

ANNUAL REPORT

2004

BANCO DE ESPAÑA



The cut-off date for the information included in this report was 19 May 2005.

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ISSN: 0067 - 3315 (print)
ISSN: 1579 - 8615 (on-line)
Depósito legal: M. 26000 - 2003
Impreso en España por Artes Gráficas Coyve, S. A.

ABBREVIATIONS

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

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)
CZ	Czech Republic	CZK (Czech koruna)
DK	Denmark	DKK (Danish krone)
DE	Germany	EUR (euro)
EE	Estonia	EEK (Estonia kroon)
GR	Greece	EUR (euro)
ES	Spain	EUR (euro)
FR	France	EUR (euro)
IE	Ireland	EUR (euro)
IT	Italy	EUR (euro)
CY	Cyprus	CYP (Cyprus pound)
LV	Latvia	LVL (Latvian lats)
LT	Lithuania	LTL (Lithuanian litas)
LU	Luxembourg	EUR (euro)
HU	Hungary	HUF (Hungarian forint)
MT	Malta	MLT (Maltese lira)
NL	Netherlands	EUR (euro)
AT	Austria	EUR (euro)
PL	Poland	PLN (Polish zloty)
PT	Portugal	EUR (euro)
SI	Slovenia	SIT (Slovenian tolar)
SK	Slovakia	SKK (Slovakian koruna)
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.

ANNUAL REPORT 2004

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1 OVERVIEW

1 Introduction

The year 2004 was a good one for the world economy, which posted the highest growth rate of recent decades despite the rise in oil prices. The expansion was very widespread. While the United States continued to be the driving force, many emerging economies, China in particular, experienced high growth rates which contributed to the global boom. The stability of financial markets, the abatement of geopolitical tensions and the predominance of expansionary macroeconomic policies, against a backdrop of contained inflation repressions, helped dynamism take hold. Nonetheless, far from lessening, the imbalances inherited from the recent period – mainly as a result of mismatches between saving and investment in the main areas – continued to worsen. In particular, the sizable volume of the US budget deficit and the shortage of private saving, arising from the forceful pace of spending, are manifest in a burgeoning external deficit which, despite the US economy's ability to attract capital flows, will be difficult to sustain. The pressures generated by the persistence of these imbalances have been evident in a significant depreciation of the dollar, chiefly against the euro. The pressures are also a major factor of risk since great uncertainty remains over how they might be absorbed and over the extent to which this may affect growth in the different areas and in the world economy as a whole.

Although the euro area began its long awaited recovery, it once again lagged behind the generalised expansion under way. After a promising first half of the year, the final six months saw a grinding halt which has, at the very least, put back the foreseeable path of gradual recovery. Adding to a lack of confidence and structural rigidities has been the contractionary effect of the appreciation of the euro on net external demand, which had been the most buoyant and leading component of the new cyclical impulse. This highlighted the vulnerability of the area to the imbalances in the world economy, such vulnerability arising from the area's own internal weaknesses.

The Spanish economy departed, for another year, from the pattern of behaviour of the euro area, with its activity running at a brisker pace and firmer continuity in its growth pattern. On base year 2000 National Accounts data, released a few weeks before the publication of this Report, GDP grew by 3.1% (see Box 1.1). This rate is substantially higher than the estimate (2.7%) for the same year using base year 1995 National Accounts figures, on which this Report is based, and it entails a significant acceleration in domestic demand and in employment. While consumption and construction remain very buoyant, the thrust of investment in capital goods has contributed to an incipient re-balancing of the composition of domestic demand. Conversely, the deterioration in external transactions has significantly heightened the drain on growth that net external demand has been exerting. Inflation, meanwhile, posted an annual figure of around 3%, similar to that for the previous year, but with an accelerating profile that reflects the vagaries of oil prices. The inflation differential with the euro area persisted at around 1 pp.

Broadly, the economic situation for 2004 and early 2005 has been marked by the extension of the long growth phase experienced by the Spanish economy since the convergence and macroeconomic stability policies began to be pursued after emerging from the 1993 recession. This period saw, on one hand, powerful boosts to demand, largely linked to the process of accession to the Economic and Monetary Union which prompted, among many other things, a strong decline in interest rates and inflation, a pronounced rise in asset prices and burgeoning growth in financing extended to the resident sectors; and, moreover, certain favourable supply-side developments, as a result of improvements further to certain reforms and of the buoyancy of the population, which has provided for a considerable increase in the use of the labour factor.

A few weeks ahead of the publication of the 2004 Annual Report, INE (the Spanish National Institute of Statistics) has released the new CNE figures (CNE 2000 base) which, for obvious reasons, it has not been possible to use in the detailed analysis contained in the Annual Report. This Box presents a summary of the most significant changes included in the new data and an initial comparison is made with previous estimates in terms of the rates of change of the main aggregates, enabling the principal results of the Annual Report to be assessed under the new CNE 2000 perspective.

In accordance with the new base, GDP grew by 3.1% in 2004, entailing a 0.4 pp upward revision of the figure released using the 1995 base. During the period 2001-2004, the CNE 2000 base shows a development in GDP over time similar to that revealed by the figures of the previous base, albeit with somewhat higher average growth of approximately 0.5 pp per year (see the accompanying table and chart). The composition of this growth is somewhat different from that provided by the previous CNE, since domestic demand growth is, on average, 0.5 pp higher with the new data, while the contribution of external demand is similar. The higher growth is discernible above all in investment in construction. Developments over time in both private consumption and gross capital formation show significant changes. Private consumption now evidences a slowdown in 2002 and 2003, followed by a rapid acceleration in 2004, compared with the moderately rising path previously estimated for the whole period. Meanwhile, investment in equipment, which had posted a

recovery in 2004 on CNE 1995 estimates, now shows stable growth at lower rates.

On the supply side there is also a notable upward revision of the average growth of value added in construction (1.6 pp) in 2001-2004, and in market services (0.6 pp). Activity across the market-services branches as a whole outgrew the previous estimate for this period by 0.6 pp. As expected in the light of the recent revision of the EPA (Labour Force Survey) estimates, employment growth was also revised substantially upwards; in the period 2001-2004 it stood 0.7 pp above what the previous data offered for the whole economy (2.7%), and it was 0.8 pp up in the case of the market economy (2.9%). As a result, apparent labour productivity growth was revised downwards by 0.2 pp on average, both for the whole economy (0.4%) and the market economy (0.0%). The productivity profile for the period as a whole has been appreciably altered as it now recovers slightly, albeit from lower rates of change.

The new figures released at end-May 2005 are the first revision of CNE since the adoption of ESA 95 methodology, the occasion for the previous change in base. The main aim of the periodic revisions of the CNE is to adjust the weights used in the calculation of the aggregates in volume terms to the changes in the structure of relative prices, thereby avoiding the loss of representativeness of the base year. Re-basing, moreover, is usually accompanied by methodological changes, the incorporation of new statistical sources and the amendment

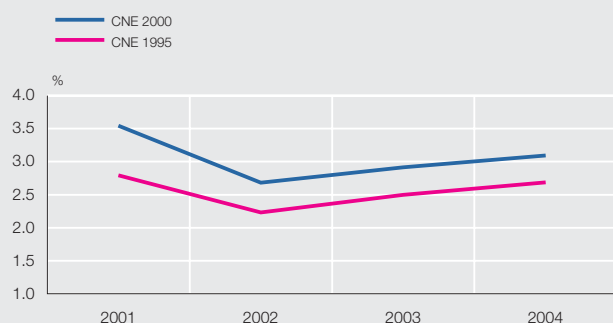
SPANISH NATIONAL ACCOUNTS (CNE) BASE YEAR 2000: MAIN CHANGES

Changes in volume. Rates of change

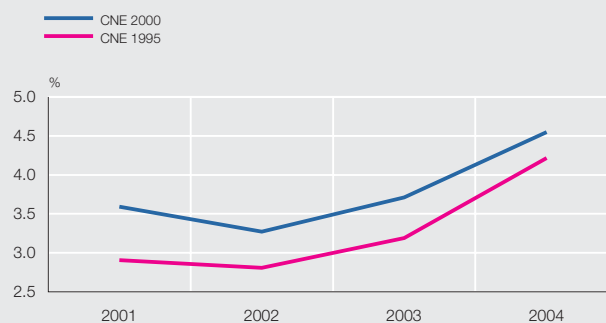
	CNE 2000				Average growth 2001-2004		Differences in rates of change CNE 2000 - CNE 1995	
	2001	2002	2003	2004	CNE 2000	CNE 1995	2001-2004	2004
Private consumption	3.2	2.8	2.5	4.3	3.2	3.0	0.2	0.8
Government consumption	3.9	4.5	3.9	6.4	4.7	4.1	0.6	1.5
Gross capital formation	4.2	3.4	6.2	3.9	4.4	3.3	1.1	-1.6
<i>Fixed capital in equipment</i>	<i>0.1</i>	<i>-2.9</i>	<i>1.9</i>	<i>2.1</i>	<i>0.3</i>	<i>0.0</i>	<i>0.2</i>	<i>-3.7</i>
<i>Fixed capital in construction</i>	<i>6.8</i>	<i>6.2</i>	<i>6.3</i>	<i>5.5</i>	<i>6.2</i>	<i>4.8</i>	<i>1.4</i>	<i>1.1</i>
Domestic demand	3.6	3.3	3.7	4.6	3.8	3.3	0.5	0.3
Exports of goods and services	4.0	1.7	3.5	2.7	3.0	3.0	0.0	-1.8
Imports of goods and services	4.2	3.8	6.2	8.0	5.5	5.2	0.3	-1.0
Contribution of external demand	-0.2	-0.7	-0.9	-1.6	-0.8	-0.8	0.0	0.1
Gross domestic product	3.5	2.7	2.9	3.1	3.1	2.6	0.5	0.4
Agriculture and fisheries	-1.3	0.4	-0.1	-1.0	-0.5	-0.8	0.3	-0.4
Industry and energy	2.7	1.0	1.0	0.9	1.4	1.6	-0.2	-1.2
Construction	8.5	6.3	5.1	5.1	6.3	4.6	1.6	1.4
Services	3.6	2.6	2.8	3.5	3.1	2.7	0.5	0.7
<i>Market services</i>	<i>3.7</i>	<i>2.6</i>	<i>2.7</i>	<i>3.6</i>	<i>3.2</i>	<i>2.5</i>	<i>0.6</i>	<i>1.1</i>
<i>Non-market services</i>	<i>3.1</i>	<i>2.7</i>	<i>3.2</i>	<i>3.1</i>	<i>3.0</i>	<i>3.1</i>	<i>-0.1</i>	<i>-0.4</i>
Net taxes on products	2.9	4.2	6.5	4.0	4.4	3.8	0.6	0.1
MEMORANDUM ITEM:								
Employment	3.2	2.3	2.5	2.7	2.7	1.9	0.7	0.5
Productivity	0.3	0.3	0.4	0.4	0.4	0.6	-0.2	-0.1
Compensation per employee	3.2	2.3	2.5	2.7	2.7	4.1	-1.4	-1.4
Unit labour costs	3.3	3.0	2.7	2.7	2.9	3.5	-0.6	-0.7
GDP deflator	4.2	4.4	4.0	4.1	4.2	4.3	-0.1	-0.4

SOURCE: INE.

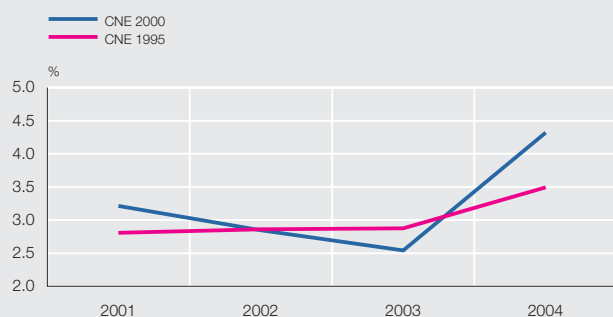
GROSS DOMESTIC PRODUCT
Changes in volume. Year-on-year rate



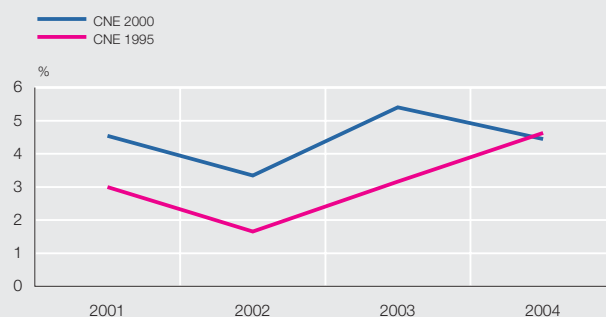
DOMESTIC DEMAND
Changes in volume. Year-on-year rate



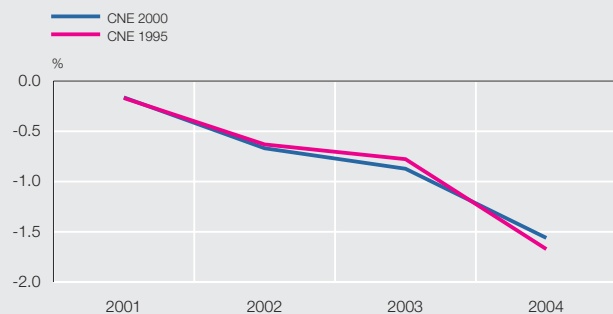
PRIVATE CONSUMPTION
Changes in volume. Year-on-year rate



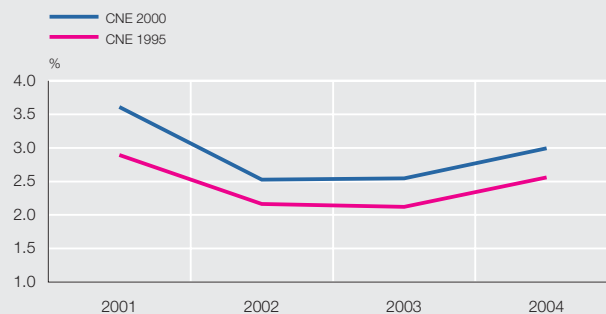
GROSS FIXED CAPITAL FORMATION
Changes in volume. Year-on-year rate



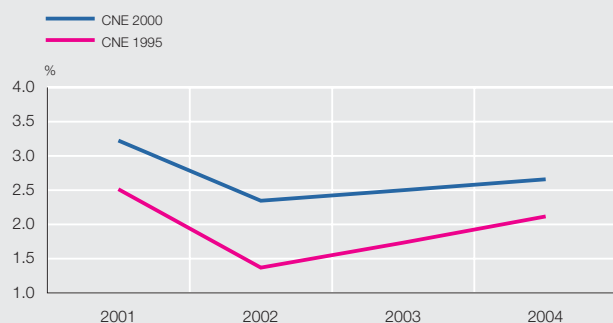
NET EXTERNAL DEMAND
Changes in volume. Contribution to GDP growth



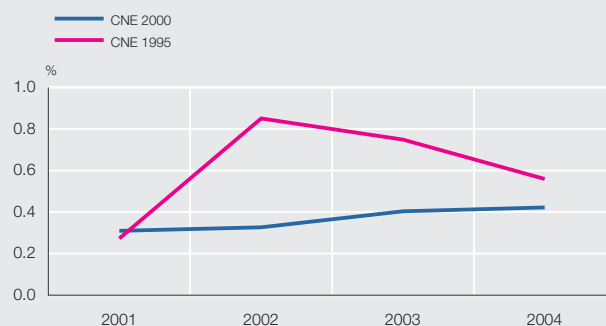
GROSS VALUE ADDED. WHOLE ECONOMY
Changes in volume. Year-on-year rate



EMPLOYMENT. WHOLE ECONOMY
Year-on-year rate



PRODUCTIVITY. WHOLE ECONOMY
Year-on-year rate



SOURCE: INE.

of estimation procedures, when necessary. As a result, both the growth and level of GDP may undergo relevant changes. Although this box focuses on the changes in the growth rates of aggregates in real terms, it should be borne in mind that the level of GDP at current prices has also altered (5% up in 2004).

While the current revision includes few methodological changes, one fairly significant change affects the measurement of the growth of the macroeconomic aggregates in volume (i.e. real) terms. In the CNE 2000 base, the previous year is to be used as the base year for this measurement – therefore taking the attendant relative-prices structure as a reference – rather than using a fixed base year, as was the case with CNE 1995. From this standpoint, the new National Accounts are a system of account with a moving base, which allows for the ongoing updating of the structure of weights and prevents potential biases arising from products being substituted for one another. The trend in volume of each macroeconomic variable will be included in the form of a *chained index*, where the growth of each period, evaluated at the prices of the preceding period, is chained to that of the previous years.

The change which has perhaps had the greatest bearing in quantitative terms on the new data released, for both employment and output, is the use of the 2001 census as a population base and of the new EPA 2005 figures as a reference for estimating employment. The

EPA 2005 survey has recently incorporated new population projections drawing on the 2001 population census and the “Padrón Continuo” (a continuously updated municipal population census). These projections have highlighted the intensity of immigration and its demographic impact on the population resident in Spain. Their effect on employment has been reflected in the revision of the EPA series for the period 1996-2004, which entail growth in the labour force and in employment far higher than that estimated with the previous EPA. These revisions have been particularly intense in the construction and services sectors, which are the industries into which much of the immigration flow has been absorbed.

Apart from the two foregoing changes, the CNE 2000 base features further methodological changes and the incorporation of other new information sources. The most important methodological change is in the calculation by sector and by branch of activity of financial intermediation services indirectly measured (FISIM), an issue which had been left pending when ESA 95 was approved. At the end of 2002, the EU Commission approved a method for calculating the production and distribution of these financial services, which has to be complied with by all EU members as from January 2005. Advantage has also been taken of this revision of CNE to make some amendments to the sectorisation of certain institutional units, such changes affecting general government, non-financial corporations and non-profit institutions serving households (NPISHs).

The short-term outlook points to the continuity of this exceptionally long upturn and of the improvement in well-being the recent decades have brought. However, that should not conceal the risks underlying the prolongation of a growth pattern so strongly based on certain domestic demand components and with such meagre labour productivity growth rates as those witnessed in recent years. The main problems arising from the pattern followed by the Spanish economy relate to competitiveness, where price and cost differentials exist alongside low productivity growth, and to the household financial position, which is affected both by the ongoing growth of debt and by the persistent rise in house prices. Some of these risks, addressed in previous editions of the *Annual Report*, have begun to show signs of materialising in the current situation. A far-reaching analysis of their diagnosis and of the demands made of economic policy is thus imperative in order to avoid such risks being exacerbated and to ensure the sustainability of growth. Following an analysis of the international picture and of the euro-area and Spanish economic situation, the remaining sections of this overview look closely, from the perspective of the long-running expansionary phase of the past decade, at the challenges posed by the problems of competitiveness and the household financial position in respect of the housing market. The chapter concludes with some reflections on the implications arising for economic policy design and implementation.

2 The international setting and the euro area

The world economy expanded considerably in 2004. This placed its growth rate (over 5%) at its highest level in recent decades. The favourable performance of economic activity affected all geographical regions, although in view of its influence on other areas, the notable increase in GDP in the United States (4.4% for the year as a whole) was to the fore, and this country

continued to act as the driving force of the world economy. National output also quickened notably in the other advanced economies. Japan experienced growth in 2004 at a rate of over 2.5% for the first time in the last eight years, despite the considerable slowdown seen from Q2 onwards. GDP in the euro area increased at a relatively modest rate of less than 2%. In any event, it was the emerging economies of Asia and Latin America which posted the highest growth rates. In particular, China alone, whose rapid modernisation continued apace, accounted for 25% of the increase in global GDP. This widespread improvement in global economic conditions also led to an appreciable stepping up of trade – which grew at a rate of close to 10% – and of international financial flows.

The worldwide economic expansion was assisted by the stability of financial markets, which benefited from the easing of geopolitical tensions, and supported by expansionary macroeconomic policies. Further, there was a considerable improvement in business results in the main industrialised economies, which prompted a rise in stock market prices. Long-term interest rates fell on the main bond markets to very low levels, which cannot be readily explained in terms of macroeconomic fundamentals. The appreciable reduction in borrowing costs contributed to the acceleration in private consumption and investment, and pushed property prices upwards in many countries.

The impact of these expansionary stimuli on global growth was greater than the contractionary effect of the marked rise in oil prices, which was over 30% in 2004 and led the price per barrel to an all-time high in 2005 Q1. In recent months, the market for crude has been affected by events in the ongoing Middle East conflicts, by the reduction of surplus capacity in the exporting countries and by refining capacity constraints. However, it is demand factors which most appear to account for oil price rises in the recent period. In particular, high global economic growth and, especially, the intensity of the demand for oil products by China, in its current phase of accelerated industrialisation, have placed sharp upward pressure on crude oil prices. The effect of oil market developments on economic activity in oil-importing countries is proving comparatively more benign than during the crisis in the second half of the seventies and early eighties. This is due to the lesser intensity of the price rises and of the increased cost in real terms, to the reduction seen in the industrialised countries' oil dependence and to the depreciation of the dollar.

In spite of the increase in oil and other commodities prices and of the marked increase in global economic activity, significant inflationary pressures have not hitherto been detected. In the industrialised economies, inflation rates broadly stood at similar levels to or only slightly above those observed in 2003. Indeed, dearer crude did not, in the main areas, prevent inflation rates from holding in line with the average figures for the past ten years and, therefore, appreciably below the figures for earlier periods. Undoubtedly, the factor that best explains the inflation performance is the wage moderation witnessed in the main countries and which, against a background of quickening productivity, entailed very low or negative increases in unit labour costs in most of them.

Such wage behaviour is closely linked to the growing credibility of the anti-inflationary stance of the monetary policies pursued in the most advanced countries. This, in turn, has allowed central banks – despite the increases applied by the US Federal Reserve and the Bank of England, among others – to hold their intervention interest rates at very low levels, without this worsening medium-term inflation expectations.

Yet although consumer price growth remains moderate, maintaining low interest rates at a time of buoyant economic activity might be contributing, in some countries, to the emergence

of other imbalances and, in particular, to a pronounced and persistent growth in house prices that cannot always be readily reconciled with the habitual determinants of housing demand. What is involved here has potentially relevant financial and macroeconomic consequences, and adds complexity to the framework in which central banks must take their decisions.

In any event, the main disequilibria currently facing the world economy are those arising from the mismatch between saving and investment in the main areas. In particular, scant private saving and the considerable increase in the US budget deficit (4.3% of GDP in 2004), coupled with the strong expansion of demand, continue to fuel a growing external deficit which, in current-account terms, already stands at over 5.5% of GDP. That has prompted a considerable depreciation of the dollar against the main currencies and, in particular, against the euro. The lack of exchange-rate flexibility in some Asian economies running a surplus on their external position distorts international financial and trade flows and, in particular, it hampers a balanced distribution of the exchange rate adjustment caused by the US external deficit.

Despite the notable appreciation of the euro, the euro area economy grew at a rate of 1.8%, up on 2003, as was the case in the other main industrialised countries. Nonetheless, the euro area was appreciably less buoyant last year than expected, against a background in which, as discussed, the expansion of the world economy gathered exceptional steam. Indeed, GDP growth in the euro area in 2004 was once again the lowest among the main industrialised economies and moved on a declining quarter-on-quarter path during the year. Hence the European economy has not yet managed to entrench the recovery that began in the second half of 2003, despite the favourable external setting. This is largely due to the ongoing slackness of internal demand, which continued to fail in 2004 to respond significantly to the favourable monetary and financial conditions, despite the slight acceleration in private consumption and in gross capital formation during the second half of the year (see Chart 1.1).

Private consumption trended in line with disposable income, which grew moderately, essentially as a result of scant job creation. Thus, neither low interest rates nor the rises seen in financial and real-estate assets significantly boosted households' propensity to spend. The latter continues to be held back by relatively weak confidence, probably associated with the weakness of the labour market, with the perceived uncertainty over the future viability of current public pension systems and, in general, with the absence of reforms to anchor agents' expectations about their future income.

Turning to investment, although the economy has once again moved into a phase of increasing capital expenditure, the attendant expansion is as yet very moderate. This containment of gross capital formation is in contrast to the low level of the cost of capital within the euro area, to which several factors have contributed: the maintaining of short-term rates at the lowest levels of recent decades; the decline in long-term interest rates; the reduction in credit risk premiums; and the rise in stock exchange prices. The sound behaviour of external demand and of business margins might also have provided for a sharper recovery in investment. However, European companies appear to have harnessed the improvement in the economic environment in which they operate to further the restructuring of their balance sheets. As a result, capital expenses drew largely on the funds generated within businesses, with the increase in credit scant and the issuance of bonds and equity on capital markets limited. Furthermore, surplus capacity continues to check the construction industry in Germany, the crisis in which is impacting the overall indicators of activity for the euro area as a whole.

Exports expanded significantly in 2004, in step with the favourable international setting, after being virtually flat the previous year. Nonetheless, there was an appreciable slowdown in the



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.

second half of the year, possibly derived from the cumulative rise in the euro, while imports remained substantially buoyant. This occurred despite the fact that the appreciation of several currencies – singularly the other European currencies – against the dollar cushioned the impact of the depreciation of the US currency on the effective exchange rate of the euro.

Clearly, then, the European economy remains notably sensitive to exchange rate oscillations, despite the trade integration which the monetary union, albeit very gradually, appears to be promoting. This is partly in response to the maintenance of trade specialisation patterns – concentrated in medium-technology products – which, though enabling the area to benefit from the growing demand for these products on international markets, obliges it to withstand stiff competition, where price and cost advantages are decisive when it comes to sustaining exports. While the euro area has been able to face up to the emergence of new competitors without seeing sizable declines in its export shares, there have so far been no signs of a change in specialisation pattern towards more sophisticated products, which would offer the area greater stability in respect of its markets and less vulnerability to exchange-rate changes.

In this context, where it is the economy's structural shortcomings which largely determine its scant momentum, the contribution of demand-side policies to productive buoyancy is naturally limited. In the euro area, the automatic fiscal stabilisers have operated acceptably, in such a way that the fiscal policy stance was virtually neutral in 2004, as it was the previous year. In some countries, this stabilising capacity of fiscal policy might undoubtedly have been greater had the fiscal consolidation process been more ambitious in the high-growth period in the closing years of the last century.

Monetary policy conduct has been considerably assisted, as in other areas, by the continuing and appreciable degree of wage moderation, which has helped limit the inflationary effects of the rise in oil prices. The trend of labour costs, the surplus capacity the area's economy maintains and the effect of the euro appreciation on increasingly competitive international markets all account for the limited force of inflationary pressures. That has enabled the ECB to hold interest rates at very low levels (at 2% since mid-2003) even during a phase of recovering activity, without this altering expectations about future inflation, which remain in line with the institution's own definition of price stability. The ECB thus appears to have cemented the credibility of its priority objective, which has given it greater leeway to act in a manner consistent with developments in economic activity.

Forecasts for the course of the world economy in the near future are bright. In particular, if the favourable monetary and financial conditions hold and, specifically, long-term interest rates do not rise abruptly, world growth should continue to exceed the average for recent years. Something of a slowdown, however, is to be expected, arising above all from the likely easing of economic policy stimuli, both in the United States and in China, and from the lesser intensity of the gains in real-estate wealth in countries where housing has grown more sharply in recent years.

True, the main risk to this scenario stems from the possible worsening of global disequilibria which, in the current circumstances, the continuing buoyancy of domestic demand in the United States will involve. Past experience shows that these types of imbalances may ultimately generate significant exchange-rate turbulence and, often, they entail considerable reductions in the growth rates of economies running a deficit. Through both channels, the world economy as a whole could be severely affected.

The possibilities of a gradual adjustment of these disequilibria that were to minimise the impact on activity and exchange-rate stability would require a fiscal consolidation programme in the United States, one perhaps more solid than that announced by the US authorities, to accompany the progressive tightening of the monetary policy stance. This scenario would be strengthened if policies were implemented that provided for the adjustment of the exchange rate of the Asian currencies to levels more consistent with domestic and external equilibria and, in particular, if movement were in the direction accepted by the Chinese authorities in this sphere. Finally, the orderly absorption of the disequilibria would naturally be more likely if there were an improvement in the growth prospects of the less dynamic economies, whose external accounts are balanced or in surplus, such as Japan and the euro area.

In the euro area, economic activity may be expected to gather some momentum in the short and medium term. In keeping with the above-mentioned scenario of continuing buoyancy in the euro area's external environment, if there are no fresh rises of significance in oil prices or further processes involving the sharp appreciation of the European currency, conditions in the area will be propitious to the expansion of economic growth. The incipient recovery in investment might gain momentum in the coming months, underpinned by the favourable interna-

tional outlook, healthy corporate earnings and low borrowing costs. This latter factor, along with the fact that corporate balance sheets have been shored up, will ease the way for borrowing and bond and equity issues, thus sustaining the extension of plant capacity. The pick-up in investment, combined with prevailing wage moderation, would entail an expansion in the demand for labour, which should increase household disposable income and confidence, thereby contributing to strengthening consumer spending. Accordingly, while the continuing slackness of domestic spending for some time cannot be ruled out, the quarter-on-quarter growth of the European economy is likely to stabilise in the near future at a rate close to that of its potential output.

No significant changes are discernible, however, in the longer-term outlook for the European economy. Structural deficiencies continue to hold back prosperity, affecting the two elements into which per capita income is habitually broken down: labour productivity and the degree of intensity of the use of this productive factor.

Contrary to what has been asserted in the past, the latest empirical evidence belies talk of a significant labour productivity deficit in Europe compared with other more dynamic areas. The difference in the current level of well-being between the United States and Europe – measured by per capita income – lies not so much in output obtained per hour worked as in the number of hours worked per person, i.e. in the lesser relative use of the labour factor (see Box 1.2).

Likewise, while – at least since the mid-nineties – labour productivity has slowed significantly compared with previous periods and has grown at appreciably lower rates than those observed in the same period in the United States, there are some positive elements to this pattern. For instance, the slowdown in output per hour worked is typically concentrated in traditional industries where there has been intense job creation, derived in part from the reforms in certain countries to make the labour market more flexible. The outcome of these reforms has been a reduction in structural unemployment and an increase in the participation rate, making for greater use of the labour resources available. As a result, the relative use of the factors used in productive processes has changed, mechanically reducing labour productivity.

More worrying is the scant incorporation of technological advances into certain European industries. Reflecting this is the modest increase in total factor productivity, the variable that best approximates to the efficiency of productive processes. Once again, these shortcomings are not seen in all productive branches but are present in some – such as financial services and distribution – that have become particularly dynamic in other economic areas.

It is discouraging, despite the sound behaviour of labour hiring in Europe in recent years, that participation and employment rates are still below those seen in the United States and that the number of hours worked per employee is not only comparatively low but has, in fact, fallen in recent years. This situation arises fundamentally from the flaws of the European labour market and, in particular, from the inefficiency of the current social protection mechanisms which, in many cases, lessen job-search incentives and reduce the demand for labour. Consequently, the European authorities face a dual challenge: to promote greater use of the labour factor and to foment productivity through boosting innovation and the incorporation of technological developments into productive processes.

In this respect, there have been relevant reforms in recent years in certain countries, particularly as far as the labour market is concerned. Acknowledgement is due to the importance of the Hartz reform in Germany, the flexibility added to the 35-hour week in France, and the

FACTOR

A widely used measure of economic development is the real value of a country's output relative to its population, i.e. per capita GDP. The table below shows that the differences in per capita GDP between the EU 15, including Spain, and the United States have not been significantly reduced in recent years, so that the process of real convergence between these two areas, which progressed very rapidly in the third quarter of the twentieth century, seems to have stagnated. The design of policies to kick-start convergence between Europe and the United States requires analysis of the factors behind such differences in per capita GDP.

For this purpose it is useful to express per capita GDP as the product of two factors: i) the use of the labour factor (number of hours worked relative to the total population), and ii) productivity per hour worked. The use of the labour factor can, in turn, be expressed as the product of the ratio of the working-age population to the total population, the participation rate, the employment/labour force ratio (or one less the rate of unemployment) and hours worked per employed person. Using the standard methodology of growth accounting, productivity per

hour worked is, in turn, determined by capital accumulation (the capital/labour ratio) and total factor productivity (TFP), an approximation of technological progress. The table below shows the levels of EU-15 per capita GDP relative to the United States, and of Spain's per capita GDP relative to the EU 15 in 1991 and in 2003, as well as their breakdown into the variables mentioned above. Given that there are notable differences between the first half of the 1990s and the period 1995-2003, the growth rates of these variables are also presented for these two periods.

In fact, the gap in per capita GDP between the EU 15 and the United States has remained at a level of 25-30 percentage points since the early 1990s. However, this stagnation conceals a significant change in the pattern of EU-15 growth. During the first half of the 1990s, productivity per hour worked in the EU 15 grew at higher rates than in the United States, while the use of the labour factor grew at lower rates, following a pattern observed from the mid-1970s. Since the mid-1990s, the EU 15 recovered some of the lost ground in its use of the labour factor, primarily as a result of higher participation rates, but

	RELATIVE LEVELS		GROWTH RATE DIFFERENTIALS (a)	
	1991	2003	1991-1995	1995-2003
EU 15 - US	UNITED STATES = 100			
PER CAPITA GDP (b)	75.0	71.2	-0.7	-0.3
Hourly productivity (c)	95.2	92.5	1.2	-0.9
Capital / labour ratio	112.0	114.9	0.9	-0.4
TFP (e)			0.3	-0.6
Use of the labour factor	78.8	77.0	-1.9	0.7
Annual hours per employee	90.8	87.4	-0.7	-0.1
(1 - unemployment rate)	98.6	97.7	-0.9	0.3
Labour force / pop.(15 - 64)	85.5	89.4	-0.3	0.7
Pop.(15 - 64) / Total pop	101.9	100.0	0.0	-0.2
SPAIN-EU 15	EU 15 = 100			
PER CAPITA GDP (b)	79.2	85.3	-0.1	1.0
Hourly productivity (c)	86.4	81.5	-0.2	-0.6
Capital / labour ratio	77.5	79.1	0.4	-0.1
TFP (e)			-0.6	-0.6
Use of the labour factor	91.7	104.7	0.1	1.6
Annual hours per employee	111.2	114.9	0.1	0.4
(1 - unemployment rate)	94.2	96.2	-0.9	0.7
Labour force / pop.(15 - 64)	88.5	90.8	0.4	0.1
Pop.(15 - 64) / Total pop	100.1	105.9	0.5	0.4
MEMORANDUM ITEM: SPAIN - US	UNITED STATES = 100			
PER-CAPITA GDP (b)	59.4	60.7	-0.8	0.7
Hourly productivity (c)	82.2	75.3	1.0	-1.6
Capital / labour ratio	72.3	80.6	-1.8	2.3

SOURCE: Banco de España, using the European Commission's AMECO database and OECD information.

a. Period averages.

b. Based on constant price series expressed in terms of 1995 purchasing power standard (PPS).

c. Based on data for annual hours worked per employee compiled by the OECD. Although these series have been partially harmonised, some caution is required when interpreting small differences in levels between countries.

d. The rate of change has been calculated in terms of the contribution to productivity growth. This contribution is calculated by multiplying the rate of growth of the capital/labour ratio by the weight of capital income in value added, which is assumed constant throughout the sample period.

e. This variable is obtained as an index (1995 = 100), so that only rates of change are shown in the table.

FACTOR (cont'd)

productivity per hour worked grew more slowly than in the United States.

The reasons for this relative deterioration in productivity is still the subject of intense debate, but there appears to be a consensus that the EU 15 has not been capable of innovating and exploiting the productive potential of new technologies at a comparable rate to the United States. In fact, as can be seen in the adjoining table, the productivity slowdown in the EU 15 has basically been a result of the behaviour of TFP and not so much of that of capital accumulation, although the latter has also grown more slowly than in the United States in recent years.

Currently, the difference in productivity per hour worked explains a third of the gap in per capita GDP between the EU 15 and the United States. The rest is attributable to the lower rate of use of the labour factor, which is more than 20 percentage points less than in the United States. The basic reason for this low use of labour is the shorter working day in Europe¹, although the differences in employment rates are still considerable.

In short, analysis of the components of per capita GDP shows that both innovation and the incorporation of new technologies are fundamental to a recovery in European productivity. Also, the fact that two-

thirds of the gap in per capita GDP with the United States is attributable to low use of the labour factor makes further reform of the labour market all the more pressing.

Turning to Spain, during the period 1995-2003, considerable progress was made in convergence with the EU 15, although the gap in terms of per capita GDP with respect to the United States remained more or less constant. In Spain's case, the weight of the explanatory factors is different since, while most of the gap in the case of the EU 15 is attributable to lower use of the labour factor, the most important factor in Spain is lower productivity per hour worked.

Indeed, as may be seen in the adjoining table, use of the labour factor is currently higher in Spain than in the EU 15, thanks to the gains in participation and employment since the mid-1990s and the longer working day. In contrast to this improved use of labour, Spanish productivity has grown more slowly than in Europe, even during the second half of the 1990s, when European productivity slowed relative to the United States, preventing more rapid convergence with the EU 15. This poor productivity performance is attributable primarily to the slowdown in technological progress, approximated by TFP, which grew by 0.6 pp less per year than in the EU 15 throughout the period.

In conclusion, although the technological deficit is more evident and the use of the labour factor greater in Spain than in the EU 15, economic policies designed to improve both factors are as necessary as in the rest of Europe. In particular, it is essential to develop measures to increase the efficiency of the economy which, at the same time, maintain the current capacity to generate employment.

1. This statement is based on series of annual hours worked provided by the OECD, which has made a big effort to harmonise data obtained from diverse sources. Even so, some caution is required when interpreting small differences in level between countries, since they may be attributable to methodological differences. In any event, according to the OECD the series may be used to make broad comparisons between countries, and to analyse changes over time in annual hours worked in the same country.

measures to promote part-time employment in France and Italy. In any event, although increases in employment and participation levels have been seen, as has some headway in the degree of penetration of new technologies, structural reform in Europe continues to move at a slow pace. That is an obstacle to meeting the quantitative targets set in the so-called Lisbon Agenda, which was intended to boost the quality of productive factors in the short and medium term, to promote spending on R&D and to improve the workings of factor and product markets, all with the aim of ensuring high growth in activity.

The March 2005 European Council has reviewed this reform strategy on the basis of reports from the European Commission and a group of experts (the Kok Report) which highlighted the shortcomings of the method used to date to move ahead in this field. A re-launching of the Lisbon Agenda on firmer bases has been announced, specifying priority areas – essentially innovation, the business environment and employment – and simplifying monitoring and co-ordination procedures. However, the European Council has not been as ambitious as some of the proposals contained in the aforementioned reports, so it is not possible to ensure that certain countries' lack of resolve to adopt the reforms can be corrected. In this respect, the Council's conditional support to the directive to liberalise the provision of services in the EU is

a sign of the limited political support currently behind certain initiatives aimed at completing the integration of European markets.

In this climate of relative slackness apparently characterising the current state of European construction, the Council also discussed the possibility of amending certain aspects of the current fiscal discipline arrangements in the EU. It specifically announced a series of proposals to reform the set of legal provisions and sundry rules making up the Stability and Growth Pact. Some of these reforms may contribute to improving the workings of the Pact, particularly as regards strengthening the preventive measures open to the Commission and the Council, the aim of which is to avoid fiscal laxity in economic upturns. Of greater concern are the reforms adopted in respect of the corrective mechanisms, insofar as they might, taken as a whole, dilute the attendant disciplining effect. Admittedly, a final assessment may only be made once the specific amendments made to the regulation or to other provisions are precisely known, meaning it will be necessary to await the proposals the Commission has to formulate in this connection. But it is in any event crucial that the European authorities should interpret with caution the flexibility added by the reformed legal texts, so as not to weaken the system of fiscal rules that the proper functioning of the Monetary Union requires.

At the institutional level, the biggest enlargement in the history of the EU took place on 1 May 2004. This was a far-reaching move in terms of the dynamics of continental integration and of the strengthening of competition, which poses significant challenges for institutional arrangements. The European authorities will have to face these challenges against the delicate background brought about by the “no” vote returned by the French and Dutch referendums on the ratification of the Constitutional Treaty.

3 A long expansionary phase for the Spanish economy

In 2004 the Spanish economy once again showed greater vigour than the euro area, extending the long growth phase which began in the mid-nineties. Spanish GDP increased by 3.1%, compared with 2.9% in 2003, on base year 2000 National Accounts figures. Nonetheless, in base year 1995 terms, the rate of increase of GDP for 2004 had been estimated at 2.7%. This meant that the growth differential with the euro area remained significant, at close to 1 pp, although it narrowed in relation to 2003, against the backdrop of recovery in the area's economy. In contrast to the sluggishness in the rest of the euro area, the growth rate of activity rose somewhat during the year, more markedly so in the closing months. Driving the buoyancy of the Spanish economy was, once again, the resilience of domestic demand, the growth of which intensified notably to 4.2%, against 3.2% in 2003 (4.6% and 3.7%, respectively, according to base year 2000 National Accounts figures). The same pattern was the case for the main expenditure components, in respect of both consumption and investment, while the contribution of net external demand to growth was, conversely, significantly negative of the order of -1.7 pp (-1.6 pp on base year 2000 National Accounts figures), almost 1 pp up on 2003 and to which the increase in imports contributed significantly (see Table 1.1).

Employment growth rose from 2.5% in 2003 to 2.7% in 2004, according to base year 2000 National Accounts figures, and the pace of labour productivity stabilised at a low rate (0.4% according to the same accounting base). The annual average rate of inflation held stable in 2004, with an increase of 3%, similar to that observed in 2003. However, the year-on-year profile was very different: while inflation moved on a declining trend in 2003, such that it started the year 2004 posting very low figures, it rebounded in the course of this latter year. The inflation differential with the euro area held at the same level as in 2003, in annual average terms (1 pp), although it trended on a similar profile to that of the Spanish inflation rate.

		1999	2000	2001	2002	2003	2004
REAL CONVERGENCE INDICATORS: (Spain/EU) (b)	Per capita GDP at current prices (in EU - 15 PPPs)	83.4	83.3	84.1	86.4	89.5	89.7
	Per capita GDP (c)	82.7	82.9	83.4	84.1	85.3	85.4
	Apparent labour productivity	93.2	92.5	92.5	92.6	92.7	91.8
	Employed as proportion of total population	86.0	86.8	86.9	86.7	86.9	88.1
	Population aged 16-64 / total population	103.2	103.3	103.8	104.7	105.9	105.7
DEMAND AND OUTPUT AT CONSTANT PRICES (d)	Private consumption	4.7	4.1	2.8	2.9	2.9	3.5
	Government consumption	4.2	5.6	3.5	4.1	3.9	4.9
	Gross capital formation	9.0	5.3	2.7	1.8	3.4	5.4
	Fixed capital in equipment	7.8	4.7	-1.2	-5.4	1.0	5.8
	Fixed capital in construction	9.0	6.2	5.3	5.2	4.3	4.4
	Exports of goods and services	7.7	10.1	3.6	1.2	2.6	4.5
	Imports of goods and services	12.6	10.5	3.9	3.1	4.8	9.0
	Gross domestic products	4.2	4.4	2.8	2.2	2.5	2.7
EMPLOYMENT, WAGES, COSTS AND PRICES (d)	Total employment	3.7	3.7	2.5	1.4	1.7	2.1
	Compensation per employee	2.7	3.5	3.8	4.3	4.3	4.0
	Unit labour costs	2.1	2.8	3.5	3.4	3.5	3.4
	GDP deflator	2.8	3.4	4.2	4.5	4.0	4.4
	Consumer price index (12-month % change)	2.9	4.0	2.7	4.0	2.6	3.2
	Consumer price index (annual average)	2.3	3.4	3.6	3.5	3.0	3.0
	Consumer price differential with the euro area (HICP) (e)	1.1	1.2	1.0	1.3	1.0	0.9
SAVING, INVESTMENT AND FINANCIAL BALANCE (f)	Resident sectors: saving (g)	23.6	23.2	23.4	23.9	23.9	23.7
	General government (g)	2.3	2.3	3.0	3.4	3.9	3.4
	Resident sectors: investment	24.6	25.6	25.6	25.5	26.0	27.9
	General government	3.5	3.1	3.3	3.5	3.5	3.7
	Resident sector: domestic net lending (+) / net borrowing (-)	-1.0	-2.5	-2.2	-1.6	-2.1	-4.2
	General Government	-1.2	-0.9	-0.4	-0.1	0.4	-0.3
	General government gross debt	63.1	61.3	57.9	55.0	51.4	48.9
MONETARY AND FINANCIAL INDICATORS (h)	ECB weekly intervention rate	2.7	4.0	4.3	3.2	2.3	2.0
	Ten-year government bond yield	4.7	5.5	5.1	5.0	4.1	4.1
	Synthetic bank lending rate	4.9	5.9	5.8	4.9	4.1	3.9
	Madrid Stock Exchange General Index (DEC 1985 = 100)	894.4	994.8	853.4	723.6	706.4	863.3
	Dollar/euro exchange rate (i)	1.07	0.92	0.90	0.94	1.13	1.24
	Nominal effective exchange rate vis-à-vis developed countries (j)	98.73	95.76	96.27	97.09	100.00	100.76
	Real effective exchange rate vis-à-vis developed countries (k)	99.07	97.40	98.74	101.04	106.03	110.24
	Real effective exchange rate vis-à-vis the euro area (k)	100.39	101.99	102.76	103.76	105.33	108.61
	Cash and cash equivalents	12.7	4.4	6.8	10.5	12.1	10.7
	Liquid assets (l)	2.4	8.1	9.5	8.7	8.8	7.6
	Total financing of households	19.6	17.3	12.3	15.6	18.7	19.7
	Total financing of non-financial corporations	19.4	18.7	18.0	13.3	13.8	13.9

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

a. The National Accounts data are base year 1995.

b. EU=100.

c. Calculated using series at constant 1995 prices in EU PPPs.

d. Rates of change.

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

f. Levels as percentages of GDP. The saving and investment figures for 2002 are Banco de España estimates.

g. Includes net capital transfers received.

h. Annual average levels for the Stock Exchange General Index, interest rates and exchange rates and rates of change for financial assets and liabilities.

i. Prior to 1999, dollar/ECU exchange rate.

j. 1999 H1 = 100.

k. 1999 H1 = 100. Measured with unit labour costs.

l. Includes cash and cash equivalents, other bank liabilities and money market funds.

The Spanish economic situation thus described is part of the continuation of a long expansionary phase which has been upheld by forceful impulses from both the supply and demand sides. It began with the recovery following the 1992-93 crisis, and at present it is holding and looking like continuing, despite the moderate slowdown in the early years of the current decade. Average growth in the ten years from 1995 to 2004 was 3.2%, without it having fallen below 2% in any single year (see Chart 1.1).

The success of the convergence policies and integration into the euro area generated expansionary impulses on domestic demand, which has grown at an average rate of 4.1% during the last decade. The strong reduction in interest rates and the rise in asset prices prompted a substantial easing of monetary and financial conditions. Under these conditions, both companies and, in particular, households have notably increased their spending, resorting to debt, and they have adjusted the structure of their finances to a situation of durable macroeconomic stability.

The momentum of domestic demand, which has been a fundamental underpinning of the expansion, has also coincided with certain favourable factors on the supply side that have eased its feed-through into economic growth and have mitigated its potential unbalancing effects. During this long period, the Spanish economy has witnessed significant transformations, some linked to the process of monetary integration and others not, which have contributed to heightening its growth potential. Structural and demographic changes have been very important in this connection, and have provided for the increase in job offers and labour supply.

The nineties saw a series of tax and labour market reforms, some of which as a consequence of agreements reached between the social partners. The reforms strengthened the incentives for job-search – lowering, for example, the replacement rate of unemployment benefits – and raised the incentives for hiring employees, giving rise to a substantial cut in structural unemployment and, therefore, to an increase in the economy's employment potential. The unemployment rate, which was drawing close to 18% in 1995, fell to 10.6% in 2001, a reduction which may in the main be seen as structural. Subsequently, the unemployment rate has trended more steadily, standing at 11% in 2004.

In parallel, there have been highly relevant social and demographic changes, which have also contributed to increasing labour supply. The progressive incorporation of women into the labour market, which began several decades back, has continued in recent years. This has given rise to a 10 pp rise in the female participation rate from 1996 to 2004, taking it to 57.7% of the population aged 16-64 in this latter year. More recently, immigration has stepped up notably. While the immigrant population of working age had previously been growing forcefully, from 2000 to 2003 it grew at a rate of over 30%, increasing once more by around 20% in 2004, according to EPA figures, and contributing most significantly to the increase in the labour force. Overall, the working population in Spain has grown at an average rate of 2.9% between 1996 and 2004 (see Box 1.3).

The increase in labour supply, combined with the wage moderation that has followed the decline in inflation expectations and the reduction in structural unemployment in the second half of the nineties, has allowed for an increase in the economy's output, underpinned essentially by intense job generation. The National Accounts data show that GDP growth between 1995 and 2004 – which, as indicated, was 3.2% on average – was accompanied by a 2.5% rise in employment, with more than 3.5 million net jobs being generated. The buoyancy of employment has, in turn, been a fundamental factor behind the expansion of demand, since it has sustained the income growth expectations of households without which financial conditions would not have had such a sharp and persistent impact on expenditure.

The available supply of labour in the Spanish economy has increased notably in recent years, both as a consequence of the increase in population, basically stemming from the inflow of immigrants, and of the increase in labour market participation by workers resident in Spain. Overall, these two phenomena have produced an average annual increase in the supply of labour, as measured by the labour force estimated by the Labour Force Survey (EPA), of 2.9% between 1996 and 2004.

According to the Municipal Census of Inhabitants, the total Spanish population increased by 3.5 million between 1996 and 2004, to 43.2 million on 1 January 2004. These figures, which must be treated with some caution, involve average annual growth of 1.1%, combining very different behaviour by the national and foreign populations. In particular, while in 1996 the number of immigrants was 542,314, by 2004 this figure was 3,034,326, which implies annual growth of 24%. By contrast, the national population grew in the same period at the low annual rate of 0.3%. As a result of these developments growth in the immigrant population was responsible for 71% of the total population growth between 1996 and 2004, although it still makes up a relatively small proportion of the total population (7% in 2004). Moreover, the importance of immigration has accentuated in recent years. In fact, while the annual growth rate of the national population has remained relatively stable, the

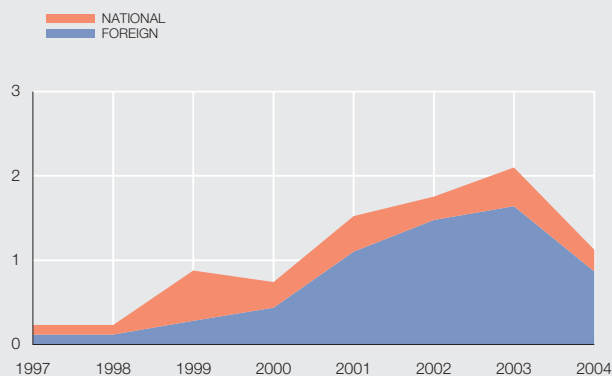
growth rate of the foreign population has accelerated, so that the contribution of the foreign population to the growth of the total population increased from 46% between 1996 and 2000 to 78% between 2000 and 2004 (see the upper left-hand panel of the adjoining chart). The differences are even greater when the working-age population is considered. Between 2000 and 2004, the contribution of the immigrant population to the growth in the population between 15 and 64 years of age was 87%, i.e. nine percentage points more than for the total population.

Moving on to analyse developments in the supply of labour, on EPA data the number of labour force participants increased by 4.2 million between 1996 and 2004. The rate of expansion of the labour force of foreign nationality was very notable and rising during this period, reaching an average annual rate of 32.9%, while the national labour force, which still displayed greater buoyancy than the total population, grew at more moderate rates (1.8%).

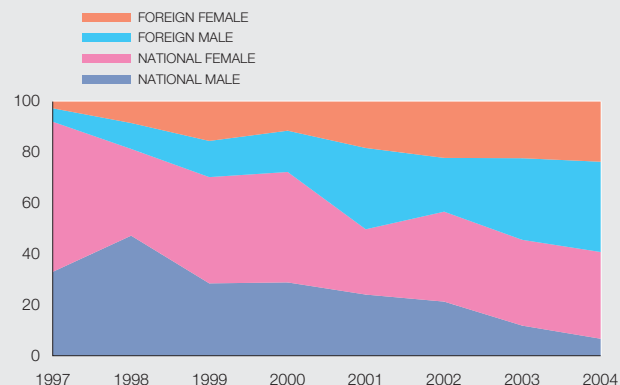
A more disaggregated analysis of the contributions to the growth in the labour force shows that the progressive incorporation of women into the labour market also played a fundamental role in the recent growth in the supply of labour in Spain. The upper right-hand panel of the adjoining chart shows the contributions to growth of the labour force in the period 1996-2004, distinguish-

LABOUR SUPPLY: EXPLANATORY FACTORS

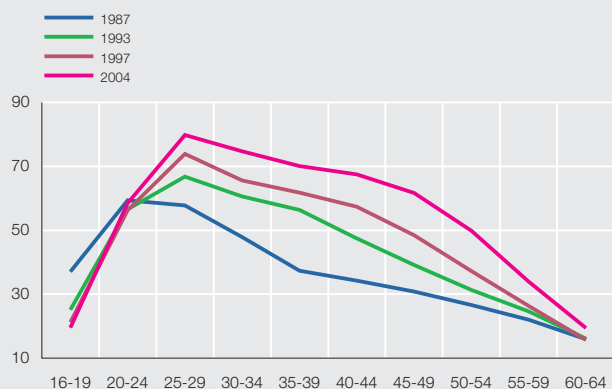
1. CONTRIBUTIONS TO GROWTH IN THE TOTAL POPULATION



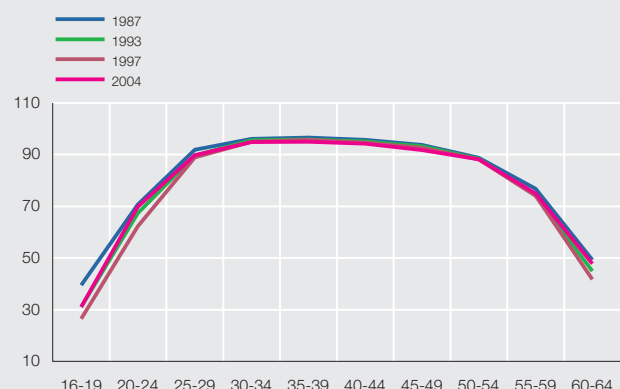
2. RELATIVE CONTRIBUTIONS TO GROWTH IN THE LABOUR FORCE



3. FEMALE PARTICIPATION RATES



4. MALE PARTICIPATION RATES



SOURCE: INE

ing between four population groups according to their nationality and sex. Despite being the majority group in the labour force (representing around 60% of all participants), the total contribution of males of Spanish nationality to the growth in the labour force was only 21.7%, with a downward trend from 2000 and very small contributions in the last two years. Meanwhile, the group of Spanish females was one of the main drivers of the overall growth in the labour supply in this period, with a total contribution of 36.9%, although this also displayed a slight downward trend. For their part, immigrant workers accounted, in total, for 41.4% of the increase in the labour supply, with a smaller difference between the sexes, men accounting for 23.7% and women for the other 17.7%. The most significant development here was the rising trend in the contribution of the immigrant population which, in the last two years, represented more than half of the increase in the total labour supply.

As already mentioned, the increase in labour force participation is one of the main drivers of growth in the labour force in recent years. Behind this increase can be detected a notable change in the pattern of the female group's labour-market behaviour. The lower left-hand panel of the chart shows the increase in female participation rates by age, although those corresponding to the over-fifties are still very low. As can be seen in the lower right-hand panel, a process of convergence is taking place towards male behaviour patterns, which are characterised by a peak in participation at around the age of 30, following completion of the education process, with rates subsequently remaining very steady throughout the working life, at least until over the age of 50. Overall, the differences between the two sexes are still appreciable so that, even though they are not expected ever to be completely eliminated, this pattern of convergence will help sustain medium-term growth in the female participation rate, which will therefore continue to contribute positively to increasing the supply of labour in the coming years.

The main trends prevailing in the Spanish economy since the mid-nineties, and described in the previous paragraphs, extended into 2004. And in relation to the previous year, the growth of domestic demand and of job creation increased at an even steeper rate. But there have also been changes. These denote, first, a re-balancing of the composition of domestic demand, thanks to the impulse of investment in capital goods; and, further, the accentuation of some of the factors of risk that usually accompany the prolongation, over such a long period, of a growth pattern based on the momentum of spending on consumption and construction.

The rate of increase of household spending on consumption and residential investment increased in 2004, against the background of higher growth in disposable income and strong gains in wealth. Although the rise in nominal wages was less than in 2003, the increase in employment, welfare benefits and other income offset this effect, giving rise to an acceleration in disposable income. As regards wealth, the financial component benefited from the rises on stock markets, for the second year running, while the continuing growth of house prices at very high rates further boosted the value of household real assets. Overall, the effects of wealth on spending remained forceful in 2004. Private consumption duly increased by 3.5%, up on 2.9% in 2003, and the household saving ratio dipped once more. Residential investment exceeded the estimated growth for the previous year, with a rate of 6.1%, leaving households, in view of their low saving level, with a net borrowing requirement. All these developments were set against the loose financing conditions which continued to encourage the resort to credit to finance expenditure, especially for house purchases.

Drawing on the information provided by base year 1995 National Accounts figures, business investment also recovered in 2004 after a lacklustre performance since 2000, despite the favourable financial conditions in place. In recent years, certain corporations – especially the biggest ones, belonging to certain services and network industry sectors – had expended considerable resources in restructuring their financial position, which had been affected by heavy investment in the recent past both within and outside Spain. Once the restructuring process progressively drew to a conclusion, the improvements in economic growth expectations, the increase in business earnings and the additional improvements recorded in financing conditions ultimately translated in 2004 into a positive response in terms of greater investment,

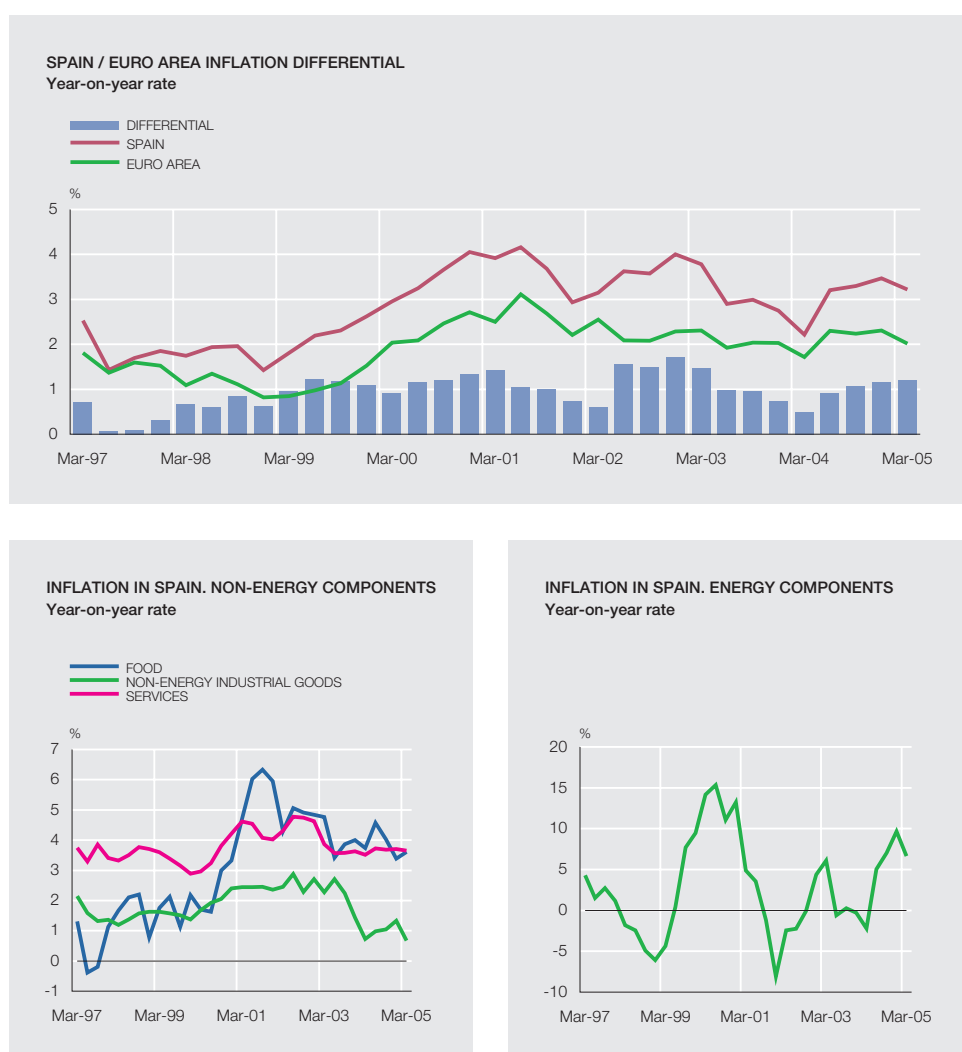
especially in capital goods. This as yet incipient development was the most encouraging note for the correction of the currently unbalanced growth of aggregate demand.

Conversely, net external demand subtracted strongly from GDP growth in 2004, as part of a trend that has intensified over recent years. Goods and services exports grew at a higher rate than in 2003, underpinned by the strong recovery in the world markets for goods, while services exports, especially tourism, were depressed, which compounded the deterioration seen the previous year. In any event, sales abroad increased, overall, at a lower rate than that of trade, both within and outside the euro area. That points to a loss of competitiveness of Spanish products, the result – among other factors – of the relative rise in their price and of the notable appreciation of the euro since 2002. Goods and services imports, meanwhile, rebounded strongly in 2004. Part of this rise is in response to the higher growth of final demand, but such a burgeoning expansion also reflects the greater competitiveness of foreign products in the domestic market.

On the supply side, the main trends of previous years were maintained in 2004, in relation both to the sectoral composition of activity and to the intensity of job generation. GDP growth was centred mainly on value added in construction and in services, although industry regained some momentum, benefiting to some extent from the rise in exports. However, job creation was confined to the first two sectors, as there was a net reduction in jobs in agriculture and industry. Strong employment creation in 2004 was once again accompanied by a pattern of low productivity gains, which stepped up as the year elapsed, and which bore particularly on construction and on market services, where apparent labour productivity fell off for the third consecutive year.

As indicated, inflation held in 2004 at an average of 3%, on a rising path linked mainly to dearer energy prices. That said, manufactured good prices, which had begun the year at very moderate rates, also quickened somewhat (see Chart 1.2). Generally, setting aside the various transitory factors which bore on price developments, inflation in 2004 followed a similar pattern to that which has characterised it since the start of the expansionary phase described in this section. In this respect, particular mention should be made of the duality that has continued to govern the behaviour of consumer prices, as a result of the high and persistent price rises of products from the most sheltered sectors. Particularly illustrative of this duality are services prices, which increased in 2004 by 3.7%, a similar rate to that of 2003. Nor has significant headway been seen in terms of reducing the inflation differential with the euro area, which stood at 0.9 pp in 2004, and which indeed widened somewhat during the year. The relatively inefficient workings of certain markets with limited exposure to competition and the mechanisms that reinforce the inertial behaviour of wages are two features which contribute, in a setting of strong demand, to the duality and persistence of inflation in Spain.

However, the outlook is for the prolongation of the current growth phase of the Spanish economy in the near future, as a result of the continuity of the main factors that have been driving the vigour of the economy. The data for the opening months indicate sustained activity. Nonetheless, the favourable short-term forecasts should not conceal the pressures that have been incubated over so many years of expansionary demand conditions, and which may pose a risk to the continuity of growth in the medium term. The main potential problems may be identified in two areas. First, the mismatches in competitiveness owing to the leakage of demand pressures towards prices and costs and to the flatness of actual labour productivity. And second, the household financial position, where the high rate of debt is combining with rises in house prices.



SOURCE: Eurostat.

4 The challenge of competitiveness

For a long growth phase, such as that seen in Spain, to be sustainable and still conducive to real convergence, it must be compatible with continuing competitiveness. Competitiveness is a complex concept ranging from the most basic forms of price competition to broader considerations of product differentiation, the efficiency of the productive system and the country's pattern of productive specialisation. Nonetheless, there are simple indicators – such as the external balance, export shares and import penetration – that can signal the potential existence of problems in this area, and most of them show that the risk of the Spanish economy's competitiveness deteriorating has already begun to materialise.

As Indicated in the previous section, the persistence of domestic demand pressures exceeding the supply-side capacity to absorb them has generated cost and price pressures, which erode competitiveness. These problems have been manifest, above all, in the detraction from growth brought about by the negative contribution of external demand which, as earlier signalled, intensified notably in 2004. The deficit on trade in goods, measured in nominal terms, grew to 6.8% of GDP and the economy's borrowing requirement, once the surplus on services (including tourism) and the balance of foreign transfers and income are taken into account, amounted to 4.2% of GDP, compared with 2.1% in 2003. Admittedly, other transitory factors may have influenced the performance of external demand in 2004, thereby dampening – excep-

tionally – tourist demand. And it is also true that, from the standpoint of domestic equilibrium, the increase in the economy's borrowing needs is due more to greater investment than to lower saving. However, the scale of the deterioration exceeds what may be attributed to cyclical discrepancies or to the intensity of imports accompanying the renewed vigour of investment in capital goods; rather, it should be viewed as indicative of the difficulties encountered by the productive system to meet spending dynamics and of the possibility that such difficulties may limit growth in the economy.

Spanish euro area membership has significantly altered the nature and scope of the external deficit. Sharing a currency and exchange rate with an area of stability greatly eases the financing of this deficit and, above all, the financial and foreign exchange instability effects that accompany it in economies with monetary sovereignty are eliminated. However, that does not mean that the economy has become immune to foreign trade mismatches reflecting competitiveness problems. On the contrary, if the exchange rate is not available to correct the misalignment of relative prices and costs, competitiveness problems may entail significant risks for the sustainability of growth in the monetary union.

In this respect, the recent behaviour of export shares points to the presence of competitiveness problems. As the more detailed analysis in Box 1.4 shows, in the late nineties Spanish exports ceased to gain share in the main markets for goods as they had previously been doing, although Spain's share in the market for tourism continued to increase for a few years more. Since 2002, however, the tendency of export shares to stagnate has been increasingly evident, resulting in a loss in share in 2004 extensive also to tourism. Imports of goods and services rose significantly last year, raising their share in real GDP, which had held stable since 2000, by 1 pp.

The substantial appreciation of the euro in 2003 and 2004 has no doubt contributed to the deterioration in the external sector and to the fall-off in the presence of Spanish products on different markets last year. But the persistence of positive price and cost growth differentials, against virtually all competitors to Spanish products, has also played a significant role here. Indeed, in the euro area markets it is these differentials which explain the difficulties of maintaining the share of Spanish products. Although the differentials measured via export prices have increased less than when they are measured in terms of output prices or labour costs, this merely highlights the effort exporting sectors have had to make, through reducing margins, to defend their position in foreign markets (see Chart 1.3).

The loss of competitiveness measured by the relative trend of unit labour costs is particularly significant, as it encapsulates two of the main factors at play in this process: the nominal inertia still characterising wage-setting and low productivity growth. The growth of nominal wages in the Spanish economy may be considered moderate when compared with past episodes. However, the wage-setting arrangements currently in place have anchored this growth at rates of close to 3% and they include, moreover, indexation clauses against deviations by inflation from target. That adds considerable inertia to wage behaviour which hampers convergence with the euro area in respect of inflation.

On one hand, while the low productivity gains reflect high job creation and the choice of a capital-labour mix relatively favourable to labour, the factor which is most increasing in the Spanish economy, there are also signs of a real lag in the incorporation of technical progress and in the intensity of gains in efficiency in the economy. The virtual flatness of total factor productivity in recent years shows the difficulties of incorporating innovation and technological progress into the workings of the economy. High employment generation is proving a key fac-

In recent years, the competitiveness indicators for the Spanish economy based on relative prices and costs vis-à-vis its main competitors have continued to show signs of deterioration. To interpret the scope of this phenomenon, it is necessary to analyse the behaviour of trade flows in relation to the behaviour of the various markets.

On the export side, in recent years the process of convergence of Spanish export shares towards levels comparable with those recorded by other economies of similar size and with a similar weight to that of the Spanish economy in world GDP has halted. In fact, the share of the exports of Spanish goods, in real terms, having grown continuously since the mid-1980s, stabilised in the late 1990s and fell in 2004. Notable by geographical area was the slight reduction in the share in euro area markets in 2004, following the improvement in 2003, which contrasts with the greater loss of share in the rest of the world. In terms of real exports of goods and services¹, the decline in the presence of Spanish products in international markets began earlier, in 2002, although this process intensified last year². Meanwhile, the penetration of imports in final demand, in real terms, which has been rising continuously since the early 1990s, increased notably

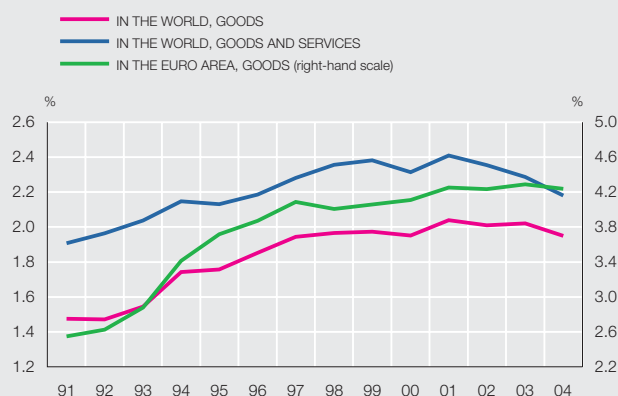
again in 2004, following a moderation in its growth from 2000, against a background of notable domestic demand growth.

Notable among the factors explaining the developments in the share of Spanish exports is, first, their geographical and sectoral structure. The main markets for Spanish exports, such as the euro area, have grown moderately in recent years, while others, such as the United States and Asian countries, have been more buoyant. In the last five years exports to euro area countries have accounted for about 60% of sales of goods abroad (more than double their weight in world trade), while exports to Asian countries (the most dynamic market in this period) represented only 2.4% of total exports (as against a share of 15.9% in world goods imports). A positive aspect worth mentioning is the notable increase in recent years in the weight of the new members of the EU in the structure of Spanish exports, countries in which the most dynamic markets are to be found.

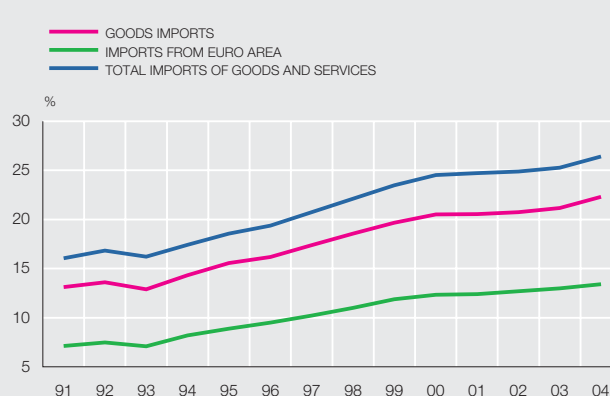
The sectoral composition of Spanish exports is dominated by medium-high and low technology industries, while the weight of high-technology industries is relatively low and has not increased significantly in recent years. Given the recent developments in the demand of Spain's main trading partners, characterised in recent years by greater buoyancy in the high-technology sectors, this structure has tended to have a slightly negative effect on the share of Spanish exports. Moreover, the higher weight of low-technology industries, whose products are generally less differenti-

1. As regards exports of services, the Spanish share of world tourism, measured as a percentage of the total number of tourists, increased until 2003. However, in terms of tourism receipts the performance was less positive. 2. In nominal terms, the trend was somewhat more positive until 2003, as a consequence of exchange rate developments, but in 2004 there was a clear deterioration in share, despite the further appreciation of the euro.

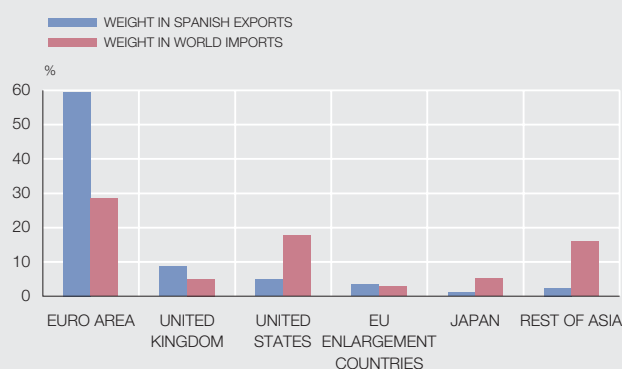
REAL SHARES OF SPANISH EXPORTS



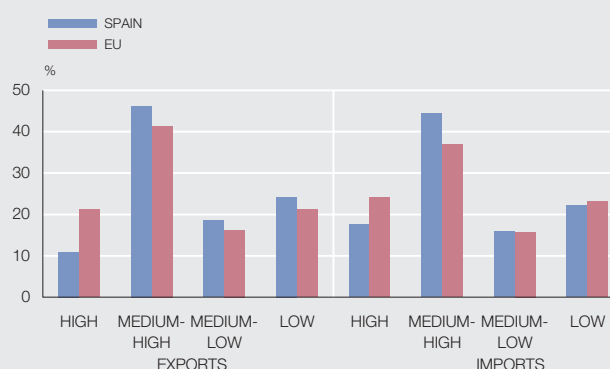
REAL PENETRATION OF IMPORTS IN FINAL DEMAND



MARKET STRUCTURE IN THE WORLD AND IN SPAIN 1999 - 2004



STRUCTURE OF FOREIGN TRADE BY TECHNOLOGICAL INTENSITY 2002



SOURCES: IMF, OECD, INE, Departamento de Aduanas, Ministerio de Economía and Banco de España.

ated and more exposed to the growing competition from emerging economies, may have adversely affected exports in recent years.

However, the composition effects are not sufficient to explain the decline in the share of Spanish exports, whose growth in 2004 was not only lower than the growth of world trade, but also lower than the growth of their markets. In this respect, another key factor in explaining this development is the trend in price and cost competitiveness. The appreciation of the euro exchange rate since 2002, together with the increase in euro export prices³, has in-

3. Export prices have increased, in recent years, by much less than the Spanish economy's main price and cost indicators, reflecting the reduction in the margins of exporters to maintain their market share. However, this trend was even more moderate in the EU countries on average.

volved a notable deterioration in the price competitiveness of Spanish exports. This problem has been accentuated by the growing presence in international markets of certain countries with significant cost advantages, notable among them being the new EU members and the Asian economies. In fact, in the period 1999-2004, the weight of the Asian economies in world trade increased significantly, their penetration increasing across the board in all markets, while the increase in the share of the EU enlargement countries was concentrated in European markets, especially Germany. The growing competition from these countries is not only manifest in the fact that Spanish exports fell most in those markets in which the share of these countries increased most, but also in the growth of the imports of their products in Spain; in 2004, nominal imports from south-east Asian countries and from the EU enlargement countries grew by 22.4% and 17.8%, respectively.

tor in driving the economy but, if this is not accompanied in the future by a significant improvement in the behaviour of productivity, it will be increasingly difficult to ensure the continuity of growth and of real convergence.

On the other, against the background of the comparatively high growth of labour costs, the Spanish economy's specialisation pattern is a further source of risk when it comes to maintaining Spanish positions on world markets. This is because it is concentrated mainly on certain products facing stiff competition from the new central and eastern European partners, who have lower labour costs, and on other low-technology industries marked by flat demand which make intensive use of relatively unskilled labour.

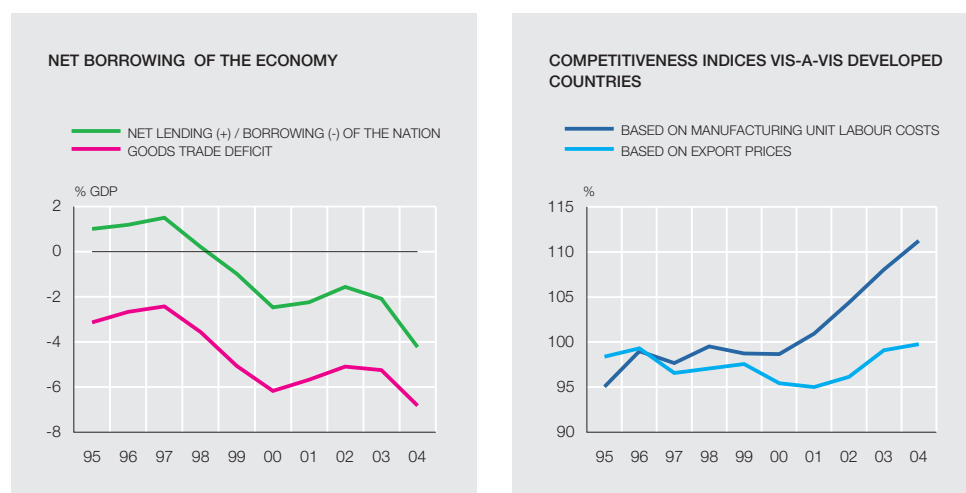
In sum, the continuity of the economy's expansionary phase and of real convergence requires a strategy to improve competitiveness, through fomenting productivity and the search for a pattern of specialisation that is not based on cost differences but on the gearing of production and exports to the most dynamic industries and geographical areas.

