

**ANNUAL REPORT**

**2005**

**BANCO DE ESPAÑA**





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## 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 Statistics Institute
CNMV	National Securities Market Commission	INVERCO	Association of Collective Investment Institutions and Pension Funds
CPI	Consumer price index		
DGS	Directorate General of Insurance and Pension Funds	LIFFE	London International Financial Futures Exchange
EAGGF	European Agricultural Guidance and Guarantee Fund	MEFF	Financial Futures and Options Market
ECB	European Central Bank	MEFF RF	Fixed-income derivatives market
ECCO	ECB External Communications Committee	MEFF RV	Equity derivatives market
ECOFIN	Council of the European Communities (Economic and Financial Affairs)	MFIs	Monetary financial institutions
EDP	Excessive Deficit Procedure	MMFs	Money market funds
EMU	Economic and Monetary Union	MROs	Main refinancing operations
EONIA	Euro overnight index average	NCBs	National central banks
EPA	Official Spanish Labour Force Survey	NPISHs	Non-profit institutions serving households
ERDF	European Regional Development Fund	OECD	Organisation for Economic Co-operation and Development
ESA 79	European System of Integrated Economic Accounts	OPEC	Organisation of Petroleum Exporting Countries
ESA 95	European System of National and Regional Accounts	PFs	Pension Funds
ESCB	European System of Central Banks	PPP	Purchasing power parity
EU	European Union	QNA	Quarterly National Accounts
EU-15	Countries making up the European Union as at 31/04/04	RoW	Rest of the World
EU-25	Countries making up the European Union as from 1/5/04	SCLV	Securities Clearing and Settlement Service
EUROSTAT	Statistical Office of the European Communities	SDRs	Special drawing rights
FASE	Financial Accounts of the Spanish Economy	SICAV	Open-end Investment Companies
FDI	Foreign direct investment	SMEs	Small and medium-sized enterprises
FIAMM	Money market funds	TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
FIM	Securities funds	TFP	Total factor productivity
FISIM	Financial Intermediation Services Indirectly Measured	ULCs	Unit labour costs
GDI	Gross disposable income	VAT	Value added tax
GDP	Gross domestic product	XBRL	Extensible Business Reporting Language

## COUNTRIES AND CURRENCIES

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 <sup>9</sup> ).
m	Millions.
bp	Basis points.
pp	Percentage points.
...	Not available.
—	Nil, non-existence of the event considered or insignificance of changes when expressed as rates of growth.
0.0	Less than half the final digit shown in the series.

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## 1 OVERVIEW

### 1 Introduction

In 2005, the Spanish economy's long upswing, that began in the mid-1990s, continued and actually gathered pace. Growth, according to the annual rate of change of GDP, rose to 3.4%, from 3.1% the previous year. The impulse came from highly dynamic domestic demand, which reached a rate of 4.1%, sustained by the persistence of monetary and financial conditions that were very loose for the Spanish economy's cyclical position and by demographic developments. The main new factor was the acceleration in equipment investment, which responded to the favourable profitability conditions, balance sheet rebuilding and corporate financing conditions. However, this recovery was not sufficient to significantly counterbalance a spending pattern that is still heavily based on consumption and construction investment.

Growth continued to be job-intensive. As a result, the rate of unemployment fell to levels unknown in recent decades, despite the strong increase in labour supply stemming from high levels of immigration and the rise in the participation rate, caused particularly by the increasing incorporation of women into the labour market. The Spanish economy continued to converge with the European Union countries, its per capita income reaching 91% of the average for the 15 pre-enlargement members and 98% of that for the current 25 members. However, labour productivity growth remained very weak, actually falling last year in relative terms.

The boost from domestic demand was increasingly offset by the draining effect of net external demand, which subtracted 1.9 percentage points from GDP in 2005, as a consequence of weak exports and increasingly vigorous imports. The current account deficit and the nation's net borrowing rose to historic highs. Although there are some temporary factors behind this behaviour, there are signs that it also reflects a deterioration of competitiveness generated by the prolonged pressure from domestic demand that has not met with a sufficiently flexible response from supply, giving rise to persistent inflation differentials. The upsurge in prices in 2005 was partly a reflection of higher oil prices, but also of the distortions arising from the continued pressure of spending and the rigidities in cost and price formation.

Forecasts point to continuation of the current growth scenario, with a slight trend slowdown, based on the lower buoyancy of domestic demand and a certain correction in the negative contribution of net external demand. The euro area recovery and the adaptation of monetary conditions will probably help with progress towards re-balancing the economy. However, this scenario, which would enable the narrowing of the welfare gap with the most advanced countries of the area to continue, requires sufficient correction of the imbalances generated by so many years of domestic spending pressure.

After analysing the external environment of the Spanish economy, focusing on the euro area, where monetary policy and financial conditions are determined, this overview considers in greater detail the factors underlying the continued expansion of the economy. Subsequently, it analyses the risks to the sustainability of growth, which arise from the high buoyancy of spending, and the scope of the imbalances that are reflected in inflationary pressures and the competitiveness disparity, growing private-sector indebtedness and a rising external deficit. Finally, the challenges that all this poses for the conduct of economic policy are addressed.

### 2 The international setting and the euro area

The most notable feature of international economic developments in 2005 was the continuation of relatively high growth against a background of low inflation, despite the sharp rise in oil

prices, which ended the year at about \$60 a barrel, around twice their level in early 2004. The rise in oil prices during 2004 and 2005 was primarily a consequence of the strong growth in demand from the most dynamic economies, in particular China and the United States, as well as of the limited surplus capacity in production and refining, which cannot be easily increased in the short term. In this respect, the view took hold during 2005 that the price of oil will remain at its current high levels for a prolonged period, and could rise further, given that the limited surplus capacity makes the market very vulnerable to geopolitical tensions and to other supply shocks. This was seen in summer 2005 and more recently in spring 2006, when Brent crude reached an all-time high of more than \$70 a barrel. In real terms the price of oil is still lower than at the beginning of the 1980s, but the high levels are proving more persistent than they were then.

In 2005 the world economy, driven by strong growth in the United States and in the emerging Asian economies (in particular China and India), remained highly buoyant, with output growth of 4.8%, only 0.5 pp down from 2004. The firming of expectations of recovery in Japan and, to a lesser extent, in the euro area gave growth a slightly more balanced character in 2005, although both these regions had growth rates well below the world average. The rise in energy prices had a relatively moderate impact on general price indices, while underlying inflation and inflation expectations held steady at the global level. This situation of general economic boom was also reflected in developments on financial markets, which posted very positive results in 2005, against a background of low volatility and generally low risk premiums.

The oil price hike does not, therefore, seem to have had the consequences for activity and inflation observed in the past. This is due to a combination of factors. First, unlike in previous episodes (like 1973-1974, 1978-1980 and 1989-1990) that were characterised by supply cuts, the rise in prices on this occasion has been more a result of the strong demand pressure, caused in turn by the general economic boom and by the emergence of new countries onto the international economic scene. The contractionary impact on activity has thus, to some extent, been diluted in a setting marked by strong world economic activity. Second, the structural reforms implemented in recent decades to make markets more flexible and to reduce the energy dependence of the industrialised countries, seem to have made the world economy more resilient to the adverse consequences of rising oil prices. Third, governments have generally refrained from applying offsetting policies that, in the past, served to delay the necessary adjustments and, thus, ended up increasing their contractionary impact. Finally, the absence of second-round effects on wages (against a background of heightened competition, especially in manufacturing, on account of the sudden rise of China and other emerging economies on global goods and services markets) enabled underlying inflationary pressures to remain relatively contained, so that monetary policies could continue (albeit to a decreasing extent as the year passed) to stimulate growth.

Despite the resilience shown by the world economy to diverse shocks, economic developments in 2005 also evidenced the presence of certain vulnerabilities to possible rises in interest rates (in particular long-term rates, that remain at “abnormally” low levels) or to revisions in economic agents’ future income expectations. Thus, although the accommodative fiscal and monetary policies of recent years have helped to sustain the high levels of activity, they have also, in numerous industrialised countries, brought with them strong and widespread rises in the prices of financial and real assets, in particular housing, which has been accompanied by high borrowing. The recent experience of certain countries that have seen the growth of their house prices grind to a halt indicates that stabilisation of these prices may sometimes have a significant impact on consumption.

The information available on 2006 suggests, first, that the general economic boom is continuing, albeit perhaps against a somewhat less dynamic background, owing to the permanence of high energy prices and their volatility; and second, that risks to global growth, essentially on the downside, persist. In this respect, neither the distribution of world growth (although it tended to become slightly more balanced in comparison with the previous year) nor the course of the dollar (whose nominal effective exchange rate appreciated by around 6% over the year) contributed to the correction of the global imbalances in 2005. The July 2005 exchange rate reform in China, which involved formally tying the renminbi to a basket of currencies and a 2.1% revaluation against the dollar, and the subsequent mild appreciation do not seem to have contributed sufficiently to this correction either. The distribution of the current account balances remained practically unchanged in 2005 and the US deficit reached a new high, equivalent to 6.4% of GDP and to 1.8% of world income. Thus, the possibility that the persistence of these imbalances may ultimately affect the stability of the international monetary system and global growth continues to be seen as the main medium-term risk confronting the world economy. This is joined, in the short-term, by potential oil-market shocks arising from geopolitical tensions. As diverse analyses have been indicating, the orderly correction of these imbalances requires a combination of more restrictive fiscal policies in the United States, greater exchange rate flexibility in Asia and structural reforms in Europe and Japan to help increase their potential growth.

In the first half of 2005, the euro area was unable to capitalise on the favourable situation of the world economy. Thus, economic activity, and domestic demand in particular, remained lacklustre, in line with the trends detected from the second half of 2004, and the growth outlook for the year as a whole deteriorated progressively as the months passed. However, in Q3 the euro area emerged from this period of slackness, with a notable acceleration in growth, driven by investment (assisted by highly favourable financial conditions and strong corporate earnings) and exports (based on the strong growth of world trade and the movement in the exchange rate, which declined in 2005 in nominal effective terms by around 6% year-on-year). Even so, the euro area grew by a modest 1.4% in 2005, as against 1.8% in 2004. The information available for end-2005 and early 2006 points to a progressive firming of the recovery, in line with a scenario in which activity is gathering pace and approaching its potential growth rate, but with spare capacity remaining for some time. However, this scenario is not free of risks. In particular, the absence of clear signs of a recovery in employment and consumption is an element of uncertainty for the prospects of sustained growth of activity in the area in the short and medium term, exacerbating the external risks mentioned above.

On the prices front, the HICP growth rate in 2005 was 2.2%, slightly above the reference rate considered compatible with medium-term stability. The developments in actual inflation reflected the fluctuations in oil prices during the year, while underlying inflation slowed smoothly to levels below 1.5%. Meanwhile, inflation expectations and wage growth remained contained and moderate, respectively, against a background of weakness in aggregate demand and in the labour market, so that no pressures were seen to emerge in underlying inflation. However, the growing perception of higher oil prices as a persistent phenomenon tended to increase the risk that the rises in production costs would eventually cause prices to rise in all sectors and bring an end to wage moderation, especially if the progressive strengthening of economic activity and the pick-up in the labour market are confirmed. The rise in the price of oil in spring 2006 to levels clearly above \$70 a barrel accentuates these risks.

As inflationary risks became apparent during the year, in particular, from the summer, against the background of a progressively firming recovery, the ECB exercised increasing vigilance, with the intention of preserving the preventive role of monetary policy. Eventually, at its meeting on 1 December, the Governing Council raised official interest rates (which had been held unchanged at

historically low levels for two and a half years) by 25 basis points. A further increase of the same size was decided upon at the meeting on 2 March 2006, which took the level of rates to 2.5% and ended the prolonged period of negative real short-term real interest rates. Despite these adjustments, the ECB's monetary policy remains conducive to an expansion in domestic demand, which has yet to become fully entrenched.

In the fiscal area, the problems arising as a result of the breach of some of the clauses of the Stability and Growth Pact, particularly in the application of the excessive deficit procedures vis-à-vis Germany and France, led to a far-reaching revision of the institutional framework governing fiscal policies in the euro area. In March 2005, the European Council ratified the agreement to reform the Stability and Growth Pact. As well as changing certain specific aspects of the preventive and corrective arms of the Pact, this agreement called for a number of actions to stimulate the institutional commitment to fiscal discipline. The effectiveness of these actions will, of course, depend upon their strict application and greater commitment by the countries to comply with the Pact. However, in 2005, as in previous years, the budgetary developments in the Member States were characterised by insufficient fiscal consolidation and by large structural deficits, so that once again most of the countries failed to fulfil the deficit and debt targets contained in their stability programmes. According to the budget plans for this year, the existing imbalances will not be significantly corrected in 2006 either.

In various countries, the persistence of large structural deficits has deprived fiscal policy of sufficient leeway for automatic stabilisers to operate during cyclical downturns. Thus, the prolonged low level of interest rates has been the main factor that has enabled the recovery of activity in the euro area to be stimulated, in so far as risks to the ultimate objective of ensuring medium-term price stability have not been perceived. However, certain structural reforms undertaken in the past, particularly in the labour market, have played some role. That said, the economic slackness in the area in recent times indicates that, despite the progress achieved, obstacles remain that, leaving aside conjunctural factors, limit the economy's growth potential. These obstacles become more evident when the challenges posed by globalisation and population ageing are taken into account.

In 2005, the structural reform agenda designed in Lisbon five years previously was relaunched. In March, the European Council examined the degree of fulfilment of the targets set and concluded that although progress had been made in the use of labour, the overall balance was not satisfactory, in particular with regard to productivity growth, the rate of innovation and adoption of new technologies, entrepreneurial dynamism and the degree of market integration. The surfeit of simultaneous targets and failure to establish priorities, along with the absence of wholehearted political commitment by the Member States, were identified as the main reasons for the lack of progress. In the light of this analysis, the heads of state and government adopted a new strategy to relaunch the agenda, based on two key ideas: focusing efforts on those areas most relevant to economic growth and job creation, and defining more clearly the division of responsibilities between the Community and national levels, involving national agents to a greater degree in the design and application of the reforms.

In July 2005, the Commission presented a set of measures within its own sphere of action. The priorities established by the Commission's programme are: the creation of a true single market in services, completion of the European energy market, a reduction in the Community regulatory burden, improvement in the environment for innovation and effective liberalisation of international trade. In the second half of the year, the Member States (who retain responsibility for most of the policies necessary to achieve the final targets) submitted their National Reform Programmes, structured around five priority areas: improvement in the functioning of the labour market, improvement of the regulatory environment for business activity, promotion of educa-

**GDP, PRIVATE CONSUMPTION, EMPLOYMENT AND GROSS FIXED CAPITAL FORMATION (a)**  
**Percentage change on year ago**

CHART 1.1



SOURCES: Eurostat and national statistics.

tional reforms aiming to increase the quality of education, boosting of research and development, and the achievement of sustainable, high-quality public finances. Having analysed the contents of the programmes, the European Commission presented an Annual Progress Report on 25 January, in which it highlighted certain elements of the programmes that should serve as a reference. Further, the March 2006 ECOFIN decided to give top priority to the implementation and strengthening, where necessary, of the measures agreed in the national reform programmes.

Although the commitments achieved following this review are a reasonable starting point for strengthening the reform process, it is hard to know to what extent these proposals are sufficient instruments to achieve the targets set, given that, ultimately, the will of the political authorities and social agents is still an essential ingredient. It is most important that the full range of necessary structural reforms should be undertaken in the cyclical upswing that appears to be approaching, since in periods of more buoyant activity the potential short-term costs can be minimised.

### 3 Continuity of the domestic demand-driven expansion

Last year saw the extension of the upswing in the Spanish economy, which has continued, with more or less intensity, since the middle of the last decade. In 2005, GDP growth picked up to a rate of 3.4%, up 0.3 pp from 2004 (see Chart 1.1). Output also displayed a slightly

upward profile, to end the year with growth of 3.5% year-on-year in Q4. The expansion of the world economy provided a favourable environment for these developments, although it was somewhat qualified by the weakness that still characterised the euro area during most of the year. However, as throughout the current upswing, it was domestic factors that continued to drive activity in Spain. The buoyancy of the economy continued to attract strong immigration flows, which have, in turn, been acting as one of its driving forces.

Spain's economic results in 2005 refer to the new base 2000 National Accounts estimates, which the INE began to publish last year. These estimates have involved a notable upward revision to GDP growth, to an average annual rate of 3.7%, between 1996 and 2004, 0.4 pp above the rate estimated for the same period by the Spanish National Accounts with base 1995. The revisions were especially significant from 1999 (0.4-0.7 pp) and show that the current growth phase has reached an intensity and scale beyond what was initially estimated and that the expansionary forces have also been more powerful. In particular, the buoyancy of the population and employment, one of the factors most supportive of growth, made a larger contribution during these years than originally estimated, primarily on account of the scale of the immigration flows.

In fact, according to new data from the 2001 population census and the *"Padrón Continuo"* (a continuously updated municipal population census), the Spanish population rose between 1998 and 2005 by 4.3 million, 73% of whom were immigrants who, in 2005, represented 8.5% of the total population. The inclusion of information from these sources in EPA estimates has enabled the significance of immigration for the labour market to be quantified. Thus, the foreign labour force increased at an annual average rate of 36%, between 1998 and 2005, as against average growth in the total labour force of 3.5%, providing 46% of new entrants to the labour force. In 2005, the growth of the foreign population remained notably strong, at 23%, with no sign of any moderation vis-à-vis 2004, and the total labour force again increased by 3.2%. The intensity of these population flows has been reflected in job creation. According to the National Accounts, the number of full-time equivalent jobs grew at an average annual rate of 3.3% in the period 1996-2004 (a significant upward revision from the 2.6% rate estimated by the CNE base 1995) and in 2005 employment grew by a further 3.1% (see Table 1.1).

Monetary and financial conditions remained exceptionally favourable to spending growth. Interest rates stayed very low, despite rising in the second half of the year, while the wealth of households and businesses, in both financial and non-financial assets, rose significantly, owing to the rise in stock markets and the further rise in house prices (although this was smaller than in previous years). In general, business and consumer confidence and expectations of growth in demand and income remained high. In these circumstances, national demand increased by 5.1% in 2005, returning to rates not seen since 2000, albeit with a slight downward profile over the year.

These expansionary factors continued to sustain household consumption and residential investment, which in 2005 grew at high rates, similar to those recorded in 2004, of 4.4% and 6%, respectively. Disposable income accelerated slightly in real terms, to close to 3%, underpinned by strong job creation. For its part, the increase in household wealth was again significant, pushing the rate of growth of consumption above that of income and giving rise to a further decline in the saving ratio. In addition, the low cost of mortgage finance continued to stimulate residential investment. However, in the second half of the year some braking was discerned in the expansion of household spending, which lost momentum in line with the behaviour of some of its main determinants, such as the smaller rise in property prices and the higher cost of mortgage finance.

		2000	2001	2002	2003	2004	2005
REAL CONVERGENCE INDICATORS: (Spain/EU) (b)	Per capita GDP at current prices (in EU-25 PPPs)	92.2	93.2	95.2	97.4	97.6	98.2
	Per capita GDP (c)	96.7	97.4	97.8	98.2	97.6	98.2
	<i>Apparent labour productivity</i>	103.0	102.3	101.7	101.1	99.7	98.7
	<i>Employed as proportion of total population</i>	91.9	93.0	93.8	94.7	95.4	96.9
	<i>Population aged 16-64 / total population</i>	102.2	102.4	102.5	102.5	102.6	102.7
DEMAND AND OUTPUT. VOLUME INDICES (d)	Private consumption	5.0	3.2	2.9	2.6	4.4	4.4
	Government consumption	5.3	3.9	4.5	4.8	6.0	4.5
	Gross capital formation	6.0	4.2	3.5	5.4	4.8	6.9
	<i>Fixed capital in equipment</i>	7.1	0.1	-2.9	2.5	3.7	9.5
	<i>Fixed capital in construction</i>	6.0	6.8	6.2	6.3	5.5	6.0
	Exports of goods and services	10.3	4.0	1.8	3.6	3.3	1.0
	Imports of goods and services	10.8	4.2	3.9	6.0	9.3	7.1
	Gross domestic product	5.0	3.5	2.7	3.0	3.1	3.4
EMPLOYMENT, WAGES, COSTS AND PRICES (d)	Total employment	5.0	3.2	2.4	2.5	2.6	3.1
	Unemployment rate	13.9	10.6	11.5	11.5	11.0	9.2
	Compensation per employee	2.9	3.6	3.3	3.4	3.3	2.5
	Unit labour costs	2.8	3.3	3.0	2.9	2.8	2.3
	GDP deflator	3.5	4.2	4.4	4.0	4.1	4.4
	Consumer price index (12-month % change)	4.0	2.7	4.0	2.6	3.2	3.7
	Consumer price index (annual average)	3.4	3.6	3.5	3.0	3.0	3.4
	Consumer price differential with the euro area (HICP) (e)	1.2	1.0	1.3	1.0	0.9	1.2
SAVING, INVESTMENT AND FINANCIAL BALANCE (f)	Resident sectors: saving (g)	23.1	23.0	24.0	24.5	23.5	23.2
	<i>General government</i> (g)	2.3	2.9	3.3	3.5	3.3	4.7
	Resident sectors: investment	26.3	26.4	26.6	27.5	28.3	29.7
	<i>General government</i>	3.1	3.4	3.6	3.5	3.4	3.6
	Resident sector: domestic net lending (+) / net borrowing (-)	-3.2	-3.4	-2.6	-3.0	-4.8	-6.5
	<i>General government</i>	-0.9	-0.5	-0.3	0.0	-0.1	1.1
	General government gross debt	59.2	55.6	52.5	48.9	46.4	43.2
MONETARY AND FINANCIAL INDICATORS (h)	ECB weekly intervention rate	4.0	4.3	3.2	2.3	2.0	2.0
	Ten-year government bond yield	5.5	5.1	5.0	4.1	4.1	3.4
	Synthetic bank lending rate	5.9	5.8	4.9	4.1	3.9	3.9
	Madrid Stock Exchange General Index (DEC 1985 = 100)	994.8	853.4	723.6	706.4	863.3	1,066.1
	Dollar/euro exchange rate	0.92	0.90	0.94	1.13	1.24	1.24
	Nominal effective exchange rate vis-à-vis developed countries (i)	95.76	96.27	97.09	100.00	100.76	100.90
	Real effective exchange rate vis-à-vis developed countries (j)	96.73	98.34	100.20	104.61	107.75	109.08
	Real effective exchange rate vis-à-vis the euro area (j)	101.24	102.45	103.13	104.25	106.56	107.98
	Cash and cash equivalents	4.4	6.8	10.5	12.0	11.3	14.4
	Liquid assets (k)	8.1	9.5	8.7	8.7	7.1	11.4
	Total financing of households	17.6	12.6	16.2	19.0	20.1	21.2
	Total financing of non-financial corporations	18.1	17.4	12.4	13.5	12.9	20.1

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

a. The National Accounts data are base 2000.

b. EU=100.

c. Calculated using series at constant 2005 prices in EU-25 PPPs.

d. Rates of change, except for the unemployment rate, for which the level is shown.

e. Until December 2001 the differential is calculated using the series published on that date.

f. Levels as percentages of GDP.

g. Includes net capital transfers received.

h. Annual average levels for interest rates and exchange rates and rates of change for financial assets and liabilities.

i. 1999 H1 = 100.

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

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



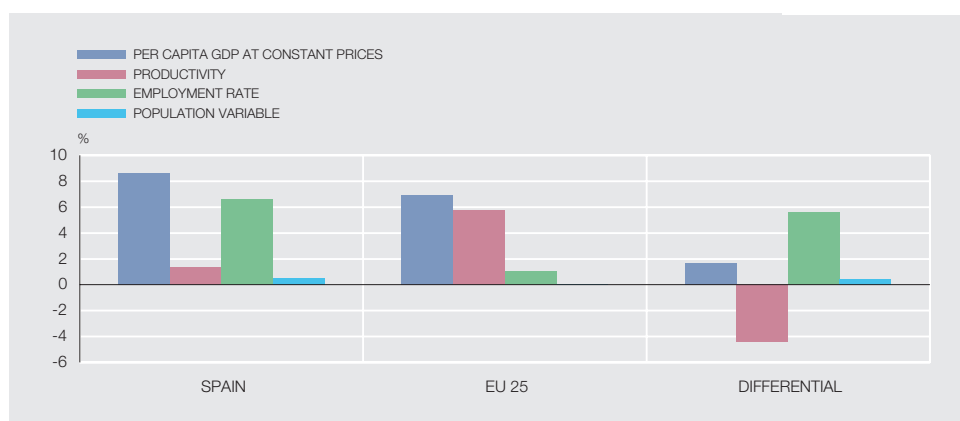
Equipment investment accelerated notably in 2005 by almost 6 pp to 9.5%. This acceleration was preceded by a strong recovery in the second half of 2004 and was sustained throughout 2005. The improvement in business investment was a result of the strengthening of activity and the economic climate that characterised 2005. This strengthening was concentrated in those sectors that make more intensive use of capital goods, such as certain services (transport and business services) and construction. The looseness that has been characterising the economy's financing conditions continued to support the growth of business investment. At the same time, public works picked up significantly last year, so that non-residential construction grew by more than in 2004.

In 2005, as in previous years, a significant portion of the strength of national demand leaked abroad, although the penetration of imports in the domestic market increased at a somewhat slower rate than in 2004. For their part, goods exports stagnated, in contrast to the dynamism of world trade, and their slackness could not be offset by the recovery in tourism. In 2005 as a whole, the negative contribution of net external demand to growth increased, although in the second half a certain decline in this effect was observed owing to the improvement in tourism and the smooth slowdown in imports which, even so, continued to increase at high rates.

To sum up, the greater buoyancy of economic activity in 2005 was accompanied by an intensification of domestic demand pressures and a larger deduction arising from external demand, against a background of strong population and employment growth, loose monetary and financial conditions and a further deterioration in price competitiveness. Only in the second half of the year was there some re-balancing of these two components of demand, assisted by the moderation of household spending. In accordance with the pattern of demand, the higher growth in activity originated in the greater buoyancy of construction and services, while industry, although also recovering, grew at a very modest rate, in line with the slackness of goods exports and increasing import penetration.

The sectoral composition of output and the increase in the labour supply largely explain why growth continued to be strongly employment-intensive and was, consequently, still characterised by very low labour productivity gains at the aggregate level, although significant discrepancies were apparent between sectors. Given the high rates of unemployment recorded by the Spanish economy in recent decades and the significant immigration flows received more recently, it is desirable that growth should, in the present situation, be job-intensive. The fact that it has been so has enabled the rate of unemployment to continue to be reduced. At end-2005, unemployment was 8.7% (the lowest rate since the late 1970s), only slightly above the euro area average. Indeed, some euro area countries, such as France and Germany, had higher rates.

One implication of this pattern of behaviour is that the progress in real convergence of the Spanish economy towards the per-capita income levels of the EU as a whole is almost entirely based on the strong rise in employment. As seen in Chart 1.2, Spain's productivity relative to the EU has declined somewhat in recent years, with an even greater widening of the productivity gap vis-à-vis the most dynamic economies, such as the United States. In the current situation, however, there is still room for the employment rate to rise further. This is, firstly, because the Spanish participation rate is still low and may rise through increasing female participation and immigration flows which, even if they lose momentum, will continue to raise average participation. And, secondly, because strong employment growth will provide for the absorption of a growing labour supply. However, in the medium term, as the gap between the employment rates of Spain and the euro area narrow, only higher productivity growth will be able to ensure continued real convergence.



SOURCE: Banco de España.

a. National Accounts, base 2000. The 2005 data are provisional.

The outlook for 2006 is one of continuity, according to the new National Accounts figures. The current year began with high growth rates; GDP growth in Q1 was 3.5%, which have continued to be underpinned by the factors driving activity in recent years, particularly the buoyancy of employment. In any case, the smooth trend slowdown in national demand that became apparent during 2005 seems to be continuing.

These trends can be expected to continue in the rest of 2006, so that growth will be on average somewhat lower than in 2005, reflecting a certain weakening of the expansionary impulses on the demand side in response to the slowdown in house prices and the somewhat less loose monetary conditions. However, there remains some uncertainty, recently aggravated by the growing tension in international oil markets, over the intensity of the slowdown in domestic spending and the moderation of the draining effect exerted by net external demand. Within this setting, continued upward pressures on prices, like those seen in the first few months of the year, and continued widening of the external imbalance cannot be ruled out.

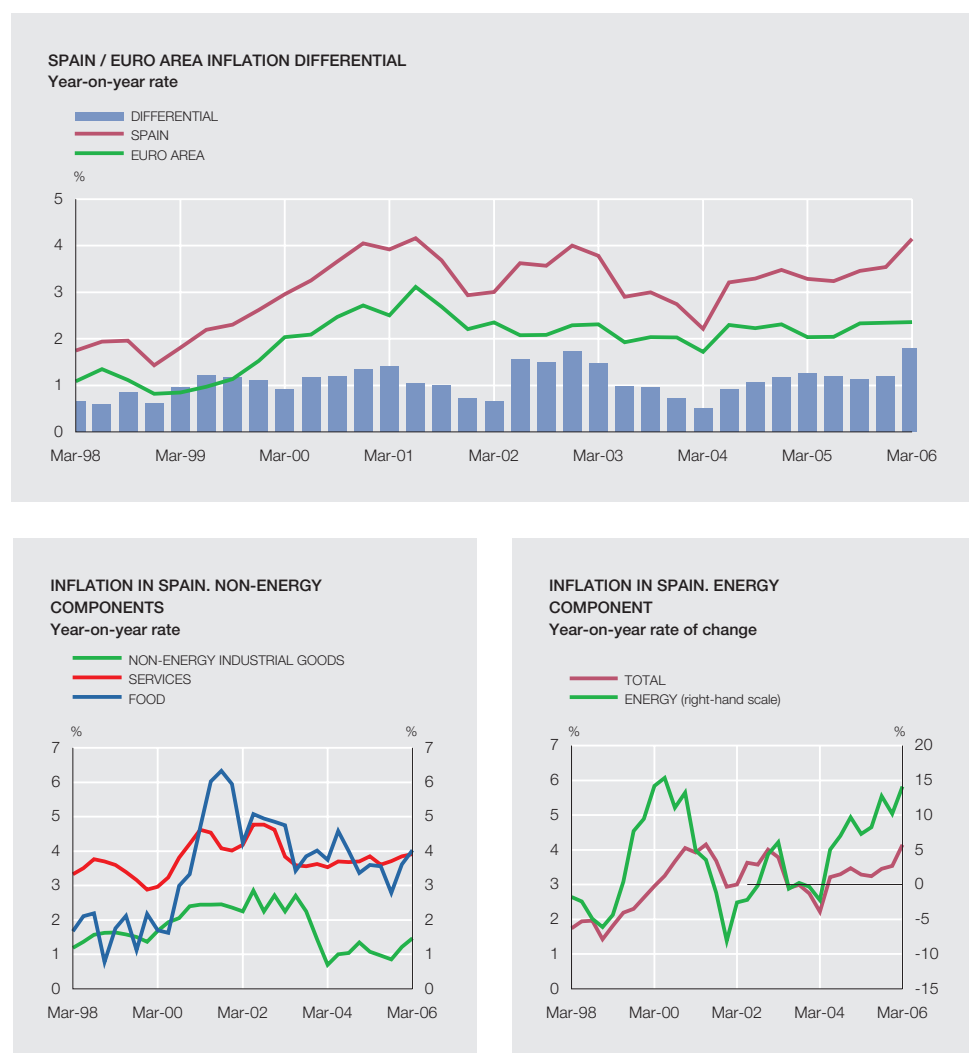
To ensure the sustainability of growth in the medium and long term it is therefore necessary to correct the imbalances generated by a national-demand-based pattern of growth. The following section analyses the most significant risks.

#### **4 Nature and scope of the risks generated by the continued pressure of demand**

The buoyancy of national demand in 2005, described in the previous section, enabled the long period of expansion of the Spanish economy to be prolonged. However, it also sustained and stoked the imbalances that had been accumulating, driving price pressures, the deterioration in competitiveness, the foreign deficit and private-sector indebtedness.

The growth in spending at a higher rate than can be satisfied by supply under stable conditions has generated inflationary pressures, although the composition of domestic spending, with the demand for consumer goods and services and investment in construction having a significant weight, is consistent with a high inflation rate too. In addition, this rise has led to a widening of the inflation differential with the euro area, where inflation was influenced by relatively weak demand for much of last year.

The consequent deterioration in price competitiveness (along with the strength of spending) was reflected in a substantial increase in the external deficit which, in 2005, reached its highest level since the mid-1970s, pushing the nation's net borrowing to historic highs.



SOURCE: Eurostat.

This basically reflects the sharp increase in net borrowing by businesses and, especially, households, which stems from the fact that private spending increased by more than income.

If these imbalances continue to grow, it will eventually be difficult for the buoyancy that has characterised the Spanish economy since the mid-1990s to be sustained in the medium term, so it is vital that their scope be confined and their possible implications identified.

#### 4.1 INFLATIONARY PRESSURES AND THE DETERIORATION IN COMPETITIVENESS

Inflation remained high in 2005 (at an annual average rate of 3.4%, both in terms of the CPI and the HICP), even rising somewhat from the level of the previous two years. Prices accelerated more rapidly than in the euro area, so that the inflation differential (as measured by the HICP) widened by 1.2 pp on average in 2005. The increase in inflation was particularly sharp in late 2005 and early 2006: specifically, in Q1 of this year, inflation stood at 4%, 1.8 pp higher than in the euro area, although the differential can be expected to narrow during the year (see Chart 1.3). These developments were the result of intense demand pressure and an insufficient supply side response capacity, reflecting both a certain cyclical component and the structural rigidities that prevail in some markets.