5 The household financial position and the housing market

A further risk posed by the prolongation of the Spanish economy's current growth phase stems from the changes in the household wealth position brought on by the long period of high spending on consumption and residential investment, against a backdrop of notably loose financial conditions and of sustained employment growth.

The marked buoyancy of household spending has outpaced household income and has prompted substantial and sustained growth in this sector's debt since the mid-nineties. The expansion has even intensified of late, meaning that in 2004 the aggregate household debt ratio stood at over 100% of household disposable income, exceeding the average levels observed in the euro area (see Chart 1.4).

The debt levels attained can be explained as a consequence of Spanish households' adaptation to the new setting of macroeconomic stability. Indeed, their financial burden has increased to a much lesser extent than the liabilities incurred, owing to the reduction in interest rates and the lengthening of maturities. Notwithstanding, the proportion of income set aside by households for saving, net of debt service, significantly declined to practically zero in 2004.



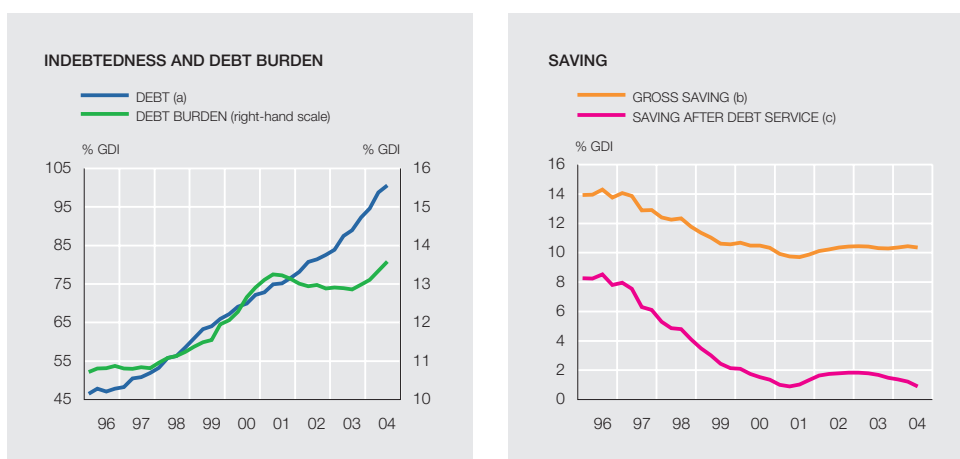
SOURCES: IMF, OECD, INE and Banco de España.

With a greater level of debt and less of a saving cushion available, household spending decisions are potentially more sensitive to those shocks that may adversely affect their capacity to face the payments arising on the debt incurred. Notable among such shocks are those associated with developments in employment, which plays a pivotal role in the formation of income expectations, interest rates and house prices. Households' sensitivity to possible interest-rate rises has increased owing to the fact that most of their liabilities are in the form of floating-rate loans. And, in turn, the influence of house prices has been reinforced as a result of the fact that the bulk of funds received by households has been invested in the acquisition of real-estate assets.

The strong rise in house prices since the late nineties has contributed to reinforcing the sector's wealth position; despite the increase in debt, household net wealth has grown uninterruptedly to approximately 600% of GDP. Accordingly, the correction of house prices would adversely affect private spending, especially if it were to coincide with a significant increase in interest rates or with a drastic slowdown in employment. In 2004, house prices did not show signs of slowing and once again posted a very high rate of expansion, of over 17%. Although the main determinants of the long-term trend of these prices, such as income levels, demographic variables and borrowing costs, have continued to drive their equilibrium level, the increases recorded have been far greater than might be attributed to the trajectory of the attendant fundamentals. Hence the overvaluation that has been detected in this market for several years – of an amount that varies according to the model used to estimate it – has not only not been corrected but has tended to increase, whereby the likelihood has also increased that the correction of the current maladjustment may become significantly intense (see Box 1.5).

Yet it should be borne in mind that the short-term adjustment dynamics characterising prices in a market with such inertial movements, as is the case of the housing market, entail a degree of persistence in deviations from trend, which can usually be absorbed gradually. In line with this behaviour, which is that which has traditionally prevailed in the Spanish economy, it is however possible that the absorption of the overvaluation characterising the current situation may follow the pattern of previous episodes, without sharp corrections therefore taking place.

In any event, the greater exposure of households to the above-mentioned shocks should not be confused with signs of weakness of the sector's wealth position. The opposite is rather the



SOURCE: Banco de España.

- a. Includes bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing intermediated by securitisation SPVs.
 b. Balance of households' use of disposable income account.
 c. Gross saving less estimated debt repayments.

case. Viewed as a whole, the household financial position is sound, as the high level of net wealth and the moderate weight of the financial burden in income testify. Likewise, disaggregated household data drawn from the recent Banco de España Spanish Survey of Household Finances (EFF) tend to support this assessment when the situation of the representative indebted household is analysed, though a segment of the household sector is also detected to have shown a more marked degree of vulnerability in 2002, the reference year for the Survey.

When assessing the potential repercussions on expenditure arising from any of the above-mentioned risk scenarios materialising, the presence of certain mitigating factors should be taken into account. The most significant of these lies, no doubt, in the soundness of the Spanish banking system. Broadly conceived, its stability minimises the possibility of any shocks such as those described ultimately leading to a constraint on banks' ability to efficiently meet the demand for new funds. It should further be borne in mind that Spanish households, unlike in other countries, do not appear to have used the rise in the value of their real-estate assets to apply for mortgage loans aimed at financing their current consumption spending. That also contributes to moderating the wealth effects associated with potential downward adjustments in house prices.

In any event, the maintenance of recent house-price and household-debt trends would ultimately exhaust the safety margins still in place; consequently, only if both variables move promptly onto a slowing path will household spending be capable of maintaining a sustained expansion.

6 Economic policies to promote growth sustainability

The diagnosis of the Spanish economic situation in this chapter indicates the continuation in 2004 and 2005 to date of the expansionary phase in train since the mid-nineties and the prospects of further buoyancy. However, the persistence of some of the risks highlighted requires an economic policy response that provides for balanced growth in domestic demand and increases the responsiveness of aggregate supply.

In 2004 the single monetary policy stance remained relaxed. At the same time, fiscal policy was designed with a moderately expansionary bent, departing from the restrictiveness

The housing market in Spain has been exposed to a significant succession of demand shocks in recent years, arising from changes in variables such as the degree of macroeconomic stability, future household income expectations, interest rates, demographics and the demand for second homes by residents and non-residents. Supply, meanwhile, has responded more flexibly than on previous occasions, but ultimately not sufficiently to absorb these shocks fully, with the result that property is overvalued. The precise quantification of this overvaluation, however, is subject to a high degree of uncertainty.

In 2003, house prices in Spain were estimated to have been overvalued by between 8% and 20% in mid-2002, depending on the valuation model considered¹. The magnitude of this range is a good indication of the uncertainty surrounding quantification of the distance between the long-term equilibrium value of property and its market value. Moreover, this figure fails to characterise the situation in this market adequately because, owing to the specific nature of a house, prices may be expected to adjust relatively slowly to changes in their fundamental determinants. In fact, the conclusion drawn from the

analysis was that the degree of overvaluation was perfectly compatible with its gradual and orderly disappearance, as had occurred in similar episodes in the past.

The charts below show the results of updating the calculations for a sample period extending to 2004 Q4. Specifically, they show the estimates of the equilibrium level of house prices and the short-term adjustment dynamics that would be expected in accordance with previous episodes. These estimates are shown for each of the three available models, two of which are based on a macroeconomic approach, in which the value of property is basically related to variables such as household disposable income and the cost of mortgage finance (models 1 and 2), the other using a financial asset pricing approximation in which property is treated as being equivalent to a financial asset, its dividends taking the form of rents or accommodation services provided to its owners (model 3)².

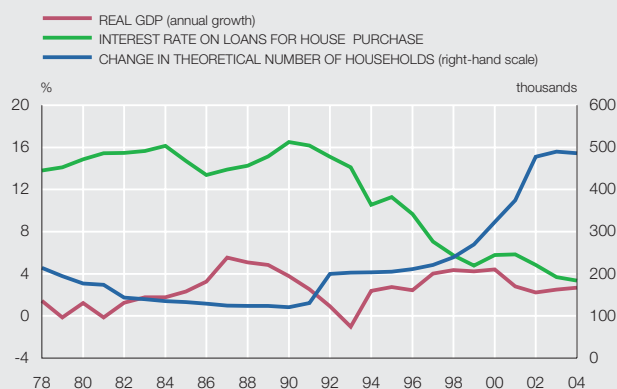
As can be seen, all three models indicate a sustained increase over the last two years in the degree of overvaluation, the estimated value

1. Ayuso, Martínez, Maza and Restoy (2003), "House prices in Spain", *Economic Bulletin*, Banco de España, October.

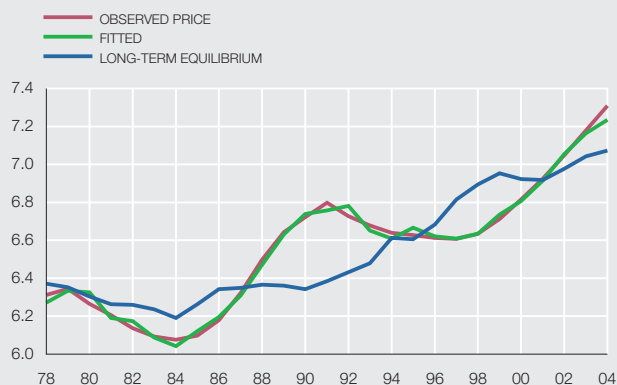
2. For further details see the Banco de España Working Papers 0304 and 0307, in which these models are developed.

HOUSE PRICES (a)

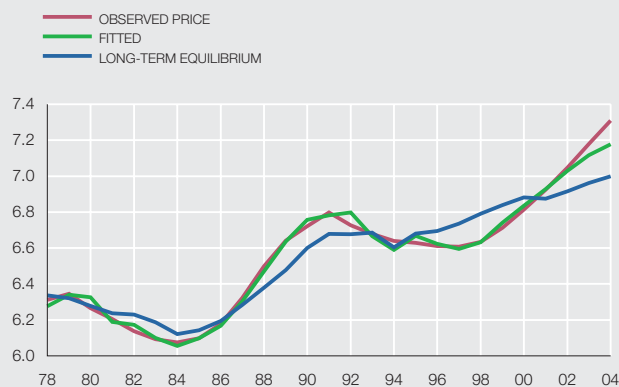
SOME BASIC DETERMINANTS OF PRICES



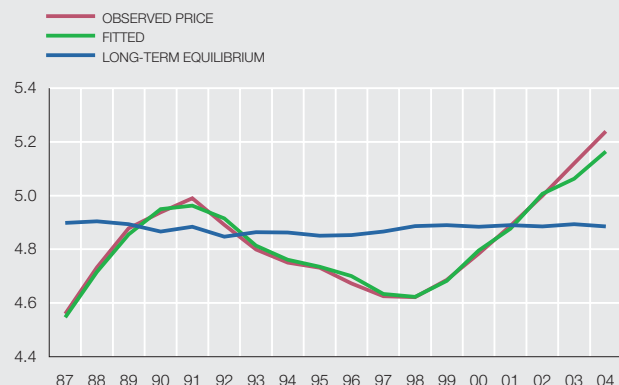
MODEL 2. UNIT INCOME ELASTICITY



MODEL 1. UNRESTRICTED INCOME ELASTICITY



MODEL 3. HOUSE PRICES/RENTS



SOURCES: INE, Ministerio de Vivienda, Tecnigrama and Banco de España.

a. Models 1 and 2: Price series, deflated by the CPI, in logarithms. Model 3: Ratio of house prices to rent in logarithms.

of which rose from 14%-23%, in 2003, to 24%-35%, in 2004. Note, however, that the mid-point of these intervals is not necessarily the best estimate of the gap between actual and equilibrium prices. On the one hand model 3, by its very nature, does not characterise the behaviour of house prices, but rather that of the ratio of house prices to rents. The problems involved in measuring the latter³ mean that part of the overvaluation seen in the charts probably reflects some undervaluation of the denominator of the ratio analysed. On the other hand, the results of model 1 depend on an estimate of the elasticity

3. To give an example, the available information enables the average value of rentals to be calculated, but not their marginal value, which is the relevant value from the theoretical standpoint. Given that contracts are renewed relatively infrequently, the average price adjusts slowly to changes in the marginal price.

of property values with respect to household income that, from a theoretical standpoint, is excessively high (this, in fact, being the reason why there are two alternative models for the macroeconomic approach). Consequently, any point estimate of the degree of overvaluation should give a higher weight to the results of model 2 and would, therefore, tend to be situated in the lower half of the various ranges mentioned above.

House prices have deviated somewhat more from their estimated short-term adjustment path. Yet, the most likely future scenario for this market continues to be one of gradual and orderly elimination of the overvaluation, with a slowdown in observed prices and a rise in long-term equilibrium values. Clearly, however, the probability that should be assigned to this scenario will be lower the longer the trends shown by the charts continue.

predominant in earlier years. Nonetheless, implementation ultimately proved more contained. The general government balance in 2004 posted a deficit of 0.3% of GDP but, once the effect of the assumption of RENFE (the State-owned Railway Company) debt was stripped out, the result was a surplus of the order of 0.4% of GDP, several tenths of a point up on the balanced budget programmed at the start of 2004. This better performance, against the background of the upward deviation in current primary expenditure, was possible thanks to revenue growth which, as in previous years, was far higher than initially forecast.

In the near future the single monetary policy, even with a less expansionary stance, will hardly bring about a sufficient adjustment of monetary conditions to the Spanish economy's domestic requirements. Budgetary policy, as programmed in the State budget for 2005 and in the latest update of the Stability Programme to 2008, points to the continuation of a virtually neutral stance, as part of a trajectory of modest surpluses for the overall general government sector, which does not provide additional domestic-demand-containment impulses. There is thus sufficient leeway for budgetary policy to reinforce its stabilising potential, projecting the improvements witnessed in 2004 ahead to the future by means of more ambitious surplus targets. Indeed, the buoyancy shown by budgetary receipts in 2004 has been a fixture of recent fiscal years; accordingly, if this pattern is maintained in the future, it should be harnessed to entrench a more favourable public finances position.

When, as at present, the starting point is a balanced budget, the stabilising role of fiscal policy has a relatively limited sphere of action. There is, however, significant room for manoeuvre in respect of the rationalisation of public revenue and expenditure and the improvement of the quality of public finances, which may prove very effective for sustaining economic growth. Some of the measures announced, such as the creation of a State agency (Agencia Estatal de Evaluación) for evaluating public policy and the quality of public services, or the definition of a strategy for the rationalisation of State holdings in the corporate public sector, should allow headway along these lines. Likewise, the fiscal reforms envisaged for the coming years should contribute to improving efficiency in the allocation of resources, through encouraging decisions to participate in the labour market and saving by economic agents, without jeopardising budgetary stability.

In any event, both the increase in the primary structural surplus and the improvement in the quality of public finances prove particularly relevant in the light of the long-term sustainability problems being posed. The demographic projections available point to significant population ageing, even under the most favourable scenario of continuing strong immigrant inflows. This process will have far-reaching repercussions on public spending on pensions, on health and on care for the elderly, which are areas in which little progress has been made in introducing reforms to forestall the future impact of ageing. A strategy based on increasing the Social Security reserve fund, employment promotion and fiscal consolidation is vital for checking future sustainability problems. But this may be insufficient if it is not also accompanied by measures to reform the social protection systems or if the public spending flows linked to the rise in immigration and in dependency are not provided for in advance.

Maintaining budgetary stability, in line with the content of the latest Stability Programme, is fundamental for the proper working of the economy in the short run and for strengthening its growth possibilities in the long term. To maintain consistency with these goals, it is important that the reforms it is intended to introduce in this area, such as the revision of the legislation governing budgetary stability and the regional government financing arrangements, should not weaken the Spanish economy's fiscal discipline framework.

That said, within the euro area the leeway for demand-side policies is limited and their main contribution to growth consists of ensuring a framework of stability, whereby supply-side policies aimed at increasing growth potential become very important. From this perspective, the diagnosis outlined in the foregoing sections reflects the need for the impulse to growth capacity to stem simultaneously from a greater and more intense use of the labour factor and from an increase in total factor productivity. The requirement that high rates of employment be maintained is particularly important for growth potential, given the deficit the Spanish economy still evidences in terms of participation and employment rates and of the prospect of population ageing. At the same time, a growth pattern that does not incorporate substantial efficiency gains would impose serious constraints on growth potential and on real convergence.

The considerable robustness of job creation in recent years has been assisted by the reforms implemented to promote stable employment and to encourage labour market participation. Nonetheless, despite the favourable behaviour in 2004 of most of the structural labour market indicators, there are signs that the effects of these reforms might have run their course. The stabilisation of the ratio of temporary to permanent employees at a relatively high level and the slowdown in advances in participation may be illustrative in this respect.

In parallel, wages – as seen in the previous sections – have not yet fully adjusted to the stability standards of the euro area. Among other factors, this is the result of the absence of reform to a collective bargaining system that does not sufficiently promote the adaptation of wage increases to sectoral productivity differences and in which low productivity growth has led to substantial rises in unit labour costs in nominal terms, especially when compared with the growth seen in other European countries. In turn, the application of wage indexation clauses has contributed in recent years to widening the unit labour cost growth differentials with the euro area. The announced rise in the official minimum wage might intensify, albeit indirectly, wage increases at the lowest levels of the remuneration scale and, through this channel, adversely affect employment possibilities for the groups of workers with the lowest productivity, perhaps affecting the Spanish economy's capacity to sustain the current process of intense job creation.

The foregoing underscores the need to push through labour market reforms. These should revise the structure of collective bargaining, hiring arrangements, so as to reduce the current

duality in the market without jeopardising the buoyancy of job creation, and intermediation arrangements. Likewise, measures aimed at improving the effectiveness of active employment policies and of training are required so as to align labour supply and demand. Some of these recommendations are drawn from the Report of the Committee of Experts for Social Dialogue, which considers the need for Spanish companies to have a flexible labour framework that provides for adaptation to an increasingly competitive environment.

The challenge of competitiveness requires, however, that as well as maintaining robust job creation, efficiency and productivity gains be generated. To overcome the shortcomings that the growth pattern pursued by the Spanish economy has thrown up in this connection, investment in physical and technological capital must be stepped up and innovation encouraged. The role of public policy here should be geared essentially to creating the institutional environment and the regulatory framework to foment education and vocational training, and promote private-sector initiative aimed at the upgrading of capital equipment, the adoption of new technologies and the rationalisation of productive processes.

Along these lines, the Government Plan to reinvigorate the economy and boost productivity, approved in late February 2005, places productivity improvements at the focal point of economic policy goals. The scope of the Plan's first raft of measures, however, is only partial owing to the gradual approach adopted, the limits of central government powers and the incomplete nature of some of the proposals. Most of the measures focus on specific markets for goods and services – essentially in the energy sector – and on the financial markets, and they have been designed to deepen the levels of competition attained. They encompass some of the sectors in which, after several years of liberalisation, advances are needed towards a greater degree of effective competition, as is the case of the electricity, liquid and gaseous hydrocarbons, and postal service industries. They also cover others where liberalisation is more incipient, such as the rail transport sector. In the financial markets, a series of measures have been adopted which will no doubt contribute to broadening competition and reducing intermediation costs. Some of the measures taken here involve the transposition of a series of Community directives, making primary-market issuance conditions more flexible and amending resolutions on collateral security. Along these same lines, the incentives for investment in venture capital have been improved and charges in the capital markets have been reduced. The effect of this set of competition-boosting sectoral measures may be bolstered by the changes that are to be introduced into the workings of the bodies entrusted with the protection of competition.

Promoting competition is vital for encouraging the continuous introduction of new technologies that act as a basis for increasing productivity. The distribution industry – where there has nevertheless been backtracking in the regulation of trading hours – plays a significant role here. Above all, however, the labour market should provide sufficient flexibility so that companies may efficiently organise the use of the factors of production. Action in this area is pivotal for encouraging the incorporation of new technologies and so that improved productivity may also contribute to job creation. The boosting of productivity further requires measures specifically aimed at improving technological and human capital, along the lines of the goals of the Lisbon Agenda.

In respect of housing, steps have been taken to alleviate the problem of rising house prices by means of measures affecting land supply, officially subsidised housing and rented housing. Most of these measures are, however, still at the preliminary stages of implementation. Among the measures applied, those affecting the house rental market are excessively based on the resort to subsidised financing, and do not sufficiently address aspects of importance for ensuring the working of this market, such as the amendment of the urban rental law, or

they do so only indirectly, through covering, for instance, the subscription of insurance against default.

The objectives and priorities of the Plan to reinvigorate the economy and boost productivity set the right course for economic policy to tackle the challenges facing the Spanish economy. The commitments assumed must, however, be specified and deepened; and, at the same time, other far-reaching reforms affecting the labour market, land use and pensions must be addressed. A forward-moving reforming impulse should, therefore, continue to be the guiding principle of economic policy.

2 THE EXTERNAL ENVIRONMENT OF THE EURO AREA

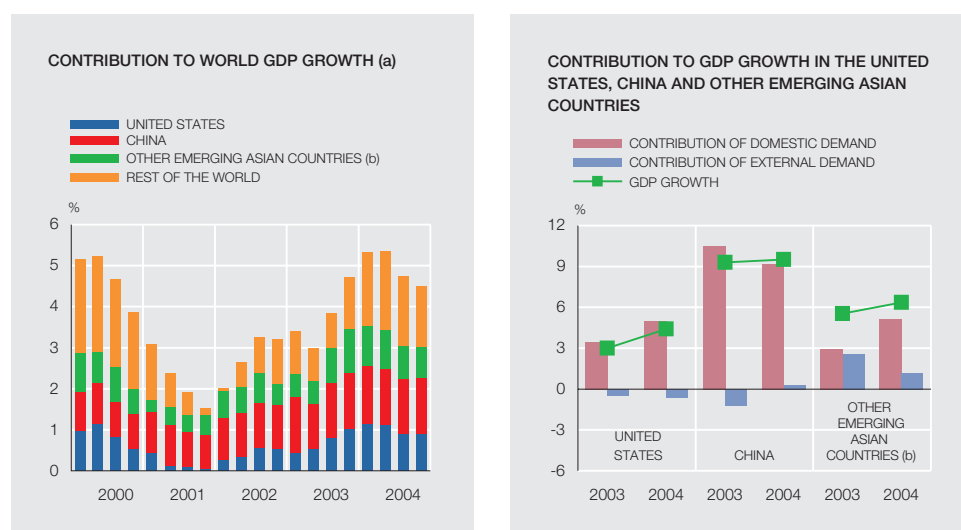
1 Robust growth, financial stability and global imbalances

One of the most salient aspects of international economic developments in 2004 was the unusual coincidence of a boom in economic activity, contained inflationary pressures and the favourable behaviour of financial markets, a particularly notable conjunction of circumstances against the background of a marked hike in oil prices. This apparent paradox might perhaps be explained by a series of factors, addressed in this chapter, whose simultaneous impact on the world economy allowed it to weather the rise in energy prices without scarcely departing from the path of recovery initiated two years earlier.

The growth of the world economy in 2004 was, at over 5%, the highest since 1976, and it was accompanied by the notable buoyancy of international trade, which grew at close to 10%. The expansion, which was greater than initially foreseen but tended to moderate towards more sustainable rates in the second half of the year, was supported by diminished geopolitical tensions and by monetary policies which remained expansionary, despite increases in official interest rates in those economies further ahead in the cycle. The picture was clouded, however, by the widening of the external imbalances between the main areas, a development due to the persistence of profound differences in the growth rates of domestic demand, in saving rates and in exchange-rate policies. At the same time, in a considerable number of cases there was a sustained increase in private-sector indebtedness and a rise in the price of real-estate assets to values that were very high and, occasionally, unwarranted by economic fundamentals.

The economic expansion spanned a greater number of countries and areas last year than in 2003, although the United States and China continued to be the driving forces of the world economy, contributing 0.9 and 1.2 pp, respectively, to its growth. The momentum of the Chinese economy underscores its growing importance as one of the main actors on the international stage. This was reflected in 2004 in China's role as a competitor on export markets, in its demand for oil and other commodities, and in its capacity as a recipient of private capital flows and financier of the US budget and external deficits. The acceleration in growth also spread to the other emerging Asian countries (which contributed as a whole another 0.7 pp to world growth in 2004), to Latin America, to the Central and Eastern European countries, to Russia and, to a lesser extent, to Japan. In those economies with more vigorous rates of activity, the contribution of domestic demand generally increased compared with the previous year, while the contribution of external demand was more negative in the United States and less positive in the emerging Asian countries. China's performance was a notable exception in this respect, as the contribution of its domestic demand declined and that of its external demand increased, turning slightly positive in 2004 (see Chart 2.1). That is perhaps somewhat paradoxical in an economy that has been growing at very high rates for years, and it appears to confirm its extraordinary competitiveness. Analysing demand components, there was a greater contribution by investment compared with 2003 in most areas, while the contribution of consumption to growth generally held steady.

The buoyancy of the world economy boosted the demand for energy, which contributed to the price of oil reaching an all-time high in nominal terms, although in real terms it was still below that attained in the early eighties. Unlike on previous occasions, however, this increase in oil was reflected virtually in its entirety in long-term futures contracts, which would point to greater expectations that prices will remain at high levels (see Box 2.1). The dynamism of the world economy was also apparent in industrial metal prices, which rose 20% on their already high



SOURCES: National statistics and IMF.

a. Contribution in percentage points to the annual change in world GDP, calculated drawing on the data of 56 countries, accounting for 91% of world GDP.

b. India, Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines.

2003 levels. Conversely, the prices of agricultural products, which had climbed significantly the previous year, underwent a strong downward correction in 2004 Q2, after which they held relatively stable (see Chart 2.2).

As indicated, a key feature of the economic performance in 2004 was the containment of inflation, despite the momentum of economic activity and the surge in oil prices. A contributing factor here was the favourable trend in labour costs in most countries, especially the most developed economies, and the growing penetration on international markets of products from the emerging Asian and Eastern European countries. The curbing of inflation is also due to the anti-inflationary credibility acquired by monetary policies, which contributed to anchoring price expectations and to avoiding so-called “second-round effects” of the rise in oil via greater wage pressures, and to the tightening of the monetary policy stance in most of the economies further ahead in the cycle. Despite this broadly favourable behaviour, rises were seen in overall price indices in certain emerging economies, most particularly in Latin America.

On foreign-exchange markets, the weakness of the dollar against the euro continued, translating into a loss of 5% between December 2003 and April 2005. The US currency has thus depreciated by 33% since it began its downtrend in February 2002. The dollar also weakened against other currencies of the main developed countries in 2004 and early 2005 (8% against sterling and 6% against the Canadian dollar), while it held relatively stable against the yen for most of 2004, depreciating in Q4 and regaining lost ground in 2005 Q1. The effective depreciation of the dollar was, however, only about 4% in nominal terms between December 2003 and April 2005, and 2% in real terms, a result attributable to its stability against many of the main Asian economies’ currencies (see Chart 2.3). The exchange-rate policy pursued for years by most of these countries, which has been geared to upholding their currencies against the dollar in order to safeguard their favourable levels of competitiveness, has prompted a strong increase in foreign reserves in Asia, which was also favoured by the current-account surpluses and, in some cases, by the heavy capital inflows into the region. The oil-exporting

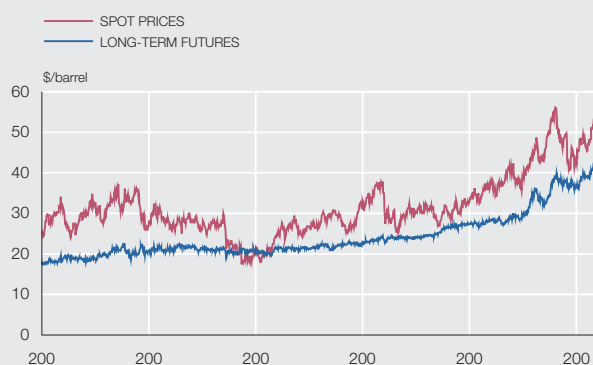
Oil prices have held a prominent place in discussions on the international economic outlook due to their significant rise from early 2002 to mid-March 2005 (160% in dollars and 25% in euro). This rise placed their price in dollars at an all-time high in nominal terms in October 2004 and once again in early 2005 (see panel 1). While significant, both the increase in and level of oil prices in real terms are still smaller than in previous episodes, especially the rises seen in the seventies. Indeed, in real terms the oil price stood, in early 2005, at 60% of its level in the early eighties. Likewise, the direct impact of the increase in oil prices on the trade balance of the developed countries in 2004 was, according to the IMF, only 0.3% of their GDP, compared with 3.7% in the 1978-1980 period. This box analyses the causes of the recent increase in oil prices, assessing the medium-term outlook and the potential impact of a scenario involving an additional rise.

The main cause behind the increase in oil prices since 2002 has been the strong rise in demand for crude oil, especially from China, the other emerging Asian countries and the United States, at a rate outpacing that of production and refining capacity (see panels 2 and 3). A substantial portion of the increase in demand may be considered as unexpected, judging by the continuous revisions to the forecasts

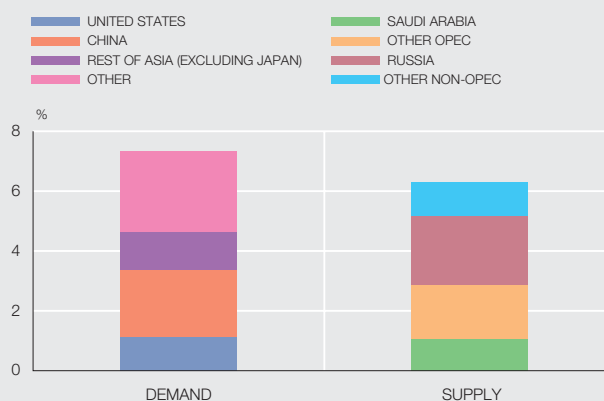
of the International Energy Agency, the main market monitoring and analysis body. On the supply side, the scant increase in crude oil production and refining capacity reflect the limited investment in the sector during the nineties, in the wake of the over-investment experience in the seventies and the subsequent collapse of prices in 1986, exacerbated in the refining sector by considerable environmental restrictions. This reduction in extra production and refining capacity has contributed to heightening the volatility of oil prices, against a background of high geopolitical and social instability in the main oil-exporting regions.

One of the main differences between this latest phase of higher prices and previous episodes (in 1989-1990 and in 1999-2000) has been the trend of long-term futures contracts, to which 90% of the spot price increase has passed through since the beginning of 2004, whereas this pass-through was traditionally much lower. This would suggest a significant permanent component in the recent price increase, since futures contract prices are the best indicators of the future course of spot prices. The prospect of a relatively permanent increase in crude oil prices is further strengthened by the rising trend of exploration and exploitation costs, owing to the difficulty of access to the new fields, environmental pressures and the taxes levied on production, which

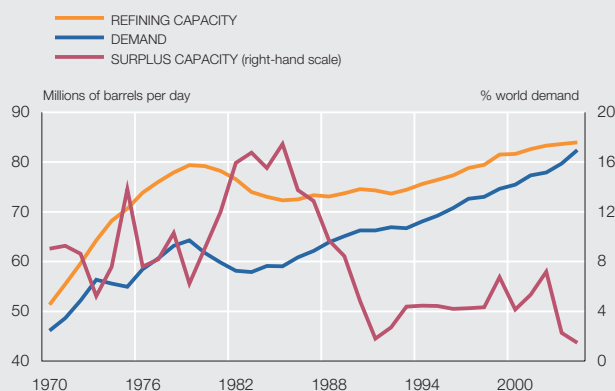
1. WEST TEXAS INTERMEDIATE CRUDE OIL.



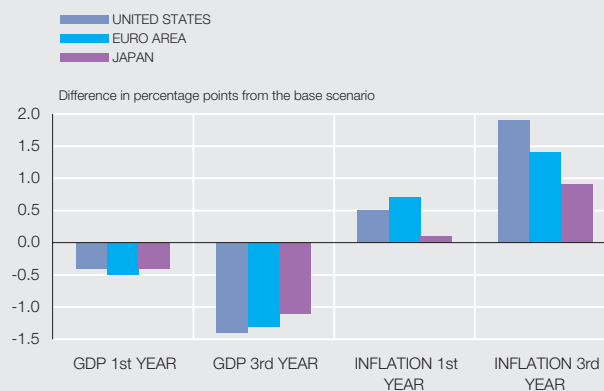
2. CONTRIBUTIONS TO THE CUMULATIVE INCREASE IN OIL SUPPLY AND DEMAND BETWEEN 2001 AND 2004



3. DEMAND, REFINING CAPACITY AND SURPLUS PRODUCTION CAPACITY



4. CUMULATIVE EFFECTS OF A PERMANENT INCREASE OF 50% IN THE OIL PRICE (USING THE NIGEM MODEL)



SOURCES: Bloomberg, British Petroleum, International Energy Agency and Ruiz (2004).

a. For delivery between six and seven years hence.

are not sufficiently countered by the technological innovations in the sector.

Although an increase in oil prices tends to be reflected in lower growth and higher inflation in the world economy, the size of the impact has diminished compared with the seventies and eighties. Admittedly, the price increase in real terms has been less than was then the case. But there are several reasons why the macroeconomic impact of a given increase would now be less: *i)* the lower energy intensity of production, especially in the developed countries; *ii)* the greater sophistication of the financial derivatives markets, which would allow for better diversification of risks in the face of an increase in crude oil prices; *iii)* the greater credibility of monetary policies, with better anchored inflation expectations; *iv)* the greater flexibility of labour markets, which would diminish second-round effects on inflation; and *v)* the greater recycling of additional revenue in the oil-exporting countries through greater imports from other geographical regions, as opposed to the greater external saving by these countries in previous episodes. Finally, the fact that the increase in oil prices has taken place against the backdrop of a highly buoyant world economy has perhaps softened their impact on growth.

While the global impact of the increase in oil prices would be less than in the seventies and eighties, their impact on the different regions is influenced by a series of factors: *i)* the energy intensity of each region; *ii)* the differing tax burden on energy products, which cushions to a greater or lesser extent the effect of the increase in crude oil on re-

financed products; *iii)* the degree of trade integration with oil-importing or exporting countries, which respectively heightens or reduces the direct effects on production for the domestic market; *iv)* the different degree of flexibility of labour markets; *v)* the different position of economies in respect of the output gap; and *vi)* changes in the exchange rate against the dollar, the basic currency in which international oil prices are set.

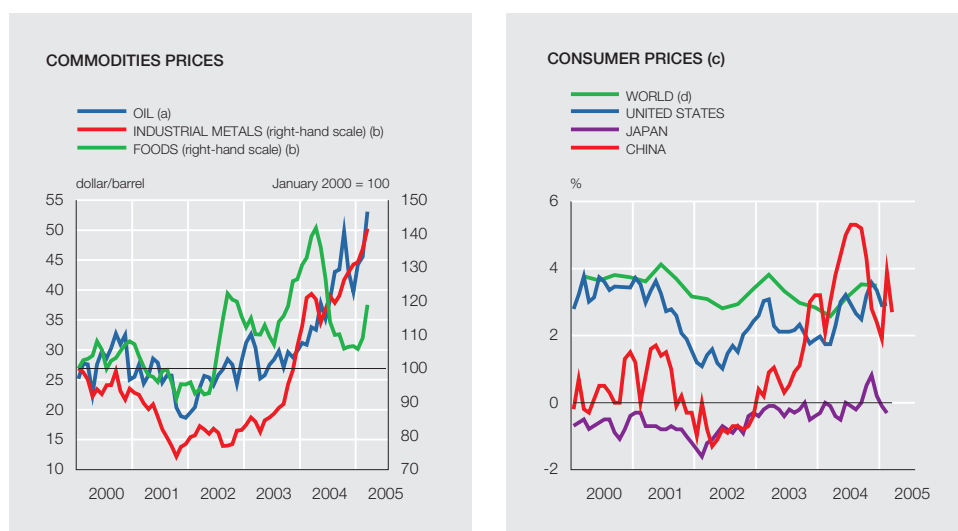
Panel 4 shows simulations of the effect of a permanent 50% increase in the price of oil¹ from the March 2005 level, bearing in mind the possible monetary policy response in each area. Despite the fact this increase would place the price of oil in real terms at similar levels to the all-time high reached in 1980, its effect would be relatively limited in comparison with the scale of the shock considered. Across the different areas, the cumulative effect on GDP after three years would be more pronounced in the United States, given its greater energy intensity, as opposed to the euro area and Japan. The effect on inflation in the United States would also be greater, among other things because of the lower tax charge on oil-related products, which increases the direct effects on the CPI. However, these results should be viewed with caution, owing both to the major uncertainties associated with exercises of this nature and to the difficulties of incorporating the effect of the cyclical position of economies into these types of models.

1. Simulations conducted using the NIGEM model. See J. Ruiz (2004), "Una valoración de la evolución reciente del precio del petróleo", *Boletín Económico*, Banco de España, December.

countries and, to a lesser extent, Latin America also posted notable increases in reserves (see Chart 2.3). Indeed, most of the emerging economies pursued an active policy to build up reserves, in some cases to avoid an appreciation of their currencies against the dollar and, in others, to protect themselves against possible future reversals in capital flows.

The slight depreciation in the dollar in effective terms did not prevent global imbalances from continuing to increase in relation to 2003. This made for a widening both of the deficits and surpluses of countries whose starting external positions were most unbalanced (see Chart 2.3). In particular, the US current-account deficit continued widening to reach 5.7% of GDP in 2004, which is equivalent to 1.6% of global GDP and to more than 70% of the sum of current-account deficits in the world. The counterpoint to this bigger deficit was, above all, the wider external surplus of Japan, China and the main oil-exporting countries. Several factors contributed to these burgeoning external imbalances: the positive differentials between growth rates in the United States and those in the euro area and Japan; the US fiscal deficit, which contributed, along with the low level of private-sector saving, to continuing low domestic saving rates; the relative immobility of exchange rates against the dollar in the Asian economies, which are precisely those countries with which the United States has built up growing trade deficits; and the increase in the value of oil imports, as a result of higher prices.

Economic policies generally retained an accommodating stance, despite the favourable cyclical position. The tendency to correct this expansionary character was uneven: in the fiscal



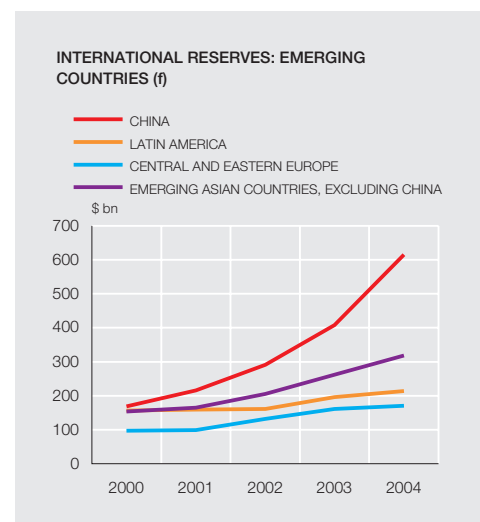
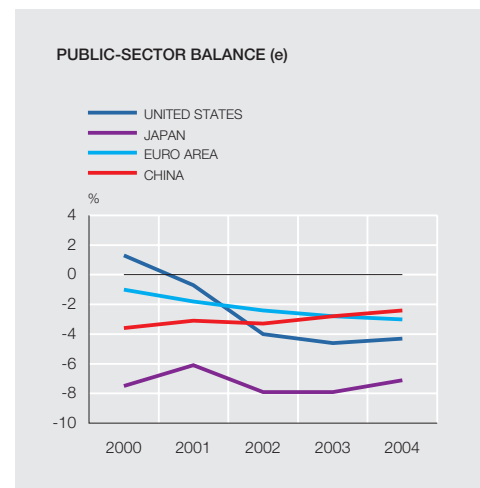
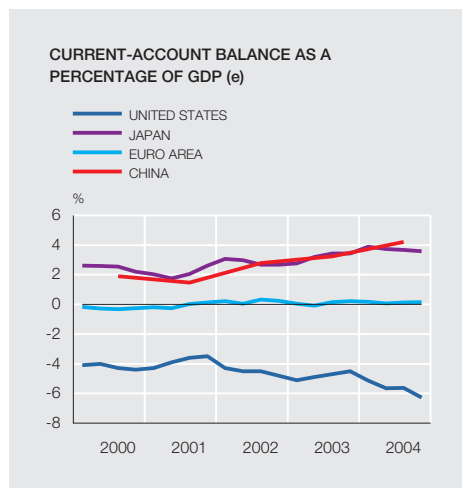
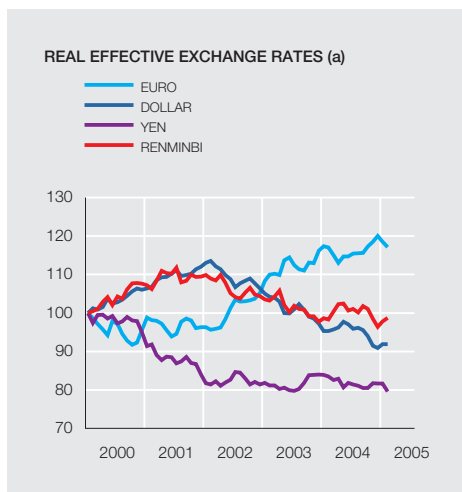
SOURCES: National statistics, Banco de España and Goldman Sachs.

- a. Brent crude.
- b. Goldman Sachs indices.
- c. Annual percentage change.
- d. Aggregate calculated drawing on data from 56 countries, accounting for 91% of GDP.

policy realm, the major developed economies maintained high deficits – even those which showed high growth, such as the United States – while the emerging economies generally harnessed the good economic situation to make headway in reducing theirs (see Charts 2.3 and 2.8); conversely, in respect of monetary policies, interest rates were raised rather in economies ahead in the cycle although, in the case of many emerging economies, the adoption of tighter monetary policies in the face of the rise in inflation ran counter to their goal of preventing an appreciation of their exchange rates against the dollar.

A significant development was the start, in June last year, of the upward cycle of official US interest rates, which entailed a gradual withdrawal of the monetary stimulus from which the US economy has been benefiting in recent years. In the period to April 2005, the Federal Reserve thus raised its intervention rate by 175 basis points overall (see Chart 2.4). Other areas, such as the United Kingdom, Canada, Australia and certain Asian and Latin-American economies, also tightened their monetary policy stance during the year. Despite these increases, it is estimated that in most of these countries official rates would still be below levels considered neutral, in particular in the United States. One notable feature is that, contrary to what might have been expected, the rise in US official rates did not feed through to long-term rates (see Chart 2.4). This moderation in US Treasury bond yields might be due, to some extent, to the demand exerted by Asian central banks in their reserve-placement operations – which contributed, therefore, to containing US budget-deficit and external-deficit financing costs – and to low inflation expectations and the notable credibility of US monetary policy. Nonetheless, the differential between US interest rates and those of the euro area, which had hitherto remained very narrow despite the profound differences in developments in the economies of these regions, was seen to widen significantly in the closing months of the year.

The still-low level of bond yields does not cease to be somewhat paradoxical against the background of the prevailing economic boom, high budget deficits and substantial increases in oil prices. Indeed, it reflects the persistence of notably lax financial conditions in most countries. In this setting of ample liquidity, stock exchange indices trended very favourably in 2004, with



SOURCES: JP Morgan, National Statistics and IFM

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

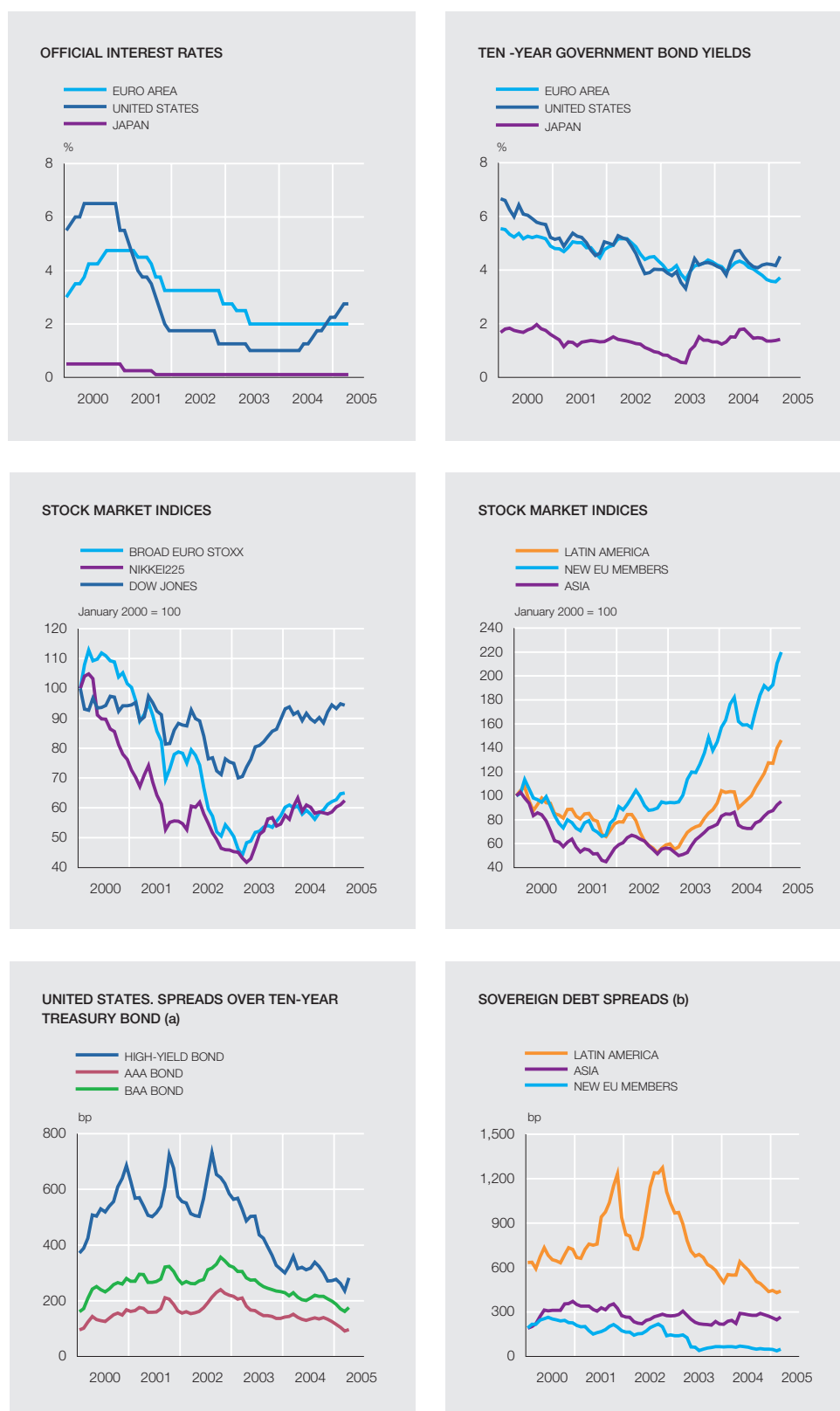
b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.

c. Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Philippines, Singapore and Taiwan.

d. Czech Republic, Hungary, Poland, Slovenia and Slovakia.

e. (+) surplus, (-) deficit.

f. Country aggregates based on IMF (WEO) definition.



SOURCES: Banco de España and Bloomberg.

- a. Moody's BAA and AAA industrial bonds, and Standard and Poor's B2-rated high-yield bond.
 b. EMBI + for Latin America and Global EMBI for Asia and Central and Eastern Europe.
 c. Hungary and Poland.

gains on most world markets, and there was a continuation of the reductions in risk premia on corporate bond markets and in the sovereign spreads of the emerging economies, which in some countries reached a level at year-end which was the lowest since these indicators were first compiled (see Chart 2.4). In addition to ample liquidity, the strong reduction in corporate debt along with the high growth and external surpluses many emerging economies have built up also contributed to these favourable financial conditions. However, the tendency towards more favourable financial conditions reversed slightly at the end of 2005 Q1, as there was a rise in US long-term interest rates accompanied by corrections on the main stock markets and increases in the spreads on corporate bonds and on the emerging countries' sovereign bonds.

In line with this boom situation on international financial markets, private capital flows towards the emerging economies increased by over 30% on 2003, the highest figure since 1997. Across the different zones, Asia was by far the main recipient of these flows, accounting for two-thirds of the total, followed by Central and Eastern Europe. Conversely, private capital inflows fell by 15% in Latin America. Nonetheless, foreign direct investment (FDI) increased in the three major emerging areas, reversing the slowdown seen the previous year in Central and Eastern Europe and in Latin America. Portfolio flows and bank loans were positive in Asia and Central and Eastern Europe, but highly negative in Latin America, which contrasted with the favourable trend of FDI (see Chart 2.5). Further, official financing flows in Latin America turned negative once the recent crises were behind, in contrast to the sizable financing received from international financial institutions in the three previous years. FDI flows to emerging countries offset the slowdown – for the fourth year running – in those to industrialised countries, which meant that total FDI increased in 2004 for the first time since 2001, albeit only by 6%.

World trade expanded notably in 2004, at a rate close to 10%. That exceeded the trend of the last 30 years, which had stood at around 7% (see Chart 2.5). Assisting this pick-up was the strong economic growth in areas with a high impact on world trade in volume terms, the case of the United States and China, or in terms of the high degree of openness, as is the case of the rest of the emerging Asian countries. On the other hand, headway in trade liberalisation was relatively limited. The Doha round only managed to reach a basic agreement in July on “negotiation frameworks” for agriculture and industrial products, the details of which are expected to be released in the forthcoming ministerial conference in December in Hong Kong. The ongoing tendency for the regionalisation of trading agreements continued both in Asia and in Latin America, although little of substance has actually materialised so far. Lastly, January 2005 saw the implementation of the final phase of the gradual elimination of the Multifibre Agreement, which had restricted international trade in textiles over the last fifty years, and whose effects might be felt almost immediately.

Regarding the prospects for the current year, the most likely scenario points to continuity in growth, albeit at a lower and therefore more sustainable pace than in 2004. This is in step with the developments observed in the second half of the year in many countries, in a setting of presumably less expansionary monetary and financial conditions in the future. This growth would, however, continue to be uneven: China and the rest of the emerging Asian countries would increase their contribution to world growth to almost 50% in 2005, while doubts about the continuity of the recovery in Japan and the euro area persist. World trade, meanwhile, would slow slightly, in line with the foreseeable deceleration in growth. Inflation rates are expected to remain contained, despite the fresh increase in oil prices in 2005 Q1, thanks to the likely increase in official interest rates to levels closer to those considered neutral and to the favourable behaviour of inflation expectations.

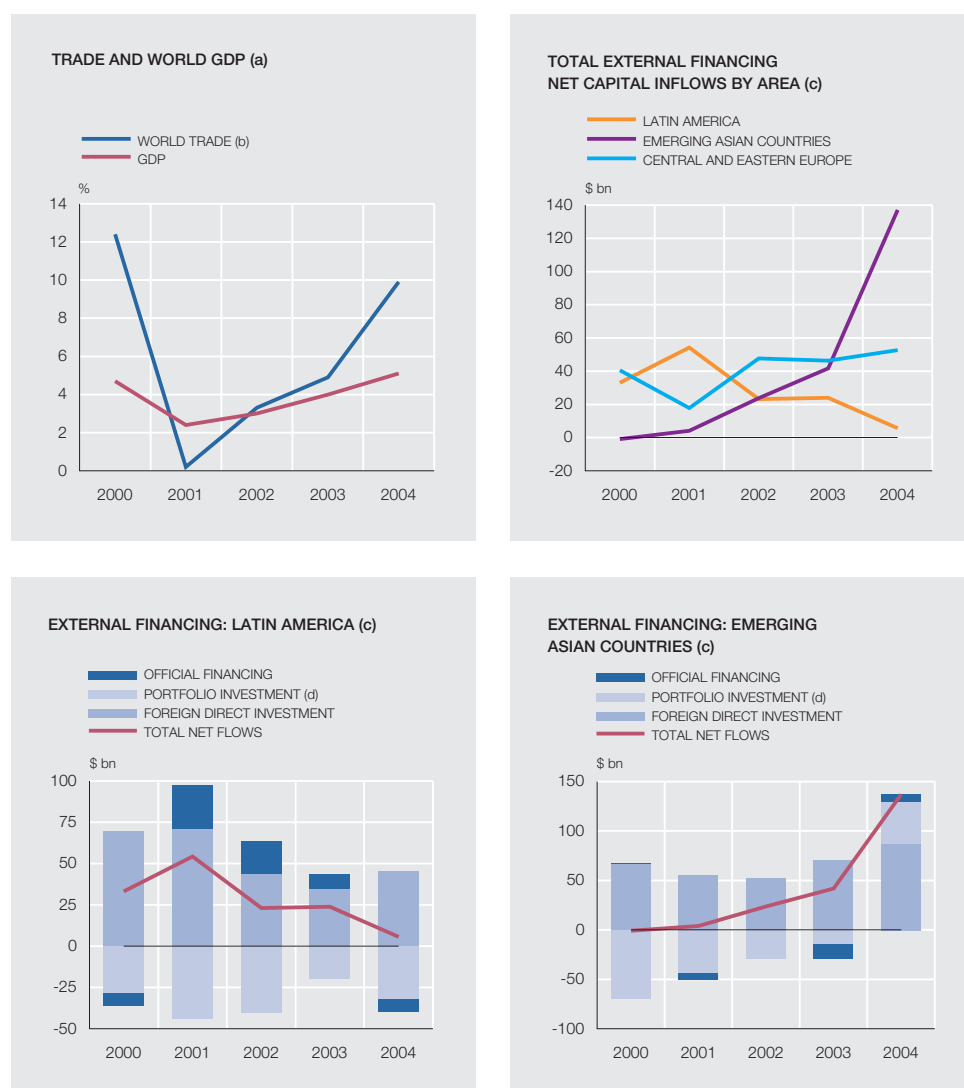
However, there are several risks linked to this central scenario. First, it is worrying that the recent growth revisions should have improved the outlook for the most dynamic countries or regions and worsened that for those most lagging in the cycle, which would point to a deterioration in global imbalances. Moreover, a sharp change in the behaviour of the investors financing the US external deficit – e.g. lower purchases of dollar-denominated assets by Asian central banks or a restructuring of their international reserves with a move towards other currencies – could prompt instability on currency markets. That could in turn induce sudden and marked increases in long-term interest rates, with potential effects on corporate risk and sovereign spreads, and on the price of financial and real-estate assets. There is also a risk that long-term interest rates may increase sharply in the event of a significant worsening of the US inflation outlook. Accordingly, a disorderly adjustment of global imbalances or the emergence of inflationary pressures would very probably entail a significant reduction in world growth, since part of the recent economic boom has been underpinned by an environment of ample liquidity, highly favourable financial conditions and, in some countries, significant increases in private-sector wealth. Another considerable risk, especially in the light of developments in recent months, is that oil prices will once again be subject to upward pressure, given that the exporting countries' scant room for manoeuvre in respect of output capacity means that this market is highly sensitive to geopolitical tensions or unforeseen increases in the global demand for oil. That could have an unfavourable impact on global growth and inflation expectations.

The main challenge currently facing the world economy is to maintain sustained growth rates while correcting the excessively expansionary fiscal and monetary policy stance in those countries most ahead in the cycle, and to move forward in resolving current global imbalances. Consequently, it seems reasonable that each of the main world economic areas should gear its policies to resolving its main problems. Hence, in the United States, an increase in the domestic saving rate, particularly in the public-sector saving component, would contribute decisively to halting the progressive deterioration of the country's external accounts. In Europe and Japan, meanwhile, structural reforms should improve the flexibility of their economies and strengthen their growth capacity. And in the emerging Asian countries, greater exchange-rate flexibility would help contain domestic demand pressures and bring to a halt a build-up in foreign reserves that threatens to generate inflationary pressures. These policies are not only those best suited to the particular interests of each of these areas, but they would also lead to a smoother correction of global imbalances, through more balanced growth across the various areas. Moreover, that would help stave off the risk of a sharp and disorderly depreciation of the dollar, which is no mean risk in a scenario in which international financial markets were to perceive that there is no resolve to adopt the appropriate economic policies in each area.

2 The United States: the recovery strengthens

Last year the US economy continued to grow above its long-term potential, thanks in part to the notable increase in investment, which made for an increase in GDP of 4.4%, the highest rate since 1999 (see Table 2.1). Even when doubts arose about the continuity of the economy's momentum in the wake of the heavy slowdown in Q2, these were dispelled in the second half of the year, thanks to the surge in consumption.

Over the year as a whole, growth was driven above all by domestic demand, which contributed 5 pp, while the external sector subtracted 0.6 pp, with both figures up on the previous year. On the domestic demand front, there was a notable increase in the contribution of investment and, to a lesser extent, of consumption, which respectively contributed 2 and 2.7 pp to GDP growth (see Chart 2.6). The ongoing effect of expansionary macroeconomic policies, greater household wealth (as a result of the increase in the value of their financial and real-es-



SOURCE: IMF.

- a. Annual percentage change.
- b. Total volume of imports and exports
- c. Country aggregates based on IMF (WEO) definition.
- d. Including bank loans.

tate assets) and job creation provided for a bigger increase in consumption than in 2003 (3.8%, against 3.3%). However, the most notable behaviour was that of fixed investment, the rate of expansion of which quickened from 5.1% in 2003 to 10.3% in 2004, due essentially to investment in equipment and software. This improvement in investment, which confirmed the soundness of the recovery, was supported by the generous financial conditions, reflected in low long-term interest rates and moderate risk premiums on corporate bonds, and by high corporate earnings, despite the increase in input costs, especially energy.

Following several years of labour market slackness, the increase in output at last began to be reflected in employment, with the creation of somewhat more than 2 million jobs over the course of the year. Despite this, employment scarcely regained its end-2000 levels and it continues to trend appreciably below other similar expansionary phases in previous cycles. This moderate increase in employment, against a background of strongly expanding output, trans-

	2000	2001	2002	2003	2004	2004			
						Q1	Q2	Q3	Q4
UNITED STATES									
GDP (a)	3.7	0.8	1.9	3.0	4.4	5.0	4.8	4.0	3.9
Private consumption (a)	4.7	2.5	3.1	3.3	3.8	4.2	3.6	3.6	3.8
Gross private fixed capital formation (a)	5.7	-7.9	-2.4	4.4	13.2	12.8	16.8	11.7	11.6
External demand (b)	-0.9	-0.2	-0.7	-0.4	-0.6	-0.8	-1.1	-0.1	-1.4
General government balance (c)	1.3	-0.7	-4.0	-4.6	-4.3				
CPI (a)	3.4	2.8	1.6	2.3	2.7	1.8	2.9	2.7	3.3
Current-account balance (c)	-4.2	-3.8	-4.5	-4.8	-5.7	-5.1	-5.7	-5.6	-6.3
Unemployment rate (d)	4.0	4.7	5.8	6.0	5.5	5.7	5.6	5.4	5.4
JAPAN									
GDP (a)	2.4	0.2	-0.3	1.4	2.7	4.5	3.2	2.6	0.6
Private consumption (a)	0.5	1.1	0.5	0.2	1.5	1.9	2.1	1.8	0.1
Gross private fixed capital formation (a)	2.0	-1.4	-5.7	0.9	1.6	5.2	1.8	1.5	-2.0
External demand (b)	0.4	-0.6	0.6	0.6	0.8	1.2	1.1	0.8	0.3
General government balance (c)	-7.5	-6.1	-7.9	-7.9	-7.1				
CPI (a)	-0.7	-0.7	-0.9	-0.3	0.0	-0.1	-0.3	-0.1	0.5
Current-account balance (c)	2.5	2.1	2.8	3.2	3.7	3.5	3.6	3.6	3.7
Unemployment rate (d)	4.7	5.0	5.4	5.2	4.7	4.9	4.6	4.8	4.6
UNITED KINGDOM									
GDP (a)	3.9	2.3	1.8	2.2	3.1	3.0	3.6	3.1	2.9
Private consumption (a)	4.4	3.1	3.2	2.3	3.3	3.6	3.4	3.4	3.0
Gross private fixed capital formation (a)	3.6	2.6	2.7	2.3	5.6	4.6	6.6	6.8	4.5
External demand (b)	-0.1	-0.7	-1.2	-0.4	-0.8	-0.9	-0.8	-0.9	-0.8
General government balance (c)	3.8	0.7	-1.7	-3.4	-3.2				
CPI (a)	0.8	1.2	1.3	1.4	1.3	1.3	1.4	1.2	1.4
Current-account balance (c)	-2.5	-2.3	-1.7	-1.7	-2.2	-2.0	-1.9	-3.2	-1.7
Unemployment rate (d)	5.4	5.1	5.2	5.0	4.7	4.8	4.8	4.7	4.7

SOURCES: IMF and national statistics.

a. Annual percentage change.

b. Contribution to the increase in GDP.

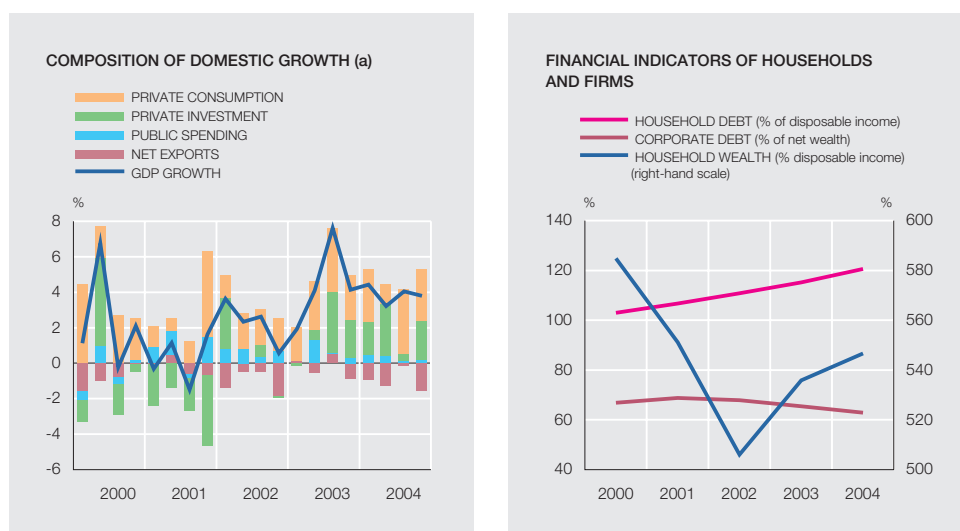
c. Percentage of GDP. In the case of the United Kingdom, the general government balance incorporates the Maastricht criteria.

d. Percentage of the labour force. Average for each period.

lated into an additional rise in labour productivity. This variable increased by 4% in 2004, only slightly below the rate for 2003 and 2002, although it tended to slow at the end of the year (see Box 2.2).

Inflation rose moderately during 2004, and the CPI posted a 12-month growth rate of 3.5% in April 2005, more than 1 pp up on the December 2003 figure (see Chart 2.2). Underlying inflation – excluding food and energy – also climbed, registering a year-on-year rate of 2.2% in April 2005, compared with 1.1% at the close of 2003. Neither the rise in oil prices nor the depreciation of the dollar appeared to have been reflected in a significant increase in inflation, thanks possibly to the Federal Reserve's anti-inflationary credibility and its clear communication policy, to the limited pass-through of the dollar depreciation to final product prices and to the strong growth of productivity, which provided for a containment of unit labour costs. However, the latest data would suggest a deterioration in inflationary risks in 2005, due in part to a possible reversal of the last two factors.

The start of the expected upward cycle of interest rates in mid-2004 led to gradual increases in the official interest rate of 25 basis points apiece at each of the Federal Reserve's Open



SOURCES: National statistics and Federal Reserve.

a. Contributions to annualised quarterly GDP growth.

Market Committee meetings, which raised it from 1% in early 2004 to 2.75% in April 2005 (see Chart 2.4). Despite these increases, the official rate is still below the levels that might be considered neutral, which explains why the financial markets continued, in early 2005, to expect an additional and gradual increase during the current year. From the outset of the upward cycle, the Federal Reserve's communication policy clearly conveyed to financial markets that the rise in rates would be measured and orderly, although it also underscored that it would respond rapidly to changes in the economic outlook, to preserve price stability. Apart from being conducive to a containment of inflation expectations, the Federal Reserve's strategy contributed to a climate of relative calm on the financial markets in the face of the change in monetary policy stance, which in turn partly explains the moderation of long-term bond rates and the prolongation of the setting of ample liquidity in which US and, by extension, international financial markets moved.

The favourable tone of financial markets contrasted vividly with a US fiscal policy that remained strongly expansionary in 2004. The budget deficit declined only slightly, from 4.6% of GDP in 2003 to 4.3% in 2004 (see Chart 2.3), despite the fact that high economic growth would have allowed more ambitious fiscal consolidation targets to be reached. The US fiscal imbalance was once again among the highest, in relative terms, of the major economic regions, behind only that of Japan, due in part to the increase in defence spending of over 12%. True, the recent draft budget for the fiscal year commencing October 2005 incorporates a reduction in the deficit to half its current level by 2009. But there are major risks that this forecast will not be met, owing both to the possibility of this proposal resulting in a less ambitious programme in its passage through Congress, and to the likely supplementary expenditure on defence and the reform of the minimum alternative tax, which have not been envisaged in the draft budget.

The bloated budget deficit is a major source of vulnerability and, along with low household saving rates, contributes to maintaining the sizable US external imbalance, which was on a markedly rising course during 2004. This was due above all to an acceleration in imports, reflected in the deteriorating trade balance which ran a deficit of 5.3% of GDP, more than half of which was attributable to the trade deficit with China and, to a lesser extent, with the Euro-

From the early seventies to the mid-nineties, hourly productivity in the US non-farm corporate sector held at an average growth rate scarcely above 1.5% per annum (1.3% if we refer to productivity per person). That is a very low figure on past experience in the United States and in other developed economies. From 1996 to 2001, however, the growth of hourly productivity climbed to an average of 2.5% per annum (2.1% per person), which contributed to the initial talk about the existence of a “new economy” in the United States. Since then, productivity (both hourly and per person) has continued accelerating, exceeding 4% per annum in each of the last three years. And that despite a series of adverse events, such as the bursting of the technological bubble and the 2001 recession, the geopolitical tensions after the 11th September attacks, corporate scandals and, more recently, the strong increase in energy costs.

Given such a favourable performance of productivity in recent times (see adjoining chart), the key question is whether what is involved is a structural change that will last in the coming years or a temporary phenomenon. Indeed, productivity usually fluctuates with the business cycle, meaning that the estimates based on averages for several years are sensitive to the definition of each period and to the intensity of the cyclical effect at each point in time. Thus, at the start of a recession, companies usually keep their employees even though they produce less, which entails a decline in productivity; conversely, when the recovery begins, companies delay hiring more workers and use more intensively those at their disposal, meaning productivity increases above its long-term trend. Finally, once the expansion of activity is confirmed, companies hire more workers and the increase in productivity falls once again to more normal rates. In the case of the US economy, the increase in the trend growth of productivity in recent years appears to be confirmed by a series of recent studies¹ which take into account possible cyclical effects and which conclude that

the trend growth of productivity has risen from 1.5% per annum in the 1972-1995 period to 2.5% in the 1996-2003 period.

The most usual explanation for this acceleration in productivity is, undoubtedly, the emergence of a series of major technological advances in the past two decades and a parallel increase in investment in new information and communications technologies. The studies available on the breakdown of productivity growth show that half of the acceleration in productivity is due to an increase in the capital available per worker, and the other half to an increase in total factor productivity growth. Most of the increase in the capital available per employee has come about in the new technology-producing sector, but a rise in investment has also been seen in other sectors. As to the acceleration in total factor productivity, however, most of this has been in sectors that do not produce new technologies, especially those that intensively use such technologies (see adjoining table). This breakdown highlights, first, the important role the new technologies sector has played in the acceleration of productivity, despite accounting for only 5% of GDP; and further, its extension to those sectors – such as distribution – which use the new technologies more intensively, thereby allowing companies to improve their organisational methods, lower their costs and increase both their output and its quality.

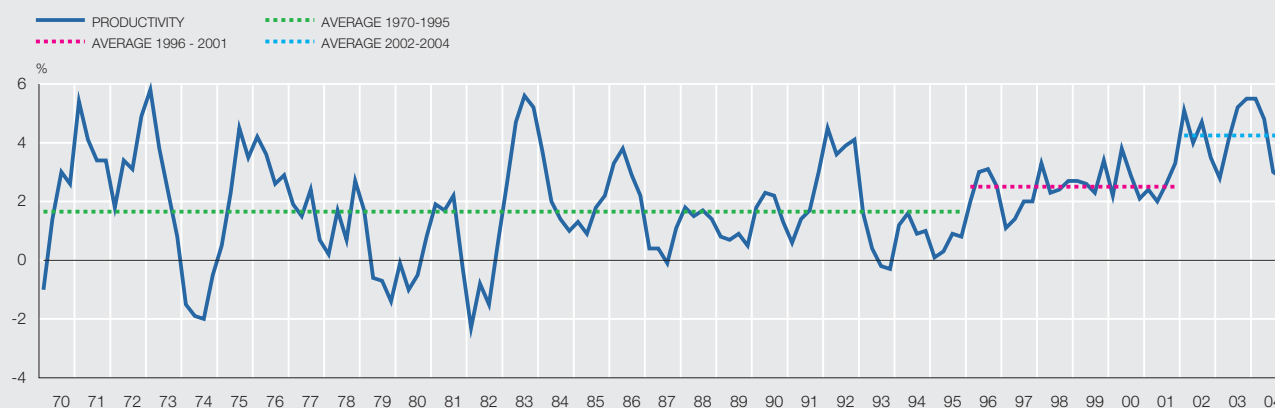
Although it is difficult to predict future productivity growth, most studies concur that these variables will grow at a similar rate to that observed since the nineties, meaning that productivity will tend to grow at around 2%-2.5% per annum. In any event, given that structural and cyclical factors have combined in the recent acceleration in productivity, it seems reasonable to believe that its rate of increase will diminish in the coming years towards rates closer to the trend figure of 2.5% of the last decade, below the figure of 4% in recent years. At present, more than three years after the end of the 2001 recession, the US economy appears to have moved into a phase of more moderate productivity growth; in the second half of 2004, productivity dipped from a rate of over 5% in early 2004 to 2.8% in 2004 Q4.

The consequences of this slowdown in productivity for activity and prices will initially depend on the intensity of the response of aggre-

1. See, for example, the paper by R. Gordon (2004), *Five puzzles in the behaviour of productivity, investment and innovation*, Centre for Economic Policy Research Discussion Paper 4414; and that by D. Jorgenson, M. Ho and K. Stiroh (2004), *Will the US productivity resurgence continue?*, Current Issues, Federal Reserve Bank of New York, December.

US PRODUCTIVITY

Annual percentage change



SOURCES: Bureau of Labor Statistics and Banco de España.

gate demand, and also on what the monetary policy reaction will be. In principle, the most significant effect of the slowdown in productivity is that the current growth rate of private spending, on consumption and investment, could not be sustained in the face of the lower expectations of future income, meaning that GDP growth would diminish. The effect on inflation would be more ambiguous. This is because, on one hand, lower productivity growth would give rise to higher unit labour costs, if wages did not moderate sufficiently. But, on the other, the lower growth of demand might contribute to con-

taining inflationary pressures. In the current scenario, in which a very sharp slowdown in productivity is not foreseen, consumption and investment spending is expected to hold at a relatively robust growth rate which, combined with higher unit labour costs, would give rise to a gradual increase in inflationary pressures. This is what appears to have happened recently, with increases in unit labour costs, following more than two years of declines, and with a gradual rise in the underlying rate of inflation. In any event, developments in prices and growth will pivot on the response of the Federal Reserve.

BREAKDOWN OF PRODUCTIVITY GROWTH

BOX 2.2

Percentage points

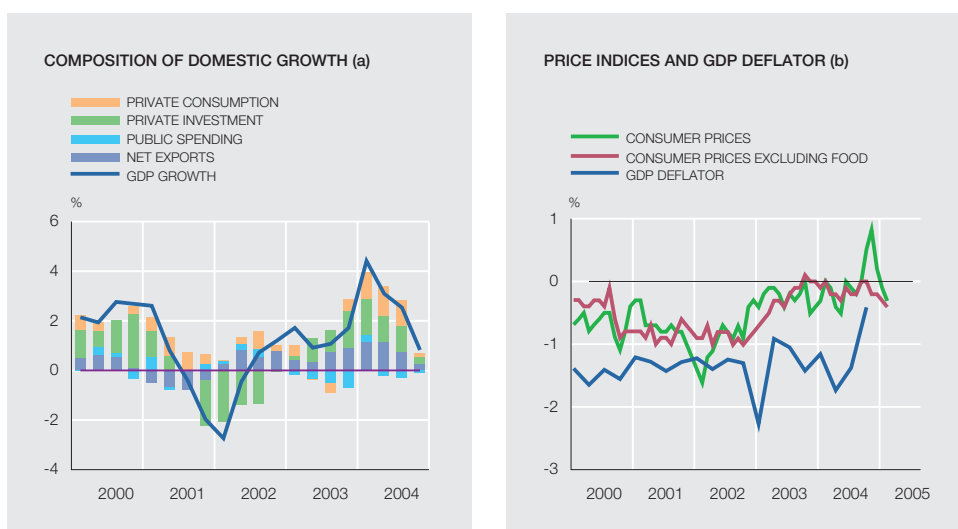
	1959-2003	1959-1973	1973-1995	1995-2003	Difference 1995-2003 1973-1995
Output	3.58	4.21	3.06	3.90	0.84
Hours	1.37	1.36	1.57	0.85	-0.73
Productivity	2.21	2.85	1.49	3.06	1.57
Capital per employee	1.21	1.41	0.89	1.75	0.86
New technologies	0.44	0.21	0.40	0.92	0.52
Other sectors	0.78	1.19	0.49	0.83	0.34
Quality of the labour factor	0.26	0.33	0.26	0.17	-0.09
Total factor productivity	0.74	1.12	0.34	1.14	0.80
New technologies	0.25	0.09	0.24	0.53	0.28
Other sectors	0.49	1.03	0.10	0.61	0.51

pean Union and Japan. The slight depreciation of the dollar in effective terms has so far proven insufficient to reverse this trend, since the buoyancy of US domestic demand is far higher than that of its main trading partners. The current-account deficit stood at 5.7% of GP in 2004, heightening concern about its sustainability in the medium and long run (see Chart 2.3).

Finally, a further factor of risk for the US economic outlook lies in real estate prices, which in certain regions would have reached levels hardly warranted by economic fundamentals. In addition, a sharp correction of such prices might jeopardise the continuing buoyancy of consumption, which has been underpinned to date by the increase in household wealth.

3 Asia: an increasingly important global role

As in previous years, Asia was one of the world's most dynamic economic regions. The emerging Asian countries saw the highest growth rate since the 1997 crisis and even Japan – whose growth was much more moderate and tended to flatten from Q2 – obtained its best results since 1996. However, there was a slowdown throughout 2004, with the notable exception of China, in line with the moderation of the world expansion. The countries in the region generally ran high current-account surpluses which, combined with strong capital inflows, saw the Asian currencies with a flexible exchange rate against the dollar appreciate or, in the case of countries with fixed – de jure or de facto – exchange-rate regimes, they contributed to Asia amassing the bulk of the increase in global foreign reserves. With the exception of Japan, where deflation continued albeit slackening compared with previous years, the region experienced some inflationary pressures.



SOURCE: National statistics.

- a. Contributions to annual GDP growth.
b. Annual percentage change.

3.1 JAPAN: UNCERTAINTY YET TO BE DISPELLED

The Japanese economy was most robust in early 2004, which proved pivotal to its annual growth figure of 2.7%, compared with 1.4% in 2003 (see Table 2.1). However, the momentum in the opening months faded notably over the rest of the year (see Chart 2.7), giving rise to a considerably uncertain outlook in the short and medium term.