From the standpoint of price formation, in 2005 there was a reduction in the rate of change of compensation per employee, to 2.3%, owing to the hiring of workers with below-average wage and productivity levels, since wage settlements were unchanged at around 3% and the indexation clauses relating to the previous year were activated, adding 0.6 pp to settlements. In any event, the rate of growth of compensation per employee continued to be higher than in the euro area, while productivity gains continued to be lower, so that average unit labour costs grew by 1.5 pp more in Spain than in the euro area. In the case of manufactures, where production is more sensitive to cost pressures owing to the intensely competitive environment, the differential was still higher, since the rate of growth of unit labour costs in Spain was more than 2 pp higher than in the euro area. Meanwhile, the difference in the gross operating surplus per unit of output also increased in 2005, in all productive sectors, although it was significantly larger in those less exposed to international competition, such as construction and services. In fact, although the mark-up in manufacturing improved in 2005, the increase was smaller than in the same sector in the euro area.

These differences in price formation across productive sectors are largely reflected in consumer prices. The deterioration of the inflation differential vis-à-vis the euro area cannot be exclusively attributed to the rise in oil prices, since the direct effect of higher energy prices on the HICP was somewhat lower in Spain than in the euro area. In fact, the bulk of the differential vis-à-vis the euro area is explained by the strong inertia of Spanish underlying inflation, which is, in turn, strongly influenced by the persistent duality manifest in the fact that the rate of increase in services prices is strongly resistant to falling significantly below 4% (1.5 pp above the euro area), while the prices of non-energy industrial goods increase at a rate of 1%. Moreover, in 2005, food prices continued to rise faster in Spain: in the case of unprocessed food, the differential vis-à-vis the euro area narrowed, but still remained significant (2.5 pp), while the rate of increase in processed food prices was 1.5 pp higher than in the euro area. All this shows that the high rate of Spanish inflation originates, above all, in sectors that are sheltered from foreign competition or insufficiently liberalised, such as the wholesale and retail trade and other services. The rigidity in these sectors, along with the indexation mechanisms that exist, facilitates the transmission of demand pressures to the rate of growth of prices.

The accumulation of inflation differentials year after year has been generating a Spanish competitiveness gap, which is apparent in the trends in relative consumer prices and unit labour costs or producer prices. In the case of export prices, changes in Spain had been relatively moderate in recent years, and more in line with those of our competitors, as cost pressures were offset by the containment of margins in the export sector, but in 2005 these prices also grew at substantially higher rates than in competitor countries, leading to a deterioration in Spain's export shares.

In principle, losses of competitiveness act as a mechanism to correct excess demand, because the deduction from growth made by the external sector limits the expansion of household and business income and tends to curb spending. However, when there are no significant restrictions on the financing of the external deficit, as in the case of a monetary union, this form of adjustment exerts its effects notably slowly, as shown by the persistent strength of demand in the case of Spain. In consequence, the loss of competitiveness cannot be expected to correct these disparities by itself. Meanwhile, it should be noted that the effects generated by these processes can be difficult to reverse, given the likely existence of hysteresis, which hinders the recovery of foreign markets once national exports have declined in certain countries or markets. Even more relevant, from the viewpoint of its implications, is that the restoration of levels of competitiveness within a monetary union, where there is no possibility of adjusting the exchange rate, requires highly flexible prices and wages or rapid increases in productivity,

which are not usually possible in the short term, particularly when, as is desirable, employment is highly buoyant.

#### 4.2 THE INCREASE IN PRIVATE- SECTOR NET BORROWING

The main factors to be found behind the strong demand pressures upon which the prolonged expansion of the Spanish economy has been based also explain why businesses and households continue to finance a large part of their spending out of expected future income. Thus, the macroeconomic stability delivered by membership of the euro area, expectations of income growth and financing conditions that were notably loose last year continued to drive private-sector indebtedness.

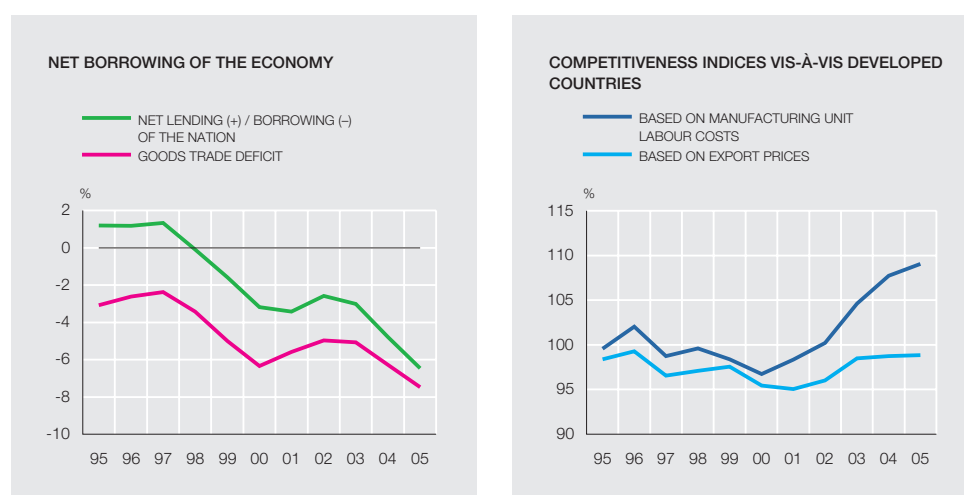
The financing received by companies increased at rates of around 20%, which gave rise to further growth in aggregate debt ratios and in the associated debt burden. This growth is partly linked to the recovery in equipment investment and is a reflection of the behaviour of industrial companies, whose debt and debt burden levels, at the beginning of last year, were below those of the sector as a whole. Also, the expansion in funds raised has taken place at the same time as the completion of the balance-sheet restructuring undertaken by large corporate groups in recent years, of which there are increasingly clear signs. However, those businesses linked to construction and property development and property services were those that continued to act as the main engine of growth in business credit.

The increase in the financial pressure on companies as a result of their higher debt ratio and debt burden was partly offset by their favourable results, which were especially positive in the case of the largest ones. The available aggregate indicators of pressure on investment and employment thus display slight rises. However, both remain at levels that may, from an historical perspective, be considered reasonably comfortable. Consequently, the main elements of uncertainty in the medium term according to an analysis of the financial situation of Spanish firms continues to be linked to possible changes in the cost of financing their growing volume of debt and to real-estate market developments.

On the property market, house prices again recorded double-figure growth (12.8%) at end-2005, but it was around 4 pp lower than a year earlier. This slowdown, which continued in the first quarter of this year, is a departure from the trends of previous years and increases the likelihood that the margin of overvaluation existing in this market can be reabsorbed in an orderly manner over the coming years. For this scenario, which continues to be the most plausible, to materialise effectively, further progress will need to be made in gradually reducing a rate of property inflation that is currently still too high.

The growth in house prices, on the other hand, along with the vigorous demand for these assets, continued to stimulate the increase in household financing, which grew at rates similar to those experienced in the case of companies and was mostly channelled towards spending on residential investment. Indebtedness and the associated debt burden thus followed a clearly upward path and the already scant cushion of savings available to households to withstand possible adverse shocks without needing to reduce their level of spending was thus squeezed a little more. Accordingly, there was a further increase in 2005 in the exposure of the sector to the possibility of unexpected unfavourable changes in employment, interest rates or property prices that have been referred to in previous reports. This growing exposure (most marked in the case of lower-income indebted households) is, however, compatible with the solidity of their financial position. In fact, the latter was once again strengthened by the rise in the value of financial and real assets.

In short, therefore, the changes in the financial situation of households and businesses in 2005 involve some additional elements of uncertainty regarding the medium-term trend in consump-



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

tion and investment expenditure and, to a lesser extent, in investment and hiring by companies. Their relevance, on the other hand, is increased in a setting in which it is more likely than in the immediate past that interest rates will move progressively towards levels consistent with a more neutral monetary policy stance and that house prices will move in greater unison with the fresh changes that may occur in their basic determinants.

That said, these elements of risk are still within relatively moderate margins. First, because the growing exposure of the private sector has occurred in parallel with an increase in its wealth. And second, on account of the continued strength of the Spanish banking system, which is the main creditor of Spanish businesses and households. Its levels of profitability and solvency put it in a favourable position to absorb the potential impact on its balance sheet of possible adverse shocks like those mentioned, without jeopardising the financial stability of the Spanish economy and without it generating additional elements of pressure on the private sector's spending and hiring decisions.

#### 4.3 THE WIDENING OF THE EXTERNAL IMBALANCE

The deterioration in competitiveness and the increase in private spending have been reflected in a growing external deficit and in the nation's heavy net borrowing. And this has occurred despite the fact that the public sector has reversed its traditional role as a demander of funds, by reducing and then eliminating its budget deficit. In fact, the public sector, through its fiscal consolidation, which culminated in a surplus of 1.1% of GDP in 2005, has helped to reduce the impact of the growing borrowing requirements of companies and households on the nation's financial position vis-à-vis the rest of the world.

Whatever concept of external deficit is taken, the deterioration since 2003 in the external accounts of the Spanish economy is substantial. During these two years the trade deficit has increased by 2.4 pp of GDP, the current account deficit by 3.3 pp of GDP and the nation's net borrowing by 3.5 pp of GDP, to 6.5% of GDP in 2005 (see Chart 1.4). To put this rapid increase in the balance of payments deficit in historical perspective, Box 1.1 examines the changes in the main items of the balance of payments over recent decades and the latest trends.

Part of the deterioration in the trade balance since 2003 is explained by the significant rise in oil prices. Although the future course of energy prices is shrouded in uncertainty, the strong world demand for oil and the difficulties there appear to be for supply to meet that growing

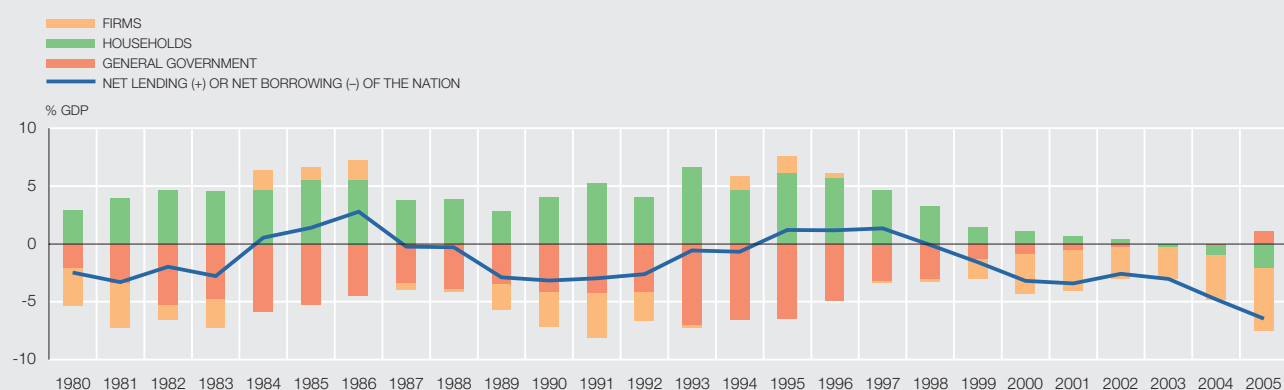
Historically, the expansionary periods of the Spanish economy have characteristically been accompanied by a deterioration in the external balance, this being reversed (generally through an exchange rate devaluation) when the net borrowing requirement reached a considerable size, normally around 3% of GDP. However, in the current expansionary phase, the net borrowing requirement is rising in a more prolonged and sharper manner. In the second half of the 1990s, after Spain joined the euro area, the external balance, which had been showing a surplus, once again moved into deficit and reached 3.2% of GDP in 2000, close to the highs seen in the previous three decades. Following a slight dip in 2001 and 2002, the nation's net borrowing requirement rose once again in 2005 to stand at a historical high of 6.5% of GDP. Unquestionably, membership of the euro area is the distinctive factor which enables the Spanish economy to sustain an external imbalance of this size without straining the financial and exchange markets.

The first chart shows that the external balance deteriorated particularly sharply in 2004 and 2005 because of a worsening in the balance of the items that had traditionally offset the trade deficit, which continued to rise following the deterioration seen in previous years,

reaching 7.6% of GDP compared with 5.1% in 2003. Thus the surplus on the tourism balance decreased from the high in 2000 as a result of the scant growth of tourism revenue and, in particular, of the growing expenditure by Spanish tourists abroad. As remarked in the main text, the increase in the trade deficit and the behaviour of the tourism surplus in the last two years are partly a reflection of certain transitory factors, but they also evidence a problem of loss of competitiveness.

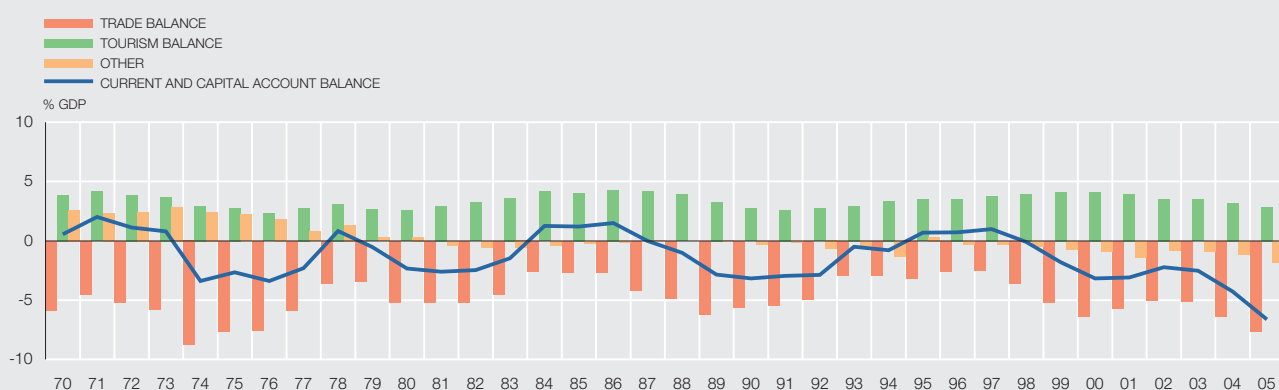
Regarding the other components of the current and capital accounts, their overall balance, which was positive in the 1970s and stayed roughly in balance in the following two decades, underwent additional deterioration from the end of the 1990s, reaching levels of nearly 2% of GDP. Contributing to this were the fall in the non-tourism services balance (which went into slight deficit, although lately it has recovered somewhat), the worsening of the income account (because the debit balance of the international investment position meant higher net outward payments of interest) and the decrease in the current transfers surplus, linked to the growing size of remittances sent by immigrants to their countries of origin and to the decrease in transfers from the EU. This latter factor also explains the fall-off in the

#### NET LENDING (+) OR NET BORROWING (-) BY SECTOR



SOURCES: INE and Banco de España

#### EXTERNAL BALANCE. COMPONENTS



SOURCES: Ministerio de Economía and Banco de España.



surplus on capital transfers. Most of these changes have a structural component, so the lower coverage of the trade deficit by other items may be regarded as largely permanent.

The deterioration of the external balance has its domestic counterpart in the saving and investment decisions of resident agents. In recent years, the rate of saving of the Spanish economy has remained relatively steady at around 24% of GDP, with a slight fall in 2004 and 2005. The ratio of investment to output has shown a rising trend since the mid-1990s, with a particularly pronounced slope in the last few years. Hence in 2005 the weight of investment in GDP amounted to nearly 29%, its highest level in the last 25 years. From the standpoint of the institutional sectors, this trend in overall saving and investment is the result of widely disparate behaviour in each of them, which has given rise to significant changes in their net borrowing or lending.

First, mention may be made of the change in the public sector's contribution to the nation's net borrowing requirement. The process of fiscal consolidation under way since the second half of the 1990s has resulted in a rise in public saving from -2.7% of GDP in 1995 to 4.7% of GDP in 2005, while the weight of general government investment in GDP has held steady in the same period, allowing the deficit of 6.5% of GDP in 1995 to give way to a general government surplus of 1.1% of GDP in 2005.

Hence the recent increase in the economy's net borrowing requirement originates in the saving and investment decisions of firms and

households. Spanish firms were net lenders in the 1990s. However, at the end of that decade, against a background of interest rates that were by then already very low, saving by firms decreased and their investment increased. The negative gap between these two magnitudes held at between four and five percentage points of GDP until 2004, and then widened to 6.8% in 2005, fuelled by a further rise in investment.

However, the most important counterpart of the recent increase in the external deficit is unquestionably the appearance of similarly growing household net borrowing. Until the end of the 1990s, households showed net lending similar to their historical average, i.e. nearly 5% of GDP. From then on, owing to the surge in house purchases, investment by this sector rose continuously to slightly above 9% of GDP in 2005, whereas the rate of saving declined against a backdrop of low interest rates and notable appreciation in real estate wealth. The prolongation of these trends has progressively reduced the financial balance of this sector, which has been negative since 2003.

In short, the external deficit of the Spanish economy has reached historical highs in the last few years. These mainly reflect a sharp rise in the trade deficit, which may start to constrain the ability of the Spanish economy to generate income in the future. From the standpoint of resident agents, the deficit is the result of a growing gap between private sector saving and investment, which has given rise to a rapid increase in household and corporate indebtedness, and which has not been offset by the improvement in general government accounts.

demand flexibly make it unlikely that spending on energy will fall, so that trade in energy may continue to reduce the trade balance of the Spanish economy by around 3 pp of GDP. An in-depth examination of the sources of energy used by Spain and the efficiency of their use is needed, since it is possible that an excessive reliance on oil and a low degree of efficiency in its use may be overburdening both the external deficit and business costs.

Spain's more advanced cyclical position relative to its main trading partners (who belong to the euro area) may also be responsible for part of the large external deficit, since the buoyancy of Spain's export markets has been reduced by the weakness of euro area demand. Moreover, the greater vigour of equipment investment in Spain in 2004 and, especially, in 2005, which has a higher import content than any other kind of investment, also helps explain the recent increase in the trade deficit.

However, a significant part of the large external deficit seems to be attributable to factors relating to the economy's competitiveness, which need to be countered by policies capable of reversing current trends. The competitiveness problems arising from the pressure of demand have been aggravated by the composition of Spanish foreign trade in terms of products and geographical areas (highly concentrated in euro area countries), which means that the potential growth of Spanish exports is less than that of world markets as a whole. In this respect, the cumulative competitiveness losses and the emergence of new competitors on the world stage have checked Spain's foreign sales, while facilitating import penetration.



The offsetting potential of other relevant items of the balance of payments, like travel and the transfers balance, which traditionally served as a counterweight to the regular trade deficit, has been reduced as a consequence of the intense growth of external travel payments, the increase in immigrants' remittances abroad and the smaller flow of transfers from the EU. Also, the large external deficit has been reflected in growing net capital income payments, which it will be difficult to curb given the large accumulated external imbalance and its foreseeable inertia.

The nation's net borrowing has reached very high levels, certainly the highest in recent decades. However, it should be pointed out that monetary union membership has significantly changed the nature and possible consequences of this imbalance. Specifically, balance of payments financing problems should not be expected to arise, as the most important financial variables, like the interest rate and the exchange rate, are determined for the euro area as a whole and are barely affected by developments in the Spanish economy. National exchange risk has disappeared as a determinant of the decisions of investors, whose focus of attention in the new macroeconomic regime is the financial position of borrowers. In this respect, the financial balance sheets of households, firms and, above all, financial institutions, the agents who intermediate a large part of external borrowing, show a basically healthy position (see Box 1.2).

Despite this, the growing net borrowing of the nation is indicative of a pattern of growth that cannot be sustained indefinitely, particularly if productivity does not become more dynamic. Should these trends continue, the private sector will have to devote an increasingly high proportion of its income to debt service, while agents' vulnerability to changes in any of the basic variables on which their spending decisions hinge, such as interest rates, income, employment and, in the case of firms, demand prospects, will be increased.

## **5 The task of economic policy**

The challenge for economic policy is to ensure a sustained growth path that enables the increases in the participation and employment rates that may arise in an expansionary demographic setting to continue to be absorbed, and to adjust the productive structure of the Spanish economy to the challenges posed by an increasingly competitive and globalised international environment. All this requires the economy to function more efficiently and flexibly, facilitating the adaptation of productive processes and the adjustment of product and factor markets to the new demands. This is particularly important in the current situation of the Spanish economy, so as to curb the growth of the imbalances generated by the pressure of demand and to help redress them. However, given the time lags involved in measures to improve the response capacity of supply, it is essential that the available room for manoeuvre in relation to expenditure management policies, even if limited, be used appropriately.

The Spanish economy has had very large external imbalances in the past, but those experiences are not relevant to the current juncture; participation in Stage Three of EMU, as already mentioned, has substantially modified the rules of macroeconomic behaviour and the relative role of the various economic policy instruments available to address this type of situation. The external constraint does not operate immediately and integration into a supra-national monetary area tends, to some extent, to limit the margins for divergence. There is considerable uncertainty, however, as to how the adjustment mechanisms operate and as to the intensity and pattern of the correction of imbalances within a monetary union.

At the current juncture, the change in the stance of the single monetary policy, which points to a gradual correction of the expansionary orientation of recent years, is in line with the requirements of the Spanish economy. The moderate interest rate rises must help the slowdown in credit and the gradual absorption of the overvaluation of housing, and may also contribute to

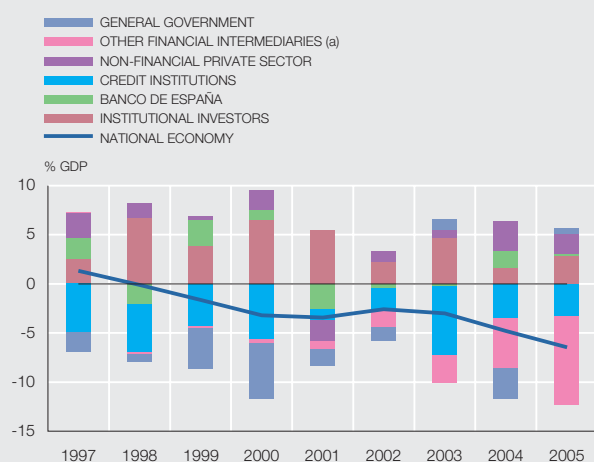
The Spanish economy's net borrowing requirement has been growing since 1997. The net funds raised abroad have thus financed the excess of domestic spending over domestic saving, which was more than 6% of GDP in 2005.

The trend in Spain's external financial flows in recent years has to a large extent been linked to structural factors such as the deregulation of capital movements, the internationalisation of Spanish firms and the development of the finance industry. However, the most important change derives from Spain's participation in the euro area. The adoption of the euro has broken the direct link between the nominal exchange rate and possible national macroeconomic imbalances, as well as eliminating exchange risk between the member countries of

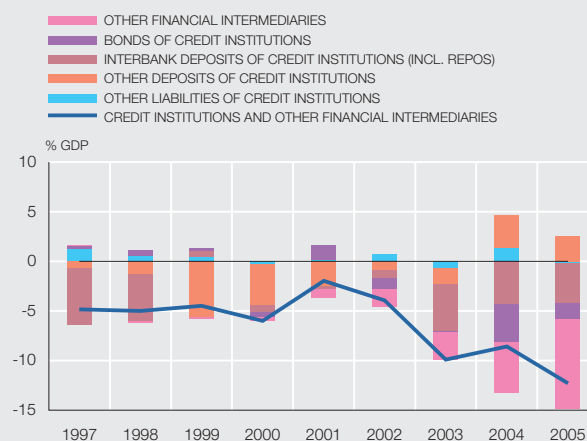
the euro area. As a result, the cost of raising cross-border financing has decreased and has come to depend largely on the financial soundness and credit quality of the borrowers, on the characteristics of the instruments used and on the depth of euro capital markets, and less on the general situation of the economy.

The vigorous corporate and household spending has been compatible with sizeable flows of foreign asset purchases, and this has generally resulted in a credit balance in their net transactions with non-residents (see first panel of Chart 1). In line with the trend in the general government deficit, the inflow of foreign saving via Spanish public debt securities has been less significant since 2001 (even becoming negative in 2003 and 2005). Against this background, financial inter-

### 1 NET EXTERNAL FINANCIAL FLOWS: SECTORAL BREAKDOWN



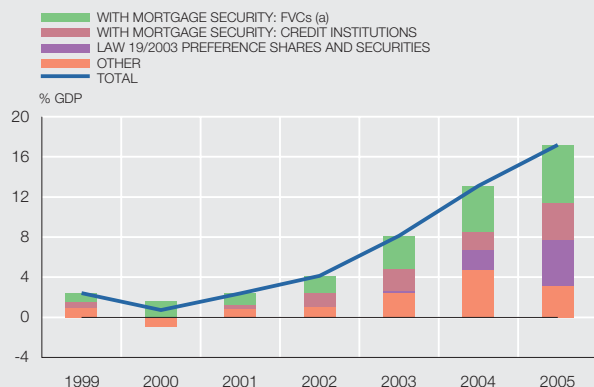
### 2 NET EXTERNAL FINANCIAL FLOWS: CREDIT INSTITUTIONS AND OTHER FINANCIAL INTERMEDIARIES



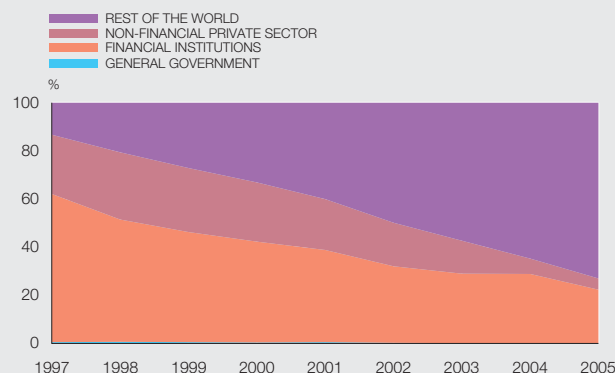
SOURCE: Banco de España

a. These include financial vehicle corporations, financial auxiliaries, securities-dealer companies, venture capital companies and funds, financial holding companies and SPVs issuing preference shares.

### 1 NET ISSUANCE OF BONDS BY CREDIT INSTITUTIONS AND OTHER FINANCIAL INTERMEDIARIES



### 2 ISSUES OF CREDIT INSTITUTIONS AND FINANCIAL INTERMEDIARIES: DISTRIBUTION BY HOLDER



SOURCE: Banco de España

a. FVCs holding securitised mortgage assets.

mediaries, particularly credit institutions<sup>1</sup> and financial vehicle corporations, have played a major role in raising the required foreign capital.

Credit institutions and, above all, other financial intermediaries (OFIs),<sup>2</sup> which include financial vehicle corporations, financial auxiliaries, securities-dealer companies, venture capital companies and funds, financial holding companies and SPVs issuing preference shares, substantially increased their recourse to external saving from 2002 onwards and recorded net flows equivalent to 3% and 9%, respectively, of GDP in 2005 (see second panel of Chart 1). Analysis of the instruments used to raise these funds reveals that the transactions of credit institutions' in the interbank market have held at a notable volume in these last three years, which has, however, coexisted with recourse

to long-term fixed-income securities (second panel of Chart 1). Noteworthy among the latter are those backed by mortgages, as shown by the first panel of Chart 2. In the case of OFIs, this same chart also illustrates the significant and growing relative weight of mortgage-backed securities. Overall, the bond issues of these financial institutions exceeded 17% of GDP last year, of which around 55% related to the mortgage market. The demand for these securities by the rest of the world has been very high and at end-2005 non-residents held 73% of the outstanding balance, against 40% in 2001 (see second panel of Chart 2).

Hence the indebtedness of Spanish financial institutions via long-term issues, particularly those backed by mortgage loans, have played a central role in channelling saving from the rest of the world, especially in the last three years. This means that, on the one hand, the risks associated with mortgage loans have to some extent been transferred to foreign investors, and that, on the other, the cross-border financing conditions of the Spanish economy may to some extent be sensitive to developments in real estate markets in Spain.

1. Including deposit institutions, specialised credit institutions and official credit but excluding the Banco de España. 2. Note that this definition differs from that of the Spanish National Accounts, which includes collective investment institutions (except money market funds) and excludes financial auxiliaries.

the necessary containment of spending on consumption and residential investment, being conducive to a certain re-balancing of the pattern of spending. However, a moderate rise in nominal interest rates, which will foreseeably continue to be relatively low, in real terms, for the specific situation of the Spanish economy, cannot be expected to be sufficient to correct the trends underlying the imbalances. As a result, decisive action is necessary in the area of policies under national responsibility.

Accordingly, it is important that the stabilising function of budgetary policy should continue to be exploited, to help cushion the pressure of private sector demand and absorb the imbalances that have been generated. This is particularly necessary in prolonged expansionary phases, when there is a risk that the buoyancy of revenues may lead to questioning of the need to persevere with the drive to contain spending. As recent European experience has shown, achieving sufficiently sound fiscal positions during cyclical upturns is the best strategy to ensure that fiscal policy is capable of having a stabilising effect during less favourable stages of the cycle, without compromising budgetary stability.

The latest data for the general government accounts in 2005 show a surplus of 1.1% of GDP and a debt/GDP ratio of 43.1%, figures that are sufficiently illustrative of the degree of soundness of Spanish public finances, especially when comparing with most other EU countries. According to this information, fiscal policy had a moderately contractionary influence on national demand in 2005, primarily as a consequence of highly buoyant tax revenues, which were boosted by the vigour and composition of domestic spending. To strengthen the stabilising role of fiscal policy, at a minimum, any revenues that may arise in excess of budget projections must be used, as in 2005, to improve the general government balance relative to the figures included in the latest Stability Programme Update for the coming years.

The fiscal policy requirements become more demanding when the medium-term challenges facing the Spanish economy are considered. On one hand, in order for the public sector to

contribute to modernising and improving the efficiency of the economy, the quality of public revenues and expenditure needs to be improved, in line with some of the actions undertaken by the government within the framework of the National Reform Plan. On the other hand, public finances need to be in sufficiently good shape to meet the challenges arising from population ageing, not only in terms of spending on pensions and health, but also the borrowing requirement that will be generated by dependency expenditure. It should be taken into account that the longer the adoption of the necessary social welfare reforms is delayed, the greater the fiscal adjustment that will be required, despite the substantial increases recorded in recent years in the Social Security reserve fund and the greater margin of sustainability provided by the significant reduction in the public debt/GDP ratio (see Box 1.3).

A number of changes to the institutional structure of the Spanish economy must be addressed, the final outcome of which is important to ensure budgetary discipline and avoid, in the short run, the risks of a looser fiscal policy, which would tend to complicate the slowdown in domestic demand. Following their recent reform, the Budgetary Stability Laws establish a suitable framework for promoting the maintenance over time of sound public finances. At the same time, they provide for a sufficient margin of cyclical flexibility in their application, which is consistent with the stabilising function of fiscal policy. It is important, however, to reduce as far as possible the risks that may arise from the application of the rules established in those cases in which regional and local governments are allowed to maintain a certain margin of deficit and to ensure that the co-ordination mechanisms established do not give rise to pressures to increase public spending. More generally, it is most important that any changes made to the regional government financing arrangements should be fully consistent with the objective of budgetary stability. Finally, the reform of direct taxation, currently before parliament, involves some improvement to the incentives to allocate resources efficiently and, through this channel, for potential growth. It is expected to have a moderate impact on revenues, so that the potential risks for budgetary stability are limited.

In any case, although fiscal policy may help to moderate the imbalances in the Spanish economy, there is limited leeway available for it to stabilise private spending. Moreover, as already mentioned, monetary policy cannot be expected to make a significant contribution to that task in the immediate future. Accordingly, if competitiveness is to be improved, then aggregate demand policies need to be supplemented by supply-side policies to help promote greater flexibility in cost and price formation and to cut the productivity gap that handicaps the Spanish economy.

The existence of competitiveness problems, when the exchange rate is fixed (as in the euro area) and when increases in apparent labour productivity are systematically very low, means that the functioning of the labour market and its influence on cost formation are especially important. As seen in previous sections, wage and unit cost increases have in recent years been higher in Spain than in the euro area, although from an historical perspective they have undoubtedly moderated. However, there are also structural rigidities bearing on price and margin formation in the sectors most sheltered from competition, which underlie dual inflation and the deterioration in competitiveness.

Certain characteristics of the labour market, and in particular of the collective bargaining system, limit the flexibility that is needed if wages are to grow more in line with productivity. The framework agreements for collective bargaining, as currently structured, tend to produce uniform wage increases across the economy, with little sensitivity to the specific situations of sectors and companies, and establish a floor for pay increases that may be excessive in circumstances of competitiveness losses. Also, the widespread existence of

In 2003 the ECOFIN Council mandated the Economic Policy Committee to update the earlier projections of the impact of population ageing on public expenditure in EU countries. The results of this exercise, released in February 2006, cover the period 2004-2050 and are based on a set of homogeneous assumptions about demographic and economic trends in the EU countries. However, in the case of pension expenditure, the projections were made using national models, which take into account the specific features of the different pension systems, under the assumption that the current regulatory framework will remain in force.

According to the underlying demographic projections, which were made by EUROSTAT for this exercise based on harmonised criteria for the EU countries, the population age pyramid will change radically in the coming decades. For the euro area on average, the weight of working-age individuals in the total will fall from 67% to 56% in 2050, while the proportion represented by those over age 65 will increase from 17% in 2004 to 30% in 2050 (see accompanying table).

The phenomenon of ageing will be common to all the euro area countries. However, its magnitude will differ notably among the Member States. Thus the effects will be particularly sizeable in Spain, where, starting from very similar levels to those of the euro area as a whole in 2004, the projection is that the fall in the weight of the working-age population and the rise in the population over age 65 will both be 5 pp higher than in the euro area.

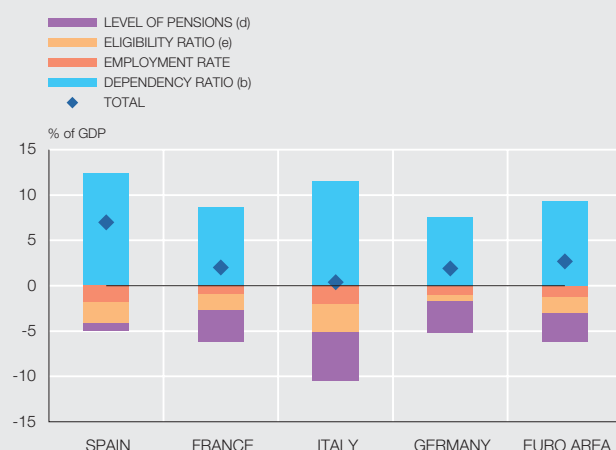
As a result of this demographic trend, spending on pensions will grow considerably. At present, the expenditure on this budget item in Spain amounts to 8.7% of GDP, nearly 3 pp below the euro area average. However, the report concludes that by the end of the projection period expenditure is expected to rise by only 2.7 pp in the euro area, whereas it will increase by 7 pp in Spain.

The trend in pension expenditure as a percentage of GDP can be broken down into the contributions from four different factors (left-hand panel of accompanying chart). The first is the change in the old

# 1 DEMOGRAPHIC VARIABLES AND PROJECTIONS OF EMPLOYMENT AND SPENDING ON PENSIONS

	2004					2050					Change between 2004 and 2050				
	Spain	France	Italy	Germany	Euro area	Spain	France	Italy	Germany	Euro area	Spain	France	Italy	Germany	Euro area
Life expectancy (a)	80.0	79.8	80.3	78.9	79.4	84.5	85.1	85.3	84.4	84.7	4.5	5.3	5.1	5.5	5.3
Fertility rate	1.30	1.89	1.31	1.35	1.49	1.40	1.85	1.40	1.45	1.56	0.10	-0.04	0.09	0.10	0.07
Working age population	68.8	65.1	66.5	67.3	66.9	53.3	57.5	54.5	57.9	56.5	-15.5	-7.7	-12.0	-9.4	-10.4
Population aged 65 and over (% total population)	16.8	16.4	19.2	18.1	17.3	34.9	26.7	33.8	30.0	30.3	18.1	10.4	14.7	11.9	13.0
Dependency ratio (b)	24.6	25.2	28.9	26.8	25.8	65.6	46.4	62.2	51.7	53.6	41.0	21.2	33.3	24.9	27.8
Employment rate (c)	59.7	63.1	57.2	65.4	62.9	71.4	68.0	65.7	73.5	70.5	11.7	4.9	8.5	8.1	7.6
Expenditure on pensions (% of GDP)	8.6	12.8	14.2	11.4	11.5	15.7	14.8	14.7	13.1	14.1	7.1	2.0	0.5	1.7	2.6

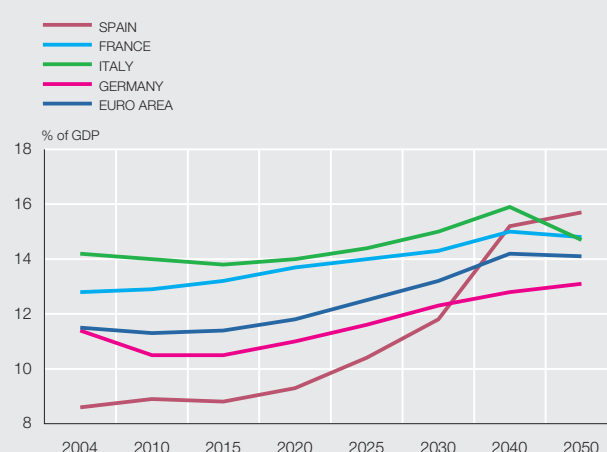
## 2 CONTRIBUTION OF DIFFERENT FACTORS TO THE CHANGE IN SPENDING ON PENSIONS BETWEEN 2005 AND 2050



SOURCE: European Commission

- a. Average for men and women.
- b. Population aged 65 and over as a percentage of the working age population.
- c. The 2004 data are actually for 2003.
- d. Average pension divided by labour productivity.
- e. Number of pensions divided by population aged 65 and over.

## 3 PUBLIC SPENDING ON PENSIONS BETWEEN 2005 AND 2050



age dependency ratio (ratio of the population aged 65 and above to the working-age population), which captures the effect of population ageing. Because of the particular intensity of ageing in Spain, this factor contributes 12.4 pp to the increase in the ratio of pension expenditure to GDP.

A second factor is the benefit ratio, obtained as the ratio between the average pension and the output per employee (which approximates the average wage). The numerator reflects the impact of indexing rules on pensions, the changes in the length of the contribution period and the pattern of past contributions, while the denominator measures productivity growth. This factor partially offsets the demographic impact, although its contribution to the decrease in the ratio of pension expenditure to GDP is very moderate in Spain (−0.8 pp).

The last two factors determining the increase in pension expenditure as a percentage of GDP are the employment rate (number of employed divided by working-age population) and the eligibility ratio (defined as the number of pensions relative to individuals over age 65). These two factors will also offset the impact of population ageing on public expenditure. Specifically, the increasing employment rate used in the macroeconomic assumptions would reduce expenditure by 1.8 pp, while the fall in the eligibility ratio would account for a reduction of 2.3 pp, despite the fact that this ratio is expected to increase in the coming decades for retirement pensions. Consequently, the negative contribution of the eligibility ratio is explained by the projected change with respect to the number of disability and survivor's pensions.

The disparity between the increase, measured as a percentage of GDP, in Spanish pension expenditure and the euro area average is mainly due to the faster ageing of the Spanish population and to the projected trend in the benefit ratio. The contribution of the dependency ratio will amount to 9.3 pp on average in the euro area, 3 pp less than in Spain, while the benefit ratio will reduce average euro area pension expenditure by 3.1 pp. In particular, the larger negative contribution of this latter ratio in the main euro area countries is largely due to the reforms that have begun to be implemented in their respective public pension systems. The employment and eligibility ratios also partially offset the increase in pension expenditure in the euro area, by 1.3 pp and 1.8 pp, respectively.

It should be mentioned that, although the calculations give an order-of-magnitude estimate of the size of the challenge facing euro area public finances in the coming decades and of its main determinants, the projections used as a basis for assessing the impact of ageing incorporate a large degree of uncertainty, particularly in regard to the demographic outlook. In this respect, the population projections prepared by EUROSTAT reflect, in the case of Spain, a more unfavourable scenario than that deriving from the projections prepared by the INE. This is basically because the latter assume larger net migrant inflows throughout the projection period. Note that the partial information available for 2005 would give population figures nearer to the INE scenario, and this may indicate that the Eurostat projections for the initial years of the time horizon in question are, to some extent, obsolete. In any event, it is unquestionable in the Spanish case that the budget effects deriving from ageing will be marked and that the decrease in cost resulting from higher migrant inflows, such as those projected by the INE, will be small in the long term since they would put the old age dependency ratio at slightly above 55% in 2050.<sup>3</sup>

Subject to the cautions mentioned above, these projections allow a reasoned assessment of the risks posed by this factor to the sustainability of public finances and of the implications for the formulation of medium-term fiscal objectives. As regards specific economic policy recommendations, the significant increase in pension expenditure suggests the need for reforms to ensure the viability of the existing public systems. In the case of Spain, particular consideration should be given to those designed to postpone the effective retirement age, boost productivity growth and stimulate labour participation, given that the relatively low employment rates in Spain suggest that there is considerable room for manoeuvre in this respect. From the standpoint of sustainability of public finances, the challenges posed by population ageing require the application of strategies that combine this type of reforms with an ongoing sound financial position of general government, so this problem can be tackled from the most favourable starting position possible.

1. See S. Puente and M. Gil (2006). "Una comparación de las proyecciones de población para España, la zona del euro y Estados Unidos". Boletín Económico, January, Banco de España.

indexation clauses introduces an element of inertia into wage behaviour that is distortionary when temporary price shocks arise or when, as also may currently be the case, it is necessary to reverse the deterioration in competitiveness accumulated over a lengthy period of expansion. All in all, the problem of insufficient flexibility affects more general aspects of the labour market, as shown by the existence of a marked duality between permanent and temporary employment, despite the numerous reforms implemented in recent years to correct it.

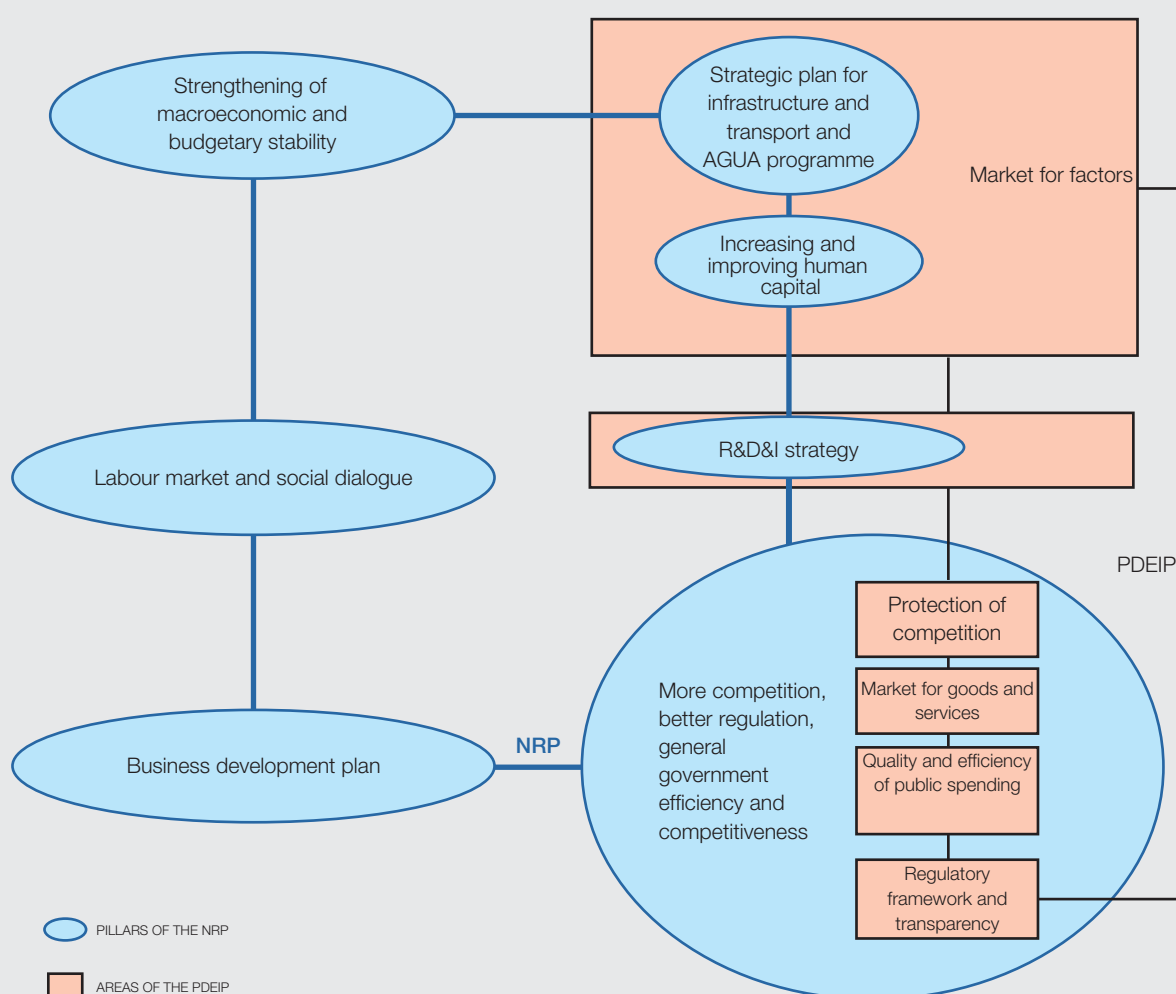
In any case, as already mentioned, productivity growth is fundamental to guarantee competitiveness and potential growth in the medium and long term. The Plan to Invigorate the Econ-

One objective of government economic policy is to impact on those aspects of the workings of the economy that restrict its potential growth. According to its diagnosis, low productivity growth in Spain, apart from reflecting a very employment-intensive growth pattern, is the result of the impact of a number of characteristics that reduce the efficiency of productive processes, such as the lack of competition in certain factor and product markets, the technology and innovation lag, the quality of regulation, etc. Moreover, there is scope to increase the contribution of employment to potential growth. Against this background, the government has set itself the objective of achieving a pattern of growth based on productivity growth and employment creation. The strategy to pursue these objectives involves a succession of action plans. On 1 March 2005 the first package of the Plan to Invigorate the Economy and Boost Productivity (PDEIP, by its Spanish initials) was introduced and a series of actions to be undertaken at a later stage were announced. Subsequently, on 15 October 2005, after the Spring European Council had agreed that each Mem-

ber State should prepare a National Reform Programme setting out the actions to achieve the objectives of the Lisbon Agenda, the Spanish government approved the Spanish National Reform Plan (NRP), which summarises the measures taken on this front, including those initially contained in the PDEIP. On 31 March 2006, a second package of measures was announced that completes the PDEIP.

The NRP sets out two objectives that are formulated in terms of achieving full convergence of per capita income with the European Union in 2010 and an employment rate in that same year of 66%. It also establishes seven pillars, which range from aspects related to the strengthening of macroeconomic and budgetary stability to improvements in the functioning of the labour market and the institutional environment, and increases in the factor endowment (infrastructure, technological capital and human capital). As seen in the adjoining chart, four of these pillars were already contained in the PDEIP.

PILLARS OF THE NATIONAL REFORM PLAN AND AREAS OF THE PLAN TO INVIGORATE THE ECONOMY AND BOOST PRODUCTIVITY



SOURCES: Banco de España.



## PRODUCTIVITY (cont'd)

As it would take a long time to consider all the pillars, briefly summarised below are the actions of a more microeconomic nature (on which there is less detail in the main text of this Report), which are included in the pillars: More Competition, Better Regulation, General Government Efficiency and Competitiveness<sup>4</sup>, "R&D&I strategy" and "Business Development Plan".

The first of these pillars establishes the objectives of ensuring effective competition in goods and services markets, improving and increasing the transparency of sectoral regulation, increasing the competitiveness of Spanish firms, rationalising the consumption and improving the efficiency of natural resources and complying with the commitments assumed in the Kyoto Protocol. The bulk of the measures approved in the first package of the PDEIP, which are mostly already in force, belong to this pillar<sup>5</sup>. Notable among the other actions are, the amendment of the Antitrust Law (*Ley de la Defensa de la Competencia*), which is currently being considered by Parliament and which envisages the creation of a new and independent competition authority, and the approval, also in 2006, of the Law to Improve the Protection of Consumers and Users (*Ley de Mejora de Protección de los Consumidores y Usuarios*). In the area of general government modernisation, there are plans to set up a State Agency to Assess Public Policy and Service Quality, to approve a new Public Sector Contracts Law and a Basic Statute for Public Employees, to establish a regulatory framework for government agencies and the promotion of e-government. There are also plans to launch Comprehensive Market Development Plans and the Plan for the Internationalisation of High-Technology Sectors, in order to promote the internationalisation of Spanish businesses, and to introduce measures to invigorate certain key sectors, in particular, network industries, financial services, housing, tourism and distribution.

The objectives set in relation to the R&D&I Strategy pillar, included in the INGENIO 2010 programme, initiated in June 2005, are specifi-

cally to increase spending on R&D to 2% of GDP in 2010 (1.6% in 2008), to increase private-sector participation in R&D to 55% that year (52.5% in 2008) and to raise the proportion of GDP devoted to ITC to 7%, also in 2010 (6.4% in 2008). The instruments envisaged to achieve these objectives are budgetary and regulatory and concentrating resources on strategic actions. In particular, this concentration takes the form of the AVANZ@ plan (to converge with Europe in relation to the main Society and Information indicators) and the programmes known as CENIT (to encourage integration between universities, public research centres and businesses) and CONSOLIDER (to promote the creation of large groups of researchers with long-duration projects that may participate in international programmes).

Finally, the Business Promotion Plan, approved on 27 January 2006, has as its objectives, to increase the rate of creation of businesses by around 25%, to stimulate the entrepreneurial spirit and to improve the technological and exporting base of Spanish firms, and of SMEs in particular. This Plan envisages measures aimed at reducing financial costs and red tape, and also increasing financial support. Also, it is desired to strengthen the ties between universities and business, while reforming syllabuses so that students learn about the business environment. In order to promote innovation, measures are included such as extending the line of equity loans to innovative and technology based firms, with an interest rate linked to the performance of the firm, reducing social contributions for companies' research staff and, in co-operation with the regional governments, putting into effect a programme to stimulate non-technological innovation.

The measures referred to above and the rest of the actions planned in the PNR are appropriate to address the structural problems the Spanish economy faces. However, the existence of a common framework for diagnosis, action and follow up is equally important, since it will only be possible to achieve the targets set in terms of productivity growth and employment generation through the integrated implementation of the measures making up all the pillars, including those relating to the labour market and human capital. In that way, it will be possible to impact factor and product markets simultaneously, thereby boosting the reform programme's synergies.

1. Box 1 of the January 2006 issue of the Banco de España Economic Bulletin gives a somewhat more general view of the NRP. 2. For more details of the measures included in the first package of the PDEIP, see Box 4 of the April 2005 issue of the Banco de España Economic Bulletin.

omy and the National Reform Programme are along these lines and take the right approach in defining economic policy priorities and objectives. Both elements of this programme define a strategy to promote long-term growth, based on stimulating productivity and boosting the dynamism of employment generation. The measures taken combine a number of actions that aim to increase competition, raise the efficiency of certain product markets and the quality of regulation, to boost R&D&I and improve the business environment (see Box 1.4). However, in order for this set of measures to be fully effective it is very important that the labour market reforms to permit better adaptation to an increasingly competitive environment and to facilitate the dynamism of company innovation be implemented and that the necessary quality improvements in educational and training processes are made to ensure a more efficient use of productive resources.



Increasing flexibility in product and factor markets through greater competition is a fundamental tool both to destroy the most resistant core of inflationary pressures and to provide for the propagation of technological diffusion and innovation towards the most backward areas of the economy in terms of productivity, among which certain services branches are prominent. In fact, the wholesale and retail trade, R&D activities and business services display particularly unfavourable productivity behaviour, by international standards, especially in relation to the most dynamic economies. There, it is precisely this type of activity which is seen to be the dynamic core of services, playing a fundamental role as a determinant of their international competitiveness. It is also important to press ahead with the liberalisation of network industries, especially in activities linked to the production and distribution of energy, since a certain exhaustion is apparent in the process of increasing the level of effective competition, following a decade of liberalisation of the markets concerned. Also, progress is required in rationalising road haulage, which displays low levels of productivity, and promoting the improvements in efficiency that a more competitive environment for rail transport, such as that made possible by the latest restructuring of the sector, may generate. Greater liberalisation of the rented housing market and better regulation of the land market also need to be pursued in order for the housing market to function more efficiently.

Only if these tasks are addressed will it be possible to make the necessary increases in the participation and employment rates, in an expansionary demographic setting compatible with the recovery of competitiveness in the euro area, and to adapt the productive structure of the Spanish economy to the challenges of globalisation. In short, the way in which the imbalances that have begun to emerge are redressed is important, both for the continuity of the current phase of expansion and the future of the Spanish economy within the euro area.

## 2 THE EXTERNAL ENVIRONMENT OF THE EURO AREA

### 1 Overview

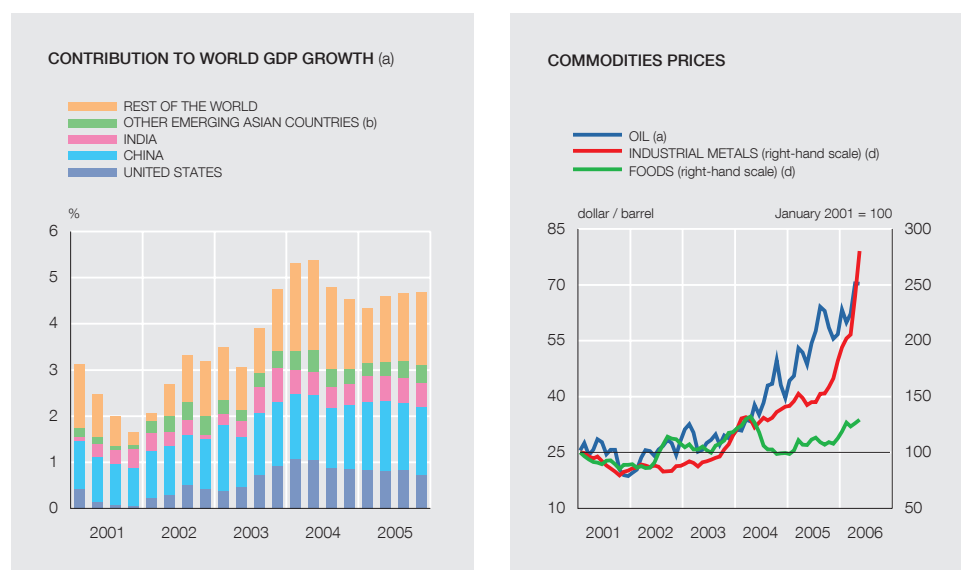
Activity in the world economy grew strongly once again in 2005, in a setting of low inflation – despite the ongoing upward trend in oil prices – and against a background of increases in official interest rates in several of the main advanced economies. As will be seen throughout this chapter, the still-expansionary stance of economic policies, easy financing conditions and the favourable behaviour of the financial markets, along with the property boom in some countries, contributed to sustaining economic vigour. However, these factors also raise some concern, especially given the risk of greater inflationary pressures or significant adjustments on financial markets which, among other reasons, could be triggered by a disorderly correction of global imbalances, which have continued to build up.

Growth in the world economy in 2005 (4.8%) exceeded expectations and was only slightly down on the exceptional 2004 figure (see Chart 2.1). After a slight slowdown in Q1, global activity held at a sustained pace of growth for the rest of the year. Its geographical distribution was relatively similar to that of the previous year (see Table 2.1), insofar as China, the United States and India (which contributed 1.3 pp, 0.7 pp and 0.5 pp, respectively) were responsible for more than half of world growth, and inasmuch as the other emerging economies generally sustained high growth rates, especially so in the case of the oil-exporting countries. Nonetheless, a key development was the firming of expectations of a revival of the Japanese economy and, to a lesser extent, of the euro area (albeit with growth rates that were still far below the world average), which appears to point to a somewhat more balanced distribution of growth.

The expectations in early 2005 that the cost of energy products would stabilise proved overly optimistic, and oil prices rose by more than 60% between January and September (see Chart 2.1) to \$68 per barrel, coinciding with the hurricanes on the Gulf of Mexico coast. Similar prices were again recorded in January, and followed by even higher ones in April and May 2006 further to the heightening of geopolitical tension in the Middle East. As in 2004, the hike in prices occurred against the background of buoyant demand in the economies with the most dynamic growth rates, and such demand came up against restrictions in the leeway for expanding the supply of crude oil, as well as against global refining capacity constraints, which raised concerns about future supply. Both market expectations and fundamentals would point to a consolidation of a substantial portion of the recent price rises. Compared with previous episodes of oil price increases, the greater permanence and gradualism of the increase in the revenue of the oil exporting countries in recent years appears to be generating a greater response in their imports (see Box 2.1). The prices of other industrial commodities likewise rose markedly, due also to the increase in demand and, in certain cases, to the rise in the attendant production costs, which are strongly dependent on the price of energy.

Although dearer oil and other energy products moderately impacted overall price indices, this pressure did not feed through to the measures of underlying inflation, which held stable at a low level (see Chart 2.2). The anchoring of inflation expectations, against the background of the anti-inflationary credibility of monetary policies, which was also due in part to international competition from the emerging economies, contributed to easing wage pressures and was pivotal in avoiding second-round effects of the increase in oil prices.

This controlled inflation environment enabled the central banks of the industrialised countries to withdraw the monetary stimulus in a gradual and orderly fashion (see Chart 2.3), a move largely anticipated by the markets, which contributed to its limited impact on activity. In the



SOURCES: National statistics, Goldman Sachs 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. Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and the Philippines.  
 c. Brent crude.  
 d. Goldman Sachs indices.

United States, the Federal Reserve increased its federal funds target rate by 275 basis points from early 2005, taking it up to 5% by May 2006. The European Central Bank, for its part, raised its key interest rate by 0.5 pp over the same period to 2.5%. The Bank of Japan, faced with the prospect of emerging from deflation, changed its monetary policy arrangements in a move which was interpreted as a preamble to a future rise in interest rates which, however, had not yet come about at the time of this report going to press. The different pace of adjustment of US and euro area monetary policies entailed the opening of a significant positive short-term yield differential between the two areas, of the opposite sign to that in 2004, and the widening of the differential between these economies and Japan. In the emerging countries, interest rates rose in those where it was necessary to contain inflationary pressures (as was the case in some of the Asian economies), while in general – both in Latin America and in Central and Eastern Europe – the monetary policy stance eased as domestic financial conditions stabilised, in a situation of widespread buying pressures on exchange rates.

In addition to dearer oil and the rise in official rates, the world economy overcame various local and more cyclical shocks with scarcely any discernible pressures, despite their potentially significant implications. Notable in this connection were the hurricanes on the Gulf of Mexico coast, the main economic impact of which was the temporary reduction in oil refining capacity and gas production in the United States, and the slowdown in the pace of US activity in the closing months of the year. At the financial level, neither the crises at major US car manufacturers nor the political tensions in Brazil had a lasting impact thanks, among other factors, to the greater maturity attained by the credit derivative and emerging public debt markets. Further, the various episodes of geopolitical uncertainty, such as the July terrorist attack in London or events in the Middle East, had no more than a fleeting effect on spirits in the financial markets and on consumer and investor confidence.

In step with the global economic situation, the growth in trade was high (7.3%), although slightly down on 2004. The World Trade Organisation Ministerial Conference in Hong Kong

	2001	2002	2003	2004	2005
UNITED STATES					
GDP	0.8	1.6	2.7	4.2	3.5
CPI (a)	2.8	1.6	2.3	2.7	3.4
Current-account balance (% of GDP)	-3.8	-4.5	-4.7	-5.7	-6.4
General government balance (% of GDP)	-0.7	-4.0	-5.0	-4.7	-4.1
JAPAN					
GDP	0.4	0.1	1.8	2.3	2.7
CPI (a)	-0.7	-0.9	-0.3	0.0	-0.3
Current-account balance (% of GDP)	2.1	2.9	3.2	3.8	3.6
General government balance (% of GDP)	-6.4	-8.2	-8.1	-6.6	-5.8
UNITED KINGDOM					
GDP	2.2	2.0	2.5	3.1	1.8
CPI (a)	1.2	1.3	1.4	1.3	2.1
Current-account balance (% of GDP)	-2.2	-1.6	-1.4	-2.0	-2.6
General government balance (% of GDP)	0.9	-1.5	-3.2	-3.2	-3.6
CHINA					
GDP	8.3	9.1	10.0	10.1	9.9
CPI (a)	0.7	-0.8	1.2	3.9	1.8
Current-account balance (% of GDP)	1.3	2.4	2.8	3.6	7.2
General government balance (% of GDP)	-2.3	-2.6	-2.2	-1.3	-1.1
LATIN AMERICA (b) (c)					
GDP	0.4	-0.2	2.1	5.9	4.3
CPI (a)	5.8	9.3	10.9	6.0	6.3
Current-account balance (% of GDP)	-2.9	-0.2	0.8	1.2	1.3
General government balance (% of GDP)	-3.2	-5.1	-2.0	-0.6	-0.8
NEW EU MEMBERS (b) (c)					
GDP	2.7	2.5	3.9	5.3	4.6
CPI (a)	-1.0	2.9	2.8	3.5	-0.8
Current-account balance (% of GDP)	-4.3	-4.4	-4.2	-5.5	-3.9
General government balance (% of GDP)	-4.1	-4.8	-4.8	-3.5	-2.8

SOURCES: Banco de España, IMF and national statistics.

a. The aggregate for the different areas has been calculated using the weight of the countries making up such areas in the world economy. Based on IMF information.

b. Annual rate of change of the average price index.

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

d. Latvia, Lithuania, Estonia, Czech Republic, Hungary, Poland, Slovenia, Slovakia, Cyprus and Malta.

concluded without any immediate results other than the commitment to eliminate export subsidies before 2013. Given the substantial trade imbalances internationally, the risk of protectionist pressures emerging in several countries continued.

#### 1.1 WIDENING OF GLOBAL IMBALANCES

The corollary to the aforementioned distribution of world growth was a widening of global imbalances (see Chart 2.4). The United States posted a new all-time high current account deficit, at 6.4% of GDP for the year as a whole, accounting for around 2% of world income measured at market exchange rates and for 65% of the total global financing requirement. The euro area position, by contrast, was virtually in balance, with only a minor deficit, while the United Kingdom recorded a deficit of 2.6% of GDP. Among the economies clearly in surplus, the block of oil exporters outranked Japan (traditionally the country with the highest foreign saving rate) as the main source of international financing. China's role was also notable since, despite having one of the highest investment rates in the world (43% of GDP), it had an even higher saving

The rise in oil prices over the last three years has significantly improved the terms of trade of oil-exporting countries, whose oil revenues totalled approximately \$700 billion in 2005 (73% more than in 2001). Around 80% of this amount accrued to the members of OPEC and Russia. As a result of the dynamism of the world economy, the rise in oil prices was accompanied by a strong increase in the price of other commodities, also an important export of these economies. This box analyses the international use of these export revenues through the trade and financial channels, and draws comparisons with previous episodes of oil-price rises<sup>1</sup>.

One possible measure of the additional resources obtained by oil-exporting countries is the difference between the value of their exports in a given year and the equivalent value in a base year, which for the current episode has been taken as 2002. Chart 1 shows the strong increase in this revenue differential, which took the cumulative value of additional revenue between 2002 and 2005 to almost \$785 million. Exporters of crude oil can recycle these resources internationally by increasing their imports or their net assets. Indeed, imports

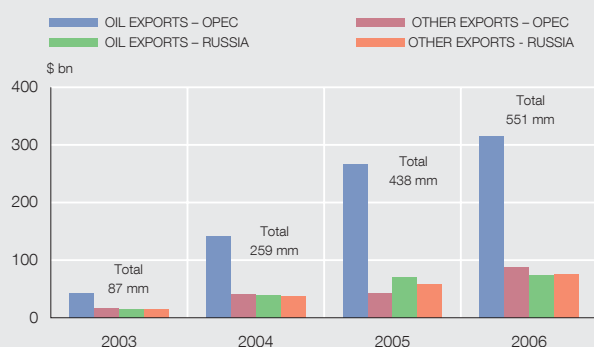
in oil-exporting countries have risen above the stable levels recorded since the mid-1980s (see Chart 2).

Chart 3 shows that futures markets appear to view the recent rise in oil prices as relatively permanent. Given that futures markets have existed for only a short time, a rigorous comparison with previous episodes is not possible, although historical developments in oil prices would also indicate that the rise in 1973 was more persistent than in 1979 and 2000. Furthermore, the increased permanence of high crude oil prices in the current episode may also be underpinned by the demand-driven nature of the rise, unlike previously, when the price rises stemmed from temporary or concerted reductions in supply. If the increase in export revenues is perceived to be longer-lasting, the effect on consumption and imports ought to be greater than in the case of a temporary increase. In short, in view of the evidence, a relatively high propensity to consumption and to imports could well be expected in the current episode, with greater similarities to 1973 than to 1979 or 2000<sup>2</sup>.

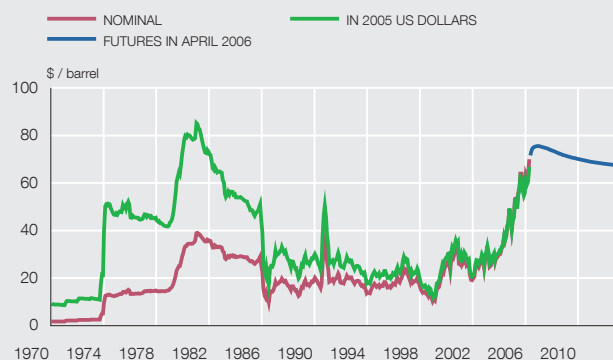
1. See J. Ruiz and J. Vilarrubia (2006), "Canales de reciclaje internacional de los petrodólares", *Boletín Económico*, Banco de España, February.

2. The low propensity to consumption and imports seen in the episode of 2000 may also have been influenced by prices that had recovered from the very low levels of 1999.