During 2004, the contribution of domestic demand to GDP growth increased by 1.2 pp to 1.9 pp, due mainly to private consumption, while that of external demand rose by only 0.2 pp to 0.8 pp. That suggests a recovery that is more home-grown and less dependent on the rest of the world. Nonetheless, there were very strong slowdowns during the year in private consumption and investment. The slowdown in consumption came about despite the improvement in the labour market, which made for a reduction in the unemployment rate to 4.7%. Exports and private investment – linked largely to the external sector – felt the impact of the weakness of the global demand for ICT-intensive products despite the strong increase in Japanese corporations' earnings and solvency. That said, the Japanese external sector was most buoyant, with the annual rate of increase of exports and imports quickening to 14.4% and 8.9%, respectively, making for a widening of the current-account surplus to 3.7% of GDP. The exchange rate of the yen against the dollar appreciated over the year as a whole, but weakened subsequently, meaning that by April 2005 it had virtually resumed its end-2003 level. Between these two latter dates, the yen depreciated in nominal effective terms by 2.4%. The Japanese authorities intervened very heavily on the foreign-exchange markets until March 2004, whereafter they announced they were halting currency-purchasing transactions. As a result of the policies of recent years, Japan's foreign reserves, by far the highest in the world, rose to \$824 billion, an increase of 26% over the past year.

Despite higher economic growth, the problem of deflation in the Japanese economy persisted. The annual rate of change of the CPI over 2004 as a whole was 0%, a slight improvement on the previous year's figure of -0.3% (see Chart 2.7). However, deflation returned in the opening months of 2005, meaning it remains one of Japan's main sources of vulnerability, especially if the slowdown in economic activity continues and the appreciation of the yen against the dollar becomes sharper.

The monetary policy of the Bank of Japan retained its expansionary tone, manifest mainly in the increase in the monetary base and in the official interest rate continuing at close to zero (see Chart 2.4), aimed at providing for a permanent exit from deflation. The stock markets trended favourably and the solvency of the banking system also improved, with a reduction in non-performing loans and stronger balance sheets, especially for the main banks. As a result, in September 2004 the Bank of Japan announced the end of its policy of purchasing shares from commercial banks' portfolios, which it introduced in 2002 in order to shore up the stability of the financial system.

The high budget deficit fell only slightly in 2004 to 7.1% of GDP (see Chart 2.3), while public debt held on a growing path and rose to 164% of GDP, the highest ratio among the OECD countries. The reduction of the Japanese budget deficit was largely due to the cut in public investment, which was 10.4% down on 2003. Following years of expansionary fiscal policies aimed at emerging from the recession, one of the main challenges facing the Japanese economy continues to be the orderly reduction of the sizable fiscal imbalance that has built up, but without precipitating a sharp adjustment such as that of 1997, which might prompt a loss of momentum in domestic demand and exacerbate deflationary pressures.

Admittedly, there has been headway in recent years in strengthening the financial position of the banking industry and of corporations. But it is vital that the Japanese economy should further reform in order to ensure the prolongation of the economic recovery and the end of deflation. In this respect, achieving a higher return on and capitalisation of the banking system, along with a reduction in corporate debt, will provide essential support to investment and to increasing growth potential.

3.2 CHINA: THE OTHER DRIVING FORCE OF WORLD GROWTH

As in previous years, China's importance in the global economy continued to increase during 2004. This significance ranges from its share of world GDP – now at 13% in purchasing power parity terms – and trade flows and investment, to its role in the changing demand for commodities and in the financing of the global imbalances (see Box 2.3). Chinese GDP growth in 2004 stood at 9.5%, the highest of the main world economies. It was underpinned by buoyant exports and investment in fixed assets, which combined, on the supply side, with excellent results in the agricultural sector. In the first half of the year, set against the strong growth in activity and the worrying rise in prices, the Chinese authorities adopted a broad range of monetary, fiscal and administrative measures. These were aimed at tempering the expansion of aggregate demand, a goal only very partially achieved in the second half of the year.

In step with the vigour of output, annual inflation rose in 2004 and peaked at 5.3% in August, falling subsequently to 1.8% in April 2005 (see Chart 2.2). This increase was mainly due to the strong rises in food prices (which followed a similar pattern to that of inflation during the year), but also to cost pressures, including wage increases and electricity supply restrictions. All these factors were reflected in producer prices, which posted a year-on-year increase of 7.1% in December 2004, notably up on the related figure of 3% a year earlier.

The external sector continued to perform very dynamically in 2004. The volume of both exports and imports grew by 28%, and the current-account surplus increased significantly to 4.2% of GDP. Under a fixed-exchange-rate regime against the dollar, this surplus, combined with notable capital inflows, led to a 50% increase in international reserves, which rose at end-2004 to \$610 billion. At the global level, that places China second only to Japan in terms of the volume of reserves. The notable build-up in reserves in China in recent years has fuelled expectations of a potential revaluation of the renminbi, either in the form of a one-off revaluation of the currency while maintaining the fixed exchange-rate regime, or under the

Two decades of reforms geared to the transition to an open market economy have transformed China and changed its role on the international economic stage. Since the onset of the reforms in 1978, real average GDP growth has exceeded 9% in annual terms and per capita income has increased sixfold. After joining the World Trade Organisation (WTO) in 2001, a landmark in China's relationship with the world, real GDP growth has quickened, standing at an annual rate of 9.5% in 2004 (see panel 1). Such dynamism has made China the chief contributor to world growth in 2004 in purchasing power parity (PPP) terms. Indeed, China contributed 1.2 pp (24%) of the figure of 5.1% for global growth in 2004. China's weight in global GDP amounted to 13% in 2004 in PPP, just behind the United States (21%) and the EU (21%) (see panel 2). On estimated trends, incorporating relatively high – though declining – rates of potential growth, and which assume a smooth transition to a less interventionist economic system, China could become the leading world power in terms of GDP in less than 40 years¹.

In the light of the foregoing, China has a preponderant role in the global economic scenario, with major consequences, including most notably the change in the pattern of trade flows and of foreign direct investment (FDI). Moreover, China has contributed substantially to the rise in global demand for commodities and oil. Finally, as described in the introduction to this chapter, China has played a key role in movements in global imbalances.

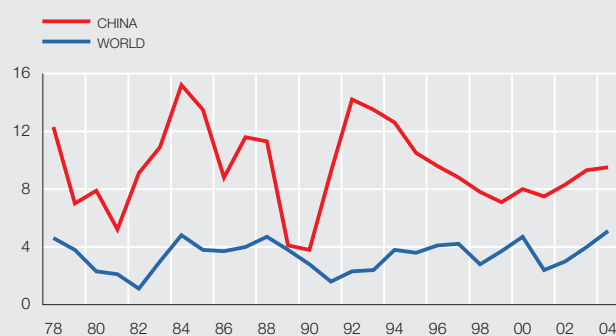
As regards international trade, Chinese exports and imports have grown at annual rates of close to 15% since the start of the reforms and have accelerated to over 30% following WTO membership. Further, there has been a change in the composition of exports and imports. First, the weight of exports of electronic products has more than doubled (from 17% in 1993 to 43% in 2003), while that of other manufactures has fallen (from 65% to 49% in the same period). In turn, the composition of imports has altered: those intended for assembly, processing and subsequent export, essentially from the rest

of Asia, have increased from 35% in 1993 to 40% in 2004. In parallel, the weight of imports of electronic goods has risen from 31% in the early nineties to 47% in 2003. This change in the composition of Chinese trade reflects a growing process of productive integration in the Asian region, in which China provides relatively cheap skilled labour for the manufacture of intermediate goods imported from the rest of Asia for re-exportation to other developed economies. As a result of this regional integration, China's trade deficit with the rest of Asia has widened, while its trade surplus with the United States and with the EU has increased strongly (see panel 3). Overall, the Chinese trade surplus has held stable at a level of slightly more than 2% of GDP. In addition to the build-up in growing bilateral surpluses or deficits, third countries have been affected in different ways by Chinese trade expansion, depending on the degree of complementarity or substitutability of their trade structure with China. Among the beneficiaries have been the intermediate-good and commodity-exporting countries. Among those adversely affected are the countries with highly labour-intensive exporting industries, which have experienced strong competitive pressure from low Chinese labour costs.

Another factor behind the surge in Chinese growth is the capacity to attract FDI flows. China has become the world's leading recipient of FDI, with a total of \$61 billion in 2004 (see panel 4), placing it in third position in terms of the stock of FDI behind the United States and the United Kingdom. Nonetheless, this figure might be overestimated owing to financial flows abandoning China for tax reasons, generally to Hong Kong, and which then return in the form of FDI, a phenomenon known as roundtripping. Foreign companies, mainly Asian ones (revealing another important aspect of regional integration), have been attracted by two factors: first, by the strong Chinese economic growth, its big population and its growing domestic demand; and further, by its comparative advantage as an export platform, thanks to a skilled labour segment and to its low labour costs. And accompanying these have been a relative improvement in legal protection for investors and the ongoing liberalisation in certain industries, namely distribution, telecommunications and financial services, following WTO membership. FDI flows have been concentrated in manufactures, property and energy infrastructure. However, a portion of

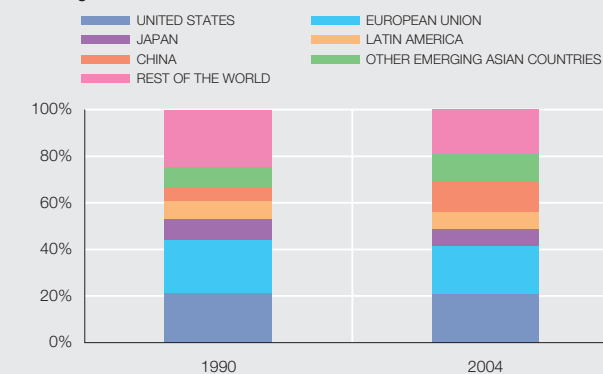
1. See D. Wilson and R. Purushothaman (2003), *Dreaming with the BRICS*, Goldman Sachs.

1. GDP GROWTH
Percentage



SOURCE: IMF.

2. WEIGHT OF ECONOMIES IN WORLD GDP
Percentage of total

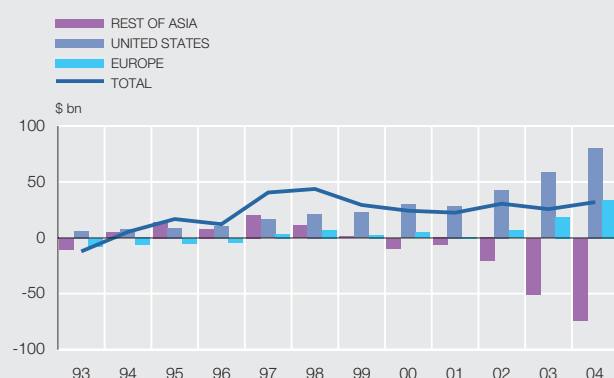


investment is routed increasingly towards the production of goods with a high technology-intensive component made by highly skilled human capital, IT applications being a case in point. Recently, Chinese FDI abroad has also increased, albeit from very low levels (from \$785 million in 2001 to \$3.6 billion in 2004). Even so, this remains practically negligible when compared with incoming investment.

Lastly, the increase in China's demand for commodities and energy products represents a significant change for the world economy, and has pushed prices upwards. In 2003, China became the

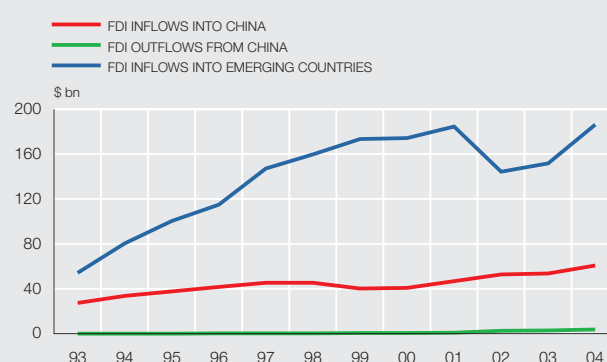
world's leading importer of copper, steel and cement, and among the biggest buyers of iron ore and aluminium. Moreover, Chinese demand for oil in 2004 ranked it second worldwide, with 32% of the increase in global demand attributable to it, a figure higher than its contribution to world growth, which is indicative of its inefficient energy use and of the shortcomings of its energy infrastructure. Far from being a transitory effect, Chinese demand for oil is expected to increase even further in the coming years owing to continued economic growth and to the future development of its stock of motor vehicles.

3. CHINESE TRADE BALANCE VIS-A-VIS:



SOURCES: Administración de Aduanas, Chinese statistical office and IMF.

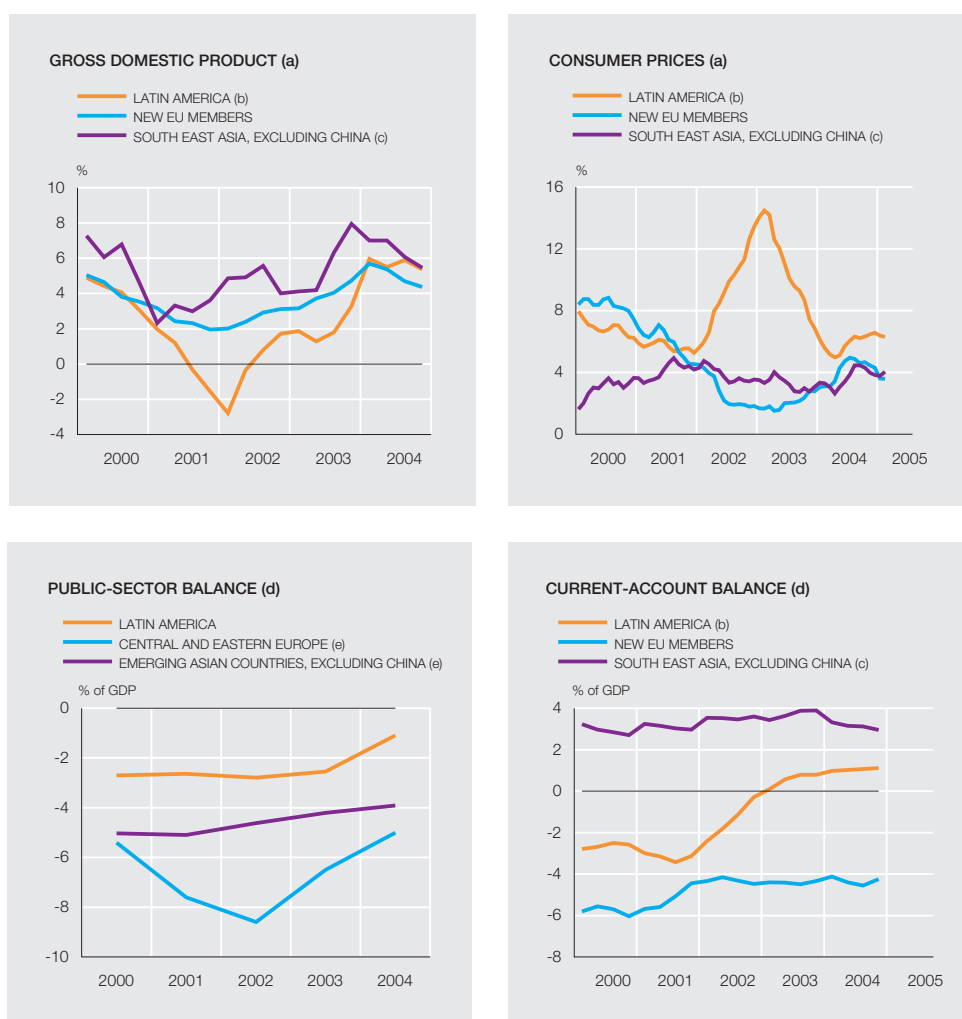
4. FOREIGN DIRECT INVESTMENT FLOWS



adoption of a more flexible exchange rate regime, which the Chinese authorities have announced as desirable in the medium term. Although the renminbi held constant in nominal terms against the dollar, its nominal effective exchange rate depreciated by 3.7% between December 2003 and April 2005, owing to the weakness of the US currency against third currencies. The poorer performance of prices in China, however, cancelled out these gains in competitiveness, meaning that the real effective exchange rate held relatively stable throughout the year (see Chart 2.3).

Monetary policy was geared towards moderating the buoyancy of economic activity through the restriction of bank credit, the lower growth of the monetary base and the as yet very incipient rise in interest rates, with the added goal of sterilising the rapid build-up in foreign reserves. Fiscal policy contributed to reducing the vigour of demand through cuts in public investments and curbs on local government spending. The budget deficit declined slightly on the previous year to 2.4% of GDP. An even bigger reduction in the deficit would seem appropriate in order to contain domestic demand and to tackle major unresolved issues, such as the restructuring of the financial sector and the foreseeable increase in social demands in the medium term.

One of the main challenges facing the Chinese economy is to steer the forceful current pace of growth towards rates more sustainable in the long term, warding off the danger of a hard landing for the economy that could potentially have unfavourable repercussions globally. In



SOURCES: National statistics and IMF.

- a. Annual percentage change.
 b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
 c. India, Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines.
 d. Surplus (+) or deficit (-)
 e. Country aggregates based on IMF (WEO) definition.

turn, China's trading and financial integration at the international level has been growing, especially since it joined the World Trade Organisation. As a result, it is not only important to pursue macroeconomic policies preventing an overheating of the economy, but also to move ahead with the reform of the banking industry and of State-owned corporations, so as to achieve a more efficient allocation of resources.

3.3 OTHER ASIAN COUNTRIES: ECONOMIC DYNAMISM AND THE BUILD-UP OF RESERVES

Growth was also high in 2004 in the remaining emerging Asian economies. This dynamism was partly due to the beneficial effect of demand from China, which has become an important export market for the region, and to the reinvigoration of domestic demand, the contribution of which to GDP increased in 2004 (see Charts 2.1 and 2.8). Growth eased slightly in the second half of the year, in line with the slowdown in the pace of activity worldwide. Another reason was the strong downward correction of semiconductor market returns, a product which accounts for a significant portion of the exports of a large number of the region's countries. Even though the tsunami that hit the Indian Ocean coastal countries was devastating in terms of human lives, its effect on GDP in the area was relatively small, owing to the limited dependency on the

industries most affected, namely tourism and fishing. The outlook for 2005 points to a slight slowdown in growth, with the possible exception of India, although a faster-than-expected deceleration in the Chinese economy could jeopardise the other Asian countries, given the growing trade integration in the region and their greater dependency on China.

Inflationary pressures increased to some extent in the region, especially in the second half of 2004 (see Chart 2.8). The causes were strong economic growth and the rise in oil prices, although energy subsidies in some countries helped prevent bigger increases in final prices. At the same time, the ongoing reduction in budget deficits continued, with the significant exception of India. The Indian deficit was 9.5% of GDP in 2004, and its public debt now stands at 83% of GDP. In the face of inflationary pressures in the second half of 2004, monetary policies became moderately tighter in most of the region, with the exception of South Korea, where the strong appreciating trend of the won and the weakness of domestic demand advised against a rise in interest rates. The persistence of high current-account surpluses – except in India – and strong capital inflows, set against substantial aversion, in general, to accepting an appreciation of exchange rates, made for a substantial build-up in foreign reserves (see Chart 2.3) which have been only partly sterilised. The foreseeable maintenance of high current-account surpluses and strong capital inflows poses a significant challenge to the region, as the recent pace of the build-up in reserves seems hardly sustainable and the difficulties of sterilising them tend to generate an increasingly greater clash between the goals of reducing inflation and avoiding the appreciation of exchange rates against the dollar. In any event, in terms of consistency between monetary policies and external competitiveness objectives, the Asian countries appear to be paying increasing attention to the exchange-rate strategy of the Chinese authorities, whose economy is becoming the main destination for exports from the rest of the region.

4 Latin America: recovery, external surpluses and the persistence of certain vulnerabilities

Latin America posted a growth rate of 5.9% in 2004, the highest since 1980, allowing it to entrench the process of recovery initiated in 2003. The momentum of growth held up throughout the year, though signs of a slight easing of activity began to be discernible in early 2005 (see Chart 2.8).

The economic boom in the region was sustained mainly by domestic demand, which took root as the main driving force of growth in 2004 and accounted for virtually the entire increase in GDP during the year, in contrast to its contribution of practically zero the previous year. The composition of domestic demand was also more balanced, with a notable acceleration in investment, while consumption remained solid. Investment was boosted by more favourable financial conditions and by export growth, while the recovery in the labour market was the determining factor behind the buoyancy of consumption. Employment grew at a rate of over 3.5% in 2004 for the region as a whole, while real wages picked up partially from the depressed levels of the previous years, especially in countries such as Brazil and Argentina, where the adjustment had been sharper.

Conversely, the contribution of external demand was virtually nil, although the growth of the value of exports and imports was very high, at around 30% in both cases. Contributing, in the main, to the continuing buoyancy of exports were commodity prices. That entails a further improvement in the region's terms of trade, especially in those countries with a higher proportion of mineral and oil exports, such as Chile, Venezuela and Peru. From a geographical standpoint, Chinese demand played a significant role in the high growth of exports. Consequently, the Latin-American trade balance showed a surplus of over 4% of GDP, 3 pp of which were attributable to the improvement in the terms of trade. In turn, the current-account balance ran a surplus in excess of 1% of GDP, the coincidence of which with a period of strongly dynamic

activity is unparalleled in the history of the region. Hope can thus be harboured regarding the possibility that the external imbalances will not ultimately quash the economic expansion on this occasion, as has frequently happened in the past. The process of trade integration made little headway, especially as far as the Free Trade Area of the Americas agreement and that of the EU with Mercosur were concerned. Admittedly, however, numerous intra-regional agreements were signed, albeit with a more symbolic than substantive effect.

Against this favourable domestic and external background, the start of the upward interest-rate cycle in the United States did not have the feared adverse affect on Latin America. On the contrary, sovereign spreads resumed their pre-Asian crisis levels, and in some countries they were at low values not seen since this type of indicator first began to be compiled (see Chart 4). However, net capital inflows declined notably compared with the previous year, although their composition tended to be more favourable: foreign direct investment increased, discontinuing the declining trend in train since 2001, while official and portfolio flows fell, pointing to a greater permanence and stability of capital.

Sound economic and financial conditions drove prices upwards on Latin American stock markets which, along with those of the new EU Member States, were the best performers in 2004, especially in the second half of the year (see Chart 2.4). In step with the favourable economic environment, Latin American currencies appreciated by 7.9% against the dollar between December 2003 and April 2005, although the nominal appreciation was restricted to 4.5% against their trading partners as a whole and amounted to 11.4% in real effective terms (see Chart 2.3). The rising trend of the Latin American currencies became stronger in the second half of 2004, while their foreign reserves increased by \$22 billion over the course of the year. The Brazilian real and the Mexican peso appreciated notably, thereby breaking the falling trend on which they had been moving since early 2002. The divergence between the exchange rate against the dollar and that against other currencies exerted a very favourable impact. Specifically, it enabled a lower financial burden – owing to the preponderance of public and private agents' dollar-denominated external liabilities – to be reconciled with limited losses in terms of competitiveness against the broader group of their trading partners.

The continuing economic recovery, a comfortable external position and favourable financing conditions prompted a reduction in the degree of vulnerability and an improved economic and financial outlook, which translated in turn into upward revisions of sovereign ratings in many countries. Nonetheless, certain factors of vulnerability remain in place and some indicators, such as public and foreign debt as a percentage of GDP, are notably higher than in the mid-nineties (see Box 2.4). That indicates the need to reduce levels of debt and to improve its composition in terms of maturities and currencies, to move ahead with reform – which in general has remained relatively stagnant in recent years – and to reinforce the discipline of macroeconomic policies in order to entrench stability and increase growth potential.

Aggregate inflation in the area was subject to certain vagaries: it fell in the opening months of 2004 to 4.9% year-on-year in April, but increased thereafter to close the year at 6.5%, holding at 6.7% in April 2005, driven by the acceleration in activity and price pressures from the more volatile components (see Chart 2.8). The behaviour of underlying inflation was more favourable, declining in the course of the year to 5.8% year-on-year in April 2005. In the case of Mexico, the rise in the overall price index meant the explicit inflation target was not met, while in Brazil the rate of change of prices at the end of the year was close to the upper limit of its target band. The surge in inflation since end-2004 is more worrying in Argentina, since that might hinder economic recovery. In step with deteriorating prices, monetary policies in the region acted preventively, adopting a tighter stance which became extensive over the course

The recent positive economic and financial performance suggests that Latin America might have left behind a long period of financial turbulence, the result of which was a sharp fall in growth and in external financing. Financial vulnerability indicators for Latin America as a whole faithfully reflect the vagaries of the region in recent years. From 1996 (before the start of the sequence of emerging market crises) to 2002 these indicators worsened markedly, while in the past two years there has been a remarkable improvement. Nonetheless, and although the outlook remains favourable, the financial fragility characterising the region has far from been overcome.

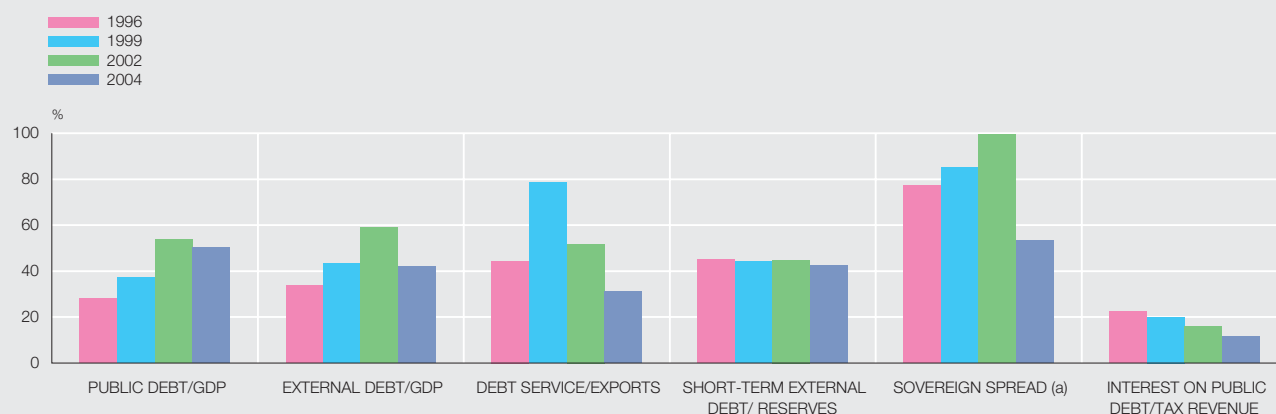
The persistence of vulnerability is reflected in the high level of certain indicators, which are even higher than those before the crisis in the regional aggregate and in many of the countries, as is the case of the ratios of public debt and external debt to GDP (see panel 1). Other indicators, such as external debt service in proportion to exports or interest payments on public debt as a proportion of tax revenue, have fallen considerably. Regarding public debt, a ratio at 50% of GDP may not seem excessive in comparison, for example, with those recorded in many EU countries. However, Latin America suffers from

what has recently been coined as debt intolerance¹, owing to the greater financing costs these countries tend to bear and, above all, to the changing nature of the international capital markets, which may prevent access to such markets. Given these conditioning factors, the critical thresholds of public and external debt sustainability are substantially lower for Latin America than for the developed countries and, in certain countries of the region, they may be considered to be below the current levels.

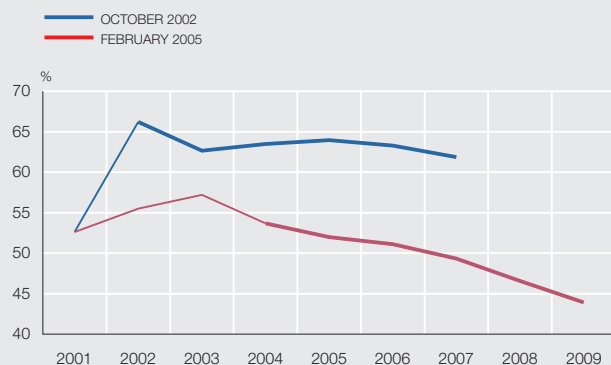
Debt intolerance has its roots in a long history of financial crises and debt restructuring in the region. But other factors continue to come into play, such as the limited degree of trade openness, insufficient economic stability and institutional shortcomings. The main consequence of these is the difficulty of issuing local-currency-denominated debt on international markets (and even in the local market) at a sufficiently lengthy maturity. That implies a short-maturing debt composition, skewed towards foreign currency or, in other cases, indexed

1. C. Reinhart, K. Rogoff and M. Savastano (2003), *Debt Intolerance*, NBER Working Paper 9908.

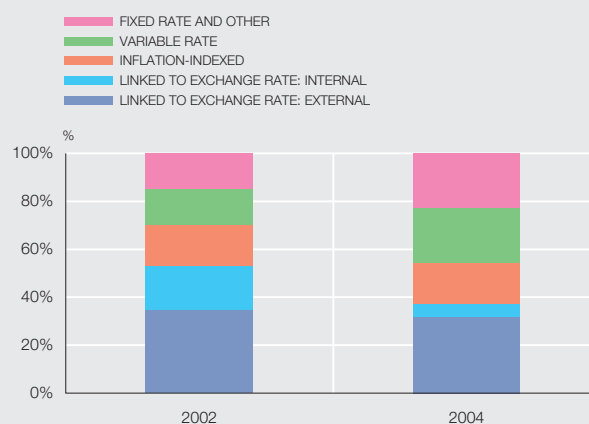
1. LATIN AMERICAN VULNERABILITY INDICATORS



2. SUSTAINABILITY OF PUBLIC DEBT IN BRAZIL (FORECAST PUBLIC DEBT AS % OF GDP) (b)



3. PUBLIC DEBT COMPOSITION IN LATIN AMERICA



SOURCES: National statistics and Banco de España.

a. JP Morgan's EMBI+ spread, multiplied by 10.
b. Thicker part of line: forecasts.

to other financial variables: the exchange rate, interest rates or the inflation rate. Such characteristics translate into a high sensitivity of public debt, and of vulnerability indicators in general, to financial conditions, in particular to changes in the exchange rate and in interest rates. At times of turbulence, the exchange rates tends to depreciate and financing costs to rise, leading to an increase in public and external debt. As a result, there is a risk that debt will move onto an unsustainable growth path in the medium term, even when starting from moderate ratios. Investors' perception of this type of situation serves only to exacerbate the problem, exerting additional pressure on financial variables and fiscal sustainability, leading to an often almost intractable vicious circle. Brazil underwent such a situation in 2002. As can be seen in panel 2, for the case of public debt, the then-estimated profile, even under the assumption of a progressive improvement in financial conditions, was not clearly declining and, therefore, doubts were cast on the sustainability of debt in the medium term. Nonetheless, it was possible to correct the situation thanks to a disciplined economic policy mix and external support, which were conducive to a resumption of market confidence. The contrast with the estimated debt profile under the assumptions currently wielded by the markets – including the continuation of current financial conditions – is striking, signalling a clearly declining path. It may be inferred from this example that any future tightening of financing conditions would be reflected adversely and immediately in vulnerability, which might reverse recent progress in this area.

In any event, in recent years there has admittedly been significant progress in reducing vulnerability. For one thing, headway in terms of macroeconomic stability has been notable. The control of inflation is a significant achievement of the past decade, which has taken root

against a background of flexible exchange rates. Price stability and exchange-rate flexibility tend in principle to reduce economic and financial volatility, contributing to entrenching investor confidence and, therefore, to reducing vulnerabilities. More recently, notable progress has also been seen in the fiscal realm, as reflected in the presence of primary surpluses – some of which very substantial – virtually across the whole region. More notable still, given the intensity involved, is the effort being made in these countries to structure public debt in such a way as to reduce its sensitivity to sharp changes in financial conditions. The favourable situation of the financial markets eases this task, which draws on the growing consensus that the excessive exposure to floating-rate debt or debt linked to exchange rate developments may have potentially very harmful effects on financial stability. Thus, as panel 3 shows, debt linked to the exchange rate (external debt, issued in foreign currency, and domestic debt, in instances in which it is indexed to the exchange rate) has successfully been reduced to a notable extent in the past two years, while floating-rate debt has grown moderately. That said, in certain cases these changes have been made at the expense of reducing bond maturities. As a result, the share of the two types of debt most sensitive to financial conditions has been reduced in the aggregate by around 10 pp, although it is still high (60% of the total). Fixed-rate debt has increased by about 8 pp to 22% of the total, and the weight of inflation-indexed debt has held at around 16% of the total.

In any event, since a long road lies ahead as far as reducing the degree of vulnerability is concerned, it will be necessary to persevere with these types of policies and also with structural reform, especially at this juncture in which economic and financial conditions, both internally and abroad, are favourable.

of the year to all the main countries with the exception of Colombia. The continuation of inflationary pressures in a large number of countries in the region is one of the main factors of risk this year.

One of the most favourable developments in the region in 2004 was the notable improvement in public finances. This was manifest in a reduction in the budget deficit for the area as a whole of 0.7 pp, to 1.2% of GDP, and in a widening of the primary surplus to over 3% (see Chart 2.8). Progress was across the board. In Argentina, the central government primary surplus rose to 3.9%, above the level the authorities had committed to in the IMF programme. And Brazil increased its primary surplus once again in 2004 to 4.6% of GDP, likewise above the target agreed with the IMF, while the Mexican surplus was up from 0.5% in 2003 to 0.6% in 2004. The reduction in fiscal disequilibria was compatible with an increase in primary expenditure, following a period of heavy contraction, which it was possible to finance thanks to the notable growth of revenue in a buoyant economic environment.

Regarding the region's three biggest economies, there was a forceful pick-up in the pace of activity in Brazil following three years of intense adjustment, and a growth rate of 5.2% – the highest since 1994 – was posted. Domestic demand took over from external demand as

the driving force of growth, though exports also remained robust. The renewed momentum of investment, which grew by 10.9%, and of the labour market, where both real wages and employment offset in part the heavy losses from the adjustment period, supported the resilience of domestic demand. As in other countries in the region, high economic growth combined with a surplus on current account for the first time in many years. Rounding off this scenario were favourable fiscal results, which made for a 5.6 pp reduction in public debt to 51.6% of GDP. However, prices trended less favourably, and the inflation rate at the close of 2004 stood at 7.6%. That prompted a notable tightening of monetary policy, reflected in a 300 bp hike in interest rates from September 2004 to close to 20% in April 2005. In recent years, the outlook for the Brazilian economy has improved significantly. Largely, this is due to headway in reform, which has proven compatible with a greater concern for social policy. Thanks to the greater macroeconomic stability attained, despite the recent rise in inflation, and to the improved structure of debt, the confidence of the international financial markets has progressively been restored, though factors of vulnerability remain should the climate on these markets sharply deteriorate. As a result of this more favourable picture, Brazil has not renewed the extension of its financial agreement with the IMF, signed in December 2003. This is because the agreement's aim was preventive and Brazil has in fact not needed to use it.

In Mexico, where the cycle remains closely in synchrony with developments in the industrial sector in the United States, economic activity progressively quickened during 2004. Growth for the year as a whole was 4.4%, underpinned by firmer domestic demand, while in the labour market the pick-up in employment took root. The current-account deficit held at 1.3% of GDP, since the widening of the trade deficit was offset by the increase in emigrants' remittances, which scaled new heights. In the monetary realm, inflation stood throughout the year at over 4%, the upper limit of the Mexican central bank's target range. That led to a progressive tightening of the monetary policy stance. However, in addition to maintaining disciplined macroeconomic policies, it would be highly desirable to boost the Mexican economy's growth potential. In that respect it is vital to re-launch reform, which has been relatively stagnant in recent years, despite some headway in the development of the financial sector in 2004, connected above all with pension funds.

In Argentina, the economic recovery remained robust in 2004 with growth of 9%, which placed GDP 3 pp below its 1998 level. Inflationary pressures increased during the year and especially so in the opening months of 2005. As a result, the annual inflation rate stood at 8.8% in April, in the face of which the central bank decided to tighten its monetary policy stance through stabilising the monetary aggregates and raising the yield on central bank bills. In turn, surpluses were recorded on the fiscal and external accounts, while the defaulted debt exchange concluded in February 2005 with a participation rate of 76%. The terms of the exchange signified a sizable saving in debt service, a substantial lengthening of its duration and an appreciable increase in the percentage of local-currency-denominated bonds, although public-sector debt will continue to be very high after the exchange (at around 72% of GDP), even if the debt of creditors who did not accept the offer is included. Nonetheless, the relief arising from this debt exchange should be accompanied by economic policies and structural reforms that act to sustain the growth rate achieved last year.

In sum, the current favourable economic and financial conditions offer Latin America a unique opportunity to continue moving ahead with structural reform. Such reform should allow the countries in the area to reduce their main vulnerabilities and to strengthen their growth capacity, and to avoid a return to difficult circumstances in the event of deterioration in the international economic and financial situation.

5 European countries not belonging to the euro area

Following the enlargement of the European Union on 1 May 2004, there are now 13 EU countries that do not belong to the euro area, since the ten new Member States have joined the United Kingdom, Denmark and Sweden. While this is a heterogeneous group of countries, one general aspect is that most of them saw their growth accelerate during 2004 and they ran current-account deficits, which did not prevent a generalised appreciation of their exchange rates against the dollar and, in certain cases, against the euro.

GDP growth in the United Kingdom quickened in 2004 to 3.1%, albeit moving on a declining path throughout the year, as interest-rate rises progressively bore on the economy. They particularly affected house prices, the slowdown in which as from the second half of the year tended to check the rise in private consumption (see Table 2.1). Domestic demand continued to be the main engine of growth, underpinned by still-high private consumption and the rise in investment and public spending. There was once again a negative contribution by the external sector to growth, with the acceleration in imports in 2004 outpacing that in exports.

The labour market continued to perform soundly, with a fresh reduction in the unemployment rate to 4.7%, the lowest level in almost 30 years. Inflation was also contained in 2004. The annual average increase in the harmonised CPI was 1.3%, somewhat down on 2003 and far below the 2% target. However, given the persistent rise in house prices and anticipating increases in inflation in the medium term, the Bank of England continued to raise its official interest rate. It underwent a 100 bp increase in 2004 to 4.75%, at which level it held, however, from August, in view of the slowdown in the economy in general and in the housing market in particular. The budget deficit dipped slightly to 3.2% of GDP, thanks to the favourable effect of economic activity on revenue, while the current-account deficit continued to widen in 2004 to 2.2% of GDP, 0.2 pp up on the previous year. That means the United Kingdom ranks second behind the United States in terms of the biggest external deficit in absolute value. Against a favourable macroeconomic background, household debt continued to grow sharply, standing at 145% of disposable income in mid-2004. Thereafter, there was something of a slowdown, partly as a result of the cumulative interest-rate rises in 2003 and 2004.

In Sweden and Denmark, growth accelerated in 2004 due to the greater contribution of domestic demand, underpinned by consumption and investment. The contribution of the external sector was negative in Denmark and very positive in Sweden. The harmonised inflation rate stabilised at a very moderate level, enabling the expansionary stance of their monetary policies to be maintained. Budget surpluses increased in both countries, which also ran current-account surpluses, this being particularly sizable in Sweden's case.

Taken together, the growth of the ten new Member States was 4.8%, compared with 3.8% in 2003 (see Chart 2.8). In most, the pace of expansion was greater than in 2003 and, as in the previous year, the buoyancy of activity was particularly notable in Poland and the Baltic States. Growth was essentially based on the sound behaviour of domestic demand, in both the consumption and investment strands, while the contribution of external demand was low or slightly negative in almost all these countries, despite the firmness of foreign trade flows.

Inflation rates increased in most of these countries. The biggest rises were in the first half of the year and were due, among other factors, to food prices, to the liberalisation of certain administered prices and to higher indirect taxes as a result of EU accession. However, prices began to ease across the board from mid-2004 (see Chart 2.8). In December 2004 the annual rate of inflation was 4.2%, almost double that of the euro area, compared with 2.8% in December 2003, albeit with notable differences between countries. In line with the trend in

inflation, official interest rates also increased in most of the countries in the first half of the year. Subsequently, they held stable and even declined in Hungary and Slovakia, owing to the strong appreciating trend of their currencies.

Slovenia, Estonia and Lithuania joined ERM (Exchange-Rate Mechanism) II on 28 June 2004 with fluctuation bands of $\pm 15\%$, although Estonia and Lithuania retained their fixed exchange-rate regime or currency board vis-à-vis the euro as a unilateral commitment within the mechanism. The exchange rates of these currencies held very stable around their central parities. Against a backdrop of strong net capital inflows, the other currencies with flexible exchange rates – the Hungarian forint, the Polish zloty, the Czech koruna and the Slovakian tolar – registered an appreciation against the euro, which was even greater in real effective exchange rate terms given the weakness of the dollar and the inflation differentials of these countries with the euro area (see Chart 2.3).

Turning to public finances, the budget deficit targets set in the Convergence Programmes, which in most cases envisaged a reduction on the previous year, were generally met. Notwithstanding, half the new Member States still have budgetary deficits in excess of 3% of GDP.

Current-account deficits held or even increased in many of these countries, standing at over 4% of GDP in most of them and around 10% of GDP in the Baltic States and in Hungary, although the improvements seen in Poland and the Czech Republic meant that the average for the area remained approximately constant (see Chart 2.8). While trade deficits improved in many countries following accession to the EU, the high income payments to non-resident investors have worsened their current-account balances. These deficits were financed partly by incoming foreign direct investment, which increased once again in 2004, though this did not suffice. As a result, external debt also increased in some countries. The high and persistent current-account deficit levels, linked in many cases to strong capital inflows attracted by the favourable prospects within the EU, are nevertheless one of the main factors of vulnerability of this group of countries. And all the more so in the light of the strong appreciating trend of their currencies in recent quarters, which might generate competitiveness problems in some of these economies.

As regards the EU candidate countries, the December 2004 European Council decided that Bulgaria and Romania should join the EU in January 2007, and that Croatia and Turkey should start accession negotiations during 2005. In Turkey, the biggest economy and that with most potential among the candidate States, economic recovery continued apace, with GDP growth quickening in 2004 to 8.9%, underpinned by the strong increase in consumption and investment and by its generally satisfactory compliance with its IMF programme. The inflation rate continued falling, reaching 9.3% in December 2004, below the target of 12%, which allowed interest rates to be cut. However, the increase in the current-account deficit to 5.2% of GDP and the sustainability of public debt are the two biggest problems facing the Turkish economy. As a further step to addressing these problems, a new programme has recently been agreed with the IMF for the next three years, involving an amount of approximately \$10 billion.

Finally, in Russia, GDP grew by 7.3% in 2004, slightly down on 2003. This performance was thanks to the positive contribution of both domestic and external demand, although there was something of a slowdown in the second half of the year. Underpinning the result was the favourable trend of oil prices: the strong revenue relating to oil has not only contributed to growth but has also widened the already high current-account surplus and the budget surplus to

10.1% and 3.8% of GDP, respectively. The appreciation of the exchange rate continued, as did the brisk pace of the build-up in reserves, which increased by 71% to \$125 billion in December 2004. The lack of sterilisation of this increase in reserves by the central bank contributed to checking the ongoing reduction in inflation, which stood in December at 11.7%, above the central bank target of 10%. Continuing inflationary pressures are, therefore, one of the main short-term risks to the Russian economy. From a medium and long-term perspective, headway in structural reform is particularly important, especially in the banking sector, so as to allow investment to gain renewed vigour and growth to firm.

3 THE EURO AREA AND THE COMMON MONETARY POLICY

1 *Economic conditions in the euro area*

In 2004, the economic recovery in the euro area that began in mid-2003 continued, with GDP growth of 1.8%. However, the favourable signs which, at the beginning of the year, fed expectations that activity would gather steam during the year gave way to a modest and hesitant improvement of output in the second half. The lack of momentum was partly a result of two exogenous factors, namely the rise in oil prices and cumulative euro appreciation, although other elements of a structural nature, such as the uncertainty over the income prospects of agents in some economies of the area, also hampered the growth of consumer spending and investment. This factor is more visible when set against the favourable financial conditions that have existed in the euro area, with short and long-term interest rates at historically low levels in both nominal and real terms.

Euro area inflation stood at 2.1%, as in 2003, despite the sluggishness of demand and the under-use of resources in the labour market. This persistence was mainly due to the ongoing rise in oil prices and to the increases in administered prices and indirect taxes in certain euro area countries. Indeed, the notable degree of wage moderation that continued to be seen in the area in 2004 (real wage growth was well below that of productivity per employee) enabled the inflationary effects arising from the rise in the price of energy to be contained. The appreciation in the euro during the year also contributed to this containment.

The difficulty the European economy has had in achieving a path of sustained growth suggests the existence of problems that are hampering potential growth, underlining the need for structural reforms to be implemented and a sufficient degree of fiscal discipline entrenched to ensure public finances are in a favourable position to withstand the effects of population ageing. Although there is a high degree of consensus regarding this diagnosis, a similar determination to take the measures that would improve the European economy's capacity to adapt and that would instil greater dynamism is lacking. The outlook for 2005 points to continuation of the process of economic recovery, on the basis of relatively high growth in world trade and a gradual improvement in the confidence of agents, but still at a low rate.

1.1 ACTIVITY AND EMPLOYMENT

In 2004, GDP growth was high in the first half, as the buoyancy attained in 2003 was sustained. Its rate approached that of potential output, supported by favourable developments in the external sector, there being no appreciable rise in domestic demand (see Table 3.1). In the second half, however, against a background of slower growth in world trade and rising uncertainty, stemming from the sharp rise in oil prices, output slowed, owing to the poorer export performance and the buoyancy of imports. For its part, domestic demand increased its contribution to GDP, basically as a consequence of higher stockbuilding by firms and, to a lesser extent, of the recovery in investment in capital goods.

Relative to the previous year, in 2004 domestic demand excluding the change in inventories increased its contribution to GDP growth by 0.5 percentage points (pp), to 1.3 pp. This increase was exclusively attributable to the rise in gross fixed capital formation, especially in equipment, while private and government consumption grew at similar rates to the previous year. In fact, private consumption remained slack in 2004, growing at a rate of 1.1%, in line with the growth of household disposable income, so that the savings ratio held unchanged. The moderate expansion in disposable income was attributable to the sluggishness of employment and the slowdown in compensation per employee. Moreover, the rise in inflation caused by the increase in oil prices from the second quarter reduced household purchasing power. The sta-

	2002	2003	2004	2004			
				Q1	Q2	Q3	Q4
DEMAND AND OUTPUT							
Gross domestic product	0.9	0.5	1.8	0.7	0.5	0.3	0.2
Private consumption	0.7	1.1	1.1	0.7	0.0	0.1	0.6
Government consumption	3.1	1.6	1.6	0.2	0.3	0.6	0.2
Gross fixed capital formation	-2.5	-0.5	1.6	-0.2	0.5	0.5	0.6
Exports	1.9	0.5	5.8	1.4	3.1	1.0	0.3
Final demand	0.8	1.0	2.9	0.6	1.1	0.9	0.3
Imports	0.5	2.3	6.0	0.3	2.9	2.6	0.7
Contributions to GDP growth (b)							
Domestic demand excluding stocks	0.5	0.8	1.3	0.4	0.2	0.3	0.5
Change in stocks	-0.1	0.4	0.4	-0.1	0.1	0.6	-0.2
External demand	0.6	-0.6	0.1	0.4	0.2	-0.6	-0.1
PRICES AND COSTS (c)							
Consumer prices (annual average)	2.3	2.1	2.1	1.7	2.3	2.2	2.3
Final demand deflator	1.4	1.2	1.7	0.9	1.9	2.0	2.1
GDP deflator	2.5	2.1	2.0	2.0	2.2	1.8	1.8
Unit labour costs	2.2	2.0	0.9	1.2	0.8	0.5	1.1
Compensation per employee	2.5	2.4	2.2	2.6	2.6	1.8	2.0
Labour productivity	0.3	0.4	1.3	1.3	1.8	1.3	0.9
GENERAL GOVERNMENT (d)							
Total expenditure	48.6	49.1	48.5				
Current expenditure	44.1	44.5	44.0				
Interest payments	3.7	3.5	3.3				
Public investment	2.5	2.6	2.6				
Total receipts	46.1	46.3	45.7				
Primary deficit (-)/surplus (+)	1.2	0.6	0.6				
Deficit (-)/surplus (+)	-2.4	-2.8	-2.7				
LABOUR MARKET							
Total employment	0.6	0.1	0.5	0.1	0.3	0.2	0.2
Unemployment (e)	8.2	8.7	8.8	8.9	8.8	8.8	8.8
BALANCE OF PAYMENTS (d)							
Current account	0.8	0.3	0.6	0.7	0.3	0.5	0.7

SOURCES: ECB and European Commission.

a. Quarter-on-quarter rates, unless otherwise indicated.

b. Percentage points of the percentage change in GDP.

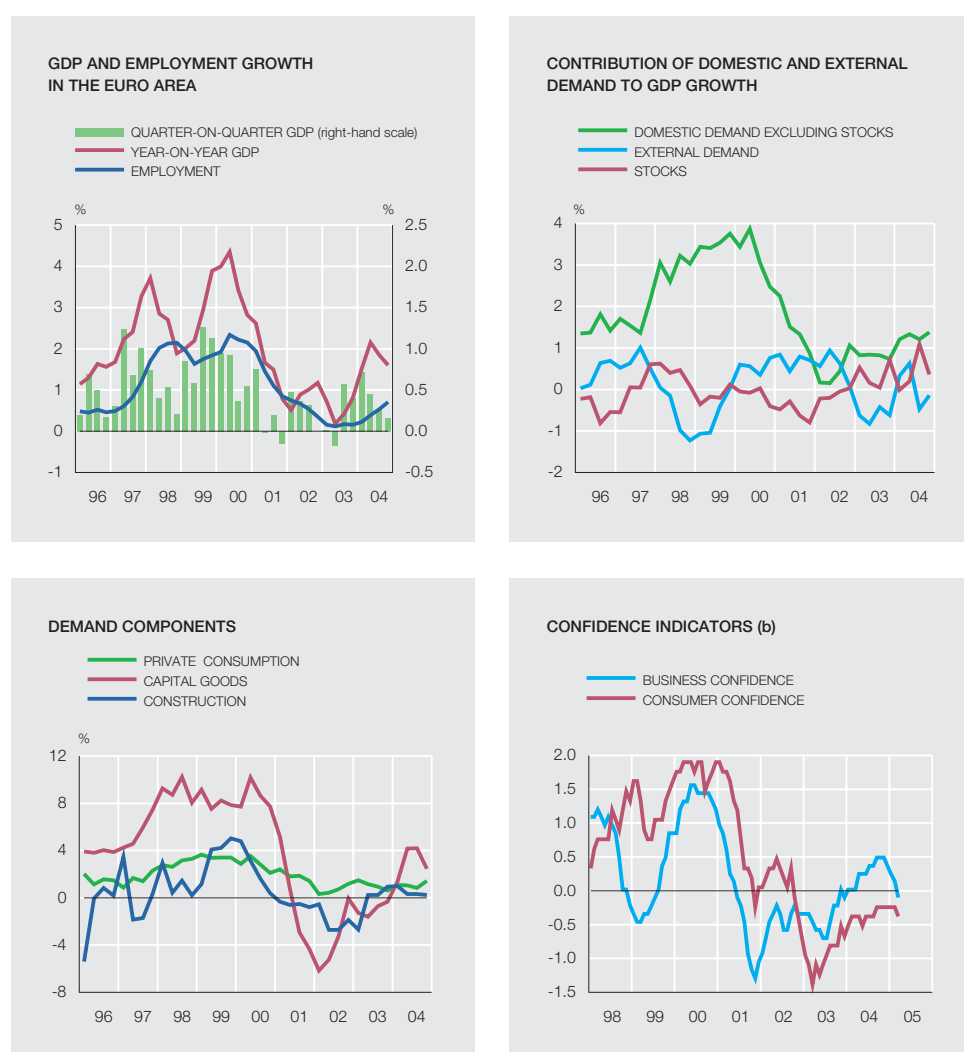
c. Year-on-year rates.

d. As a percentage of GDP.

e. As a percentage of the labour force.

bility of the savings ratio shows that household spending on consumer goods did not react to the favourable financial and monetary conditions prevailing in 2004 or to the increase in wealth arising from the stock market recovery and from the increase in house prices, which was particularly sharp in some countries. This caution on the part of households seems to indicate that the weakness of private consumption was linked, at least in some economies of the area, to low levels of confidence, stemming from scant job creation and uncertainty regarding future income developments, probably associated with doubts over the dynamism of productivity and the viability of the present public pension and health insurance systems.

Gross fixed capital formation increased by 1.6% in 2004, following three consecutive years of decline. The recovery was somewhat stronger in capital goods, gathering momentum over the year,



SOURCES: ECB, European Commission and Banco de España.

a. Annual percentage changes, unless otherwise specified.

b. Percentage balances. Normalised series.

albeit at a relatively modest rate (see Chart 3.1). The growth in investment in capital goods was based on the improvement in demand (especially external demand) expectations, the recovery in corporate profits and a favourable trend in firms' borrowing costs, which took the form of the maintenance of low interest rates, a narrowing of the yield spread on corporate bonds and rising share prices. In these circumstances, the timidity of the recovery may have been linked to the possibility that some firms are still adjusting their debt ratios, which limits their ability to undertake investment plans requiring external financing. The low growth in corporate lending would seem to support this hypothesis. Meanwhile, investment in construction, affected once again by the persistent negative trend in this component of GDP in Germany, hardly picked up. The substantial positive contribution of the change in inventories to output growth for the second year running was notable. This increase in inventories, in so far as it is involuntary, may be indicative of firms having held excessively optimistic expectations regarding the recovery in demand which, in the event, were not fulfilled.

The contribution of the net external balance to GDP in 2004 was nil, following its negative contribution the previous year. Export growth was vigorous (5.8%), driven by the strength of



SOURCES: European Commission, Eurostat and Banco de España.

the expansion of the world economy. In step with the appreciation of the euro, the growth of sales abroad was lower than that of world exports, so that the euro area again lost market share on international markets in 2004, primarily in favour of Asian (in particular, China) and Central and Eastern European countries. Imports also recovered, although somewhat less strongly than exports, in line with the moderate expansion in final demand and thanks to the fall in the price of foreign products entailed by the exchange rate appreciation. As a result of these developments in trade flows, the current account surplus increased by 0.3 percentage points to 0.6% of GDP.

In 2004, all the euro area countries, with the sole exception of Greece, posted higher rates of GDP growth than in the preceding year. The poorer the performance of a country in 2003 the stronger its recovery in output in 2004, so that, although it remains relatively wide, the dispersion of growth rates narrowed (see Chart 3.2). That said, greater divergences were observed in the composition of countries' growth, this being partly related, as explained in Box 3.1, to the different levels of competitiveness of the economies, which are reflected in the response of foreign trade to price and demand conditions.

In Germany, the Netherlands and Austria, the improvement in activity was based on the strength of exports, while in countries like Spain and France the contribution of net external demand to GDP deteriorated and domestic demand expanded at a higher rate. For another year the aggregate results of the euro area were strongly affected by the situation in Germany,

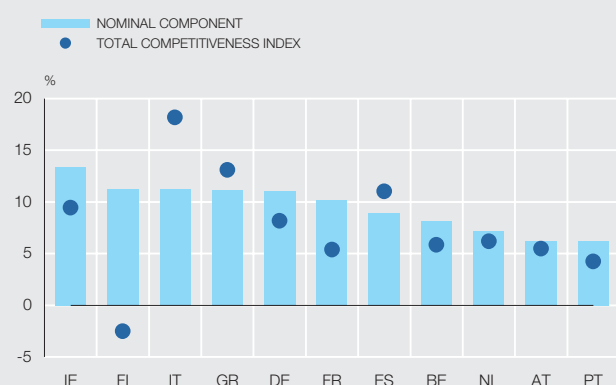
In 2004, the process of euro appreciation that had commenced at the beginning of the decade continued. In terms of the nominal effective exchange rate, the euro appreciated between 2000 and 2004 by a total of 21%. The effects of this trajectory on the economic activity of each country in the area may differ as a result of the disparities in their productive and trade structures, and in the functioning of their markets for productive factors. In particular, the change in each country in the nominal component of the competitiveness index (NCCI) (an indicator equivalent to the nominal effective exchange rate) depends, on one hand, on the relative weight of its intra-euro area trade (which is not directly affected by the appreciation of the euro) and, on the other, by the geographical composition of its extra-euro area trade. As seen in Chart 1, it is those countries with a higher percentage of extra-euro area trade, such as Ireland and Finland, whose NCCI appreciated most. At the other extreme are Portugal, whose percentage of intra-euro area trade is close to 70%, and Austria, which has strong trade links with the new European Union member countries, whose currencies generally did not fluctuate greatly against the euro. The magnitude of the appreciations is well below that recorded by the euro area as a whole, since the change in the

NCCI of each country in that part of its trade with the other member countries was obviously nil.

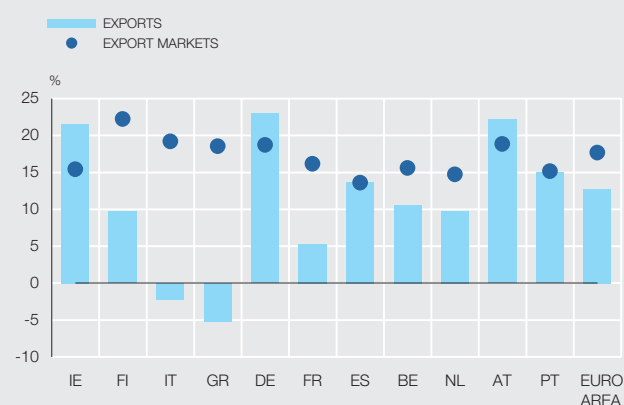
In terms of the total competitiveness index (TCI)¹ calculated using export prices, the dispersion by country is much greater than when the nominal component is analysed on its own, since its behaviour also varies from country to country owing to the different response of domestic exporters when setting prices and to differences in the behaviour of the prices of their competitors. Most countries reacted to the appreciation by maintaining or slightly reducing their export prices. Since competitors' prices also displayed moderation, this meant that the total appreciation was somewhat less than the nominal one. An extreme case is Finland, where the TCI depreciated, as a consequence of the sharp decline in export prices, which may be related to its specialisation in products whose costs and prices fell as a result of rapid technological progress. Only in three euro area countries (Spain,

1. In addition to the nominal component, the TCI incorporates the prices component, and is therefore equivalent to the real effective exchange rate.

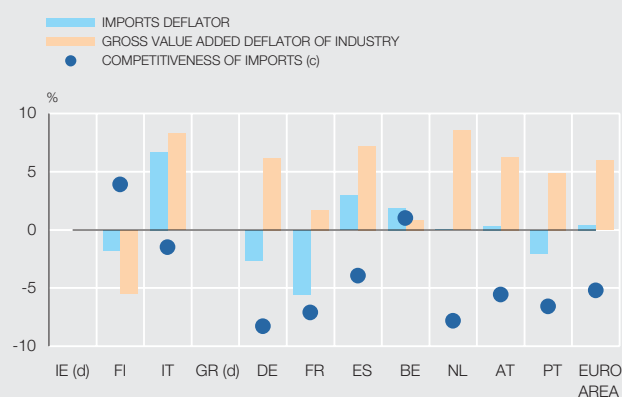
1. COMPETITIVENESS INDICES (a) (b)



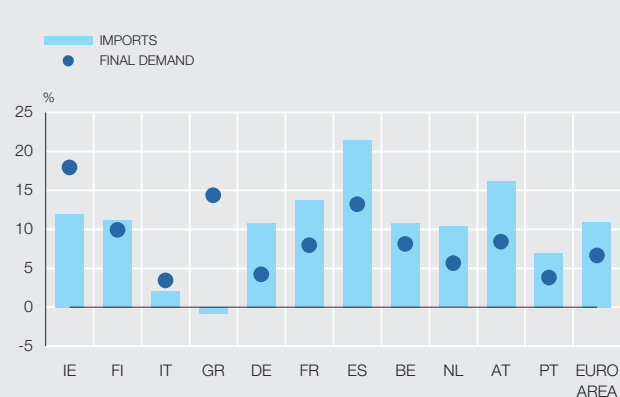
2. GOODS AND SERVICES EXPORTS AND EXPORT MARKETS (a)



3. COMPETITIVENESS OF IMPORTS VIS-À-VIS DOMESTIC PRODUCTION (a)



4. GOODS AND SERVICES IMPORTS AND FINAL DEMAND (a)



SOURCES: European Commission and OECD.

a. Total change between 2000 and 2004.

b. Calculated against a group of 34 industrialised countries.

c. Ratio of the imports deflator to the gross value added deflator of industry. A fall denotes a gain in the competitiveness of imports relative to domestic production.

d. No information available for these countries.

(cont'd)

Italy and Greece) did the trend in relative export prices involve an additional decline in competitiveness.

As a result of the loss of competitiveness, a large number of the countries (as well as the euro area as a whole) saw their exports grow at a slower rate than their export markets. Some economies suffered a very pronounced loss of share, which may also have stemmed from other aspects of their productive structure² (see Chart 2). In particular, in Italy and Greece, the loss of share is partly explained by the substantial appreciation in their TCIs, but also by their specialisation in sectors with a lower technology content, with less growth in demand and greater competition from emerging markets. A similar situation is observed in France, as result of the slackness of tourism demand and the high degree of specialisation in the aerospace industry, one of those most affected by the recent geopolitical instability. Finland is an anomalous case, since it recorded a loss of share despite the improvement in its competitiveness, which may be the result of the concentration of its exports in the communication equipment sector, whose demand has moderated in recent years. By contrast, in other countries, such as Ireland, Germany and Austria, exports increased at a somewhat faster rate than their markets, despite the competitiveness losses. In the case of Germany, its specialisation in the production of capital goods allowed it to service the higher demand for such goods in the emerging countries, where investment was highly dynamic. It is also likely that greater trade integration with the new

members of the EU, boosted by the delocation of production and the consequent increase in direct investment, justifies this trend in exports.

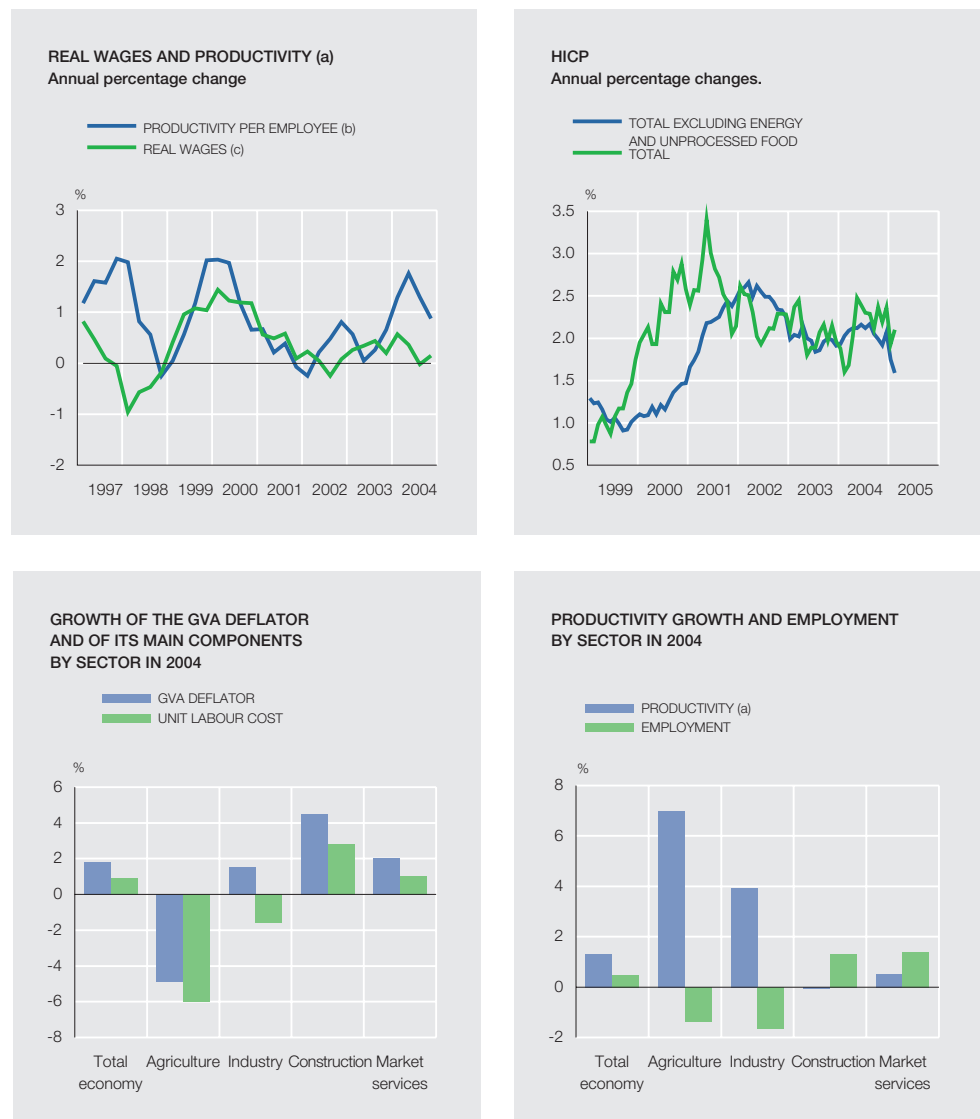
In addition to these effects, it should be noted that appreciation of the NCCI makes imports cheaper and encourages the substitution of imports for domestic production. As seen in Chart 3, the prices of domestic products (approximated by the gross value added deflator of industry, since a large proportion of imports are industrial goods) increased in almost all countries by a larger amount than those of imported products. This behaviour of relative prices was reflected in the euro area, and in the most of the countries, in larger increases in imports than in final demand (see Chart 4). Import penetration was especially intense in Germany, the Netherlands, France and Spain, in line with the poorer behaviour of relative prices. By contrast, domestic production gained weight in final demand in Ireland, Greece and Italy. The situation in Greece is a consequence of the fact that the increase in final demand was largely based on an expansion of investment in housing and public works, which are characterised by a relatively low use of imported products.

In the euro area as a whole, the prolonged appreciation of the euro exchange rate translated into a decline in export share and an increase in import penetration. However, when the effects of the appreciation on the various countries making up the euro area are analysed, it is seen that far from being a symmetric shock, the appreciation affected each country differently, according to the various factors mentioned, which may partly explain the disparities in growth rates.

2. The recent changes in Spain's share of exports are analysed in detail in Box 1.4.

where private consumption and gross capital formation posted negative rates for the third year running. In France, by contrast, output expansion was based on a rise in investment and household expenditure; in the latter case, despite zero employment growth and in line with the decline in the savings ratio. Finally, Italy was the country in which the GDP recovery was weakest, the external sector making a slight positive contribution. The latter did not stem from export growth, which was low, but from the slackness of imports, which reflected subdued consumption and investment.

The euro area labour market continued to display notable weakness in 2004, with the growth rate of employment at 0.5% and the unemployment rate at a similar level to 2003 (8.8% of the labour force). The increase in productivity (1.3%) was therefore well above the rate recorded in the last few years. The sluggishness of employment, against a background of wage moderation, is probably a sign of the low level of business confidence regarding the strength of demand. The rigidities still persisting in European labour markets, which hampered the adjustment of hiring to the economy's cyclical conditions, probably also contributed to the weakness of employment. In 2004, hours worked per employee grew slightly, following the reduction in previous years, which suggests that this variable was responsible for part of the adjustment between the labour force and output, rather than the number of employees. These employment developments were a result of uneven behaviour from sector to sector: while job shedding continued in industry (despite the buoyancy of its value added), employment in construc-



SOURCES: ECB, Eurostat and national statistics.

a. Difference between the change in GDP and employment for the total economy and between the change in GVA and employment for the various sectors.

b. Difference between the change in compensation per employee and the GDP deflator.

tion began to recover from the second quarter of the year, and in market services job creation accelerated somewhat (see Chart 3.3).

The outlook for the next few quarters points to continuation of the economic upturn (following the, possibly, temporary slowdown in the second half of 2004), based on the relatively high growth of world activity and on a gradual improvement in agents' confidence, against a background of continued favourable financial conditions and wage moderation. Notable among the main risks to this scenario are, domestically, prolongation of the climate of uncertainty as to future employment and income developments, and externally, the possibility of further oil price increases and continuation of the substantial overall macroeconomic and financial disequilibria.

1.2 PRICES AND COSTS

In 2004, the harmonised index of consumer prices (HICP) of the euro area grew on average by 2.1%, the same rate as in the previous year although, as seen in Chart 3.3, with a different

year-on-year profile, marked by the strong and continuous rises in the price of oil and by the fiscal measures taken by various euro area governments, which involved increases in indirect taxes and administered prices. The sudden acceleration in the prices of the energy component caused the euro area inflation rate to rise to 2.5% in May, and for the rest of the year it held at levels of over 2%. The less volatile components of the HICP, whose rates of change held steady or even increased slightly, also contributed to the persistence of inflation. This was the case of services prices, as described in Box 3.2.

Unlike consumer prices, the growth of the final demand deflator rose by almost half a percentage point from the rate a year earlier, to 1.5%. This was a result of the more inflationary behaviour of the external component, as a consequence of the sharp increase in oil prices, since the domestic component of inflation, approximated by the GDP deflator, decelerated.

As regards the formation of the economy's domestic prices, the rise in labour productivity, together with the lower growth in compensation per employee (2.2% on average during the year, 0.2 pp less than in 2003) gave rise to a very small increase in unit labour costs (ULCs). In fact, the slackness which continued to characterise the European labour market and the pressure on firms from growing international competition and exchange-rate appreciation helped to contain wage demands, as well as reducing the likelihood of the continuous rises in the price of energy being passed through into higher wage increases. The muted growth of ULCs enabled profit margins to widen notably, following almost no growth in recent years, as a consequence of the efforts made by firms to face up to the recent economic slowdown in the euro area, and the competitiveness losses arising from the appreciation of the euro.

As seen in Chart 3.3, there was a widening of margins, approximated by the difference between the value-added deflator and unit labour costs, in all the productive branches. In agriculture and industry, job shedding further boosted productivity growth and the reduction in ULCs. In market services, meanwhile, the acceleration of productivity was much smaller and the recovery in margins was made possible by the significant moderation in the growth of compensation per employee while the rate of increase of final prices was unchanged. Finally, the large increase in the value-added deflator in construction was conducive to a widening of margins in this sector.

The cross-country dispersion in inflation rates declined in 2004 (in terms of the standard deviation weighted by the year-on-year growth rates of the HICP of the euro area countries) (see Chart 3.2). The rise in the price of oil had a negative effect on all the European economies. However, the differences in the intensity of the economic recovery, in the impact of the appreciation of the euro and in government measures (especially those relating to indirect taxes and administered prices), along with some other more specific factors, gave rise to a convergence of inflation rates across the Member States. Notable were the significant rise in inflation in Germany (from 1% in 2003 to 1.8% in 2004) and the sharp decline in Ireland (1.7 pp to 2.3%).

The rise in oil prices in the first few months of 2005 is likely to hamper the reduction in the annual rate of change of the HICP. However, wage moderation (which is forecast to continue in the coming quarters) and the lagged pass-through of the exchange rate appreciation to consumer prices will probably check the adverse effect of the energy price on inflation.

2 Fiscal and structural policies in the euro area

2.1 FISCAL POLICY

In 2004, the fiscal policy stance was practically neutral; according to European Commission calculations, the cyclically adjusted primary surplus was only 0.1 pp lower than in the previous year, at 0.9% of GDP (see Chart 3.4). The 0.2 pp decline in interest payments and the stability

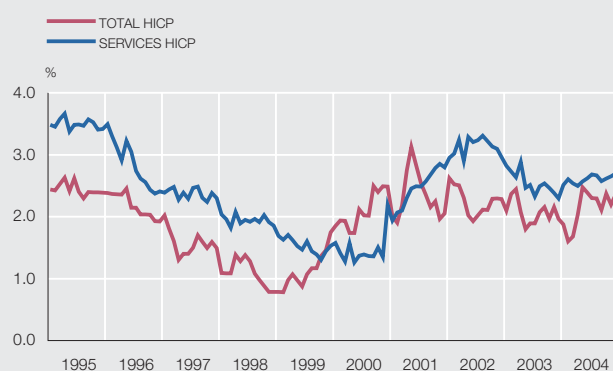
In 2004, the euro area inflation rate remained above the level that the ECB considers compatible with its price stability objective (2%), ending the year at 2.4%. During the year, its behaviour was determined by that of its most volatile components, especially by the notable rises in the price of energy. However, a factor that has also hindered the slowdown in the inflation rate in recent years has been the relatively high rate of growth of services prices, which has been above 2.5% since 2001 and on a slightly upward path since the end of 2003. The behaviour of the prices of this component is very important, since it has a substantial weight in the HICP consumption basket (41%).

It is normal for increases in services prices to exceed those of industrial goods and to be the most inflationary component of the HICP (see Chart 1). This is attributable to the lower degree of competition in this sector, as well as to the lower productivity growth usually recorded. In addition, in a scenario like the present one, in which the euro is appreciating significantly, services prices benefit to a lesser extent than other sectors from the fall in price of imported goods, since they use them in a smaller proportion. In fact, services prices

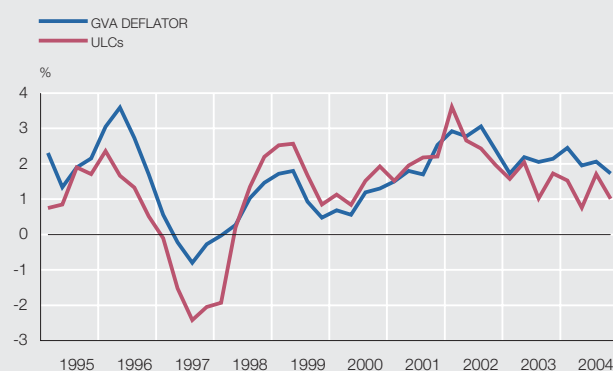
are seen to be largely explained by the behaviour of unit labour costs (ULCs). The correlation between the annual rate of change of the services component of the HICP and that of the ULCs of the market services sector is positive, with a contemporaneous value of 0.5, which increases as the number of lagged quarters considered in the growth rate of the ULCs increases (i.e. the growth of ULCs leads that of HICP services). Also, a high degree of correlation is observed between the market services value-added deflator and the ULCs of this sector, except in the latest period, in which the slowdown in ULCs has not been passed through to prices, but to a strengthening of margins (see Chart 2).

From the standpoint of costs, the growth in the market services value-added deflator has also been higher than that of the industrial sector deflator, both since the start of Stage Three of EMU and in the immediately preceding period. This difference is basically explained by the higher growth of labour productivity in industry, compared to the services sector, especially in the first period (see Chart 3). Thus, although the growth in compensation per employee has generally been lower in the services sector, this has not been sufficient to avoid

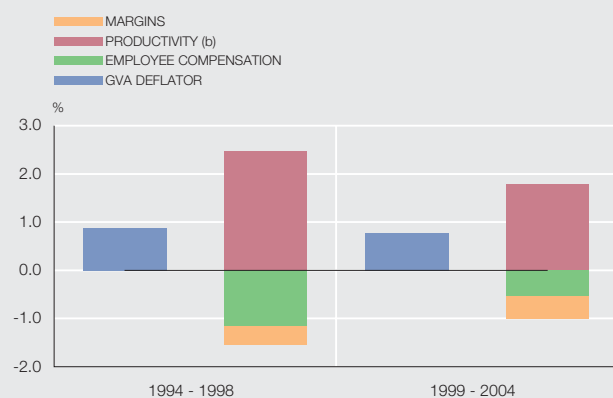
1. PRICES (a)



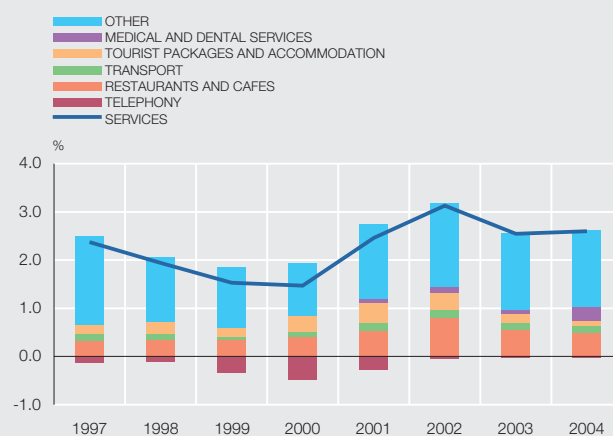
2. GVA DEFLATOR AND ULCs OF MARKET SERVICES SECTOR (a)



3. GROWTH DIFFERENTIAL IN MARKET SERVICES/INDUSTRY DEFLATOR



4. CONTRIBUTIONS TO THE ANNUAL AVERAGE RATE OF CHANGE OF THE EURO AREA SERVICES HICP



SOURCE: Eurostat.

- a. Annual rates of change.
- b. Sign changed.
- c. Data only available from 2001

a larger increase in ULCs in services than in industry. In turn, this higher growth in ULCs in services has largely been passed through to final prices, because the growth in margins in this sector has been slightly lower than that in industry.