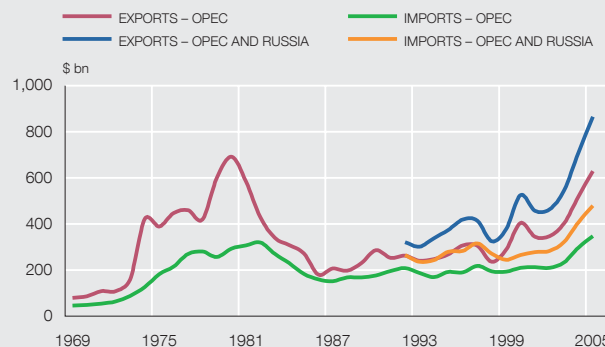
#### 1. ADDITIONAL EXPORT REVENUES RELATIVE TO 2002 (a)



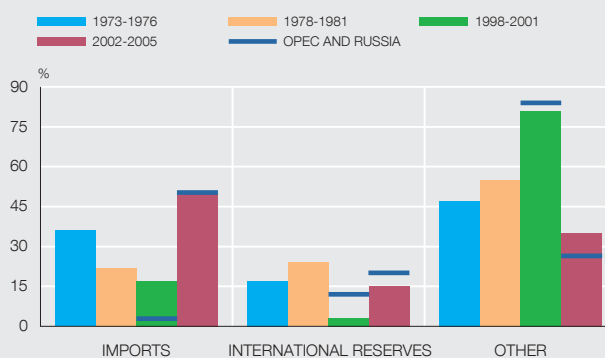
#### 3. OIL PRICES



#### 2. REAL IMPORTS AND EXPORTS (in 2005 US dollars) (b)



#### 4. RECYCLING OF ADDITIONAL REVENUES FROM EXPORTS IN THE OPEC COUNTRIES (c)



SOURCES: IMF, BEA, BIS, OPEC, Energy Information Administration, Bloomberg and Ruiz and Vilarrubia (2006).

a. The Energy Information Administration's forecast of oil exports for 2006.

b. Data for Russia are only available from 1992. The data for 2005 correspond to the first nine months calculated on an annualised basis.

c. The percentage increase in exports over the first year in each period.

Another characteristic of the current increase in export revenues in the OPEC countries has been its gradualism. Compared with 1973 and 1979, with their sudden, sharp restrictions in supply, the current progressive oil-price rise reflects the gradual increase in demand and attempts by OPEC to adjust supplies accordingly. The more gradual increase in export revenues has probably therefore permitted a greater absorption through higher imports than in previous periods.

These characteristics of relative permanence and gradualism are accurately reflected in the relative significance of the recycling channels for additional export revenues. Chart 4 shows a breakdown of the increase in the value of exports in the OPEC countries and Russia relative to a base year, into i) an increase in imports, ii) an acceleration in the rate of accumulation of international reserves, and iii) a reduction in net capital inflows, as a result of the increase in other assets or the reduction of international liabilities. If OPEC and Russia are taken together, one-half of the cumulative increase in exports between 2003 and 2005 relative to 2002 appears to have been recycled through the trade channel (an increase in imports), while the remainder would seem to have been recycled through the financial channel and taken the form, in almost equal parts, of a greater accumulation of international reserves and net capital outflows. Thus, the percentage recycled through higher imports lies within the range obtained from recent studies by the IMF and the OECD, whose estimates point to between 40 and 60%<sup>3</sup>.

3. The estimates given by the IMF in the April 2006 *World Economic Outlook* assume, unlike this analysis, that i) the increase in revenues from non-oil exports does not represent a positive shock for these countries, and ii) that the marginal propensity to import as result of an increase in other current account revenues is equal to 100%. Both assumptions form the basis of an estimate of recycling through greater imports that is lower than the estimate given here for the 2002-2005 episode, although they do not have such an effect in the other

The comparison with previous episodes reveals that recycling through higher imports was greater in the period 2002-2005, in line with the more permanent and gradual nature of the price rise. This increase in recycling through higher imports is most likely to benefit Europe and emerging Asia, which enjoy higher relative shares in the imports of the OPEC countries and Russia.

The accumulation of international reserves also represents an important recycling channel and one which is only slightly smaller than that of the two episodes in the 1970s. Finally, although the recycling by the OPEC countries through capital flows is not substantially different from 30 years ago, there are two important observations to be made: i) if Russia is included, the percentage drops significantly, and ii) unlike the 1970s, a greater share of the additional export revenues has probably been used to reduce oil-exporting countries' liabilities – especially their external debt – instead of using them to increase their assets held in international banks. Currently, therefore, there does not seem to have been such a marked increase in deposits with the international banking system as in the 1970s, which saw the creation of what were then known as the "Euromarkets".

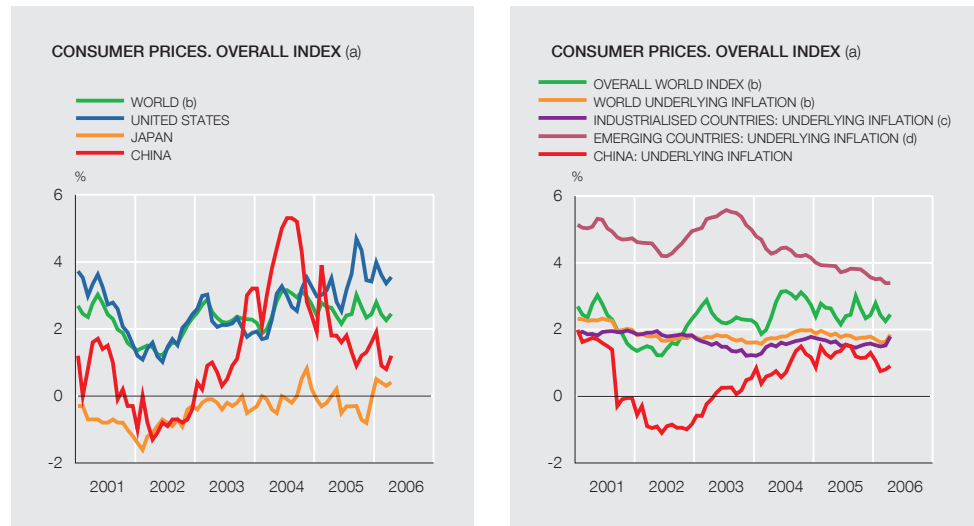
Importantly, however, the estimates given here for the period 2002-2005 – which point to levels of recycling through the trade channel as being higher than in the 1970s – cover only the current effect accumulated over the first three years of the recent oil-price rise. Therefore, many of the lagged effects on imports stemming from the strong increase in exports in 2004 and 2005 have probably still not had time to work through in full and could well be greater than those shown in Chart 4.

three periods, when the increase in revenues from non-oil exports was not as significant.

rate (48% of GDP), meaning that its current account surplus was over 13% of total financing sources in 2005 (see Chart 2.5).

The continuation in 2005 of imbalances on this scale reflects global saving and investment trends and, in particular, the fact that investment rates declined less than saving rates in the industrialised countries, while in the emerging economies the growth of saving exceeded that of investment. Consequently, the emerging countries have, as a block, tended to finance growing deficits in the industrialised nations, which runs counter to the habitual pattern and to the idea that capital flows normally move to the areas worst endowed with this factor in relative terms. Adding to this disassociation between saving and investment rates, moreover, has been the ongoing reduction in the home bias in saving since the 80s. It should be stressed, however, that although this phenomenon may have contributed to facilitating the financing of bigger external deficits, it is highly doubtful that it can justify the scale of the current imbalances, on whose unsustainability there is broad consensus.

Turning to exchange rates, the US dollar appreciated by 3.1% in real effective terms between December 2004 and April 2006. That partly corrected the trend of the three previous years,



SOURCES: National statistics and Banco de España.

a. Annual rates of change.

b. Aggregate calculated drawing on the data from 56 countries, accounting for 91% of world GDP.

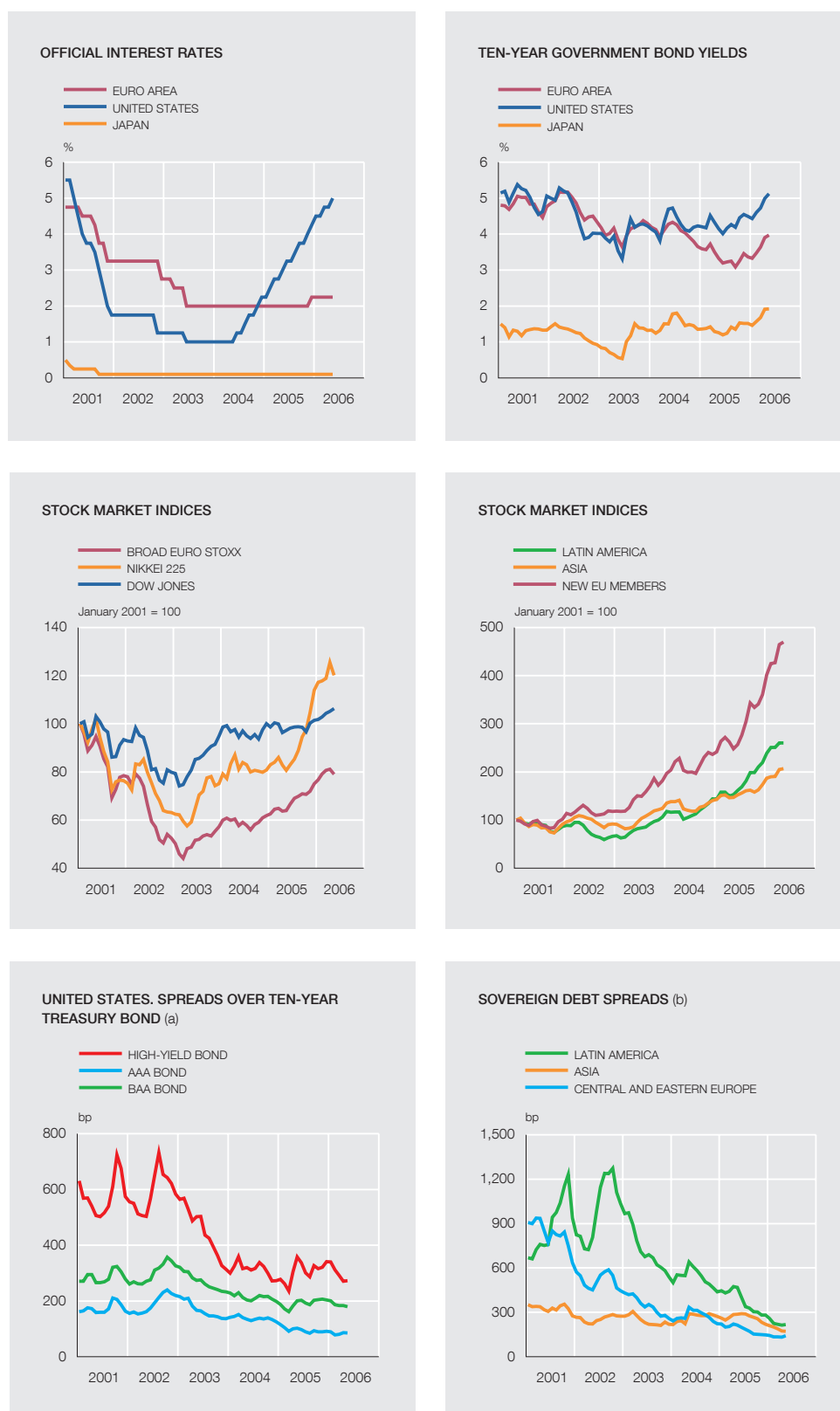
c. United States, Canada, Japan, Euro area, United Kingdom, Denmark, Norway and Sweden

d. Brazil, Chile, Mexico, Poland, Hungary, South Korea, Thailand and South Africa.

although over a broader time-span the real effective depreciation of the dollar between February 2002 and April 2006 still amounts to 13% (see Chart 2.4). The higher return on dollar-denominated assets following the rise in US official rates, along with the firming of favourable growth expectations for the US economy, appeared to exert greater influence on the course of the dollar than the country's current account deficit. The appreciation was principally against the currencies of other advanced economies (7% against the euro and 8% against the yen between December 2004 and April 2006), while the dollar tended to depreciate against most of the emerging currencies whose strength – induced, among other factors, by the search for returns and by their attractiveness for foreign investment – was partly tempered by intervention by central banks, which resulted in a significant build-up in foreign reserves in all the emerging areas (see Chart 2.4). Despite a moderate nominal appreciation by the renminbi against the dollar (3.3% between December 2004 and April 2006) and a virtually zero appreciation in real terms against the US currency, the different composition of foreign trade between China and the United States meant that the Chinese currency appreciated, in real effective terms, by 9% over the same period, although over a longer time-span the Chinese economy's gain in competitiveness over the past four years is still 4%.

As regards international capital flows, the Central and Eastern European countries (with net inflows of \$100 billion) exceeded the emerging Asian markets (\$59 billion) as the preferred destination among emerging and developing economies (see Chart 2.6). Private capital flows channelled to these economies as a whole reached a new all-time high, exceeding the 2004 figure, as did foreign direct investment. Of note were the portfolio capital outflows from the Asian markets, possibly associated with the narrowing of the yield gap vis-à-vis the advanced economies, although this was offset by the continuing attractiveness of the region for foreign direct investment. In Latin America, despite strong direct investment inflows, total net flows were virtually zero, owing to the negative sign both of bank loans and of official flows, the latter due to the absence of crisis in the region and to the early repayment of the substantial Argentine and Brazilian debts to the IMF (see Chart 2.6). This repayment meant that Latin America ceased to be the main recipient of financial resources from the IMF for the first time since



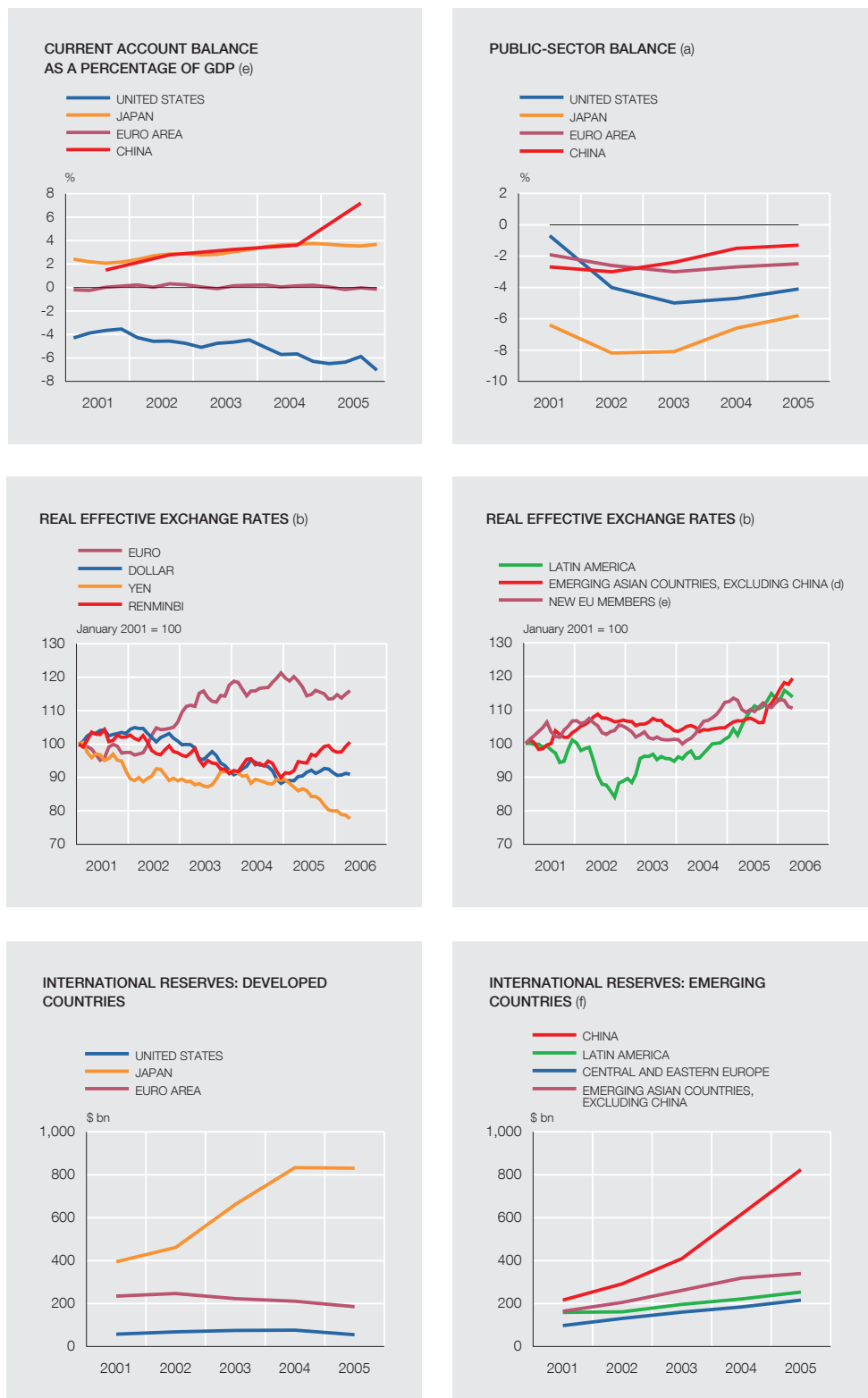


SOURCES: Banco de España and Bloomberg.

- 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.

## CURRENT ACCOUNT BALANCE, PUBLIC-SECTOR BALANCE, EXCHANGE RATES AND INTERNATIONAL RESERVES

CHART 2.4



SOURCES: JP Morgan, national statistics and IMF.

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

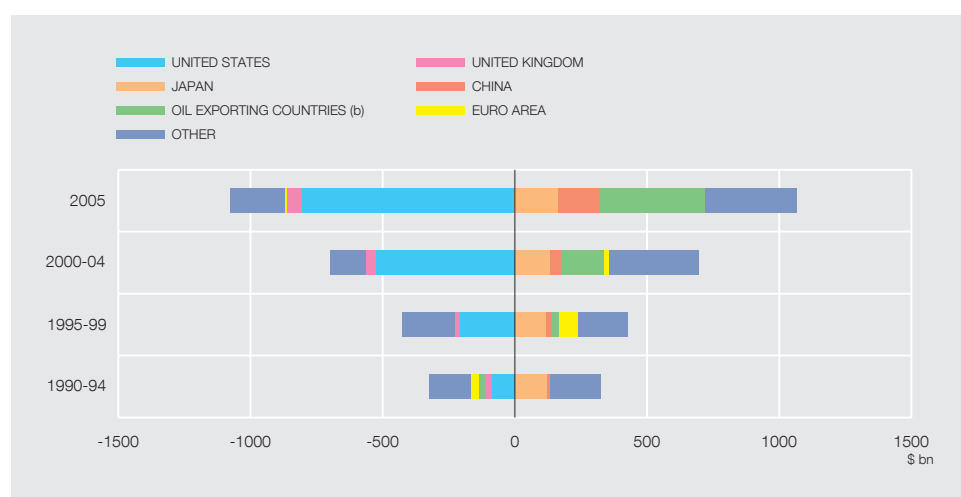
b. CPI-based. An increase (decrease) denotes an appreciation (depreciation) of the currency.

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

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

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

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



SOURCE: IMF.

a. In 2005 dollars.

b. OPEC countries plus Russia and Norway.

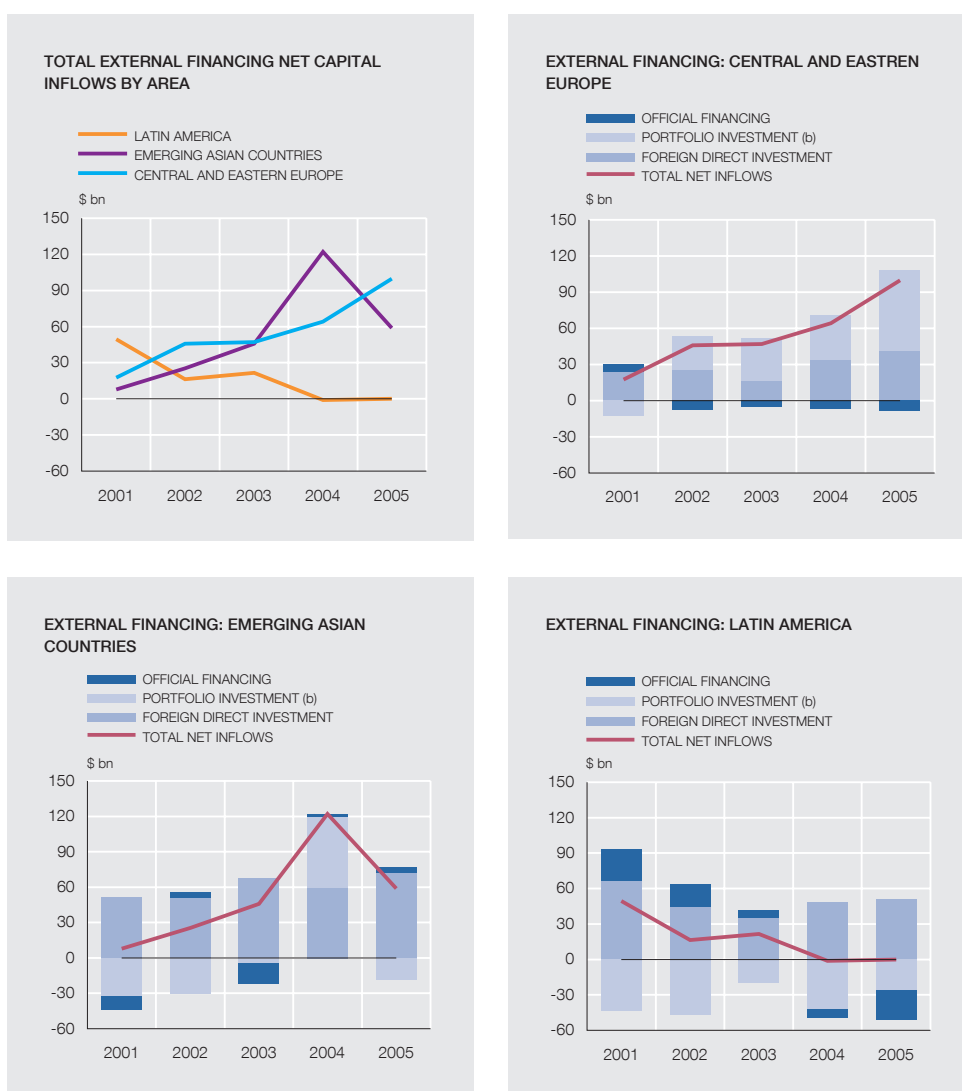
1997. The year 2006 saw a strengthening of international investors' interest in emerging markets and this, combined with the wish of the emerging countries' authorities to reduce their dependence on foreign-currency-denominated debt, bolstered the development of domestic debt markets, along with local-currency-denominated international issues.

## 1.2 THE PILLARS OF INTERNATIONAL ECONOMIC GROWTH

Among the factors underpinning activity in 2005, the still-expansionary stance of macroeconomic policies, despite its gradual correction, was pivotal. Fiscal policies continued to provide a stimulus in most developed countries (see Chart 2.4) and, although both the United States and Japan announced plans to moderate spending, these did not have a marked effect on public finances in 2005, the intention being rather to apply them gradually in the coming years. In the euro area the general government balance improved by 0.4 pp, ending 2005 with a deficit equivalent to 2.4% of GDP. Monetary policies continued to contribute, in general, to sustaining activity, insofar as the rises in official rates by the main central banks only partly corrected their accommodative stance.

Financial conditions in a broader sense remained relaxed in 2005 (see Chart 2.3). Compared with previous episodes, the increases in official interest rates had a very limited impact on the financial conditions in the economies concerned. Throughout 2005, long-term interest rates held at low levels, in nominal and real terms, in virtually all countries. However, unlike in the last four years, a sizeable positive differential between the United States and the euro area opened up owing to the reduction in government debt yields in the euro area in the first half of 2005, while these remained virtually unchanged in the United States. The course of US long-term rates led to a substantial flattening of the yield curve, which even turned negative in some segments in late 2005 and early 2006. Interest rates in Japan held at significantly lower levels than those of the rest of the world. Nonetheless, the upturn in bond yields in the main economies from March 2006 lessened the perception that long-term interest rates were at abnormally low levels.

Economic growth in 2005 was also favoured by the increase in household wealth, as a result of the widespread rises in values on financial (see Chart 2.3) and property markets. The global environment of low interest rates, which drove the search for returns on investments other than



SOURCE: IMF.

a. Country aggregates based on IMF (WEO) definition.  
b. Including bank loans.

government fixed-income, helped underpin the rises in stock market prices in a situation marked by low volatility and unusually low risk premia. Stock markets in the developed countries performed very favourably throughout the year, albeit to a lesser extent in the United States, driven additionally by sound corporate profits and the revival of the mergers and acquisitions cycle. The behaviour of the emerging stock markets was even more favourable, and there were highs on several Latin American, South-East Asian and Middle Eastern markets, due in part in this latter instance to the impact of oil exporting revenues. The performance of energy commodities, industrial metals and precious metals was also notable in 2005, denoting that the search for profitability was extensive to a wide range of investments. Corporate bond spreads remained low, although they rose slightly as a result of crisis episodes in the US car industry. Unlike in previous episodes, this rise in the corporate debt market did not extend to sovereign debt spreads on the emerging markets, and they continued on a clear downtrend in Latin America and in Asia, driven by ample liquidity, by the reduction in vulnerability and by the favourable outlook for commodity exporting countries. Among the new EU members, sover-

eign spreads also narrowed, despite having already attained very low levels in previous years. Both high commodity prices and the narrowing of debt spreads were very important factors in entrenching economic growth in several emerging markets.

In many areas, real estate asset prices posted very high rates of increase, substantially higher than those for rentals, a fact due also in part to the favourable financing conditions. However, this increase was not as marked as in 2004. Indeed, some developed countries witnessed a slowdown in the pace of property price gains and of construction industry activity. This was particularly the case in Australia and in the United Kingdom, where there was some evidence of a negative impact on consumption, while in the United States and in certain euro area economies this movement was more incipient.

Finally, apart from being related to the anti-inflationary credibility of monetary policies, the maintenance of high growth and low inflation appears to have to do with the far-reaching structural changes the world economy has undergone in the past decade. Such changes include most notably: i) the greater flexibility of the main economies, as a result of greater openness and headway in the adoption of new technologies, and ii) the penetration by China and other emerging competitors in the international markets for goods and services, which has exerted a restraining influence on inflation. A cause for concern, however, is the fact that the continuity of global growth should depend on a mix of expansionary economic policies, low interest rates and high asset prices, insofar as the confluence of these factors generates external and internal imbalances whose sustainability is highly uncertain and for which the correction mechanisms might prove costly.

### 1.3 SINGULAR FEATURES OF THE CURRENT UPTURN

The low long-term interest rates observed for most of 2005 are, to some extent, unusual, especially if the budget deficits being run in some of the main developed countries are taken into account. Bond yields in 2005 were relatively insensitive to the rise in official interest rates, although long-term interest rates moved on a marked rising trend from March 2006, possibly induced by the reaffirmed expectations of further monetary policy tightening in the main economies. Several non-exclusive explanations have been advanced regarding the low level of long-term interest rates in 2005, some with radically different consequences for the future course of monetary policy, which adds a further element of uncertainty (see Box 2.2).

The rise in financial and property asset prices also reveals some unusual features. In this respect, it is possible to attribute some of these rises to the favourable world economic outlook following the structural changes associated with globalisation. In that case, however, there should have been a firm expansion in corporate investment which, despite the favourable financing conditions and the sound performance of profits, did not occur in 2005. Capital formation was thus not particularly notable in the United States and held at what were still depressed levels in several Asian emerging markets, with the exceptions of China and India. Although the effect of the corporate scandals in recent years and the aftermath of overinvestment in the technological bubble would account in part for firms' reluctance to invest, it may be surprising that, at the same time, investors in financial markets are behaving in a way which seems to indicate a marked readiness to assume risks.

The rise in energy and other commodities prices proved a significant drag on consumer purchasing power; however, unlike in previous bouts of tension on energy markets, this did not generate significant wage pressures. In this respect, the continuity of such a benign inflation outlook as that seen in 2005 will largely hinge on the continuing credibility of monetary policies and on whether the factors influencing – favourably or adversely – the growth of price indices are cyclical or permanent. A greater incorporation of the relative permanence of the increase in

The relative stability at low levels of long-term interest rates for most of 2005, both in the United States and worldwide, may come as a surprise against the prevailing background of economic growth, rising energy prices and, in some countries, sizeable fiscal imbalances. It is striking that, unlike in previous episodes, the gradual but significant increase in the Federal Reserve's official interest rates since June 2004 has hardly affected the interest rate on ten-year US Treasury bonds. Although government bond yields have climbed considerably since March 2006, which might indicate the end of these unusual developments, prior to April 2006 the rise was still small in comparison with the cumulative change in the official interest rate (see Chart 1).

A number of hypotheses have been put forward to explain these apparently abnormal developments in long-term interest rates. One such hypothesis considers the possibility of a deterioration in future growth expectations, which would be preceded by the levelling-off, or even inversion, of the yield curve. Most forecasts, however, point to sustained growth, while developments in other financial indicators, such as equity prices and credit risk premia, similarly do not signal an impending economic slowdown. Another possible explanation is based on recent favourable inflation developments and expectations, which would have reduced not only the expected-inflation component in long-term interest rates, but also the inflation risk premium. Indeed, periods of low, stable inflation have historically coincided with periods when real interest rates have been similar to the rates seen in recent years<sup>1</sup>. One factor that is also usually mentioned is the ample liquidity in the international financial system, associated with the highly expansionary monetary policies pursued over the last few years. Investors have possibly been investing this liquidity in a wide range of real and financial assets, perhaps encouraged by an overly optimistic perception of the risk involved. An alternative hypothesis is the existence of excess global saving, as a result of high levels of saving in emerging economies, especially in Asia and – more recently – the oil-exporting countries, accompanied by relatively weak investment

demand, particularly in Asia (excluding China), but also in the industrialised countries, following the crises of the late 1990s. The role of institutional investors, such as pension funds and insurance companies, has also been highlighted, in view of the changes to accounting policies and other regulatory aspects. These changes have fostered balance sheet management strategies geared to matching asset and liability durations and reducing price volatility, with the result that they have tended to increase the weight of bond holdings to the detriment of equity holdings.

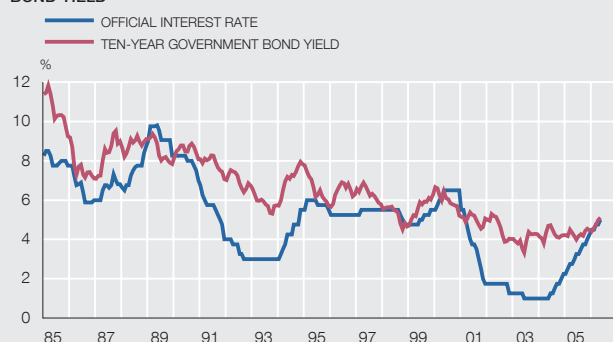
Since 1999, the strong accumulation of international reserves by the monetary authorities of a number of countries, especially in Asia (see Chart 2), and their investment in US bonds may also have contributed to lower long-term interest rates in the United States. Since the Asian crisis in the late 1990s, many countries in the region have amassed levels of foreign reserves that are far higher than traditional indicators – based on import coverage or payments of short-term external debt – would suggest. A variety of reasons have contributed to this strong increase in foreign reserves: the creation of a sufficiently large buffer of reserves as a unilateral insurance policy against future financial crises; the maintenance of an exchange rate that ensures a high degree of international competitiveness; and, in some cases, the absence of a sufficiently developed domestic financial market to channel savings into domestic currency-denominated assets. Subsequently, the central banks' investment of these reserves has been routed predominantly to US dollar-denominated bonds, mainly for reasons of safety, liquidity and market depth. Insofar as there is imperfect substitutability of financial assets, the captive demand for US government securities arising from foreign exchange transactions in Asia might have affected the interest rates in those segments of the yield curve where debt purchases are concentrated.

A recent study<sup>2</sup> has attempted to estimate the effect of purchases of US government debt by Asian central banks on long-term interest

1. See, for example, Chapter 1 of the *IMF World Economic Outlook*, April 2006.

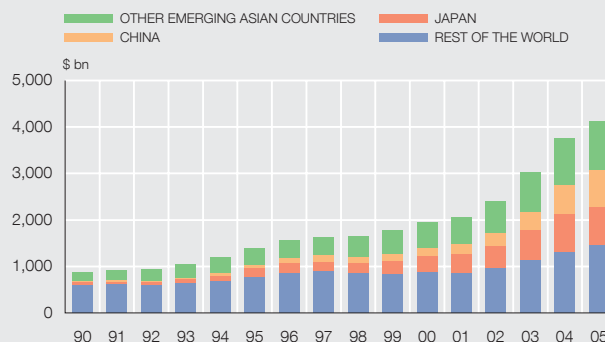
2. See L. Cuadro, S. Gavilá, E. González Mota and T. Reis (2006), "The impact of reserve accumulation on asset prices" in *The accumulation of foreign reserves*, European Central Bank Occasional Paper Series No 43. The paper will also shortly be published as part of the Banco de España Working Paper series.

1. UNITED STATES. OFFICIAL INTEREST RATE AND TEN-YEAR GOVERNMENT BOND YIELD



SOURCES: Federal Reserve and IMF.

2. INTERNATIONAL RESERVES



rates. Using an error-correction mechanism model, estimates were calculated for both long and short-term relationships between interest rates, the monetary policy stance in the United States, inflation expectations, government deficits and alternative measures of central banks' bond purchases. The estimates were made for two periods, one relatively long (1994-2005) and the other somewhat shorter (1999-2005), in which the accumulation of reserves was greater. A distinction was also made between the ten-year interest rate and the three-year interest rate, since central bank bond purchases concentrate, predictably, on short to medium-term maturities, rather than the

longer end of the yield curve. The results would suggest that bond purchases by Asian central banks have not significantly influenced the level of the US ten-year interest rate although, for the period 1999-2005, they may well have affected interest rate dynamics by adding further to an existing downward trend. The estimates relating to the intermediate segment of the yield curve indicate that, in the period 1999-2005, bond purchases were indeed significant in explaining both the interest rate level and dynamics. When the foreign exchange transactions were at a peak, the interest rates along that part of the curve could have fallen by up to 65 basis points.

oil prices into agents' expectations might induce wage pressures which have so far scarcely been seen. Moreover, insofar as the effect on final goods prices of penetration by China and other emerging economies, with their highly competitive production costs, were relatively persistent, the price stability objective pursued by central banks would be more readily attainable.

#### 1.4 OUTLOOK AND RISK FACTORS

Despite the uncertainties stemming from the above-mentioned features, the outlook for 2006 points to the maintenance of a vigorous expansion at the global level, with a more balanced geographical distribution, and to continuing low inflation. Clouding this central scenario, however, are two main risks linked to oil prices and to the abrupt reversal of the relaxed financing conditions, and regard should also be had to the global balance of payments imbalances in place. A further risk is that relating to avian flu, the nature of which means that assessment of its potential economic consequences is particularly complex.

Were a future rise in oil prices to be associated with a reduction in oil supply, and not with the momentum of demand, the adverse effect on the world economy might be more marked than in the past two years. It should be recalled that part of the resilience of growth in recent years is due to the fact that the increase in oil prices acted only as an automatic stabiliser of the forceful pace of economic activity, without denting agents' confidence as to the continuity of growth. However, a rise in oil prices linked to heavy supply cuts would have a negative impact on agents' confidence about the continuing buoyancy of activity. The degree of attention paid by the financial markets to the social conflicts and geopolitical instability in certain producer zones would confirm the importance accorded to this risk.

The second factor of uncertainty would be linked to the rise in long-term interest rates, against a background of high public- and private-sector debt (especially in the case of households), the origin of which lies in the lax economic policies and generous liquidity conditions of recent years. Admittedly, these expansionary economic policies have helped the world economy better withstand the recent shocks; but increased indebtedness has exacerbated to some extent the economy's vulnerability to rises in long-term interest rates. In this respect, at the time of this report going to press it was still uncertain what the effect of the gradual increase in debt yields seen since March 2006 would be. Furthermore, the possibility of specific shocks inducing a sharp hike in interest rates should not be underestimated.

Firstly, a sharp and generalised rise in inflation would most likely have an immediate impact on rates in the longer-dated segments of the yield curve. This rise would be the outcome of an

upward adjustment in inflation expectations, due perhaps to a greater perception of the permanent nature of the increase in the cost of oil, or to the emergence of wage pressures in countries with high capacity utilisation and labour markets close to the natural unemployment rate.

In the financial sphere, the withdrawal of the monetary stimulus in most industrialised economies in the future might, if these changes have not been properly anticipated by agents, result in a swift rise in long-term yields and risk premia, especially if the latter are currently reflecting excessive optimism among financial investors. While financial institutions generally appear to be sufficiently prepared to face this increase in financing costs, the household sector (especially where there are discernible signs of an overvaluation of the property market) and certain emerging economies which have not sufficiently improved their debt structure might bear the brunt of this adjustment.

Finally, any unfavourable trend in interest rates might also be linked to the financial turbulence to which the global imbalances might give rise. In particular, a lesser willingness of investors to finance the US budget and current account deficits would undoubtedly be reflected in a sharper increase in US long-term rates, which might spread to the rest of the world. These movements, especially if they are abrupt, might be accompanied by a widespread increase in risk premia, with unfavourable repercussions for equity markets and for private issuers' and emerging countries' borrowing costs. At the same time, widespread and sudden movements in long-term yields might entail the slowing of the US economy, for which there is no substitute as the engine of world growth, despite the expansion of the Asian emerging economies and the recent acceleration in Japan and in the euro area. That accentuates the need to push through with resolve those policies that help bring about an orderly re-absorption of imbalances, namely: tighter fiscal policies in the United States, greater exchange-rate flexibility in Asia, and structural reforms in Europe and Japan that provide for a greater autonomous growth capacity in these areas.

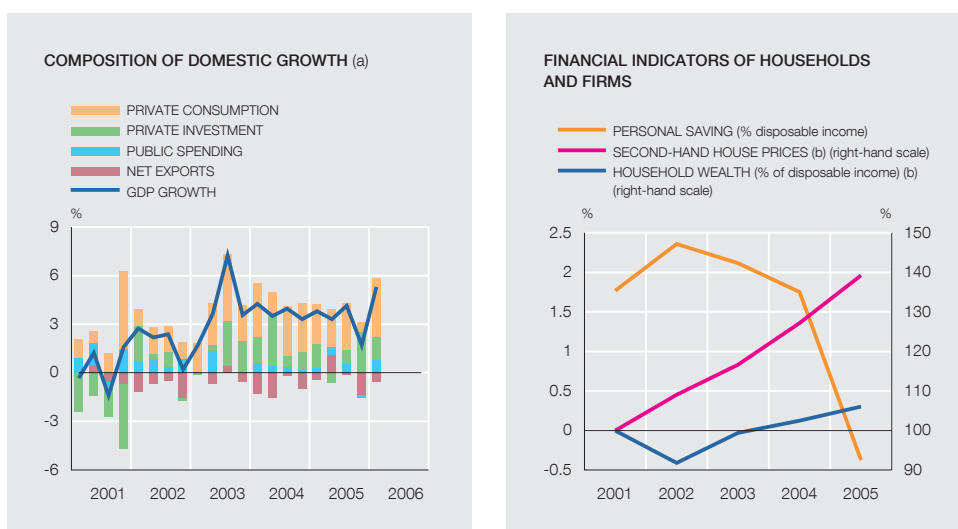
The persistence of the global imbalances in recent years should not be interpreted as a sign that the risk they entail has lessened. Conversely, the build-up in these imbalances would make any future consequences of a disorderly adjustment more serious. Further, greater financial integration and certain recent innovations in the range of financial instruments available – though they allow greater risk diversification and, therefore, greater resilience to local shocks – make it difficult to determine which agents or sectors are bearing specific financial risks. Indeed, in certain cases risk might have concentrated excessively in segments where supervision by regulators is more limited. Some aspects of the current international financial configuration, in short, have not so far been tested in a crisis situation, and that heightens uncertainty and advises caution in economic policy and regulatory decision-making.

## **2 The United States: sustained growth but scant saving and a growing external imbalance**

During 2005 the US economy sustained a sound growth rate, with GDP expanding by 3.5%. This was close to its medium-term potential, but more moderate than the 2004 figure of 4.2% (see Chart 2.7). The expansion underwent, however, an unexpected slowdown in the final quarter of the year, which may be attributed to the delayed impact of the violent hurricanes that battered the Gulf of Mexico coast in the autumn and to other temporary effects, such as the end of the discount schemes to promote car purchases. Growth in 2006 Q1 confirmed the temporary nature of this slowdown and the recovery of the vigour characterising most of 2005.

The increase in household wealth (thanks to the rise in the values of property and financial assets), together with the favourable behaviour of the labour market, countered the adverse im-





SOURCES: National statistics and Federal Reserve.

- a. Contributions to annualised quarterly GDP growth.  
b. 2001 = 100.

impact of energy prices on the growth rate of household disposable income. As a result, private consumption remained very firm in 2005, with growth of 3.5%, and the rate of household saving was negative, for an amount equivalent to 0.4% of disposable income (see Chart 2.7).

The general government deficit in 2005 declined by 0.6 pp to 4.1% of GDP. This figure was slightly better than expected, due in part to the sound behaviour of tax revenue, since the expenditure-containment plans announced during 2005 will not be applied outright but phased in over the coming years.

Companies, by contrast, continued to maintain their lending capacity in 2005, which reflected some reluctance to expand more firmly their productive capacity, despite the rapid growth of profits (over 15%), high stock market prices, low real interest rates and the completion of financial restructuring processes, following several years of substantial reductions in their indebtedness. Thus, although gross private fixed capital formation grew by 6.1% in 2005, this rate was down on the previous year and the degree of capacity utilisation rose in April 2006 to the highest level seen since 2000.

Household and public-sector financing requirements exceeded companies' lending capacity, as a result of which the US economy once again increased its external debt considerably, reflected in a current account deficit in 2005 equivalent to 6.4% of GDP, 0.7 pp up on 2004. Oil imports accounted for more than one-third of the increase in this balance, although the external deficit on other goods and services also increased. The positive differential between the return on external assets and liabilities countered the effect (negative for the first time since 2001) of the movement in the exchange rate of the dollar on the US international investment position, the deterioration in which in 2005 was, as in previous years, less than in the current account balance. Nonetheless, the rate of accumulation of international liabilities was still significant, which makes it unlikely that these mitigating factors will continue in the future. The lack of any clear sign of the external deficit converging towards a more sustainable level remains, in short, a considerable cause for concern for the world economy as a whole.

Consumer prices grew at an annual rate of 4.7% in September, but they subsequently eased to a rate of 3.5% in April 2006. Despite the upward rise caused by the increase in energy prices, strong domestic and foreign competitive pressures and continuing wage moderation prevented the emergence of second-round effects. In this respect, wages showed no sign of any significant acceleration, despite the fact that the unemployment rate stood at only 4.7% in April 2006. The underlying measures and the indicators of inflation expectations were practically unchanged, holding in general at a low level.

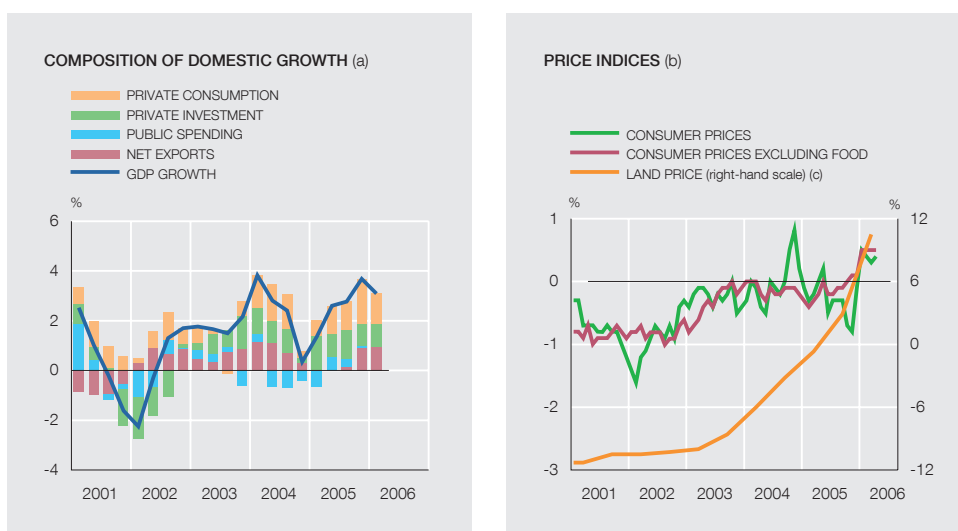
The Federal Reserve continued gradually to correct the accommodative bias of monetary policy, with the aim of withdrawing the stimulus to economic activity and of controlling the risk of inflationary pressures. Official US rates, measured in real terms, thus rose in early 2006 to a similar level to their average over the past 35 years. The communication strategy pursued by the Federal Reserve meant that these increases were widely anticipated, although as official rates rose, speculation grew on financial markets about the maximum level they could reach, which added some uncertainty as to what the future course of monetary policy would be.

Despite the marked increase in official rates and continuing budget and external deficits, long-term interest rates held for most of 2005 at a similar level to that of the previous year, around 4.3%. However, in the closing months of 2005 and in the first four months of 2006, interest rates rose gradually, placing the 10-year government bond yield at around 5.1% in May 2006. Despite this upward movement, the increase since January 2005 was significantly less marked than that in official rates. Consequently, the yield curve flattened substantially – and unusually – for the current phase of the cycle and evidenced, at certain times, a negative slope in several segments. Although in previous episodes the inversion of the yield curve had anticipated the onset of a recession, other financial indicators based on the stock market or on corporate debt would not corroborate this forecast in the current circumstances. That would suggest that the moderate inflation expectations and other alternative explanations to the still relatively low overall level of long-term interest rates would have carried more weight than the alleged investor concern over a slowdown in growth, which is not corroborated by economic forecasts (see Box 2).

The outlook for 2006 points to continuing robustness in the US economy. Nonetheless, there is a first-order risk to this central scenario from the real estate sector; the cooling seen in this sector in early 2006 might, were it to intensify, have a relatively marked impact on private consumption. Unlike to date, a worsening of inflationary pressures, against the backdrop of a labour market with a low unemployment rate and of little spare capacity, might prompt a sharper rise in long-term interest rates than that seen so far. That would hamper the recovery in private investment and might, at the same time, refuel the correction in the real estate market. However, the main challenge facing the US economy continues to be the adoption of policies that contribute to the progressive reduction of its external deficit, through the promotion of private and government saving. As earlier stated, the consequences of a disorderly correction would be very adverse both for the US economy and for the rest of the world.

### **3 Asia: dynamism, external surplus and build- up in reserves**

As in previous years, the Asian economies grew forcefully in 2005 as a result of the robustness of activity in China and other emerging countries in the region, including most notably India. The pace of growth was further reinforced by the reinvigoration of the Japanese economy. However, the challenge facing most Asian economies is to contribute more decisively to correcting global imbalances. The persistence or widening of high current account surpluses showed that the headway towards greater flexibility in exchange rates (in the case of China and many emerging economies in the region) and higher productivity growth (in Japan) was generally insufficient.



SOURCE: National statistics.

- a. Contributions to annual GDP growth.
- b. Annual percentage change.
- c. Commercial urban land price.

### 3.1 JAPAN: THE RECOVERY FIRMS AND THE END OF DEFLATION IS IN SIGHT

The Japanese economy showed sustained momentum during 2005, resulting in growth of 2.7% for the year as a whole, 0.4 pp up on 2004 (see Chart 2.8). Following the slowdown in 2005 Q3, the favourable subsequent indicators and the National Accounts data to 2006 Q1 largely dispelled doubts as to whether Japan would once more grind to a halt as had occurred on several occasions in the previous decade.

Of particular importance for embedding this optimistic diagnosis was the change in 2005 in the composition of growth, which became clearly domestic demand-led, with a still-positive (albeit on a lesser scale) contribution of external demand. Behind this turnaround in the sources of Japanese growth were the firming of private consumption, which grew by 2.2% in 2005 with a notable acceleration towards the close of the year, and the renewed vigour of gross fixed capital formation, which grew by 3.3%, 2.4 pp more than in 2004. The public-sector contribution to GDP growth was, by contrast, very small. The lesser contribution of external demand was attributable to the slowdown in exports, this being due to temporary factors, including most notably the fall-off in Chinese demand in 2005 Q1.

The greater resilience of the business sector, the growth of credit and favourable labour market trends (all of which features were absent in previous episodes when the recovery had stalled) also lay behind the optimism over the sustainability of the Japanese expansion beyond 2005. Corporations achieved sound profits, partly because of the favourable external setting, but also because of the drive to eliminate surplus capacity in certain industries and to reduce high debt levels. These factors contributed to boosting private investment and to the restructuring of bank balance sheets. Along with the build-up in liquidity resulting from the ultra-expansionary monetary policy, this was conducive to bank lending to the private sector, which grew for the first time in the past six years. The buoyancy of the labour market was evident in the reduction in the unemployment rate to 4.1% in April 2006. Of particular significance, moreover, were the decline in the ratio of temporary to total employees, for the first time in the past four years, and the gradual pick-up in wages, which played a particularly important role in the acceleration in private consumption in the closing months of 2005.

Several indicators suggested, moreover, that the end of the protracted deflation in Japan could be drawing near. Consumer prices grew at an annual rate of 0.5% in January 2006 – the highest rate since early 1998 – and continued to show similar increases in April this year. Underlying inflation turned positive from November 2005 and reached an annual rate of 0.5% in the first four months of 2006, although in Japan this measure of inflation includes energy prices and is, therefore, biased upwards. The stock market performance was exceptionally favourable, gaining 55% between December 2004 and April 2006. And the price of commercial land in urban areas, which increased for the first time since 1992, suggests that the Japanese economy may have largely emerged from the aftermath of the bursting of the real and financial asset bubble in the 90s (see Chart 2.8).

The prospect of emerging from deflation and greater economic dynamism led the Bank of Japan to change its monetary policy arrangements and to adopt a more orthodox framework of operational targets for the interest rate, replacing the policy of quantitative targets for the liquidity stock. While these changes should not, judging by the messages from the Bank of Japan, entail an immediate change in official rates, the markets reacted by anticipating a greater likelihood of rate rises. The slightly upward trend of long-term government bond yields evident at the start of the second half of 2005 was thus reinforced, although they held at levels which are still very low and substantially below those seen in other industrialised areas. The firming of inflation expectations, against the background of the transition towards a monetary policy with operational interest rate targets, and the calibration of the exact time at which official rates cease to be equal to zero are therefore the two important challenges that the authorities must face in 2006. In this respect, it is significant that the Japanese central bank has clarified its views regarding price stability, which is defined as the situation in which the annual growth rate of consumer prices stands at between 0% and 2%, despite the fact that this definition did not entail the adoption of an explicit target for the inflation rate.

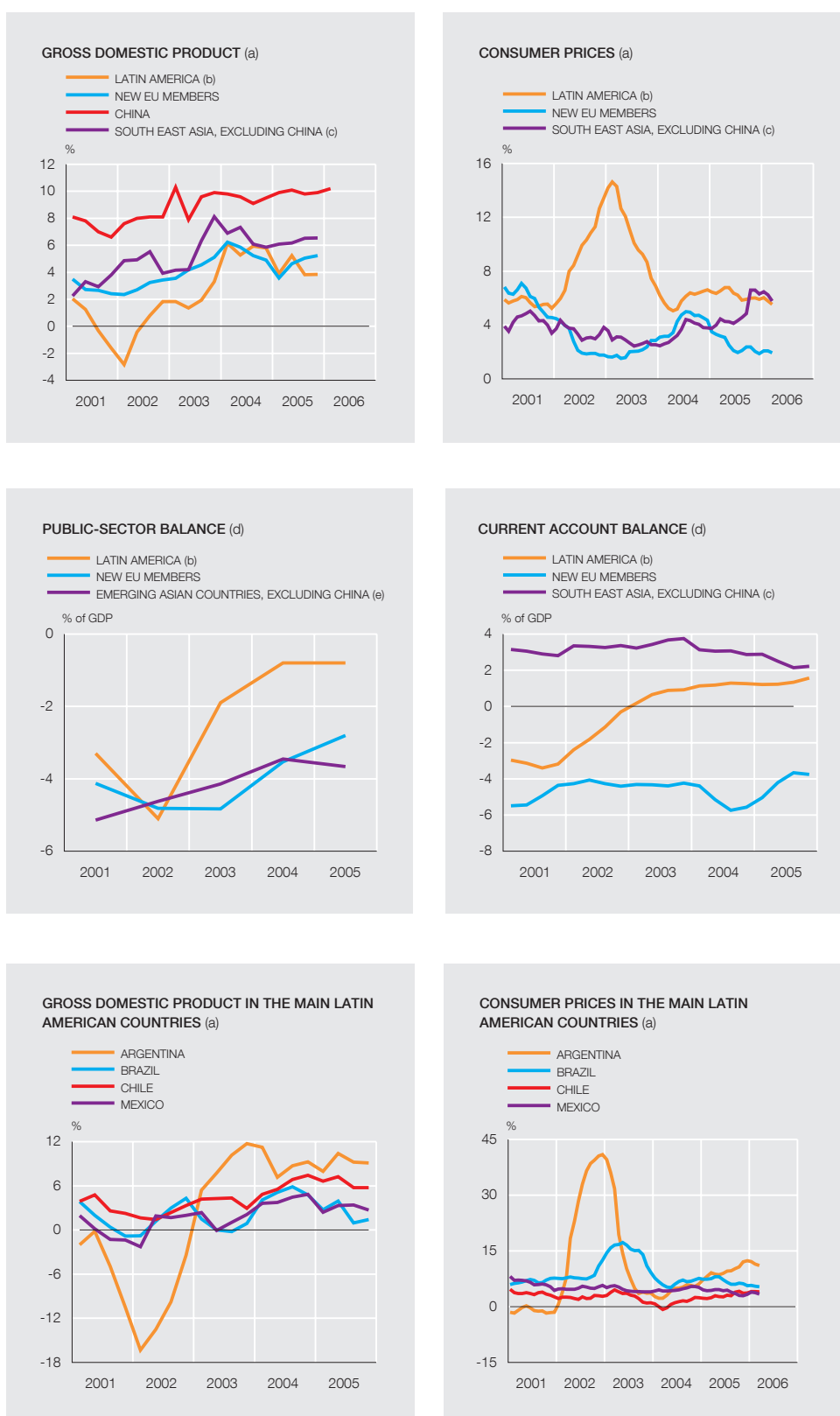
As regards fiscal policy, the general government deficit declined only moderately (from 6.6% to 5.8% of GDP), whereby the progressive reduction in the public debt/GDP ratio (which rose to 175% in 2005) by means of policies that do not jeopardise the continuity of growth is another central challenge to the Japanese economic authorities. To draw Japanese potential growth rates closer to those of other developed economies, it remains of paramount importance to further the program of reforms, which include the liberalisation of the labour markets and the restricting of shareholder links between the banking and industrial sectors. Higher growth should contribute, moreover, to progressively closing the current account surplus by means of greater demand for imports, which will provide for a correction of global imbalances and for greater international economic stability.

### 3.2 CHINA: THE EXPANSION CONTINUES WITH LIMITED REFORMS

Chinese GDP growth stood at 9.9% in 2005, 0.2 pp down on the previous year (see Chart 2.9). This rapid growth rate, which quickened in 2006 Q1 to an annual rate of 10.3%, highlighted the risk of overheating, which was already a cause for concern in 2004.

The methodological reforms in Chinese national accounts involved, firstly, a revision of the estimated size of the economy, which became the fourth biggest in the world at market exchange rates and continued to be second-ranked in terms of purchasing power parity. Further, the annual growth figures from 1993 onwards were revised upwards, raising annual average growth by half a percentage point to 9.9%. This revision also entailed an increase in the weight of services within the Chinese economy, thus partly alleviating the concern over its excessive dependence on the industrial sector.

Among the demand components, investment continued to be the main driving force of the Chinese economy in 2005 judging by the indicators available, although doubts remain about



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 the Philippines.

d. Surplus (+) or deficit (-).

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

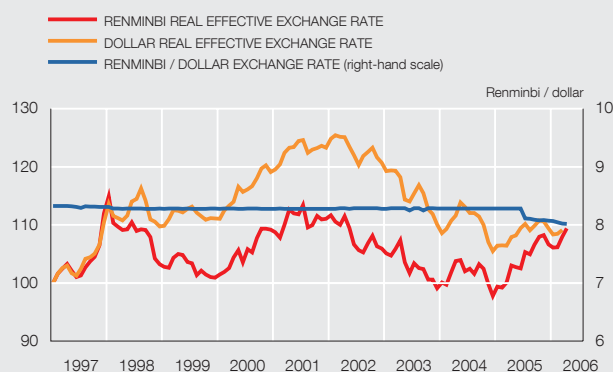
The increasing global importance of the Chinese economy (particularly its role in sustaining and financing global imbalances) is reflected in the international community's growing concern over the country's exchange rate policy. Over the last decade, the exchange rate of the renminbi, although flexible in theory, has been closely tied to the dollar. As a result, the Chinese currency underwent significant depreciations in real effective terms in the period from end-2001 – the date of China's entry into the World Trade Organization (WTO) – to 2004. In 2005, the Chinese authorities took successive steps to reform the exchange rate regime. At the beginning of the year, they announced their intention to provide for greater convertibility of the renminbi and, in May, the development of foreign exchange markets for the dollar, euro, yen and the Hong Kong dollar began, based on the figure of the market-maker. In July, the renminbi was revalued against the dollar by 2.1% and formally pegged to a basket of currencies – although the maximum daily fluctuation rate of  $\pm 0.3\%$  against the dollar was maintained – and the role of market forces in determining the exchange rate was reaffirmed. At the beginning of August, the first steps were taken to create renminbi domestic forward and swap markets to prepare Chinese agents for a more variable exchange rate through foreign exchange risk management. During this month, and again at the start of 2006, the number of agents able to participate directly in foreign exchange markets increased, along with the number of instruments traded. Furthermore, January 2006 saw the creation of the mechanism for setting daily opening prices, a further enhancement of the theoretical flexibility of the currency exchange rate, since it ended the association with the previous day's trading price. In combination, the reforms had the effect of reversing the renminbi's depreciation and, between December 2004 and March 2006, the currency appreciated 3.3% against the dollar, although owing to the composition of China's external trade, the appreciation in real effective terms was 9% over this period. From a broader perspective, however, in real effective terms the renminbi had still depreciated by 3.7% compared with 2001 (see Chart 1).

Much of the international community considers the real effective exchange rate of the renminbi to be undervalued. A number of indications lend weight to this view, namely the substantial dynamism of the Chinese economy, export growth, its growing trade surplus, the increase in its share of international markets and its massive accumulation of foreign reserves. However, the empirical evidence is not conclusive about the renminbi's equilibrium value and neither, therefore, about the magnitude of an appropriate correction. As a recent IMF publication shows<sup>1</sup>, although the median estimate of the equilibrium real effective exchange rate indicates an 18% undervaluation of the Chinese currency, the range of estimates is very wide and suggests that the exchange rate could be anything from slightly overvalued to almost 50% undervalued. Such wide-ranging results are due to the difficulties inherent in estimating equilibrium exchange rates, along with, in the case of China, singular characteristics, such as price and wage controls.

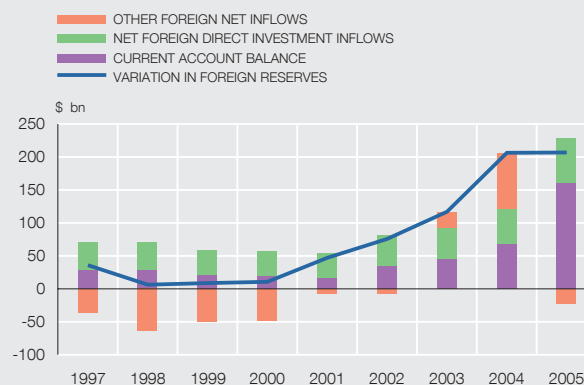
The effects of China's exchange rate policy are also felt in the implementation of domestic macroeconomic policies. An excessively tight peg to the dollar may have adverse consequences by limiting the Chinese economy's capacity to adjust to specific shocks. Moreover, the *undervaluation* of the renminbi has further negative repercussions and is difficult to maintain over time. An artificially undervalued exchange rate is beneficial to the export sector and therefore smoothes some domestic imbalances, such as the rural exodus caused by the reform of the agricultural sector and the job losses resulting from the restructuring of state-owned enterprises. Although this strategy helps to contain these pressures in the short term, from a medium-term perspective the exchange rate is a relative price and, as such, an inappropriate level disrupts the allocation of resources across sectors. In particular, an undervalued renminbi fosters the artificial develop-

1. Steven Dunaway and Xiangming Li (2005), *Estimating China's "Equilibrium" Real Exchange Rate*, IMF Working Paper 05/202.

## 1. EXCHANGE RATES



## 2. DETERMINANTS OF THE ACCUMULATION OF RESERVES



SOURCES: People's Bank of China, Federal Reserve and JP Morgan.

- a. January 1997 = 100. An increase denotes an appreciation of the currency.  
b. Includes net inflows in portfolio investment, other investment and errors and omissions.

ment of the export sector to the detriment of other sectors – which, in turn, generates inadequate incentives in the financial sector – and cannot be maintained indefinitely on account of a number of factors, including the risk of an increase in protectionism in third countries. Furthermore, the *accumulation of reserves* inherent in this strategy also has important domestic consequences. First, it diverts a portion of domestic savings abroad, rather than contributing to higher consumption and investment, or the repayment of external debt. Growth in external assets also creates problems for the implementation of monetary policy, as the assets have to be sterilised, at least partially, to prevent a situation of excess liquidity and the resulting credit growth from feeding through to consumer prices, generating asset price bubbles, or exacerbating the problem of loan defaults in the medium term. Other reserve accumulation costs that affect a central bank's balance sheet, such as foreign exchange risk or interest rate risk, should not be forgotten either. To date, however, the discretionary use of controls on capital inflows and outflows, as well as government intervention – including price controls – in markets, have alleviated some of the adverse domestic consequences of the country's exchange rate policy.

China's exchange rate policy is also having global repercussions. The *undervaluation* of the renminbi is disrupting the international allocation of resources by artificially reducing third countries' competitiveness. The *accumulation of reserves*, mostly in the form of dollar-denominated assets, helps to reduce the cost of government financing and to finance the growing US current account deficit. A sudden change in China's policy of accumulating reserves – which already account for roughly one-fifth of the world total – could well have an impact on global financial stability. A gradual increase in the exchange rate flexibility of the renminbi would therefore not only benefit China but also the rest of the world.

Reform of the exchange rate policy must also run carefully in step with the liberalisation of the Chinese economy. Accordingly, given the weakness of the country's financial institutions, the reform and restructuring of the financial system should take precedence over greater flexibility of international capital movements, especially short-term outflows. The gradual introduction of greater exchange rate flexibility would not only lessen the above-mentioned risks, but also prepare the economy for liberalisation.

the real profitability of some of the projects launched and there is concern over the excessive dependence on capital formation.

Turning to external demand, there was a persistent slowdown in imports, which declined from an annual rate of 35.8% in 2004 to 17.6% in 2005. This fall was partly caused by the progressive substitution of domestically produced goods for those produced abroad. Exports, meanwhile, remained notably firm, with growth of 28.5% on average in 2005. In step with these trends, the trade surplus tripled in relation to the 2004 level to \$102 billion in 2005, equivalent to 4.6% of GDP, and the current account surplus doubled from 3.6% of GDP in 2004 to 7.1% in 2005.

The tempered movements of the renminbi did not contribute appreciably to reducing this notable surplus, despite the fact that the Chinese authorities reformed their exchange-rate regime in July to allow, at least formally, more flexibility in the price of its currency (see Box 2.3). However, after an initial 2.1% revaluation against the dollar, the renminbi held virtually unchanged against the US currency, appreciating by only 1.2% more in the period to April 2006. The Chinese central bank's international reserves continued to grow at a high rate, though one more moderate than in 2004, rising to \$875 billion at the end of March 2006, \$266 billion more than in December 2004. The Chinese central bank thus became the biggest holder of international reserves, accumulating around 20% of the world total, ahead of the Bank of Japan.

Against this backdrop, the central bank continued with a monetary policy aimed at the partial sterilisation of the liquidity generated by this build-up in international reserves, a policy assisted by the abatement of inflationary pressures. Indeed, consumer prices showed a downward trend during the year and stabilised at a very low rate, posting annual growth of 1.2% in April 2006. Producer prices followed a similar trend, with annual growth of 1.9% in the same period. Despite this favourable situation, the incipient rise in property prices in early 2005 prompted an



increase in mortgage interest rates and a tightening of borrowing conditions for house purchases. The marked buoyancy of activity in 2006 Q1 led the central bank to raise its reference interest rate on loans by 27 bp.

The continuation of very high growth rates with scarcely no signs of slowing means the risk of the Chinese economy overheating remains in place. In this connection, the main challenge facing the Chinese economy is to stabilise the expansion at a more sustainable level, while moving the reform of the financial system ahead, absorbing internal rural-to-urban-areas migratory pressures and bringing about a greater balance between consumption and investment. The continuity of the process of reforms would contribute to smoothing this transition. One particular reform, namely greater exchange-rate flexibility, would also help provide for a greater contribution by China to the orderly re-absorption of global imbalances.

### 3.3 REST OF ASIA: EXPANSION AND SIGNS OF INFLATION

In the other Asian countries, economic growth generally remained high in 2005. In most, however, it was somewhat lower than the previous year, whereby average growth in the area was over 6% (see Chart 2.9), with notable performances in India and Hong Kong, whose GDP expanded by 8.3% and 7.3%, respectively. Economic growth, which generally tended to accelerate slightly during the second half of 2005, was based mainly on the positive contribution of domestic demand, although external demand also improved somewhat. The sound performance of exports in most economies in the area was a consequence of the continuing invigorating effect of demand from China and from the positive cycle in information and communications technology-intensive goods.

Monetary policies tended, with some exceptions, to be tightened to combat the gradual increase in inflation due to the hike in oil prices. The rise in inflation was particularly noticeable in Indonesia and Thailand, where signs of it spreading to the underlying rates were observed. There were few substantial changes in fiscal policies, though in some cases there was a clear tendency towards deficits somewhat higher than initially forecast. In India, despite high government indebtedness, the budget balance deteriorated appreciably following several years of consolidation, although the government announced corrective measures with a view to 2007. The current account balance in most economies in the region remained in surplus throughout the year, as the increase in exports offset the higher expenditure on energy imports. The continued pursuit of exchange-rate policies geared to ensuring competitiveness, through relatively depreciated exchange rates, resulted in frequent interventions by most central banks and in a significant increase in the volume of official reserves. The risks associated with this accelerated build-up in reserves, especially in the light of the inflationary pressures witnessed in 2005, coupled with the growing dependence on the Chinese economy and the consequent exposure to a potential economic slowdown in China, continued to condition to some extent the favourable outlook for activity in these countries.