Nonetheless, the acceleration in the services component of the HICP of the euro area since December 2000 (when it rose to 2.2% from 1.3% in the previous month) is partly attributable to a number of specific temporary factors which have affected some of the highest weighted items that make it up (see Chart 4). As these factors disappeared in 2003, the services HICP displayed a marked slowdown which was cut short again in 2004, however, primarily as a consequence of the health reforms in Germany (which had a significant effect on the prices of medical and dental services) and of the impact of

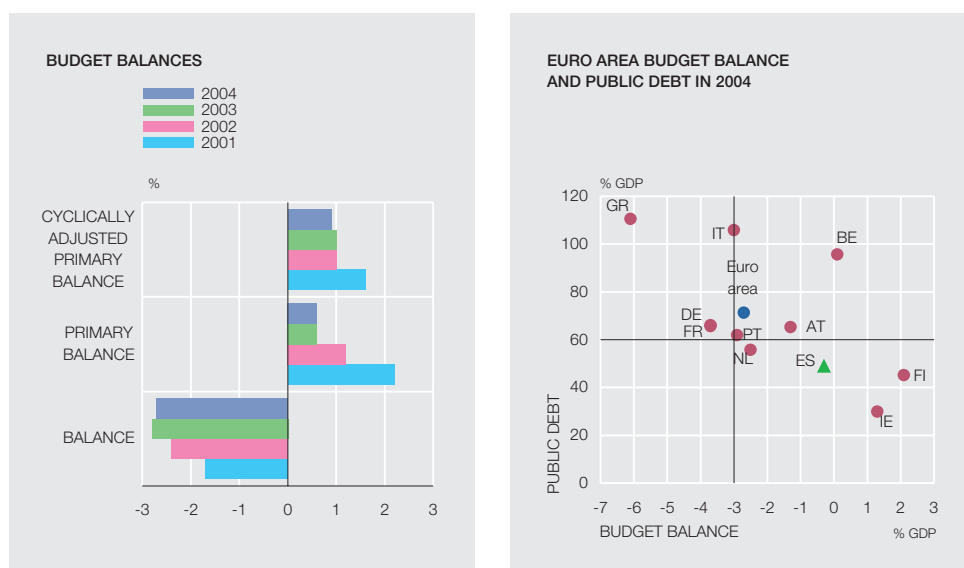
the rise in the price of oil on transport services (especially air transport).

In any event, even disregarding these transitory effects, price increases in numerous items of the services sector continued to show persistently high rates and little sensitivity to the weakness of domestic demand, which may be a consequence of the lower degree of competition some of these activities face. The importance this sector in the basket of consumer goods and its impact on total inflation also involves an obstacle to the promotion of competition in the economy as a whole, so that it is necessary to press ahead with reforms aiming to make this sector more flexible and open, such as the recent proposal by the European Commission to liberalise the provision of services in the EU, which was received with reservations by the European Council last March.

of the cyclical component enabled the observed deficit to be reduced by 0.1 pp (to 2.7% of GDP).

Last year budget outcomes continued to vary markedly from country to country. On the one hand, four Member States (Germany, France, Italy and Greece) posted deficits greater than or equal to 3% of GDP in 2004, while another two (Portugal and the Netherlands) were slightly below this level. In the other six Member States substantially lower deficits, or even surpluses, were achieved. Among the first group of countries, only the Netherlands saw a correction in its cyclically adjusted deficit of more than the 0.5% of GDP recommended in the Broad Economic Policy Guidelines, while in Germany France, Italy and Portugal this variable was either unchanged or improved slightly, and in Greece it worsened considerably. However, the changes in the cyclically adjusted balances cannot always be interpreted as changes in the fiscal policy stance. In particular, several Member States carried out operations which improved their public finances only temporarily, without altering the underlying situation, so that developments in observed and cyclically adjusted balances give a distorted picture of the budgetary position. This was the case in Italy and Portugal, where it is estimated that these measures helped to reduce the deficit in 2004 by 1.5 pp and 2 pp of GDP, respectively.

Application of the provisions of the fiscal discipline framework for the area was heavily influenced by the legal uncertainty surrounding the course of the excessive deficit procedures opened against Germany and France after the Council, in November 2003, rejected the recommendations made by the Commission and approved, in their place, conclusions according to which these two countries had to correct their excessive deficit in 2005. These Council decisions led to the filing of an action in January 2004 by the European Commission before the Court of Justice of the European Communities which entered judgment on 13 July. The Court annulled the Council's conclusions, while recognising its power to reject the Commission's recommendations. In December, the Commission issued a communication, subsequently approved by the Council, arguing that, since the Council Conclusions of November 2003 enjoyed the presumption of validity until their annulment by the Court, the actions taken by the German and French authorities had to be judged on the basis of compliance with such conclusions. Thus, as the Council considered that the measures taken will permit the excessive deficit to be eliminated in both countries in 2005, the next steps of the procedure have not yet been activated.



SOURCE: European Commission.

Also, at the beginning of the summer, the Council reported the existence of excessive deficits in the Netherlands and in Greece. The measures taken by the Dutch authorities led to suspension of the procedure for the Netherlands in November. However, in the case of Greece, the correction introduced by the government was judged insufficient by the Council, so that in February 2005 new requirements were made, whereby the excessive deficit must be eliminated by 2006 at the latest. This involved, for the first time, recourse to Article 104(9) of the Treaty. Also, the Council decided, in July 2004, not to adopt the Commission's recommendation to issue an early warning to Italy, in view of the commitments made by its government. However, in April 2005, the European Commission announced the possibility that it would open an excessive deficit procedure against this Member State, given its forecasts that the public deficit was clearly going to exceed 3% of GDP in 2005 and 2006. Finally, the Council suspended the procedure opened two years earlier against Portugal, upon confirming that the deficit had fallen below 3% of GDP in 2003.

The vagaries in the application of the excessive deficit procedures against France and Germany also led to significant uncertainty during the year as to the future of the euro-area budget discipline rules. In the light of the experience in applying the Stability and Growth Pact (SGP) in recent years and of the judgment of the European Court of Justice, the Commission set in train a process to explore possible ways of enabling the existing mechanisms to work better. This process culminated in the approval, at the European Council in March, of a number of changes to the current rules, which attempt to increase the incentives to achieve more disciplined behaviour during upswings, while introducing greater flexibility during downturns.

As regards the preventative side of the SDP, the previous medium-term budget objective, whereby each country was required to maintain a position close to balance on average over the business cycle has been replaced by a specific requirement for each Member State, depending on its debt ratio and its potential growth rate. Countries that have not achieved their medium-term objective should reduce their cyclically adjusted deficit, after allowing for measures with a temporary impact, by around 0.5 pp per annum. Also, certain structural reforms with a positive impact on the sustainability of public finances (such as reforms to public pension systems) may justify a temporary deviation from the medium-term objectives or a slower rate of approach towards them.

In relation to the corrective part of the Pact, in future a deficit that temporarily exceeds 3% of GDP by a narrow margin will not be considered excessive if accompanied by a negative GDP growth rate (as against the previous requirement that GDP should fall by at least 2%) or if justified by a number of additional factors. In addition, the periods for applying the excessive deficit procedure have been modified, so that the period for an excessive deficit to be corrected (normally, the second year following its emergence) can be extended if unexpected events occur that have a significant impact on public finances. Finally, greater importance will be attached in future to public debt developments.

Overall, the reforms to the preventative part of the Pact may increase the economic logic of the national fiscal objectives and strengthen the ability of the Council and the Commission to recommend adjustments in the event of deviations, particularly during economic upturns. At the same time, the reduction in the degree of automaticity in the application of the current framework, especially of its corrective part, involves greater discretion and ambiguity which, if not adequately limited, may dilute fiscal discipline in the area. Accordingly, it would seem necessary for the Member States and the European authorities to interpret the new agreement rigorously and to ensure that the rules are applied more strictly than they have been to date.

In this respect, it should be taken into account that the insufficiency of the consolidation efforts made by the Member States with deficits of around 3% of GDP or more underlines the need for the fiscal policies of these countries to adopt a more restrictive stance during the phase of strengthening activity, in order to create sufficient leeway for the automatic stabilisers to be able to operate fully in the next downturn. Further, compliance with the rules that discipline the behaviour of the euro area fiscal authorities is absolutely necessary in view of the costs arising from population ageing, given that debt ratios are still at very high levels in certain countries. The importance of this challenge requires the application of strategies that also include policies aiming to raise employment rates (the subject of analysis in section 2.2) and to reform pension (see Box 3.3) and health systems.

2.2 STRUCTURAL POLICIES

The prolonged period of modest growth in recent years highlights the presence of structural obstacles to the expansion of output in the area, whose elimination requires the implementation of reforms to improve the flexibility of the economy and its ability to absorb adverse shocks. This need was addressed five years ago now in the Lisbon Agenda, the name by which the programme adopted by the European Council in that city in March 2000 is known, which aims to make Europe “the most competitive and dynamic knowledge-based economy in the world” by 2010. In March 2005 the European Council examined the results achieved over the five years since the launch of the Agenda, on the basis of documents produced by the Commission and by the group of independent experts chaired by Wim Kok, concluding that insufficient progress had been made. The Council, however, has merely proposed to simplify the strategy, by reducing the number of objectives and setting priorities between them, and by evaluating the different processes under way more fully. In addition, the Member States shall present national reform programmes every three years.

As recognised by the European Council when reviewing the Lisbon Agenda, the rise in per-capita GDP requires the application of measures to promote greater use of the labour factor and an increase in its productivity. As regards the use of the labour factor, in 2003 total and female employment rates in the euro area stood at 62.6% and 53.6% respectively, so that, although they represent increases of approximately 2 pp and 3 pp since 1999 they are a long way off the intermediate targets set for 2005 for the EU 15 as a whole (67% and 57%) (see Table 3.2). In general, the promotion of labour market participation is based on both the reform of tax systems and (in particular, relieving the burden on low paid jobs) and changes

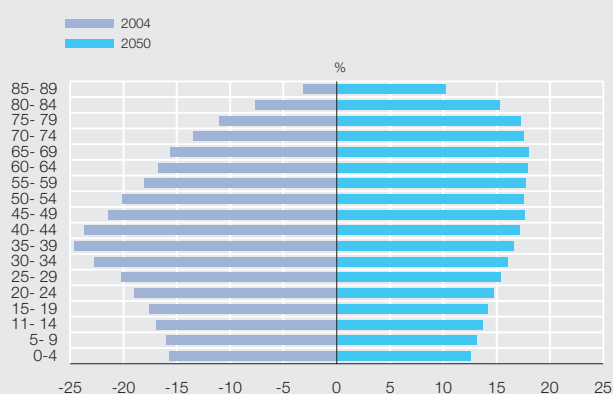
The demographic forecasts available point to a notable ageing of the population of the euro area over the coming decades, which will increase the ratio between the population of retirement age and the population of working age from 25% in 2004 to almost 50% in 2050. This will involve a significant increase in spending on pensions, health and assistance to the elderly which, although uncertain in size (like the demographic projections themselves), represents a considerable challenge to the sustainability of public finances in the long term. The European response to this challenge, defined in the Broad Economic Policy Guidelines (BEPGs), has three elements: action to stimulate an increase in employment rates, budgetary consolidation to reduce debt ratios (so that the reduction in interest payments can partly offset the increase in spending) and reform of health and pension systems.

The pension systems of the countries vary greatly in form, combining compulsory schemes (which in the euro area are normally public) with other voluntary ones. The compulsory public systems currently in force are characterised by the fact that the amount of the benefit is defined in accordance with certain parameters (so that they are usually called *defined benefit* systems). This amount may either be linked to the past wages earned and contributions made by the individual during his/her working life, or else be a fixed amount, depending simply on the number of years of contributions made. The scheme in force in every euro area country is of the first type, except in Ireland and the Netherlands. In both cases, if prompt action is not taken, extension of the benefit receipt period, resulting from longer expected lifetimes and an earlier effective age of retirement, and a reduction in the number of contributors, caused by the decline in birth rates,

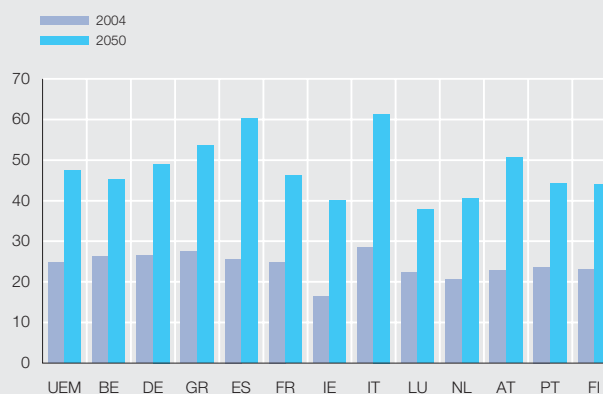
SOME PARAMETERS OF EURO AREA PUBLIC PENSION SYSTEMS (a)

Country	Regulatory base (b)	Criterion for indexation of past earned income (c)	Criterion for indexation of pensions (c)
Belgium	WL	P	P
Germany	WL	W	W → W corrected for life expectancy (2004)
Greece	last 5	discretionary	discretionary
Spain	last 15	P (until 2 years before retirement)	P
France	best 20 → best 25 (2008)	P	P
Ireland	—	—	W
Italy	5 → WL (new system) (d)	P / W → nominal GDP	P
Luxembourg	WL	W	W
The Netherlands	—	—	W
Austria	best 15 → 40 (2028)	discretionary	discretionary
Portugal	best 10 of the last 15 → WL (2017)	75% P / 25% W (maximum real growth of 0.5%)	P
Finland	10 → WL (2005)	50% P / 50% W → 80% P / 20% W	50% P / 50% W → 80% P / 20% W

1. EURO AREA POPULATION PYRAMID IN 2004 AND 2005
Millions



2. EURO AREA DEPENDENCY RATIOS (e)



SOURCES: Banco de España, Eurostat and population projections (base scenario).

a. An arrow indicates the modification introduced following the relevant reform. The year in brackets is that in which the modification comes into force.

b. WL = entire working life.

c. P = Prices / W = Wages.

d. The new defined contribution system is applicable to individuals joining the labour market from 1996. The pensions of workers with more than 18 years' contributions to 1995 are governed by the old system, while those corresponding to workers with a shorter contribution period up to that year are obtained using a combination of both systems.

e. Ratio between the over 65s and the 15-64 age group.

could lead to a sudden adjustment in the average level of benefits, even if the other two elements considered in the BEPGs are implemented. For this reason, irrespective of the possibility of introducing compulsory private systems, the current public systems need to be reformed urgently, to enable their basic structure to be maintained and to safeguard their financial viability.

These parameters can be grouped into three categories. The first are those that determine the pension eligibility conditions, including having reached a certain legal retirement age (with certain exceptions, 65) and having paid a minimum number of years' contributions (which varies significantly from country to country). The recent reforms in Belgium and France have raised this minimum period, which is currently 30 and 37.5 years, respectively, to 35 in the case of Belgium (from 2005) and 40 in that of France (from 2008). In some countries, workers may receive pensions at younger ages, in which case a longer period of contributions will be required. This, for example, is the case of Italy, where either 20 years of contributions and 65 years of age or 35 years of contributions and 57 years of age are required. Following the 2004 reform, this latter minimum age will be progressively raised between 2008 and 2014 to 62.

A second group of parameters are those defining the amount of the initial pension, which are obviously not applicable in fixed amount systems. These include the regulatory base (in general, the wages earned during part or all of the individual's working life), the rule for indexation of these wage earnings (which normally depends on the wage and price developments in the economy) and the replacement rate applied to the regulatory base (which is generally a function of the number of years of contributions). Calculation of the regulatory base may take into account the whole or the last few years of the individual's working life, or the years in which the individual earned most. As seen in the first column of the table, in some countries the number of periods used to calculate the regulatory base has been increased in recent years. As for indexation of past wage earnings to calculate the initial pension, there is a ten-

dency to increase the weight of price changes to the detriment of wage changes. Finally, recent changes in the replacement rate have tended to stimulate longer working lives. Thus, in France and Finland, the reforms have aimed to increase the deductions made in the case of early retirement and the premiums payable when retirement is postponed.

Finally the third category of parameters of defined benefit systems is the rule for the indexation of existing pensions which, in most countries, is linked to wage developments, price developments (as in Spain) or to a combination of both, while in other countries increases are discretionary (see the third column of the table). The reforms have also tended to increase the weight of prices in the indexation calculation to the detriment of wages.

A different approach to this challenge is that adopted in Italy, where it was decided in 1995 to move gradually from the traditional system in which the amount of benefits are pre-set towards an alternative system in which what is predetermined are the contributions to be made during an individual's working life, which are capitalised using the nominal GDP growth rate (known as a *defined contribution* system). The amount of the benefit depends on the contributions made corrected for life expectancy at retirement, individuals also being permitted to adjust their retirement age in accordance with the level of income desired. Within the EU, Poland and Sweden have also introduced pension systems of this type in recent years.

As can be seen, the degree of ambition of the measures taken differs notably across the countries of the area. In this respect, it should be noted that, the longer the delay in adopting the required reforms, the greater the possibility that significant cuts in benefit levels will be required or, alternatively, an increase in contribution rates, which has negative consequences for the supply of labour. The urgency of the reforms is also heightened by the fact that individuals need a long period of time to adapt their behaviour in response to changes in pension system rules.

to unemployment benefits, since it is the combined effect of these two types of policy which influences the decisions of workers to remain unemployed or outside the labour market. Unlike in previous years, progress was recorded in 2004, especially in the second of these areas.

Among the large euro area countries, this was particularly the case of Germany, where implementation of the so-called Agenda 2010 continued. This is a broad programme of reforms to the labour market and to the social benefit system introduced in 2003. The requirements for an unemployed person to be able to refuse a job offer were tightened (a benefit recipient must accept an offer when the wage exceeds 70% of the local average wage, or else lose the right to receive benefits). In addition, subsidies were introduced for unemployed persons that set-up their own businesses and for employers who hire unemployed workers, and the long-term unemployment benefit and social assistance systems have been merged into a new pro-

	2000	2001	2002	2003	2004
LABOUR MARKET					
Employment rate (15-64)	61.6	62.1	62.4	62.6	
<i>Female</i>	51.7	52.3	53.1	53.6	
<i>Male</i>	71.6	71.9	71.7	71.5	
Employment rate (55-64)	34.2	35.1	36.5	37.8	
<i>Female</i>	24.3	25.2	26.7	27.9	
<i>Male</i>	44.5	45.5	46.8	48.1	
Unemployment rate	8.1	7.8	8.2	8.7	8.8
<i>Female</i>	10.3	9.9	10.1	10.4	10.5
<i>Male</i>	6.5	6.3	6.8	7.3	7.5
Long-term unemployment rate	4.0	3.6	3.6	3.9	
Direct taxes and social contributions on low-wage earners	41.5	40.5	40.5	40.4	
Productivity per employee relative to the United States	81.6	80.5	78.5	76.6	73.6
KNOWLEDGE SOCIETY					
R&D (% GDP)	1.9	1.9	1.9		
Percentage of homes with Internet access			37.0	42.0	43.0
Patent applications per million inhabitants	225.4	238.1	229.8		
Expenditure on information and communication technology, as % GDP		5.9	5.7	5.6	5.6
<i>On information technology</i>		2.9	2.7	2.6	2.6
<i>On communication technology</i>		3.0	3.0	3.0	3.0
Venture capital investment (% GDP)	0.2	0.1	0.1	0.1	
Private investment (% GDP)	19.0	18.5	17.7	17.3	17.4
Public expenditure on education (a) (b)	5.0	5.1			
Continuous training (% population 25-64)	5.7	5.5	5.5	7.0	7.0
% population aged 20-24 who have completed secondary education	72.5	72.4	72.9	72.7	72.5

SOURCE: European Commission.

a. Average level in the twelve countries for which information is available for 2001.

b. EU-15 data.

gramme, now in force, in which the level of benefits depends on the overall income received by the individual. In January 2006, the planned reduction in the maximum duration of unemployment benefit began to be applied. Finally, other measures to stimulate an increase in the activity rate included the introduction of a reduction in social contributions for low-paid jobs and the deregulation of part-time employment. Also measures were adopted in France in 2004 to reduce the duration of unemployment benefits and to make the eligibility conditions more restrictive, requiring recipients to actively search for jobs. In Italy, the framework law for labour market reform, approved in June 2003, began to be implemented, albeit timidly, in 2004. The measures aiming to stimulate the activity rate include the introduction of more flexible types of contract.

The three countries mentioned above reformed their public employment agencies in 2004. Also, in Germany and France, provisions were introduced to simplify the administrative procedures and reduce the legal uncertainty in the event of dismissal and, in the former country, the costs of dismissal for small businesses were reduced. As regards making working hours more flexible and the introduction of greater wage differentiation according to the specific conditions of the firm, progress was uneven. While in Germany the number of agreements in this sense negotiated collectively at the firm level multiplied and, in France, the government announced measures to introduce greater flexibility into the law on working hours,

permitting a voluntary increase in the number of hours worked, in Italy the negotiations between social agents to decentralise collective bargaining, so as to ensure that settlements reflect more closely productivity (at the firm level) and the differences in the cost of living (at the regional level). Finally, progress in stimulating geographical mobility was generally very small.

As regards the second element necessary to increase the per-capita GDP of the area, the average growth of labour productivity since the mid-1990s has, despite the recovery in 2004, been very low, whether measured in terms of persons employed or hours worked. This slowdown has partly stemmed from the reduction in the growth of the capital stock per worker and partly from the lower rate of growth of total factor productivity, a concept associated with technological progress, organisational improvements and factor quality. As regards the first variable, in the last ten years, the less intense use of capital has partly been the result of the relatively high rate of job creation, insofar as workers who were previously unemployed or inactive, and whose productivity is below average, have been employed. Against this background, investment has fallen as a percentage of GDP, from 22% in 2000 to 20.5% in 2004. However, this slackness in gross fixed capital formation is not only a consequence of the changes in the composition of output, but also of the structural deficiencies in the European economy, which limit the number of sufficiently profitable investment projects and stimulate the search for attractive projects in third countries.

Meanwhile, total factor productivity growth has been held back by the failure of the area to reorient its productive specialisation towards the information and communication technology sectors, by the limited diffusion of innovations in these sectors towards services that make use of these technologies and by the scant progress in improving human capital. The euro area's shortcomings in the field of technological innovation are evident in the stagnation of spending on research and development, which in recent years has remained at around 2% of GDP, a long way from the 3% target set in Barcelona. Among the problems preventing an acceleration in the rate of innovation and in R&D expenditure in the euro area in comparison with the United States are the scarcity of private and public funds to finance innovative activities and, in particular, the development of venture capital. Finally, the deficient average quality of the labour factor stems from the scant development of postgraduate education, from the limited contacts between industry and the scientific and research community and from the absence of attractive professional careers for researchers.

A basic ingredient for the acceleration of total factor productivity is the completion of the single European market, which requires reforms to increase the degree of competition. These policies indirectly help to increase productivity, by creating incentives for resources to be re-assigned towards more productive businesses and sectors and for the creation and use of new technologies.

Some indicators point to a slowdown in the integration of product markets. Thus, the deficit in the transposition of directives relating to the single market has not been reduced recently and only Spain currently complies with the target set in the Lisbon Agenda for this deficit to be below 1.5% by March 2002. In addition, the proportion of public procurement subject to a public procedure remains very low. And finally, tax obstacles to cross-border activity persist. These are located primarily in the costs of compliance with disparate tax laws which, in particular, hamper the establishment of small and medium-sized businesses outside their home country. To alleviate the differences in tax systems the Commission has proposed a common definition of the corporate income tax base, leaving the Member States free to set the relevant rate.

In goods markets, the degree of integration achieved is high, although there persist barriers to product approval. However, in services markets, fragmentation remains high, since there are still obstacles to both cross-border establishment and the temporary provision of services in other countries, entailing significant costs for producers and consumers, since services represent more than 70% of the area's GDP. In order to reduce the obstacles to integration of the services market, in January 2004, the Commission outlined a proposed directive seeking to strengthen the home country principal, so that a services provider already established in a country would not have to obtain prior authorisation in order to operate temporarily in another Member State. The Commission intends that the legislation (from which financial and transport services will be excluded, since they are already regulated by other legal provisions) will begin to be applied in 2007, although there would be transition periods until 2010. However, the initial aspirations of this directive have been called into question by the European Council of March 2005, which suggested a less ambitious opening up of the internal market for services.

Notable progress has been made to date in the liberalisation of the network industries, although in 2004 the only significant initiative related to railway transport. This established that the markets for goods and passenger transport shall be completely opened up by 2007 and 2010. The degree of cross-border competition in these markets is currently limited.

In the specific case of financial services, progress has been greater, thanks to the approval of the Financial Services Action Plan (FSAP), which must be fully transposed into national law by the end of 2005. However, to date, the degree of financial market integration has been uneven. Thus, while it has been very high in the interbank markets and in both the public and private debt markets, in stock markets, by contrast, cross-border investment is still relatively costly. Also, in retail markets, fragmentation is still high. In particular, although there have been bank concentration processes at the national level, the number of cross-border mergers has been very limited. In order to ensure the effective application of the FSAP at the national level, a structure of supranational committees of sectoral regulators and supervisors has been established and recently completed. In the case of the securities sector, the respective committees were established in 2001, while in the banking sector the Committee of European Banking Supervisors was set up in 2003 and the European Banking Committee (which shall be responsible for preparing the relevant legislation) was set up in March 2005, to replace the Banking Advisory Committee.

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

3.1 MONETARY POLICY DECISIONS

In 2004 monetary policy faced a complex situation, with inflation above 2% for most of the year, while economic activity still showed no signs of sustained growth. In accordance with the strategy formulated, which aims to maintain price stability in the medium term, the ECB considered that the increase in inflation was primarily the direct result of the sharp rise in oil prices, while the favourable wage developments, the appreciation of the euro and the modest growth in spending allowed it to presume that these rises would not be passed through in future to higher inflationary pressures. As a result, the ECB decided to leave its key interest rates unchanged during 2004 and at the beginning of 2005, having reduced them to historically low levels in June 2003: 2% for main refinancing operations and 1% and 3% for the deposit facility and marginal lending facility respectively (see Chart 3.5). The stability of inflation expectations at moderate levels reflects the credibility of the ECB's monetary policy and its ability to adapt it to the requirements of the area. In this respect, the monetary policy applied managed to establish a setting of financial conditions conducive to economic activity, although the structural nature of some of the problems hampering economic growth in the euro area limited the expansionary effects of this policy.



Sources: ECB and Banco de España.

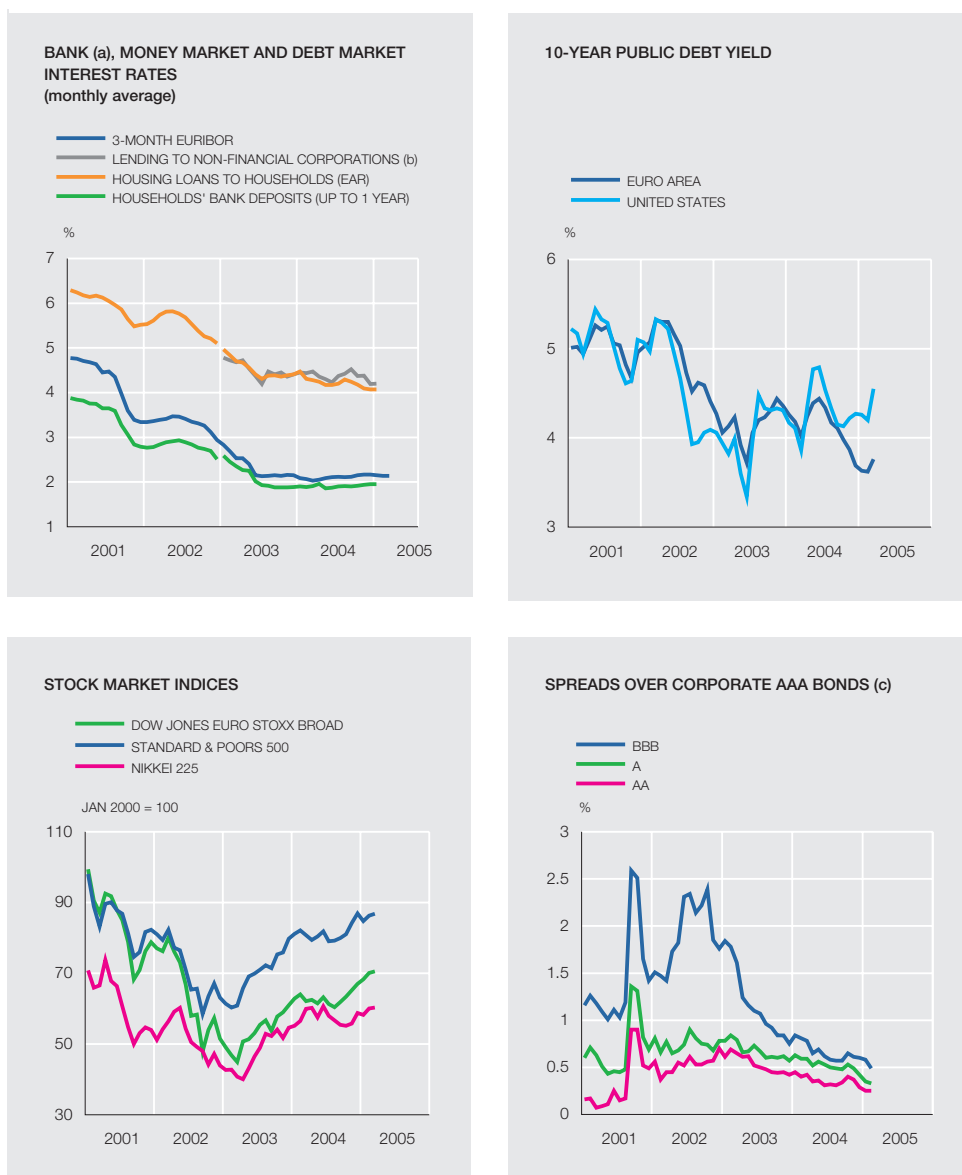
a. Estimated using EURIBOR data.

As mentioned above, in the first half of the year activity was more buoyant, in line with the trend since end-2003 and with the strength of the world economy. As regards prices, following the moderation in HICP growth rates in the first few months of the year, the rise in the price of oil in Q2 had some impact on short-term inflation, although it was partly offset by the favourable behaviour of the rest of the components. In this setting, markets began to anticipate a change of stance towards a more restrictive monetary policy. However, the Governing Council of the ECB considered that the monetary policy stance was still correct, given that it was still not clear that the economic recovery could be sustained by itself. Despite the price tensions in the oil market, the notable increase in productivity against a background of wage moderation largely neutralised the potentially unfavourable effects that oil price developments might have had on price formation in the next few months.

Half way through the year it began to become clear that the recovery was proceeding at a somewhat lower rate than forecast, although some optimism was justified by both external and domestic conditions. In fact, world economic growth, the favourable domestic financial conditions and the moderation in unit labour costs formed a scenario conducive to export growth, investment and employment. In addition, inflation was falling progressively thanks to the favourable food price developments, which offset the rise in the energy component.

During the latter months of the year and at the beginning of 2005 there were again various episodes of sharply rising oil prices, which caused the rate of growth of the HICP to clearly exceed 2% in some months. Given the scant impact of these increases on inflation expectations and the weakness of spending, the ECB decided to remain prudent and leave the stance of its monetary policy unchanged. Undoubtedly the oil market has continued to pose some risks for inflation, but the trend rise in the euro exchange rate and the firming of a pattern of moderate growth in labour costs has given rise to a more encouraging inflation outlook, which should be maintained in the absence of clearer signs of a recovery in activity.

With regard to the implementation of monetary policy, certain elements of the operational framework were changed in 2004, as described in section 2 of the *Management Report* in-



SOURCES: ECB and Banco de España.

a. Data drawn from new statistics on interest rates compiled by the ECB for new business.

b. Interest rates for loan terms of over five years.

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

cluded at the end of this *Annual Report*. The purpose of these changes was to stabilise interest rate expectations during the maintenance period and to reduce the volatility of short-term rates. As explained in detail in Box 3.4, this purpose has been largely achieved.

3.2 FINANCIAL DEVELOPMENTS IN THE EURO AREA

Money and debt market developments during the year were governed by the growth expectations in the area and by the uncertainty over the future trend in oil prices. Until March, the interest rates on interbank deposits continued to decline progressively, which led to a flattening of the money market yield curve (relative to that of December 2003). However, thereafter, the prospects for a strengthening of activity in the euro area and the increases in oil prices caused money market interest rates to rise, by an amount that increased with the length of the maturity. Thus, expectations were established of a possible, albeit moderate, rise in official interest rates by the end of the year, as seen in Chart 3.5. As the year elapsed, the less optimistic

INTERBANK MARKET

One of the design objectives of the operational framework for the monetary policy of most central banks is the stabilisation of very short-term interest rates. It is implicitly assumed that their volatility can be transmitted to longer-term rates, which are relevant to consumption and investment decisions. To achieve this end there are basically two alternative mechanisms: more or less continuous intervention in the markets; or the establishment of a reserve requirement which obliges counterparty institutions to deposit at their central bank, on average during a specific period, a pre-determined amount of money. This deposit acts as a buffer, helping to neutralise the impact on very short-term interest rates of unanticipated shocks to the system's liquidity. Specifically, when liquidity is relatively scarce (abundant) and its price is tending to rise (fall), institutions have incentives to reduce (increase) the amount of the deposit temporarily below (above) the required average level, lending (borrowing) funds in the interbank market. In this way, the upward (downward) pressures on negotiated yields moderate.

Both mechanisms have advantages and disadvantages. The main limitation of the first alternative is that it relies on a mechanism that inhibits the development of the market, while the disadvantage of the second one is that its stabilising property disappears during the final days of the maintenance period.

The Eurosystem applies the second model, so that during the final days of each maintenance period the overnight rate (EONIA) normally displays greater variability. However, this will only be a cause for concern if it interferes with the signalling of monetary policy and, in particular, if it is transmitted to the longer maturities of the interbank mar-

ket. Alonso and Blanco (2005)¹ have studied precisely this question in a recent paper. They estimate a model in which the volatility of interest rates at different maturities depends, among other factors, on EONIA. As seen in Table 1, during the final days of the maintenance period the coefficient of this variable is not statistically different from zero, which they interpret as evidence against the existence of volatility transmission. By contrast, on the other days there is some transmission (the coefficient is positive and statistically significant) to the one and three-month maturities, but not as far as the one-year horizon.

Other results play down the importance of fluctuations in EONIA at the end of the maintenance period, but the fact that the volatility is transmitted during most of this period underlines the importance of keeping it at low levels during these days. It should be noted in this respect that until now the variability of the very short-term rate has been lower in the euro area than in other industrialised countries. Moreover, in November 2001 and February 2004 changes in the operational framework for monetary policy came into force, which aimed to limit the impact on EONIA of changes in expectations regarding the future path of interest rates and should, through this channel, help further reduce the variability of such indicator. Table 2 shows how, following the changes, the volatility of EONIA on normal days (i.e. disregarding the days after the last tender of each maintenance period) actually fell significantly, especially following the last reform²

¹ For more details, see *Is the volatility of the EONIA transmitted to longer term euro money market interest rates?*, by Francisco Alonso and Roberto Blanco, a forthcoming Banco de España Working Paper. ² The volatility during the final days of the maintenance period has also been reduced, although it should be noted that this development may be related, at least in part, to the greater use of fine-tuning operations on those days by the Eurosystem in the most recent sub-sample.

1. TRANSMISSION OF EONIA VOLATILITY (a)

	1-month	3-month	12-month
	interest rate	interest rate	interest rate
End of maintenance period	ns	ns	ns
Other days	16.2	15.3	ns

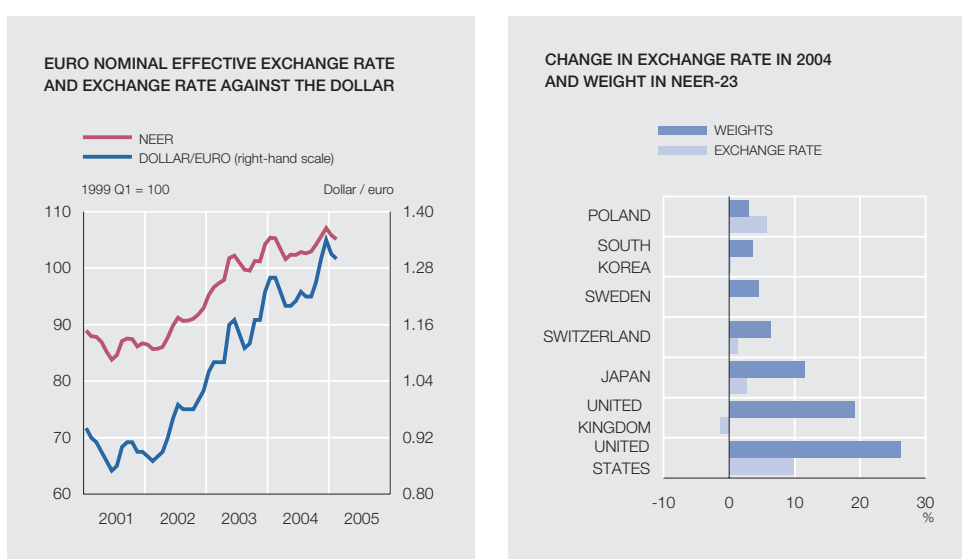
2. EONIA VOLATILITY (b)

	2 January 1999	9 November 2001	24 January 2004
	8 November 2001	23 January 2001	4 March 2005
End of maintenance period	30.7	25.2	19.0
Other days	8.5	7.9	1.4

SOURCE: Banco de España.

a. Ratio expressing the percentage of the (logarithm of the) volatility transmitted to the longer maturities. "ns" indicates that the ratio is not statistically significant.

b. Volatility is approximated by the standard deviation of the daily changes in EONIA.



SOURCES: ECB, European Commission and Banco de España.

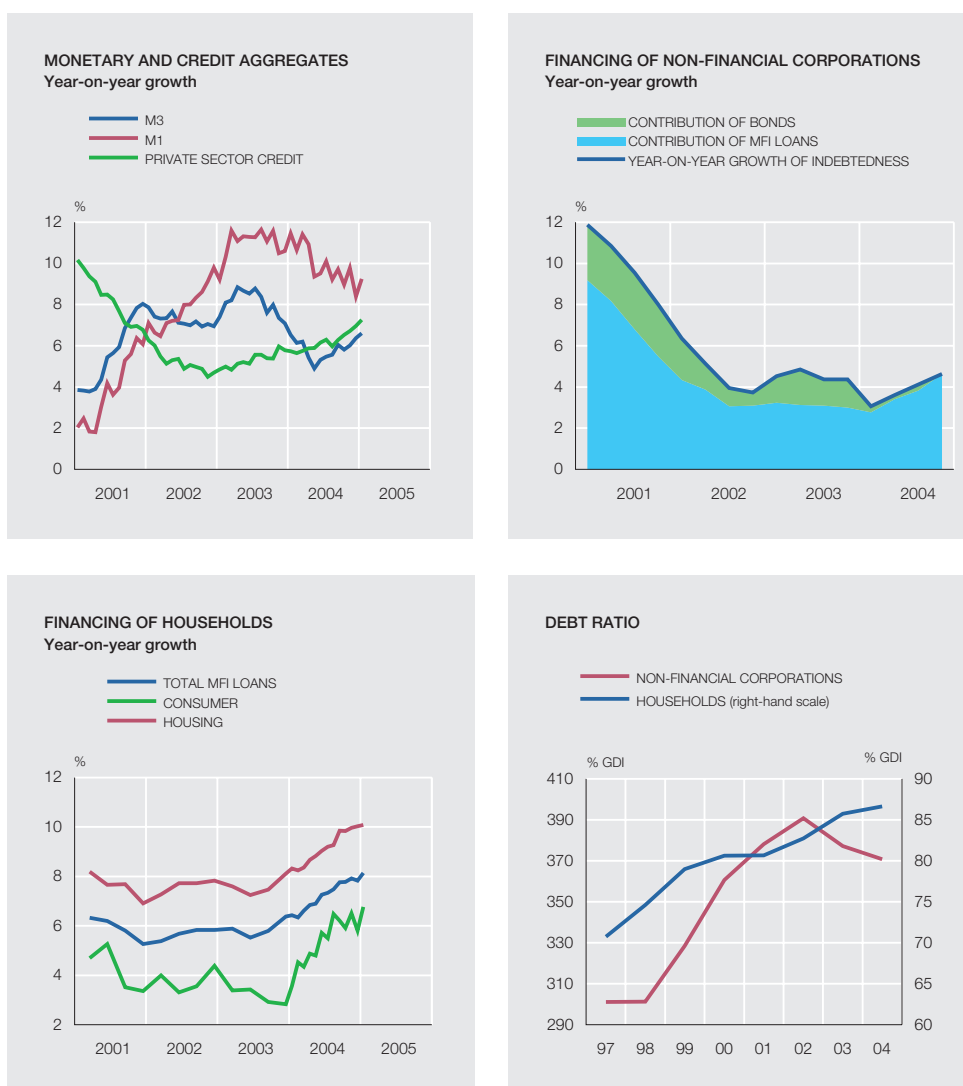
outlook for activity in the euro area meant that these expectations weakened, despite the pressures in the oil market.

Long-term interest rates generally held at very low levels, which was consistent with expectations of moderate price growth and relatively weak economic activity. Ten-year public debt yields even fell from the middle of the year, to below 4% in 2005 Q1, an historic low. Similar developments were seen in other economies, such as the United States, although it should be noted that the spread between the return on US and European bonds changed sign in 2004, becoming positive and reaching its highest level since 2000.

Equity markets reflected the improvement in corporate earnings and in the international economic environment that occurred during 2004 (see Chart 3.6). Although they started the year without any clear trend, prices began to recover from the summer. Over the year as a whole, the EURO STOXX broad index rose by around 7%. However, this index was still about 30% off its early-2000 peak. In the currency markets, the growing concern of international investors over the large and persistent US deficit continued to exert upward pressure on the euro, which rose by 8% against the dollar over the year, to reach its highest level against that currency since its launch (Chart 3.7).

Bank lending and deposit rates remained very stable during the year, at very low levels (see Chart 3.8). The favourable financial conditions were also evident in the trend in corporate bond spreads on the fixed-income markets, which continued to narrow to very low levels.

The low level of interest rates was reflected in the behaviour of the monetary aggregate M1 which, despite slowing from 2003, posted high growth rates in 2004 (see Chart 3.8). M3 displayed two different trends, moderating at the beginning of the year, and returning to higher rates of expansion in the second half, reaching around 6% by the end of 2004. The financing granted by MFIs to the private sector gathered momentum during 2004. However, growth varied by agent: while loans to households posted rising rates, which stabilised at the end of the year at around 8%, those to non-financial corporations grew at a more modest rate, end-



Sources: ECB and Banco de España.

- a. Gross operating surplus.
b. Gross disposable income.

ing the year at 5.4%. Corporations did not raise significant funds by means of securities issuance either, so that the reduction in their debt ratios (which had increased sharply since 2002) prevailed over the undertaking of new investment projects. In the case of lending to households, the house-purchase component was still highly buoyant, although there were large differences from country to country. The most buoyant were Greece, Ireland, Spain and Italy, which recorded growth rates of more than 15% in this type of financing. This phenomenon, which has occurred in parallel with the rise in house prices in some areas, has meant that household debt has increased progressively, to stand in 2004 at 87% of disposable income.

Significant differences were also seen from country to country in total lending to the private sector, in line with the disparity in their recovery patterns. Notably, financing to corporations and households remained very weak in Germany, where its growth stagnated as a consequence of the slackness of demand, although the existence of supply restrictions cannot be ruled out, given the responses of credit institutions published in the bank lending surveys conducted by the Eurosystem.

The Spanish economy

Chapter 1 in this Report described the key features characterising the behaviour of the Spanish economy in 2004. On the basis of this diagnosis, the main challenges facing the economy in sustaining a high growth rate in the coming years were also identified. This chapter offers a more in-depth analysis of the characteristics of the economy in 2004, systematically reviewing the behaviour of the main macroeconomic aggregates.

Since the economic policy setting in which the economy moved in 2004 is a key factor (along with the external environment analysed in chapters 2 and 3) of this more detailed analysis, the chapter begins with an overview of the design of economic policies for the year. In the case of a euro area economy such as Spain, monetary and financial conditions are essentially determined by the common monetary policy stance, the transmission of which to the Spanish economy is addressed in the first section. Nonetheless, the overall economic policy tone is rounded off by the design of those policy instruments still under national sovereignty, namely fiscal policy and microeconomic and sectoral policies, the guiding principles of which are also described in the first section.

The following sections then go on to analyse the behaviour of the following variables: demand and its components, GDP, value added by activity, the labour market and price formation. That provides for an assessment of the economy's competitiveness. The chapter concludes with two sections describing how the movements in the main aggregates have been reflected in the results of public finances (given the fiscal policy considerations described at the start of the chapter) and in the balance of trade with the rest of the world.

1 Economic policies

1.1 MONETARY AND FINANCIAL CONDITIONS

During 2004, financing conditions remained substantially generous, more so indeed than the preceding year. As discussed in the previous chapter, the inflation outlook and the economic situation in the euro area as a whole influenced the monetary policy stance in such a way that money market interest rates in the area scarcely changed. The interest rates applied to lending and borrowing operations by Spanish deposit institutions held relatively stable, although the cost of borrowing dipped slightly, more sharply so in the case of financing for companies.

Spanish long-term government debt yields also held stable in the first half of 2004, declining markedly in the second half of the year, which took them to historical lows. As a result, ten-year bond yields stood at 3.6% at the end of the year, a reduction of close to 80 bp compared with end-2003 levels. This behaviour was similar to that of German government debt prices, meaning that the yield spread between the two showed scant changes. The low yields on public debt, along with the maintenance of corporate risk premiums, made for a reduction in the cost for companies of financing via fixed-income issues.

The pick-up in prices on national and international stock markets in the closing months of 2004 meant that, for the second year running, the main indices closed the year with gains. These were particularly sharp on the Spanish markets, against a background of lower long-term interest rates and earnings at quoted companies which were higher than expected by analysts. The Madrid Stock Exchange General Index posted an annual gain of 18.7% compared with its end-2003 level, above that of the euro area's broad Euro Stoxx (9.9%) and the US S&P 500 (10.9%). Moreover, the volatility of equity prices diminished further. The outcome was an improvement in the conditions under which companies could raise funds on the equity markets. Conversely, the appreciation of the euro contributed to tightening monetary and

financial conditions, partly offsetting the moderating effect arising from the reductions in the cost of borrowed funds and in stock market prices.

The growth of house prices in 2004 was very similar to that the previous year, standing at 17.4% in annual average terms on Spanish Ministerio de Vivienda (Housing Ministry) data. The resilience of residential demand continued to drive property prices, despite the significant increase in the stock of houses under construction. The highest price growth was seen in the biggest municipalities (those with a population of over 500,000) where, however, prices slowed. In coastal municipalities with fewer than 50,000 inhabitants, residential property prices continued to rise at a higher rate than in inland municipalities of a similar size, with prices accelerating in both cases.

Under these conditions, external borrowing by non-financial corporations ran at a rate of increase of around 13%. In terms of instruments, behaviour was uneven since the increase in corporate liabilities was, to a greater extent, in the form of credit from financial institutions, to the detriment of other alternative sources such as foreign loans or fixed-income securities. In terms of activities, the increase in bank financing to companies was fairly widespread, although it continued to be led by operations relating to the property sector, while the rate of expansion of funds earmarked for the industrial branch increased by 5 pp, following their slackness in 2003. The growth of borrowed funds meant that debt remained on a growing trajectory, in relation to profits generated. Nonetheless, the declining course of the cost of borrowing meant that the proportion of funds earmarked for interest payments held at moderate levels, down even on those of the previous year. As a result of the behaviour of these variables, along with the pick-up in profitability, the synthetic indicator of financial pressure on corporate investment improved somewhat, while the employment indicator held at the low levels posted in 2003.

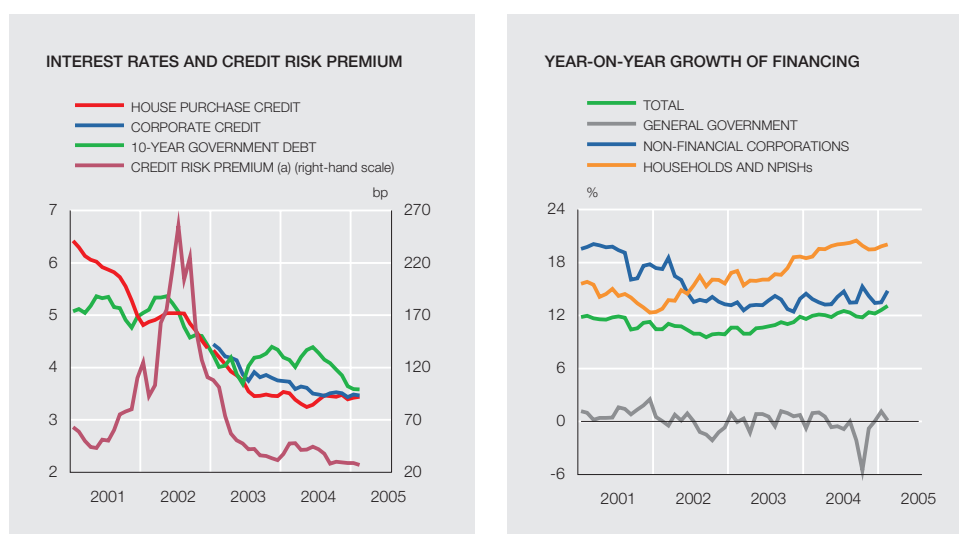
Household debt accelerated once again in 2004, driven anew by the buoyancy of loans intended for house purchases, which grew at around 23%, 2 pp up on 2003 (see Chart 4.1). By contrast, credit for other purposes slowed. The dynamism of households' liabilities was reflected in a fresh increase in the debt ratio, in relation to the sector's gross disposable income, and in a certain increase in the financial burden borne by the sector.

1.2 DOMESTIC ECONOMIC POLICIES

Fiscal policy for 2004 was programmed under the premises of the Budgetary Stability Law, whereby the State Budget targeted a general government balance on non-financial transactions in equilibrium, in National Accounts terms. The macroeconomic scenario on which the budgetary projections were prepared assumed a pick-up in GDP growth — from the figure of 2.3% estimated for 2003 to that of 3% projected for 2004 — and an improvement in the inflation rate.

In terms of agents, the State was expected to post a deficit of 0.4 pp of GDP, 0.1 pp down on that estimated for 2003, which would be offset by a surplus on social security for the same amount. The territorial government accounts, for their part, would remain balanced. The budget likewise projected a fresh reduction in the debt/GDP ratio, which would be slightly below 51% at the end of the year. Finally, a provision of €3,007 million was established for the pension reserve fund, in order to keep this fund at a level of 1.9% of GDP.

The 2004 budget targets were considered as a prolongation of the fiscal policy pursued in the preceding years, based on budgetary stability and aimed at fomenting the investment effort and the improvement of social policies. The figures relating to the consolidated spending of the State, the autonomous State agencies and the Social Security System reflected these priorities, since they provided for increases in expenditure for pensions, sickness benefit, employ-



SOURCES: Credit Trade and Banco de España.

a. Five-year credit risk insurance premium of non-financial corporations.

ment promotion and investment which outpaced GDP growth. A higher-than-average increase was also envisaged for spending earmarked for justice and personal safety policies. In the case of investment policy, a notable effort was made in the form of funds for the development of investment in railway, road and hydraulic infrastructure, which increased by 43% in 2004.

From the standpoint of measures adopted, the 2004 State budget was of a continuist nature. On the expenditure side, less restrictive criteria were approved for hiring general government employees, for the second year running, and, although the increase in public-sector wages held at 2%, there was an improvement in overtime and a contribution of the order of 0.5% of total gross wages was made to the civil servants' pension fund. The rise in pensions was set at 2% and the lowest ones were improved, especially widow's pensions. Finally, the item intended to cover rebates on social security contributions for the promotion of stable employment increased notably. On the revenue side, there were few new features in the budget: excise duties were frozen and the decision was taken not to deflate personal income tax.

These measures gave fiscal policy a slightly expansionary stance in 2004, an assessment which was corroborated by the estimates of the primary structural balance, obtained from macroeconomic and budgetary projections. This was consistent, however, with the maintenance of a slight surplus on the general government structural balance of 0.1% of GDP. That ensured compliance with the Stability Pact, which obliges budget balances to be kept in balance or in surplus in the medium term.

The change of government in March did not alter the guiding principles of fiscal policy, which continued to be geared to budgetary stability. The pluriannual budgetary stability scenarios approved in the spring, as a prior step for the preparation of the 2005 State budget, as stipulated in the Budgetary Stability Law, defined projections for the general government accounts which, departing from a position of equilibrium in 2005, ended in 2007 with a surplus of 0.5% of GDP. Moreover, the government announced a reform of the aforementioned Law, which is under debate, that will enable the target of a balanced budget to be met over the course of the

business cycle, instead of annually. A commitment to transparency in public-sector activity was made, and this has translated mainly into the establishment of a series of mandates and of release calendars for the dissemination of statistical information relating to the activity of the State, the Regional (Autonomous) Governments and the Social Security System.

In the labour market, the policies to promote stable employment and boost participation continued to be based on a combination of rebates on social security contributions, relating to the stable employment-promoting contract, and active employment policies. Representatives of the social agents and of the Government have entered into a dialogue in which it is sought to negotiate labour market reforms. Within this framework, a progressive revaluation of the minimum wage has been set in train. The first step of this process took place on 1 July, when the minimum wage was increased by 6.6% with a view to recouping the purchasing power lost by it in the four previous years. In order to limit the inflationary effects of this measure, it was decided to uncouple the amounts of public benefits, assistance and subsidies, which until then were referenced to the minimum wage, from the increases agreed for this variable. To this end, a new reference — the so-called public indicator of income with multiple effects (IPREM by its Spanish abbreviation) — was created to replace the minimum wage, standing at the amount of the minimum wage before the start of the revaluation process. At the close of 2004, a second rise of 4.5% in the minimum wage was approved, which will be added to in successive years until it stands at around €600 per month at the end of the legislature.

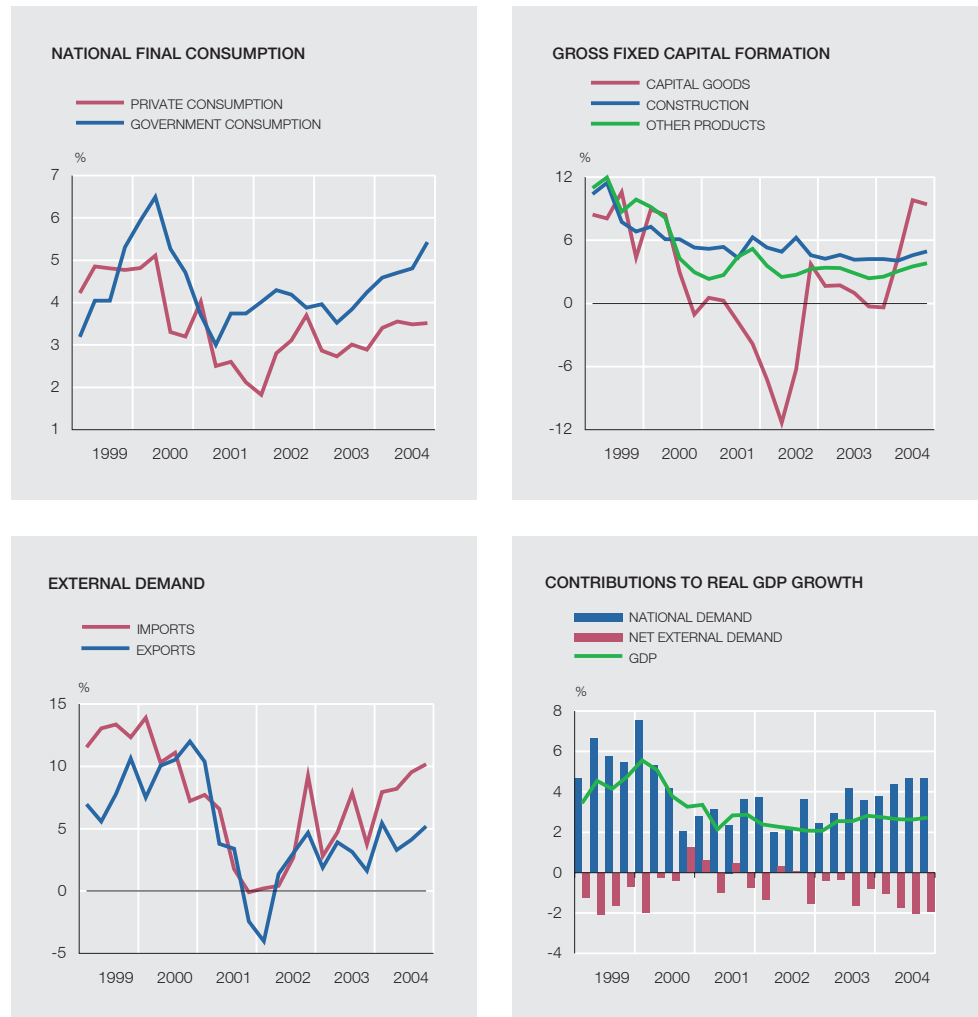
As regards housing and land use, the plan of urgent measures was approved in July. This plan includes the main guidelines envisaged for the coming years, most of which are intended to boost the supply of protected housing, rental housing and land¹. In respect of trading, there is a draft law on business hours which has reduced the number of holidays on which commercial establishments shall remain open to the public, and a weekly-opening schedule of minimum overall hours has been set². The broader guidelines of the new Executive were announced in early 2005, with the plan to reinvigorate the economy and promote productivity, aimed at encouraging an economic growth pattern grounded more firmly in productivity gains and which sustains job-creation. The first package of measures of the plan (which will be implemented in various stages), though limited in scope, entails numerous sectoral, regulatory and tax measures geared to providing for the efficient workings of sectors such as energy and transport, along with transparency in general government conduct.

2 Demand

As described in the previous section, the programmed macroeconomic policy stance in 2004 remained conducive to the growth of national demand. Indeed, it strengthened the marked buoyancy of this variable, which rose by 4.7% on new base year 2000 National Accounts estimates, up from 3.8% in 2003. Households and general government contributed particularly to this higher growth, since both private and government consumption quickened significantly to growth rates of 4.3% and 6.4%, respectively. Gross fixed capital formation slowed to 4.4%.

Before proceeding with the analysis of the Spanish economy set out in this and the following sections, it should be recalled that base year 1995 National Accounts figures have mainly been used, these being the only data available when the Report was compiled. There have been two exceptions to this rule: the labour market, where the new EPA (Labour Force Survey) projections released in March 2005 were available, and general government, since the IGAE

1. At the time this Report went to press, only the first of the measures included in the plan has been carried out, further to Royal Decree 1721/2004 of 23 July 2004, and its aim is to promote officially protected housing schemes and to encourage house rental. 2. A draft law for combating late payments was also approved, introducing certain limitations on the term within which suppliers are paid.



SOURCE: INE.

a. Base year 1995 National Accounts. Year-on-year rates of change based on real seasonally adjusted series.

(National Audit Office) published its base year 2000 estimates in February this year. The new base year 2000 National Accounts figures, which came to light in May, could not be incorporated into the analysis. These estimates have entailed significant changes in the level and in the trajectory of the main macroeconomic aggregates, meaning that the following analysis should be viewed with due caution.

In base year 1995 National Accounts terms, domestic demand grew by 4.2% in 2004. Its accelerating profile during the year was chiefly the outcome of the notable pick-up in investment in capital goods, and of the higher growth in investment in construction in the second half of the year, whereas private consumption held on a more stable path (see Chart 4.2). As can be seen in Table 4.1, final household consumption rose by 3.5% in 2004, a rate 0.6 pp up on 2003. Among the different components of consumption, there was a notable acceleration in spending on durable goods, both on cars and on other items, while it is estimated that spending on non-durable goods and on services posted similar growth to that in 2003.

Among the factors contributing to the rise in consumption in 2004 was, primarily, disposable income, which quickened in relation to the previous year. Moreover, given that consumer

	% of GDP		RATE OF CHANGE					
	1995	2004	1999	2000	2001	2002	2003	2004
HOUSEHOLDS AND NPISHs								
Final consumption expenditure	59.8	60.3	4.7	4.1	2.8	2.9	2.9	3.5
<i>Durable consumption</i>	5.7	7.3	12.9	0.8	1.9	-3.0	4.3	9.6
<i>Non-durable consumption</i>	54.1	53.0	3.6	4.6	2.9	3.6	2.7	2.7
Residential domestic investment (b)	5.7	7.3	8.6	8.6	1.2	7.3	6.1	6.5
CORPORATIONS								
Private productive investment (c)	12.6	14.3	9.9	7.0	2.8	-2.8	2.0	3.4
<i>Construction and other products</i>	6.3	7.0	11.2	10.7	7.7	1.2	3.8	2.4
<i>Equipment and other products</i>	6.3	7.3	9.0	4.3	-1.2	-6.2	0.3	4.4
GENERAL GOVERNMENT								
Final consumption expenditure	18.1	18.8	4.2	5.6	3.5	4.1	3.9	4.9
Gross fixed capital formation	3.7	3.6	4.8	-5.4	7.9	10.9	2.2	5.9
<i>Construction and other products</i>	2.9	2.6	5.0	-10.4	8.6	11.9	0.9	4.5
<i>Equipment and other products</i>	0.8	1.0	4.5	10.4	5.9	8.3	5.9	9.3
MEMORANDUM ITEM								
Gross fixed capital formation	22.0	25.2	8.8	5.7	3.0	1.7	3.2	4.6
<i>Equipment</i>	6.1	7.0	7.8	4.7	-1.2	-5.4	1.0	5.8
<i>Construction</i>	12.6	14.2	9.0	6.2	5.3	5.2	4.3	4.4
<i>Other products</i>	3.3	3.9	10.3	6.1	3.7	3.0	3.0	3.2

SOURCES: INE and Banco de España.

a. Base year 1995 National Accounts figures. Data in real terms.

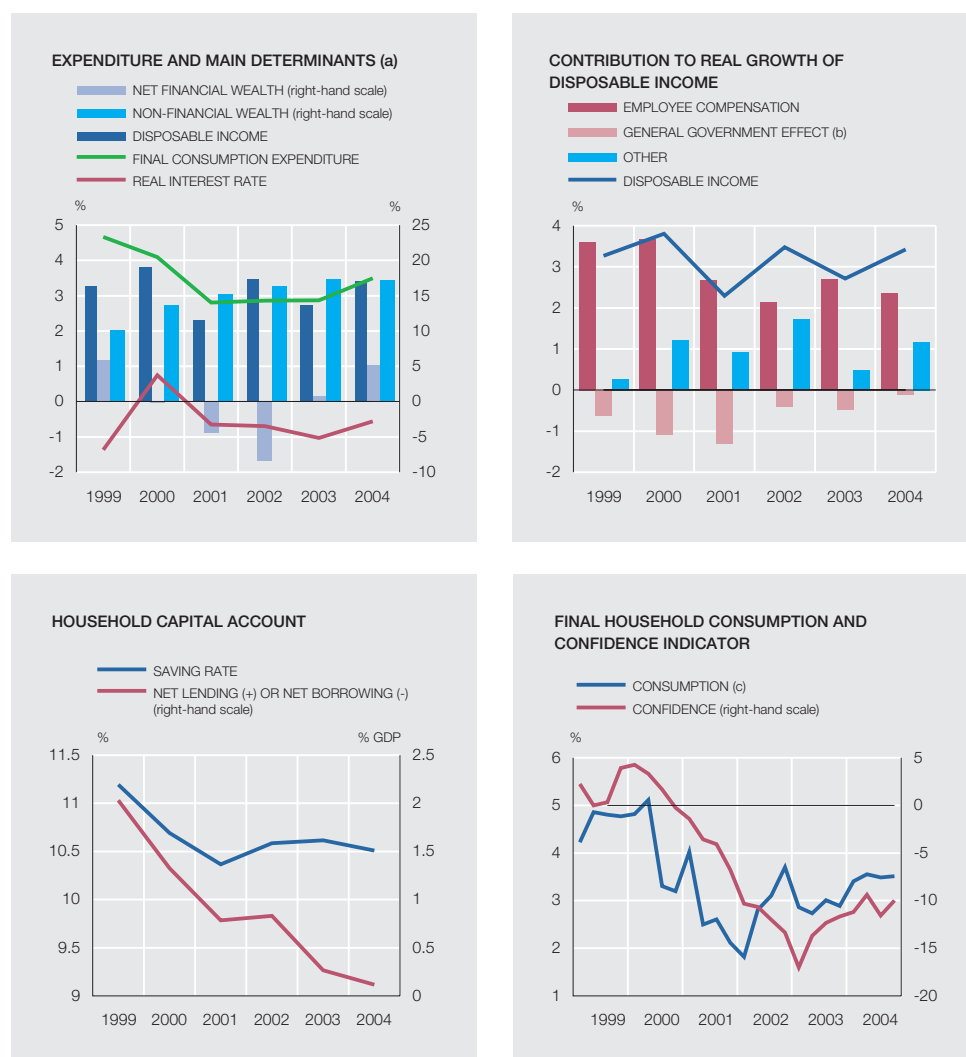
b. Excludes investment by sole proprietors.

c. Includes investment by sole proprietors.

prices increased at a similar rate to that of 2003, the acceleration in gross disposable income fed through in full to income in real terms, the growth of which was 3.4%, 0.7 pp up on the increase recorded in 2003. This bigger increase was due principally to a net contribution by general government which was less contractionary than usual and to the behaviour of the surplus of sole proprietors (see Chart 4.3). In turn, the bigger public-sector contribution to the growth of household income was the result of the behaviour of welfare benefits, influenced in part by the effect of the indexing of pensions. Further, the increase in unemployment coverage and in the minimum and maximum limits of the related benefits boosted the growth of this item. Conversely, the contribution of wage income to disposable income fell owing to the more moderate growth of real wages, which reflected the lesser rise in wage rates and a more moderate effect of the indexation clauses relative to 2003. Wage income benefited, however, from the continuing favourable behaviour of employment, the rate of increase in which stepped up in 2004.

As indicated in the first section, interest rates held relatively stable in 2004, though the cost of credit fell slightly. In general, the decline in interest rates in recent years has helped restrict the increase in the household financial burden, although the net contribution of interest to the growth of disposable income remains negative. Last year the slight reduction in nominal interest rates passed through to real rates, contributing to the buoyancy of consumption.

Net household wealth in 2004 exerted an expansionary influence on consumption which is even more intense than in previous years (see Chart 4.3). Both property wealth, which contin-

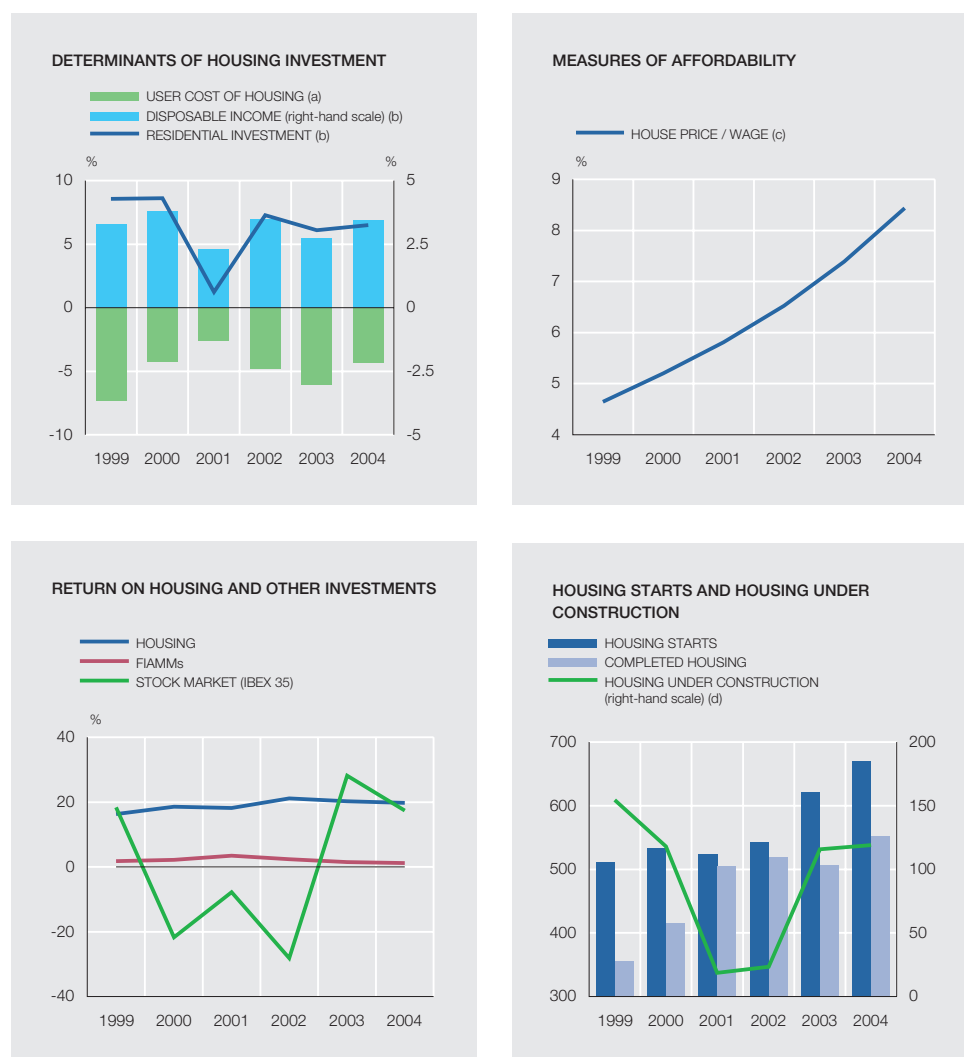


SOURCES: INE and Banco de España.

- a. Real rates of change. Interest rate in absolute variations.
 b. Includes welfare benefits, social security contributions and taxes on income and wealth.
 c. Year-on-year growth rate of the real seasonally adjusted series of final consumption expenditure of households and NPISHs.

ued to grow at a very high rate, boosted by the rise in house prices, and net financial wealth, whose average growth was higher than in 2003, were propitious to the expansion of household spending and to a reduction in the saving rate. Consumer confidence, which had clearly improved in the second half of 2003, held stable in 2004 (see Chart 4.3). There was a notable improvement in households' perception as to the possibility of saving in the future, which might denote a rise in their income expectations, a factor which would also have contributed to bringing about a decline in the saving rate in 2004. Moreover, the current low level of real interest rates and, therefore, the opportunity cost of consumption are not conducive either to a pick-up in the saving rate.

Domestic residential investment by households continued to grow at a high rate of around 6% in 2004. Contributing to this robustness were the various determinants of the demand for housing, most notably the growth of real income and of wealth built up in recent years. Likewise, the reduction in user cost — which includes the effect of interest rates and of the rise in value of these assets — continued to exert an expansionary effect on residential invest-



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

- a. Real change.
 b. Base year 1995 National Accounts. Real rates of change.
 c. Wage approximated by the ETCL annual wage cost.
 d. Annual difference: housing starts less completed housing.

ment, albeit with less intensity than in the two previous years (see Chart 4.4). However, the affordability of housing, measured in terms of the ratio of house market prices to average wages, deteriorated further, which particularly impacted potential buyers with less accumulated net wealth.

Demographic factors have also boosted the demand for primary residences in recent years. The creation of new households, running at an annual average of 240,000, has stood since 1997 above the average value in the eighties and the first half of the nineties. Contributing factors here have been the arrival at adulthood of the generations of the sixties and early seventies, when the birth rate expanded strongly, and the reduction in the average size of households, owing to the ageing of the population and, in general, to the change in the traditional models of household formation. More recently, the exceptional growth of the immigrant population has been a factor in the expansion of new households. While their influence on house purchases is still limited, their impact on the demand for rental housing is no doubt more significant.

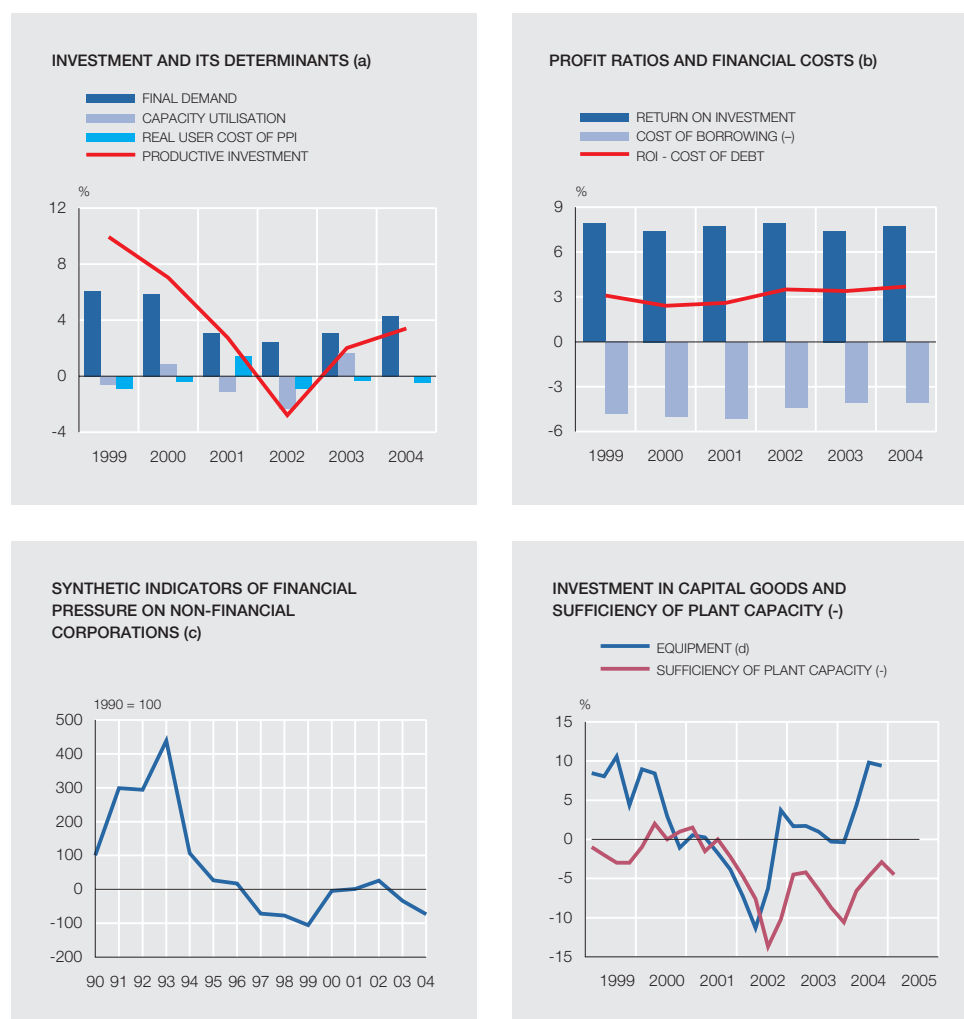
The use of housing as a form of wealth placement remained a significant motive driving the demand for real estate in 2004, owing to the attractive return provided by real-estate investment compared with other alternative placements (see Chart 4.4). Indeed, although the stock market recovery of late 2003 continued into early 2004, stock market indices fluctuated during the rest of the year. As a result, the average return on investment in equities was once again lower than that on investment in housing (including rental). Finally, the increase in a major segment of the demand for housing, namely non-resident demand, was checked significantly last year, judging by the decline in net flows directed to Spain for property purchases, which was in contrast to the growth recorded in previous years.

Overall, household spending on consumption and residential investment remained expansionary in 2004 and posted an acceleration which was particularly sharp in spending on durable goods. As indicated, this made for a decline in the saving rate and, also, for a fall-off in the sector's financing capacity, which stood at a value very close to zero (see Chart 4.3). As a result households, which have traditionally provided funds to the rest of the economy, saw their financing capacity reduced to a bare minimum.

As regards the demand exerted by general government, final consumption spending grew by 4.9% in real terms in 2004, up on the figure of 3.9% for the previous year (see Table 4.1). In nominal terms there was also an acceleration, from 7.4% in 2003 to 9.8% in 2004. Although this rate might be somewhat biased upwards (the base year 2000 data on general government accounts, released by IGAE, point to a lesser acceleration to 8.7%), it is in any event indicative of the rise government consumption underwent last year. Among the components of this aggregate, employee compensation grew by 7.4%, compared with 6.6% the previous year, despite the fact that public-sector job creation fell significantly. Purchases of inputs quickened considerably, reflecting in part some exceptional spending on military equipment.