### **4 Latin America: improved fundamentals, but a lack of reforms**

Following several years of high global growth, high commodities prices and favourable financial conditions, growth in Latin America in 2005 was strong (4.3%), though more moderate than in 2004 (5.8%). The slowdown was largely attributable to the lower growth in two of the major countries: Mexico and, above all, Brazil (see Chart 2.9). The momentum in the labour markets of all economies in the region (with notable rates of job creation, markedly so in the formal sector, and reductions in the unemployment rate) coupled with a greater availability of credit to the private sector (which grew by 13% in real terms in 2005) contributed to stimulating consumption and investment in such a way that domestic demand held up strongly. The negative contribution of external demand to growth increased, despite the notable rise in exports in 2005 (21% in value and 10% in volume).



Developments in import and export prices, however, enabled the trade balance to hold stable and the current account balance to post a surplus equivalent to 1.7% of GDP, somewhat higher than the previous year. The progressive widening of the surplus on transfers, related to the growth of workers' remittances, was partly offset by a growing deficit on the incomes balance. Against this background, it is estimated that the average exchange rate for the area appreciated by 12.8% in real effective terms between December 2004 and April 2006, despite the intense build-up in reserves by the central banks of the region.

Aggregate inflation for the area, after rising in the first half of 2005, ended the year at an annual rate of 5.9%, down on 2004. Inflation rates tended to ease in the second half of the year, and where they did increase it was from lower levels, with the exception of Argentina, which ran at double-digit rates. Moreover, all the central banks with direct inflation targets met their pre-set goals, which was a milestone in terms of the consolidation of their credibility.

Public finances continued on the favourable trend observed in previous years. Reflecting this was a primary surplus in the region of 3.4% of GDP in 2005, while the budget deficit stood at around 1%, somewhat higher than in 2004, owing to the increase in interest payments in some countries, such as Brazil. The persistence of this fiscal adjustment, with financial problems behind and recovery under way, might provide more leeway to use the stabilising properties of fiscal policy, in contrast to what has traditionally been the case in Latin America (see Box 2.4).

Apart from the maintenance of fiscal discipline, the year 2005 was marked by the consolidation of the ongoing reduction in financial vulnerability. Contributing to this were active debt management policies, aimed at reducing the exposure of still-high public debt to the exchange rate. Further, the active attitude of governments promoted a significant development of local debt markets, with a notable increase in participation by foreign investors. Thanks, among other factors, to this, external debt as a proportion of GDP declined by 8 pp to 25% at end-2005. In step with these efforts by the authorities, Latin American financial markets performed better than even those of other emerging regions, and this translated into significant stock market gains and a persistent reduction in sovereign spreads. By contrast, 2005 saw a stagnation in economic reform processes (which had already been losing steam in recent years) coinciding with the onset of an intense electoral cycle in many countries. In this respect, the favourable external environment fuelled confidence about the foundations of regional growth perhaps excessively, resulting in lesser urgency to undertake reforms aimed at bolstering such foundations.

In Brazil, activity slowed substantially. This was reflected in growth of 2.3% in 2005, less than half that the previous year, which was the outcome of the tightening of monetary policy in the first half of the year and the impact on agents' confidence of the worsening political climate, which markedly affected investment. Consumption, meanwhile, underpinned by a strong rate of job creation, retained greater momentum, as did the external sector. The current account surplus (1.8% of GDP) remained large and there was a consolidation of fiscal discipline, with a primary surplus of 4.8 pp of GDP, which exceeded the government's annual target. As regards the second half of the year, the favourable inflation trend (standing at an annual rate of 4.6% in April 2006) allowed for a reduction of 375 bp in the official interest rate between September 2005 and April 2006 to 15.75%. The Brazilian authorities made a particular point of mitigating the vulnerability of public debt, harnessing the favourable borrowing conditions to reduce the proportion of exchange rate-indexed debt and also external debt, in this latter case through the early cancellation of the debt with the IMF, of the debt with the Paris club and of its outstanding Brady bonds. However, the above-mentioned weakness of the administration also saw the process of reforms grind to a halt, after notable headway in recent years.

Fiscal policy can play a significant stabilising role by means of countercyclical action involving the adoption of an expansionary stance in economic downturns and a restrictive stance in upturns. However, empirical evidence has shown that the fiscal policy stance has traditionally been procyclical in numerous emerging countries, in particular in Latin America, although the recent upturn there has been characterised by a continuing increase in primary fiscal surpluses and by greater fiscal discipline. These signs of change, if confirmed, would improve the prospect of maintaining sustained growth, since the procyclical behaviour of fiscal policy adds a further source of volatility in countries where such volatility is already very high, with adverse consequences for investment and economic activity in the long run.

The procyclical behaviour of fiscal policy in Latin America is shown in panel 1, which includes estimates of the changes in the structural primary surplus and in the output gap – which proxies the cyclical position – for the seven major economies in the region during the period 1981-2004<sup>1</sup>. The structural primary balance is one of the commonest indicators of fiscal policy stance. An increase in this balance indicates that fiscal policy is adopting a contractionary stance, and vice versa. The negative correlation observed between both variables suggests that expansionary (contractionary) fiscal policies tend to coincide with the top (bottom) of the cycle.

Various explanations have been put forward for this systematic negative relationship between structural primary balance and cycle in Latin America, relating, for instance, to the satisfaction of interest groups or to the political cycle, in weak institutional environments. An alternative hypothesis draws on the vulnerability and structural fragility of these countries' public finances. Owing to scant domestic saving and to the shallowness and underdevelopment of national financial markets, there is a high dependence on external sources of financing. Adding to this dependence is the fact that the public debt

burden, in terms of service, maturity, composition and denomination, is highly sensitive to the financial conditions prevailing at each point in time. In these circumstances, the deterioration of financial conditions and, in particular, episodes of strong instability make a parallel adjustment of activity and of fiscal policy necessary. The adjustment of activity has its starting point in a reduction in the capacity to finance external imbalances, which prompts a sharp correction in the current account balance via, normally, a contraction in domestic demand and, therefore, in economic activity. Against this background, in which precisely the implementation of an expansionary fiscal policy would be required, this course of action is hampered by greater problems of access to external financing, which tends to diminish in this situation. Contributing to this fall-off are agents' doubts about the sustainability of public debt, which oblige the authorities to tighten fiscal policy and, therefore, to adopt a procyclical stance, which fuels the recession.

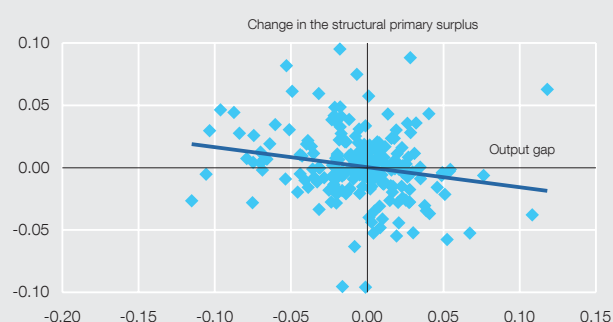
This explanation suggests that the worsening of the perception of the sustainability of public finances, which induces dearer financial costs and even the interruption of external financing, may be pivotal in explaining the behaviour of fiscal policy. To verify this hypothesis empirically, the primary balance that would stabilise the public debt/GDP ratio at each point in time (which we may call the current threshold balance) is chosen as an indicator of the perception of sustainability<sup>2</sup>. This indicator allows the objective conditions of vulnerability to be jointly evaluated with agents' perception, with both reflected in the cost of financing required at each point in time. Primary balances above (below) this threshold would mean that the debt ratio is on a sustainable (unsustainable) path.

Panel 2 shows the estimates of the changes in the structural primary balance and in the primary surplus that stabilises the debt ratio, once again for the seven main economies in the region in the

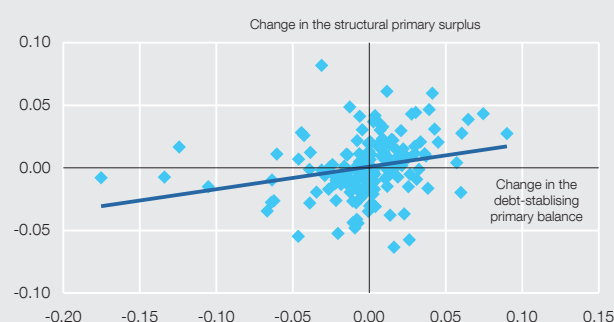
1. See E. Alberola and J.M. Montero (2006), *Debt Sustainability and Procyclical Fiscal Policies in Latin America*, Documento de Trabajo 0611, Banco de España.

2. This indicator is based on the public debt dynamics equation, which establishes that an increase in the debt/GDP ratio depends positively on the difference between the real cost of financing public debt and the real growth rate, as well as on the existing public debt ratio, and negatively on the primary surplus actually recorded.

1. RELATIONSHIP BETWEEN THE CHANGE IN THE STRUCTURAL PRIMARY BALANCE AND THE OUTPUT GAP



2. RELATIONSHIP BETWEEN THE CHANGE IN THE STRUCTURAL PRIMARY BALANCE AND THE CHANGE IN THE DEBT-STABILISING PRIMARY BALANCE



SOURCE: Alberola and Montero (2006).

same period. A positive correlation between both variables would mean that when there is a deterioration in the perception of fiscal sustainability, measured via an increase in the current threshold balance, the fiscal policy stance would tend to be more restrictive. As can be seen, there is a positive relationship between both variables, which is also statistically significant. That is to say, it is shown that the greater the surplus needed to stabilise debt in the future, the greater the fiscal adjustment made by the authorities. The veracity of the hypothesis can be confirmed by exploring the significance of the initial position of fiscal sustainability. The results show that the bigger the distance between the actual primary balance and the debt-stabilising primary balance, the greater the subsequent fiscal adjustment. Specifically, the fiscal policy reaction to the deterioration in the conditions of sustainability does not only depend on changes in perception, captured using the change in the current threshold balance, but on the existence of a sustainability problem and on its magnitude, both of which are measured through the difference between the current threshold balance and the actual primary balance. As suggested above, if the structural position of public finances were not a cause for concern, then there would be no reason to tighten

the fiscal policy stance when financial conditions and the cycle worsened, in which case it would be expected to play a stabilising role.

This evidence offers robust support to the hypothesis that the procyclical fiscal policy stance in Latin America is determined by the financial vulnerability of public finances. Nonetheless, in recent years a phase of high economic growth and financial stability has combined with greater fiscal discipline, making for high primary surpluses, and with substantial changes in the composition of public debt, which has lessened their sensitivity to fluctuations in financial variables, in particular to the exchange rate. This structural improvement in public finances is enabling the perception of fiscal unsustainability to be alleviated. However, recent experience shows – and the results described highlight this – that the perception of vulnerability is also highly fluctuating, especially in a setting of worsening economic and financial conditions. Accordingly, perseverance with this type of policy in the current favourable setting is crucial so that fiscal policy in Latin America may effectively perform the stabilising role desired in the present and future business cycles.

In Mexico, growth of 3% was recorded in 2005, 1.2 pp down on 2004, although there appeared to be something of a pick-up in the economy from the second half of the year. Although domestic demand firmed, there was a bigger negative contribution by the external sector. This notwithstanding, the deficit on the trade balance narrowed thanks to high oil prices which, along with the widening of the surplus on the transfers balance (which includes remittances), accounted for the reduction in the current account deficit to 0.7% of GDP, the lowest figure since 1995. Inflation fell gradually throughout the year to 3.2% in April 2006, while the underlying rate stood at 3.2%. That offered the central bank scope to begin reducing interest rates from August, using as its preferred instrument the bank funding rate rather than the traditional “corto” (which measures the scale of the central bank’s absorption of commercial banks’ liquidity). On the fiscal front, the budget drew nearer to being in balance, owing especially to lower interest payments. In the last year of the current presidency, progress in reforms was limited to new legislation on securities and on fiscal responsibility.

Argentina managed to achieve slightly higher growth in 2005 (9.2%) than in previous years thanks to the momentum of domestic demand and of the external sector. Accompanying this favourable performance was an ample surplus on the current account balance (equivalent to 2% of GDP) and a high primary central government surplus (3.7% of GDP), although both were slightly less than in 2004. In contrast to these sound results, inflation rose strongly to an annual rate of 12.3% at the close of 2005, double the previous year’s figure. Among the various factors contributing to this acceleration, which has become the main factor of risk in the macroeconomic outlook, is the administration’s strategy to maintain a depreciated currency. That restricted the central bank’s room for manoeuvre to raise interest rates and prompted a strong build-up in reserves, which was only partly sterilised. Real interest rates continued to be negative and the main anti-inflationary measures were of an administrative nature. The cancellation of the loan with the IMF in December 2005 enabled economic policies to be decoupled from the conditionality associated with the IMF programmes.

Although the current expansionary phase has notably strengthened the Latin American economies, given their comfortable external position and the lessening of the risks associated with high debt, at bedrock some vulnerability remains; consequently, a reversal of the favourable international trends might threaten the continuity of growth. This possibility is particularly relevant in the countries that adopted policies in recent years not especially conducive to investment. More generally, it should be stressed that the favourable economic results are in contrast to the stagnation of structural reforms, which have even seen backsliding in some cases associated with the adoption of increasingly interventionist economic policies. In some recent episodes, these policies have seriously threatened legal stability. The reactivation of the reforms and the maintenance of a climate of legal security propitious to investment are, however, vital for achieving higher, sustained growth rates that in turn enable social inequalities and poverty to be alleviated.

## **5 Non-euro area**

### **European countries: differing trajectories**

Growth in the United Kingdom economy slowed markedly in 2005 to 1.8%, down from 3.1% the previous year. This slowdown was associated with the lesser momentum of domestic demand and, in particular, with the slackness of private consumption, attributable in part to the slowdown in the rate of increase of property prices, which was notably more marked in the United Kingdom than in other industrialised countries. The indices of house prices, which had increased at an annual rate of over 15% in 2004, posted a rate of less than 3% during the summer and, following a slight rebound, ended 2006 Q1 at around 6%. Investment also slowed significantly, partly as a result of the narrowing of business margins owing to the higher cost of oil and other energy products. Wages behaved moderately in a labour market that remained very dynamic, with the unemployment rate below 5% for most of the year, although this threshold was breached towards the end of 2005. The initial indicators for April pointed to an incipient recovery in the rate of economic activity.

Inflation trended favourably, once the impact of the rise in energy prices was stripped out. The consumer price index grew at an annual rate of 2% in April 2006, thus standing at the mid-point of the interval that defines the Bank of England's inflation target. Along with the sluggishness of growth, the most worrying aspect of the economic situation was the public-sector deficit, which reached 3.6% in 2005 as a whole. As this followed a similar overrun in 2004, the European Council ruled the existence of an excessive deficit, in accordance with the criteria laid down in the Treaty of the European Union. However, the budget unveiled by the government for 2006-2007 did not fully dispel the possibility of a failure to comply with the targets set for public spending and the deficit.

The ten new EU Member States maintained notable GDP growth in 2005, generally higher than that of the previous year. However, owing to the slowdown in Poland, the biggest new entrant, regional growth in 2005 was somewhat down on 2004 [4.6% compared with 5.3% (see Chart 2.9)]. This growth was based, in most cases, on improved domestic demand and on the sound performance of exports. Both private consumption and investment benefited from the increase in disposable income and from the strong growth of credit to the private sector.

Inflation rates eased in relation to 2004. The favourable course of food prices and the appreciation of currencies in the area helped contain inflationary pressures, enabling official interest rates to be lowered during 2005 and in early 2006 (with the exceptions of the Czech Republic and Slovakia). Owing to the strong growth of credit to the private sector, some countries opted to increase their minimum reserve requirements.

As regards fiscal policy, the targets set in the Convergence Programmes were generally met. Nonetheless, in several cases the public-sector deficit increased, reflecting – given the relatively high growth rates – the application of pro-cyclical fiscal policies, which did not contribute to the fiscal consolidation objectives.

The aggregate current account deficit fell from 5.3% of GDP in 2004 to 3.9% in 2005, but this was largely due to the impact of Poland, since seven of the ten new Member States ran deficits higher than 5% of GDP. The financing of these deficits stemmed largely from capital inflows in the form of foreign direct investment, which increased slightly in 2005 from 3.9% to 4.2% of GDP. However, portfolio investment and foreign loans gained in significance in some economies, giving rise to an increase in debt levels that was particularly sharp in some of the Baltic countries.

As in other areas with emerging markets, developments on financial markets were, generally, very favourable in 2005, with a practically continuous reduction in sovereign spreads in relation to euro area long-term rates and strong stock market gains. In addition to the greater appetite for risk on international markets, this favourable behaviour is attributable to the cuts in these countries' official rates and to the favourable impact of the institutional framework of the EU. Nonetheless, this favourable situation was clouded by isolated bouts of turbulence, essentially relating to fiscal uncertainty, as in the case of Hungary.

In May 2005 the currencies of Cyprus, Latvia and Malta joined the Exchange Rate Mechanism (ERM-II), as did the Slovak koruna in November, thereby following in the steps of Denmark, Estonia, Lithuania and Slovenia. They all maintained standard fluctuation bands of  $\pm 15\%$ , although Latvia unilaterally adopted a band of  $\pm 1\%$  and Malta, also unilaterally, set its exchange rate at the central parity. The exchange rates of the currencies belonging to the ERM-II generally held stable around their central parities, with some appreciation by the Cypriot, Latvian and Slovakian currencies. The others trended unevenly: the Polish zloty and the Czech koruna appreciated against the euro by around 3.5% and 6.5%, respectively, between December 2004 and April 2006, while the Hungarian forint depreciated by 6% over the same period.

In the coming years, the challenge facing the new European Union members will be to continue making headway in real and nominal convergence, and to fulfil the conditions for the adoption of the euro. During these processes, it will be necessary to address the imbalances that have emerged and, in particular, to tackle the correction of the external deficits, to keep credit growth under control and to ensure price stability, through the adoption of prudent policies geared towards macroeconomic stability. Fiscal consolidation will be particularly important here.

Regarding the candidate countries for EU membership, Bulgaria and Romania signed their accession treaties, which envisage their entry in 2007. Accession negotiations began with Croatia and Turkey, and the Former Yugoslav Republic of Macedonia (FYRM) was given EU candidate status. All these countries achieved significant GDP growth of over 3.5% in 2005, and – with the exception of FYRM – posted high current account deficits in excess of 6% of GDP. In the case of Turkey, favourable developments in the economy were partly underpinned by the high degree of compliance with its current programme with the IMF.

In Russia, GDP continued to grow notably in 2005, posting a rate of change of 6.4%, slightly down on the figure of 7.2% in 2004. Of note was the positive contribution of both domestic demand and external demand, thanks to the favourable trend of oil prices. High oil export revenues widened the burgeoning current account surplus, which rose from 9.9% of GDP in 2004 to 11.3% in 2005, and also the budget surplus, which climbed from 4.4% to 8.6%. The exchange rate appreciated by 9% against the euro between December 2004 and April 2006, despite the sharp rate of accumulation of reserves. The difficulties in sterilising this strong increase in reserves against the background of a buoyant economy partly explain the rise in the annual inflation rate to 10.9% in December 2005, 0.9 pp above the upper target range set by the monetary authority.

### 3 THE EURO AREA AND THE COMMON MONETARY POLICY

### 1 *Economic conditions in the euro area*

The process of economic recovery in the euro area which began in mid-2003 slowed in 2005, with GDP growth of 1.4%, 0.4 pp below the 2004 figure. During the year, however, growth moved on a slightly rising course, ending 2005 with an annual increase of 1.8% in Q4, up on the figure of 1.2% in the first half of the year.

The sluggishness of growth in 2005, which highlights the lesser robustness of the current phase of recovery compared with previous cycles, was caused by the impact of the rise in oil prices, the reduction in the rate of increase of external demand and the weakness of consumer confidence. Nonetheless, beyond cyclical factors, the scant economic dynamism in the area suggests other structural factors may be constraining the area's growth potential. These factors are all the more relevant if regard is had to the accommodative monetary policy stance maintained during the year, reflected in short and long-term interest rates holding at historically low levels both in nominal and real terms.

Euro area inflation stood at 2.2% in 2005, once again exceeding the medium-term benchmark considered to be consistent with price stability, despite the scant momentum of demand and the insufficient utilisation of available capacity. Actually, the rise in the HICP chiefly reflected the continuing hike in oil prices, although this rise does not appear to have passed through either to unit labour costs or to the final prices of other goods, as indicated by the low growth of underlying inflation (1.5%). Indeed, the continuing degree of wage moderation seen in the area in 2005 – with real wage growth below that of productivity per employee – helped curb the inflationary effects stemming from dearer energy and from the depreciation of the euro over the year as a whole.

In the economic policy realm, the March 2005 European Council gave rise to new and significant institutional arrangements. First, a reform of the Stability and Growth Pact was approved aimed at increasing the incentives for achieving more disciplined behaviour at the top of the cycle and introducing greater flexibility in the downturn. Further, it was decided to give fresh momentum to the Lisbon strategy, giving priority to measures with a greater impact on activity and employment growth and defining more precisely the division of responsibilities between the Community and national levels. These measures seek to contribute to strengthening fiscal discipline mechanisms, as the proper working of the Economic and Monetary Union will require, and to speed the adoption of structural reforms, which are needed to invigorate activity in a sustained fashion. While such progress is a reasonable starting point for bolstering the economy, its effectiveness will depend on the degree of determination national authorities show in implementing the agreements reached and meeting the objectives set.

The outlook for 2006 points to a continuation of the ongoing economic recovery, based on the maintenance of relatively high growth in world trade and on the firmer pass-through of the external impulse to domestic demand and to employment. This cycle of economic expansion provides for a propitious setting, which should not be wasted, to step up efforts to correct fiscal imbalances and to set in train the range of structural reforms needed.

#### 1.1 ACTIVITY AND EMPLOYMENT

Compared with the previous year, the smaller rate of increase in GDP in 2005 was in response to the reduction in the contributions of the net external balance and of stockbuilding, while domestic demand increased its contribution by 0.2 pp (see Table 3.1). The more prominent role of domestic spending was due to the dynamism of gross fixed capital formation, espe-



	2003	2004	2005	2005			
				Q1	Q2	Q3	Q4
DEMAND AND OUTPUT							
Gross domestic product	0.7	1.8	1.4	0.3	0.4	0.7	0.3
Private consumption	1.0	1.4	1.4	0.1	0.3	0.5	0.1
Government consumption	1.7	1.1	1.4	0.2	0.7	0.9	0.0
Gross fixed capital formation	0.8	1.9	2.5	0.2	1.2	1.0	0.3
Exports	1.1	5.9	4.1	-0.2	1.6	2.7	0.7
Final demand	1.3	2.9	2.3	-0.1	0.9	1.3	0.6
Imports	3.0	6.2	4.9	-1.2	2.1	2.9	1.3
Contributions to GDP growth (b)							
Domestic demand	1.1	1.4	1.6	0.2	0.6	0.7	0.1
Change in stocks	0.2	0.4	0.1	-0.2	0.0	0.0	0.4
External demand	-0.6	0.0	-0.3	0.4	-0.2	0.0	-0.2
PRICES AND COSTS (c)							
Consumer prices (annual average)	2.1	2.1	2.2	2.0	2.0	2.3	2.3
Final demand deflator	1.0	1.8	2.2	2.3	2.0	2.2	2.5
GDP deflator	2.0	1.9	1.7	1.8	1.6	1.6	1.9
Unit labour costs	1.7	1.0	1.4	1.5	1.5	1.3	1.2
Compensation per employee	2.1	2.0	2.0	1.8	1.9	2.1	2.1
Labour productivity	0.4	1.1	0.6	0.3	0.4	0.8	1.0
GENERAL GOVERNMENT (d)							
Total expenditure	48.2	47.5	47.6				
Current expenditure	43.8	43.4	43.4				
— Interest payments	3.3	3.1	3.0				
Public investment	2.5	2.4	2.5				
Total receipts	45.1	44.7	45.2				
Primary deficit (-)/surplus (+)	0.3	0.3	0.6				
Deficit (-)/surplus (+)	-3.1	-2.8	-2.4				
LABOUR MARKET							
Total employment	0.3	0.7	0.8	0.1	0.2	0.3	0.3
Unemployment (e)	8.7	8.9	8.6	8.8	8.7	8.5	8.4
BALANCE OF PAYMENTS (d)							
Current account	0.5	0.6	-0.4	0.2	-0.7	-0.2	-0.7

SOURCES: ECB and European Commission.

a. Quarterly rates of change, unless otherwise indicated.

b. Percentage points of the percentage change in GDP.

c. Annual rates of change.

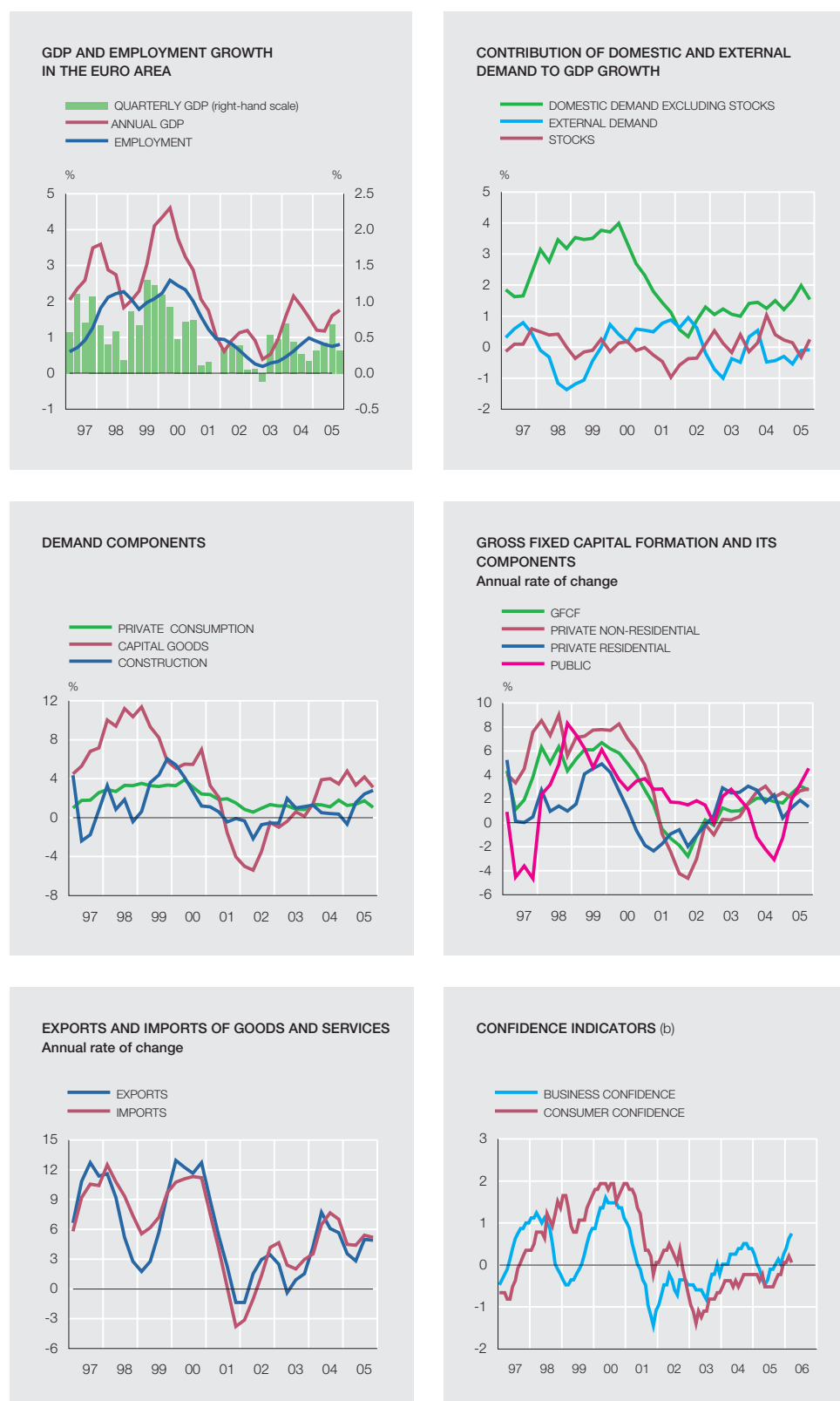
d. As a percentage of GDP.

e. As a percentage of the labour force.

cially in capital goods, while household consumption expanded at the same rate as the previous year (1.4%). Private consumption slightly outgrew disposable income, which slowed marginally in real terms. That made for a decline in the saving rate, as a result of the impulse given to household expenditure by the increase in household wealth, stimulated by the favourable performance of stock market prices throughout the year and, also, by the significant buoyancy of house prices (albeit to differing degrees depending on the country concerned). This wealth effect more than offset the upward impact on saving of the low level of consumer confidence (see Chart 3.1).

The acceleration in gross fixed capital formation from 2005 Q2 placed the annual average growth rate of this variable at 2.5%, thereby exceeding the rates recorded in the four previous years. Aggregate investment was boosted by capital goods purchases and gross fixed capital





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

a. Annual percentage changes, unless otherwise specified.

b. Balance statistic. Normalised series.

formation in construction, while other investment decelerated slightly. Taking the breakdown by agent, the acceleration in capital expenditure in 2005 was attributable to the bigger contribution of public investment and of non-residential private investment, which offset the lesser dynamism of residential private investment (see Chart 3.1). The gradual improvement in demand expectations combined with the favourable trend of non-financial corporations' cash flow and the low real cost of external borrowing thus encouraged private productive investment. As a result, low interest rates, narrow corporate bond spreads and the favourable trend of stock market prices boosted borrowing by non-financial corporations both through bank loans and through the issuance of debt securities. The progressive growth of corporate credit points to the culmination of the process of balance-sheet restructuring that had been acting as a brake on the acquisition of capital goods in recent years. The slowdown in household residential investment was due to the lesser dynamism of disposable income, although the rates of change of this variable in the various Member States remain at very heterogeneous levels. The pick-up in public investment is associated with the high volatility this demand component has shown in recent years, given its great sensitivity to the application and elimination of the temporary measures adopted in some countries to meet their budgetary commitments.

The external sector subtracted 0.2 pp from GDP growth in 2005, since the rate of increase of imports of goods and services exceeded that of exports (see Chart 3.1). Export growth was somewhat below the increase in export markets, meaning that the euro area export share in international markets declined slightly. That is partly due to the (virtually zero) effect of competitiveness on export growth, since the lagged effects in the first half of the year of the previous appreciation countered the stimulus to sales abroad of the depreciation observed during 2005 (see Box 3.1). The relative rise in the cost of imports and the slowdown in final demand diminished the buoyancy of goods and services purchases abroad although, once again, import penetration (i.e. imports as a percentage of GDP) was up on the figure a year earlier. The bigger increase in imports than in real exports, along with the deterioration in the terms of trade in 2005, led to a worsening of the balance of goods and services. This deterioration, together with the bigger deficit on the income and current transfers sub-balances, meant that the current-account balance as a percentage of GDP turned negative (–0.4%) for the first time since 2002.

GDP in most of the euro area countries slowed in 2005. However, there continued to be significant differences in the growth rates of the member countries, as indicated by the standard deviation of the annual rate of change of GDP (see Chart 3.2). Once again, the performance of the area's core economies was less dynamic than that of other countries such as Ireland, Greece and Spain. Of the former, France, Germany and the Netherlands posted rates of increase similar to or below the euro area average, although the sources of growth differed notably in each. In France, in particular, the external sector made a negative contribution which was offset by the resilience of domestic demand, while in the Netherlands and Germany activity was chiefly underpinned by net exports. Nonetheless, mention should be made of German domestic demand which, after three consecutive years of negative or zero contributions to GDP growth, was boosted in 2005 by the pick-up in investment in equipment and in government consumption, while private consumption remained slack. Finally, in line with events in past years, Italy and Portugal posted growth far below the euro area average, beset – cyclical considerations aside – by particularly acute structural problems.

Turning to the labour market, the pace of job creation was sluggish in 2005, with growth similar to that recorded the previous year (see Box 3.2). The unemployment rate fell by only 0.3 pp, despite the favourable trend recorded in some countries such as France and, especially,

There was a fresh fall-off in the euro area's real share of total exports in 2005. This development is part of the ongoing reduction in its share in the volume of world exports seen since the mid-80s and which affects not only the euro area, but most of the industrialised countries (see panel 1). The emergence on the world trade scene of regions with great growth potential and with cost advantages has led to a shift in the trade standing of the most developed countries. Specifically, according to IMF data, the share of the industrialised countries in world goods exports has fallen by more than 15% between 1985 and 2005, and by 9.4% in the case of the euro area. And the main beneficiaries of this process have been other Asian regions, Latin America and the non-EU 15 European countries.

However, the euro area's export share worsened less in 2005 than in previous years. Yet this behaviour masks highly divergent patterns from one Member State to another, highlighting the differences in productive structure and the persistent disparity in relative price and cost developments. In particular, and over a longer time span, Italy and France were, according to OECD figures, the countries that lost most export share between 1999 and 2005 (26.3% and 12.4%), while Germany and Ireland increased their presence in these markets by 2.7% and 17%, respectively.