Public investment is estimated to have grown by 5.9% in real terms in 2004, representing an acceleration on 2003. Affecting this figure, however, was the reorganisation of the railway sector last year, which involved the State taking control of the conventional railway network. If an adjustment is made for this effect, the rate of change of general government investment in 2004 will become slightly negative. It should also be borne in mind that the public investment figures do not include investment in construction routed via State-held entities of the Ministerio de Fomento group, which is recorded as a private-sector investment. Government procurement, which does include works tendered by the foregoing entities, behaved asymmetrically last year. Until June the volume of orders for works, influenced perhaps by the electoral period, saw a reduction on a scale similar to that observed in 2003 as a whole; however, as from the summer there was a notable strengthening in procurement, which ended the year 2004 at a growth rate of 18%. The rise was particularly sharp in the civil engineering works segment, which increased by 24%, mainly as a result of the works ordered directly by the Ministerio de Fomento, while procurement by the companies linked to this Ministry (AENA, GF/ADF, RENFE, Puertos, etc.), which had been very buoyant in recent years, grew much more moderately, with the exception of the public-sector entity Puertos del Estado.

The information from the PEIT (Infrastructure and Transport Strategic Plan), presented in December 2004, suggests that investment in public works will remain resilient over the coming years. The PEIT estimates investment in infrastructure — mainly roads and railways — for an amount exceeding €240 billion euro over the period 2005-2020. 60% of this infrastructure will be financed by the budget, while the remaining 40% will be privately financed (users and concessionaires). Against this background, the investment envisaged in the State budget for 2005 includes an increase in infrastructure investment of 10% in homogenous terms, that is to say,



SOURCES: INE, European Commission and Banco de España.

- a. Real rates of change and absolute variations for plant capacity utilisation and for the real user cost of PPI.
- b. CBA data to 2003 and CBQ data for 2004.
- c. Aggregate mean weighted by the stock of capital (1990=100). A higher (lower) value than 100 denotes greater (lesser) financial pressure than the benchmark.
- d. Year-on-year growth rate of the real seasonally adjusted series of gross fixed capital formation in capital goods (QNA, base year 1995).

taking into account the restructuring of the railway sector, which involves the transfer to the State of conventional railway network maintenance expenses.

Gross fixed capital formation undertaken by companies is estimated to have increased by 3.4% in real terms in 2004, up 2% on the previous year. Indeed, the pick-up in corporate investment in 2004 was sharper than these figures indicate, since they are affected by the railway reorganisation discussed above. On base year 1995 National Accounts figures, reflected in Table 4.1, the recovery in private productive investment responded to the notable momentum of investment in equipment and was also sustained by investment in construction, whereby both components contributed to the growth of this aggregate, unlike in previous years when the increase in corporate investment was concentrated to a greater extent in construction. As can be seen in the earlier reference to public works, in the case of construction the activity of the public corporations entrusted with the construction of infrastructure, whose role in sustaining productive investment was very significant in previous years, was

more moderate in 2004. In terms of its year-on-year profile, productive investment is estimated to have quickened notably in the second half of the year, following the course of investment in equipment. On Quarterly National Accounts figures, this latter variable ended 2004 at a year-on-year growth rate of 9.5% in Q4, in which period equipment became the most dynamic component of domestic demand. Overall, according to base year 1995 National Accounts figures, total gross fixed capital formation — including public and residential investment — would have increased by 4.6% in 2004, compared with 3.2% in 2003. By type of project, investment in capital goods would have risen by 5.8%, after having been flat in 2003 (1%), and investment in construction by 4.4%, in line with the previous year. The new base year 2000 figures place the increase in gross fixed capital formation in 2004 at 4.4%, close to the base year 1995 data, but with a different course and composition. In particular, they reflect a greater increase in construction, albeit on a decelerating trend, and stable growth in equipment of around 2% (see Box 1.1). The breakdown of these figures by institutional sector is not yet available.

The moderately expansionary behaviour of productive investment in 2004 as a whole, which became firmer in the second half of the year, is in response to the favourable course of its main determinants. Chart 4.5 depicts the trend of the factors conditioning this aggregate. It can be seen that, last year, the renewed buoyancy of demand, the additional cut in the user cost of capital and, in general, the improvement in the financial position of companies made for a setting, in principle, that was most propitious to investment expenditure.

Specifically, final demand, underpinned both by domestic spending and by exports, increased by 4.3% in 2004, moving on an accelerating profile in the second half of the year. This variable was one of the main factors behind the increase in investment. The higher growth in demand during 2004 gave rise to an increase in plant capacity utilisation in industry, the annual average of which stood at 79%, slightly up on the historical average (78.2%). Similarly, the percentage of industrial corporations that viewed their plant capacity as excessive diminished continuously during the year, and the business climate indicator in the capital goods industry improved as a result of the upward revision of production expectations, supported by an increase in orders, especially on the domestic front.

The user cost of capital in real terms fell for the third year running as a result of the notable revaluation of investment goods (proxied by the deflator of private productive investment), against a backdrop of low interest rates and lower risk premiums. In general, the pick-up in business investment during the year was underpinned by the favourable trend of the attendant financial determinants. Drawing on Financial Accounts information, the financing gap — which measures the net resources needed by companies to undertake investment — declined slightly in 2004. The data relating to the quarterly Central Balance Sheet Data Office survey show that companies' ordinary profits trended very favourably, and across most industries. In these circumstances, the debt ratio held on a declining profile since the companies in the sample — which are mainly major corporations — undertook their investment projects without having to resort, in net terms, to the financial markets. The favourable trend of corporate results, set against the reduction in the debt ratio and in the financial burden, meant an improvement in the synthetic indicator of financial pressure on investment (see Chart 4.5).

In sum, productive investment ended 2004 on an expansionary trend which appears to respond to the favourable demand and financing conditions, now that the business sector has largely completed the restructuring process undertaken in the opening years of this decade. In this respect, the outlook for 2005 is one of high dynamism which, indeed, is apparently borne out by medium-term profit expectations. Nonetheless, some of the trends characterising the



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

- a. Real annual rates of change.
 b. Deflator of Spanish exports in relation to rest-of-the-world export prices, adjusted 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 of GDP of countries of origin of tourists to Spain, weighted according to the relative significance of the number of visitors.
 e. Real effective exchange rate, measured by consumer prices, vis-à-vis the OECD.
 f. Inverse of the producer price index in relation to the Spanish imports deflator.
 g. Contributions to growth.

Spanish economy, such as low productivity growth or competitiveness problems, might ultimately affect corporate investment plans.

Turning to the analysis of external demand, real exports of goods and services quickened in 2004 according to base year 1995 National Accounts figures, rising by 4.3% compared with 2.6% in 2003. However, the new base year 2000 National Accounts data point to a slowdown in this variable from somewhat higher rates in 2003. Component by component, goods exports climbed by 6.5% in real terms on base year 1995 figures, while exports of services contracted for the third year running, ending the year with a decline of 0.9% (–0.3% in 2003). These developments in exports came about against the backdrop of a notable acceleration in world trade, which was reflected in a somewhat more moderate increase in Spain's export markets, given the low weight of the most dynamic markets in the structure of Spanish foreign

trade. The appreciation of the euro was partly countered by the containment of export prices, which restricted the loss of competitiveness associated with the trend of the exchange rate. As a result of the combination of these factors, Spanish exports grew at a lower rate than world markets, which gave rise to a reduction in their share in real terms (see Chart 4.6).

Looking more closely at the determinants of goods exports, world demand continued in 2004 on the expanding course on which it embarked in the second half of 2003. Underpinning the growth in global trade was the acceleration in imports to the United States, Japan and the Latin American countries, along with the continuing strength of the imports of the south-east Asian and central and eastern European countries, while the imports of the euro area countries and the United Kingdom accelerated to a lesser extent. Overall, the increase in world trade in 2004 in real terms was 9.9%, following the figure of 5.3% in 2003, while the growth of Spain's export markets was more moderate at 8.6% due to the fact that exports to the EU account for more than two-thirds of total sales.

There was a further loss in the price competitiveness of Spanish products in 2004. The euro continued to appreciate against the dollar (by 9.9%) and against most of the main currencies. Consequently, the nominal component of the Spanish economy's competitiveness indices vis-à-vis the non-euro area developed countries rose by 2.3%, placing the cumulative appreciation since 2002 at 16.1%. As has been the case in recent years, Spanish exporting firms mitigated the relatively dearer cost of their products arising from this appreciation by easing their export prices. In this respect, the base year 1995 National Accounts data reflected a fall in the goods exports deflator of 1.1%, which would have enabled most of the loss of competitiveness associated with the course of the exchange rate to be offset. That said, the behaviour of the unit value indices (UVIs) of goods exports, which accelerated moderately in 2004 (growing by 1%), would indicate that this offset was not complete. Taking the UVIs as a reference gives a loss in the price competitiveness of Spanish products vis-à-vis the non-euro area countries, while competitiveness vis-à-vis the euro area countries would have held stable.

According to the foreign trade data compiled by the Dirección General de Aduanas (Customs Authorities), deflated by the related UVIs, goods exports posted growth of 5.2% in real terms in 2004, below the National Accounts estimates. At the disaggregated level, sales to EU countries increased by 3.4%, compared with 7% in 2003, with a lower growth profile in the first half of the year and a recovery in the second, reflecting the high growth rate of exports in the opening months of 2003. Exports outside the EU remained notably buoyant and increased by 10%, in line with the greater momentum of demand in these economies. In respect of the EU countries, sales to Germany moderated notably and exports to Italy and to the enlargement countries fell, while exports to Portugal and, to a lesser extent, to France and the United Kingdom accelerated. As regards non-EU countries, there was a pick-up in most markets following the slide seen in 2003. Particularly notable were sales to Japan and to the OPEC countries, whose purchasing power increased owing to the rise in oil prices; however, sales to the United States grew at a very modest rate.

Exports of services in real terms declined in 2004 for the third year running. This was largely due to consumption by non-residents, which, according to the base year 1995 National Accounts estimates available, contracted by 1.8% (see Chart 4.6). This fall-off came about against a background of a notable expansion in world tourism, which increased by 10% in 2004 in terms of tourist numbers according to data from the World Tourism Organisation. The 3.2% rise in the number of tourists arriving in Spain, following a fall of 1% in 2003, meant a reduction of 0.5 pp in the Spanish share in world tourism — as measured by the number of visitors — to 7%. Despite this, Spain remained the second most popular tourist destination after

France. The continuing declining trend of spending per tourist and of the average duration of their stay partly explains the apparent disparity between the increase in the number of tourists and the reduction in receipts.

Certain events in 2004 contributed to limiting the number of visitors, especially in Q2 and Q3. These included most notably the Madrid terrorist bombings on 11 March and the sporting events in Portugal and Greece in the summer. Regarding the fundamental determinants of tourism demand, income picked up in the main — particularly European — countries that supply tourists for Spain. However, this improvement in demand was offset by the losses in price competitiveness and, in general, by the growing competitive pressure exerted by other destinations. For one thing, tourist prices outgrew those in alternative destinations and those in the tourist-supplying markets owing to the wide inflation differential with the euro area and to the path of the exchange rate. For another, the competition posed by certain emerging destinations, especially in central and eastern Europe and in the eastern Mediterranean, became heightened; these destinations offer a nearby and accessible alternative for European tourists when set against mature destinations such as France, Italy and Spain. Indeed, according to World Tourism Organisation estimates, tourist arrivals in central and eastern Europe increased by 8% in 2004, while tourist inflows into the southern European countries rose by around 3%. Significantly, the competition from these countries is particularly marked in the sun and beach segment, which is also in keeping with the weakness shown by tourism receipts in the central months of 2004.

The momentum of final expenditure in the Spanish economy in 2004 contributed to the buoyancy of imports of goods and services which, on base year 1995 National Accounts figures, accelerated sharply in real terms and increased at a rate of 9%, up on 4.8% in 2003. The new base year 2000 estimates confirm this acceleration, although they have it as less intense. Goods purchases, in base year 1995 terms, posted an increase of close to 10%. As indicated, final demand grew by 4.3% last year, up from 3.1% the previous year, reflecting an acceleration both in the main domestic demand components and in exports. Nonetheless, the fact that investment in equipment and the consumption of durable goods — spending components with a high import content — should have contributed particularly to this momentum no doubt intensified the resort to foreign purchases. Moreover, the course of prices also boosted the increase in imports, raising their degree of penetration in the Spanish domestic market (see Box 1.4).

As regards goods imports, the increase in the dollar price of non-energy commodities and, in particular, of oil was countered only partly by the appreciation of the euro, prompting, overall, a 4.5% increase in the prices of imported intermediate goods (proxied by the related UVIs). However, consumer goods import prices grew very moderately by 0.4%, while those of capital goods declined. Against this background, and according to Customs data, goods imports grew by 9.8% in real terms over the course of 2004. In terms of products, imports trended in step with the main demand components and with the behaviour of their prices. Capital goods purchases were notably buoyant, increasing by 14.9% in real terms for the year on average, boosted by the pick-up in private productive investment, especially in the second half of the year. Purchases of transport equipment climbed by 21.2% in nominal terms, those of office and telecommunications equipment by 14.7%, and those of industrial machinery by 12.2%. Imports of consumer goods (those chiefly responsible for the acceleration in relation to 2003) registered real growth of 13.4% in 2004, underpinned by the strength of consumer durables purchases, notably cars and motorcycles (which increased at a nominal rate of 24%), furniture (22.8%) and consumer electronic goods (20.2%). plastic, foreign purchases of intermediate goods trended more moderately, growing by 7.1% in real terms against a backdrop of moderately recovering industrial activity. By geographical area, goods purchases from the EU rose by 7.3%, while those from the rest of the world increased by

14.2%, boosted by the additional appreciation of the euro, which curbed the growth of import prices in a setting of dearer oil prices.

Services imports grew by 4.5%, up on 2.8% in 2003. This was the result of a combination of growth in tourism payments standing at a historical high of 21.8% in real terms, compared with 5% the previous year, and an easing of imports of other services. Contributing to the marked acceleration in tourism spending by residents were first, the positive trend of the determinants of consumption and, further, the appreciation of the euro in recent years, which has notably reduced the cost of destinations outside the euro area and, especially, of those where the dollar is used.

In sum, exports of goods and services in 2004 posted moderate growth below that of world trade, while imports were notably buoyant (see the bottom panels of Chart 4.2). As a result of this performance, the negative contribution of the external sector to GDP growth increased significantly to 1.7 pp, having subtracted 0.8 pp from growth in 2003. This negative contribution largely countered the expansionary impulse of national demand, restricting acceleration in output: over the year as a whole, GDP grew by 2.7% on base year 1995 National Accounts estimates, 0.2 pp up on 2003. As Chart 4.2 shows, the profile of output during the year was fairly stable, with the negative contribution of external demand increasing progressively as domestic spending stepped up.

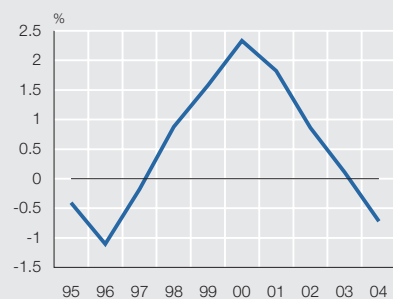
3 Activity

The new base year 2000 National Accounts figures reflected the greater dynamism shown by GDP in 2004: 3.1% against 2.9% in 2003. This was the result of the pick-up in value added in the market economy, where the growth of 3% was more than half a percentage point up on the figure of 2.4% the previous year. The base year 1995 National Accounts figures placed the growth of value added in the market economy at 2.4%, below the growth potential determined by productive factor endowment, meaning that the output gap declined once again in 2004. As can be seen in the top panel of Chart 4.7, the potential growth of the market economy increased in 2004 owing to the improvement in the contributions of total factor productivity (TFP) and, above all, of potential employment. In the case of TFP the rise was hardly noticeable, although it confirms the interruption in the previous pattern of decline. As is analysed in detail in Chapter 1 of this Report, the rise in potential employment is part of a prolonged process of increased labour supply in Spain. This is the outcome of several influences, most of which have continued to operate in 2004, such as the increase in the participation rate (linked to immigration and to the greater incorporation of women into the labour market). The year 2004 also saw a fresh decline in the structural rate of unemployment. In short, the increase in employment last year was once again the main factor behind GDP growth, while the contribution of the incorporation of technical progress (despite undergoing a slight rise) and of the stock of capital scarcely altered.

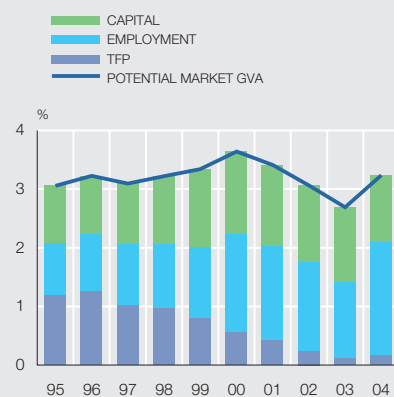
All branches of activity in the market economy were more buoyant in 2004, with the exception of construction, which lost steam despite registering the highest growth. Although the weather was not excessively benevolent during the year, the fact it improved on 2003 meant that value added in the agriculture and fisheries branches was less contractionary than the previous year (see Chart 4.7), declining by 0.6% (–1.4% in 2003). Yields for most crops increased, but in those cases where there were losses, these were significant. Specifically, both fruit and olive-oil production contracted at a rate well into double figures. Livestock production, for its part, held on the path it followed in 2003, with its growth rate moderating due essentially to the loss of momentum in the livestock breeding component.

As can be seen in the lower panels of Chart 4.7, the industry and energy branches showed fresh momentum in 2004, underpinned by the pick-up in exports and the rise in investment in capital goods, while domestic consumption had a lesser knock-on effect on the demand for

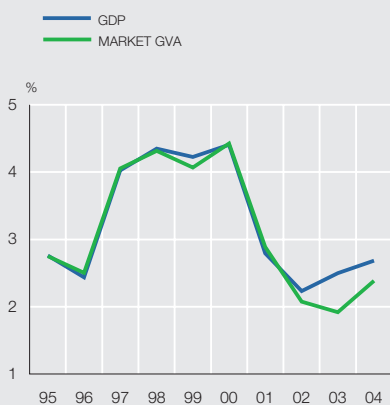
MARKET GVA (a): OUTPUT GAP



CONTRIBUTION TO GROWTH OF POTENTIAL MARKET GVA



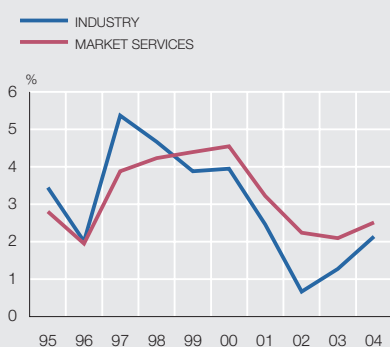
GDP AND MARKET GVA (b)



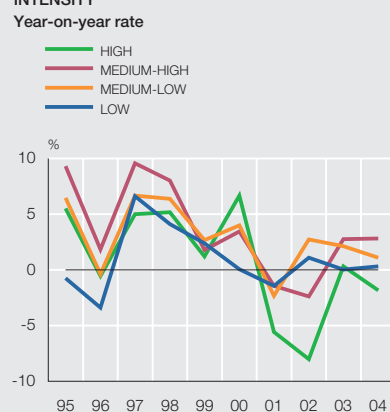
AGRICULTURAL GVA AND CONSTRUCTION GVA (b)



INDUSTRIAL GVA AND MARKET SERVICES GVA (b)



INDUSTRIAL PRODUCTION BY TECHNOLOGICAL INTENSITY



SOURCES: INE and Banco de España

a. Gross value added.

b. Base year 1995 National Accounts. Real year-on-year rates of change.

domestic industrial products. Overall, the year closed with growth in industrial value added of 2.1%, 0.8 pp up on 2003, narrowing slightly the negative gap seen the previous year in relation to its trend level. The favourable behaviour of industrial and energy-related activity was part of a scenario of moderate industrial expansion across the whole euro area, though this showed signs of weakening in the closing months of the year, both in the euro area and in Spain. As regards the technological content of the various industrial activities, those characterised by their use of medium-high technology, which retained the pace they showed in 2003, were the most dynamic. Low-technology activities picked up somewhat, while the high-technology branches contracted (see the bottom right-hand panel of Chart 4.7). The labour-intensive industrial branches continued to contract at a rate similar to that in 2003. That prevented a greater recovery in employment in industry, which saw net job destruction in 2004 on base year 1995 National Accounts estimates, albeit with an improving profile over the course of the year.

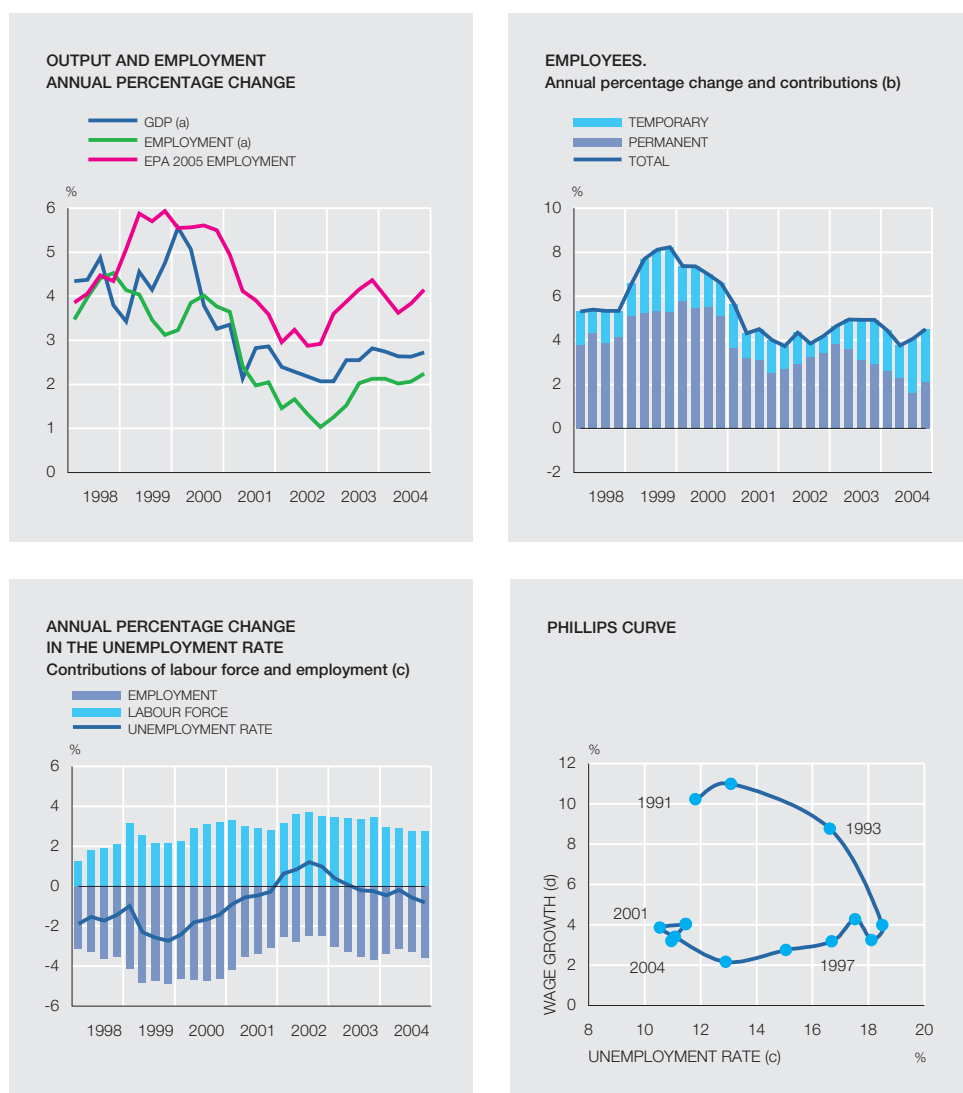
According to base year 1995 National Accounts figures, the growth rate of activity in the construction branch eased by 0.6 pp to 3.7% in 2004. The slowdown in construction activity in 2004 was continuous, albeit moderate, whereby its buoyancy remained greater than that of the rest of the economy. Consequently, the pressure on the sector's productive capacity remained considerable, and for the sixth year running the level of output exceeded its trend, although the gap between both narrowed. In terms of the type of work, the biggest increases continued to be seen in house construction, reflecting the high volume of housing starts the previous year and in 2004 itself. The construction of buildings for other uses posted more moderate growth, largely sustained by the demand for industrial plant. Finally, civil engineering works lost momentum in 2004 in view of the lesser robustness of government procurement in the second half of 2003 and in the first half of 2004. The momentum of government procurement in the latter year was concentrated in the final six months, following the hiatus caused by the change of legislature.

Value added in market services gathered a degree of momentum in 2004, and its growth rate rose by 0.4 pp on 2003 to a rate of 2.5% on base year 1995 National Accounts figures. Although there was some uncertainty at the start of the year concerning the potential economic consequences of the terrorist bombings in Madrid on 11 March, any lasting effects of these attacks were not finally discernible. Nonetheless, the negative output gap widened in 2004. Among the activities contained in this branch, mention should be made of real-estate and business services, the former for their high buoyancy and the latter for the sharp acceleration the IT and R&D sectors underwent, after several years of stagnation. The growth of commercial activities also increased, albeit in a contained fashion, thanks to the sectors related to cars and wholesale trade. Finally, hotels and catering and the transport sector, both of which are relatively sensitive to situations of uncertainty, trended moderately, mainly as a result of domestic and external macroeconomic conditions.

Regarding non-market services and taxes net of subsidies, the respective growth rates were 3.5% and 4% in real terms (6.7% and 11.9% in nominal terms, close to those observed in 2003). The caveats mentioned in connection with government consumption, concerning a possible bias in the estimation of these aggregates for 2004 linked to the re-basing of National Accounts, are also applicable here. Elsewhere, the strong growth of taxes reflects the sizable increase posted once more in 2004 by indirect taxes.

4 The labour market

This section has been compiled using the base year 1995 National Accounts figures released by INE, the only data available when the Report went to press, while the information drawn from the Labour Force Survey (EPA) relates to the revision of this survey (EPA 2005) by INE in March 2005. The new EPA series now include the information from the 2001 census and the continuously



SOURCES: INE and Banco de España.

- a. Base year 1995 QNA. Seasonally adjusted series. Equivalent employment.
 b. EPA 2005 (Spanish Labour Force Survey).
 c. EPA 2005. Unemployment series chained at the Banco de España.
 d. Compensation per employee in the market economy.

updated municipal population census, with the consequent demographic changes. This revision has entailed a considerable increase in the estimated total population owing to the rise in the immigrant population, which has fed through to the total figures for the working age population, the employed and the unemployed³. The base year 2000 National Accounts estimates, released after the close of this Report, have also included the new population and employment figures. According to the base year 2000 National Accounts data, employment increased by 2.7% in 2004, extending the mild acceleration which it showed in 2003 (see Box 1.1).

The base year 1995 figures used for the analysis hereafter also indicated that employment⁴ continued in 2004 on the progressive path of recovery initiated the previous year, running in

3. For an analysis of these new estimates, see the «Quarterly Report on the Spanish Economy» in the April 2005 Economic Bulletin, and the article in Spanish on employment in 2005 Q1 in the May 2005 Boletín Económico. 4. Measured by the number of full-time equivalent jobs.

parallel to economic activity. According to these figures, net job creation stood at 2.1% in the economy as a whole, 0.4 pp up on the growth recorded the previous year (see the upper left-hand panel of Chart 4.8). In the market economy, there was a sharp recovery in employment which posted an increase of 2.5%, compared with 1.7% in 2003. On EPA figures, the dynamism of employment was considerably higher than that reflected by the base year 1995 Quarterly National Accounts figures (and by the estimates under the new base). In particular, the new EPA shows growth in employment of 3.9% for 2004, similar to that recorded in 2003, while in the market economy the rise would be 3.8%, against 3.3% in 2003.

In any event, the base year 1995 estimates highlight the fact that the gains in apparent labour productivity in 2004 were once again very low (0.6%), close to those recorded in previous years. In the case of the market economy, apparent labour productivity fell by 0.1%, after having grown by 0.2% in 2003. As in previous years, the trend in productivity in the market economy was in line with the moderate behaviour of real-terms labour costs, which fell by 1% in 2004 owing both to a certain moderation in unit labour costs and to the high growth of the value added deflator. The growth rates of productivity were particularly affected by the re-basing of the National Accounts, since the revision has affected output and employment to differing degrees. In particular, the new estimations reduce the average growth of productivity in the period 2001-2004 by 0.2 pp. Box 4.1 offers a disaggregated analysis of the factors behind the recent behaviour of labour productivity.

The pick-up in employment in 2004 did not affect all branches of activity equally. On base year 1995 National Accounts figures, employment creation accelerated in services and in construction, whereas jobs continued to be destroyed in agriculture and industry, albeit at a lesser pace than in previous years. In industry, the recovery in activity was not enough to bring about a net increase in jobs, meaning that apparent productivity posted very high gains. In any event, the decline in employment (-0.9%) was consistent with a quarterly profile of recovery. In agriculture, job destruction continued at a rate of 2.1%. In construction, by contrast, employment accelerated mildly, posting average growth of 3.9% and moving on a rising trend in the second half of the year; however, labour productivity fell by 0.2%. Finally, employment in market services quickened slightly, showing average growth of 4.1%, while the increase in non-market services was only 0.6%. In market services, the acceleration in employment was accompanied by a significant decline in apparent labour productivity (-1.5%), in line with the reduction in real labour costs in this sector. The EPA 2005 estimates by branch of activity broadly corroborate the relative behaviour of employment across the different branches last year, albeit with higher growth rates, especially in construction. In industry, meantime, employment stabilised, without actually falling.

Turning to the composition of employment, numbers of wage-earners slowed in 2004 to 4.2% on the new EPA data, while the self-employed picked up to a rate of increase of 2.6%. Under wage-earners, the biggest growth was concentrated in the temporary-contract and part-time segments. Specifically, the number of workers with temporary contracts outgrew that of wage-earners with a permanent contract for the first time in the last ten years, increasing by 6.4% and showing, moreover, greater dynamism in the second half of the year. The growth rate of numbers of permanent-contract employees eased to 3.2%, though it picked up somewhat in the final quarter of the year (see Chart 4.8). Consequently, temporary employees as a proportion of total employees rose to 32.5% during 2004, interrupting the progressive though very moderate path of decline seen since 1995. Labour turnover, measured by the number of contracts per wage-earner, also increased again, after several years of mild reductions. These results are a warning that the current arrangements for promoting permanent contracts, through rebates on social security contributions and lower firing costs for certain types of per-

A characteristic feature of the Spanish economy's growth pattern in the last few years has been the low growth of apparent labour productivity. Against this background, the economic growth of the last ten years has been based primarily on high job creation, the impact of which has varied from one productive sector to another. The relationship between job creation and the deceleration of productivity and its causes are key issues when it comes to assessing the sustainability of economic growth in the future.

To analyse to what extent the deceleration of productivity is a phenomenon derived from a greater use of labour, from changes in the sectoral composition of employment or from a lower growth rate of technological progress in the economy, it is necessary to resort to sectoral analysis. Presented below are the results for 17 productive branches of the market economy in the period 1980-2002. By breaking down labour productivity into the contributions from the capital/labour ratio and from total factor productivity (TFP), defined as GDP growth not explained by growth of productive factors, from labour, measured as the total number of hours worked, and capital, it can be observed to what extent the behaviour of labour productivity is related to the substitution of productive factors or to total factor productivity, which is an approximate indicator of the growth rate of technological progress¹.

The accompanying table shows that labour productivity decelerated from the second half of the 1990s, having posted average annual growth in the market economy of 3.4% from 1980 to 1995 and of

0.8% from 1996 to 2002. This slowdown in productivity has been widespread in the various productive branches. Thus industry showed annual growth in labour productivity of 0.7% from 1996 to 2002, against growth of 3.1% from 1980 to 1995, and the productivity of the services sector grew by only 0.4%, against 2% in the previous period. The labour productivity of the construction industry showed zero growth from 1996 to 2002 (2.7% in the previous period) and, finally, agriculture reported higher growth (2.9%), although it was also considerably lower than in the previous period (6.6%). In all productive branches, except in the construction industry, this slowdown is due to a sharp reduction in the growth of technological progress and a slowdown in the capital/labour ratio. Thus TFP showed annual growth of 0.3% in manufacturing industry from 1996 to 2002 (over 2 pp less than in the previous period) and it is estimated that it even fell in services (by 0.1%) and in construction (by 0.2%). Although job creation was somewhat stronger in services (3%) than in industry (by 2.3%), the decline with respect to the previous period in the capital/labour ratio was similar in both sectors. Finally, in construction, despite the sharp growth in

1. That is to say, the growth of labour productivity is broken down on the basis of the equation $\Delta y - \Delta l = (1 - \alpha) (\Delta k - \Delta l) + \Delta tfp$, where y is output, l is labour, k is the capital stock and α is the share of labour income in total costs. Perfect competition is not assumed, so the share of labour income is not calculated from value added, as is usually done when this assumption is made. For more information on the construction of the various series, see A. Estrada and D. López-Salido (2001), "La contribución de los factores productivos al crecimiento económico en España: un análisis desagregado", Boletín Económico, Banco de España, February 2001.

1. BREAKDOWN OF APPARENT LABOUR PRODUCTIVITY GROWTH

Year-on-year rate of change

	Labour productivity		Capital/employment ratio		Employment		Total factor productivity	
	1980-1995	1996-2002	1980-1995	1996-2002	1980-1995	1996-2002	1980-1995	1996-2002
Agriculture, forestry and fishing	6.6	2.9	5.9	0.7	-5.3	-1.6	4.9	2.8
Energy and mining and quarrying	5.8	6.3	3.6	1.9	-2.4	-2.2	3.8	5.2
Basic metals and metal products	2.3	-0.6	1.6	0.7	-1.5	3.6	1.9	-0.7
Other non-metallic mineral products	3.1	1.2	4.6	-0.2	-2.7	3.1	2.0	1.2
Manuf. of chemicals & chem. products	5.5	0.2	1.3	2.2	-1.6	1.8	5.1	-0.4
Machinery	4.0	0.5	3.3	1.9	-0.8	3.2	3.5	0.2
Transport equipment	4.0	-0.1	4.3	1.0	-2.2	2.7	2.9	-0.3
Food, beverages and tobacco	2.0	1.9	2.8	5.3	-0.8	-1.3	1.3	0.6
Textiles & text.prod., leather & footwear	2.8	-1.3	3.7	1.0	-3.3	2.3	2.3	-1.5
Other manufactures	2.5	4.0	4.4	4.5	-1.9	1.5	1.9	3.3
Paper, publishing and printing	1.4	0.5	3.8	1.7	-0.1	5.3	0.6	0.2
Rubber and plastic products	3.1	1.1	3.0	1.9	-0.4	3.4	2.4	0.7
Construction	2.7	0.0	1.5	4.2	-0.4	4.7	2.7	-0.2
Wholesale&retail trade; hotels&restaurants	1.8	-0.1	1.9	5.3	0.4	2.2	1.7	-0.4
Transport	2.5	1.8	3.6	-0.6	-1.3	2.4	1.0	1.8
Communication	4.5	9.9	2.5	7.1	1.3	-1.7	3.1	6.4
Other market services	1.4	-1.0	1.2	0.1	3.0	4.8	1.0	-1.1
Manufactures	3.1	0.7	3.1	2.1	-1.7	2.3	2.5	0.3
Market services	2.0	0.4	2.8	1.7	0.9	3.0	1.2	-0.1
Market economy	3.4	0.8	3.6	1.3	-1.0	2.5	2.5	0.5

SOURCES: INE and Banco de España.

employment (4.7%), the capital/labour ratio increased as a result of a surge in the capital stock of this sector in that period.

The diagnosis of a widespread slowdown in TFP remained unchanged after the various productive branches were analysed at a more disaggregated level. Within the industrial sector, there was a slowdown in TFP in the 10 branches for which information was available, except in the "Other manufactures" branch, with a negative TFP growth rate in four of them in the more recent period. In services, the TFP growth rate was negative in "Wholesale and retail trade" and in "Other services", but there was a certain recovery in "Transport" and in "Communications", where labour productivity growth was very high (9.9%) due to highly positive contributions from TFP and from the capital/labour ratio.

It follows from the above considerations that there are reasons to believe that the phenomenon of slowdown in productivity is somewhat more than a temporary effect linked to an episode of vigorous job creation or of changes in the sectoral composition of employment. Consequently, while continuing to encourage job creation, it would be advisable to foment an extensive process of structural reforms. These could include, on one hand, those reforms designed to raise the employment rate and productivity simultaneously, such as the accumulation of human capital, investment in R&D, heightened competition in goods and services markets, and the rationalisation of employment protection; and, on the other, those aimed at reducing barriers to the introduction of new technologies in firms and hence boosting productivity growth, which should be a priority objective.

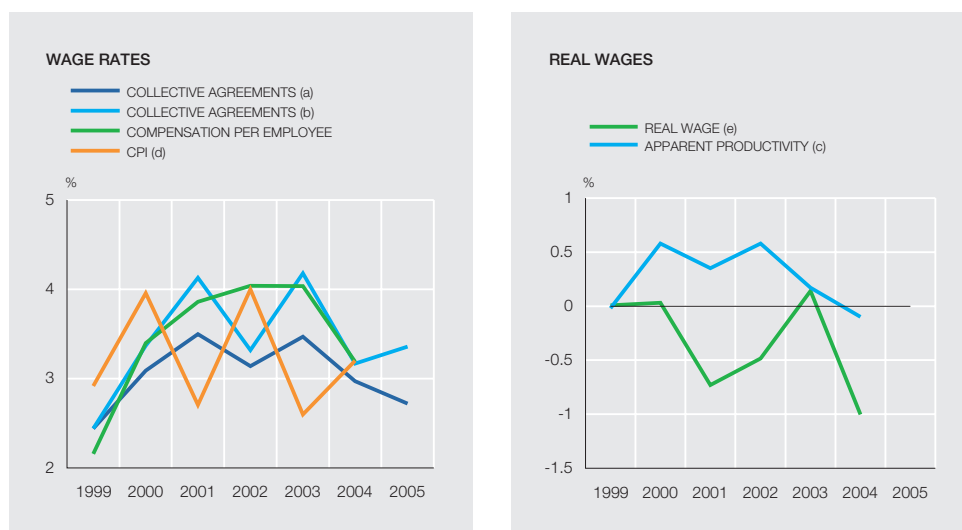
manent contracts, may not suffice to continue lowering significantly the temporary/permanent contract ratio. As mentioned at the start of this chapter, negotiations are currently under way between the government and the social agents to set the right framework for agreeing on a series of measures to effectively reduce the duality in the labour market. In this respect, the reduction of the differences between the firing costs for permanent and temporary contracts, making the former more attractive, may prove to be an effective way forward.

In terms of the length of the working day, most job creation was, as stated, concentrated in part-time employment, where numbers grew by 11.2% in 2004, almost double the rate the previous year. Conversely, the growth rate of the number of full-time employees eased to 3.3%, meaning that the proportion of part-time to total employees rose to 8.7%.

Finally, regarding nationality, the number of Spanish workers slowed slightly last year, growing by 1.8%, while the growth of immigrant workers was notably higher but also below the 2003 figure of 28.1%. As a result, foreign workers account for 9.2% of total employment in 2004, 1.7 pp up on the figure the previous year.

The number of new labour market entries last year remained high, with the labour force increasing by 3.3%, but less than in 2003, when it grew by 4%. The participation rate rose to 56.4% (0.9 pp up on 2003), or to 69.7% if this ratio is calculated for the population aged under 65. The biggest increase in participation was in the female segment, where the related rate climbed to 45.2%. In the case of the male participation rate the increase was smaller, taking it to 68.1%. The slowdown in the working population in 2004 was manifest both in Spanish nationals, whose numbers grew by 1.4%, and in immigrants; despite this latter group growing by 25.3%, the rate was down on that of the previous year.

The buoyancy of employment, along with the slight slowdown in the working population, meant that the number of unemployed fell by 1.3% in 2004, after having increased in the two preceding years (see Chart 4.8), moving moreover on a declining quarterly path. For the year as a whole, the unemployment rate fell by 0.5 pp on 2003 to 11%. Registered unemployment rate drawn from INEM data was broadly similar to that of the EPA, since although a slight increase in the number of unemployed (0.8%) was seen, this was less than in 2003 (2.2%), and in the final



SOURCES: INE and Ministerio de Trabajo y Asuntos Sociales.

- a. Excluding indexation clauses. The data for 2005 are to February.
b. Including the effect of the previous year's indexation clause. The data for 2005 are to February.
c. Market economy.
d. Annual rate of change in December.
e. Compensation per employee deflated by the value added deflator.

quarter of 2004 there was in fact a year-on-year decline in unemployment. By sex, there was a better performance by the female contingent, since the related unemployment rate declined by 1 pp to 15%, while the male unemployment rate fell by 0.2 pp to 8.2%. By age, the wide existing differences also narrowed slightly since it was the youth segments which performed best, with their unemployment rate declining to 17%, while among the over-45s the unemployment rate held stable (at 7.3%) and fell only slightly in the intermediate age group (to 9.7%).

Finally, it is estimated that the structural component of the unemployment rate declined in 2004. The weight of the long-term unemployed in total unemployment fell by 1.8 pp in 2004 to 34.9%, prolonging more sharply the gradual reduction seen in recent years. Further, the various estimates available on the NAIRU (non-accelerating-inflation rate of unemployment), made using the unemployment series prior to the EPA revision, reveal a certain reduction in this rate in the recent period, after having held stable at what were still high levels in the preceding years. Lastly, the estimation of the Phillips curve (in the lower right-hand panel of Chart 4.8) corroborates this diagnosis, as it shows how the fall in unemployment in 2004 was accompanied by wage moderation.

Wage settlements in 2004 under collective bargaining agreements eased significantly, despite the rise in inflation in the second half of the year (see the left-hand panel of Chart 4.9). The average wage settlement in collective bargaining agreements was 3%, 0.5 pp down on the related figure in 2003. This increase was in line with the implicit margins established in the AINC (Interconfederal Agreement for Collective Bargaining), which was extended in 2004, without significant differences being observed between the wage increases agreed in newly signed agreements and in revised agreements. However, it should be recalled that the ultimate deviation of actual inflation from the official target will feed through in part to the growth of wages in 2005 through the activation of wage indexation clauses, which are incorporated into 77% of collective agreements. Specifically, it is estimated that these clauses might raise wages received during the current year by 0.6 pp.

In base year 1995 QNA terms, the growth of compensation per employee across the whole economy, which includes all labour costs, dipped slightly in 2004 to 4%, compared with 4.3% in 2003. The wage slowdown was more visible in the market economy, where the growth of compensation was 3.2%, following several years of very stable increases at around 4%. As the right-hand panel of Chart 4.9 shows, compensation per employee in the market economy also fell in real terms, and it did so sharply when real wages are calculated from the standpoint of companies (i.e. using the value-added deflator as a price index). Undoubtedly, that contributed to the sound behaviour of employment, both in 2004 and over the course of the recent business cycle in which period the declines in real wages, calculated in this fashion, have been recurrent. The new base year 2000 National Accounts figures have revised substantially downwards the increase in compensation per employee in recent years, confirming the moderation of real wages.

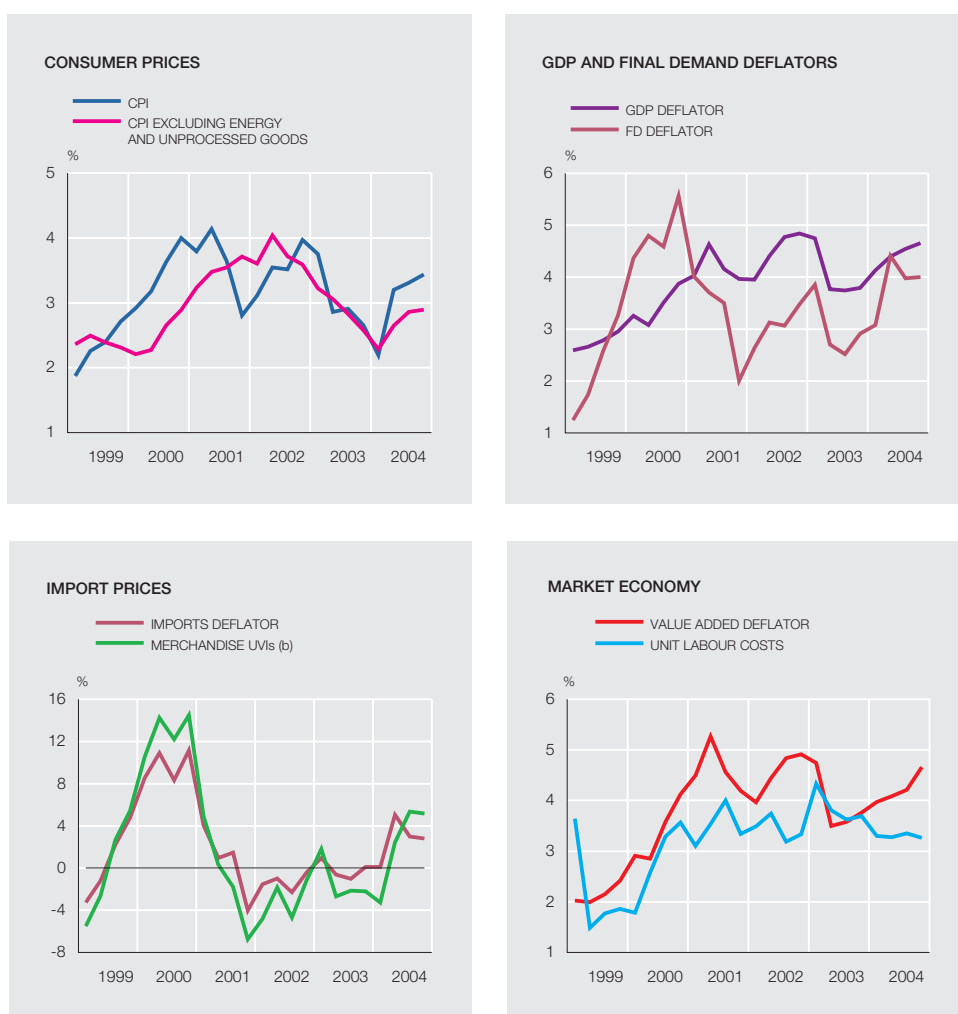
Nonetheless, wage restraint in real terms is proving compatible with nominal increases in compensation above those recorded in the other developed countries, which has consequences for the price and cost competitiveness of Spanish products. In this respect, the renewal of the AINC agreed by the social agents for 2005 involves keeping, for another year, the wage-setting procedure in place since 2002. This system adds fluidity to the collective bargaining process and allows the initially agreed wage increases to be kept within certain limits. But against a background of dearer energy prices such as that marking the start of 2005, the widespread application of wage indexation clauses means that wages will incorporate these price rises in the future. That highlights the high nominal inertia marking the wage-setting process currently in place, which tends to pass through, with something of a lag, the behaviour of prices to wage developments, making the re-absorption of price shocks more difficult and costly. The current collective bargaining arrangements fall far short in respect of the flexibility needed to adapt wage increases to the specific conditions of companies and workers.

5 Costs and prices

In 2004 the average growth of the consumer price index was 3%, similar to that in 2003. After starting the year at a very low rate, inflation moved on a rising course during the central months, which only eased in the last two months of the year, taking the rate to 3.3% in December (see Chart 4.10). The CPI excluding unprocessed food and energy ended the year 2004 at a growth rate of 2.7%, 0.2 pp down on the related figure in 2003; however, it was also moving on a rising profile, and posted a rate of 2.9% in December. At the start of 2005, inflation measured by the CPI held at over 3%, while underlying inflation grew by around 2.8%.

Among the components of the CPI, energy consumer prices rose substantially in 2004 on the previous year, affected by the rise in crude oil prices on international markets. That said, the impact of dearer oil was partly mitigated by the considerable appreciation — up to 10% — of the euro against the dollar. Government-set electricity and gas prices grew in line with the previous year, with no changes recorded in indirect taxation. Processed food prices also quickened in 2004, largely as a result of the increases in tobacco and olive-oil prices, while unprocessed food prices increased less than in 2003, despite growing at over 6% during the first half the year against a backdrop of slowing prices in source markets. In this respect, the lower growth in the prices of fruits and vegetables was particularly noticeable.

Non-energy industrial goods consumer prices posted average growth of 0.9% in 2004, compared with 2% the previous year. The appreciation of the euro and the moderation of domestic prices were contributing factors here, with the deceleration proving particularly sharp in the cases of clothing, footwear and drugs, while the prices of video, photographic and computer equipment ran once again at sizably negative rates. Lastly, services prices increased by 3.7% in 2004, unchanged on the previous year, although they accelerated moderately as the year



SOURCES: INE and Banco de España.

a. Year-on-year growth rates. Base year 1995 National Accounts.

b. Merchandise import unit value indices.

elapsed. This was the case of the prices of transport services and, particularly, of air transport, due to dearer energy. Meanwhile, urban transport prices, which are regulated, deflected the rise in fuel costs to a greater extent onto fares which were revised in January 2005. The prices of other services, such as those relating to hotels and restaurants and to education, showed lower average growth than in 2003.

Although the stability of the average rate of change of the CPI passed through to the private consumption deflator, which increased by 3% in 2004 (3.1% in 2003), the final demand deflator quickened notably from one year to the next, growing by 3.9% in 2004 on base year 1995 National Accounts figures, 0.9 pp up on the previous year. From the standpoint of expenditure, the trend of final prices reflected the sharp acceleration in the deflators of construction and of other investment products, which rose by over 7% on average during the year. House prices and those of real-estate services largely explain this trajectory. Capital goods prices increased by 2.1%, against the background of a moderate rise in domestic prices and a decline in import prices. Finally, the goods and services exports deflator fell by 0.2% since, as earlier indicated, the base year 1995 QNA figures did not reflect the increase in the goods exports unit value indices, which amounted to 1%, a figure more in line with price developments in other countries.

From the viewpoint of the source of the inflationary pressures exerted on final prices, those arising abroad were for one more year more moderate than domestic pressures, despite the fact that the goods and services imports deflator grew by 2.7% in 2004, compared with the reduction of 0.2% the previous year (see Chart 4.10). As noted, the acceleration in import prices was the result of the behaviour of energy-product prices and, to a lesser extent, of other intermediate goods, which were impacted by the rises on the markets for oil and other commodities. The appreciation of the euro against the dollar did not fully offset these rises.

Domestic inflation, proxied by the GDP deflator, increased in 2004. The deflator in question grew by 4.4%, 0.4 pp up on the previous year. This acceleration partly reflects the estimated behaviour of taxes net of subsidies per unit of output, which posted burgeoning growth of 9% for the year on average. While it is difficult to explain this increase in the context of a lack of changes in indirect taxation, it should be recalled that this variable behaved similarly in 2003, against a background of high growth in consumption, buoyant residential investment and a strong increase in purchases abroad, which has recurred — and more sharply so — in 2004. Further, it cannot be ruled out that the move to base year 2000 figures, which in the case of general government has already affected the figures for 2004, may have distorted the estimate of this variable to some extent. In any event, having taken the trend of taxes into account, the GVA deflator grew by 4.1% (4.2% in the market economy), up on the previous year.

Among the components of the market economy GVA deflator, there was a notable slowdown in labour costs per unit of value added, reflecting the smaller increase in compensation per person employed, which was offset only partly by the decline in apparent labour productivity (see the lower right-hand panel of Chart 4.10). The quarterly profile shows similar behaviour. Overall, the trend of the deflator and of costs prompted a widening of margins in the market economy, compared with the stability seen the previous year. The following section analyses these margins in greater detail, which are estimated drawing on base year 1995 National Accounts figures. It should be clarified, however, that the new base year 2000 National Accounts estimates generally indicate a more expansionary trend of unit margins over the course of recent years. Box 4.2 scrutinises the relationship between price formation across sectors and the degree of competition under which these sectors operate.

5.1 COSTS AND PRICES OF THE PRODUCTIVE BRANCHES

As indicated in the preceding section, and on base year 1995 National Accounts estimates, the unit operating margin widened markedly in 2004 in the different branches of activity. The exception here was market services, where for the second year running margins contracted. This disparity in the trend of margins came about against a backdrop marked by very different situations in terms of demand pressure and of foreign competition in the different sectors, which contribute to some extent to explaining the notable divergences in price formation in each of them.

As can be seen in the top panels of Chart 4.11, the value-added deflator in primary activities slowed in 2004, its growth rate falling to 2.3% (4.2% the previous year). Nonetheless, the slowdown in unit labour costs, set against the slight recovery in apparent labour productivity, meant that the unit margin widened again, and significantly so, in 2004.

In industry and energy there was also a widening of margins, underpinned by a reduction in employment, albeit against the background of the acceleration in the deflator. In industry, the value-added deflator grew by 2.9%, 1.6 pp up on 2003, while unit labour costs slowed slightly, posting very moderate increases. The easing of labour costs was thanks to the productivity gains achieved through job destruction, which had already been manifest in 2003 and which allowed the unit margin to continue recovering. Prior to 2003, the industrial branch, which

The degree of market competition is crucial for firms when they determine their price-setting strategies. Significant changes in the intensity of demand or in production costs modify firms' optimal prices. If they keep their prices unchanged they incur opportunity costs, in terms of profits, which depend on the level of market competition. In this respect, the profits of firms that operate in more competitive environments and, therefore, face a more elastic demand, will be more sensitive to deviations between the actual and the optimal price. By contrast, the opportunity cost of not changing the price following a shock will be more moderate in the case of firms with a high degree of market power. Accordingly, it is reasonable to expect that firms facing a higher degree of competition will employ more flexible price determination strategies, which give them a greater ability to react to changes in market conditions.

The Survey on pricing behaviour, conducted by the Banco de España in 2004, enables the differences in firms' price-setting policies and, ultimately, in the degree of price flexibility, to be analysed, in accordance with the intensity of the competition in the markets in which they operate. Around 2000 firms in manufacturing, energy, the wholesale

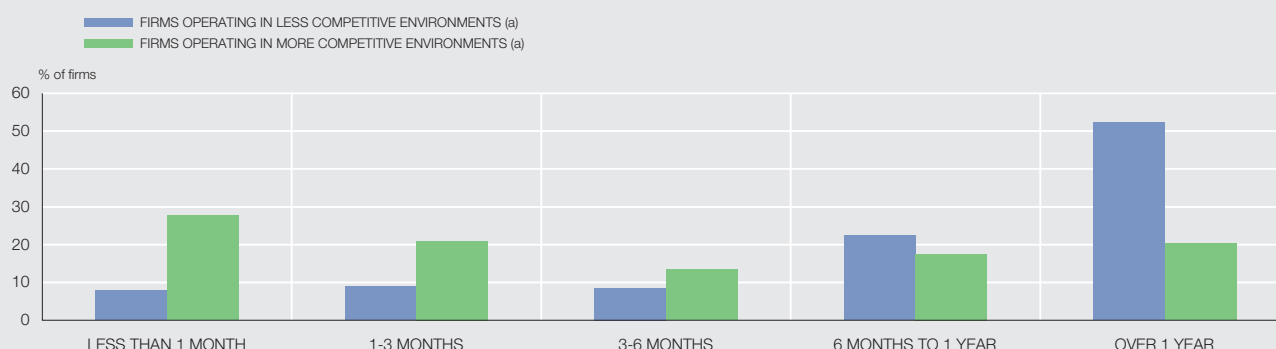
and retail trade, hotels and restaurants, and transport and communications responded to the survey. It provides information on the customers and competitive environment and on the main aspects that form their pricing policy (review and change patterns, information used to review prices, factors triggering price changes and factors hampering price adjustment).

The survey includes a question on the importance given by the firm to changes in its competitors' prices as a determinant of its own price changes. The responses to this question are a good indicator of the intensity of the competition perceived by the firm, as compared with more usual questions such as market share or the number of competitors. The use of these measures to approximate the degree of competition may be inadequate, insofar as firms may use very different criteria when defining their relevant market or identifying their potential competitors. Also, in certain oligopolistic markets there may co-exist a small number of firms (with higher market share) subject to intense competition, while there may be other sectors with a higher number of competitors in which firms maintain significant market power at the local level.

CHARACTERISTICS OF PRICE-SETTING STRATEGIES	Firms operating in more competitive environments	Firms operating in less competitive environments
Firms for which price revision periods are flexible (%)	71.2	59.8
Firms which do not use simple rules (indexing) in price revision (%)	74.5	50.0
Firms which, on revising their prices, consider indicators on the expected setting (%)	31.9	20.4
Firms that use some type of price discrimination (%)	72.3	57.6
Firms that habitually use discount policies (%)	53.9	29.9
PRICE FLEXIBILITY INDICATORS		
Average duration of prices (months)	10.3	15.0
Firms that revise their prices at least twice a year (%)	49.8	12.5
Firms that changes their prices in response to a contraction in demand in less than three months (%)	48.7	16.9
Firms that changes their prices in response to an increase in demand in less than three months (%)	35.0	13.8
Firms that changes their prices in response to a fall in costs in less than three months (%)	27.2	17.3
Firms that changes their prices in response to an increase in costs in less than three months (%)	30.3	22.7

a. A firm is considered to operate in a competitive environment if it reports that a change in its competitors' prices is a key factor in explaining its price cuts. Likewise, a firm is considered to operate in a relatively uncompetitive environment if it reports that a change in its competitors' prices is not a key factor in explaining its price cuts.

AVERAGE RESPONSE TIME IN RESPONSE TO A SIGNIFICANT DECLINE IN DEMAND



a. A firm is considered to operate in a competitive environment if it reports that a change in its competitors' prices is a key factor in explaining its price cuts. Likewise, a firm is considered to operate in a relatively uncompetitive environment if it reports that a change in its competitors' prices is not a key factor in explaining its price cuts.

The accompanying table shows findings of the survey which indicate that the pricing policies of firms operating in a more competitive environment (those reporting that changes in competitors' prices are a very important factor in their pricing decisions) show greater flexibility in certain respects. These firms do not usually carry out price revisions at pre-set intervals; they do so rather in response to changes in market conditions. Moreover, the price revisions, do not usually involve the application of a single rule but are the result of an optimising process in which, fairly frequently, expectations as to how market conditions may change are taken into account. Further, these firms use active commercial policies to a greater extent. These ingredients of the most competitive firms' price-setting strategies give them a greater capacity to react to shocks and make, in prac-

tice, for greater flexibility in their prices. Thus, as indicated in the accompanying table, prices remain unchanged on average for the most competitive firms for 10 months, while in markets more sheltered from competition prices are maintained for 15 months. Moreover, the speed of response to changes in production costs and, in particular, to changes in the intensity of demand is significantly greater. As the chart below shows, when faced with a contraction in demand almost 50% of the firms operating in a competitive environment adjust their prices within 3 months, and only 20% say they hold their prices unchanged for at least a year. Conversely, only 17% of the companies in less competitive markets respond within 3 months of demand falling, and over 50% of them take at least a year to respond to the shock.

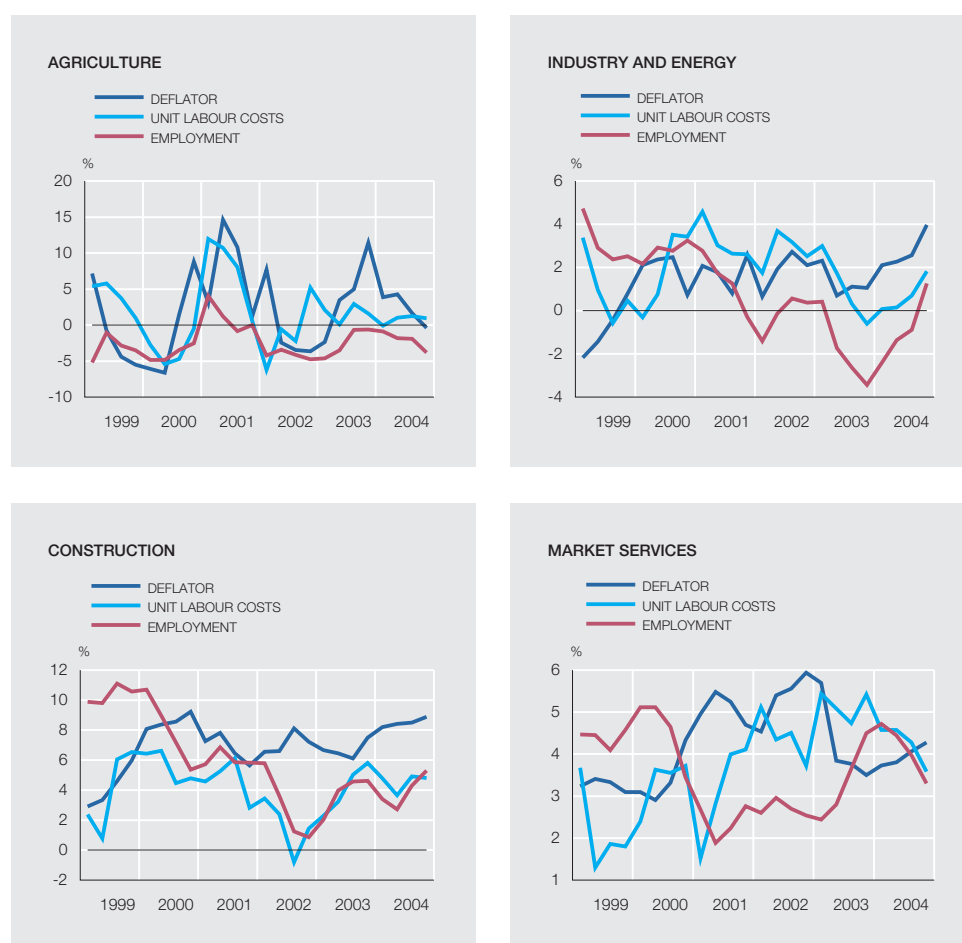
groups a series of productive activities highly exposed to foreign competition, had seen a prolonged contraction of margins, which led ultimately to an employment adjustment in order to reduce costs. The increase in margins was fairly widespread in industry, as it is estimated that only in 3 of the 13 manufacturing branches (textiles, paper and electrical equipment) did they shrink. Nonetheless, the data for 2004 Q4 appear to announce the end of the employment adjustment process in industry. In the energy branch, the value-added deflator accelerated moderately to a growth rate of 1.9% in 2004. Unit labour costs slowed significantly as a result, in part, of the smaller increase in compensation per employee, but mainly because of the considerable productivity gains associated with the stepping up of the job destruction process. However, the unit operating margin held constant, since the growth of labour costs was in line with that of the GVA deflator.

In the construction branch, the value-added deflator quickened most significantly to a rate of 8.5%, the highest growth for the last six years. This reflected the fact that demand pressures kept activity above its potential level. The unit operating margin increased significantly once again, for the sixth year running, despite the fact that unit labour costs continued growing at a very high rate. This increase in costs reflects the decline in apparent labour productivity, compared with the slight slowdown in compensation per employee.

Lastly, in market services, the deflator grew significantly, albeit more moderately than in previous years (4%), while unit labour costs also slowed, underpinned by the lower increase in compensation per employee. However, costs overall continued to outgrow the deflator, prolonging the contraction in margins already observed in 2003. Behind the increase in unit labour costs are the strong losses — bigger even than in 2003 — in apparent labour productivity, obtained against a backdrop of high employment creation. The narrowing of margins, which in principle is out of kilter with the persistently expansionary behaviour shown in the past and with the high growth of domestic demand, was across the board in the services branches, except in transport and communications, and in other social activities and services.

6 Competitiveness

The high negative contribution of net external demand to Spanish GDP growth in 2004 and the fact that goods and services exports grew below world trade are, in part, symptoms of the comparatively high growth of the Spanish economy last year and of the relatively adverse geo-



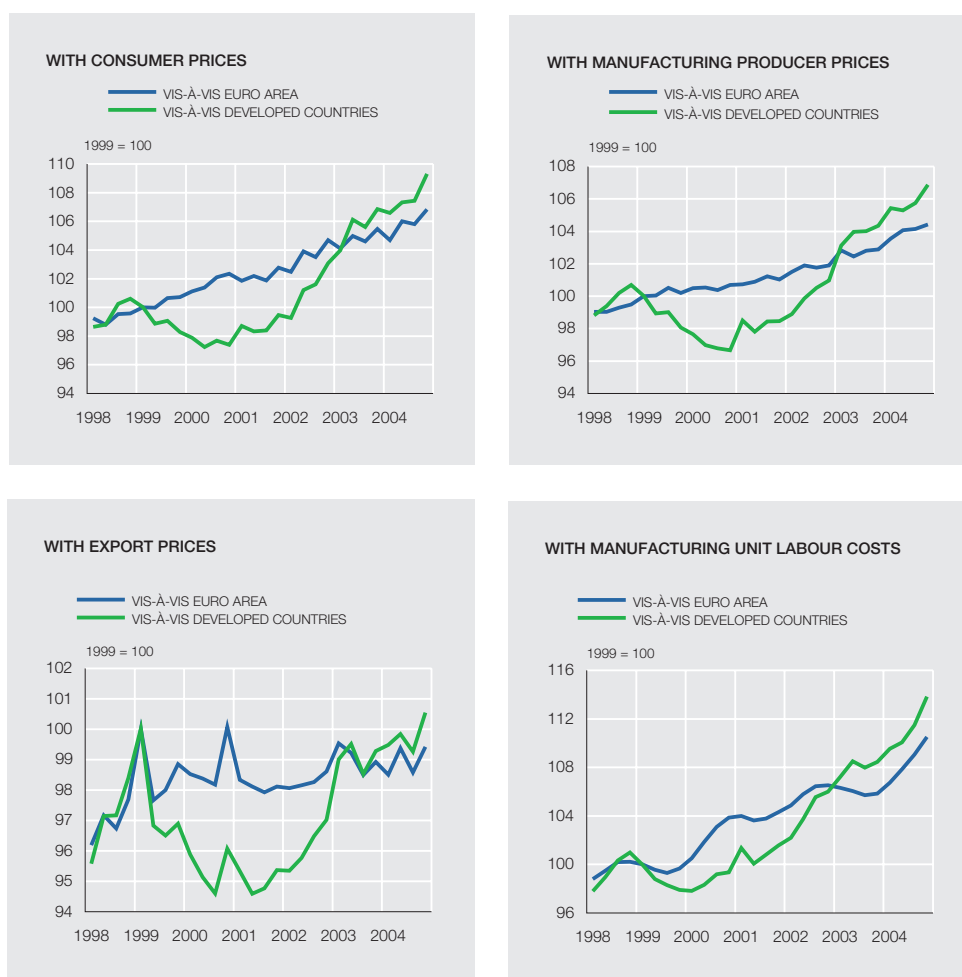
SOURCES: INE and Banco de España.

a. Uncentred annual percentage changes based on seasonally adjusted base year 1995 QNA series.

graphical pattern of world growth. But what is also reflected is a certain deterioration in the competitive position of Spanish products. Behind this loss in competitiveness are both the acceleration in final prices in the Spanish economy in 2004, which was described in the previous section, and more structural factors relating to the economy's capacity for innovation and productive specialisation.

In 2004, the indicators of price and cost competitiveness vis-à-vis the developed countries worsened, in general terms, owing to the adverse trend of relative prices and to the appreciation of the euro, which was 0.8% up in effective terms against this set of countries. The competitiveness index compiled with relative consumption prices reflected, for the fourth year running, the higher growth of prices in the Spanish economy, meaning that competitiveness against the main developed countries worsened by 1.9% (see Chart 4.12). The index compiled with manufacturing producer prices, which have performed somewhat better in recent years, posted a deterioration on the same scale. The index compiled with relative export prices also worsened, though much more moderately so. Indeed, relative export prices⁵ measured in euro fell by 0.1% in relation to 2003, whereby the course of this index in 2004 (an appreciation of 0.8%) reflected in its

5. Proxied by the export unit value indices published by the Ministerio de Economía y Hacienda.



SOURCE: Banco de España.

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

virtual entirety the appreciation of the exchange rate. Competitiveness was, however, more markedly eroded in terms of relative costs vis-à-vis the developed countries, this loss amounting to 3% in the case of manufactures, once the behaviour of the exchange rate is taken into account. Generally, the losses in competitiveness built up since the euro area was established grew last year. In terms of consumer prices, these losses totalled 9% at the end of 2004, while they were even sharper when measured with labour costs (12.7%).

By geographical area, the increase in relative prices entailed a deterioration in competitiveness vis-à-vis the euro area. Relative consumption prices rose by 1% in 2004, slightly below the increase in 2003 (1.1%). By contrast, the relative prices of industrial manufactures increased on a greater scale than in 2003 owing to the performance of intermediate-good and energy prices. Finally, relative export prices, which had climbed by 0.8% in 2003, stabilised. Set against the non-euro area developed countries, the loss in competitiveness was more marked as a result of the appreciation of the euro (2.3% against this group of countries). Moreover, relative prices increased across the board, albeit to a lesser extent in the case of export prices.

The fact that relative export prices have grown less than the other measures of relative prices and costs in recent years is a sign that, against the backdrop of an appreciating euro, Spanish exporting firms have tended to limit the growth of their export prices, so as to retain their share

EXPORT MARGINS
Rate of change

TABLE 4.2

	Average 1993-1998	1999	2000	2001	2002	2003	2004
TOTAL ECONOMY							
1. Goods and services export margins	1.0	-1.7	4.4	-0.8	-2.2	-2.8	-3.5
1.1 Goods and services export deflator	3.2	0.4	7.3	2.7	1.1	0.7	-0.2
1.2. Total economy unit labour costs	2.2	2.1	2.8	3.5	3.4	3.5	3.4
2. Total economy unit margin (a)	-0.2	-2.3	3.8	-1.4	-3.2	-3.2	-4.4
3. Relative return on exports (1/2)	1.2	0.6	0.6	0.6	1.0	0.5	1.0
SPAIN/EU15							
4. Relative export margins vis-à-vis EU 15 (4.1/4.2)	1.0	0.3	2.0	1.2	0.4	-0.3	-3.7
4.1 Relative goods and services export prices	2.1	1.0	3.1	1.8	1.5	0.9	-1.1
4.2 Total economy relative unit labour costs	1.1	0.7	1.1	0.6	1.0	1.2	2.7
SPAIN/ENLARGEMENT COUNTRIES							
5. Relative export margins vis-à-vis new EU members (5.1/5.2)	4.8	-1.5	4.3	5.7	2.0	-0.2	-4.2
5.1 Relative goods and services export prices	-7.5	-3.3	1.5	0.8	1.8	-1.3	-2.7
5.2 Total economy relative unit labour costs	-11.7	-1.8	-2.7	-4.6	-0.2	-1.1	1.5
MANUFACTURES							
1. Goods export margins	0.9	-2.7	2.4	-1.3	-1.8	-3.0	-0.8
1.1 Manufactures export prices	2.9	-1.5	4.8	2.7	1.1	-2.2	-0.3
1.2 Unit labour costs in industry	2.0	1.2	2.4	4.1	2.9	0.8	0.5
2. Unit margin on manufactures (a)	0.2	-1.5	2.7	0.6	-0.6	-3.4	-3.1
3. Relative return on exports (1/2)	0.6	-1.2	-0.3	-1.9	-1.2	0.4	2.3
SPAIN/EU15							
4. Compensation per employee (d)	-0.3	-0.5	-2.0	-0.9	-0.4	-0.9	-2.8
4.1. Relative manufactures export prices	2.1	-0.6	0.8	0.5	1.2	-1.2	-0.5
4.2. Relative unit labour costs in industry	2.4	-0.1	2.9	1.4	1.6	-0.3	2.3

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

a. Inverse of employees' share (in industry) in GDP (industrial GVA).

in world markets. The outcome has been a fresh contraction in their export margins in 2004. Table 4.2 illustrates the considerable decline in the relative profitability of exports, which reflects the growth differential between export prices and the value-added deflator.

The deterioration in the Spanish economy's price and cost competitiveness in 2004 restrained the advance of its exports, which experienced lower growth than that of their markets, in both trade in goods and in services. Export shares in nominal terms, valuing the growth of markets in euro, fell slightly to levels of 2% and 4% in world markets and in the euro area, respectively (compared with levels of 2.1% and of 4.1% the previous year). In real terms, the share of exports in world markets fell by a similar amount. The developments in relative prices were propitious to import penetration in the domestic market, raising the content of imports per unit of final demand (by 22% in the case of goods imports). One consequence of this was the notable increase in the external deficit on goods and services which, as can be seen in the base year 1995 National Accounts data, stood at 3.7% of GDP, more than double the figure the previous year (1.6%).

From a more general standpoint, the growth pattern followed by the Spanish economy in recent years has been marked by the scant increase in the degree of capitalisation, in the broad-

	1995		2004		LATEST FIGURE
	SPAIN	SPAIN/EU	SPAIN	SPAIN/EU	
GDP PER CAPITA AND COMPONENTS					
GDP per capita (a)	13.3	78.9	21.8	89.7	2004
GDP per capita (b)	13.3	78.9	17.0	85.4	2004
Population aged 16-64/Total population	68.3	102.3	70.4	105.7	2004
Employment rate (b)	50.7	81.3	58.8	88.1	2004
Labour productivity (c)	38.5	94.8	41.2	91.8	2004
Hourly productivity (d)	22.2	85.6	23.8	81.5	2003
TOTAL FACTOR PRODUCTIVITY AND CAPITAL STOCK					
TFP (e)	100.0	100.0	102.7	95.7	2004
Total capital stock/Employment	114.2	89.7	125.9	90.1	2004
Technological capital/GDP	4.2	41.4	5.6	46.4	2003
Human capital/Population aged 16-64	32.0	52.8	41.4	65.2	2003
OTHER SUPPLEMENTARY INDICATORS					
R&D expenditure/GDP	0.8	41.8	1.1	47.9	2003
ICT GVA (f)	3.7	77.7	4.0	70.1	2001
ICT expenditure per capita (g)	448.9	56.8	1,050.7	71.0	2004
Public spending on education/GDP	4.7	89.8	4.4	82.0	2002
Population of working age with tertiary education/Total population	59.0	85.3	62.5	85.0	2004

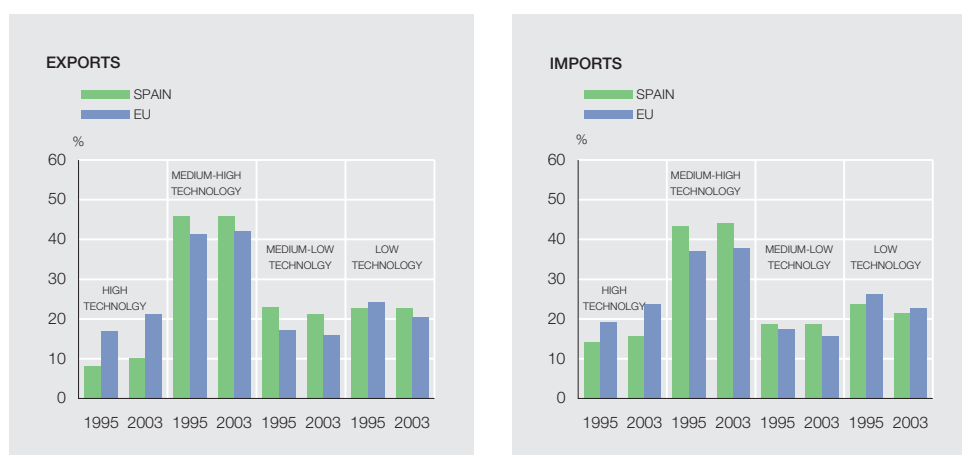
SOURCES: Eurostat, OECD, FUNCAS, Ministerio de Economía and Banco de España.

- 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 total economy GVA.
- f. Euro PPPs (000s) per inhabitant.

est sense of the term (see the indicators displayed in Table 4.3). That has made for a low growth rate of productivity and has diminished the capacity of Spanish firms to adapt their productive and commercial structure to the patterns followed by international demand. As a result, there have been obstacles in the way of attaining greater specialisation in those products offering greater value-added and technological content, the demand for which shows higher growth on international markets.

Low productivity gains, far lower than those seen in the EU 15 on average, are curbing the convergence of income and wealth levels with those of the EU Member States. Indeed, the Spanish economy's per capita GDP at current prices was 89.7% of that of the EU 15 in 2004 (85.4% at constant prices), a similar level to that in 2003. However, these estimates have been made with base year 1995 GDP data and will be affected, to an extent difficult to foresee, by the re-basing of the National Accounts to the year 2000, both in Spain and in most EU countries. As is known, measuring productivity involves many statistical and methodological difficulties. In the case of the Spanish economy, however, all the measures compiled, whether productivity per employee, per hour worked or total factor productivity (which is a closer measure of productive efficiency since it strips out the contribution of the primary productive factors) have trended adversely in recent years compared with the EU 15 average.

Concerning industrial specialisation, and in comparison with the EU 15 countries (see Chart 4.13), the Spanish economy's production and foreign trade structure remains based, first, on



SOURCES: Eurostat, Aduanas and Banco de España.

a. Percentages of total exports and imports, respectively.

those branches which use unskilled labour intensively and which face international demand with lower growth potential, in addition to facing stiffer competition from the emerging countries. Further, the sectors incorporating medium-high technology levels also have a high share. In this respect, the enlargement of the EU to the Central and Eastern European countries, which culminated in May 2004, poses a fresh challenge for the maintenance and expansion of Spanish products on international markets. This is because these countries are involved in the intense modernisation of their productive systems, driven by the activity of multinational corporations, which is translating into a notable approximation of their productive and trade structures to those of the Spanish economy (see Box 4.3 for a more detailed assessment of these effects on euro area trade).

The competitive pressures from the new trade partners might contribute to explaining the difficulties certain key industries — such as the automobile industry, which accounts for one-quarter of Spanish sales abroad — are facing in attempting to firmly increase their share on international markets. Indeed, motor vehicle exports grew by 5.9% in 2004, below the figure of 7.4% in 2003. As a result of this and of the notable growth in vehicle imports, Spain's surplus balance in trade in this type of product, which had been falling continuously in recent years, was virtually wiped out in 2004. Exports of low-technology products posted very moderate growth of 2.6% in nominal terms, affected by the fall-off in sales of textiles and various manufactures, which were particularly impacted by the growing competition from certain Asian economies. Finally, sales by the medium-low technology industries were the most buoyant in 2004, with nominal growth of 15.2%. Contributing to this was the increase in exports of oil derivatives, the price of which was boosted by the market price of crude oil.

One final factor related to the Spanish economy's position in the international environment is foreign direct investment (FDI). In 2004, FDI flows to Spain declined significantly. True, this fall was less than that recorded in other developed economies. But the diminished attractiveness of the Spanish economy in recent years compared with other less developed countries, which show significant advantages in terms of unit labour costs, is a further symptom of the economy's structural weaknesses and, in particular, of the lag in incorporating technological capital and in improving human capital endowment. These factors should be corrected in order to boost the economy's growth potential and to generate new investment opportunities.

The share of Spanish products in international markets has increased very moderately since the late nineties, in contrast to the notable increase seen in that decade. As discussed in Box 1.4, these developments have been partly due to the geographical specialisation of Spanish exports, which are directed mostly towards the euro area market, the buoyancy of which has been very scant in recent years. But even within this market the share of Spanish products has slowed, indicating that there are other factors relating to competitiveness, such as changes in relative prices and the pattern of sectoral specialisation, that may have contributed to this process.

As can be seen in the adjoining charts, Spanish manufacturing exports to the euro area increased in real terms at a slightly higher rate than imports from this area¹ in the period 1999-2003. As a result, there was a small gain in market share for Spanish products in the euro area of the order of 0.2 pp, far below the related figure of 1.5 pp achieved in the nineties. The rest of the euro area countries also saw their share in imports from the area increase slightly. Mention should be made of the notable buoyancy of exports from the Asian economies and from the new EU members, the weight of which in euro area imports increased by 4.3 pp and by 1 pp, respectively, in the period considered. Overall, other countries exporting to the euro area market experienced a loss in market share in the period under study, this being particularly the case for the United States and the United Kingdom.

In terms of the breakdown of trade by technological intensity, the small increase in the share of the euro area countries within their own market was the result of a combination of a rise in their share in high-technology goods imports and a reduction in the remaining sectors. In the specific case of Spain, meanwhile, very slight gains in share were seen both in high- and low-technology goods. The increase in the share of Asia and the new EU members was across the board in all sectors, with a notable increase in the weight of the Asian economies in high-technology goods and in that of the enlargement countries in medium/high-technology products.

Among the factors that help explain this pattern of Spanish exports to the euro area is, firstly, price competitiveness. In the period considered,

1. In the calculation of imports from the euro area, trade flows between the area's countries have been included.

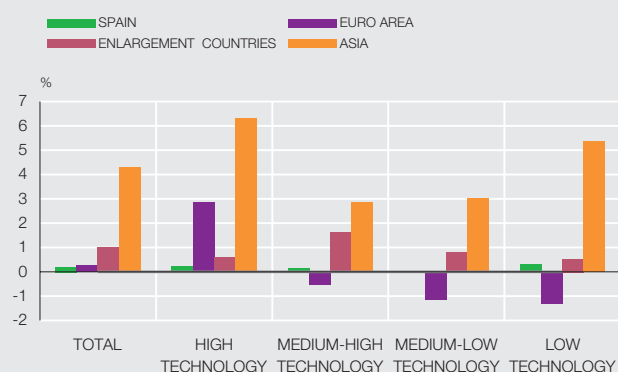
the Spanish economy maintained a positive inflation and unit labour cost growth differential with its main competitors. However, the export prices of Spanish products targeted on the euro area grew at rates very similar to or even lower than those of their competitors², which reflects the effort made by Spanish companies to retain their markets, at the expense of a notable reduction in their export margins.

Comparing the structure of the branch-based technological intensity of exports to the euro area from Spain, the Asian economies and the new EU economies, it can be seen that, in Spain's case, sales to European markets are highly concentrated in the medium/high-technology industries, where the presence of the enlargement countries is gaining notably in importance. The industries of lower technological content, whose share in the Spanish structure is still high, are also a crucial segment in the export specialisation pattern of the Asian economies, which are polarised between the highest technology and lowest technology industries. Finally, the weight of high-technology products in Spanish exports is very low compared with the other areas considered.

The growing importance in the European markets of the south-east Asian and enlargement countries' economies, which enjoy considerable advantages in terms of cost levels and which are specialised in certain branches of substantial importance in the Spanish sales structure, poses a challenge for Spanish companies. Faced with higher relative costs, Spanish firms have had to adjust their margins notably to the hold their prices in line with those of these competitors. Against this background, the positioning of Spanish products on international markets hinges increasingly on non-price competitiveness factors. The evidence available suggests that Spanish companies have, to date, competed in somewhat higher quality segments than those of these competitors³, which would have contributed to maintaining the share of Spanish products. However, if new competitive advantages are to be generated and the current ones to be maintained, Spanish firms and public policies must opt resolutely for technological innovation and quality.

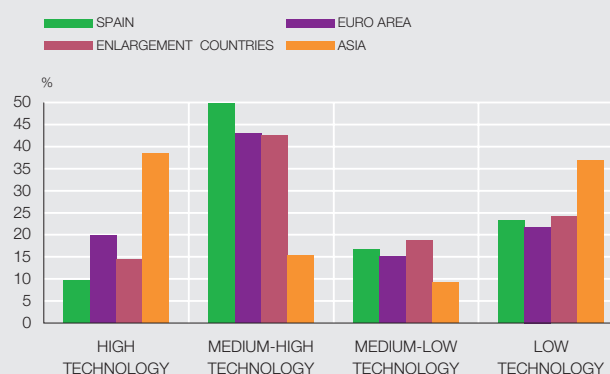
2. According to Eurostat data, the prices of Spanish exports to the euro area grew at an annual average rate of 2.9%, below the rise in the prices of those of the enlargement countries (3.4%) and of the other economies in the area (3.3%). 3. See the Article "The effects of EU enlargement on the Spanish economy: productive structures and trade flows", Economic Bulletin, Banco de España, June 2004.

CHANGE IN THE REAL SHARE IN EURO AREA IMPORTS
Period 1999-2003



SOURCES: OECD and EUROSTAT.

STRUCTURE OF EXPORTS TO THE EURO AREA
Period 1999-2003



Percentage changes and percentages of GDP					
	Rate of change (base year 2000 NA)				% GDP 2004 (a)
	2001	2002	2003	2004	
1. 1. Total revenue	7.5	8.5	7.3	7.5	40.5
Current revenue	7.3	8.3	7.0	7.7	39.8
<i>Taxes on products and imports</i>	4.2	9.1	10.2	10.5	12.4
<i>Taxes on income and wealth</i>	6.5	11.7	3.6	8.5	10.7
<i>Social Security contributions</i>	8.9	7.0	7.6	6.8	13.6
<i>Other current revenue (b)</i>	14.4	1.2	4.1	-1.5	3.1
Capital revenue	20.4	18.3	23.6	-2.1	0.8
2. 2. Total expenditure	6.5	7.8	5.7	9.1	40.8
Current expenditure	5.6	7.3	6.2	7.2	35.2
<i>Final consumption</i>	6.9	8.1	7.4	8.7	18.3
<i>Social benefits (other than transfers in kind)</i>	5.9	7.8	6.0	7.5	12.2
<i>Interest (c)</i>	1.8	-3.8	-5.6	-7.0	2.2
<i>Subsidies</i>	-2.6	10.6	8.5	0.7	1.0
<i>Other transfers</i>	2.3	16.5	14.4	14.5	1.5
Capital expenditure	13.0	11.7	2.2	22.8	5.6
<i>Gross capital formation (d)</i>	16.4	13.4	4.4	9.0	3.7
<i>Other capital expenditure</i>	4.8	7.3	-4.1	65.0	1.9
3. 3. Net lending (+) or net borrowing (-) (c) (3 = 1 - 2)	—	—	—	—	-0.3
MEMORANDUM ITEM:					
Total balance net of RENFE effect	—	—	—	—	0.4
Primary balance	—	—	—	—	1.9
Gross debt (c)	1.2	1.6	-0.3	2.0	48.9

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

a Base year 1995.

b. Includes gross operating surplus.

c. According to the Excessive Deficit Procedure methodology.

d. Includes net acquisitions of non-financial non-produced assets.

7 General government activity

The year 2004 closed with a general government deficit of 0.3% of GDP (see Table 4.4), compared with a surplus of 0.3% of GDP the previous year, against a background of nominal growth higher than initially envisaged, but of an economic recovery that was less sharp than projected⁶. The general government accounts were affected not only by economic policy decisions adopted by the government, but also by a series of effects of an essentially accounting nature, which are addressed in Box 4.4. Notable among this set of factors, owing to its quantitative effect, is the restructuring of the railway sector brought on by the transposition to Spanish law of the Community directives on the opening up to competition of this type of transport. If this transitory effect is stripped out, the general government accounts would have posted a surplus of 0.4% of GDP, with a primary balance of 2.6% of GDP. The weight of public debt in relation to GDP continued to decline (even without adjusting for the RENFE effect), falling to 48.9%. The budgetary policy of the new government, set up in April, was marked by continuity, being based essentially on the budget approved by the previous government, since the various tax and spending reform measures announced for the current legislature had not yet taken shape.

6. The general government accounts discussed here are year 2000-based, following the information provided in the February 2005 Excessive Deficit Procedure Notification. The ratios are year 1995-based.

A series of special circumstances concurred in 2004 which may hamper understanding of the public accounts and comparison with the previously published series. This box reviews the most significant changes and explains their impact on the public accounts.

Firstly, the re-basing of Spanish National Accounts from the year 1995 to 2000 must be taken into consideration. For one thing, this has meant the reclassification of about 200 public entities, mostly controlled by the regional (autonomous) governments, within the general government sector, these having been taken out the non-financial corporations sector in which they were previously classified. For another, the re-basing has also entailed a reassignment of expenditure among the different general government sub-sectors, with no effect, therefore, on the sector's consolidated accounts. What is chiefly involved here is the allocation to the regional (autonomous) governments of health expenditure, over which these governments had already assumed powers, and which were to date included in the social security sub-sector. In parallel, spending on non-contributory social benefits has been assigned to the central government sub-sector, which was already financing them, segregating them from the Social Security sub-sector. The impact on the public accounts affects non-financial and financial transactions alike, and dates back to the start of the new published series of the Spanish National Accounts¹ (year 2000). Accordingly, although the change in base year notably alters the public accounts, it exerts no differential, extraordinary or specific effect in 2004.

Of note, secondly, is the transfer of €2.5 billion (0.32% of GDP) from the State to the Regional (Autonomous) Government of Andalusia in final settlement of the financing arrangements for the period 1997-2001. As an inter-general government transfer is involved here, it does not affect the sector's consolidated account, although it does bear on the central government sub-sector (an addition to expenditure) and to the regional (autonomous) governments sub-sector (an addition to revenue). Given its nature, this

transfer is exceptional, whereby its effect may be considered as confined to 2004.

Thirdly, mention may be made of the assumption by the State of the debt of RENFE (the Spanish National Railway Corporation), for an amount of €5.46 billion (0.69% of GDP), linked to the restructuring of the railway sector. This amount can be divided into two tranches. A total of €1.8 billion relates to the incorporation into the State of the conventional railway network, while the rest, €3.66 billion, relates to the assumption of RENFE's historical debt. The first tranche can be viewed as a purchase of an investment good (the railway infrastructure) by the State from RENFE, the payment of which takes the form of the assumption by the State of the corresponding RENFE debt. This will therefore be reflected in the non-financial accounts as an increase in general government gross fixed capital formation, the counterpart being a reduction in the gross fixed capital formation of non-financial corporations. Moreover, an increase arises in general government debt, with the related reduction in the debt of non-financial corporations. The second tranche is a typical case of debt assumption, the accounting reflection of which is a capital transfers payment by general government to the non-financial corporations sector, with a reflection in debt similar to the previous case. The operation in its entirety (0.69% of GDP in the form of an addition to expenditure) is thus reflected in general government non-financial and financial transactions, and influences the sector's outstanding balance. The level of public debt is affected by the same amount, but as what is involved is a stock, the effects are permanent. Only the impact on the public-sector balance can be considered as transitory, as it is reflected solely in the year 2004. In the future, this transaction will have effects on the composition of State expenditure (lower capital transfers but higher investment expenditure, on one side, and lower subsidies but higher interest payments, in connection with the second tranche), though it will not, in principle, bear on either the balance or on public debt.

Fourthly, two recent Eurostat decisions affecting the sectorisation of RTVE (the Spanish State television network) and MINTRA (Madrid Transport Infrastructures) should be highlighted. These two public corporations, which were previously included in the non-financial cor-

1. Accordingly, the years 2000-2003 are available in both bases, but the figures for 2004 are only available in the new base year 2000.

% GDP

	2000	2001	2002	2003	2004
Base year 1995 Spanish National Accounts (a)					
Net general government lending (+) or borrowing (-)	-0.9	-0.4	-0.1	0.4	—
Public debt	61.1	57.5	54.4	50.7	—
Base year 2000 Spanish National Accounts					
Net general government lending (+) or borrowing (-)	-0.9	-0.5	-0.3	0.3	-0.3
Public debt	61.3	57.9	55.0	51.4	48.9
MEMORANDUM ITEM:					
Net general government lending (+) or borrowing (-), without including effect of RENFE	-0.9	-0.5	-0.3	0.3	0.4

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

a. These series already included RTVE.

porations sector, have now to be considered as part of general government further to the foregoing decisions and are to be included (in respect both of their non-financial transactions and of their debt) in this sector (the former in the central government sub-sector and the latter in the regional (autonomous) governments sub-sector). The impact on the public accounts dates back to the start of the new published series of the Spanish National Accounts (year 2000) and, accordingly, it exerts no differential, extraordinary or specific effect in 2004. This new sectorisation will be maintained in the future.

In sum, all these effects have involved a slight upward revision of the budget deficit and of public debt between the years 2000-2003 compared with the figures previously available (see the adjoining table). Further, the new series (base year 2000 of the Spanish National Accounts) shows a substantial deterioration in the budget balance in 2004 compared with the surplus in 2003. Nonetheless, if the transitory effect of the railway restructuring is stripped out, the consolidation process under way in recent years can be seen to be continuing, with the surplus increasing from 0.3% of GDP in 2003 to 0.4% of GDP in 2004.

In terms of the different sub-sectors, the State and its agencies posted a sizable deficit (–1.3% of GDP) which was due essentially to temporary factors and, to a lesser extent, to certain more durable elements, but ones which had not been incorporated into public finances until that year. Among the temporary factors was the payment to the Andalusian regional government in settlement of the financing arrangements made for the 1997-2001 period, which affected current transfers to the tune of €2.5 billion, and the reorganisation of the railway sector, which had a bearing on public investment and capital transfers. Notable among the durable factors was the inclusion of RTVE in this sub-sector. The Social Security System posted a bigger surplus (of 1% of GDP) than initially envisaged, owing to a better performance by revenue than had been projected at the start of the year. This improvement enabled the Reserve Fund to increase by a greater amount than expected (an additional €3,713 million, taking it to €19,330 million). The regional governments ended the year with a slight deficit the weight of which in GDP, net of the transfer by the State to Andalusia, was 0.3%. Eleven regional governments failed to meet their budgetary stability targets in 2003, although only the Valencian Community and Catalunya had to submit an economic and financial plan, in compliance with the Budgetary Stability Law, detailing the measures that should allow their deficits to be corrected in the medium term. The local government sub-sector showed a slight deficit, far below 0.1% of GDP.

In terms of components, the surplus on general government accounts (net of temporary effects) was the result both of the growth of tax revenue, the weight of which in GDP stood at 37.1%, and of the fall, for the third year running, in interest payments, whose weight in GDP stood at 2.2%. Counterbalancing this was the acceleration in final consumption spending.

The increase in tax revenue in 2004 may be attributed virtually in its entirety to the buoyancy of receipts from taxes on production and imports, which grew by 10.5% on the previous year, and, under this category, to the acceleration in value-added tax. Underpinning this strong increase in indirect taxes, the weight of which in GDP stood at 12.4%, is, necessarily, the strength of consumption. Moreover, the growth of house prices may have contributed notably to the growth of VAT takings and of transfer tax, as indicated in the 2003 Report.

The contribution of current taxes on income and wealth to the increase in tax revenue was on a smaller scale, reflecting the differing behaviour of their two main strands. While there were strong rises in taxes paid by corporations, in step with the performance of earnings, personal income tax revenue growth was very weak (2.8%). This low growth was largely due to the influence of temporary effects, bearing on the calculation of revenue in the two years being com-

pared, and also of lasting effects. Specifically, the new periodicity for general government revenue from withholdings, which became monthly instead of quarterly in 2003, and the belated (in February) application of the new withholdings schedule, associated with the reform of personal income tax, swelled takings for 2003. Revenue relating to the final tax payable for 2004 fell owing to the reform of the tax implemented the previous year. Likewise, the elimination of the fiscal transparency regime had a permanent effect on this tax, since corporations that could previously avail themselves of that regime are now taxed under corporate income tax. It is estimated that, once adjustments are made for the temporary effect, the share of personal income tax in GDP (6.5%) has attained figures in keeping with the new regulation, slightly below those observed early in the decade.

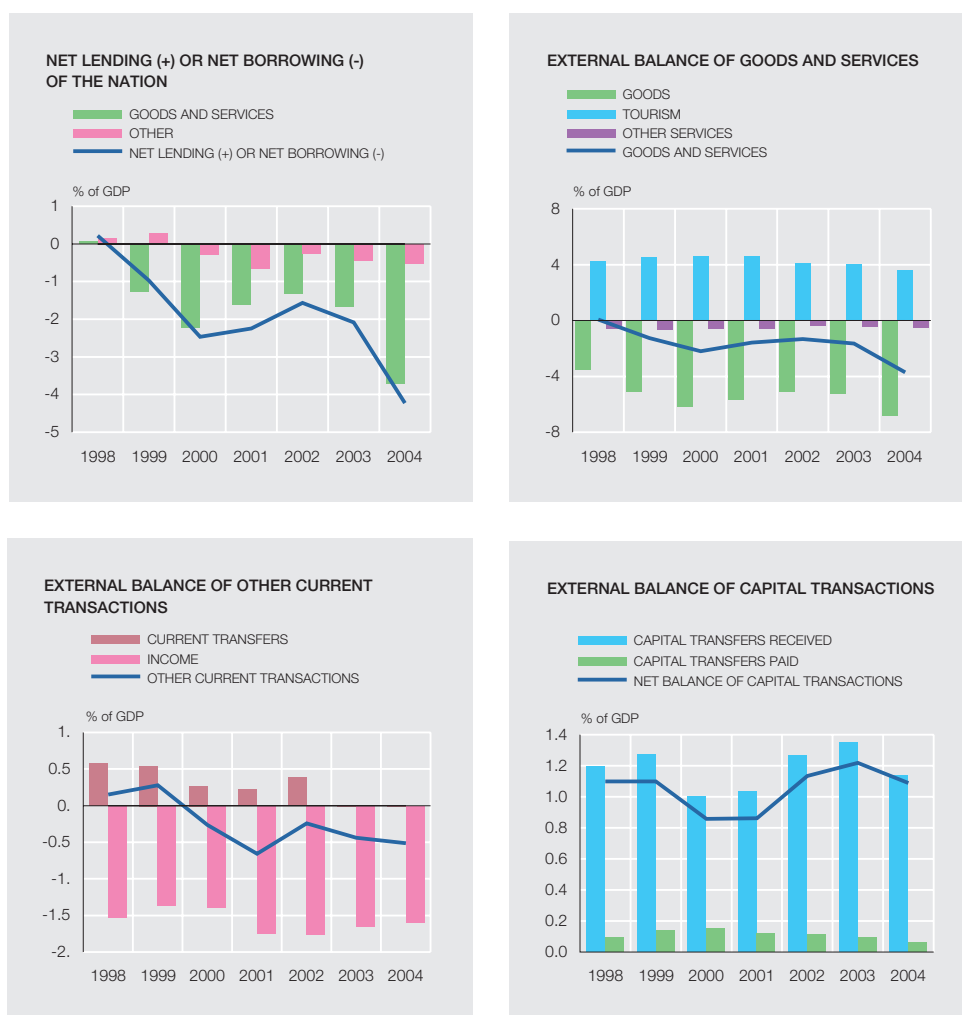
Revenue relating to social security contributions grew by 6.8% owing to wage containment and despite the considerable increase in new registrations (2.8%), which continued to outgrow employment. This revenue was favourably affected by the slight increase in the contribution rates under certain special regimes for those agents wishing to have coverage for sickness and, to a lesser extent, by the upward adjustment in the maximum bases of one percentage point above the inflation forecast (as has been the case in other years). The revenue was adversely affected by the growth in rebates on contributions relating to employment-promoting contracts, although in this latter case such growth was far lower than budgeted. Conceivably, the effects on revenue of the various measures adopted in recent years (such as the unification of maximum bases) have already become entrenched in the system, whereby the weight of this revenue in GDP might be expected to hold at a figure close to that attained in 2004 (13.6%)⁷.

Finally, there was a decline in the amount of other revenue, attributable to the fall in that relating to Banco de España profits and to the heavy reduction in capital transfers from the European Union.

Particularly behind the growth of non-financial uses was the restructuring of the railway sector and the increase in government consumption. The assumption of RENFE debt was reflected in an increase in capital transfers paid, while the incorporation of the conventional railway network into the State sector resulted in an increase in gross capital formation. Nonetheless, the strong deceleration in this latter expenditure item channelled through the territorial governments ultimately had more of a bearing on how this caption trended. It should be recalled, however, that a notable part of the public sector investment drive is routed through companies not included in the general government sector, which are financed through capital contributions or loans and which have no effect on the general government balance. The increase in the sector's final consumption, which stood at 18.3% of GDP, was due mainly to the increase in intermediate consumption and in social transfers in kind (relating essentially to expenditure on health and on State-subsidised private education), the weight of which in the aggregate has been increasing since the start of the decade. By contrast, the other component of consumption, general government employee compensation, held at a growth rate similar to that seen the previous year (6.6%). Spending on subsidies in 2004 showed virtually no growth on the previous year.

Welfare benefits quickened significantly, with their weight rising to 12.2% of GDP. This was mainly the outcome of a higher deviation from forecast inflation than in 2003, of an above-inflation rise in minimum and widow's pensions, and of a 9.6% increase in spending earmarked for unemployment benefits, compared with the 5.9% rise in 2003. The acceleration in unemploy-

7. Depending on the final impact of the immigrant regularisation process, this ratio might change in the future.



SOURCE: INE.

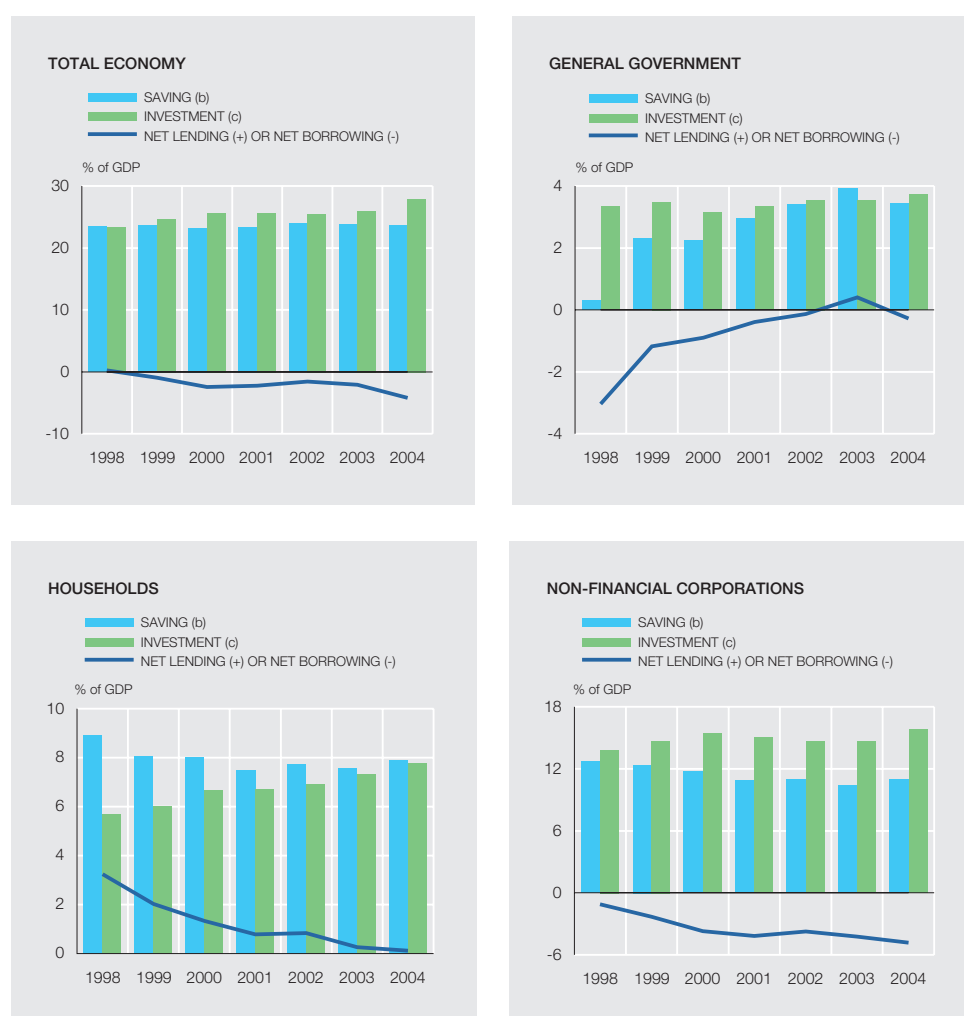
a. Base year 1995 National Accounts.

ment benefits came about despite the smaller increase in the numbers of unemployed with a previous job. It therefore reflects the increase in the eligibility ratio, which stood at 74.5%, substantially above the end-2003 level owing to the decline in long term unemployment.

In sum, the negative general government balance in 2004 was mainly due to the temporary increase in capital expenditure, associated with the restructuring of RENFE. Stripping out the impact of these effects on public finances gives a surplus, which essentially reflects an increase in tax revenue and a decline in interest payments. Mention should be made of the acceleration in consumption spending. The degree of compliance with the various fiscal rules to which general government conduct in Spain is subject was satisfactory in 2004. The annual expenditure ceiling set in the Budgetary Stability Law was thus observed, although the stability principle, defined in the current legislation as a budget in balance or in surplus, did not hold at all levels of general government. The criteria laid down by the Stability and Growth Pact regarding the maintenance of a balanced budget or a budget surplus were also met.

8 The capital account and the rest of the world account

On base year 1995 National Accounts figures, the Spanish economy's net external financing requirements heightened notably over the course of 2004 to stand at 4.2% of GDP, compared with 2.1% the previous year. This result, which places the Spanish external deficit at an all-time



SOURCES: INE and Banco de España

- a. Base year 1995 National Accounts.
- b. Gross national saving.
- c. Gross capital formation.

high, was essentially the outcome of the unfavourable trend of the current-account deficit (-5.3% of GDP) and, to a lesser extent, of the reduction in the capital-account surplus (1.1% of GDP) (see Chart 4.14).

The adverse behaviour of the current-account balance was mainly caused by the increase in the deficit on trade in goods, which widened to -6.8% of GDP, from -5.2% in 2003. As discussed in previous sections, the robustness of real goods import flows during the period, which outpaced export flows, combined with the deterioration in the terms of trade — affected, on one hand, by the strong rise in international commodities prices and, on the other, by the moderate growth in export prices — to bring about a highly unfavourable trade imbalance.

During 2004, the weight of the services surplus in GDP declined by 0.5 pp to 3.1% , as a result of a further deterioration in the tourism balance and a worsening of the deficit on other services. The tourism surplus has moved on a declining profile in the past four years, standing at 3.6% of GDP in 2004, 1 pp down on 2001. Last year real tourism revenue fell for the second

year running, influenced in part by one-off factors such as the terrorist attacks on 11 March. However, also bearing on developments were the structural problems that have been affecting the sector in recent years, such as the progressive loss in competitiveness vis-à-vis the eastern Mediterranean countries, compounded by the continuing strength of the euro. Tourist expenditure, by contrast, was very expansionary, driven by the appreciation of the euro and the growth of disposable income.

The weight of the income deficit in GDP fell by 0.1 pp to -1.6 %. From the standpoint of the balance of payments, the widening of the income deficit was the outcome of the deterioration in the balances relating to the non-financial private sector and to monetary financial institutions, while the general government deficit was corrected slightly. In terms of instruments, there was a deterioration in the balances of income relating to direct investment and to other investment (loans, deposits and repos). The balance on current transfers stabilised at virtually the same level of the previous year (0% of GDP). Receipts posted a very moderate increase, the outcome of the rise in flows received, especially from the EU under the European Social Fund, since Community funds under the EAGGF-Guarantee fund declined. Payments, meanwhile, were more buoyant owing to the increase in resources earmarked for Community cof-fers in connection with the GNP resource and traditional own funds, and to the continuing vigour of emigrants' remittance payments (18.7%), which already account for almost 22% of total current transfer payments made.

Finally, the share of the surplus on capital transactions in GDP dipped slightly (1.1%, compared with 1.3% in 2003), affected by the decline in transfers from the ERDF structural funds and the EAGGF-Guidance fund, while flows relating to the Cohesion Fund trended more favourably. It should be recalled that net capital transfers from the EU are quantitatively the most significant item of capital transactions, whereby their gradual reduction from 2007 will prevent around 1 pp of the current imbalance from being countered.

The notable increase in the Spanish economy's financing requirements in 2004, which include the data in the rest of the world account, was the result of significant momentum in investment, the share of which in GDP increased by 1 pp following three years of stability or very moderate increases (see Chart 4.15). The share of national saving in GDP, by contrast, held steady, in line with the average level attained in recent years. All sectors contributed to the expansion of domestic investment, with the contribution of households the most significant. Indeed, the growth of residential investment once again raised the weight of this sector's gross capital formation in GDP and entailed a further deterioration in its lending capacity to an all-time low of 0.1%. This result came about against the background of the stability of the share of this sector's saving in GDP in the past four years. The increase in the public sector deficit was the outcome of a reduction in general government saving capacity which, combined with the rise in its investment, meant a reduction in its lending capacity to -0.3% of GDP (although it should be remembered that these figures are affected by the restructuring of the railway sector). Finally, the year 2004 saw a recovery in corporate saving, the share of which in GDP remains, however, below the levels attained in the second half of the nineties. The growth of non-financial corporations' gross capital formation — which would have been even greater without the accounting effect of the aforementioned restructuring — led, however, to an increase in their financing requirements, which rose to 4.8% of GDP.

Financial developments in Spain

In 2004, continuation of the long phase of expansion of the Spanish economy, against a background of increasingly generous financial conditions, was accompanied by an increase in the risks deriving from household indebtedness and housing market developments. Also, there was an improvement in the financial position of firms and an expansion in the balance sheets of deposit institutions, which remained notably solid.

Household debt grew at a rate of close to 20%, strongly boosted by the acceleration in lending for house purchases, which increased by more than 23% from the previous year. Consequently, the debt ratio of the sector exceeded 100% of its gross disposable income by some margin, moving away from the euro area average and approaching the levels recorded by US households. The associated debt burden also rose to its highest level in recent years, while saving after debt service stood at close to zero.

Although the prices of shares and long-term public debt rose both in Spain and in most international markets, the changes in the net financial position of households continued to be linked basically to the behaviour of house prices which increased again, in 2004, by more than 17%. As explained in Box 1.5 of this report, this behaviour of the value of property led to a further widening in the gap between the current and long-term equilibrium levels. Under normal conditions this gap would tend to close gradually, but the probability that should be assigned to a still unrealistic scenario in which prices adjust less gradually than expected has increased.

Continuation of the trends in lending and house prices described in the preceding paragraphs would erode the safety margins that still exist, thereby feeding the risks to the medium and long-term developments in the Spanish economy indicated in Chapter I of this report.

In 2004, some of the signs of improvement indicated in the previous report in other relevant financial spheres from the standpoint of macroeconomic stability also tended to be confirmed. Corporations also capitalised on the reduction in financing costs by increasing their liabilities, which grew at a similar rate to that recorded in 2003, with a further rise in their aggregate debt ratio. However, the associated relative debt burden declined, against a background of notable growth in the sector's profits and completion of the balance sheet rebuilding undertaken by large national corporate groups. In fact, the available composite indicators of financial pressure on investment and employment remained at the low levels achieved a year earlier and, in the first case, even showed some additional improvement.

The profits of Spanish deposit institutions performed very favourably. The aggregate solvency ratio dipped, but still remained at comfortable levels, well above the required minimum. Also, the soundness of the sector was reinforced by the rise in doubtful assets coverage ratios. Thus, banks, savings banks and co-operatives have a wide safety margin to absorb the possible impact of existing risks, in particular those associated with the behaviour of the property market, to which they have been significantly increasing their exposure in recent years.

There was also greater buoyancy in primary and secondary fixed-income markets, although this was indirectly boosted by the vigour of bank lending. To finance the growth of their lending, Spanish deposit institutions had to resort to alternative sources to traditional deposits since, although the latter increased notably in 2004, they did not keep pace with lending. In

% GDP	1999	2000	2001	2002	2003	2004
National economy	-1.0	-2.5	-2.2	-1.6	-2.1	-4.2
Non-financial corporations and households and NPISHs	-0.3	-2.4	-3.4	-2.9	-4.0	-4.7
<i>Non-financial corporations</i>	-2.3	-3.4	-4.5	-4.4	-4.5	-4.6
<i>Households and NPISHs</i>	2.0	1.1	1.1	1.4	0.6	-0.1
Financial institutions	0.5	0.8	1.5	1.5	1.5	0.8
General government	-1.2	-0.9	-0.4	-0.1	0.4	-0.3

SOURCE: Banco de España.

consequence, issues of debt securities by these institutions increased, as did issues of securitised banking assets, against a background in which certain regulatory changes led to a decline in the placement of this type of security by foreign subsidiaries in favour of that by the parent companies and domestic subsidiaries.

It should also be noted, however, that 2004 was also characterised by the subdued activity of non-bank financial intermediaries, in particular of those specialising in the management of long-term savings.

1 Financial flows in the Spanish economy

The balance of the net financial transactions of the non-financial private sector declined again in 2004, as a result of the deterioration in the position of households, who became net borrowers and, to a lesser extent, of the increase in the net borrowing of corporations (see Table 5.1 and Chart 5.1). Financial institutions and general government also reduced their net lending, which in the case of the latter turned negative. As a result, the debit balance of the nation's net financial transactions increased, to stand at 4.2% of GDP, double the level in 2003.

1.1 FINANCIAL FLOWS OF HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS

The net financial saving of households and of private non-profit institutions serving households (NPISH) fell again, to the point that it actually became net borrowing, equal to 0.1% of GDP. This change was strongly influenced by the behaviour of residential investment, the gross saving of the sector remaining relatively stable.

Households' assets-side financial transactions increased relative to GDP for the third consecutive year to reach 11.1%, up 1.1 pp from 2003 (see Table 5.2). By component, the upward trend since 2001 in the weight of cash and cash equivalents (cash and sight and savings deposits) came to a halt and their contribution fell slightly, although they remained the main component of asset flows (4.1% of GDP). By contrast, investment in time deposits rose to 1.4 % of GDP, following a decline in their outstanding balance in 2003. Also, purchases of fixed-income securities, basically of those issued by non-residents, increased. The acquisition of shares and other equity fell moderately, despite the increase in share prices and their low volatility, as did investment in mutual funds, owing mainly to the negative net purchases of shares in FIAMM (money market funds).

On the liabilities side, the funds received by households increased by 1.7 pp of GDP to 11.1%. This increase is largely explained by the acceleration in lending for house purchase, to a growth rate of more than 23%, the highest level of recent years. The main factors behind this acceleration were the low level of financing costs, the rise in the price of property, which meant that



SOURCE: Banco de España.

the value of collateral for mortgage loans rose, and the buoyancy of the Spanish economy. By contrast, liabilities used to finance consumption and for other purposes grew at a more moderate rate of around 11%, down somewhat from 2003.

The net borrowing of non-financial corporations increased slightly, as the rise in gross capital formation was somewhat higher than that in their gross saving. However, this outcome was strongly affected by the assumption of RENFE debt by the State¹, a one-off extraordinary operation that reduced the net borrowing of the sector by approximately 0.7 pp of GDP. These developments were accompanied by a 40% decline in investment in foreign equities, so that the financing gap, a measure of the external funds needed to cover permanent financial and real investment, decreased by more than one percentage point to 7.3% of GDP (see Chart 5.2).

The net acquisition of financial assets by corporations was 15.7% of GDP, 2 pp less than in 2003. This reduction basically stemmed from the disinvestment in fixed-income securities is-

1. See Chapter 4 for further details.

% GDP	2001	2002	2003	2004
HOUSEHOLDS AND NPISHs				
Financial transactions (assets)	7.9	8.8	10.0	11.1
Cash and cash equivalents	1.2	3.7	4.4	4.1
Other deposits and fixed-income securities (a)	3.5	1.6	-0.1	2.1
Shares and other equity (b)	-0.2	0.7	0.7	0.3
Mutual funds	0.8	0.2	2.3	1.5
<i>FIAMM</i>	1.3	0.7	0.6	-0.2
<i>FIM</i>	-0.5	-0.5	1.8	1.7
Insurance technical reserves	2.7	2.6	1.9	2.0
Of which:				
<i>Life</i>	1.5	1.5	0.7	0.8
<i>Retirement</i>	0.9	0.9	0.9	1.0
Other	0.0	0.0	0.8	1.1
Financial transactions (liabilities)	6.8	7.4	9.4	11.1
Credit from resident financial institutions (c)	5.4	7.2	9.3	11.0
<i>House purchase credit (c)</i>	4.8	5.1	7.2	8.9
<i>Consumer and other credit (c)</i>	0.6	2.1	2.1	1.9
Other	1.4	0.2	0.0	0.2
NON-FINANCIAL CORPORATIONS				
Financial transactions (assets)	16.6	16.5	17.7	15.7
Cash and cash equivalents	1.7	1.7	0.9	1.0
Other deposits and fixed-income securities (a)	0.8	1.8	1.5	0.7
Shares and other equity (b)	6.1	6.9	7.5	4.2
Of which:				
<i>Vis-à-vis the rest of the world</i>	4.6	5.2	4.6	2.6
Other	8.0	6.2	7.9	9.8
Financial transactions (liabilities)	21.1	20.8	22.3	20.3
Credit from resident financial institutions (c)	6.5	6.3	7.2	9.8
Foreign loans	4.0	3.0	2.8	0.3
Fixed-income securities (a)	0.0	-0.4	-0.2	0.0
Shares and other equity	5.2	5.9	4.9	2.6
Other	5.4	6.0	7.6	7.7
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):				
Financing (d)	15.4	14.3	15.9	16.0
Households and NPISHs	12.3	15.6	18.7	19.5
<i>House purchase</i>	17.1	16.6	21.3	23.3
<i>Consumer and other</i>	3.9	13.6	13.2	11.1
Non-financial corporations	17.8	13.3	13.9	13.4

SOURCE: Banco de España.

a. Not including unpaid accrued interest, which is included under "other".

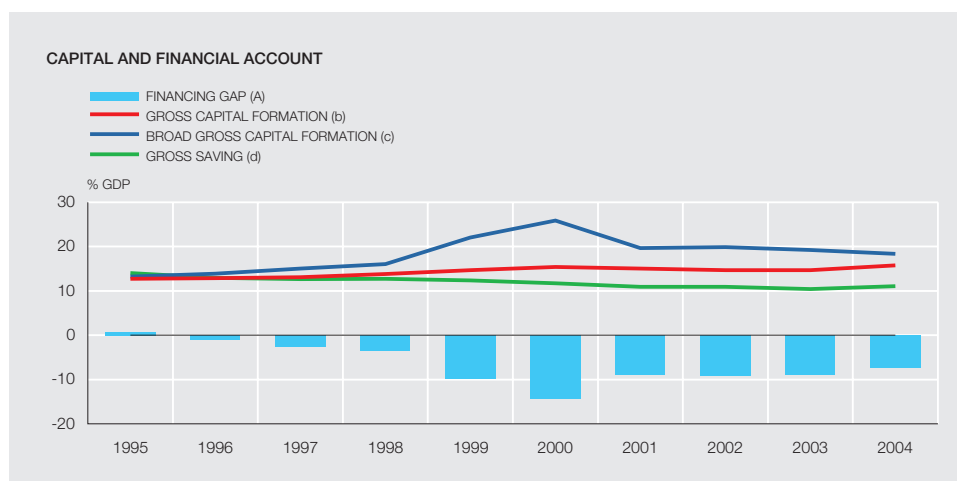
b. Excluding mutual funds.

c. Including 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.

NON-FINANCIAL CORPORATIONS (cumulative four-quarter data)

CHART 5.2



Source: Banco de España.

- a. Financial resources that cover the gap between permanent financial and real investment and gross saving.
- b. Including the change in stocks
- c. Gross capital formation plus foreign equities.
- d. Includes capital transfers.

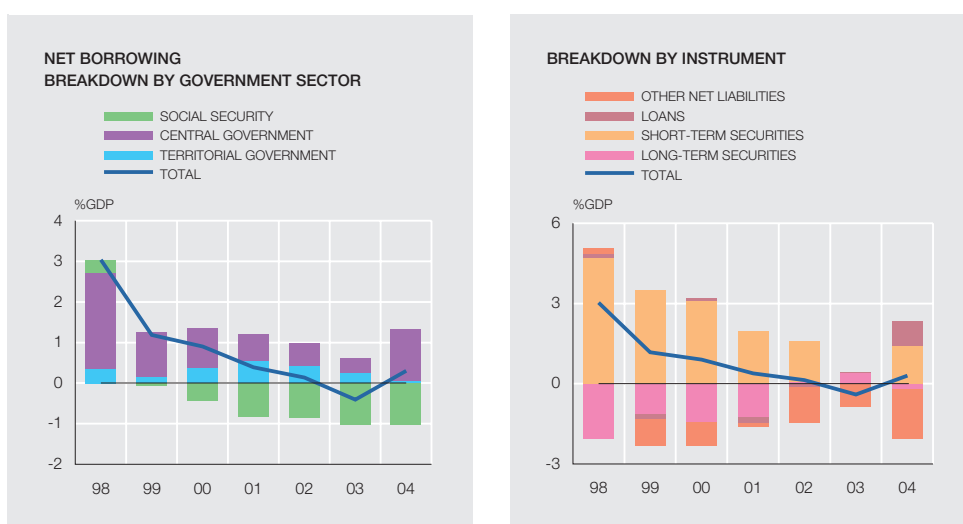
sued by residents and, above all, from the lower purchases of both domestic and foreign shares and other equity (3.3 pp of GDP less than in 2003).

The liabilities-side transactions of corporations amounted to 20.3% of GDP in 2004, as against 22.3% in 2003. This reduction is largely explained by the significant decline that occurred, despite the increase in share prices, in funds raised via the issuance of shares and other equity. Interest-bearing external financing (securities other than shares and loans), by contrast, grew at a rate of more than 13% (see the memorandum items in Table 5.2), a similar rate to that of the preceding year, but with a different composition. The flow of foreign loans was barely 10% of that in 2003, in line with the lower issuance of fixed-income securities by subsidiaries abroad, while funds from resident financial institutions were up 19% from the previous year. Meanwhile, following two years of negative figures, the net issuance of fixed-income securities was again positive, though small. The greater buoyancy of credit as compared with the recourse to debt markets and the raising of funds abroad basically reflects the less expansionary behaviour of the indebtedness of larger corporations, but also a relatively higher recourse to bank finance by this type of company.

An analysis of credit behaviour by productive sector shows that credit to the construction and property services sectors was notably buoyant. Credit to the latter sector, which grew at a particularly fast rate (43.3%), was at its highest levels in recent years. Meanwhile, there was an increase in the rate of growth of financing to industry, which exceeded 5%, following a period of slackness from end-2003.

1.2 GENERAL GOVERNMENT FINANCIAL FLOWS

The net balance of general government financial transactions declined in 2004 and turned negative (−0.3% of GDP, as seen in Chart 5.3). By sector, this outcome was the result of an increase in the net borrowing of central government (almost 1 pp), which exceeded the decline in that of territorial government (regional and local government), and which coincided with a level of net lending by the social security system that was unchanged from 2003. However, as in the case of corporations, these data are strongly affected by the one-off transaction of as-



Source: Banco de España.

sumption of the debt of RENFE by the State. In the absence of this transaction, general government would have been a net lender (in the amount of 0.4% of GDP).

The net issuance of marketable securities by general government was positive and concentrated at the longer maturities, stimulated by the downward path of the interest rates at these terms, which stood at historic lows at the end of the year. There was a net redemption of Treasury bills and medium-term bonds which was offset by a high level of long-term bond issuance (€11.6 billion). As a result, the average life of State debt rose moderately, to 6.16 years. The net issuance of territorial government, meanwhile, amounted to 0.2% of GDP.

As regards the distribution by institutional sector of the flows of debt financing, the rest of the world recovered its position as the main supplier of funds to general government, basically through its purchase of long-term debt securities, which reached its highest level since 2000 (following the disinvestment in 2003). By contrast, the net acquisition of public debt by credit institutions was negative (–€18 billion).

1.3 INVESTMENT AND FOREIGN FINANCING OF THE SPANISH ECONOMY

The increase in the nation's debit balance was the result of a reduction in assets-side financial transactions and an increase in those on the liabilities side (see Table 5.3). Financial institutions and, to a lesser extent, general government were the sectors through which the inflows of funds were channelled, these mainly taking the form of purchases of fixed-income securities. The financing of the deficit therefore followed a pattern characteristic of an economy in which banks, savings banks and co-operatives play a central role in financial intermediation. Deposit institutions had to resort to foreign savings to fill the gap between the demand for credit from households and corporations and the growth in their traditional liabilities. They did this both directly, by issuing debt securities, and indirectly, with the main banking groups selling asset-backed securities (arising from the securitisation of their assets by subsidiary SPVs) to non-residents.

Net purchases of foreign assets fell by almost one percentage point to 12.7% of GDP. This decline was basically the result of the significant contraction in purchases of securities other than shares, which were at their lowest volume since 1997. Conversely, flows in the form of cash and deposits and shares and other equity increased by three and one percentage points respectively, to stand at 3.8% and 5.8% of GDP. On provisional balance of payments informa-

FINANCIAL TRANSACTIONS OF THE NATION
Cumulative four-quarter data

TABLE 5.3

% GDP	2001	2002	2003	2004
NET FINANCIAL TRANSACTIONS	-2.2	-1.6	-2.1	-4.2
FINANCIAL TRANSACTIONS (ASSETS)	12.2	13.9	13.6	12.7
Gold and SDRs	0.0	0.0	0.0	0.0
Cash and deposits	-2.7	3.5	0.8	3.8
Securities other than shares	7.2	4.3	7.0	1.6
<i>Of which:</i>				
<i>Credit institutions</i>	2.0	0.5	3.7	1.0
<i>Institutional investors</i>	5.4	3.3	3.3	-0.1
Shares and other equity	5.1	5.4	4.8	5.8
<i>Of which:</i>				
<i>Non-financial corporations</i>	4.6	5.2	4.6	2.6
<i>Institutional investors</i>	0.5	-0.1	1.2	1.1
Loans	2.5	0.7	1.0	1.5
FINANCIAL TRANSACTIONS (LIABILITIES)	14.4	15.4	15.7	16.9
Deposits	2.8	4.4	7.5	1.8
Securities other than shares	3.1	4.5	5.6	12.8
<i>Financial Institutions</i>	1.5	3.2	6.7	10.0
<i>Other national sectors</i>	1.6	1.2	-1.1	2.8
Shares and other equity	4.6	4.1	0.8	1.8
<i>Of which:</i>				
<i>Non-financial corporations</i>	4.1	3.5	0.9	0.6
Loans	4.3	3.4	3.2	1.4
Other, net (a)	-0.4	-1.0	-1.4	-0.9

SOURCE: Banco de España.

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

tion, direct investment abroad was 63% higher in 2004 than in 2003. This outturn was affected by two large one-off transactions. Meanwhile, portfolio investment declined by 62%, primarily reflecting lower purchases of foreign debt by residents.

Liabilities-side transactions with the rest of the world stood at 16.9% of GDP, as against 15.7% in 2003. Again, it was financial institutions that raised the bulk of these funds, although their composition by sub-sector and instrument differed from that in previous years. There was a notable reduction in flows in the form of deposits and loans. However, this was a result of the lower level of issuance by the subsidiaries of financial and non-financial corporations abroad, which tend to use this channel to transmit funds raised on international markets to their parents. By contrast, the acquisition by non-residents of securities other than shares increased very significantly, especially in the case of those issued by deposit institutions and by securitisation SPVs.

On provisional balance of payments information, direct investment in Spain in 2004 by non-residents was barely one third of the amount in 2003. Disregarding the operations of foreign-equity holding companies (ETVEs)², whose activity is less related to final flows into and out of Spain, the decline was somewhat lower, although still significant. This second consecutive

2. ETVEs have generally been set up by non-resident multinational groups to centralise the holding of their foreign direct investments not only in Spain but also in third countries. A substantial part of the transactions performed by these companies is therefore reflected in increases in the assets and the liabilities of similar amounts.

year of decline was in line, according to the preliminary information available, with the outturn in the euro area as a whole, but contrasts with the recovery in other areas, such as the United States, the United Kingdom, the developing countries and those of central and eastern Europe. The breakdown by country of origin of the funds shows that the reduction was practically across-the-board, so that the EU continued to be the main investor region in Spain.

Conversely, the level of portfolio investment in Spain by non-residents was almost three times that of the previous year. However, it needs to be stressed that this increase was largely a result of the greater importance of the domestic fixed-income markets in the channelling of funds towards Spain. Part of the acquisition of these securities by non-residents replaced funds obtained from international debt markets, which were previously channelled in the form of loans or deposits through the foreign subsidiaries of Spanish companies (those that issued securities on such markets). In the balance of payments, loans and deposits are recorded under the heading other investment, which fell significantly in 2004.

2 The Spanish financial markets

The behaviour of the Spanish financial markets in 2004 was shaped by greater domestic and international economic buoyancy, which favoured the growth of the earnings of Spanish listed companies, by the increase in the level and volatility of oil prices, by the reduction in geopolitical tensions and by generous monetary conditions, which remained conducive to credit growth. Against this background, Spanish markets experienced notable growth in activity, a reduction in the yields negotiated on long-term fixed-income markets and, for the second year running, stock market gains, which were accompanied by further falls in their volatility.

2.1 THE PRIMARY MARKETS

The net issuance of fixed-income securities by resident sectors increased notably in 2004 (70% with respect to 2003), to stand at €129 billion, the highest amount recorded in one year, equivalent to one quarter of the increase in the supply of this type of instrument in the euro area as a whole (see Table 5.4). In the case of equities, there was also a significant increase, although the value reached was much lower (€18 billion), and it was influenced by some large one-off transactions carried out by deposit institutions. For their part, the funds raised through public offerings were also much more dynamic than in previous years, as a result of the listing of three new high-capitalisation non-financial corporations. In the first few months of 2005, activity in the primary debt markets remained highly buoyant.

As regards the characteristics of fixed-income issuance in 2004, the weight of long-term securities was up 6 pp from the previous year, at 92%. At the same time, variable rate issues continued to gain in importance, representing 26% of the total, as against 18% in 2003.

By sector, financial institutions continued to be the main issuers of fixed-income instruments, issuing an amount of €120 billion (94% of the total volume placed by means of this type of instrument). The new supply was equally distributed between that made by credit institutions and that corresponding to other financial intermediaries, which basically include the operations of securitisation SPVs. As in the previous year, the high level of net borrowing by deposit institutions, arising from the fact that the growth in bank lending, especially mortgage lending, continued to be much higher than the growth in deposits, contributed to this expansionary trend. It is, therefore, not surprising that covered bonds and mortgage-backed securities accounted for approximately half of the net flow of funds obtained on the primary debt markets (€17.3 and €44.5 billion, respectively).

Another important factor driving activity in the domestic primary markets was the decline in the issuance activity of foreign subsidiaries (mainly preference shares and subordinated

EUR millions	2001	2002	2003	2004
Net issuance by residents (a)	33,068.4	44,990.9	77,241.2	146,154.0
Fixed income	28,266.5	41,233.3	75,466.0	128,650.1
<i>Central government</i>	4,334.1	7,586.2	327.7	6,650.1
<i>Territorial government</i>	601.4	3,169.5	1,784.3	1,533.0
<i>Monetary financial institutions</i>	13,008.8	13,656.6	42,410.9	60,855.7
<i>Other financial intermediaries</i>	9,899.9	19,098.3	31,892.6	59,591.0
<i>Non-financial corporations</i>	422.3	-2,277.4	-949.6	20.3
Equities	4,801.9	3,757.5	1,775.2	17,503.9
<i>Monetary financial institutions</i>	2,191.4	1,725.0	248.2	15,728.4
<i>Other financial intermediaries</i>	323.4	140.8	62.4	486.3
<i>Non-financial corporations</i>	2,287.2	1,891.7	1,464.5	1,289.1
Public offerings	3,085.8	1,009.4	417.4	2,557.0
Privatisations	696.4	0.0	0.0	0.0
Other	2,389.4	1,009.4	417.4	2,557.0
MEMORANDUM ITEM:				
Net issuance by foreign subsidiaries	23,326.1	14,378.1	12,473.2	-29,344.5
Financial institutions	11,838.3	12,678.9	8,325.1	-26,632.8
Non-financial corporations	11,487.8	1,699.2	4,148.1	-2,711.6

SOURCES: CNMV and Banco de España.

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

bonds) in favour of that carried out by parents or domestic subsidiaries, as a consequence of the entry into force of Law 19/2003, which encourages the issuance of these types of security in Spain. As a result, the net flow of funds attained by the foreign subsidiaries of financial institutions was negative for the first time in the last fifteen years. This shows the importance that particular measures may have in the development of this segment of the Spanish financial system; those recently adopted in this area, within the framework of the plan to invigorate the economy and stimulate productivity can be expected to boost it further.

Equity issuance by financial institutions also grew at a high rate, following three years of decline. This behaviour was connected with various large transactions to finance acquisitions of domestic and foreign institutions.

General government also significantly increased the amount of its net issuance from the level in 2003. This expansionary trend in the supply of securities of the sector was attributable to the State, since territorial government slightly reduced the funds it raised. By instrument, there was a net redemption of €1.8 billion of Treasury bills, while an amount of €9.8 billion was obtained from medium and long-term debt transactions.

Meanwhile, the net issuance of debt by non-financial institutions turned positive again, following two years of negative figures, although the volume was very low (€20 million). The net flow corresponding to foreign subsidiaries, as in the case of financial institutions, contracted markedly and turned negative. If these two segments are added together, a negative amount is also obtained, in contrast to the high levels of preceding years. As regards capital increases, their volume was moderate, so that the downward path of previous years continued, despite the recovery in the prices negotiated.

EUR millions				
	2001	2002	2003	2004
Public-debt book-entry market (a)	16,237,439	18,805,433	21,290,331	22,833,682
Spot (b)	2,041,091	2,310,943	2,246,882	2,136,698
Repos	14,173,002	16,475,994	18,979,902	20,584,242
Forward (b)	23,346	18,496	63,547	112,743
AIAF fixed-income market (b)	141,510	264,974	380,197	566,580
Commercial paper	97,801	204,883	261,526	286,468
Ordinary and asset-backed bonds and mortgage certificates	41,488	56,289	115,269	276,019
Matador bonds	2,220	3,802	3,403	4,093
Stock exchange: fixed-income (b)	56,049	69,820	74,346	82,790
State debt	50	40	55	44
Territorial government debt	55,105	69,171	73,260	82,269
Other	894	609	1,031	478
Stock exchange: equities	445,380	445,071	499,745	643,542
MEFF derivatives markets (c)	499,951	356,413	292,539	393,666
Fixed-income	29,050	5,473	138	5
Equities	470,901	350,939	292,401	393,661
Ibex 35	435,384	320,051	268,879	371,494
Stock options	35,517	20,668	12,714	12,014
Stock futures	—	10,220	10,808	10,153

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

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 value.

2.2 SECONDARY MARKET

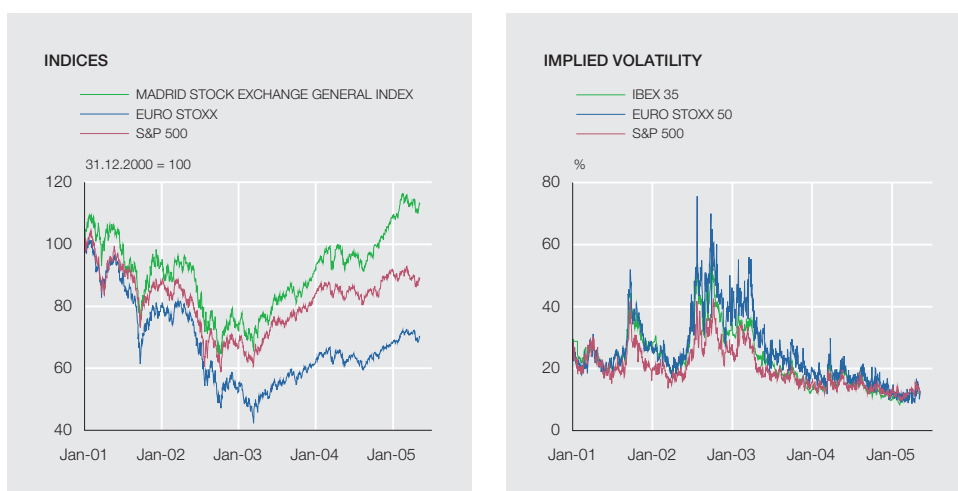
ACTIVITY

On secondary markets, in line with the behaviour on the primary ones, trading volume grew in relation to the preceding year in most segments, including derivatives, where the downward path of the last four years ended (see Table 5.5). In any case, the most notable increase was in the AIAF fixed-income market, with a rise in turnover of almost 50%, especially in mortgage-backed securities. This buoyancy was sustained in the first few months of 2005.

Conversely, in the fixed-income segment of the stock exchange, which mainly trades securities issued by territorial government, and in the public-debt book-entry market, the growth in the volume of transactions was moderate. Activity across the various segments of this market behaved disparately: while the volume of repos and sell and buy-back transactions (which absorb more than 90% of the total) increased by 8%, the amount of spot transactions fell by almost 5%.

The stock market recovery helped boost share trading on the stock exchanges, which increased by 29% relative to 2003. By sector, the largest rises were in communications (41%) and in banking (35%). By type of operation, the level of M&A activity on Spanish stock exchanges was notably lower in 2004 (€2 billion, as against €7.9 billion in 2003).

On the derivatives markets, the volume of trading increased by 36% from 2003. This favourable performance was the result of greater buoyancy in the main products, futures and options on the Ibex 35, since the amounts of operations involving share-based instruments held at around the same levels as in the previous year. The expansionary trend in activity was assisted by the drive by MEFF to attract international investors, as seen, for example, in the incorporation of new non-resident settlement and trading members.



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

In the institutional arena, the improvements in communication systems established by Iberclear, the Spanish central securities depository, in its first full year of operation following the merger of the SCLV and CADE in 2003, should be noted. In 2004 a project (Single Match System) was implemented that will allow the participating institutions, from end-October, to send and receive information using as connection channels the most efficient means offered by SwiftNet.

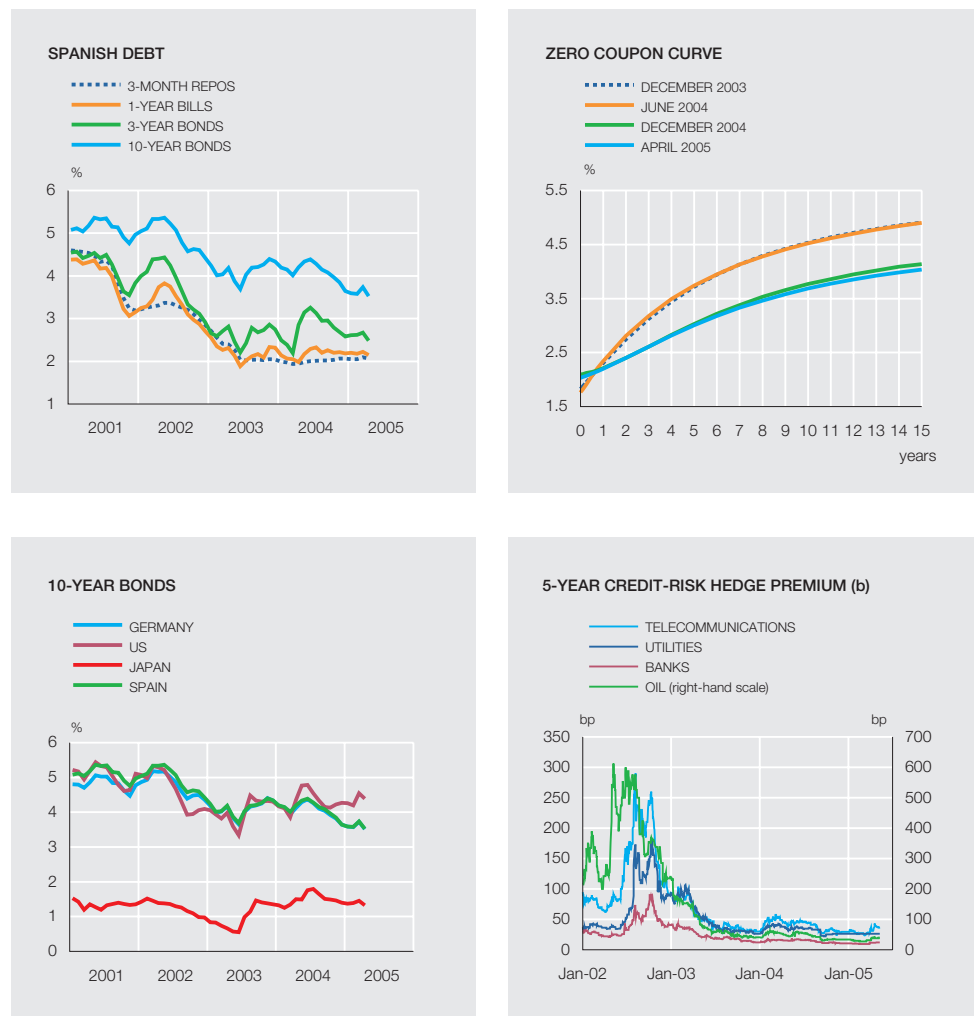
2.3 SECONDARY MARKET PRICES

In the first eight months of the year prices on Spanish stock markets showed no definite trend, moving within a relatively narrow fluctuation band. Following this period, stock market indices began to display a clear upward path, which led to positive gains for the second year running (see Chart 5.4). The rise in the Ibex 35 was 17.4%, very similar to the rise in the Stock Exchange General Index (18.7%), and greater than that in the EURO STOXX broad index for the euro area markets (9.9%) and in the US S&P 500 (10.9%). This rise was accompanied by a decline in implied volatilities, which reached historically low levels by the end of the year. The Madrid terrorist attacks of 11 March had a temporary effect on the level of prices and their volatility, which rapidly disappeared.

The main factors contributing to the rise in share prices during the latter months of the year were the favourable developments in corporate earnings which, for listed companies as a whole, were up 20% from 2003, exceeding analysts' expectations; the background of low long-term interest rates; and the lower tensions in the oil market. Oil prices fell, following their marked upward path during the first three quarters of the year, before rising again at the beginning of the current year.

The rise in prices was practically across-the-board, although there were some differences in behaviour from sector to sector. Specifically, the larger rises occurred in consumer goods and services, in step with the buoyancy of this component of demand, with rises of 34.7% and 34.3% respectively. Similarly large were the gains in the basic materials, industry and construction index (28.7%) and in the oil and energy index (20.1%). Conversely, financial and real estate services posted much more moderate growth (8.9%).

In the Spanish public debt market, as in the rest of the European markets, medium and long-term interest rates, having held relatively steady in the first half of the year, followed a downward course during the second half, to reach historical lows (see Chart 5.5). As a result, at the end of the year the yield on 10-year bonds stood at 3.6%, a reduction of almost 80 bp from a year earlier. For its part, the spread over the ten-year German bond held at around the low levels seen in the previous



SOURCES: Credit Trade and Banco de España.

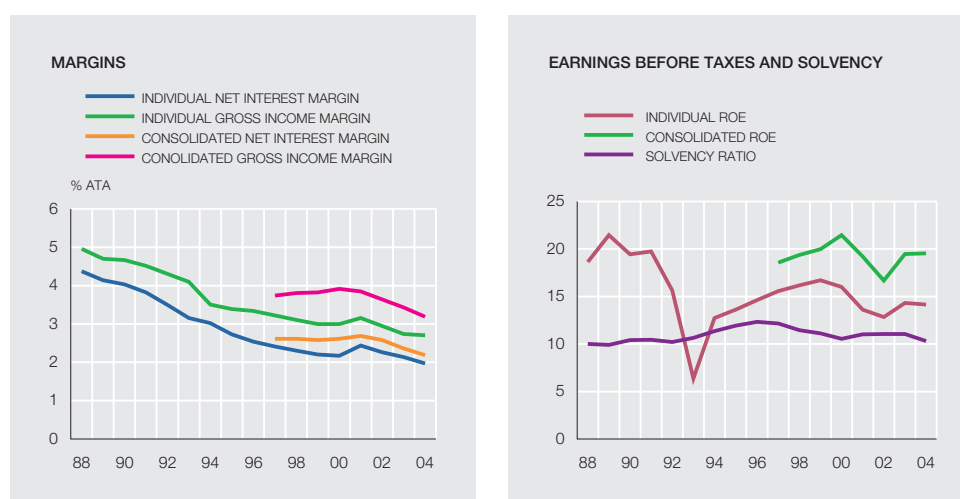
a. Monthly averages.

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

year of 2 or 3 bp. In this respect it should be noted that, in December, Standard and Poor's assigned the highest rating to Spanish sovereign debt, as the other main international agencies had done previously. Short-term interest rates, in step with unchanged key ECB interest rates, barely moved, so that the yield curve flattened in the final part of the year.

Finally, the credit default swaps premiums of Spanish corporations negotiated in the derivatives markets increased moderately during the first few months of 2004, a movement that was corrected in the second half. As a result, at the end of the year they stood at around the low end-2003 levels (see Chart 5.5). This behaviour, along with the trend in long-term rates mentioned above, led to a further fall in the cost to corporations of bond financing.

During the first two months of 2005 stock markets remained on the upward course that commenced in September 2004. This trend ended later amid further bouts of oil price tightening. In mid-May, therefore, the Madrid General Stock Exchange Index stood slightly above its level at the end of the previous year. In the public debt market, long term yields continued to fall during the same period.



SOURCE: Banco de España.

3 Spanish financial intermediaries

2004 was again a period of brisk activity for Spanish financial intermediaries. The total volume of acquisitions of assets and liabilities of financial institutions amounted to 85% of GDP, up 26% from the previous year. As in 2003, transactions between the institutions themselves increased sharply (83%), reflecting the growing complexity of the financial system, as did those with households and corporations (39%), given the high borrowing requirement of this sector. The relative weight of institutional investors in the raising of funds, which had reached nearly 50% a year earlier, fell to around 30%.

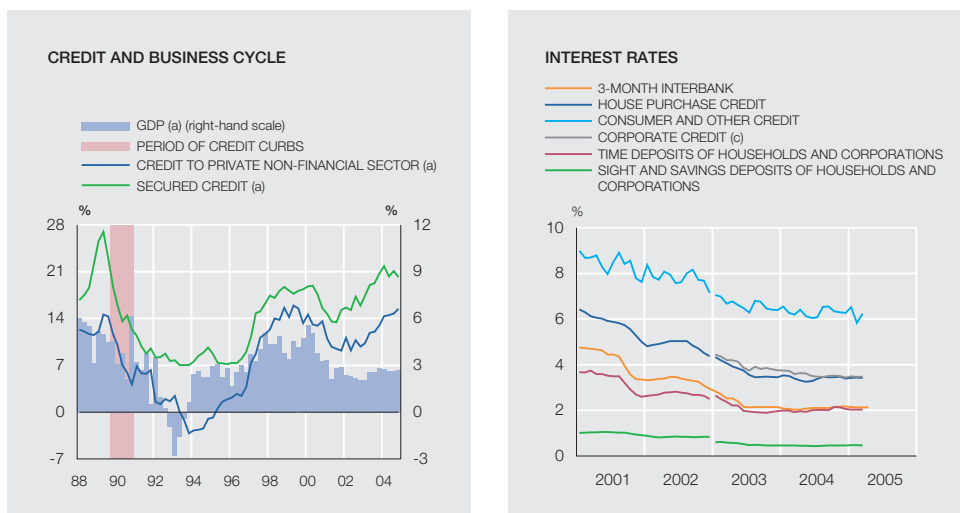
3.1 DEPOSIT INSTITUTIONS

Following a dip around 2001-2002, the profitability of Spanish deposit institutions returned, during the last two years, to the relatively high levels they had been posting since the 1993 crisis (see Chart 5.6). Behind this long period of favourable results was the ability of the sector to counter the constant narrowing of margins by capitalising on the opportunities to increase business that have emerged in recent years at the domestic and international levels. Among these, however, should be highlighted those associated with the behaviour of the demand for credit by the resident private sector³.

The year-on-year growth rate of loans to corporations and households again increased, to 19%. This was equivalent to a real rate of change (deflated by the CPI) only slightly below the highs recorded at the end of the 1980s (see Chart 5.7). Despite the recovery in other forms of lending, the concentration of risk in the institutions' balance sheet intensified in that with mortgage security (75% of the increase in total lending) and with a variable interest rate (90% of the increase in total lending), at the same time as lending as a whole again gained weight within the assets of the sector (see Table 5.6).

In recent years, the growth in financing to households and non-financial corporations has been driven mainly by the continued expansion of demand, which began in the mid-1990s and intensified after Spain joined the euro area. However, it should be noted that there have also been important developments on the supply side, associated with the growing competition between institutions and their efficiency gains. In this respect, the stabilisation of market interest rates in 2004 also led to a smaller change in those applied by banks in their new business

3. Including both that which remains on the institutions' balance sheet, and that granted and removed from the balance sheet as a consequence of securitisation.



SOURCES: ECB and Banco de España.

a. Real year-on-year rates.

b. There is a break, in January 2003, in the series of banking rates owing to changes in the data compilation statistical requirements.

c. 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.

(see Chart 5.7). That said, lending margins, calculated with respect to the 12-month interbank rate, continued to narrow in most cases, although more clearly in the case of loans to corporations (10-16 bp) than in those to households for house purchase (4 bp) and for consumption and other purposes (8 bp).

Paradoxically, the results of the Bank Lending Survey indicated a certain hardening of the approval criteria and of the conditions for extending financing for house purchase. This hardening would have been less than in the previous year, however, and, in any case, insufficient to contain the growth of this type of lending. In the case of consumer lending and, above all, loans to enterprises, the approval criteria tended to be relaxed, while developments in the conditions applied were more variable. According to the institutions' responses, the more favourable behaviour of the supply of this type of loan in comparison with those for house purchase was partly attributable to their perception of improvements in the economic situation, but also to greater competition between them in the search for alternatives to the mortgage market.

In this setting of low interest rates and economic buoyancy, the quality of the loan portfolio continued to improve; there was a decline in the level of doubtful assets from the previous year (attributable, above all, to the behaviour of assets vis-à-vis non-residents) and doubtful assets ratios were at historic lows, of 0.72% in the case of total lending to the resident private-sector, and 0.33% in the case of loans for house purchase.

On the liabilities side competition from other financial institutions (insurance companies, mutual funds and pension funds) to attract the savings of Spanish households and non-financial corporations remained fierce. That said, the narrowing of the spread between market interest rates and the rates offered by institutions meant that the latter could continue to raise a significant volume of funds. In 2004, the deposits of non-financial residents increased by 9%, with sight, savings and time deposits all growing at similar rates. The average interest rates applied to new business held steady in the case of the former and in-

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

TABLE 5.6

% average balance sheet						
	TOTAL		BANKS		SAVINGS BANKS	
	2003	2004	2003	2004	2003	2004
ASSETS						
Cash and central banks (b)	1.3	1.3	1.2	1.1	1.5	1.5
Interbank market assets (c)	14.5	14.0	18.7	18.3	9.3	8.7
Lending	56.9	58.0	49.7	49.7	65.7	68.3
<i>General government</i>	2.3	2.2	2.4	2.4	2.2	2.0
<i>Other resident sectors</i>	52.0	53.4	43.7	44.1	62.1	64.9
<i>Non-residents</i>	2.6	2.4	3.5	3.2	1.4	1.4
Securities portfolio	20.6	20.5	23.2	24.1	18.0	16.4
Of which:						
<i>Government debt</i>	7.7	6.4	7.4	5.8	8.5	7.4
<i>Equities</i>	6.2	6.3	7.5	7.7	4.8	4.7
Other assets (d)	6.7	6.3	7.3	6.9	5.5	5.2
LIABILITIES						
Banco de España	1.5	1.6	2.2	2.4	0.6	0.6
Interbank market liabilities (e)	17.8	17.2	24.2	24.0	9.7	8.6
Customer funds	61.7	61.4	51.7	50.2	74.3	75.9
<i>Asset repo sales to customers</i>	6.8	6.0	6.8	6.0	7.3	6.5
<i>Creditors: general government</i>	3.1	2.9	3.4	3.0	2.7	2.8
<i>Creditors: other resident sectors</i>	38.6	38.2	25.5	24.1	54.2	55.2
<i>Creditors: non-residents</i>	8.3	6.8	10.9	8.4	5.1	5.0
<i>Debt securities</i>	4.9	7.4	5.1	8.7	5.0	6.3
Own funds, special reserves and subordinated financing	12.8	12.5	13.7	13.4	11.4	11.2
Of which:						
<i>Subordinated financing</i>	3.3	3.3	3.7	3.5	3.2	3.2
Other liabilities (f)	6.3	7.3	8.2	10.1	4.0	3.8
PROFIT AND LOSS ACCOUNT						
(+) Interest income	4.0	3.69	3.98	3.69	4.07	3.68
Of which:						
<i>Dividends</i>	0.38	0.42	0.51	0.53	0.23	0.29
(-) Interest expenses	1.90	1.73	2.06	1.93	1.71	1.48
Net interest income	2.13	1.97	1.91	1.75	2.36	2.21
(+) Commissions	0.64	0.63	0.68	0.66	0.58	0.58
(+) Profits on financial operations	-0.03	0.11	-0.10	0.15	0.07	0.06
Gross income	2.74	2.70	2.49	2.56	3.01	2.85
(-) Operating expenses	1.61	1.48	1.41	1.28	1.84	1.71
Net income	1.13	1.22	1.08	1.28	1.17	1.14
(-) Write-downs and provisions	0.41	0.37	0.41	0.40	0.39	0.31
(+) Other income	0.14	-0.04	0.19	-0.06	0.07	-0.03
(-) Taxes	0.17	0.12	0.18	0.13	0.15	0.11
After-tax profit	0.69	0.70	0.68	0.70	0.70	0.69
MEMORANDUM ITEM:						
After-tax profit (€ m)	9,507	10,839	5,302	6,184	3,767	4,152
As a % of own funds	11.5	12.0	11.4	12.1	12.1	12.2
Average total assets (€ m)	1,372,909	1,555,214	782,913	889,441	537,127	606,018
Year-on-year growth rate (%)	10.1	13.3	9.6	13.6	10.7	12.8

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. Except Banco de España repos.