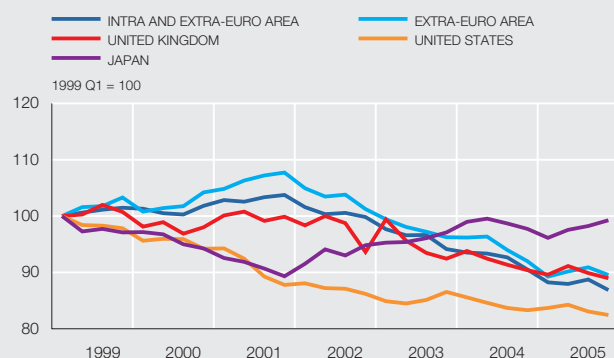
In any event, the euro area's price competitiveness indicators vis-à-vis the industrialised countries improved in 2005. As can be seen in panel 2, the different measures of the real effective exchange rate showed a reduction of 5% in 2005, which was more pronounced in terms of unit labour costs and of producer prices than in terms of consumer prices, owing to the fact that the latter incorporate the hike in energy prices to a greater extent. A portion of the improvement in the nominal exchange rate was harnessed by exporters to increase their export prices, above their unit labour costs, so that their margins widened after having held stable in the two previous years.

It is also possible that the relative specialisation of euro area exports in medium/high-technology products (see panels 3 and 4), where competition from the emerging countries has been felt with less intensity, may have prevented a greater deterioration in the euro area export share in recent years, compared with the more unfavourable performance of the United States and, until the end of 2003, of Japan.

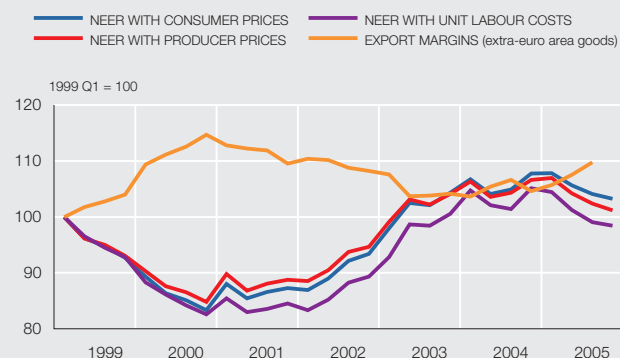
Along with changes in the export share, the capacity to supply the domestic market, proxied by the degree of import penetration, is also a relevant aspect for assessing a country's external competitiveness (see panels 5 and 6). In 2005, the real penetration of goods and services imports increased in most euro area countries, meaning that since 1999 the rate of purchases abroad in the euro area as a whole has been somewhat more than 11% higher than the growth of final demand. As to the regional and product breakdown of imports from the rest of the world, the figures are along the same lines as the analysis of export shares, namely: a gain in the share in the internal market of imports from emerging economies and a comparative disadvantage in products incorporating a high technological content.

To conclude, despite the depreciation of the euro and the subsequent improvement in the price competitiveness indicators in 2005, the euro area has not seen gains in its export share or a reduction in import penetration. This situation is largely the outcome of the emergence in world trade of the emerging economies which, with their substantial cost advantages, have been increasing their share in world exports since the mid-eighties. The incomplete pass-through of the depreciation of the euro to export prices, which has allowed export margins to be increased, has diminished the capacity to sell to the rest of the world. Moreover, although in the recent past the composition of the euro area's foreign trade has contributed to alleviating the loss in share, the area's scant specialisation in high-technology products will foreseeably act as a brake on its future export capacity, since it is precisely for these products that the most dynamic international demand is observed.

## 1. REAL SHARE OF EURO AREA EXPORTS OF GOODS AND SERVICES AND THEIR MAIN COMPETITORS

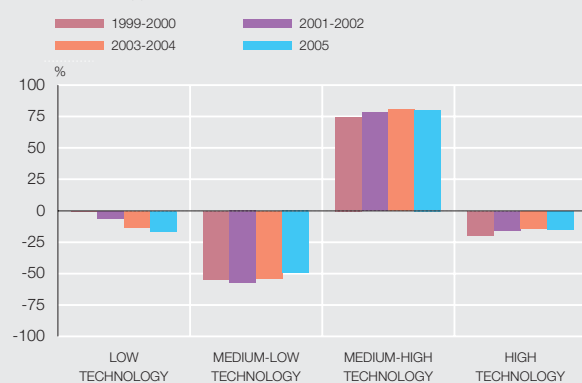


## 2. EURO AREA COMPETITIVENESS INDICES AND EXPORT MARGINS (b)

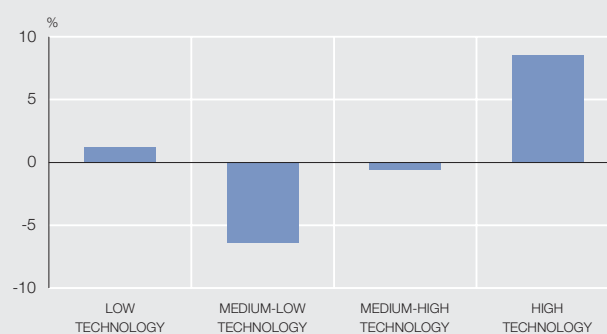


## 3. REVEALED COMPARATIVE ADVANTAGE OF EURO AREA REAL GOODS EXPORTS.

Extra-euro area (c)

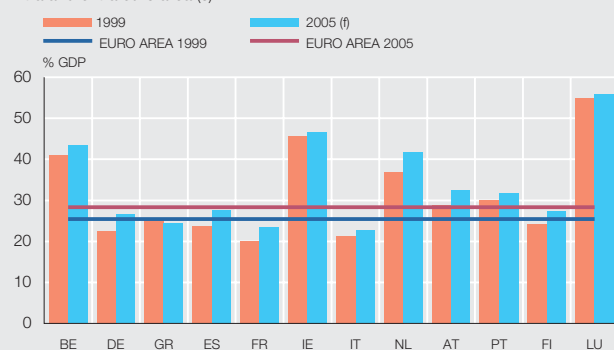


## 4. RELATIVE INTENSIFICATION OF REAL PENETRATION OF GOODS IMPORTS IN THE EURO AREA (d)



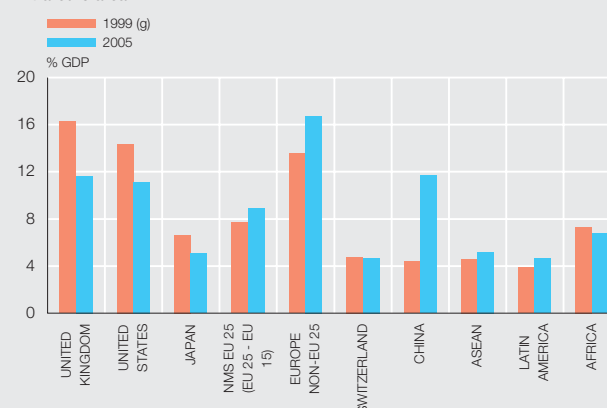
## 5. REAL PENETRATION OF GOODS AND SERVICES IMPORTS IN THE EURO AREA.

Intra and extra euro area (e)



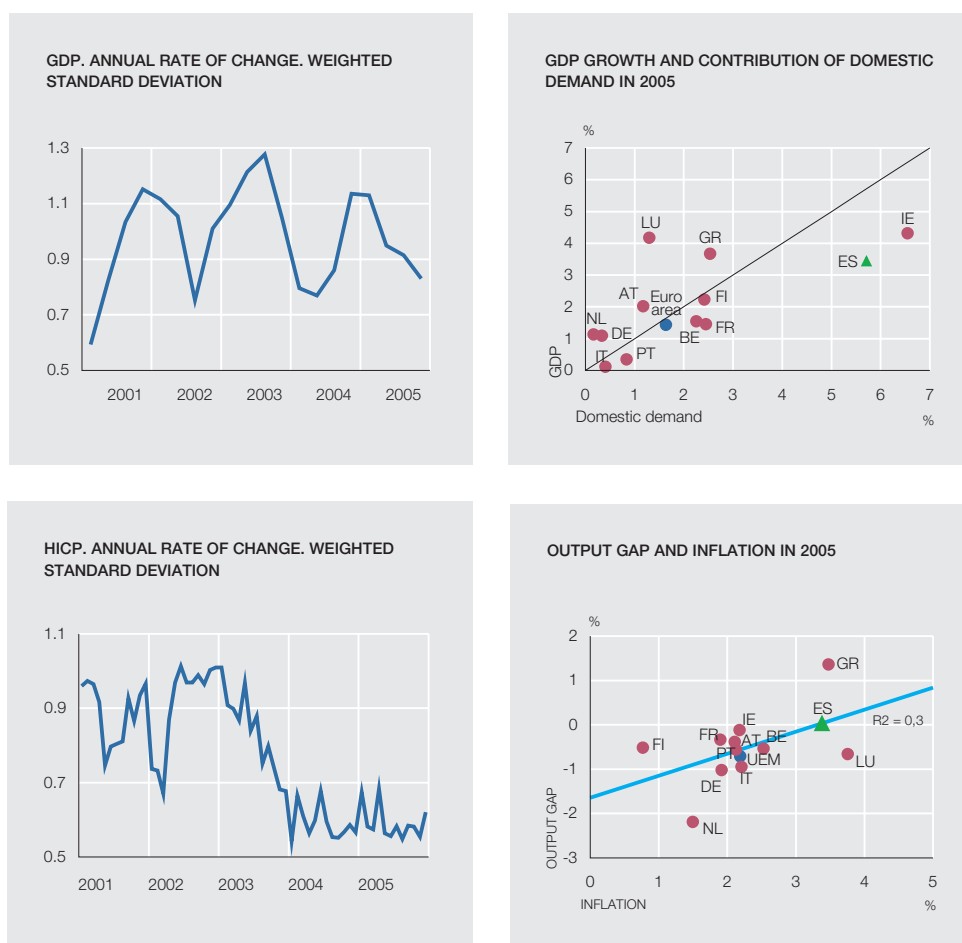
## 6. SHARE OF EACH AREA OR COUNTRY IN THE VOLUME OF EURO AREA GOODS IMPORTS.

Extra-euro area



SOURCES: EUROSTAT and OECD.

- Quotient between the volume of exports and goods and services export markets. Export markets are proxied by the weighted sum of the total volume of the main trading partners' goods and services imports.
- Export margins are proxied by the quotient between the UVI of goods exports and the ULCs of industry (excluding construction).
- Proxied by the relative contribution of each product or group of products to the country's merchandise trade balance.
- Proxied by the difference between the cumulative growth of imports of each group of products and the cumulative growth of total goods imports.
- Quotient between imports of goods and services and final demand.
- The last figure available for Ireland and Luxembourg is for 2004.
- The first figure available for new Member States of the EU 25 is for January 2000, and the latest, for July 2005.



SOURCES: European Commission and Banco de España.

Spain, and it averaged 8.6% for the year. The performance across the different sectors was uneven, since employment in the agricultural and industrial sector continued to decline, while in construction and market services it expanded. The stability of the rate of change of employment combined with the slowdown in output gave rise to a deterioration in productivity growth. The diminished buoyancy of this variable since the late 90s thus extended into 2005, reflecting the insufficient use of new technologies and inefficient market workings (see Chart 3.3).

The outlook for 2006 suggests GDP in the area will grow at a rate higher than in 2005 and one close to potential, thereby entrenching the recovery in activity. The sound financial conditions and the strength of external demand will foreseeably give rise to highly buoyant investment and exports, the latter stimulated, moreover, by the depreciation of the euro in 2005. Consumption, however, will continue to grow slowly, in line with disposable income and, in particular, with the slow expected acceleration in wages and in employment. Nonetheless, this scenario is subject to some risks. The absence, at present, of clear signs of a pick-up in employment and in consumption in the area is compounded by uncertainty over how oil prices will move, the exacerbation of global imbalances and the possibility that protectionist pressures on trade will intensify. Regarding this latter risk, it is important that the multilateral trade agreements under the Doha Round of talks should be satisfactorily concluded so as to benefit the different world regions. In particular, the liberalisation of exports of goods and services from the rest of the world must allow the European economies to specialise more in the market niches in which they have comparative advantages.

In 2005, employment grew at a sluggish rate (0.8%) similar to that of the previous year. That had a bearing on the notable slackness of consumption, insofar as it did not stimulate household disposable income and was not conducive to improving consumer expectations. Accordingly, the analysis of recent labour market developments is an essential ingredient for assessing the situation and economic prospects of the euro area.

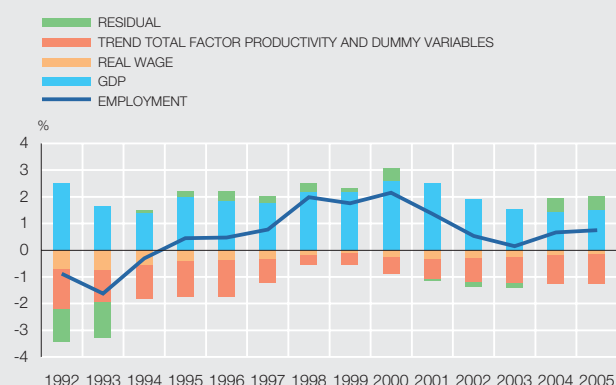
A habitual means of analysing the behaviour of a macroeconomic variable such as employment is through the use of a structural equation, which relates changes in the variable to its main determinants<sup>1</sup>. Thus, as can be seen in panel 1, during the recent slowdown in the area (especially in 2002 and 2003), the growth in numbers employed in the euro area was slightly less than would be explained by the attendant determinants. A similar phenomenon, albeit one of greater intensity, occurred in the recession in the early nineties, when the strong process of job destruction between 1991 and 1994 (almost four million jobs) was on a greater scale than may

be explained by variables such as activity and wages. Among the determinants of employment developments, the behaviour of real wages may be identified as a significant differential factor between both periods. Indeed, in the early 90s, the negative contribution of real wages to the rate of change of employment totalled almost 1 pp, far above the figure of 0.3 pp contributed in the recent slowdown.

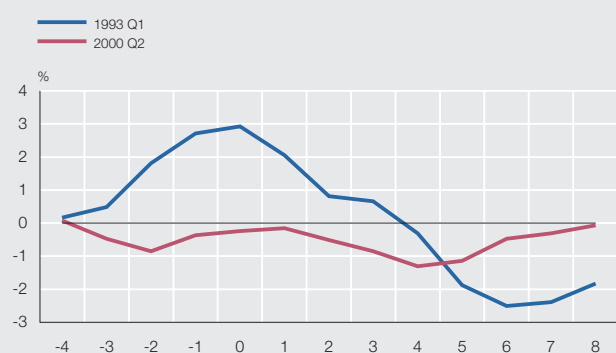
As can be seen in panel 2, which depicts a Phillips curve, increases in the rate of unemployment between 1992 and 1995 were accompanied by a reduction in wage pressure. Between 1995 and 1999, an inward shift in the curve can be seen, chiefly reflecting the nominal convergence process preceding the creation of the euro area and, possibly, the labour market reforms undertaken by certain countries in that period, which might have prompted a decline in the structural unemployment rate. Thereafter, nominal wages increased by around 2%, entailing a long phase of wage moderation (to which the growing international competition the euro area faces has undoubtedly contributed). Reflecting this were the reductions in real unit labour costs from 2002, which were conducive to the labour market adjustment, in the face of the cyclical slowdown, not having a greater impact on employment (see Chart 3).

1. The equation used is from the European Commission document "Labour market and wage developments in 2004, with special focus on risk of jobless growth", *European Economy, Special Report no. 3/2005*.

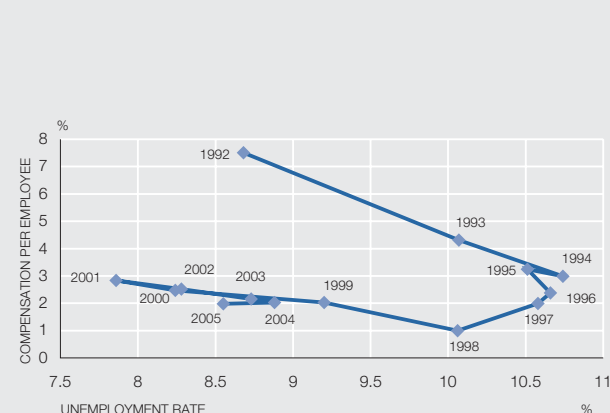
### 1. EMPLOYMENT GROWTH AND CONTRIBUTIONS (a)



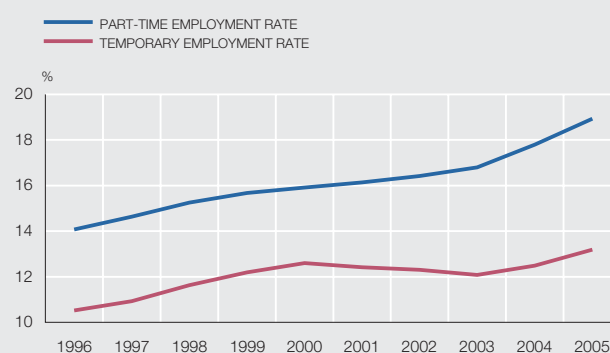
### 3. REAL ULCs (b)



### 2. PHILLIPS CURVE



### 4. PART-TIME AND TEMPORARY EMPLOYMENT RATE



SOURCES: ECB and Eurostat.

a. Contributions of the determinants according to the European Commission's equation.

b. Annual rate of change. The period "0" depicts the quarters in which GDP was at its cyclical trough.

In any event, although the pace of employment has been slow over the past two years, it has been higher than the trend of its determinants would indicate, despite the uncertainty surrounding the ongoing recovery in the euro area economy (see Chart 1). This may be partly in response to certain statistical and methodological changes that have tended to increase the employment figures in some euro area countries. Likewise, greater use has been made of temporary and part-time contracts by European employers, which may have prompted an increase in the number of jobs. As panel 4 shows, part-time as a proportion of total employment has been on a rising trend in the past 10 years, and this has stepped up notably in 2004 and 2005. The course of the temporary employment rate appears to be consistent with the hypothesis that the employment adjustment in the

slowdown from 2001 to 2003 would have mainly been through temporary workers, for whom firing costs are virtually zero, while in the past two years temporary hires have once again been encouraged. The recent implementation of labour reforms in some euro area countries would be along these lines. A case in point is the introduction in Germany of the so-called mini-jobs and one-euro jobs<sup>2</sup>, or the reform introduced in Italy in 2003 (the Biagi Law) promoting the use of new, more flexible temporary and part-time contracts.

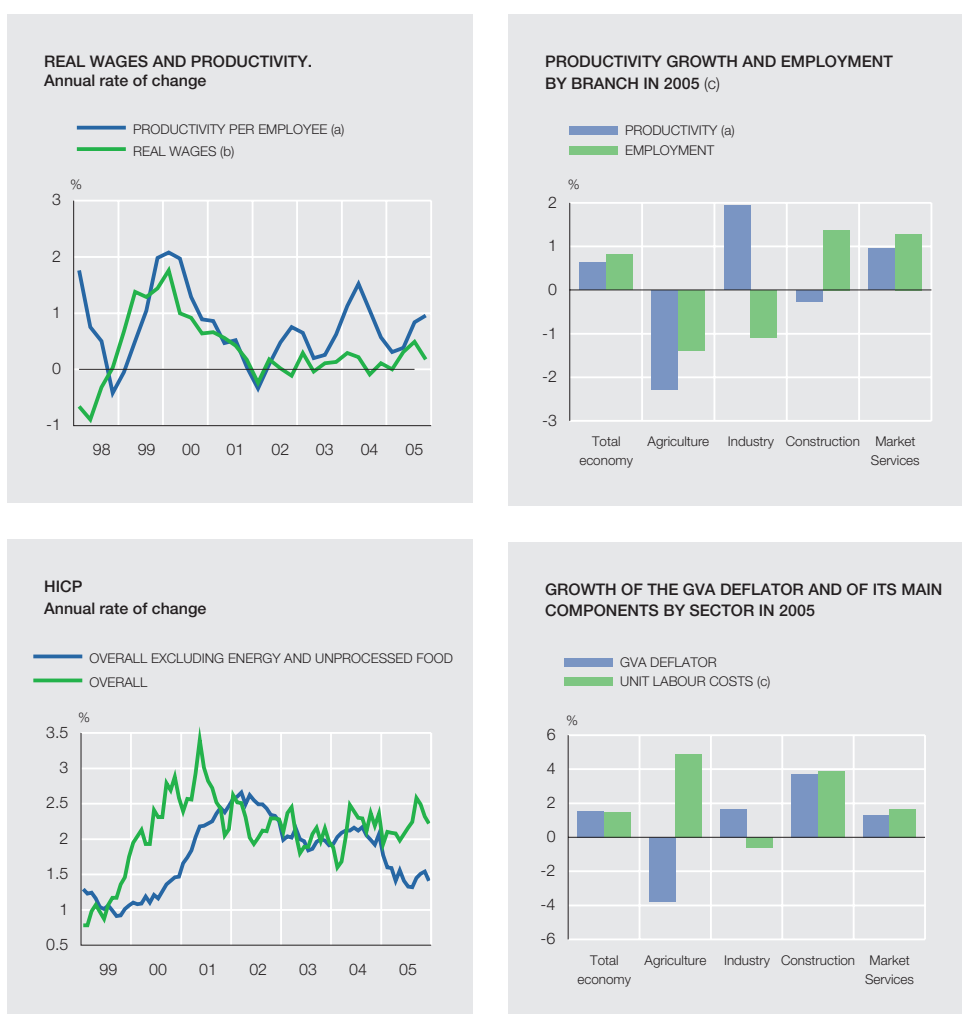
<sup>2</sup> Mini-jobs, introduced in 2004, are part-time jobs paid at up to €400 per month, while one-euro jobs, which were introduced in 2005, give work to the long-term unemployed, who receive up to €2 per hour in addition to unemployment benefit.

## 1.2 PRICES AND COSTS

The euro area harmonised index of consumer prices (HICP) posted average growth of 2.2% in 2005, 0.1 pp up on the previous year's figure. Its profile during the year was determined by the trend of the energy component, and this, in turn, by the behaviour of oil prices. The all-time highs in oil prices in the summer – further to the effects of the destructive hurricanes Katrina and Rita, which seriously damaged production and refining capacity in the Gulf of Mexico – raised the annual rate of change of the HICP to 2.6% in September, while the decline in oil prices in Q4 meant that inflation ended the year at 2.2% (see Chart 3.3). However, all the less volatile components of the HICP slowed notably, meaning that underlying inflation, measured by the consumer price index excluding energy and unprocessed food, moved on a clearly declining trend in the first half of the year, stabilising subsequently at a low level with its annual average rate at 1.5% (as opposed to 2.1% in 2004). This appears to show that the indirect effects from the rise in energy prices have been fairly limited, except in those items most directly related to oil prices via production costs, such as transport services. The limited emergence of indirect effects is also evidenced by the slow growth rate of the producer prices of non-durable consumer goods, which stood at 1% in 2005 compared with 1.4% the previous year.

The moderation in underlying inflation was partly due to the lesser contribution of fiscal measures (increases in indirect taxes and administered prices) compared with previous years. But it was also related to the effects of globalisation and the vigorous emergence in world trade of the developing countries (whose exports to the euro area have proliferated), whose focus has been especially on the non-energy industrial goods component. The need to withstand strong international competition and massive imports of cheaper goods, intended both for final and intermediate consumption (with the subsequent cheapening of production costs), have exerted downward pressure on prices in the area, adding to which has been the moderating influence of the persistent sluggishness of consumer spending.

The annual growth rate of the final demand deflator increased by 0.4 pp to 2.2%, owing to the notable acceleration in import prices, mainly because of dearer oil but also because of the depreciation of the euro in 2005. Conversely, the domestic component, proxied by the GDP deflator, slowed once more. This behaviour of domestic prices in the area was the outcome of the lesser pace at which margins increased, which offset the greater dynamism of unit labour costs. However, the increase in unit labour costs remained modest, this being due as in 2004



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.  
 c. Calculated as the average of the quarters available.

to wage moderation. The growth rate of compensation per employee stood, as in 2004, at 2%, indicating the absence of second-round effects associated with past increases in oil prices. The scant momentum of demand in the labour market and the downward pressure exerted by international competition on labour costs in the area largely explain this behaviour by wages.

In the services and construction branches, margins expanded at a lower rate than in 2004. Conversely, in the industrial branch (including energy) margins continued to widen at a notable pace thanks to the acceleration in final prices and to the contraction in unit labour costs (see Chart 3.3). In the case of services, the growth rate of wages increased in the sub-sector of market services, while it fell in that of non-market services.

In 2005, in comparison with 2004, the dispersion of inflation rates in the countries of the area – measured by the weighted standard deviation of the annual growth rate of the respective HICP – held stable on average (see Chart 3.2). In all countries, inflation rates were influenced



by the adverse behaviour of the energy component, although differing cyclical positions and the differing impact of government measures on indirect taxes and administered prices (both those applied in 2005 and those in the previous year, owing to the disappearance of their base effects) accounted for the differences in the behaviour of inflation. In France, Portugal, Italy and Ireland, the growth rate of the HICP fell in relation to 2004; in the other countries the rises in inflation ranged from 0.1 pp (e.g. in Germany, to 1.9%) to 0.7 pp in Finland, although this country continued to post the lowest inflation in the area (0.8%).

The inflationary outlook for 2006 suggests that, after the rise in January, inflation in the euro area will tend to slacken progressively over the course of the year (as has been seen to March), although the various forecasts available once again place annual average inflation at over 2%. Moreover, the risks remain on the upside. This is mainly due to the possibility of further increases in oil prices (given the instability of the market). But other factors include the gradual materialisation of the indirect effects of the past rises in oil on the non-energy components of the HICP, the potential appearance of second-round effects in a more buoyant economic setting and possible increases in indirect taxes and administered prices. The pressure on prices that may stem directly from the expected strengthening of domestic demand should also be added to these factors; however, given that the output gap is still negative, the recovery will conceivably run for some time without generating excessive inflationary pressures.

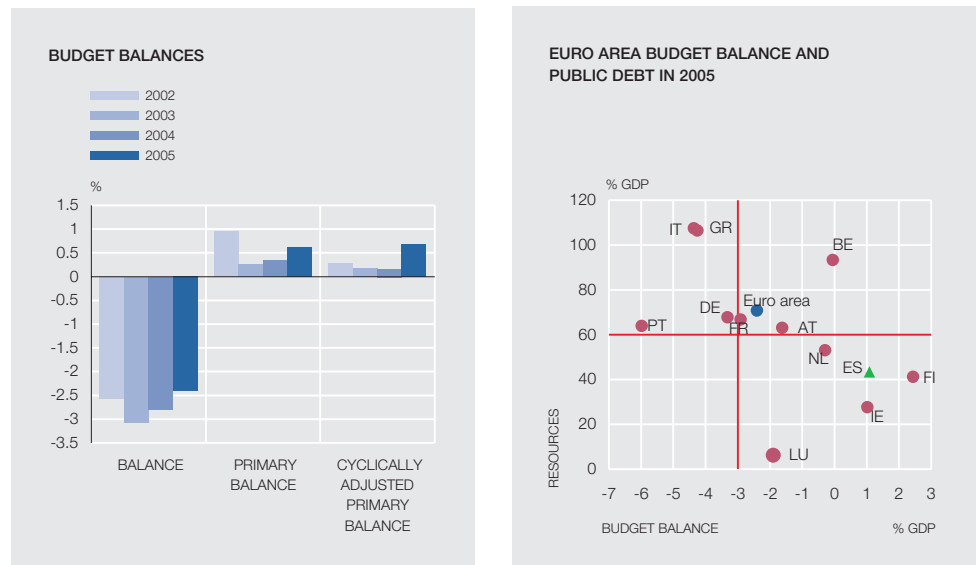
## **2 Fiscal and structural policies in the euro area**

### **2.1 FISCAL POLICY**

Fiscal policy adopted a contractionary stance in 2005, according to the calculations by the European Commission, whereby the cyclically adjusted primary surplus was up 0.6 pp on the previous year. However, in terms of the actual balance, the improvement was only 0.4 pp – to 2.4% of GDP – since the weakness of economic growth contributed to worsening public finances by 0.3 pp, while interest payments as a percentage of output fell by 0.1 pp (see Chart 3.4). The overall euro area budget deficit was 0.1 pp higher than that resulting from aggregating the Stability Programme targets submitted between late 2004 and early 2005. Nonetheless, it should be borne in mind that these targets were based on a macroeconomic scenario that foresaw output growth for the area of 2%, i.e. 0.6 pp above the final result. Consequently, once the impact of the business cycle of public finances is taken into account, the objectives set for themselves by the Member States may be considered to have been met in aggregate terms.

The persistent fiscal imbalances in several Member States continued last year. As in 2004, Germany, Greece, Italy and Portugal posted deficits of over 3% of GDP, while the French deficit was very close to this level. The trend of the actual balances in these countries diverged notably. While in Portugal and Italy they worsened substantially (by 2.8 pp and 0.7 pp to 6% and 4.1% of GDP, respectively), in Greece, France and Germany there was a reduction in the deficit. Yet it should be borne in mind that several of these countries have made intensive use in recent years of operations that provide for an improvement in the budget balance over a specific period but which do not alter the underlying situation, which clouds the significance of the deficit in a given year or its comparison from one period to another.

As a result of the process initiated by the European Commission in 2004, the March 2005 European Council approved a set of changes to the Stability and Growth Pact. The agreed amendments attempt to increase the economic logic behind the euro area's fiscal discipline rules, squaring the requirements for a correction of budgetary imbalances with the specific circumstances of each case. At the same time, the reform seeks to boost the incentives for achieving more disciplined behaviour in the boom stages of the business cycle. Following this agreement at the European Council, the Commission and national governments continued working on the adaptation of the legal texts and on the technical procedures that make the agreement workable. In June, therefore, the Council approved the two regulations reforming



SOURCE: European Commission.

the legal bases of the original Pact and, in October, it lay down the new Code of Conduct, which defines the format of the Stability and Convergence Programmes and develops the details relating to the application of the new rules.

The application of the agreements has given rise to certain changes both in the procedures applied to countries running an excessive deficit and to the examination of the most recent generation of Stability and Convergence Programmes. While under the original Stability Pact an excessive deficit had to be corrected in the year after it was identified, the new rules allow this time to be extended if special circumstances are involved. Thus, on ruling on the existence of an excessive deficit in Italy and Portugal, in July and September, respectively, the Council recommended the correction of this situation one year later than the habitual time limit in the former case, and two years later in the latter. In justifying these decisions, the Council considered that special circumstances were at play, such as the sluggishness of activity and the considerable scale of the adjustment effort needed. In Germany's case, the Commission's December 2004 communication required that the excessive deficit be corrected no later than last year. The announcement by the German authorities that this had not occurred led the Council to adopt, in March 2006, a Decision under article 104 (9) of the Treaty on European Union whereby the term within which the deficit was to be reduced to below 3% of GDP was extended to 2007. Finally, prior to the reform of the Pact, the Council had, by virtue of this same article, warned the Greek authorities in January 2005 to adopt measures to do away with the excessive deficit in 2006 at the latest. In a communication issued in April, the Commission deemed the measures taken in response to this warning to be sufficient.

As they are the first to be drawn up since the reform of the Pact, the Stability Programmes submitted between late 2005 and early 2006 have to meet certain new requirements. These include most notably the definition of a medium-term target for their cyclically adjusted budget balance net of temporary measures that must lie, according to each case, between a surplus and deficit of the order of 1% of GDP. Nonetheless, none of the Programmes of the five countries running an excessive deficit aim to reach their medium-term target before the end of the decade. Moreover, the countries in this situation should specify the path of adjustment towards their medium-term target, which should be such that their cyclically adjusted balance

net of temporary measures improves annually by at least 0.5% of GDP. Greece, Italy and Portugal envisage complying with this prescription in 2006 and 2007, while in Germany and France the obligation will be met on the whole over the term of these two years, but not in the year 2006 taken in isolation.

Accordingly, despite the fact there was a minor improvement in public finances in the area as a whole in 2005, all the countries except Spain, Finland and Ireland continue to show notable fiscal imbalances, in contrast to the modest degree of ambition observed in the latest generation of Stability Programmes. In this respect, the strengthening of economic activity since mid-2005 offers an opportunity that should not be wasted to ensure compliance with the obligations undertaken by the countries running an excessive deficit, and to accelerate the rate of approximation to positions close to a balanced budget. This requirement is heightened by the pressing need to reduce debt ratios so that the budgetary consequences of population ageing may be tackled departing from the healthiest possible general government financial position. The scale of the impact of this phenomenon has been highlighted in the February 2006 report by the Economic Policy Committee of the EU and the European Commission, in which the effects on spending on pensions, health care, dependency, education and unemployment benefits are projected to 2050. According to the results of the report, spending in the area as a whole would increase over that horizon to 4.6% of GDP. Box 1.3 analyses in greater detail the course of spending on pensions, the item responsible for more than half the total increase.

Further, so that fiscal policy may be geared to promoting economic growth and employment, the budgetary imbalances must be corrected. This is because the evidence available is conclusive concerning the need for fiscal consolidation to ensure the sustainability of growth in the medium and long-term. In this respect, it is crucial – in line with the requirements posed by the ECB – that the reformed Stability and Growth Pact, with its new added flexibility, should be rigorously applied, as this is the only way of ensuring its credibility and demonstrating its disciplinary effectiveness over time. Likewise, the budget must be structured so as to promote economic development, whereby reforms reducing the distortions generated by tax systems and the redirecting of public spending towards more productive uses will be required.