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

creased by some 10 pp in the case of time deposits and repurchase agreements with customers.

In any event, in recent years, the growth of traditional liabilities to the non-financial resident private sector has been clearly insufficient to finance the growth of assets. This has forced institutions to resort much more actively to financing on the markets (whether the interbank or securities markets), altering their traditional balance sheet structure (see Box 5.1). In 2004, there were again large increases in both the issuance of debt securities and the securitisation of assets, to the extent that, in December, they accounted for 22.5% of the total volume of credit extended (up almost 6 pp from a year earlier). However, these figures do not incorporate issuance through resident and non-resident subsidiaries. For its part, the overall (uncollateralised) net debit balance of the institutions on the interbank market increased by €31.4 billion, although 80% of this amount is explained by the behaviour of foreign banks.

The above developments had a significant impact on the net interest margin which, in 2004 and in terms of total assets, fell again (see Table 5.6), as a consequence not only of the aforesaid narrowing of asset and liabilities spreads on new business but, above all, of the lagged effect of the reductions in interest rates in previous years. By contrast, commissions grew by 12%, in line with the increase in assets. Some 40% of this increase was attributable to those received for marketing financial products, helped by the favourable performance of the markets in 2003 and 2004. The rest generally grew by less than the volume of assets but by more than the net interest margin, thereby explaining the increase in its weight in the institutions' revenues.

Meanwhile, operating costs, which again grew by less than the volume of assets, continued to be contained, although the differences in behaviour between commercial banks and savings banks persisted. These costs grew less in the former, as shown by a clearer improvement in their efficiency ratio (operating costs to gross income), with the gap in their favour vis-à-vis savings banks reaching 10 percentage points (50%, as against 60%). To close the gap, savings banks will need to make the significant number of new branches they have opened in recent years profitable.

Overall, individual net profit grew by 14% which, together with the sound behaviour of business in Latin America in 2004, translated into an 18% increase in consolidated profit attributed to the group. This positive result was accompanied by a decline in the solvency ratio (from 11% to 10.3%⁴). That said, the solvency ratio is still more than two percentage points above the minimum level required. In addition, thanks to the operation of the statistical provision during the last few years, the volume of loan loss provisions is more than three times higher than doubtful assets, at the individual level, and around 2.5 times at the consolidated level.

Spanish deposit institutions can thus currently be said to enjoy a sound financial position, which will enable them to continue to cover the borrowing requirements arising from economic activity with declining intermediation costs and to withstand any adverse developments. This strength also allowed them in 2004 to resume the international expansion they had initially embarked upon in the second half of the 1990s as a way of diversifying revenues and improving efficiency. However, a significant part of the current situation is attributable to the exceptionally favourable performance of the Spanish economy in recent years, so that it is also affected by the risks identified in Chapter 1 of this report, in particular those associated with the high level of household indebtedness and price developments in the housing market.

4. From 12.6% to 11.7%, according to the rules of the Basel Committee on Banking Supervision.

Over the past nine years, the loans and advances of Spanish deposit institutions tripled, while the deposits of their resident customers doubled, resulting in a cumulative shortfall of deposits of €330 billion (41% of the 2004 GDP)¹. The financing of this shortfall has altered the traditional structure of the balance sheet of Spanish banks. The charts illustrate this by showing the abridged balance sheets² of commercial banks (panel 1) and savings banks and credit co-operatives (panel 2) in December 1995 and December 2004.

The institutions reacted to this situation by reducing their net cash positions and issuing more securities on the markets. The commercial banks increased their net debit position on the interbank market, although there were differences between the behaviour of domestic and foreign banks. The net interbank indebtedness of the former is lower and, following several years of growth (between 1995 and 2000), has remained relatively stable. Thus, the increase in the last two years in this indebtedness is almost exclusively attributable to foreign banks, which have significantly increased the rate of growth of their balance sheet and, consequently of their borrowing requirements. Savings banks and credit co-operatives, meanwhile, started from a position of greater liquidity in 1995, and

were able to offset, as seen in Chart 2, part of the lower growth in their customer deposits than in their lending, by a reduction in the funds raised for liquidity positions (interbank and fixed-income securities of the government and credit institutions)

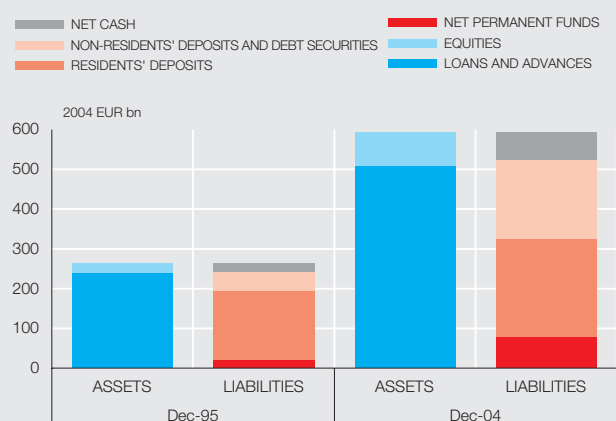
Accordingly, the securities markets were the main alternative source of financing for institutions, covering 74% of the total cumulative shortfall (79% if we include securitisation). Their weight in the balance sheet of the commercial banks and savings banks (and, to a lesser extent, of credit co-operatives) therefore increased substantially.

The changes in the structure of financing of the institutions have, at least potentially, implications for their risks and margins. For example, their greater dependence on the interbank market involves, in principle, greater liquidity risk (given the generally very short term of the transactions on this market). In any case, only foreign banks and a small group of large institutions have significant net debit positions on the interbank market.

The average cost of both interbank loans and financing on securities markets is higher than that of traditional deposits, so that their greater use has been an additional factor in the narrowing of margins. Indeed, had the structure of liabilities in 2004 been the same as in December 1995, the total average cost would have been 13 basis points lower than that observed, in the case of commercial banks, and 6 basis points in that of savings banks and credit co-operatives. In the latter case, however, the true effect was even larger, since the lower revenues arising from the reduction in cash assets must also be taken into account. In any event, these effects are moderate (around 10% of the total net interest income of all Spanish deposit institutions), owing to the low level of current interest rates.

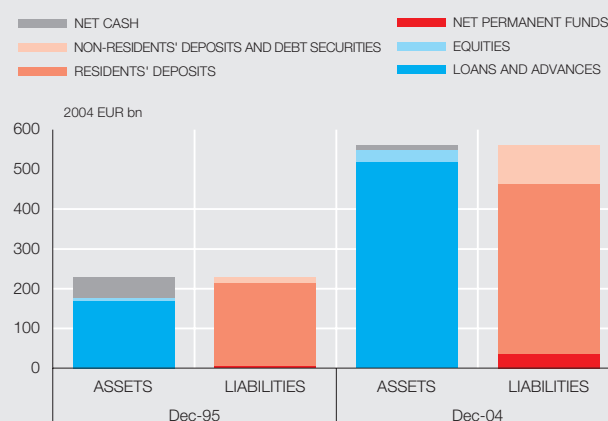
1. The shortfall was €400 billion if the credit removed from the balance sheet as a result of securitisation is included. 2. The balance sheets presented have been constructed as the sum of the earning assets net of interbank transactions and of purchases and sales of assets under repurchase agreements. The non-earning assets (property, compulsory reserves and other assets accounts) have been subtracted in the liabilities from the permanent funds with no explicit cost (own funds, special funds and other liabilities accounts). The deposits of non-residents are grouped together with debt securities and subordinated financing because recently their behaviour has been affected by the channelling through them of funds raised by the institutions from securities issuance on international markets.

1. ADJUSTED BALANCE SHEET. COMMERCIAL BANKS



SOURCE: Banco de España.

2. ADJUSTED BALANCE SHEET. SAVINGS BANKS AND CREDIT CO-OPERATIVES



	2000	2001	2002	2003	2004	2004
Total (b)	2,258	15,980	18,632	27,065	22,602	389,721
Pension funds						
Net contributions (c)	6,454	6,738	6,422	4,823	4,630	62,882
Life assurance						
Premiums net of claims (d)	11,212	9,435	10,936	2,829	2,983	107,534
Mutual funds						
Net share purchases	-15,408	-194	1,274	19,413	14,989	219,306
FIAMM	-10,156	9,798	8,327	3,830	-744	57,989
FIM (e)	-5,251	-9,991	-7,053	15,583	15,733	161,317
MEMORANDUM ITEM:						
Deposit institutions: change in accounts payable						
Non-financial private sector	51,869	53,622	32,845	27,537	44,067	573,725

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. Banco de España estimate based on the change in the net asset value and annual yield of the funds.
- d. The 2004 figure is provisional (based on ICEA assuming the same ratio of premiums to claims as in the previous year).
- e. The 2003 and 2004 data are estimates correcting for the double-counting associated with funds of funds.

3.2 INSTITUTIONAL INVESTORS

After correcting for the double counting arising from the fact that some funds invest in other domestic collective investment institutions, the net funds raised by the various institutional investors (capital market mutual funds, insurance corporations and pension funds) remained at similar levels to those of the previous year, except in the case of FIAMM (money market funds), which recorded negative net purchases of their shares (see Table 5.7). As a result, there was a moderate decline in the total volume of funds raised, to some €22.6 billion⁵.

Despite the funds raised, the weight of institutional investors in the total assets of the non-financial resident private sector has remained steady since 2000 without returning to the highs reached in 1998. Both the losses arising from the fall in share prices in the period 2000-2002 and the narrowing of the spread between the return on traditional banking liabilities and market interest rates may have affected this outcome.

A notable development in 2004 was the increase in the penetration of foreign managers both directly, through the sale in Spain of their own collective investment institutions⁶, and indirectly, through the investment of Spanish funds in shares of institutions domiciled abroad. Given the economies of scale that exist, one would expect more rapid integration at the European level in this sector than in others, such as retail banking. In this respect, although Spanish management companies have improved their product offering in recent years and also have an advantage in the extensive sales network of their parent institutions, they should not neglect other aspects, such as portfolio management and commissions. As indicated in Box 5.2, the latter have hardly changed in recent years.

5. Real estate investment companies and mutual funds, which are not included in the table, continued to represent a relatively insignificant percentage (1.5%) of all non-bank financial intermediaries. However, they have benefited from the persistent high returns on real assets in recent years, and in 2004 their net assets increased by 53%. 6. Which rose from 3.7% to 6.3% of total net assets.

Current Spanish law establishes five types of fee that mutual funds may charge their shareholders: asset-based management fees, result-based management fees, deposit fees, load fees and redemption fees. The law also establishes certain maximum limits, distinguishing in each case between FIAMM (money-market funds) and FIM (capital market funds) and, also, in the case of management fees, between when they are applied individually and when jointly.

This box assesses the asset-based management fees and the deposit fees charged by the managers of Spanish mutual funds. The other types of fee are excluded from the analysis as they are less important¹. Mutual funds are grouped into the following four categories: FIAMM, fixed-income FIM, equity FIM and guaranteed FIM².

1. Management fees linked to results are very uncommon and when they appear they do so jointly with those calculated on the basis of the assets. Likewise, load and redemption fees are far from widespread in most categories. Also, managers limit the time of application of this type of fee according to marketing periods, the expiry of the guarantee periods (in the case of guaranteed funds) or volumes purchased, so that they are rarely charged. 2. In terms of the total assets managed, these categories represented, in October 2004, 26%, 30%, 30%, 13% and 23%, respectively. The other 8% corresponded to global FIM which, owing to their special characteristics, are excluded from the analysis.

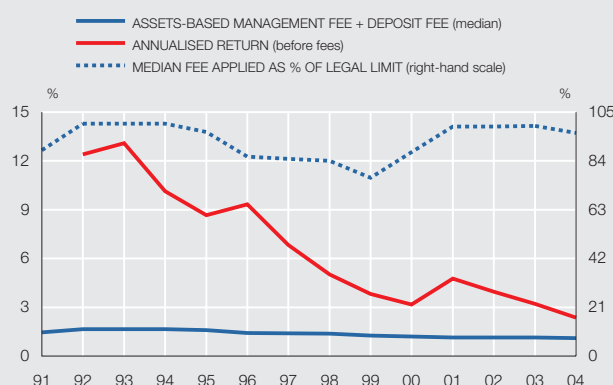
The levels of the representative fees applied to mutual funds in Spain have, during the period analysed, fallen slightly, although by a significantly smaller amount than their returns (see adjoining charts). While the return on FIAMM and fixed-income FIM is currently around 80% lower than in 1993 and equity and guaranteed funds display highly variable returns, the fees applied have remained practically unchanged, with the sole exception of fixed-income funds, a category that has seen a reduction in the fees applied that goes beyond the reductions associated with the changes to the legally established maximum limits³.

The adjoining charts also show that, with the sole exception of fixed-income funds, the median level of the fees represents a percentage of the legal maximum that has been rising in recent years, to stand, in the case of FIAMM at practically 100%. This would seem to indicate that the slight downward movements in fee levels have been caused, except in the case of fixed-income funds, more by changes in the legal limits than by any increase in competition on this variable between managers, against a back-

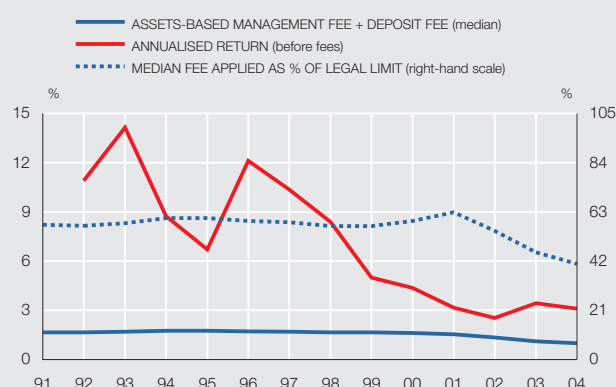
3. The main legal change was made by RD 6/2000 on urgent competition measures, which reduced the maximum fee limits.

FEES AND RETURNS. ANALYSIS BY CATEGORY (a)

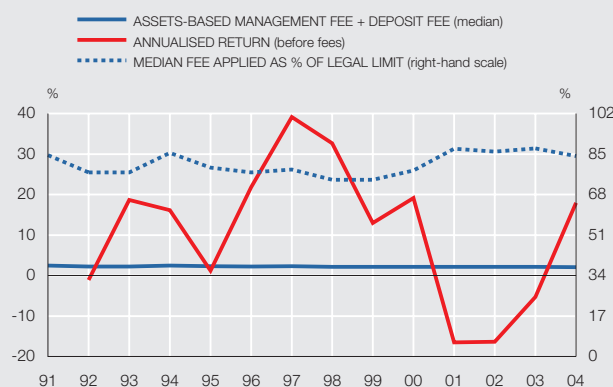
FIAMM



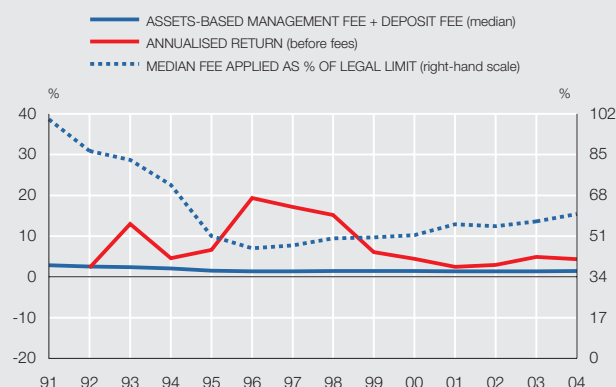
FIXED-INCOME FIM



EQUITY FIM



GUARANTEED FIM



SOURCES: CNMV and Banco de España.

a. Average annual data. In the case of 2004, for the first ten months.

ground in which shareholders may not be efficiently exploiting all the opportunities offered to them by the new legislative framework.

The adjoining table shows the low dispersion of fees within each of the fund categories analysed. In some cases this dispersion even

displays a downward trend. Likewise, there are few differences in the median levels of the fees applied between FIAMM and guaranteed FIM, according to the promoter group to which the manager belongs. However, the fees of fixed-income and equity FIM managed by entities other than banks and savings banks are lower than when they are managed by deposit institutions.

ANALYSIS OF FEE DISTRIBUTION

		FIAMM	FIXED-INCOME FIM	EQUITY FIM	GUARANTEED FIM
Standard deviation (%)					
Asset-based management fee	DEC 1996	0.30	0.49	0.59	0.36
	DEC 2000	0.19	0.47	0.50	0.37
	OCT 2004	0.26	0.52	0.51	0.38
Deposit fee	DEC 1996	0.04	0.11	0.11	0.11
	DEC 2000	0.04	0.10	0.10	0.08
	OCT 2004	0.04	0.05	0.05	0.04
Median (%) October 2004					
Asset-based management fee	Banks	1.14	0.80	2.20	1.50
	Savings banks	1.10	1.10	2.01	1.35
+ Deposit fee	Other	1.15	0.50	1.60	1.49

In terms of results, 2004 saw little change from the previous year, with low returns that were negative again in real terms in the case of FIAMM (1.2%, as against 1.5% in 2003), and greater than inflation but modest in the case of FIM (capital market mutual funds) and pension funds (4.1% and 4.5%, respectively, as against 5% and 5.4% in 2003).

Finally, as regards the portfolio structure (see Chart 5.8), there was a further fall in the weight of Spanish public debt and an increase in that of private fixed income (included within other euro fixed income) and in domestic and foreign equities. For its part, the foreign portfolio increased slightly in relative terms in the case of pension funds and declined in that of FIM and FIAMM⁷. In any event, the portfolios of Spanish institutional investors remain relatively conservative in comparison with those of other countries.

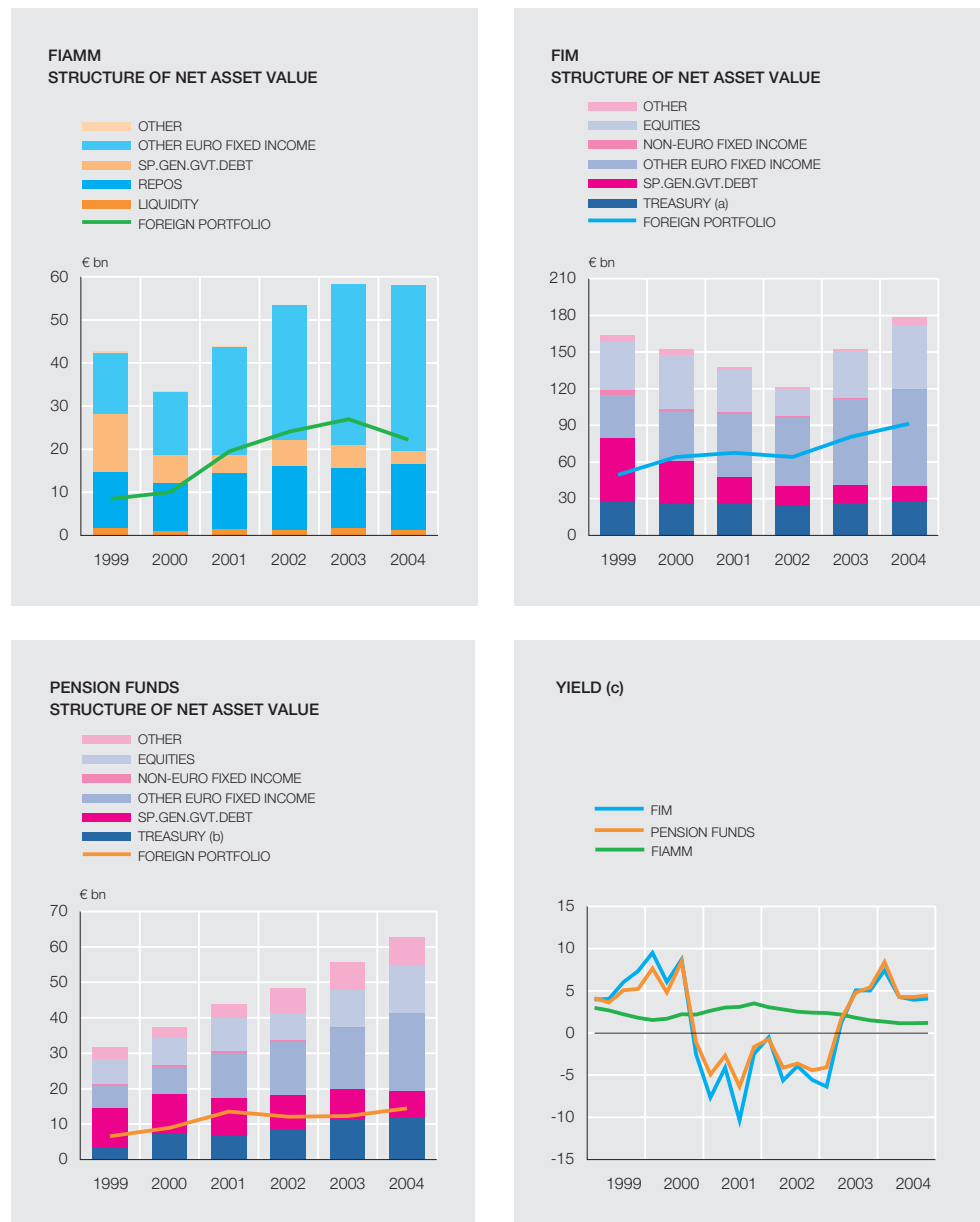
4 The financial position of the non-financial private sector

Among the most significant changes in the financial position of the non-financial private sector were the increases in debt ratios as a consequence of the buoyancy of external funds, which also led to a rise in the debt burden of households and a contraction in their ability to save. In the case of corporations, by contrast, the proportion of funds used to pay interest on debt remained on a downward path. At the same time, the rise in stock markets and, especially, the increase in house prices enabled the net wealth of households to grow again in 2004.

4.1 HOUSEHOLDS

The relative weight of real-estate assets in the aggregate (gross) portfolio of households continued to rise, to over 75%, to the detriment of the financial component, which was still dominated by liquid and low-risk assets. The relative importance of the latter, however, diminished slightly. Cash, deposits, debt, FIAMM and euro fixed-income FIM represented 49% of total fi-

7. However, part of the growth in the domestic portfolio of FIM and pension funds is attributable to shares in mutual funds, which may be investing, in turn, in foreign assets rather than domestic ones.



SOURCES: CNMV, Banco de España and INVERCO.

a. Includes repos.

b. Includes repos and money market assets.

c. Cumulative return over last 12 months.

financial assets, down 0.7 pp from the previous year. By contrast, the proportions of total financial assets in the form of shares and other equity and in other FIM increased, by 0.2 pp and 0.4 pp, respectively, to 26.1% and 6%, thanks to the favourable behaviour of prices. Finally, insurance accounted for 15.2% of total financial assets, practically the same figure as in 2003.

As for liabilities, most of them were still in the form of bank loans. Those for house purchase continued to gain weight, reaching 63%, while the opposite was the case with financing from deposit institutions for consumption and other purposes, which fell to 25.2%

The expansionary behaviour of household financing, along with a less buoyant trend in the sector's income, led to further rises in the aggregate ratio of debt to gross disposable income



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.

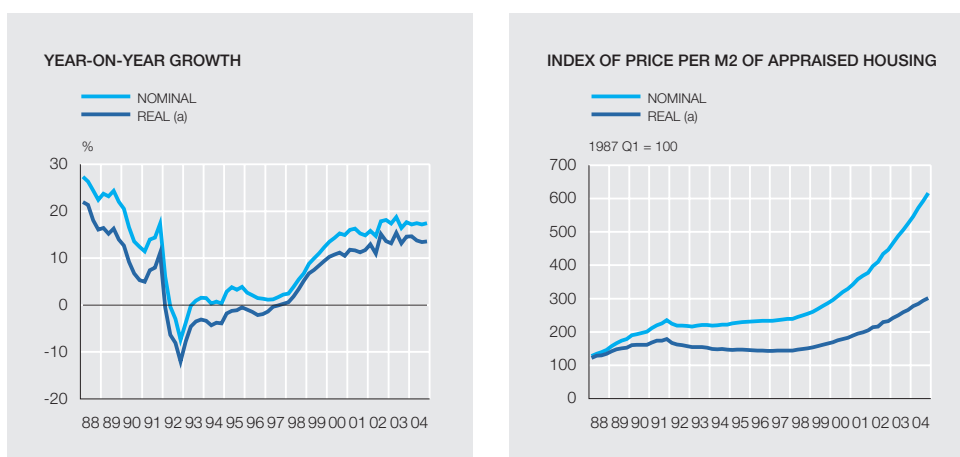
(GDI) which, at year-end, stood at 104%, up 11 pp from 2003 (see Chart 5.9). Consequently, the indebtedness of Spanish households is moving away from the average EU level (90%) and approaching that in the United States (115%). The ratios calculated with different definitions of financial assets also rose.

Unlike in the two previous years, the increase in the sector's liabilities in 2004 was accompanied by a rise in the associated debt burden. Thus, the proportion of GDI that households assigned to the interest payments and principal repayments in respect of their debt increased by almost one percentage point to nearly 14%, a high for recent years. Likewise, the growth in financial obligations, against a background of stability in the gross savings rate, led to a decline of approximately one percentage point in saving after debt service, to 0.5% of GDI, its lowest level since the mid-1990s.

Despite the increase in liabilities, the net worth of the sector continued to grow thanks to the rise in the value of the financial portfolio and, above all, the expansionary behaviour of house prices, which grew at a rate – practically unchanged from 2003 – of more than 17% (see

CHANGE IN HOUSE PRICES

CHART 5.10

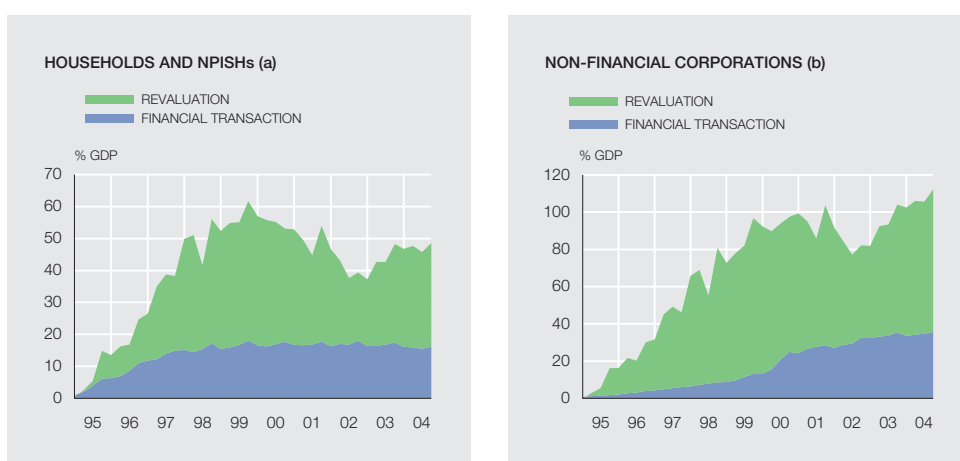


SOURCE: Banco de España.

a. CPI-deflated.

CUMULATIVE CHANGE IN NET FINANCIAL WEALTH OF HOUSEHOLDS AND NPISHs AND NET WORTH

CHART 5.11



SOURCE: Banco de España.

a. Net financial wealth (financial assets less liabilities).

b. Net worth approximated by market-price valuation of the shares and other equity issued by non-financial corporations.

Charts 5.9, 5.10 and 5.11). Following this rise, the cumulative gain in the value of real estate assets since end-1997 was 158% and 110%, in nominal and real terms respectively. As mentioned in Chapter 1, these figures cannot be fully explained by the behaviour of their fundamentals, so that the market value of property is currently overvalued to a degree that has been increasing in recent years.

As seen in Chapter 4 of this report, households' aggregate financial position continued to help sustain consumption and residential investment and will foreseeably keep doing so over the coming months. However, the rise in indebtedness, the increasing degree of overvaluation of real-estate assets and the low level of the savings buffer involve an evident increase in downside risks which may affect the behaviour of consumption and residential investment in the medium and long term. In particular, the absence of clear signs of a significant slowdown in house prices tends to increase the probability that the adjustment in this market, which in

Since the mid-1990s, household debt has increased significantly, and in 2004 it exceeded the value of the sector's gross disposable income. The debt service burden has also grown, albeit less than proportionately, owing to the reduction in interest rates and to the lengthening of loan terms. However, to be able to draw precise conclusions regarding the implications of these changes in terms of the potential risks to macroeconomic stability and to the financial stability of the Spanish economy, the aggregate information needs to be supplemented by a study of the distribution of these variables according to a number of relevant characteristics of households, such as their income and wealth levels and the age and employment situation of the household head. The Survey of Household Finances recently compiled by the Banco de España enables these questions to be analysed¹.

In 2002, the sector's liabilities were divided between a high percentage of households, since 43.6% had some type of debt. However,

1. For more information on this survey, see Bover (2004): *The Spanish Survey of Household Finances (EFF): description and methods of the 2002 wave*, Occasional Paper no. 0409, Banco de España.

analysis of the median by population group, according to their income reveals the existence of a notable dispersion in the debt burden among all indebted households, the lower-income households being those with comparatively higher median ratios (see adjoining table). For example, in the lowest quartile of the income distribution the debt burden is more than three times the level in the highest decile². By levels of wealth, the differences in the distribution of this ratio are, conversely, much smaller, though again the groups with fewest resources (in the two lowest quartiles, in this case) had the highest ratios. The analysis by age and employment situation shows that those households with younger and with self-employed heads bear the highest burden. There is also significant dispersion in the distribution of the debt ratio, those households whose head is younger or self-employed and those whose income is in the lower half of the distribu-

2. The values shown in the adjoining table are median values of the debt-burden and debt ratios for individual households, so that they are not comparable with the ratios that may be constructed on the basis of Financial Accounts aggregates. Also, mean values cannot be inferred from the medians, given that the distribution of wealth in the population is very asymmetric, with tails of very different density.

HOUSEHOLDS' DEBT AND DEBT BURDEN

	Debt service/household income ratio(%)		Total debt/household income ratio (%)	
	Median	Percentage of households with a ratio above 40%	Median	Percentage of households with a ratio above 3
All households	15.2	7.2	73.3	8.5
INCOME PERCENTILE				
Below 25	29.8	28.2	95.5	28.2
25-50	19.3	9.3	100.3	12.6
50-75	15.4	3.7	74.9	4.7
75-90	11.5	2.6	54.8	3.2
90-100	8.5	1.2	54.4	1.5
NET WEALTH PERCENTILE				
Below 25	17.2	10.9	75.7	14.3
25-50	16.2	4.7	85.0	8.4
50-75	13.8	6.6	68.3	5.4
75-90	13.4	5.2	58.8	4.8
90-100	12.9	10.4	74.9	9.2
AGE OF HOUSEHOLD HEAD				
Below 35	17.2	8.8	133.9	16.5
35-44	16.7	7.2	87.2	10.0
45-54	13.1	7.0	48.2	3.3
55-65	12.9	5.7	41.8	4.9
Over 65	12.3	6.4	28.7	3.6
EMPLOYMENT SITUATION OF HOUSEHOLD HEAD				
In employment	14.9	4.0	79.9	7.4
Self-employed	18.8	16.6	92.7	14.4
Retired	13.1	6.1	33.7	2.4
Unemployed or otherwise economically inactive	14.8	12.8	47.7	11.4
EMPLOYED PERSONS				
None	16.8	14.8	47.0	11.4
One	16.1	8.3	78.5	10.9
Two	14.0	4.7	77.2	6.4
Three or more	12.1	4.7	46.1	1.6

SOURCE: Survey of Household Finances.

tion being those with comparatively higher median values³. It is notable that almost half of the debt is concentrated in the upper income quartile (15% of all households), while the self-employed (7% of household units) account for almost 25%.

Given the greater sensitivity of their spending decisions to adverse shocks, it is important to characterise those households that assign a significant proportion of their income to the payment of their debts or that have a high level of indebtedness. As seen in the second column of the adjoining table, the proportion of indebted households that assign more than 40% of their gross income to the payment of their liabilities is 7.2%, while 8.5% have levels of debt that are at least three times their gross income (last column). In the case of lower-income households (below the 25th percentile) with outstanding debts, these percentages rise to 28.2%. An analysis based on wealth shows

3. When the debt ratios are calculated using wealth instead of income, the self-employed do not have the highest values, since the value of the assets of these households is greater.

that it is those households in the lowest quartile of the distribution that have the highest values, although the differences are less significant than in the analysis based on income levels. Accordingly, it is indebted households with fewest resources, and those in which none of the members are in employment, that have the highest proportion of debt ratios and debt burdens that may be considered high. Meanwhile, the age-based analysis shows concentration among the youngest who, obviously, have the highest potential income growth.

The data of the Survey of Household Finances tend to confirm the overall soundness of the financial position of households in 2002, the representative household having moderate debt service burden and debt ratios. However, they also show the existence of a significant proportion of households for which these ratios are high, meaning that their vulnerability to adverse changes in employment, asset prices and interest rates could be significant. Given the high level of borrowing since then, the possibility of substantial changes in these proportions in the most recent period cannot be completely ruled out.

comparable episodes in the past was gradual and orderly, may on this occasion be achieved less smoothly, although this possibility is not part of the most realistic scenario.

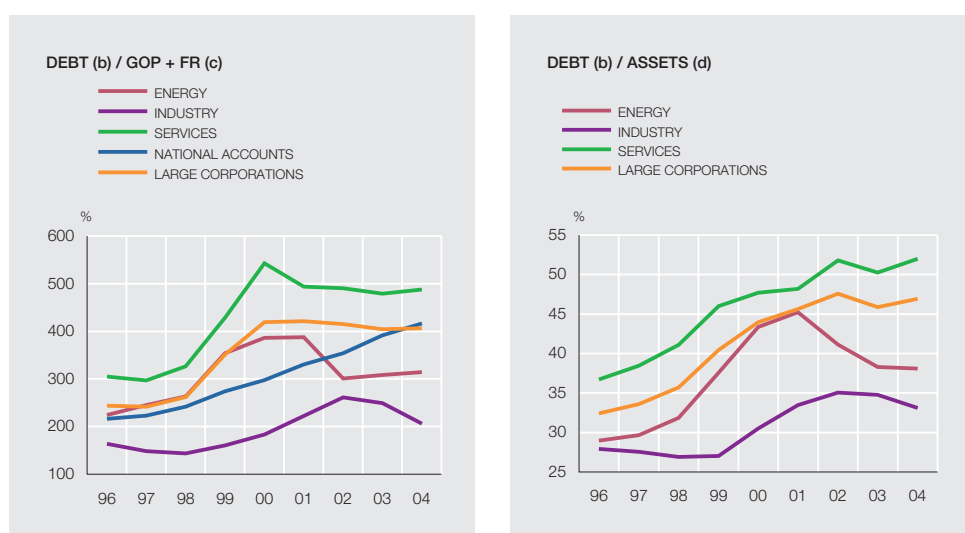
Also, the available disaggregated information from the BE Household Financial Survey reveals that, although the sector as a whole may be sound, this does not rule out the existence of certain groups concentrated in low income segments which, albeit small, are subject to a relatively high degree of financial pressure (see Box 5.3). These groups may be particularly vulnerable to adverse changes in employment, interest rates or house prices.

4.2 NON-FINANCIAL CORPORATIONS

The composition of the financial portfolio of corporations was practically unchanged in 2004. Thus, shares and other equity continued to be the main instruments, with a weight of almost 45%, despite the decline in the relative importance of external assets.

On the liabilities side, own funds were still the largest item, although they declined in weight by 0.2 pp to 47.8%, despite the rise in share prices. The weight of trade credit increased by 0.1 pp, to 22.6%. Finally, the relative importance of interest-bearing borrowing increased slightly to 27.8%, with a composition in which financing from resident institutions gained almost one percentage point. The opposite was the case with foreign loans and fixed-income securities, instruments normally used by larger enterprises.

As in the case of households, the buoyancy of corporate borrowing translated into an ongoing rise in the ratio of aggregate debt to profits, which reached 417%, up 25 pp from 2003 (see Chart 5.12). However, the microeconomic information available suggests that this variable did not behave uniformly across the sector. In the case of the main corporate groups, the ratio was relatively stable, so that, following the rebuilding of balance sheets in recent years, it was well below the levels recorded at the beginning of the current decade (see Box 5.4). Meanwhile, according to Central Balance Sheet Data Office (CBSO) data, industrial corporations reduced their ratio, primarily as a result of the rapid expansion of the denominator.



SOURCE: Banco de España.

a. All the series, except "National Accounts", are calculated with CBSO information. Up to 2003, the information is from the CBSO annual survey (CBA). The data to 2004 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.

The decline in financing costs enabled the proportion of profits used to pay the interest on debt to continue to fall, to around 17%, down 2.5 pp from the level in 2003 and close to the lowest level recorded since the mid-1990s (see Chart 5.13). For its part, drawing on CBSO information, the debt burden indicator, which includes, in addition to financial costs, interest-bearing short-term debt, fell again in 2004 for the respondent corporations as a whole. This decline was somewhat steeper in the case of the industrial corporations.

The financial results of non-financial corporations were very favourable last year. According to the CBSO sample, gross operating profit increased by 8.6%, a much larger increase than in the previous year. This development, together with the decline in financial costs, meant that ordinary net profit was even more expansionary (21.5%). The sharp decline in capital gains and extraordinary income, a very erratic item, which was abnormally high in 2002 and 2003, prevented this improvement from extending to net profit. Among the various activities best represented in the CBSO sample, the recovery in the industrial branch was notable, its ordinary net profit rising by 32.2% on the previous year. The profits of listed companies were in line with the rest of the sector and, according to analysts' expectations, will continue to grow at relatively high rates over the coming months (see Chart 5.14). Also, expected long-term returns were gradually revised upwards to levels closer to their historical average.

The composite indicators of financial pressure on investment and employment, which are compiled on the basis of CBSO information and summarise the overall impact of indebtedness, the debt burden and profits on decisions relating to capital expenditure and hiring, remained at low levels, which shows that their financial position is favourable for the growth of both these macro-economic variables (see Chart 5.14). In the case of investment, the outlook is even somewhat better than a year ago.

Developments in the net worth of non-financial corporations were also favourable, basically thanks to the rise in share prices, since, as mentioned in section 2, capital increases were

In the second half of the 1990s, large Spanish corporate groups expanded and internationalised their businesses, with a significant increase in their foreign investments. To meet the large financing requirements arising from this process, these corporate groups increased their volume of debt. Between 1997 and 1999 the rates of growth of borrowing by these groups were thus well above those for all Spanish non-financial corporations (see Chart 1). This, along with their much more muted earnings growth, led to a rapid rise in their debt ratio, which started from well below the sector average to reach a similar level in 1999 (see Chart 2). In 2000 and 2001, against a background of slowdown in their financial and real investments, the external financing of large corporate groups decelerated, although it still continued to grow at positive rates which, given the moderate growth in income generated, entailed unchanged debt ratios.

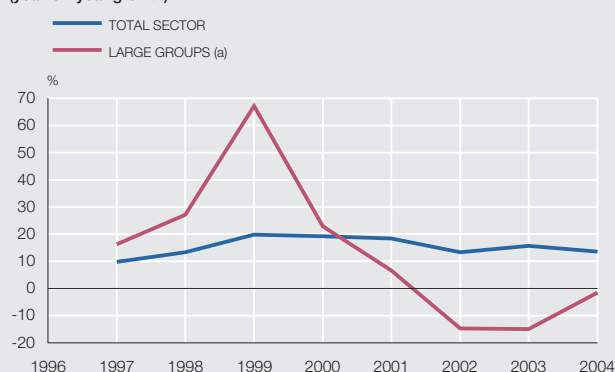
Unfavourable developments in certain Latin American countries at the beginning of the current decade, together with the low return on some investments, such as those relating to UMTS, associated with the delay in the technology, led these companies to set about restructuring and rebuilding their balance sheets. This was reflected in

a negative growth rate for their debt between 2002 and 2004. During these three years, the interest-bearing borrowing of large groups was reduced by approximately one third. At the same time, the ratio of debt to earnings followed a downward path, in contrast to the upward trend in this indicator at the aggregate sectoral level. As a result, by the end of 2004, the debt ratio of large Spanish corporate groups stood at around its 1996 level, while for non-financial corporations as a whole it had more than doubled.

The latest provisional information suggests that the balance sheet rebuilding carried out by large Spanish corporate groups may be ending. According to these data, there was a slowdown in the rate of decline of debt during 2004.

As a result of the balance sheet rebuilding undertaken by large Spanish corporate groups, their financial position is now more favourable than in previous years. This is reflected, for example, in the moderate credit risk premiums negotiated on the derivatives markets. Against a background of low interest rates on public debt, the financing conditions for these companies are therefore very generous, which will facilitate their hiring and investment decisions.

1. INTEREST-BEARING BORROWING
(year-on-year growth)

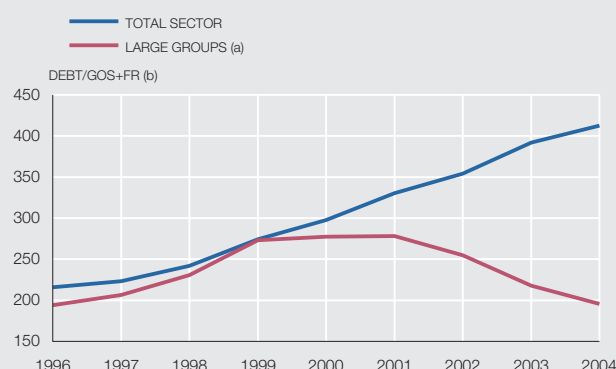


SOURCES: Annual reports and Banco de España.

a. Data for Endesa, Iberdrola, Unión Fenosa, Repsol YPF and Telefónica.

b. Gross operating surplus plus financial revenues.

2. DEBT RATIO



again small. As a result, the market value of Spanish companies relative to GDP stood above the highs reached in 2001 (see Chart 5.11).

The strength of the financial position of corporations was also reflected in further declines in their non-performing loans ratios, which reached very low levels, and in an increase in the difference between the number of upward and downward revisions to the credit ratings of non-financial corporations that issue fixed-income securities.

Taken together, the various indicators available of the financial position of non-financial corporations show a situation propitious for buoyant private productive investment. Unlike in the

DEBT BURDEN OF NON-FINANCIAL CORPORATIONS (a)

CHART 5.13

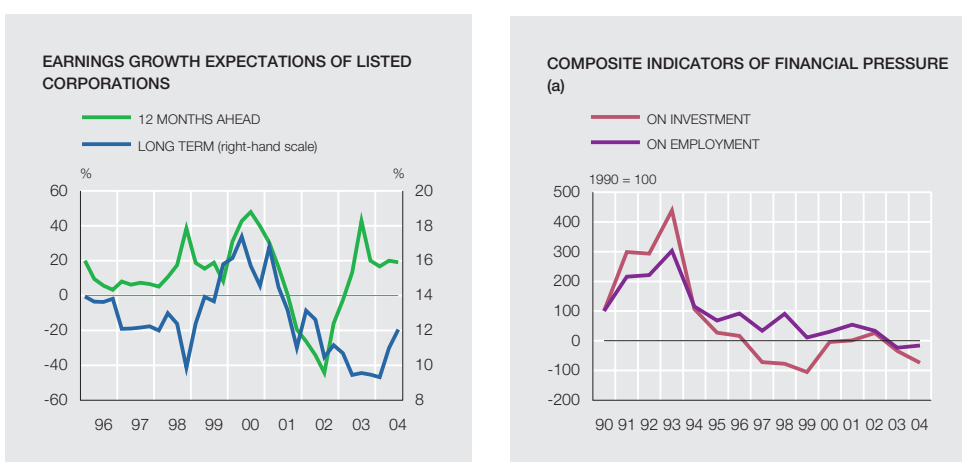


SOURCE: Banco de España.

- a. All the series, except "National Accounts", are calculated with CBSO information. Up to 2003, the information is from the CBSO annual survey (CBA). The data to 2004 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.

OTHER FINANCIAL INDICATORS FOR NON-FINANCIAL CORPORATIONS

CHART 5.14



SOURCES: I/B/E/S and Banco de España.

- a. A value of more (less) than 100 indicates higher (lower) financial pressure than the reference.

case of households, the increase in indebtedness has not resulted in a rise in the associated debt burden and has been accompanied by a notable recovery in profits, which last year extended to the industrial sector and which has been compatible with a significant rebuilding of the balance sheets of large groups. This favourable assessment should not, however, obscure the fact that the higher leverage and increasing relative importance of variable rate loans has raised the exposure of corporations to possible adverse changes in financing costs and in profits.

1 Introduction

This chapter of the *Annual Report* is devoted to the management of the Banco de España during 2004, a year in which the institution was able to respond satisfactorily to the problems of considerable complexity that arose in the various areas of its responsibility. The past year was, moreover, one of mourning for the Bank following the loss of its council member Eugenio Domingo Solans, who passed away in November following a distressing drawn-out illness, and in the wake of the savage terrorist bombings of 11 March in Madrid, in which one of the Bank's employees, Ángel Pardillos Checa, was killed. This summary of the year 2004 could not begin without our remembering them.

An overall description follows in which the key aspects of the Bank's activity in 2004 are drawn together, without prejudice to the more detailed treatment some functions will be given in the related annual publications of certain departments (Banking Supervision, Balance of Payments, Complaints Service, Central Balance Sheet Data Office and Public Debt Market).

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

The Banco de España's activity as a member of the Eurosystem remained intense in 2004. The Governor participated in the meetings of the Governing Council of the European Central Bank (ECB), at which decisions were adopted on the interest rates to be applied in monetary policy operations and on other matters falling within this institution's remit. Throughout 2004, the Council held monetary policy interest rates at 2%, as explained in detail in Chapters 1 and 3 of this Report.

Moreover, an extensive group of specialists from the Banco de España participated in various Eurosystem committees and groups to prepare the taking of decisions by the ECB Governing Council, and worked on the tasks needed to perform the functions of this institution. It should also be mentioned that one of the members of the Banco de España Executive Commission, José Manuel González-Páramo, was appointed to the ECB Executive Board effective 1 June 2004, on which date Eugenio Domingo's term of office concluded.

In the European institutional sphere, 2004 was marked by two far-reaching and interrelated events: the enlargement of the European Union and the drafting and approval of a Treaty establishing a Constitution for Europe. On 1 May 2004, 10 countries – the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia – joined the Union, and their respective central banks became part of the European System of Central Banks (ESCB). The Eurosystem contributed in several ways so that this process might be successful, smoothing the incorporation of the new countries into the legal, institutional and operational framework of the ESCB. Further, the central bank governors of the new EU Member States, who had until then acted as observers on the ECB General Council, became fully fledged members of this latter Council.

After the enlargement, the ministers of Economy and Finance of Slovenia, Estonia and Lithuania applied for their currencies to join the Exchange Rate Mechanism II. This occurred on 28 June 2004 following the agreement of the Eurogroup, the ECB and the respective national authorities. As a result, four currencies (those of these three countries plus the Danish krone) are now in this mechanism, the aim of which is to ensure the stability of national exchange rates against the euro and to provide a framework in which countries can move towards convergence with the euro area and, finally, join the Monetary Union.

The Treaty establishing a constitution for Europe was adopted by the European Council on 18 June and signed by the Heads of State or Government on 29 October. The Constitution does not entail significant changes in the treatment of the ECB and of monetary policy. It acknowledges the special status of the ECB, incorporating it under the heading of *other institutions*, it does not amend the structure of its governing bodies and it retains an explicit reference to price stability as one of the objectives of the EU. The Eurosystem participated in the preparation of those sections relating to its organisation and functions, drafting proposed amendments to the texts submitted for consultation by the EU Council.

Regarding the operational framework of the Eurosystem's monetary policy, several measures came into force in March 2004 aimed at reducing the volatility of interest rates at the shortest dated terms and at adding greater stability to entities' liquidity bids at tenders. Specifically, it was agreed that the reserve maintenance period should begin on the settlement day of the main refinancing operation following the first meeting of the month of the ECB Governing Council, that the changes in interest rates on the marginal lending and deposit facilities should be applied on the first day of the reserve maintenance period, and that the maturity of the main refinancing operations should be shortened from two weeks to one.

The Eurosystem also decided during 2004 to establish a single list of collateral eligible for monetary policy operations, instead of the two current lists, in order to homogenise these instruments and to deepen the markets. The decision was taken to set the single list in place gradually, following a public consultation to credit institutions which highlighted the widespread acceptance of the project. To date, the use of specific loans as collateral has been accepted, while to this same end equities have been rejected.

Headway was also made in the creation of a new shared platform for Eurosystem payment systems, known as TARGET 2. This platform was approved in December 2004 on the basis of a joint bid by the Italian, French and German central banks. It will come into force in 2007, and all the Eurosystem central banks will participate. The Banco de España Settlement Service, the Spanish component of TARGET, will be integrated into this new platform.

A decision was adopted in June 2004 whereby the Eurosystem may provide euro reserve management services to central banks, international organisations and countries that are not part of the Monetary Union as from 1 January 2005. In this connection, standard services have been established which are to be provided in a harmonised fashion by all the central banks. The Banco de España undertook to provide these management services to any such institutional client.

Finally, the ECB Governing Council has launched various initiatives to improve the Eurosystem's corporate culture and to transmit the goals and framework of values that the 13 central banks making up the Eurosystem share. A Eurosystem Mission Statement was thus drafted, which also includes the System's strategic objectives and organisational principles. This was distributed to all Eurosystem personnel early in 2005, and was also published on the central banks' websites.

3 International activities

This section analyses the international activities of the Banco de España both in the European Union (with the exception of the Eurosystem, whose activities are described in Section 2) and in 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.

3.1 INTERNATIONAL RELATIONS

Within the European Union, the Banco de España has had an active presence in representing Spain on various groups and committees, such as the Economic and Financial Committee

(which prepares ECOFIN meetings) and the Economic Policy Committee. The reform of the Stability and Growth Pact and the review of the objectives and strategy of structural reforms (known as the Lisbon Agenda) were probably the most relevant matters discussed in these fora.

During 2004 the Bank continued to play a very active role on the committees and working groups of the Basel Committee on Banking Supervision (hereafter the Basel Committee) and in the framework of European institutions. The publication on 26 June 2004 of the new solvency framework for the treatment of banking risks, *International Convergence of Capital Measurement and Capital Standards*, known as Basel II, marked a milestone in banking regulation. The Basel Committee, presided since March 2003 by the Governor of the Banco de España, is the principal international forum for banking supervisors. In 2004, it chiefly addressed matters relating to the new solvency regulations, their implementation in practice (through the Accord Implementation Group, AIG), and the new accounting regulations introduced under the principles of International Accounting Standards and their relationship to the regulatory capital of credit institutions (through the Accounting Task Force, ATF).

The transposition in the European Union of the new solvency framework agreed upon in Basel has entailed significant work for the Commission and Council groups set up in this connection and in which the Banco de España has collaborated extensively. Although the Commission's legislative proposal was largely based on the Basel Committee's document, the work has involved ensuring that the EU text properly reflects the particularities of the European market and, especially, the need for the new solvency regulations to continue being applicable to all credit institutions, irrespective of their size and level of complexity, and to the investment companies operating in the EU.

The Bank has also had an active presence on the EU Banking Consultative Committee, acting as a level 2 committee under the Lamfalussy approach, and on the new (level three) Committee of European Banking Supervisors (CEBS), one of the most important fora and one which has most advanced during 2004. This Committee, which was set up in November 2003 to oversee supervisory convergence, to advise the Commission on prudential regulation and to strengthen information exchange between European supervisors, is chaired by the Director General for Banking Regulation of the Banco de España. In its first year, the work of the CEBS has focused essentially on matters relating to the implementation of the new bank solvency regulations and to the application of the new International Financial Reporting Standards (IFRS).

The Banco de España has continued to deepen relations with the Bank for International Settlements (BIS) through the Governors' meetings, other high-level encounters (such as the Global Financial System Committee and the Markets Committee) and the economists' meetings on matters of interest to central banks and supervisors.

During 2004 the Bank consolidated its presence in the representation of Spain in the International Monetary Fund (IMF). In close collaboration with the Ministry of Economy, issues on the agenda of the IMF Executive Board were monitored and contributions to the preparation of the Spanish representation's position in the Institution increased significantly.

In respect of the Center for Latin American Monetary Studies (CEMLA), the Bank participated, as in previous years, in its Governing Board meetings, its Alternates Committee meetings (which prepare the Board meetings) and collaborated in specific meetings on various issues such as central banking, internal auditing, and central bank payment and communication

systems. The Bank is, moreover, a collaborating member of the Association of Supervisors of Banks of the Americas, and participates actively in its annual General Assembly.

Collaboration with the Multilateral Development Banks has been further stepped up, mainly with the Inter-American Development Bank (IADB) and the World Bank, with which numerous meetings and work projects on matters of common interest have been organised and pursued. In addition, with the Spanish Ministry of Economy, the Bank has taken part in the meetings of the Paris Club and in various groups of the Organisation for Economic Co-Operation and Development (OECD), such as the Economic Policy Committee, the Committee on Short-Term Economic Prospects (STEP), the Single Premiums Committee, the Financial Markets Committee and the Export Credit Consensus Group.

The Banco de España has likewise continued to strengthen bilateral relations with other central banks and supervisory authorities, essentially in the Eurosystem and also in the main industrialised countries, Latin America and Asia. In particular, the technical co-operation drive increased notably in 2004. Of note was the implementation of a training programme including the regular imparting of courses aimed at the staff of central banks and of supervisory authorities. This first year saw a total of 79 participants, hailing mainly from the Latin American central banks. Moreover, there was a significant increase in the traditional co-operative activities conducted by the Bank, which also participated in several international projects aimed at providing technical assistance to the central banks of Russia, Turkey and most of the Latin American countries. Among the latter, mention may be made of the collaboration with the Central American Monetary Council, involving comprehensive advice for the harmonisation of national payments systems in Central America, and the start of co-operation with the Latin American Institute of Securities Markets.

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

Among the conferences and seminars organised in 2004, two in particular should be mentioned. First, the XIII International Conference of Banking Supervisors (ICBS) in Madrid, organised jointly by the Basel Committee Banking Supervision and the Banco de España. The ICBS is the biggest of all the events on the supervisory agenda and is held once every two years. Spain, the latest member of the Basel Committee, took up the baton from South Africa, which hosted the ICBS in 2002. Delegates from over 130 countries were present in Madrid, making the event the biggest ever organised by the Banco de España. Two key issues were discussed at the Conference: the implementation of the Basel Accord and the relationship between accounting and supervision, both of which are matters of great importance for the development of financial systems. Completing the programme were meetings of regional groups of supervisors, conferences and speeches by leading figures from the banking and supervisory world.

The second prominent event in 2004 was the International Conference organised in Madrid in conjunction with the International Monetary Fund on the occasion of the 60th anniversary of the Bretton Woods Agreements, which gave rise to the creation of the IMF and of the World Bank. The conference was attended by leading academics and acknowledged experts from the public and private sectors of a large number of countries, this being one of the very few occasions on which the IMF has chosen a venue other than Washington to hold such a meeting. The conference saw a highly fruitful exchange of views on the major challenges currently facing the international monetary system and on the future role of the Bretton Woods institutions. Specifically, the main areas of debate were the global imbalances in the international economy, exchange rates, the problems relating to the emerging countries' debt and the role of the IMF in the international financial architecture.

In conjunction with the Centre for Economic Policy Research (CEPR), the Bank organised the European Summer Symposium on International Macroeconomics. Other public events were

the presentation at the Banco de España of the IMF's Global Financial Stability Report; the Second High-Level Seminar of the Eurosystem and Latin American Central Banks, organised jointly with the ECB and the Central Bank of Brazil in Rio de Janeiro; the Conference on Economic and Financial Prospects for Latin America, organised in conjunction with the IADB, and the presentation by this latter institution of the *Annual Report on Economic and Social Progress in Latin America*, which acted as a framework to promote debate on the region's economic and financial prospects and on the assessment of the risk of investing in the area.

4 Economic analysis and research

The analysis of and research into the Spanish economy and its international environment, and the stability of the Spanish financial system, are conducted by several departments in the Banco de España, with the aim of advising the Bank's governing bodies so the institution may comply with the functions entrusted to it.

4.1 PRIORITY AREAS OF ANALYSIS

The Bank's research agenda is geared essentially to contributing to knowledge of the workings of the Spanish economy and to the analysis of financial stability. Consequently, the main subjects on this agenda refer to the external determinants of the Spanish economy, in particular those relating to Monetary Union membership, and to the economic and structural factors that may affect the workings of the economy. Banking risk is also analysed, as is its impact on the profitability and solvency of Spanish deposit institutions.

Several avenues of research were opened in 2004 in connection with the analysis of cyclical divergences across the euro area countries, the price formation process, the efficiency of factor and product markets, macroeconomic modelling, the interrelatedness of financial assets and real activity, and the study of monetary policy. As regards cyclical divergences in the euro area, particular attention was paid to the interpretation and identification of the factors causing inflation differences in the euro area. Notable in the analysis of price formation were the projects aimed at identifying the impact of changes in the exchange rate on prices and their consequences for trade in manufactures, and those projects developed under the Inflation Persistence Network organised by the ECB to study nominal rigidities and price dynamics in the euro area countries.

The analysis of the relationship between financial assets and real activity has been significantly boosted by the compilation of the initial results of the Spanish Survey of Household Finances, conducted by the Banco de España in collaboration with INE and the State Tax Revenue Service in 2002. As regards the efficiency of the factor and product markets, particular attention was paid to the behaviour of productivity and profit margins. Finally, regarding the study of monetary policy, several projects analysed the characteristics of optimal monetary policy in different contexts, defined by the heterogeneity of agents and the behaviour of their expectations in relation to price formation.

To continue honing the instruments used in the analysis and forecasting of Spanish economic trends, certain extensions have been made to the quarterly macroeconomic model of the Spanish economy. This allows agents' decisions to be analysed in a more disaggregated fashion. In particular, progress has been made in the modelling of the determinants of household spending (and corporate investment) decisions and of the external block. As regards inflation, a series of papers have analysed the individual behaviour of consumer prices and of their determinants in a joint project undertaken within the framework of the Eurosystem. Turning to the labour market, the analysis of collective bargaining characteristics has continued and, in the field of public finances, headway has been made in matters relating to long-term sustainability and, in this context, to the incentives for early retirement. Lastly, as concerns sectoral analysis and structural policies, the effects of the enlargement of the EU on the Spanish economy have

been studied and further analysis has been undertaken of the trends and determinants of productivity and of real convergence.

Notable among the avenues of research on financial stability and banking regulation have been the study and design of a new prudential dynamic provisioning system to reinforce the solvency of the Spanish financial system, the potential inter-substitutability of capital and provisions and the incentives for bank managers of the existence of transparent prudential mechanisms. The culmination of the process of reform of regulatory capital requirements, known as Basel II, has prompted impact studies on credit institutions and Spanish non-financial corporations. Headway has also been made in the construction of a set of financial stability indicators; these go beyond those proposed by the IMF as they include the risk profile of non-financial corporations and of Spanish deposit institutions' foreign assets. The competitiveness and efficiency of the Spanish banking market has a bearing on its stability. That has prompted, first, the macroeconomic analysis of the interest rates on lending and deposit operations; and further, the study of the workings of credit markets and, more specifically, of the role that collateral plays in loans to companies as a risk-signalling mechanism and its relationship to the business cycle. Finally, the advance of banking integration in Europe has also been studied.

As regards studies relating to the external environment of the euro area, these have continued to pay particular attention to the emerging economies and to the international financial architecture. In the case of the former, there has been notable empirical analysis of the determinants of sovereign spreads in emerging countries (especially balance-sheet effects and global risk aversion) and of international banking activity, along with its impact on the financial stability of recipient countries. There has also been research into how exchange rate regimes may influence fiscal discipline and the balance sheet effects on employment.

In respect of the international financial architecture, assessments were made of the reforms undertaken in the wake of the Asian crisis, of the catalytic role of the IMF and of the financial system assessment programmes (FSAP) conducted by the Fund. Other global studies addressed the rise in oil prices, global imbalances, the definition of financial stability and the impact of globalisation on cyclical synchronisation. Finally, specific studies were conducted on the enlargement of the EU, the Chinese financial system, China's impact on investment in Latin America and the effectiveness of Japanese exchange rate interventions.

4.2 RELATIONS WITH THE ACADEMIC COMMUNITY

The Banco de España has forged tighter links with the academic community and with the economic analysis and research units in other central banks and international organisations. These links are essentially pursued in four ways. First, the analytical and research work produced by the Banco de España is presented and discussed in national and international academic seminars, meetings and conferences, and, moreover, it is published in the profession's habitual outlets. Second, the Banco de España organises its own seminars, in which members of the national and international academic community participate, and it organises national and international conferences, occasionally in collaboration with other organisations. Third, the Banco de España participates in the research networks organised within the Eurosystem for the analysis of the euro area economy, as was the case in 2004 with the *Inflation Persistence Network*. Finally, there are regular external visitors' and fellows' programmes, boosting projects that may be considered strategic in different areas of analysis and research.

4.3 DISSEMINATION AND COMMUNICATION OF ECONOMIC ANALYSIS AND RESEARCH

The findings of analysis and research studies are made available to the scientific community and to public opinion, generally through several types of publications. These include most notably the Working Papers and Occasional Papers series, which include a good number of articles devoted to economic analysis and research.

	31.12.2004
CREDIT INSTITUTIONS	348
Banks	75
Savings banks	47
Credit co-operatives	85
Branches of foreign credit institutions	61
Specialised credit institutions	79
Official credit institutions	1
OTHER	143
Mutual guarantee and reguarantee companies	24
Currency-exchange bureaux	58
Appraisal companies	61

In addition to these series, the monthly *Boletín Económico* (and a quarterly *Economic Bulletin* in English) publishes abstracts of work performed or research under way, all of which are disseminated on the Bank's website, in addition to the distribution of the printed version. In 2004 an additional effort was made in respect of the dissemination of economic analysis in the form of the compilation of the book *El análisis de la economía española* (The analysis of the Spanish economy). This offers an overview of the various models and approaches used for the economic analysis of the Spanish economy, and it will be published in the second half of 2005.

Along with these publications, the half-yearly review *Estabilidad Financiera*, created in 2001, continues to be published. The review is intended to offer a communication channel between the banking industry and the general public in matters of banking regulation and supervision and, in general, of financial stability. The articles published in 2004 addressed, inter alia, financial stability indicators, the analysis of Spanish and European deposit institutions' profitability, and the risk indicators of the foreign financial assets of Spanish banks and of non-financial corporations, with particular emphasis on small and medium-sized companies. Jointly with the review, the *Financial Stability Report* is also published half-yearly, in which Spanish deposit institutions' risk, solvency and profitability are analysed.

Some of the analysis and research papers referred to in the foregoing paragraphs have subsequently been published in academic journals and in specialised books. In 2004 these included: *Journal of Monetary Economics*, *Journal of Financial Intermediation*, *Journal of Financial Services Research*, *European Economic Review*, *Public Finance Review*, *European Financial Management*, *European Journal of Political Economy*, *Journal of Money Credit and Banking*, *Economic Journal*, *Spanish Economic Review* and *Investigaciones Económicas*.

5 Banking supervision and regulation

5.1 SUPERVISORY MEASURES

As at 31 December 2004, a total of 491 entities were under the supervision of the Banco de España, 348 of which were credit institutions, as can be seen in Table 6.1. As the supervisor on a consolidated basis of the groups that have a Spanish credit institution at their helm, the Bank is moreover the supervisor of 138 foreign financial institutions.

As the Bank's annually published *Banking Supervision Report* explains in greater detail, there were substantial regulatory changes in 2004 which had a considerable bearing on supervision, requiring a notable training and analytical drive. This had to be made compatible with the perfecting of the supervisory tools already in place and, of course, with the habitual task of supervising the institutions within the Bank's purview.

REQUIREMENTS OF AND RECOMMENDATIONS TO SUPERVISED INSTITUTIONS

TABLE 6.2

	2004
Credit Institutions	87
Banks	35
Savings Banks	16
Credit co-operatives	27
Branches of foreign credit institutions	2
Specialised credit institutions	7
Other	23
Mutual guarantee and reguarantee companies	4
Currency-exchange bureaux	13
Appraisal companies	6

Following several years' experience, the risk-profile-based supervision methodology is fully in place. The bank is striving to extend a common "risk profile management culture" to all Spanish institutions, irrespective of size and complexity. This culture is rooted in leading international practices and has, naturally, inspired the regulatory changes under way. To this end, without discarding matters relating to compliance with the regulations in force at each point in time, the Bank's communications, advice and recommendations increasingly address good management and control practices, which should be implemented by the institutions themselves.

Supervisory conduct in 2004 saw the issuance of 110 recommendations and requirements, containing 486 observations on various aspects. The breakdown of these communications by type of institution is detailed in Table 6.2.

The 486 requirements and recommendations in question referred, in a high proportion, to the management of credit risk, its control, and accounting matters relating thereto, which is natural in the light of the specific weight of credit risk in bank balance sheets. Nonetheless, requirements and observations were also made in connection with many other matters, including most notably: the management and control of market risks or those relating to position, such as interest or overall liquidity risk; specific compliance with accounting rules on revenue and expenditure allocation; the setting up of special reserves; the need to reinforce internal auditing; and regulatory compliance in general (for instance, returns to the Central Credit Register). For supervised entities that are not credit institutions, formulations were made relating to standardisation requirements, along with general observations on risk control, where applicable.

There were no episodes in 2004 requiring the adoption of any of the cautionary measures envisaged in legislation at any credit institution, although the proceedings initiated the previous year concerning the placing under administration of Eurobank del Mediterráneo, SA were pursued with notable success. The continuation of the legal procedure of suspension of payments to creditors has allowed it to be confirmed that there are sufficient assets to meet commitments to creditors, enabling the repayment in 2005 of outstanding debt plus the agreed interest, thereby supporting the decision adopted in July 2003 by the Banco de España.

A key event in late 2004 was the takeover by a large Spanish institution, Grupo Santander Central Hispano, of one of the prominent British financial institutions specialising in mortgage

financing, Abbey National Bank, itself the head of a sizable group. Apart from the unquestionable importance of this operation, owing to its significant impact on the volume of assets of one of the main groups supervised by the Banco de España, it is highly relevant in that – with the exception of previous activity in Portugal – it is the first major acquisition by a Spanish bank within the European Union. While Spanish banks have been present for some time in other EU markets, the biggest investments had to date been in Latin America.

This operation saw the co-operation mechanisms between supervisors envisaged under Community regulations come into play, mechanisms it is intended to reinforce significantly following the reforms under way. The resulting group is of weight both in its Spanish home market and in the UK market, posing unquestionable challenges to the respective supervisors: the Banco de España at the consolidated level and as the local Spanish supervisor, and the Financial Services Authority as the local British supervisor.

5.2 IMPOSING OF SANCTIONS

As regards *sanctioning proceedings initiated* in 2004, 13 cases were opened against supervised institutions or individuals and 20 cases against the directors or managers of such institutions. Specifically, and with regard to the different types of institutions supervised, disciplinary proceedings were initiated against 1 appraisal company, 4 currency exchange bureaux, 2 unauthorised currency exchange bureaux (one an entity, the other an individual), 1 entity engaging in activities restricted to credit institutions and 1 entity using a name restricted to credit institutions. Lastly, 4 cases were initiated and processed in connection with the failure to comply with the ECB minimum reserve requirement.

With regard to *sanctioning proceedings concluded* during 2004, a total of 22 cases against supervised institutions and 60 cases against the directors or managers of such institutions were resolved by the Banco de España. As to the types of infringements in cases processed and concluded during this period, which are normally directly related to the complexity that their handling and processing involves, the authorities imposed sanctions on supervised institutions in relation to the committing of 16 very serious, 73 serious and 14 minor infringements. And regarding the directors and managers of such institutions, there were sanctions for 61 very serious and 199 serious infringements. Further, 4 sanctions were imposed in relation to the failure to comply with the ECB minimum reserve requirement, 1 sanction as a consequence of engaging in activities restricted to credit institutions, 1 sanction for the use of names restricted to such institutions and, finally, 1 sanction for the carrying out of unauthorised currency exchange activities.

In view of their close relationship to sanctioning procedures, with which they evidently run in parallel, 183 *proceedings to withdraw authorisation* to engage in currency exchange activities in establishments open to the public were initiated in 2004, owing to the inactivity of the institutions subject to the disciplinary proceedings. During 2004, 61 of these proceedings were resolved, with authorisation being withdrawn, while in two cases it was agreed not to proceed with the withdrawal.

In the case of *credit institutions*, there were sanctions for *very serious infringements* in connection with conduct relating to the inadequate setting aside of provisions for loan losses, to the maintaining of capital lower than required by regulations, to the failure to comply with reporting veracity vis-à-vis depositors and the public in general and, lastly, obstruction of inspections. Here it should be highlighted that, in view of the most serious circumstances surrounding one of the resolved cases, it was agreed to impose a sanction involving the withdrawal of authorisation for engaging in activity as a credit institution.

In the case of *appraisal companies*, infringements deemed as very serious related essentially to the failure to comply with various standardisation requirements envisaged in the applicable regulations, referring to minimum capital requirements (not having the minimum percentage of fully paid-in capital, i.e. holding capital lower than the minimum paid-in capital), not having an appropriate organisation and internal control resources and systems, not having insurance for third-party public liability arising from appraisal activity, not having statutorily restricted their corporate purpose to the valuation of all types of assets, companies or properties, and not having the minimum number of professionals legally required. Lastly, sanctions were imposed on the failure to meet the professional certification requirements required of those signing reports and appraisal certificates. It is likewise notable that, in one of the cases pursued against an appraisal company, the particular seriousness of the conduct punishable meant that the sanction imposed involved the definitive loss of the authorisation to provide appraisal services.

Finally, a total of 3 sanctions for very serious infringements were imposed on various individuals and legal persons with shareholdings in a credit institution in connection with the purchase of or increase in significant holdings in the capital of a credit institution, breaching the provisions of Part VI of Law 26/1988.

The sanctions for *serious infringements* cover a mixed range of punishable conduct, which depend largely on the nature of the institution subject to disciplinary proceedings. However, a substantial portion of such sanctions are closely related to institutions' solvency, to the technical suitability of the activity being pursued to applicable regulations, to transparency vis-à-vis customers and to the appropriate transmission of information to the Banco de España, as an essential part of its supervisory remit.

5.3 REGULATORY CHANGES

As regards the organisational and disciplinary rules to which credit institutions and other financial intermediaries are subject, the main legislative changes related to the accounting regulations for credit and savings institutions.

On 22 December 2004, the Banco de España approved Circular 4/2004 on Public and Confidential Financial Reporting Standards and Financial Statement Formats for credit institutions. This Circular, like Circular 4/1991 before it, regulates the annual accounts and other financial information to be disclosed by credit institutions and their groups, along with all the financial information that institutions should send to the Banco de España to assist it in its supervisory and statistical functions. The new accounting criteria, which are identical for all individual and consolidated financial information, both public and confidential, are compatible with the IFRSs adopted in the European Union. In general, however, the number of alternative criteria allowed under these standards has been reduced, choosing measures which reflect the most prudent profile from the supervisory standpoint; this prevents so-called accounting duality, since institutions do not need to apply different criteria in preparing their financial information. The Circular significantly boosts the transparency of credit institutions, with the aim of promoting the role that market discipline may play in the prudent management of such institutions.

Circular 4/2004, like its forerunner, Circular 4/1991, also regulates all information, except that relating to the balance of payments and interest rates, that credit institutions must send to the Bank for the compilation of the financial accounts and other statistics on the credit sector and the Spanish economy, and to meet the statistical requirements of the European Union and of the BIS.

Besides this, the main regulatory changes within the national sphere, most of which were predominantly of a technical nature, were the following:

- in respect of the solvency of credit institutions, and particularly as far as savings banks are concerned, the substantive regime of non-voting equity units (“cuotas participativas”)¹ was implemented. This regime focused mainly on the arrangements for the issuance, trading, valuation, remuneration and early redemption of these units;
- in respect of prudential supervision, the regime for the Banco de España Central Credit Register² was amended, in order to smooth the proper exercise of the powers of supervision on a consolidated basis and data exchange with other European Central Credit Registers, in addition to detailing more thoroughly the exercise of borrowers’ rights regarding access, rectification and cancellation of the data referring to them.

Among the not specifically financial regulation bearing particularly on the organisation or workings of credit institutions, mention should be made of that which, in implementation of Law 26/2003 of 17 July 2003, has continued to promote the transparency of listed institutions issuing securities traded on official secondary markets³.

Regarding Community regulations, the year 2004 was not a particularly prolific one regarding financial and, in particular, credit regulations. Of note were various initiatives adopted in order to identify and prevent abusive market practices, and to achieve greater market transparency and the more effective protection of investors.

5.4 FINANCIAL SYSTEM ASSESSMENT PROGRAMME FOR SPAIN

In the final quarter of the year the Banco de España, under the general co-ordination of the Secretariat of State for the Economy, participated in the work to launch the Financial System Assessment Programme for Spain which, on the invitation of the Spanish Ministry of Economy and Finance, is to be conducted by the IMF during 2005.

This assessment programme, known internationally by the acronym FSAP, is a methodology that has been developed by the IMF and the World Bank to ascertain the stability of national financial systems and, where appropriate, to improve it via the application of corrective measures addressing the shortcomings highlighted by the exercise.

The programme essentially consists of reviewing the state of the three pillars on which the stability of all financial systems resides and the joint effect of these pillars. The first pillar is an appropriate legal and institutional environment for the pursuit of financial activity; the second is a sound regulatory and supervisory environment for the institutions making up the financial system; and the third is the set of significant – and mainly macroeconomic – risks that financial institutions must manage and whose quantification in terms of impact on the system’s soundness is conducted through the performance of various types of stress tests.

Although the programme began in the final quarter of 2004, the Bank has been making intense preparations since 2003, based on self-assessment, pursuant to the methodology defined to this end by the IMF, and through exercising the competences which, in respect of the regula-

1. Royal Decree 302/2004 of 20 February 2004 on savings banks’ non-voting equity units. 2. Ministerial Order ECO/697/2004 of 11 March 2004, and Banco de España Circular 1/2004 of 29 June 2004. 3. Ministerial Order ECO/3722/2003 of 26 December 2003 on the annual corporate governance reports and other reporting instruments of listed public limited companies and other entities; Ministerial Order ECO/354/2004 of 17 February 2004 on the annual corporate governance report and other information on savings banks issuing securities traded on official securities markets; and Ministerial Order EHA/3050/2004 of 15 September 2004 on the obligatory reporting of related-party transactions of corporations issuing securities traded on official secondary markets.

tion and supervision of financial institutions, markets and infrastructure, have been entrusted to it under current legislation.

6 Operational functions

6.1 MANAGEMENT OF 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 ECB and the national central banks; the former takes the monetary policy decisions and the latter formalise the related liquidity-supply operations with credit institutions. Against this background, and within its sphere of competence, the Banco de España managed in 2004 the liquidity tenders called by the Eurosystem, receiving bids from credit institutions and compiling lists ordered in terms of interest rates. It continued to formalise the pledges of collateral presented by the banking system and to implement the loan and repo transactions with eligible counterparties resulting from the outcome of the tenders.

Last summer the main refinancing operations of the Eurosystem began to be implemented weekly and with a maturity of seven days, with amounts bid every Tuesday and operations formalised every Wednesday. The average amounts extended under lending transactions by the Eurosystem to Spanish institutions totalled €23,030 million.

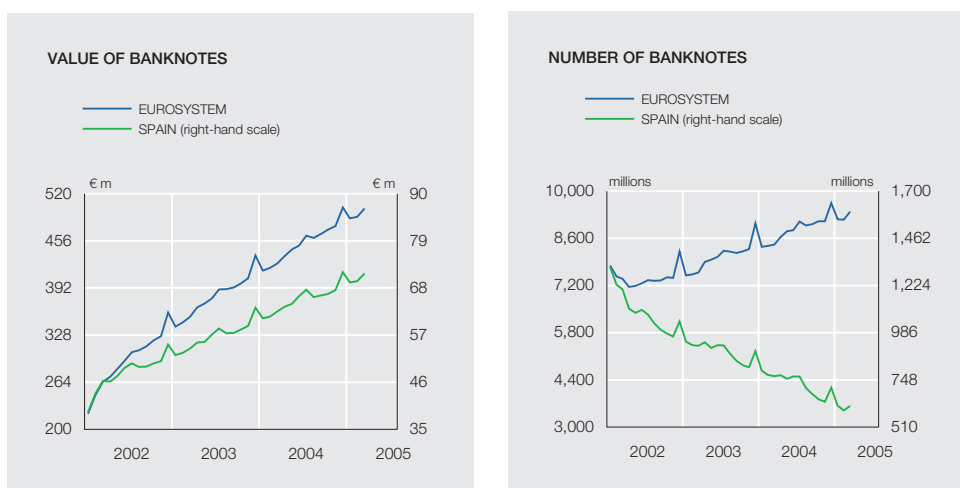
The demand for euro banknotes continued to expand extensively in 2004 and the Eurosystem did not intervene on the foreign-exchange markets. Both factors served as a basis for a more active management and medium-term-oriented view of the domestic and external assets of the Banco de España. During 2004 the Bank reduced its holdings of foreign currency assets so as to lessen its exposure to foreign exchange risk, and it correspondingly increased its investments in euro-denominated bonds, building up a fixed income portfolio which, at the close of the year, stood at around €30 billion.

6.2 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 ESCB. It also administrates the SNCE (National Electronic Clearing System), through which all retail payments pass and in which a total of 1,230 million transactions in the form of transfers, cheques, commercial paper, trade bills and direct debits were exchanged in 2004.

Far-reaching changes in the organisation of both systems were discussed and approved last year. The ECB Governing Council agreed to alter the decentralised arrangements for TARGET and to concentrate operations in a central computerised core, which will accumulate the liquidity of the current accounts of credit institutions in all European Union countries. Once the liquidity is centrally concentrated, it will be possible to provide a series of new services to the banking system, such as a central information facility on the liquidity in euro of European banking organisations and a centralised settlement procedure for the area's financial markets. In 2004, the system's specific characteristics were approved and the technical specifications of the project were sent to the banking system. Currently, work is under way on the IT developments for the central platform; during 2006 the related tests with the banking system will be performed and it is expected that, in the opening days of 2007, the new system will come on stream, with the incorporation of the Spanish banking community scheduled for the first fortnight of March that year.

Turning to retail payments, a project to create a Single Payment Area in Europe is being discussed at Community level. The incorporation of the Spanish banking system into this project will entail the reform of the National Electronic Clearing System. In late 2004, the Spanish parliament approved the legislative amendments required to create a new company, Sociedad



Española de Sistemas de Pago SA, entrusted with managing the National Electronic Clearing System. This new company will have to take the institutional decisions needed to incorporate the Spanish banking community and retail payment systems into the European Single Payment Area project.

6.3 MANAGEMENT OF BANKNOTES

As an integral part of the Eurosystem, the Banco de España performed euro banknote issuance and withdrawal services in 2004. 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. As a result of this net inflow of banknotes placed in circulation by other Eurosystem central banks, at the end of the third year of the euro's existence the net balance of low-denomination banknotes issued by the Banco de España stood at negative amounts in the case of €20 and €10 notes, and it had virtually disappeared in the case of the €5 denomination. Conversely, the net issuance of high-denomination banknotes has advanced normally. On the basis of this uneven trend in both sets of denominations, the value of euro banknotes placed in circulation by the Banco de España in 2004 posted a rate of change of around 15%, which was not as sharp as that seen in the Eurosystem (18%). Conversely, the number of banknotes issued by the Banco de España fell over the course of 2002, 2003 and 2004, as can be seen in Chart 6.1.

The Bank remained entrusted in 2004 with the delivery, withdrawal and sorting of euro banknotes. These are the core issuance tasks of a central bank, which has to ensure the quality of the cash in circulation in its market. In the course of last year, the Banco de España delivered 1,680 million banknotes of different denominations to the banking system and collected 1,857 million units. These gross figures are in keeping with the decline in the number of banknotes in circulation indicated in the preceding paragraph. Over the course of 2004, the Banco de España sorted 1,900 million banknotes from the banking system, destroying 700 million of these in view of their deterioration, leaving 1,200 million units ready to be returned into circulation.

The central bank also performs these tasks of placement in circulation and withdrawal for coins issued by the Spanish Treasury, acting as its financial agent. In 2004, on behalf of the Treasury, the Bank placed 1,800 million coins in circulation and withdrew 300 million, with the circulation of Treasury coins therefore increasing by approximately 1,500 million. All face values

Period	Banknotes		Coins	
	Millions of units	Amounts (€ m)	Millions of units	Amounts (€ m)
Circulation (31.12.2001)	1,379	46,228	11,684	2,522
Changed in 2002	1,307	44,937	5,735	1,579
Changed in 2003	5	132	87	19
Changed in 2004	2	76	38	7
Circulation (31.12.2004)	65	1,080	5,824	918

showed increases during the year, but these were particularly notable in the case of the low-face-value (10, 5, 2 and 1 cent) coins.

The exchange of peseta banknotes and coins continued in 2004 in increasingly smaller amounts, as can be seen in Table 6.3, which details the amounts exchanged over the past three years.

7 Statistics

7.1 THE STATISTICAL FUNCTION OF THE BANCO DE ESPAÑA

The main statistics compiled and disseminated by the Banco de España under 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 – the National Securities Market Commission, and the Spanish Directorate General of Insurance). The statistics compiled and disseminated under the National Statistical Plan are the Balance of Payments and the International Investment Position, the Financial Accounts of the Spanish Economy and the Survey of Household Finances. By means of its Central Balance Sheet Data Office, the Banco de España also compiles and disseminates information on the balance-sheet position and results of non-financial corporations, which are based on questionnaires voluntarily completed by the reporting corporations. The aforementioned statistics are published in the *Boletín Estadístico* and in monographic publications, and they are also disseminated on the Bank's website.

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, along with the information relating to credit institutions' financial statements, by the Banco de España as a source for work and papers arising from its supervisory and statistical functions. The Bank ensures the confidentiality of these individualised data.

The Bank's services are users of the statistics produced by other national and international agencies and supervisors, in some instances in order to complete their studies on the financing of the various institutional groupings and, in general, to make this information available to the analysts of the Bank itself and to academics in general, indicating the source when it is not the Banco de España itself. These activities are complemented by the active participation of Bank representatives in international statistical fora (within the ESCB, the European Commission – i.e. Eurostat –, the European Committee of Central Balance Sheet Data Offices, the IMF, the BIS, etc.), and in the maintenance of databanks and databases, which provide for the study of changes over time in all the variables.

7.2 MAIN CHANGES

INTRODUCED DURING 2004

7.2.1 Statistics on financial

institutions and markets and on interest rates. Financial accounts

Regarding the statistics included under the National Statistical Plan, the following were of particular interest:

1. The publication of the Spanish Survey of Household Finances, which is the only statistical source in Spain allowing the incomes, assets (financial and non-financial) and spending of each household unit to be related.
2. The dissemination of further breakdowns in the public debt statistics under the Excessive Deficit Protocol, as part of the initiatives to add transparency and greater analytical value to the statistics in this area.

The work conducted within the ESCB included most notably:

1. That relating to the monitoring and review of regulations on the balance sheet of Monetary Financial Institutions (MFIs) and interest rates applied (improvements in quality, recording and sanctioning of the failure of reporting units to comply, the preparation of breakdowns additional to those hitherto required, etc.).
2. That geared to setting in place the Centralised Securities Data Base (CSDB), which will provide for 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.
3. The promulgation of two new Guidelines, one relating to Monetary Union Financial Accounts (MUFA) and the other to Public Finance Statistics, and the start of work for the regular production of statistics on Other Financial Institutions (OFIs).
4. The preparations to allow simultaneous access during 2005 to specific euro area statistics, with the breakdown of the contribution of each of the Member States to the area aggregate.
5. Finally, regarding the Quarterly Financial Accounts of the Spanish Economy in terms of ESA 95, the previous time series (1995-2003) has been extended to 1990, whereby a 1990-2004 quarterly 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 and to the publication of geographically detailed data on the Euro Area Balance of Payments and International Investment Position. The monetary presentation began to be published quarterly in 2003 and was subsequently disseminated monthly in 2004. The publication of data broken down geographically began during 2004.
2. The inclusion of new data on tradable securities (on a security-by-security basis) in the compilation of the International Investment Position. This has involved compiling the portfolio investment heading of this statistic drawing on data on balances valued at market prices, thereby improving the previous accumulation of flows procedure.

3. The implementation of procedures to cross-check the Direct Investment Data against those of the Investment Register of the Secretariat of State for Tourism and Trade. This led in 2005 to the signing of a collaboration agreement which will enable the data under this heading of the Balance of Payments and of the International Investment Position to be improved.

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

In 2004 the CBSO assigned significant resources first, to improving the procedure for calculating the discount rate, on the basis of which the market-price of the value of shares issued by unlisted non-financial corporations is estimated; and further, to updating the rate of depreciation of the stock of capital, to adapting the bases of the CBSO to smooth its integration as a source in the process of compilation of the financial accounts of the sector non-financial corporations in the FASE, and to collaborating with the Asociación XBRL España on accounting taxonomies and the national and international implementation of the new International Financial Reporting Standards (IFRSs), a matter linked to the adoption of XBRL (Xtensive Business Reporting Language).

The annual (CBA) and quarterly (CBQ) databases, set up further to corporations' voluntary collaboration, now draw on questionnaires received from over 8,000 medium and large corporations (whose gross value added is approximately 34% of the total for the sector) and from more than 800 major companies (coverage of close to 15%). 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 12%).

7.2.4 Introduction of XBRL language for the receipt of data from financial institutions

The Banco de España has pressed ahead with the introduction of XBRL language for the transmission of the financial information sent to it by financial institutions. In this respect, following the satisfactory test run with appraisal companies, it has been decided to extend the use of this language to the public information that credit institutions have to disclose with the new public formats, for data from 30 June 2005. In this connection, the Bank has created a working group to develop the necessary taxonomy. The experience has been confined in principle to a select group of institutions with a view to extending it subsequently to other entities and financial statements.

7.2.5 Central Credit Register

Banco de España Circular 1/2004 of 29 June 2004 amended Circular 3/1995 of 25 September 1995 on the Central Credit Register. The main amendment concerns the means of reporting data. The respective returns on borrowers' data and risks will be transmitted separately to the Banco de España, and not jointly as was hitherto the case, to attain greater flexibility and quality in data editing processes. Further, the latter are extended to improve the borrower identification process, to obtain new information and to provide for data exchange with European Central Credit Registers.

In addition, one of the aims of the reform is to allow the optimal use of the new information technologies, for the purpose of improving the reliability and availability of data both on the part of the Banco de España and on the part of borrowers and reporting entities. The foregoing lies within the scope of the protection of the rights of borrowers regarding access, rectification and cancellation of the data referring to them, in particular the data on individuals, as enshrined in Law 15/1999 of 13 December 1999 on the Protection of Personal Data, and in Law 44/2002.

8 Complaints Service

The year 2004 saw several changes in the workings of the Complaints Service. First, the presentation of its Annual Report (in Spanish), which is now divided into two parts, has been substantially improved. The first contains the traditional information, while the second includes a

compilation of financial consumer protection rules, ordered by their first letter for easier use. Users of financial services are thus made further aware of their rights when engaging bank services.

The Complaints Service has been reorganised in order to comply not only with its traditional function of resolving claims lodged against institutions, but also with responding to enquiries (a new competence of the service) and collaborating, with the Banco de España Regulation Department, in the review of the working rules of the Customer Attention and Ombudsman Services, whose presence is obligatory under the rules in force.

In this respect, enquiries – whether procedural or substantive – addressed to the Service can be made by phone, online or in writing, and they can be replied to in a very short space of time. Internal procedures have also been simplified in order to reduce claim and consultation processing and resolution times, in step with the related provisions.

In keeping with the Service's intention to make banking service users better aware of their rights, work has been jointly undertaken with other departments of the Bank on initiatives such as the Bank Customer's Portal, which is available on the Bank's website.

Another notable initiative directed at bank customers has been the strengthening – through means of greater resources – of telephone assistance, offering more direct and immediate information to financial consumers, and also a response to telephone enquiries.

The Service's work is not restricted to the national sphere. It is a founding member of the FIN-NET Network, entrusted with the resolution of cross-border conflicts in the banking and insurance area within the European economic space. It consequently participates in the monitoring of compliance with Community regulations on the protection of financial services users.

Following the incorporation of new members into the European Union in 2004, the Service has collaborated in the homogenisation and implementation of out-of-court conflict settlement systems in financial systems. In this connection, there has been contact with the European Union and with representatives from the new Member States. The Service also participated as a member in the International Forum on Financial Consumer Education and Protection.

As regards enquiries and requests for information, a wide range of matters are raised, including most notably: fees and commissions for cash transfers; fees and commissions for early loan repayment; terms for returning bills, etc.; matters raised by various consumer associations and groups; and numerous different enquiries by financial consumers via the Bank Customer's Portal, and via the European Union, which is in contact with the Service via the FIN-NET Network.

Regarding complaints lodged, the heading of deposit operations has increased significantly, compared with a slight decline in that of lending operations, where traditionally most cases were raised. That reflects the change that has taken place in consumers' problems, which stem from the emergence – with increasing frequency – of new, complex and risky operations, and contracts that are mostly atypical and not specifically regulated. Here the need is stressed for institutions to heighten informative transparency when formalising contracts with their customers so that the latter may be aware of the characteristics of the product they are acquiring.

Complaints about fees, commissions and expenses increased in almost all the headings included in the Service's Annual Report, due partly to increases in charges and, moreover, to

their application to services which were previously provided free of charge. Under this heading, there was a significant increase in the number of cases lodged in connection with the charging of commissions for cross-border transfers, within the European Union area, further to the entry into force of Community Regulation 2560/2001.

The number of cases relating to the fraudulent use of cards has continued to increase, and last year complaints about card-duplication were prominent. The Service insists on the need clearly to establish in contracts the liability ceiling applicable in these cases, along with the obligations to be assumed by both parties in the contractual relationship.

Significantly, the increase in cases relating to drawdowns on deceased holders' accounts has been persistent. Telephone and Internet banking cases have also been prominent, owing to the greater use by the public of this type of banking product.

9 External communications

The communications policy of the Banco de España is geared to improving the general public's knowledge of its functions and activities with the ultimate aim of ensuring confidence as to the sound functioning of the financial system.

9.1 RELATIONS WITH THE MEDIA

As part of the Bank's general communications strategy, the priority aim of the specific actions with the media in 2004 was to improve media professionals' understanding of the information on two of the main challenges facing the financial system: the implementation of the New Capital Accord, known as Basel II, and the adaptation of banking regulation to the new International Financial Reporting Standards.

In this respect, as part of the economic and financial training programme for media specialists, several informative meetings focusing on the two above-mentioned regulatory aspects were organised, in addition to others addressing topical matters such as the scenarios for economic recovery in the euro area or the influence of monetary policy on price stability.

In step with the Bank's growing presence in international organisations, particular attention has been paid to contacts with foreign media specialising in areas relating to banking regulation and supervision. During 2004, the Governor gave 11 interviews to international publications, focusing mainly on the work on the New Capital Accord carried out by the Basel Committee, which he has chaired since 2003.

In addition to the regular appearances by the governor before Parliament (June and October) and the Senate (November), which are an essential means of disseminating the Bank's viewpoints on developments in the economic situation and the financial system, members of the governing bodies of the Bank participated in 2004 in 37 national and international public fora, which were widely covered by the media.

This media presence was also significant on the occasion of international events in whose organisation the Banco de España participated directly. The most important of these included the International Conference *Dollars, Debt and Deficits*, organised in June in Madrid with the IMF to commemorate the 60th anniversary of the Bretton Woods Agreements, and the ICBS 2004, organised jointly with the BIS in September, and also staged in Madrid (see Section 3).

The Banco de España was also the scene in December, in the presence of his Majesty the King, of the presentation of the Rey Juan Carlos Economics Prize, awarded by the Fundación José Celma Prieto to the economist Xavier Sala i Martín.

9.2 INSTITUTIONAL COMMUNICATIONS PROGRAMME

The Bank has also developed a specific communications programme with the regional and local media in the light of the completion of the branch network restructuring plan. Against this background, informative meetings were held in each of the branches which ceased to operate on 31 December 2004 and specific informative materials were provided.

The institutional communications activities initiated in 2003 were built on in 2004. In addition to rolling out its new institutional identity, the Bank pursued its programme of visits by opinion leaders, the aim of which is to promote knowledge of the Banco de España by means of informative meetings between the Governor and Deputy Governor with personalities from the communications and finance spheres visiting the Madrid headquarters. Further, around 3000 people took part in the programme of weekly guided visits around the Bank's premises, promoting knowledge of its art collection.

During the first half of 2004, the Bank set in place an institutional visual identity designed the previous year by Zimmermann Asociados. As from June 2004, the Bank began to use the new image following a most satisfactory in-house adaptation.

As a public institution committed to informing and educating citizens and users, the Banco de España has several training tools at its disposal, using direct communications channels with the public, the preferred one being its Internet website for reasons of efficiency, accessibility and cost.

In this connection, a survey was conducted for the first time to gauge citizens' knowledge of and attitude towards the Banco de España. The demoscopic study consisted of a personal home interview using a sample of 2000 residents in Spain. It is a strategic element for the design of a communications plan with the public, and it will foreseeably be repeated in the future.

Along with the programme to continue enhancing the content and accessibility of the Bank's website, there was intense work in 2004 on the Bank Customer's Portal, which aims to offer bank users practical information and guidance when acquiring banking products and services.

To further knowledge of the mission of a central bank and, in particular, of the Banco de España, an educational website – aimed at a young audience – is being developed, in collaboration with IBM and the School of Economics and Business Studies of the Madrid Complutense University, on money and financial stability, and on prices and the payment system. This site, which will promote knowledge through entertainment and simulation games, is intended to act as a platform for the subsequent creation of a basic educational programme for young people.

In addition to its own initiatives, the Banco de España, as a national central bank, disseminates knowledge on the euro and the Eurosystem monetary policy, and it actively co-operates with the ECB in imparting information to the different sectors of society and in educating them, through the initiatives launched by the ECB External Communications Committee (ECCO), such as the student educational tool on price stability.

Initial preparations also began in 2004 for the commemorative programme of the 150th anniversary of the Banco de España, which will fall in 2006 as from 28 January, coinciding with the enactment of the 1856 Decree whereby the Banco Español de San Fernando – founded in 1782 as the Banco Nacional de San Carlos – took up the current name of Banco de España.

The initiatives envisaged include the issuance of a commemorative stamp; two exhibitions, one on the Banco de España and banking, and another on the Banco de España building,

which will coincide with the inauguration of the new chamfered corner; the staging of an international conference, with the presence of internationally renowned central bankers and economists; and a concert.

9.3 CO-OPERATION WITH THE ESCB

As a member of the ESCB, the Banco de España participates in the definition and implementation of the Eurosystem's communications policy through its presence on the ECCO.

In addition to the translation, distribution and publication on the Internet of the information issued by the ECB, the Banco de España contributed during 2004 to the dissemination of the Eurosystem's mission and of the monetary policy and other decisions adopted by the ECB Governing Council. In this connection, new sections have been set up on the Bank's website to provide ready access to this information.

The Banco de España and the ECB have also worked closely in the organisation of joint events, such as the address by the Vice-President of the ECB, Lucas Papademos, at the Bank's headquarters on the occasion of the award of the Germán Bernácer Prize, and the exhibitions on euro banknote design in Tenerife and Gran Canaria in May and June 2004.

10 Internal organisation and administration

10.1 BRANCH RESTRUCTURING

Last year saw the conclusion of the branch network restructuring process, which entailed the closure of 30 centres, at a rate of 10 per year, over the 2002-2004 period. The final structure of the network consists of the 22 current branches, with the Bank retaining a presence in each of Spain's autonomous regions. This process is anchoring a structure in keeping with the Bank's membership of the Eurosystem, thereby providing for a more efficient network. In parallel, the branches have been equipped with greater technical and human resources, and a new Branch Management Service has been set up, reporting to the Directorate General for Operations, Markets and Payment Systems. The aim of this Service is to achieve greater co-ordination, resulting in enhanced branch performance.

10.2 HUMAN RESOURCES POLICIES

The Bank's staff renewal and redimensioning plan, undertaken through the above-mentioned branch network restructuring and early retirement arrangements, was concluded in 2004. At the close of the year the total workforce stood at 2,560 employees. If the theoretical future staff from ongoing competitive entry examination processes still to be concluded as at that date are added, this figure would be 2,668 employees, making for a net reduction in the workforce of 379 employees during the 2002-2004 period. It should be noted that the number of personnel selection processes increased from 22 (completed) in 2002 to 41 in 2004. The renewal plan has led to a lowering of the average age of the workforce and to notable growth in the number of highly skilled as opposed to lesser skilled positions.

The successful completion of negotiations for a collective bargaining agreement for the 2002-2004 period, in addition to the resolution of certain disputes and to the individual improvements across the workforce, paved the way for greater rationality in wage costs and wrought changes enabling a better working/family life balance, with leave for international adoption having been extended and greater flexibility allowed in respect of reduced working hours and time off for breast-feeding mothers.

A joint declaration against mobbing was inserted in the collective agreement, establishing an additional list of behaviours considered as meriting a disciplinary offence and the specific procedure for pursuing them.

As part of an active policy to prevent mobbing, a high-level Committee chaired by the Deputy Governor was set up and entrusted with drawing up proposals on this issue. The Human Re-

sources and Legal Departments, and the Representative of the Bank's Personnel on the Governing Council took an active part, as members of this Committee, in implementing an anti-mobbing policy.

As regards training and development, a comprehensive project for the development of competencies was launched. The project included, inter alia, a Senior Management Programme, Workshops on Middle Management Skills, courses on Documentation, Work and Teamwork, etc. These programmes have been structured for different groups: departmental directors, team managers and other groups that do not have employees under their supervision. At the first of these levels, that of departmental directors, subjects such as people management, leadership through change, ongoing improvement, excellence of service, strategic vision, bargaining, project management, teamwork, communication techniques, etc. were addressed. A training course to improve skills in the international arena was also imparted: the training was conducted entirely in English for those groups that relate directly to international organisations, and it was geared towards improving bargaining processes in international environments. A specific training process has likewise been set up for High-Potential Specialists, the aim of which is to strengthen the group of professionals representing the Banco de España in European and international institutions.

10.3 ADMINISTRATION AND PROPERTIES

The work initiated in 2003 on the construction of the new building to close off the block making up the central bank's headquarters in Madrid, following the project drawn up by the architect Rafael Moneo, continued apace. The work is expected to be completed by early 2006.

Work has begun this year on the full-scale restoration of the landmark Madrid building's zinc roofing, part of the artistic heritage of this building which has been declared an "asset of cultural interest" and given monumental status.

The Bank has likewise undertaken an ambitious programme to renew and update its general installations and anti-fire facilities. It is also modernising its offices, following an open-plan format which not only makes for more efficient use of space and a reduction of costs, but also improves functionality and team work, providing for readier communication between work groups.

An extensive plan to update and expand Bank branch installations has been implemented. This covers the improvement and adaptation of garages for access of cash-transit armoured vehicles.

As regards the management of goods and services acquisitions, the Administration and Properties Department has set in place a computer application developed jointly with the Information Systems Department. The application is based on work flow and documentary management tools, and it has automated real work flows in respect both of purchases and the contracting of external goods and services, and of maintenance. It has provided for easier control of processes, the homogenisation of procedures, online authorisations, the computerised filing of all documents associated with each case, greater flexibility in lead times and, therefore, the optimisation of management, with the subsequent improvement in the quality of service.

10.4 CORPORATE DOCUMENTARY MANAGEMENT

The Banco de España is an institution with a most substantial documentary activity. An extremely large number of documents requiring flexible, effective and safe treatment is produced, processed and received daily. Accordingly, it was decided in 2004 to set in place a corporate documentary system offering a flexible, modern and uniform solution to the treatment of the various types of documents that are managed daily.

To this end, a documentary audit was performed in 2004 to identify the strengths and weaknesses of the documentary management actually being undertaken in the different units of the Bank, with a view to subsequently evaluating the best model for the institution.

Following this study, the project was set in train. It was decided to set a new corporate documentary system in place in four pilot administrative units, pre-selecting specific types of documents (these types being understood to be a document or set of documents linked to a specific administrative procedure). It was attempted to select diverse and complex documentary types, with a view to allowing their extension to the other Bank units, once the worth of the system in the pilot units has been verified.

In parallel, the Corporate Documentary Management Service has been created, within the General Secretariat. In conjunction with the Information Systems Department, this Service will co-ordinate the implementation of the system in the Bank and, once this initial implementation phase is concluded, it will provide system support, maintenance and enhancement services.

10.5 INFORMATION SYSTEMS

There was intense activity in 2004 in terms of IT projects, as had been envisaged in the second year of implementation of the three-year Master Plan launched in 2003.

In the area of IT security, the PKI (public key, private key) project was undertaken. This will provide for a system of identification, access to applications and access control, as well as incorporating the digital signature and, in the future, the electronic bill. Further, the Bank may set itself up as a certifying institution, which will enable it to issue its own digital certificates. PKI will also allow the most modern employee identification card currently existing to be set in place.

The reform of the User Help Desk has continued. New procedures have been established meaning that, at present, the level of satisfaction of employees with assistance is very high. The technological renovation process has concluded, attaining the objective whereby employee PC stations do not have a life of over four years, the limit being three years for laptops. The intention of equipping all bank branches with the latest IT infrastructure was successfully met in 2004, bringing them onto the same level as the central services. This reform involves replacing the entire communications network with a more modern, broadband one.

Data storage has also been centralised, making for easier management thereof and no restrictions when one-off increases are called for. The Bank Customer's Portal has been completed and work has begun on the departmental portals for in-house information sharing.

Among the most important projects, mention should be made of the externalisation of the public debt book-entry system (CADE) to Iberclear, meeting the target date of end-2004. Work continues on the re-engineering of the Central Balance Sheet Data Office, on the Systems Plan for the Directorate General for Banking Supervision, and on the reform of the Balance of Payments.

In conjunction with the Control, Budget and Accounting Department, a study has been conducted on reforming the accounting and budgetary systems, evaluating best practices and solutions.

Concerning the aim of bringing about readier information exchange with financial institutions, new network designs have been finalised, in conjunction with institutions, and they are to be implemented in 2005. Further progress has been made on the XBRL standard for financial

reporting, led by the Asociación XBRL España, and actual projects have been launched which will be completed in 2005.

Finally, an IT contingency plan for distributed applications has been finalised, and will be set in place for all Bank applications in 2005. 100% of applications and data will have back-up in the event of a disaster. Moreover, the Bank's Ongoing Management Plan has been set in motion, based on the practices recommended by Basel II.

10.6 INTERNAL AUDIT

The aim of internal auditing, according to the Statute approved by the Executive Commission on 28th November 2001, is to evaluate the risks inherent in the Bank's activities and the effectiveness and efficiency of the systems in place for their management and control.

The internal audit function is performed by the Department of the same name, which reports directly to the Governor. In addition, the Internal Audit Department has to offer the Governing Council Audit Committee every assistance it may require and provide it with the information it needs.

The Department 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 principles, standards and procedures laid down in the Internal Audit Manual authorised by the Deputy Governor on 17 December 2004 and reported to the Executive Commission that same day.

The Department's activity is subject to an Annual Plan approved by the Governor and Deputy Governor, and reported to the Executive Commission. Under the Plan for 2004, the Internal Audit Department performed the following key audits: the annual accounts; the report envisaged in Law 44/2002 on Financial System Reform Measures; the adaptation of automated files to Organic Law 15/1999 on the protection of personal data and its Regulation; the administration of IT security within the General Secretariat and the Directorate General for Banking Supervision; the management of ECB external reserves; the minimum reserves system; TARGET supervision; monetary income; the updating of the ESCB-net technology; and inspection of the Alicante, Seville, Melilla, Las Palmas and Valladolid branches. Audits have begun and are under way on the monitoring system for counterfeit banknotes and on the security policies for the ESCB's information systems. In addition, other audits not envisaged in the Annual Plan were performed, including most notably collaboration in the review of TARGET 2 costs and the counting of the Strategic Reserves deposited by the ECB.

ANNUAL ACCOUNTS OF THE BANCO DE ESPAÑA
2004

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 resolutions of the Bank's Governing Council of 19 December 2003 and 28 January 2005. 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 Economy and Finance, 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 are expressed in millions of euro. Those relating to 2003 are given solely for comparison with 2004. In this respect, it should be noted that the 2003 information relating to the book-entry State debt portfolio and to certain transfers and additions to other funds and provisions has been reorganised, as described in the relevant explanatory notes. Also, 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 2004. Section 1 includes the balance sheet and profit and loss account; Section 2 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 3, 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 those amounts.

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 1-3.

1 Balance sheet and profit and loss account

BALANCE SHEET OF THE BANCO DE ESPAÑA AS AT 31 DECEMBER 2004¹

(EUR m)

	NOTE NUMBER	2004	2003
ASSETS			
1. Gold and gold receivables	1	5,410.70	5,558.96
2. Claims on non-euro area residents denominated in foreign currency		9,035.87	14,798.80
2.1. Receivables from the IFM	2	1,540.94	1,852.78
2.2. Balances with banks and security investments, external loans and other external assets	3	7,494.93	12,946.02
3. Claims on euro area residents denominated in foreign currency	4	440.56	0.06
4. Claims on non-euro area residents denominated in euro		1,287.25	1,528.69
4.1. Balances with banks, securities investments and loans	5	1,287.25	1,528.69
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	6	23,408.39	33,188.15
5.1. Main refinancing operations		20,723.01	32,964.66
5.2. Longer-term refinancing operations		2,684.45	220.90
5.3. Fine-tuning reverse operations		0.00	0.00
5.4. Structural reverse operations		0.00	0.00
5.5. Marginal lending facility		0.00	0.00
5.6. Credits related to margin calls		0.93	2.60
6. Other claims on euro area credit institutions denominated in euro	7	4.48	4.53
7. Securities of euro area residents denominated in euro	8	28,044.91	21,122.67
8. General government debt denominated in euro	9	8,541.93	9,154.92
9. Intra-Eurosystem claims	10	32,286.36	18,656.02
9.1. Participating interest in ECB		432.70	444.68
9.2. Claims equivalent to the transfer of foreign reserves		4,326.98	4,446.75
9.3. Net claims related to the allocation of euro banknotes within the Eurosystem		0.00	0.00
9.4. Other claims within the Eurosystem (net)		27,526.68	13,764.59
10. Items in course of settlement		0.97	0.71
11. Other assets		2,063.29	2,770.27
11.1. Tangible and intangible fixed assets	11	195.30	200.79
11.2. Other financial assets	12	51.94	55.10
11.3. Off-balance sheet instruments revaluation differences	13	44.11	752.67
11.4. Accruals and prepaid expenses	14	678.13	531.73
11.5. Sundry	15	1,093.81	1,229.97
TOTAL ASSETS		110,524.69	106,783.78

1. Numbering in the breakdown of balance sheet items (sub-items) is sequential, instead of following, as was done until 2003, the numbering of sub-items in the harmonised model balance sheet of the Eurosystem.

	NOTE NUMBER	2004	2003
LIABILITIES			
1. Banknotes in circulation	16	50,158.28	44,068.96
2. Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	17	13,090.90	14,409.08
2.1. Current accounts (covering the minimum reserve system)		13,085.97	14,408.04
2.2. Deposit facility		0.00	0.00
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		4.93	1.04
3. Other liabilities to euro area credit institutions denominated in euro		0.00	0.00
4. Debt certificates issued		0.00	0.00
5. Liabilities to other euro area residents denominated in euro		15,908.16	17,237.94
5.1. General government	18	13,972.89	15,790.14
5.2. Other liabilities	19	1,935.26	1,447.80
6. Liabilities to non-euro area residents denominated in euro	20	30.36	21.13
7. Liabilities to euro area residents denominated in foreign currency		1.54	2.86
8. Liabilities to non-euro area residents denominated in foreign currency		15.72	92.23
8.1. Deposits, balances and other liabilities	21	15.72	92.23
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	22	340.52	351.99
10. Intra-Eurosystem liabilities	23	21,503.24	19,350.57
10.1. Net liabilities related to the allocation of euro banknotes within the Eurosystem		21,503.24	19,350.57
10.2. Other liabilities within the Eurosystem (net)		0.00	0.00
11. Items in course of settlement	24	44.87	91.95
12. Other liabilities		1,539.64	1,909.37
12.1. Off-balance-sheet instruments revaluation differences		0.00	0.00
12.2. Accruals and income collected in advance	25	89.50	288.80
12.3. Sundry	26	1,450.15	1,620.57
13. Provisions	27	2,794.26	2,814.64
14. Revaluation accounts	28	4,283.72	4,481.05
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	808.95	1,947.47
TOTAL LIABILITIES		110,524.69	106,783.78


	NOTE NUMBER	2004	2003
Interest income	1	2,044.24	2,022.34
Interest expense	2	-689.97	-690.15
Net interest income		1,354.26	1,332.19
Realised gains/losses arising from financial operations	3	223.97	833.32
Write-downs on financial assets and positions	4	-507.99	-1,165.56
Transfer to/from provisions for foreign exchange rate and price risks	5	199.90	1,145.54
Net result of financial operations, write-downs and risk provisions		-84.12	813.31
Fees and commissions income		10.50	13.24
Fees and commissions expense		-3.87	-2.16
Net income from fees and commissions	6	6.63	11.08
Income from equity shares and participating interests	7	12.41	69.53
Net result of pooling of monetary income	8	-145.03	0.61
Other income and losses	9	45.75	39.30
TOTAL NET INCOME		1,189.91	2,266.01
Staff costs	10	-214.77	-199.77
Administrative expenses	11	-88.79	-77.84
Depreciation of tangible and intangible fixed assets	12	-25.65	-24.25
Banknote production services	13	-31.26	-48.97
Other expenses		-2.67	-2.93
TOTAL OPERATING EXPENSES		-363.14	-353.76
Transfers and additions to other funds and provisions	14	-17.82	35.22
PROFIT FOR THE YEAR	15	808.95	1,947.47

Countersigned by
The Governor,



JAIME CARUANA

The Comptroller,



ANTONIO ROSAS

2 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 a 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	<p>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. When 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.</p>
	<p>The cost in euro of foreign currency sold is calculated using the daily net average cost method.</p>
	<p>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.</p>
	<p>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.</p>
Foreign banknotes	<p>The criteria applied are the same as those indicated in the preceding section for foreign currencies.</p>
Special drawing rights (SDRs)	<p>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.</p>
Securities	<p>Securities are recorded at acquisition cost, which is determined by the cash amount paid, less any accrued gross coupon.</p>
	<p>The cost of foreign securities sold or redeemed is determined by the average book price of the security in question.</p>
	<p>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.</p>
	<p>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.</p>
	<p>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.</p>
	<p>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.</p>

<p>Repurchase agreements involving securities</p>	<p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p>
<p>Doubtful debtors</p>	<p>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.</p>
<p>Loans to financial institutions and balances with EU central banks</p>	<p>These are valued at their nominal amount.</p>
<p>Special loans to the State and the Social Security System</p>	<p>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 that granted to the Social Security System pursuant to transitional provision six of Law 41/1994 on the State budget for 1995, are valued at their nominal amount.</p>
<p>Shares and participating interests</p>	<p>Shares and participating interests in national and/or international institutions, including the participating interest in the European Central Bank (ECB), are valued at cost. The participating interest in Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros S.A. is valued at its underlying book value.</p>
<p>Tangible and intangible fixed assets</p>	<p>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 €300 are recorded as expenses in the year in which they are acquired. Up to 21 September 2004, this limit was €200.</p> <p>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.</p> <p>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.</p> <p>In 2004, the depreciation percentages applied to the various fixed assets were the same as those applied in 2003, and were as follows:</p>

%	
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 2002². The total value of euro banknotes in circulation is allocated on the last working day of each month in accordance with the banknote allocation key³.

The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation as from 2002, while 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 interest⁴, 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*”.

2. 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. 3. “Banknote allocation key” means the percentages that result from taking into account the ECB’s share in the total euro banknote issue and applying the subscribed capital key in force at each month-end to the NCB’s share in that total. 4. 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 distribution of profit⁵. 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 2004, the Governing Council decided that, in light of its estimates, 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 the sub-item "*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 and the net balance resulting from the transfers issued and received by TARGET⁶ among the national central banks of the ESCB, including the ECB. They also arise from the balances vis-à-vis the ECB resulting from allocation of euro banknotes within the Eurosystem, from the outcome of the contribution and allocation of monetary income and from the positions vis-à-vis the ECB owing to the deferral of sundry receipts and payments.

Intra-ESCB 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 sub-item "*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, together with the accrued coupons, according to the internal rate of return method.

⁵. 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. (ECB/2002/9), OJ L 323, 28.11.2002. ⁶. Trans-European Automated Real-time Gross settlement Express Transfer system.

Pension Scheme	<p>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 7.5% of the so-called “regulating salary”⁷, 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.</p>
Off-balance sheet positions ⁸	<p>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.</p> <p>Interest rate futures are revalued on an item-by-item basis and treated in a similar manner to securities.</p> <p>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.</p>
Post-balance-sheet events	<p>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.</p>
Notes on the balance sheet 1 GOLD AND GOLD RECEIVABLES	<p>The Banco de España’s gold holdings amount to €5,410.70 million, consisting of 16.826 million troy ounces⁹ of fine gold valued at €321.56 per ounce. This amount is €148.26 million less than in 2003, basically as a result of the fall in the market price of gold in euro (at end-2003 the price per ounce was €330.36), the number of ounces having remained unchanged during the year, except for slight differences arising from deposit and swap transactions.</p>
2 RECEIVABLES FROM THE IMF	<p>These include: a) Special Drawing Rights (SDRs) within the reserve tranche (€1,155.88 million), which include the net International Monetary Fund (IMF) position (€1,155.88 million) and the euro tranche position and its balancing account (€2,340.12 million, with a positive and negative sign); b) SDRs at the IMF (€243.81 million), and c) other claims against the IMF (€141.25 million). In total, receivables from the IMF decreased by €311.84 million with respect to end-2003, as a result of the net effect of the following: a) net purchases and sales of foreign currency (€–280.63 million), b) variation in the market exchange rate (€–53.84 million) and c) interest received in SDRs (€22.62 million). Spain’s IMF quota remained unchanged in 2004 at SDR 3,048.90 million.</p> <p>SDRs are valued at the year-end market rate, calculated by the ECB for all the Eurosystem national central banks, of €1 = SDR 0.8775.</p>
3 BALANCES WITH BANKS AND SECURITY INVESTMENTS, EXTERNAL LOANS AND OTHER EXTERNAL ASSETS	<p>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 €7,494.93 million, with the following breakdown:</p>

7. This contribution was set at 6.5% until the signing of the collective agreement entered into in 2004, which set it at 7.5% with effect from 1.1.2003. 8. 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 11.3 on the assets side and 12.1 on the liabilities side, depending on their sign. 9. One troy ounce is equal to 31.1035 grams.

EUR m		
TYPE OF ASSET	2004	2003
Balances with banks	1,912.67	4,572.79
Security investments ¹⁰	5,434.13	8,212.75
External loans and other external assets	147.20	166.69
<i>Loan provisions</i>	—	–8.40
Non-euro area banknotes	0.93	2.18
TOTAL	7,494.93	12,946.02

At end-2004, 99.92% 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 1.3621).

The decrease in the balance of this sub-item (€5,451.09 million) was due to the net effect of the factors listed in the following table:

EUR m	
BREAKDOWN OF THE CHANGE	AMOUNT
Net purchase/sale of foreign currency	–4,950.43
Decrease in the outstanding gold swaps position at year-end	–91.73
Increase in repos in direct security loans outstanding at year-end	16.13
Foreign-currency-denominated interest received	249.84
Price-based losses realised on sale of securities and futures	–10.39
Change in the market price of foreign securities	–75.64
Change in the market exchange rate	–588.90
Other	0.03
TOTAL	–5,451.09

4 CLAIMS ON EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY.

This balance sheet item includes balances with banks and security investments in foreign currencies vis-à-vis euro area residents, although the only balances now held are those of deposits held at monetary financial institutions and amounting at end-2004 to €440.56 million, while in 2003 they were insignificant.

5 CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN EURO.- BALANCES WITH BANKS, SECURITY INVESTMENTS AND LOANS

This balance sheet sub-item 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. Of the total of this sub-item (€1,287.25 million), substantially all (€1,286.60 million) relate to fixed-income securities issued in euro by international agencies, which decreased by €241.95 million with respect to 2003.

¹⁰ As at 31 December 2004, repurchase agreements were constituted over part of the USD-denominated securities portfolio with a market value of USD 314.27 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.

6 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.

Although the average daily flow of financing extended during the year rose by 27.25% from €19,899.37 million in 2003 to €25,322.51, its balance as at 31 December 2004 was 29.5% lower than as at 31 December 2003 (€23,408.39 million in 2004, against €33,188.15 in 2003).

91.66% of the average daily financing balance was extended through “*Main refinancing operations*”, 8.31% was granted under “*Longer-term refinancing operations*”, and only 0.03% 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 rates, 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 one week, by means of standard tenders. Until 8 March 2004 these reverse transactions had a weekly frequency and a maturity of two weeks.

The balance of this sub-item was €20,723.01 million as at 31.12.2004. This was €12,241.65 million less than at 31.12.2003.

b. Longer-term refinancing operations

These operations aim to provide counterparties 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 €2,684.45 million as at 31.12.2004. This was €2,463.56 million more 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-2004 was zero, as it was at the previous year-end. Three fine-tuning reverse operations took place in the Eurosystem during the year. Financing was requested by Spanish credit institutions in only one of them.

d. Structural reverse operations

The Eurosystem is able to engage in reverse open-market transactions through standard tenders to adjust its structural liquidity position vis-à-vis the financial sector.

The end-2004 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-2004 balance was zero, as it was at the previous year-end. Very few of these transactions were carried out during the year.

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 counterparty must provide additional assets or cash (see Note 17). 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 counterparty 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 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 31.12.2004 this sub-item had a balance of €0.93 million, down €1.67 million on the previous year.

7 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 €4.48 million includes the amount of the correspondent accounts in euro with euro area credit institutions, having decreased by €0.05 million with respect to 2003.

8 SECURITIES OF EURO AREA
RESIDENTS DENOMINATED IN
EURO

This item includes the holdings of marketable euro-denominated fixed-income securities issued by euro area residents. Its balance as at 31.12.2004 was €28,044.91 million, of which €19,100.63 million relate to securities issued by non-Spanish euro area general government¹¹ and €8,944.28 million relate to book-entry State debt. The 2004 balance of this item includes the portfolio of book-entry State debt, which in 2003 was included in the item “Other assets” and which had a balance of €7,163.78 million at the end of that year.

Overall, the securities of euro area residents denominated in euro increased by €6,922.24 million in 2004, of which €5,141.75 million relate to non-Spanish general government fixed-income securities, and €1,780.49 million to book-entry State debt. The changes were for the reasons reflected in the following table:

EUR m	REASON FOR CHANGE	AMOUNT
	Non-Spanish general government fixed-income securities	5,141.75
	Net purchases of securities	5,248.25
	Increase in net unrealised gains at year-end	75.22
	Decrease in accrued implicit interest	-181.72
	Book-entry State debt	1,780.49
	Net purchases of securities	1,772.60
	Decrease in net unrealised gains at year-end	-18.99
	Increase in accrued implicit interest	26.88
	TOTAL	6,922.24

11. As at 31 December 2004, repurchase agreements had been constituted over part of the euro-denominated securities portfolio, with a market value of €17.58 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.

9 GENERAL GOVERNMENT
DEBT DENOMINATED IN EURO
a. State

This sub-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 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, inclusive.

The outstanding balance as at 31 December 2004 of the loans granted to the State amounted to €7,387.53 million, broken down as follows:

EUR m	31.12.2004	REPAYMENT	31.12.2003
Treasury. Law 3/1983 special account	1,952.51	97.63	2,050.14
Treasury. Law 4/1990 special account	4,863.58	347.40	5,210.98
Treasury. Credits arising from subscription for participating interests, contributions and quotas in international agencies	571.44	40.82	612.25
TOTAL	7,387.53	485.84	7,873.37

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 (€1,154.39 million) corresponds to the outstanding amount of a loan granted to the Social Security System under Law 41/1994 of 30 December 1994 on the State budget for 1995. This loan includes the principal of another loan granted to this institution, which was not paid on its maturity, of €1,539.19 million. The repayment of this 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.

€76.96 million of the reduction in the balance of this sub-item (€127.15 million) corresponds to receipt of the fifth repayment instalment on the aforementioned loan, the unmatured balance of which amounts to €1,154.39 million. The remaining €50.19 million of the reduction corresponds to receipt of the tenth and last repayment instalment on another loan of €501.90 million, also extended under Law 41/1994 of 30 December 1994 on the State budget for 1995, which included the unpaid interest due on the previous loan to the Social Security System. 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.

10 INTRA-EUROSISTEM 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 €432.70 million, which is equal to a share of 7.7758% in such capital. This percentage 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.

Pursuant to Article 28 of the ESCB Statute, the ESCB national central banks are the sole subscribers to the capital of the ECB. Subscriptions depend on shares which are fixed in accordance with Article 29.3 of the ESCB Statute and which must be adjusted every five years. The first such adjustment following the establishment of the ECB 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 keys of the NCBs were adjusted on 1 January 2004 and 1 May 2004, by means of transfers among the NCBs.

Consequently, on 1 January 2004, the share that the Banco de España held in the subscribed capital of the ECB – €5,000 million in total – decreased from 8.8935% to 8.7801% and asset item 9.1 "Participating interest in the ECB" decreased from €444.68 million to €439.01 million.

In accordance with Article 49.3 of the Statute of the ESCB, which was added to the Statute by the Treaty of Accession, the ECB's subscribed capital is automatically increased when a new member joins the EU and its NCB joins the ESCB. The increase is determined by multiplying the prevailing amount of the subscribed capital (i.e. €5,000 million) by the ratio, within the expanded capital key between the weighting of the entering NCB(s) and the weighting of those NCBs that are already members of the ESCB. Therefore, on 1 May 2004 the subscribed capital of the ECB was increased to €5,565 million. Consequently, on 1 May 2004, the share that the Banco de España held in the increased subscribed capital of the ECB – €5,565 million in total – decreased from 8.7801% to 7.7758% and asset item 9.1 "Participating interest in the ECB" decreased from €439.01 million to €432.70 million.

As a result of the aforementioned capital key changes, the relative shares of NCBs in the accumulated net profits of the ECB (also referred to as *net equity*) as at 31 December 2003 and 30 April 2004 changed.

b. Claims equivalent to the transfer of foreign reserve assets to the ECB

These represent the Banco de España's claims arising from the transfer of foreign reserve assets to the ECB. The claims are denominated in euro at a value fixed at the time of their transfer. They are remunerated at the latest available marginal rate for the Eurosystem's main refinancing operations, adjusted to reflect a zero return on the gold component.

The adjustments to the capital key weightings of the ECB on 1 January 2004 and 1 May 2004 also resulted in the adjustment of the claim of the Banco de España with respect to the foreign reserve assets transferred to the ECB. In order to reflect its reduced capital key share, the euro-denominated claim of the Banco de España decreased from €4,446.75 million to €4,390.05 million on 1 January 2004 and decreased from €4,390.05 million to €4,326.98 million on 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, this information is presented on the liabilities side of the balance sheet.

d. Other claims within the Eurosystem (net)

The balance of €27,526.68 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-2004 balance of the transfers via TARGET amounted to €27,582.11 million, while the correspondent accounts showed a zero balance. 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 debit position vis-à-vis the ECB 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 among them, amounted to €2.89 million.

Finally, the credit position vis-à-vis the ECB relating to the interim dividend arising from the seignorage of euro banknotes issued on its behalf by the NCBs amounts to €58.32 million, since the ECB Governing Council, in the light of its estimates, decided to retain the 2004 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 €58.32 million as mentioned above.

11 TANGIBLE AND INTANGIBLE ASSETS

The balance of this sub-item amounted to €195.30 million at end-2004, of which €424.03 million related to cost and €228.73 to accumulated depreciation.

The breakdown of this sub-item into its components, together with their accumulated depreciation, is as follows:

EUR m					
COST OR VALUATION	PROPERTIES AND FACILITIES	FURNITURE AND EQUIPMENT	FIXED ASSETS UNDER CONSTRUCTION	OTHER FIXED ASSETS	TOTAL
1 January 2004	225.45	114.76	14.20	64.18	418.60
Additions	8.63	13.80	13.06	6.05	41.54
Disposals	22.34	6.08	7.43	0.25	36.10
31 December 2004	211.74	122.47	19.83	69.99	424.03

EUR m					
ACCUMULATED DEPRECIATION	PROPERTIES AND FACILITIES	FURNITURE AND EQUIPMENT	FIXED ASSETS UNDER CONSTRUCTION	OTHER FIXED ASSETS	TOTAL
1 January 2004	118.38	76.09	—	23.33	217.80
Change during the year	-2.17	9.03	—	4.07	10.93
31 December 2004	116.21	85.12	—	27.40	228.73

The increase in fixed assets in 2004 was basically due to renewal of furniture and the construction of the west wing of the Bank's headquarters in Madrid. The disposals relate essentially to the sale of the buildings housing the ten branches closed on 31 December 2003 as part of the restructuring of its branch network. A sale commitment still remains in respect of the buildings affected by the restructuring relating to the ten branches closed on 31 December 2004.

12 OTHER FINANCIAL ASSETS

On 1 January 2004 the portfolio of book-entry State debt was reclassified to asset item 7 “*Securities of euro area residents denominated in euro*”. The amount of this reclassification was €7,163.78 million.

The current balance of this sub-item (€51.94 million) includes basically the Banco de España’s participating interest in Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A. and the change therein (€–3.16 million) is due to the decrease in the underlying book value of the shares following the distribution of dividends during the year (€10.24 million), basically with a charge to reserves, partially offset by the write-up at year-end to adjust the accounting records to the underlying book value of the company’s shares, which increased as a result of the profit included in the company’s balance sheet in 2004.

13 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-2004 balance of €44.11 million, which is the net value of the forward transactions outstanding as at that date, is €708.56 million lower than at end-2003.

14 ACCRUALS AND PREPAID
EXPENSES

The main components of this sub-item, the balance of which amounts to €678.13 million, are as follows:

EUR m	
ACCRUALS AND PREPAID EXPENSES	AMOUNT
Accrued coupon interest receivable	489.55
On securities denominated in foreign currency issued by non-euro area residents	38.60
On securities denominated in euro issued by non-euro area residents	22.46
On securities denominated in euro issued by non-Spanish euro area residents	298.74
On securities denominated in euro issued by euro area residents (book-entry State debt)	129.75
Other accrued interest receivable	175.61
On forward foreign exchange transactions	–1.88
On deposits and other assets denominated in foreign currency	50.26
On claims equivalent to the transfer of foreign reserves to the European Central Bank	75.72
On other intra-Eurosystem claims arising from TARGET transactions	44.47
Other	7.04
Accrued commissions receivable and prepaid expenses	11.12
Accrued dividends receivable	1.85
TOTAL	678.13

15 SUNDRY

The most significant component is the transfer made to the Treasury on 2 November 2004 of €807.89 million, equivalent to 70% of the Bank’s recorded profits earned to 30 September 2004.

The other main components are the home loans granted to employees of the Bank amounting to €111.19 million and the accrued coupon interest as at the purchase date of fixed-income securities, amounting to €102.76 million.

16 BANKNOTES IN CIRCULATION

The balance of banknotes in circulation (€50,158.28 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, which decreased from 10.1020% to 10.0065% of the total issue by all the central banks after deducting those corresponding to the ECB (8% of the total) as a result of the changes in the ECB's capital key derived from the five-year adjustment and from the accession of new Member States to the European Union. This balance was €6,089.32 million higher than in the previous year because of the greater volume of euro banknotes in circulation in the Eurosystem.

17 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 €13,090.90 million at end-2004, €1,318.18 less than in the previous year. This decrease took place in the sub-item "*Current accounts (covering the minimum reserve system)*", which includes 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. These deposits declined from €14,408.04 million at 31.12.2003 to €13,085.97 million at 31.12.2004. However, in terms of their average balance in the two years, there was an increase from €11,828.09 to €13,322.18 million.

Also included in this item 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 31.12.2004 only deposits in relation to margin calls (see Note 6.f on the balance sheet), amounting to €4.93 million, had been placed. The other types of deposit had zero balances.

18 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 €13,972.89 million, which breaks down as follows:

EUR m	2004	2003
Central government (State)	3,478.35	3,320.81
Treasury current account	299.93	300.21
Other central government agencies and similar bodies	3,178.43	3,020.61
Territorial government	87.76	86.30
Regional (autonomous) governments, administrative agencies and similar bodies	83.59	80.39
Local government	4.17	5.91
Social security funds	10,406.78	12,383.03
Social Security System	8,832.75	10,835.55
Other	1,574.03	1,547.48
TOTAL	13,972.89	15,790.14

The decrease in the balance of this sub-item (€1,817.25 million) was basically due to the decline in the balances held by the Social Security System with the Banco de España.

19 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 non-administrative autonomous agencies of the State, the current accounts of employees and pensioners and other accounts of legal entities classified in “ <i>Other resident non-financial sectors</i> ”. The balance at end-2004 was €1,935.26 million, an increase of €487.47 million on end-2003, basically due to the increase in the balances of the current accounts of “ <i>State agencies—Regional agencies</i> ” (€372.69 million).
20 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 €30.36 million was €9.23 million higher than a year earlier.
21 LIABILITIES TO NON-EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY. – DEPOSITS, BALANCES AND OTHER LIABILITIES	Substantially all of the €15.72 million balance of these liabilities at end-2004 related to securities repurchase agreements (€14.95 million), the balance of which was zero as at 31.12. 2003. The total amount of this sub-item decreased by €76.51 million because the debt arising from gold repurchase agreements relating to management of the Banco de España’s foreign reserves, which amounted to €91.73 million as at end-2003, had a zero balance as at end-2004.
22 COUNTERPART OF SPECIAL DRAWING RIGHTS ALLOCATED BY THE IMF	This item of €340.52 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 €11.47 million with respect to the previous year due to the variation in the exchange rate.
23 INTRA-EUROSISTEM LIABILITIES a. Net liabilities related to the allocation of euro banknotes within the Eurosystem b. Other liabilities within the Eurosystem (net)	<p>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 “<i>Banknotes in circulation</i>” and “<i>Intra-Eurosystem balances</i>” in the notes on accounting policies).</p> <p>This sub-item had a net debit balance in 2004. Therefore, the explanation is given in note 10.d on the balance sheet.</p>
24 ITEMS IN COURSE OF SETTLEMENT	Of the total balance of this item (€44.87 million), €37.29 correspond to transfers received as at 31 December 2004 by the Sistema Nacional de Compensación Electrónica (National Electronic Clearing System) that have been settled and are pending payment and €4.62 million relate to transfers ordered by credit institutions pending payment at year-end, the latter being responsible for most of the decrease in this item with respect to 2003 (€47.08 million).
25 OTHER LIABILITIES. ACCRUALS AND INCOME COLLECTED IN ADVANCE	The most significant components of this sub-item totalling €89.50 million relate to interest accrued but not yet paid (€82.55 million). The decrease in this sub-item (€199.30 million) mainly results from the existence as at 31.12.2003 of profit of €226.98 million on unmatured forward transactions that were executed in 2004.
26 OTHER LIABILITIES.– SUNDRY	The main component of this sub-item is “ <i>Banknotes in circulation.– Pesetas</i> ”, the balance of which (€1,080.14 million) decreased by €75.43 million in the year and relates to the peseta-denominated banknotes pending exchange as at year-end. Another significant component is the contributions payable to the Banco de España employee social welfare scheme (<i>Mutualidad de empleados</i>), the amount of which (€293.03 million) decreased by €25.11 million during the year. Finally, the settled credit interest pending allocation, corresponding to a loan granted

in the past to the Social Security System, with a balance at end-2003 of €50.19 million, was no longer included as at end-2004, since in 2004 the last of the outstanding payments took place.

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:

EUR m	2004	2003
For exchange rate and interest rate risks	2,422.14	2,622.04
For ECB losses – Contributions arising from monetary income	147.92	—
For early and regular retirement	107.06	119.53
For sundry liabilities and charges	116.90	72.82
For other risks	0.24	0.26
TOTAL	2,794.26	2,814.64

The most important provision is that for exchange rate and interest 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. Also, on 14 April 2004 the Executive Commission resolved to extend the purpose of this provision to include the coverage of interest rate risk. The balance of this provision as at 31.12.2004 amounted to €2,422.14 million. This resulted from the use of €507.99 million and the addition of €308.09 million to reach the level that is considered to assure the coverage of exchange rate and interest rate risks, in accordance with the resolutions of the Executive Commission on 28 January and 22 April 2005.

Further, under Article 33.2 of the Statute of the ESCB, the Governing Council of the ECB can decide to offset the loss incurred by the ECB against its general reserve fund and, if necessary, against the monetary income for the year, in proportion and up to the amounts allocated to the national central banks. On 13 January 2005 the Governing Council decided to retain, initially, €1,360 million of the pooled monetary income to offset the ECB's loss in 2004. Accordingly, the Banco de España set up a provision of €147.92 million to offset the ECB's loss, an amount equal to its participating interest in the Eurosystem (10.87664%). In accordance with the procedures established in the Eurosystem, this provision was used for its stated purpose on 31 January 2005, within the process of settlement of the monetary income for 2004.

Finally, the increase in the provisions for sundry liabilities and charges (€44.08 million) was due basically (€37.49 million) to the provisioning required as a result of the commitments assumed under the Collective Agreement for 2002/2005 approved by the Executive Commission on 17 December 2004, which will have to be fulfilled in 2005.

28 REVALUATION ACCOUNTS

This item includes the revaluations arising from unrealised gains on financial assets and liabilities. The breakdown is as follows:

EUR m			
	TYPE OF ACCOUNT	2004	2003
	Due to exchange rate differences	—	0.01
	Due to price differences	4,283.72	4,481.04
	Gold	3,830.38	3,978.59
	Securities denominated in foreign currencies issued by non-euro area residents	32.34	91.69
	Securities denominated in euro	377.57	364.19
	<i>Issued by non-euro area residents</i>	<i>7.31</i>	<i>2.30</i>
	<i>Issued by non-Spanish euro area residents</i>	<i>89.58</i>	<i>14.36</i>
	<i>Book-entry State debt</i>	<i>280.68</i>	<i>347.53</i>
	Other	43.44	46.57
	TOTAL REVALUATIONS	4,283.72	4,481.05

The decline of €197.33 million in the revaluation accounts in the year has the following breakdown:

EUR m		
	BREAKDOWN OF CHANGE	AMOUNT
	Due to exchange rate differences	-0.01
	Due to price differences	-197.32
	Gold	-148.22
	Securities denominated in foreign currencies issued by non-euro area residents	-59.35
	Securities denominated in euro	13.37
	<i>Issued by non-euro area residents</i>	<i>5.01</i>
	<i>Issued by non-Spanish euro area residents</i>	<i>75.22</i>
	<i>Book-entry State debt</i>	<i>-66.86</i>
	Other	-3.13
	TOTAL	-197.33

The main change was in gold, the unrealised gains on which decreased by €148.22 million due to the fall in its market price in euro in 2004. As regards the revaluation accounts based on the price of securities, the change in those denominated in foreign currencies was a decrease of €59.35 million, partly due to the effect of sales and partly due to the rise in interest rates on assets denominated in US dollars, while the change in the revaluation of securities denominated in euro consisted of a slight increase (€13.37 million). This latter change resulted from a significant rise in the price of securities issued by non-Spanish euro area residents (€75.22 million), which were acquired during the year at an interest rate higher than that at the end of the year, offset by a decrease in the gains on book-entry State debt as at end-2004 with respect to those as at end-2003, largely because of prior-year unrealised gains recognised in the year.

The capital of the Banco de España, constituted in accordance with the provisions of Royal Legislative Decree 18/1962 of 7 June 1962, totalled €1.37 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 (€1.62 million), amounted to €808.95 million, down 58.5% on 2003. Of this amount, €807.89 million was paid to the Treasury on 2 November 2004, 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 2003:

- a) On 2.2.2004, €817.35 million, in order to reach, together with the amount paid in November 2003, 90% of the profit for 2003 (€1,947.47 million).
- b) On 10.8.2004, once the balance sheet and profit and loss account for the year 2003 had been approved by the Council of Ministers, €194.75 million, representing the rest of the profit for 2003.

The details of the various components of the profit for 2004 are given in the following section, relating to the profit and loss account.

Note on the profit and loss account

This item includes income from interest accrued on the main assets of the Banco de España. It was made up, in 2004 and 2003, as follows:

1 INTEREST INCOME

EUR m						
	FOREIGN CURRENCY		EURO		TOTAL	
	2004	2003	2004	2003	2004	2003
Securities	171.18	432.62	758.41	384.15	929.59	816.76
Monetary policy operations	0.00	0.00	522.03	460.61	522.03	460.61
Intra-Eurosystem balances	0.00	0.00	515.70	567.35	515.70	567.35
Other assets	74.26	174.20	2.65	3.42	76.91	177.62
TOTAL	245.44	606.82	1,798.79	1,415.52	2,044.24	2,022.34

As regards the interest on foreign-currency investments (€245.44 million), the majority (€171.18 million, equivalent to 69.74%) arose from investments in fixed-income securities denominated in US dollars, which had an average balance of USD 7,961.49 million and an average yield of 2.6% in 2004, compared with €18,804.95 million and 2.7%, respectively, in 2003. The rest of the interest arose from other dollar-denominated investments (deposits, repos, etc.) and from investments in SDRs.

The interest on euro-denominated investments (€1,798.79 million) arose from the following assets:

EUR m and %

ASSETS	AVERAGE INVESTMENT	INTEREST	AVERAGE YIELD IN 2004
Loans to institutions related to monetary policy operations	25,322.51	522.03	2.0%
Net balance with the ECB arising from TARGET transactions	21,456.28	439.98	2.0%
Claims equivalent to the transfer of foreign reserves	4,348.17	75.72	1.7%
Securities portfolios	27,743.09	758.41	2.7%
Other	—	2.65	—
TOTAL	78,870.05	1,798.79	2.2%

The increase in euro-denominated interest income (€383.27 million) was due to the higher average investment (€56,974.82 million in 2003), offset by the fall in the average return on these assets (down from 2.5% in 2003 to 2.2% in 2004).

2 INTEREST EXPENSE

This item includes interest expenditure on liabilities, with the following breakdown:

EUR m and %

	AVERAGE FINANCING	INTEREST EXPENSE		AVERAGE COST IN 2004
		2004	2003	
Remuneration of minimum reserves	13,322.18	271.88	274.38	2.0%
General government deposits	11,400.43	227.50	270.73	2.0%
Intra-Eurosystem liabilities. — Net liabilities related to allocation of euro banknotes within the Eurosystem	8,852.84	181.41	133.11	2.0%
Liabilities denominated in foreign currency	379.92	6.81	11.64	1.8%
Other liabilities	—	2.37	0.30	—
TOTAL	33,955.36	689.97	690.15	2.0%

The decrease in the expense compared with the previous year (€0.18 million) was practically insignificant and due to the fall in the average cost of financing (2.2% in 2003), offset partly by the increase in the average balance, which in 2003 amounted to €30,370.05 million.

3 REALISED GAINS/LOSSES ARISING FROM FINANCIAL OPERATIONS

This item includes the profits and losses arising from dealing in financial assets. In 2004 it also includes the realised gains on book-entry State debt (€105.96 million), which in 2003 were included in the sub-item “Other income and losses”. In 2004 the realised gains on financial operations amounted to €223.97 million, basically arising from the following sources:

	EUR m					
	FOREIGN CURRENCY		EURO		TOTAL	
	2004	2003	2004	2003	2004	2003
Sale of foreign currency	99.08	86.63	0.00	0.00	99.08	86.63
Sale of securities (price gains)	-10.44	657.73	135.18	87.57	124.74	745.30
Other gains/losses	0.16	0.44	0.00	0.95	0.16	1.39
TOTAL	88.79	744.80	135.18	88.52	223.97	833.32

- The net gains due to exchange rate differences upon the sale of foreign currency amounted to €99.08 million, of which €84.68 million corresponded to the net loss for the year and €183.76 million to the realisation of unrealised gains on forward transactions arranged in 2003 and executed in 2004. €93.84 of the aforementioned total net gains relate to the sale of US dollars.
- The net price-related gains arising from the sale of securities amounted to €124.74 million, of which €135.18 were gains on the sale of euro-denominated securities and €10.44 million were losses on the sale of securities denominated in foreign currency (US dollars).

Compared with the previous year, the total net realised gains arising from financial operations decreased by €609.34, basically due to a decline of €620.56 on the sale of securities, offset partially by an increase in exchange rate gains on the sale of foreign currency (€12.45 million).

- The rise in net exchange rate gains on the sale of foreign currency with respect to the previous year (€12.45 million) was due to the smaller loss in 2004 as a result of the lower volume of daily net sales of US dollars in the year (€3,870.44 million in 2004 against €12,851.32 million in 2003) and, above all, to the recognition in profit and loss of unrealised gains on the aforementioned forward transactions upon maturity.
- The decrease in gains on the sale of securities (€620.56) was a result of the loss on the sale of foreign currency-denominated securities in 2004 (€10.44 million), as opposed to the gain in 2003 (€657.73 million), offset by the higher gains on the sale of euro-denominated securities (€135.18 million against €87.57 million in 2003). The change in the profit on foreign currency was due to the overall effect of developments in securities market prices and to the lower volume of sales (down from USD 34,276.07 million in 2003 to USD 11,820.32 million in 2004). Meanwhile, the rise in gains on the sale of euro-denominated securities with respect to the previous year was basically due to the higher volume of sales (up from €1,356.70 million in 2003 to €8,426.91 million in 2004).

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 securities prices, for that portion that cannot be offset by unrealised gains from previous years. In 2004 this item includes the loss on book-entry State debt (€-0.20 million), previously classified in the sub-item "Other income and losses".

The depreciation posted in 2004 amounted to €507.99 million, €488.75 million of which related to exchange rate losses recorded in foreign currency, basically in US dollars (€431.05 million), in SDRs (€41.94 million) and in Swiss francs (€15.62 million).

Unrealised losses relating to securities price movements amounted to €18.97 million, of which €16.29 million were in US dollar-denominated securities and €2.68 million in euro-denominated securities.

5 TRANSFERS TO/FROM
PROVISIONS FOR FOREIGN
EXCHANGE RATE AND PRICE
RISKS

In 2004 provisions covering exchange rate and price risks for an amount of €507.99 million were reversed to income to cover the unrealised losses on financial assets and positions described in the preceding section. Also, a transfer of €308.09 million was made to raise this provision to the level considered appropriate for the risks to be covered.

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, settlement service for securities transactions, etc.). It may be broken down as follows:

EUR m	INCOME		EXPENSES	
	2004	2003	2004	2003
Foreign operations	0.16	0.80	-2.49	-1.29
Domestic operations	10.34	12.44	-1.38	-0.87
TOTAL	10.50	13.24	-3.87	-2.16

Lower net fee income in 2004 (down 40.12%) 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 and to a reduction in the rates applied since 1 March.

7 INCOME FROM EQUITY
SHARES AND PARTICIPATING
INTERESTS

Of the total amount of €12.41 million recorded, €10.24 was from the participating interest in Bolsas y Mercados Españoles, and €2.17 from interests in international agencies. The difference with respect to the previous year (€-57.12 million) arose basically because the ECB did not distribute an ordinary dividend (in 2003 it distributed €67.47 million out of the 2002 profit). Also, in 2004 the income of the ECB from euro banknotes in circulation (total amount: €733 million) was retained in full by the ECB in accordance with a decision of its Governing Council and in view of its estimated results for 2004. Consequently, as in 2003, the ECB did not distribute an interim dividend relating to seignorage of its banknotes in 2004.

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 a 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 €896.91 million, and that reallocated to it, amounting to €899.80 million, is the net result arising from the calculation of monetary income.

In addition, in 2004, owing to the results reported by the ECB, the net result of pooling of monetary income also reflects the Banco de España's participating interest (€147.92 million) in the monetary income retained to cover the loss incurred by the ECB in 2004 (see Note 27 on the balance sheet).

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:

EUR m			
	DESCRIPTION	2004	2003
	Extraordinary profit	75.23	76.42
	Employee social welfare scheme	-34.99	-37.48
	Sundry	5.52	0.36
	TOTAL	45.75	39.30

The €75.23 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) and the income on the sale of branch buildings closed in 2003 (€22.46 million). Most of the "Sundry" caption relates to the compensation of €4.60 million received for the reduction of the Banco de España's relative share in the net equity of the ECB as at 30 April 2004 due to the changes in the capital key.

As mentioned in the introduction and in Notes 3, 4 and 14 on the profit and loss account, in 2004 there were various reclassifications from this sub-item to others (realised and unrealised gains and losses on book-entry State debt and death and retirement assistance) and from other sub-items to this one (expenses arising from payment commitments to the employee social welfare scheme). The overall effect of these reclassifications in 2004 was to reduce the amount of this sub-item by €131.03 million.

10 STAFF COSTS

The increase in staff costs (€14.99 million) is basically due to transfers of €37.49 million to provisions relating to the collective agreement entered into for the years 2002 to 2005, offset by the effects deriving from the restructuring of the branch network and of human resources agreed in 2002.

11 ADMINISTRATIVE EXPENSES¹²

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 €46.04 million, and costs relating to premises, which amounted to €18.25 million.

¹² 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.

It breaks down as follows:

EUR m			
	DESCRIPTION	2004	2003
	Office expenses	-46.04	-38.55
	Property expenses	-18.25	-16.18
	Transport and communications	-6.32	-6.06
	Surveillance and security	-5.98	-6.25
	Training and grants	-2.86	-2.12
	Sundry operating expenses	-8.49	-7.77
	Local taxes	-0.88	-0.91
	TOTAL	-88.79	-77.84

“Sundry operating expenses” include €122,199.62 (including VAT) relating to the fees of the external auditors PricewaterhouseCoopers, S.L. for the audits in 2004 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 €92,609.30 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:

EUR m			
	DESCRIPTION	2004	2003
	Depreciation of property	-8.26	-8.41
	Depreciation of transport equipment	-0.64	-0.51
	Depreciation of furniture and office equipment	-13.23	-12.27
	Depreciation of computer applications	-3.51	-3.06
	TOTAL	-25.65	-24.25

13 BANKNOTE PRODUCTION SERVICES

This amount (€31.26 million) corresponds to payments made by the Banco de España to purchase banknotes, basically from the National Mint. The decrease with respect to the previous year (€17.71 million) was attributable to the lower volume of euro-denominated banknotes acquired by the Bank in 2004.

14 TRANSFERS AND ADDITIONS TO OTHER FUNDS AND PROVISIONS

The transfers in 2004 amounted to €17.82 million, compared with reversals of €35.22 million in 2003. This change (€53.04 million) is primarily due to the reversals in 2003 (€45.26 million) arising from modification of the method of calculating the provision for death and retirement assistance provided for in Article 190 of the Banco de España Employment Rules, as against the transfers that had to be made in 2004 (€9.73 million) due to the fall in the interest rates to be applied in calculations.

Since the Banco de España provides financial services, it is not an institution with a high environmental risk. In 2004 it was not considered necessary to record any provision for environmental liabilities and charges.

As detailed and explained in the preceding notes, the net profit for 2004 amounted to €808.95 million, down 58.5% on the previous year.

Pursuant to Royal Decree 1080/2002, €807.89 million was paid into the Treasury on 2 November. This was 70% of the Bank's profit as at 30.09.2004. It was not necessary to make any additional payment on the first working day of February 2005 to bring the previously paid amount up to 90% of the profit, since this percentage was already covered by the payment on 2 November 2004. Once the 2004 annual accounts have been approved by the government, any remaining amount will be paid into the Treasury.

3 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 2004 the Banco de España made no contributions whatsoever to the Deposit Guarantee Funds.

Loss of profit

The table below shows the loans outstanding in 2004 with interest rates below the reference rates used, in order to estimate the loss of profit for the year pursuant to the provisions of Article 4.2 of Law 13/1994 of 1 June 1994 of Autonomy of the Banco de España.

EUR m and %				
	ESTIMATED AVERAGE BALANCE IN 2004	INTEREST RATE RECEIVED (%)	REFERENCE INTEREST RATE (%)	ESTIMATED LOSS OF PROFIT
Net State debt	7,489.67	0.00	2.02	150.97
Loans to the Social Security System	1,281.20	0.00	2.02	25.83
Housing loans and repayable advances to employees	28.82	0.39	2.02	0.47
<i>Housing loans</i>	6.74	1.68	2.02	0.02
<i>Repayable advances</i>	22.08	0.00	2.02	0.45
TOTAL	8,799.69	0.00	2.02	177.26

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.

ANNEXES

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 2004, 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 2004 figures, those for the previous year for each balance sheet and profit and loss account item. Our opinion refers solely to the 2004 annual accounts. Our audit report issued on 31 May 2004 on the 2003 annual accounts contained an unqualified opinion.

In our opinion, the attached 2004 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 2004 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 2.1 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

27 May 2005

2 Report of the Audit Committee

We the undersigned, Juan Muñoz García, Ángel Luis López Roa and Jesús Leguina Villa, 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 2004.

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 2004, prepared by the Associate Directorate General Internal Affairs of the Banco de España; 2) studying the audit of the balance sheet and profit and loss account of the Banco de España for 2004, 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 2004 give a true and fair view of the net worth and financial position of the Banco de España.

Madrid, 12 May 2005



JUAN MUÑOZ GARCÍA



ÁNGEL LUIS LÓPEZ ROA



JESÚS LEGUINA VILLA

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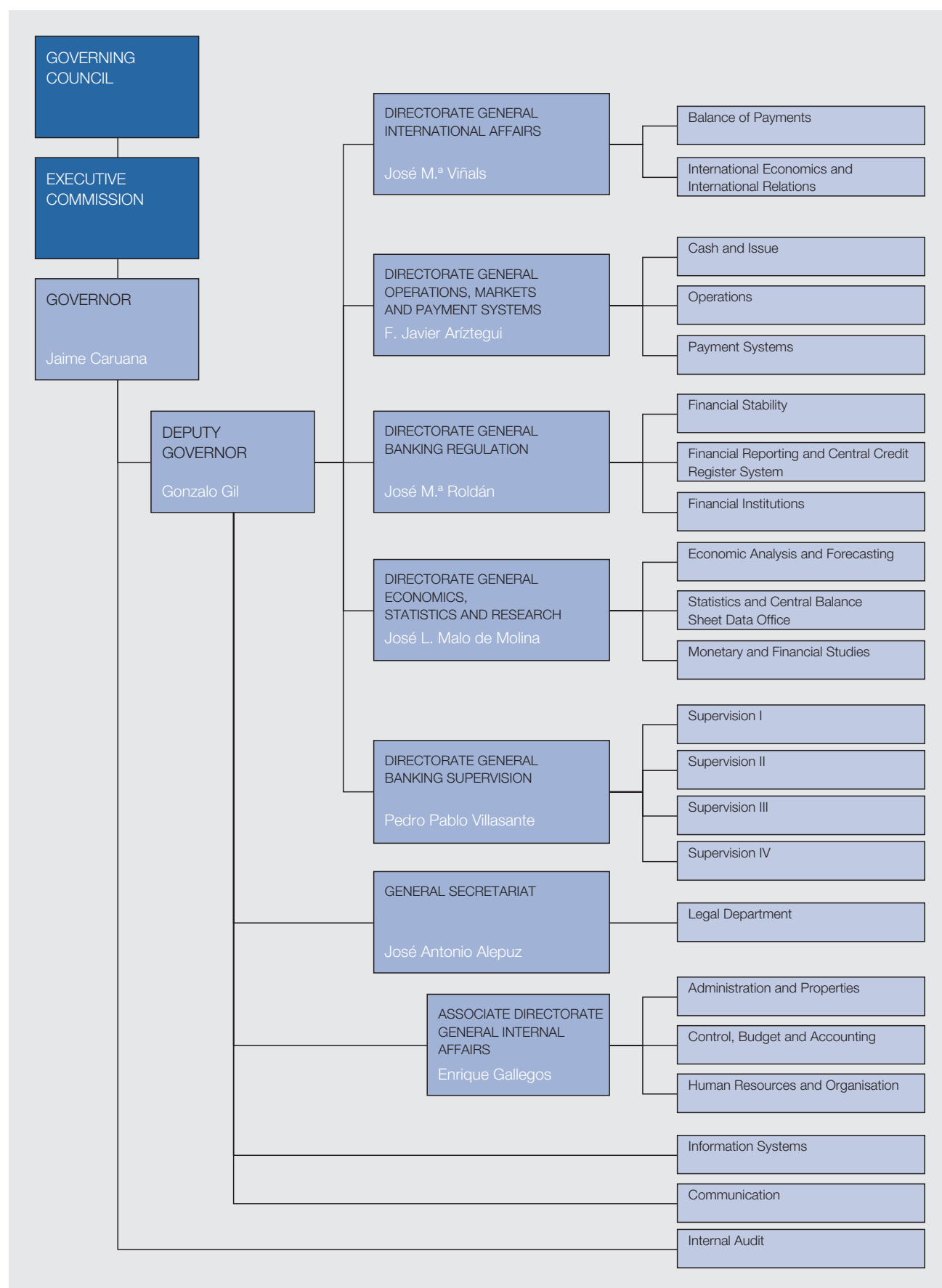
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