## 2.2 STRUCTURAL POLICIES

The long sluggish phase in euro area economic activity has highlighted the presence, beyond cyclical factors, of structural obstacles restricting the area's potential growth capacity and hampering the adjustments needed in the face of shocks. These frictions prevent the reduction of the high structural unemployment prevailing and give rise to relatively low employment rates, both of which phenomena particularly affect the youngest and oldest workers and those least skilled. The persistence of these obstacles is, moreover, a particularly unfavourable starting point for the euro area economy to tackle the challenges arising from population ageing, growing competition from other regions and the forceful pace of technological change.

Against this background, there is currently broad consensus on the need to step up the pace of implementation of structural reforms covering a wide range of fields. These include most notably labour markets, completing the single market (particularly in the services sector), promoting entrepreneurship and boosting technological innovation. Indeed, in recent years there has been some progress in the specific field of labour markets, where reforms have been appropriately targeted to combat those institutional features that tend to lead to this productive factor being under-used. Such features are, namely: high tax wedges; flawed collective bargaining arrangements, where the interests of unemployed workers are insufficiently represented; and disincentives generated for labour supply or demand by employment protection legislation, the mechanisms that encourage early retirement, and the level of minimum wages

	2000	2001	2002	2003	2004	2005
<b>LABOUR MARKET</b>						
Employment rate (15-64)	61.7	62.2	62.4	62.6	63.0	
<i>Female</i>	51.7	52.4	53.1	53.6	54.5	
<i>Male</i>	71.6	72.0	71.7	71.6	71.6	
Employment rate (55-64)	34.2	35.2	36.5	37.9	38.6	
<i>Female</i>	24.3	25.2	26.6	28.0	29.0	
<i>Male</i>	44.6	45.6	46.7	48.2	48.6	
Unemployment rate	8.1	7.9	8.3	8.7	8.9	8.6
<i>Female</i>	10.3	9.9	10.1	10.5	10.5	10.0
<i>Male</i>	6.5	6.3	6.9	7.4	7.6	7.4
Long-term unemployment rate	3.9	3.6	3.6	3.9	4.0	
Direct taxes and social security contributions on low-wage earners	41.5	40.5	40.5	40.4	39.0	
Productivity per employee relative to the United States	81.7	81.0	80.9	79.4	77.7	76.6
<b>KNOWLEDGE SOCIETY</b>						
R&D (% GDP)	1.9	1.9	1.9	1.9	1.9	
Percentage of homes with Internet access			36.0	40.0	44.0	50.0
Patent applications per million inhabitants	208.4	187.7				
Expenditure on information and communication technology, as % GDP			6.1	5.9	5.9	
<i>On information technology</i>			2.9	2.7	2.7	
<i>On communication technology</i>			3.2	3.2	3.2	
Venture capital investment (% GDP)	0.2	0.1	0.1	0.1		
Private investment (% GDP)	18.9	18.4	17.7	17.4	17.6	
Public expenditure on education	5.0	5.1	5.2			
Continuous training (% population 25-64)	5.7	5.5	5.5	7.0	7.8	8.7
% population aged 20-24 who have at least completed secondary education	72.5	72.2	72.6	72.5	72.9	73.6

SOURCE: European Commission.

a. EU-15 data.

and of unemployment benefits, along with their duration. Despite the slowness with which these reforms are being adopted in most countries, they are showing some fruit judging by the increase in employment rates among specific population groups (most notably among individuals aged 55 to 64 – see Table 3.2). However, the headway made in this and other areas has been very limited, which runs counter to the widely acknowledged need to act with firmer resolve expressed by the national and European authorities.

In 2005 and in 2006 to date, the area's biggest economies introduced or announced measures aimed at alleviating the problems besetting their labour markets. The German authorities reduced the duration of unemployment benefits for the oldest unemployed, in order to lessen the disincentives to work when close to retirement age, and they approved a gradual increase in the legal retirement age from 65 to 67. The government also announced the reduction, effective 2007, of 2 pp in social security contributions relating to unemployment, in order to lessen the tax wedge on labour income. In France, a type of permanent employment contract was introduced which extends to two years the trial period for new workers in companies with fewer than 20 employees. Further, measures have recently been implemented to encourage those aged over 57 to work and the restrictions on the duration of the working day have been eased, although the obligation to compensate time worked in excess of the 35-hour week with a bonus remains in force. The French government has indicated that it plans to reduce em-

employers' social security contributions in respect of lower-remunerated jobs, in order to contain the associated labour costs and to improve the incentives for these jobs to be taken up by the unemployed. Finally, in Italy, the 2006 budget contains reductions in social security contributions for the lowest earners, in order to boost unskilled employment.

The biggest euro area economies also introduced reforms in 2005 and early 2006 affecting the working of product markets. In Germany, the government announced the deregulation of fees for certain professions. In France, the authorities revealed their intention to deregulate retail price-setting mechanisms. Finally, in Italy, local government procurement has become subject to tendering procedures and, in order to combat corporate governance shortcomings, new bankruptcy and business accounting transparency laws have been approved.

In the EU, the European Council agreed in spring 2005 – after noting the shortfall between the ambitious objectives laid down and the muted actual achievements – to give fresh impetus to the Lisbon strategy. First, it was decided to give priority to measures with a greater impact on growth in activity and employment. Further, the strategy governance arrangements were reformed with the dual aim of simplifying procedures and achieving greater commitment by the Member States to the objectives set. The new arrangements are based on a three-year cycle of economic policy formulation and evaluation, which began in June 2005 following the Council's adoption of the so-called Integrated Guidelines for Growth and Employment. This document, which reflects the priorities in different economic policy areas, was the basis for the preparation of the Lisbon Community Programme (comprising the measures to be adopted at the overall EU level) by the European Commission, and of the National Reform Programmes (NRPs) by the Member States (the measures relating to policies that are within the Members' remit). Finally, in January 2006 the Commission presented its Annual Progress Report, in which it analysed the NRPs and proposed specific measures for certain areas.

The Community Programme has initiatives for various fields, including most notably the integration of financial, goods and services markets. As regards research and development, it contains measures to foment joint public and private research partnerships and to promote projects of a European dimension, such as satellite navigation or European air and rail traffic management systems. Finally, it has several initiatives for financing new companies in innovative industries, for simplifying the regulatory burden and for fostering competition in areas such as the energy markets or financial services. Although the European Commission has, since the Programme's approval in June, adopted more than two-thirds of the projected measures, some legislative strands are pending ratification by the Council and the Parliament and, in cases where financial resources are required, the financial prospects for the period 2007-2013 must be concluded. Among the major areas subject to discussion are the Directive on the single market for services and the Community patent (see Box 3.3).

Moreover, in the Community field, the European Council voiced its support in March 2006 for the conclusions of the Green Book on energy prepared by the Commission. The book considers the need to complete the internal market for gas and electricity which, in turn, requires an improvement in cross-country connections and in co-ordination between regulators, competition authorities and the Commission. Lastly, regarding financial services, 2005 saw the conclusion of the legislative phase of the Financial Services Action Plan (FSAP), which lays the foundations for the effective integration of the market for these services in Europe. It remains now to see through the application of and compliance with the Plan. In this respect, the European Commission published its White Book on Financial Services Policy in December 2005. The emphasis of the Book lies in the integration of retail markets, which are still deeply fragmented, as highlighted by the scant number of cross-border mergers between European financial intermediaries (see Box 3.4).

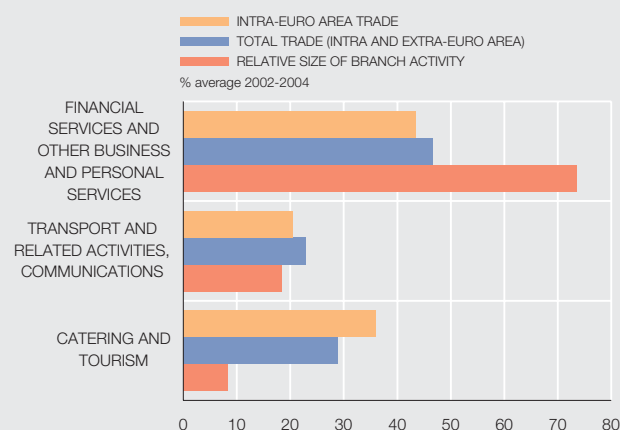
The euro area services sector accounts for around 70% of the economy's gross value added and total jobs. Moreover, this sector generates virtually all new jobs, since there has been net job destruction in industry and agriculture. These figures highlight the importance of services in the euro area economy. Nonetheless, compared with other geographical areas, such as the United States or the United Kingdom, the area's services sector is smaller, generates less employment and shows lower productivity gains. That suggests there are regulatory obstacles preventing greater efficiency in its workings. On one hand, these obstacles include the regulations restricting competition within each country. Generally, and with the inherent difficulties that measures approximating the degree of regulation entail, the most strictly regulated countries tend to show a lower level of

competition, proxied by the relative margins of the services sector compared with the manufacturing sector (see panel 1). On the other, there are regulatory barriers that limit the cross-border supply of services, preventing the effective integration of these markets into the euro area and Europe as a whole, as they entail very high costs to potential foreign suppliers (in particular if small and medium-sized enterprises are involved). The combined effect of both types of obstacles explains why trade in services in the area is concentrated in activities related to tourism, where trade is determined to a greater extent by the initial endowment of resources than by the regulatory environment. And it likewise explains why, conversely, trade is very limited in business, transport and personal services, which nevertheless account for the bulk of the sector (see panel 2).

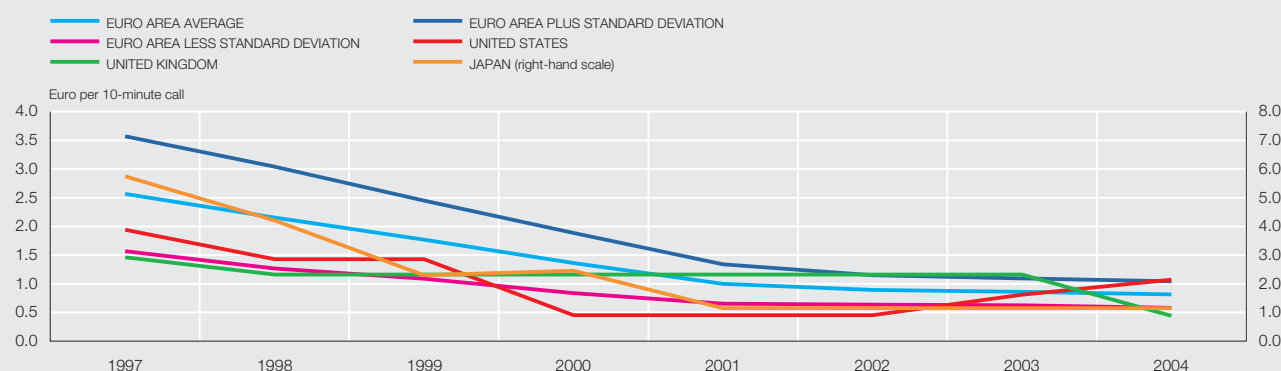
### 1. MARGINS AND REGULATION OF THE MARKETS FOR SERVICES (a) (b)



### 2. BRANCHES OF ACTIVITY: SHARE IN GVA AND IN TOTAL MARKET SERVICES TRADE (c) (d)



### 3. CONVERGENCE IN TELECOMMUNICATIONS PRICES IN THE EURO AREA (DOMESTIC CALLS)



SOURCES: STAN (OECD) and EUROSTAT.

a. The indicator of the degree of restriction in the services market is a mean of the obstacles posed to the conducting of activity by foreign and national services providers. It was compiled by Copenhagen Economics (2005). Its value, which refers to 2004, oscillates between 0 and 1, with the degree of restriction greater (and competition lower) the closer it is to 1.

b. Margins are calculated as the quotient between value added and employee compensation. The mean for the period 1996-2003 of the ratio of the mark-up of market services in relation to that of manufacturing industries is shown.

c. The relative size of the branch of activity is proxied by the quotient between its GVA and the GVA of market services.

d. The share of the branch of activity in the total volume of trade in market services is calculated as the quotient between the sum of the branch's imports and exports and the sum of market services' imports and exports.

The persistence of these obstacles is in contrast to the relevance of the arguments warranting greater integration of the market for services in the euro area. The low productivity gains in the sector are an obstacle to output growth in the area that the integration of services markets should contribute to overcoming through the harnessing of economies of scale and the exploitation of comparative advantages. Estimates of the effects on the economy of the full integration of these markets give widely differing results, ranging in the case of GDP from 0.7% to 1.8% and, in the case of employment, from 0.3% to 1.5%<sup>1</sup>. In any event, the benefits arising from the integration of the market for goods, along with the importance of the services sector in European economies, mean it may be assumed that this impact will be notable. Further, as experience shows in the partly liberalised branches, as is the case of telecommunications, integration should provide for convergence of price levels towards those of the countries where such levels are lowest, which would principally benefit consumers. By way of example, panel 3 shows how both average national telephone call charges within the euro area countries and their dispersion have gradually fallen in recent years.

The spring 2000 European Council, as part of the set of economic reforms envisaged in the Lisbon strategy, assigned a relevant role to the completion of the single market for services, aware of the advantages to be had from it. The main tool for achieving this objective is the Directive on services in the internal market, on which the European Commission presented an initial proposal in January 2004. The aim of the Directive is, in the field of services, to make the principles of freedom of establishment (which allows agents to operate in a stable fashion in another Member State) and freedom of provision of services (which enables agents operating in one Member State to offer their services temporarily in another country without having to establish a presence there). The initial proposal resided on two pillars: its general application to all economic services activities (with the exception of public services, and of financial, telecommunications and transport services, which were already covered by other EU statutes), and the application of the country-of-origin principle, to whose legislation the supplier of services shall be exclusively subject.

Nonetheless, despite being an important ingredient in the overall mix of national and supranational policies that should help raise the

well-being of European citizens, the original formulation of this proposal encountered some difficulty gaining sufficient political and social consensus. This may have been due to the fact that the communication of its content was not made in quite the right way. The conclusions of the March 2005 European Council reflected this lack of consensus, calling for the Directive to be revised. Along these same lines, following almost one year of deliberations, the European Parliament approved a resolution in February 2006 within the framework of the Community co-decision procedure, containing a broad set of amendments. The proposal entailed replacing the "country-of-origin" principle with the "freedom of provision of services", meaning that even if the provider of services remains subject to the legislation of the State of origin for the purposes of its establishment, the host country is entitled to oversee the subsequent pursuit of the activity. Further, the list of services not subject to the Directive was extended, excluding from its scope of application "services of general interest", whose definition remained at the discretion of national legislations.

Last April, the European Commission unveiled a new proposal that sought to square the search for the necessary consensus with other institutions with minimum levels of application for the Directive, seeking to make it as unrestrictive as possible. In this respect, it wished to limit arbitrariness in the definition of services of general interest (eliminating the reference to their possible interpretation by the Member States) and it demanded a more limited use of the exceptions to the principle of "freedom of provision of services". This notwithstanding, the ensuing text, which now has to be sanctioned by the European Parliament in second reading, has abandoned the ambitions of general application sought in the original text.

In sum, the effective completion of the single market for services offers great potential to accelerate output and employment growth in the area, and thus to increase the well-being of citizens across the Monetary Union. Yet it cannot be ruled out that, at the same time as new opportunities are created in certain branches, the process may impose costs on others. For costs to be minimised and advantages harnessed to the full will require that the euro area economies be as adaptable as possible to the changes, which underscores the pressing need to accelerate structural reform in the product and labour markets. Moreover, the full exploitation of the potential of the single market will depend on the final content of the Directive, insofar as its fundamental principles are not watered down. In this respect, the current state of debate would indicate that, although the final text will be a step forward from the situation prior to the Directive, it is likely that its content will provide a liberalising impulse clearly weaker than that in the Commission's original proposal.

1. The highest figures correspond to the European Commission's estimates [*Extended Impact Assessment of a Proposal for a Directive on Services in the Internal Market*, (2004)], while the lowest estimates, which take into account only the immediate impact, are drawn from the Copenhagen Economics Institute [*Economic assessment of the barriers to the internal market for services*, (2005)].



Mergers and acquisitions (M&A) activity in the EU financial sector has been markedly cyclical and, generally, similar to that observed in consolidation operations in other sectors. As the adjoining panel shows, corporate integration activity in the financial sector, where national operations have been predominant throughout the period analysed, reached a cyclical peak in 2000. In the following years it fell substantially, although a pick-up was seen in 2003 and 2004 which appears, on the evidence already available for 2005, to have firmed.

However, despite the pattern of corporate consolidation activity in the financial sector matching that in other industries, certain differential traits can be identified in respect of the characteristics of integration operations between financial corporations. Firstly, unlike in non-financial sectors, international operations between financial firms are not of a substantially higher average volume than that of national operations. Furthermore, size differences between merged corporations are more pronounced than in the non-financial sectors. These features reveal that while in certain cases the process of integration between non-financial companies has spawned corporations of a true pan-European dimension with a balanced distribution of their activities across different European countries, in the financial industry consolidation operations at the national level have been to the fore,

prompting the emergence of major national institutions with only a very secondary presence in other countries. Indeed, until recently international operations between large financial corporations were few and far between.

The relative scarcity of cross-border operations may reflect to some extent the fact that the integration difficulties characterising any M&A process tend to be exacerbated in international operations owing to the possible existence of various obstacles (differences in corporate culture or in the regulatory framework, among others). These barriers make it more difficult to attain efficiency gains which, along with an enhanced competitive position and risk diversification, are the motives behind corporate integration operations.

To look at the creation of value associated with M&A in the financial industry, a sample of 172 announcements of such operations between EU financial institutions in the period 1998-2002 has been analysed<sup>1</sup>. The key piece of information in this analysis is excess

1. The results of this analysis are set out in greater detail in Banco de España Working Paper no. 0516, entitled *M&As performance in the European financial industry*.

## EXCESS RETURNS (a)

### 1. ALL MERGERS

	Window (b)		
	(t-90, t-1)	(t-1, t+1)	(t-1, t+30)
Companies acquired	4.4 (d)	3.2 (d)	2.4 (d)
Purchasing companies	-0.1	-0.9 (d)	-1.2
Creation of value (c)	1.4	-0.3	-0.5

### 2. NATIONAL MERGERS

	Window (b)		
	(t-90, t-1)	(t-1, t+1)	(t-1, t+30)
Companies acquired	5.3 (d)	3.0 (d)	2.7 (d)
Purchasing companies	-0.2	-1.1 (d)	-1.7 (d)
Creation of value (c)	1.3	-0.4	-0.8

### 3. INTERNATIONAL MERGERS

	Window (b)		
	(t-90, t-1)	(t-1, t+1)	(t-1, t+30)
Companies acquired	2.2	3.8 (d)	1.6
Purchasing companies	0.2	-0.4	0.0
Creation of value (c)	1.5	0.1	0.0

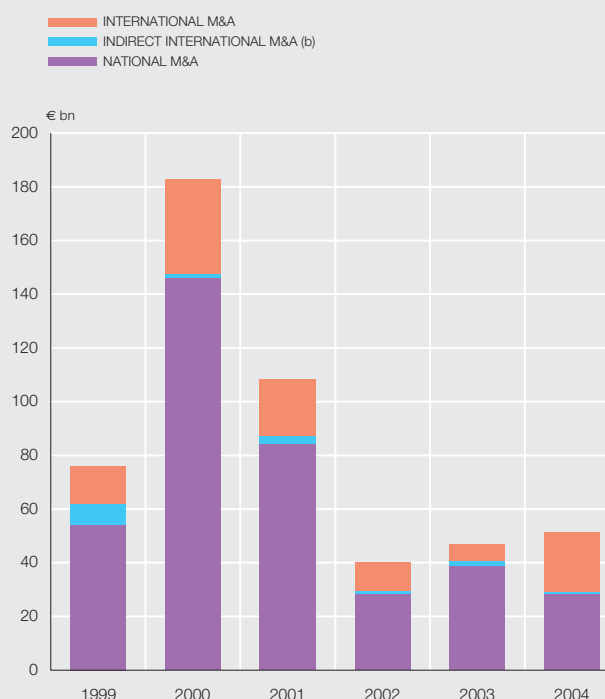
a. Excess returns are calculated over a period around the date of the merger announcement.

b. t denotes the date of the merger announcement, and the figures refer to the number of days before or after the announcement date.

c. Weighted average of excess returns of acquired and purchasing companies, taking stock market capitalisation as a weight. It is calculated for 158 M&A for which the stock market capitalisation of both companies is available.

d. Statistically significant value at 5%.

## VALUE OF M&A IN THE EU FINANCIAL SECTOR (a)



SOURCE: European Commission.

a. Included are all operations in which both the purchasing and acquired companies belong to the financial sector and are based in a European Union country.

b. Indirect international M&A are those in which the purchasing company is a local subsidiary of a foreign company.



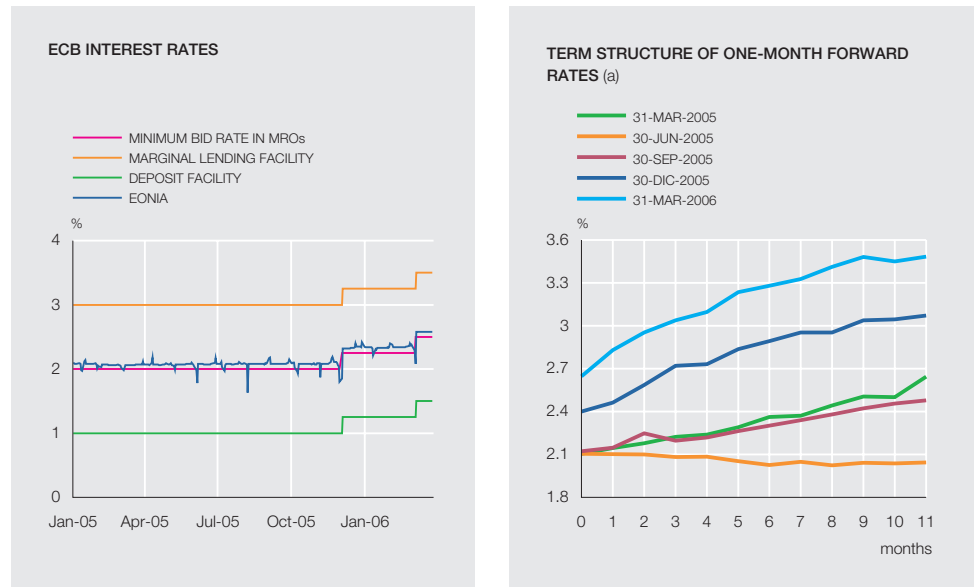
returns to the shareholders of the companies involved, defined as the difference between the actual return in a specific period (or window) around the time of the announcement and the expected return in that same period<sup>2</sup>. The accompanying table shows the average excess returns for the overall M&A in the sample, drawing a distinc-

tion on the basis of the geographical scope of the operations. The results obtained, which are consistent with those found in the literature, indicate that the creation of value (i.e. the overall return on M&A, obtained by weighting the excess returns on the corporations involved by their respective stock market capitalisation) is in no case statistically significant. Moreover, no significant difference in the creation of value is discerned between national and international operations. This evidence suggests that, even though the various above-mentioned obstacles may have deterred international consolidation operations, those finally announced have not, on average, been viewed more unfavourably by the markets than national operations.

2. The expected return is calculated using a CAPM model estimated with information from the six months prior to the start of each of the windows considered. An implicit assumption of the exercise is that risk does not change following M&A. This assumption is consistent with the findings in the literature, which usually indicate that corporate consolidation operations do not have significant effects on the level of risk.

The NRPs contain a series of specific national and scheduled measures for implementation, although both the degree of ambition and the policies proposed are widely diverse. Concerning the strategies to increase labour market participation, most of the programmes envisage an increase in the legal retirement age, incentives to lengthen working life, the reform of employment protection legislation and the adoption of measures to improve labour force skills, in order to lessen the mismatch between labour supply and demand and to increase productivity. Some Member States have decided to introduce changes into their tax and welfare benefits systems aimed at reducing structural unemployment, although in more than half the cases employment targets have not been included. As for innovation, which most Member States have identified as a key challenge, numerous countries will resort to increasing public spending on research and development or to granting financial aid to private expenditure on this area. Although all the Programmes have set defined objectives for their spending on research and development, even in the event of their intended goals being met, this spending will be 0.4 pp below the objective of 3% of GDP set in the original Lisbon Agenda. Finally, regarding the improvement of the business environment, many countries have announced measures to lighten the regulatory burden, in particular through simplifying the prerequisites for starting new businesses.

By identifying and addressing the problems burdening the original Lisbon Agenda, the strategy review means expectations can be harboured that the pace of reform will gather the necessary steam to meet the existing challenges. However, there are substantial reasons for caution. Firstly, the experience with the initial NRPs, which were unknown to vast swathes of the public, shows that the aim to secure broad-based social support for the reforms has not been fully achieved. Along these same lines are recent events in France, where the authorities, faced with substantial social rejection, withdrew their initiative to introduce a new type of contract for those aged under 26 in companies with over 20 employees which envisaged an extension of the trial period up to two years. Secondly, there are still no powerful mechanisms to ensure that the authorities will adopt the measures contained in the Programmes, which will probably have an unfavourable bearing on the objectives being met. Irrespective of these difficulties or the degree of ambition of the NRPs, the Programmes need to be resolutely applied if the European economy is to grow at a rate of close to 3% as targeted. The ambitiousness of this target, which will become more difficult to attain as population ageing begins to exert its adverse effects on potential growth, merely underscores the need to step up productivity gains



SOURCES: ECB and Banco de España.

a. Estimated using interbank market data.

and the use of the labour factor through a higher participation rate – especially for the oldest labour force segments – and lower structural unemployment.

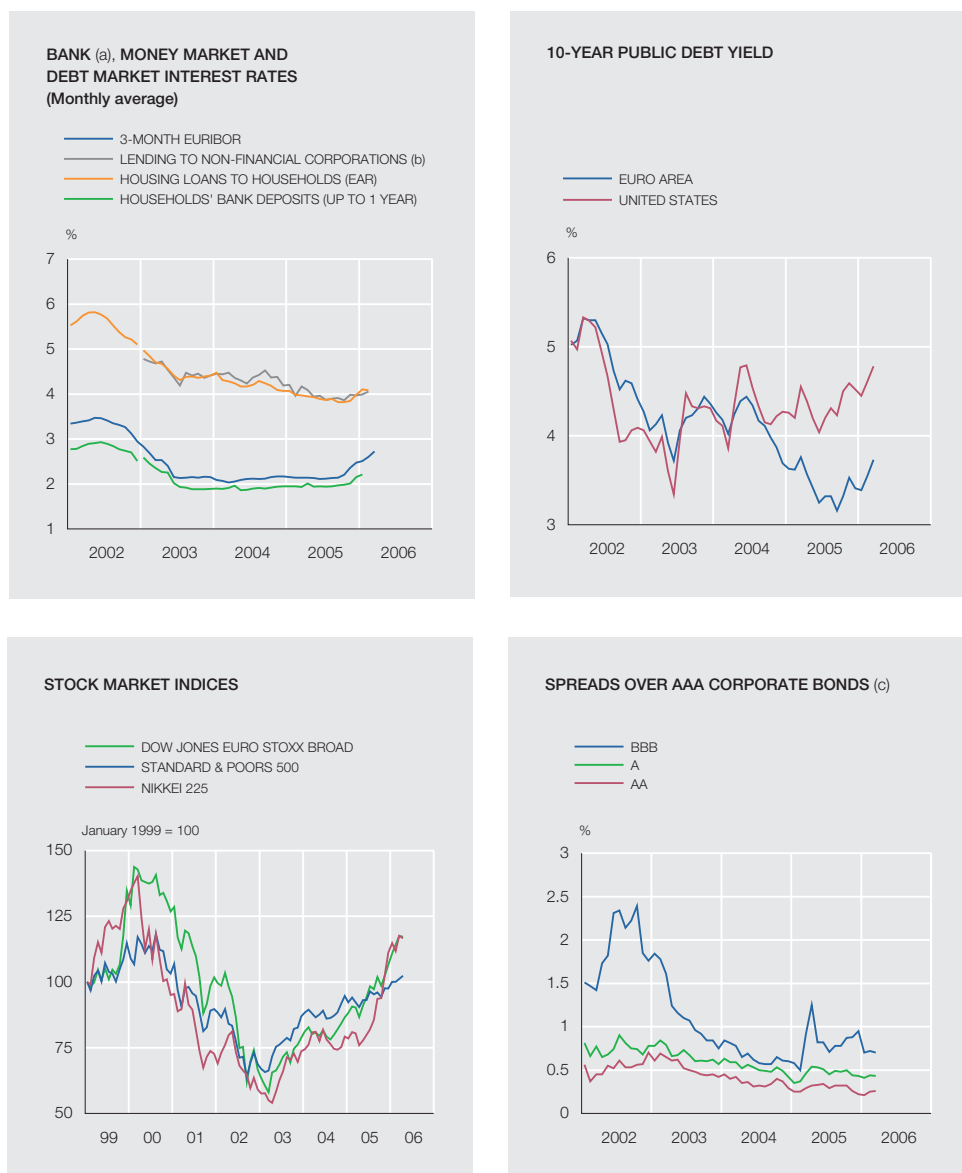
### 3 The common monetary policy and monetary and financial conditions in the euro area

#### 3.1 MONETARY POLICY DECISIONS

The hesitant course of economic activity in the euro area during 2005, along with the maintenance of the inflation rate at over 2% for most of the year and the considerable uncertainty about price developments in the medium-term, shaped a complex scenario for monetary policy. Over the course of the year and, in particular, as from the summer, the ECB adopted an attitude of growing watchfulness as inflationary risks gradually increased against the background of the progressively firming recovery.

In the opening months of 2005, ECB analyses noted the sluggishness of activity as a result of the temporary slowdown in external demand and of the scant robustness of internal demand. Indeed, analysts' consensus growth forecasts for 2005 were reduced by around 0.5 pp during the first half of the year. As to price developments, although the growth rate of the HICP eased in the early months of the year to around 2%, the perception of the presence of inflationary risks held firm as a result of oil price rises and, additionally, in Q2, of the depreciation of the euro. In any event, the ECB considered that in this scenario the prevailing monetary policy stance was still the appropriate one since, in the medium term, inflationary expectations remained contained against a background of slow growth and the weakness of the labour market.

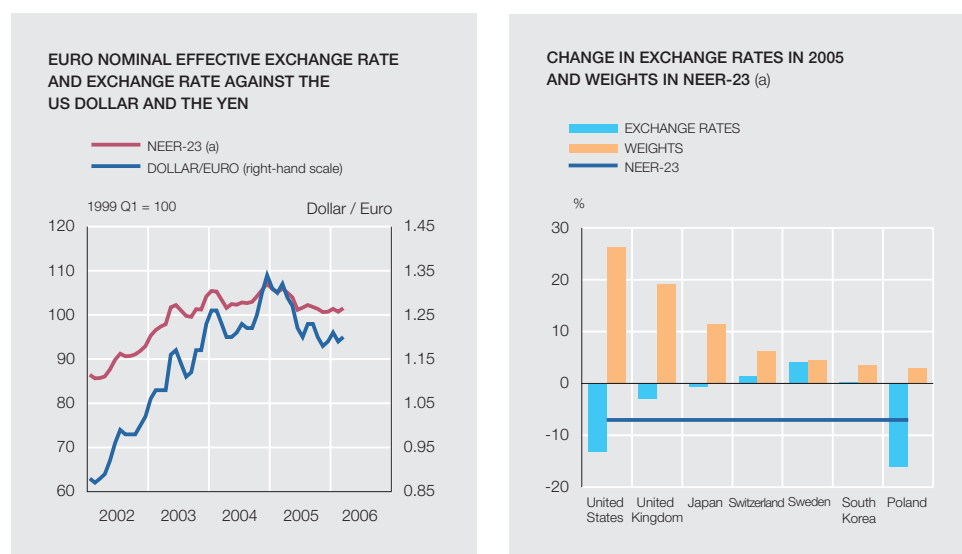
At the end of the summer there were initial signs of an improvement in the economic outlook for the area due to the relatively sharp growth in world trade and to the dynamism that investment finally acquired, driven by very favourable financial conditions. The rate of change of the HICP increased notably, in line with oil prices, to 2.6% in September. In this setting, the markets began to anticipate a shift in stance towards a more restrictive monetary policy (see Chart 3.5). Despite the fact that the ECB Governing Council decided to hold official interest rates stable in view of the absence of significant inflationary pressures, it signalled at that time an intensification of the upside risks to inflation, which it said it would monitor closely.



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 over five years.  
 c. Spread in yields on euro-denominated bonds issued by non-financial corporations over yields on AAA bonds issued by non-financial corporations.

Inflation eased in the second half of the year, assisted slightly by the reduction in oil prices from the high levels posted in the summer months. Underlying inflation stabilised at 1.5%, without any significant impact being observed as a result of the pass-through of dearer energy to this index, and with no perceptible second-round effects on wages. However, the instability on oil markets, which raised the likelihood of further price rises, and the gathering momentum of activity, which might be propitious to the transmission of price rises to wage increases, led the ECB Governing Council to decide, in December, to raise the interest rate on its main refinancing operations by 0.25 pp to 2.25%, after this rate had held unchanged for almost two and a half years. The aim was to ensure that the increase in the inflation rate and its attendant risks would not ultimately affect expectations, keeping such expectations anchored at levels consistent with price stability.



SOURCES: ECB, European Commission and Banco de España.

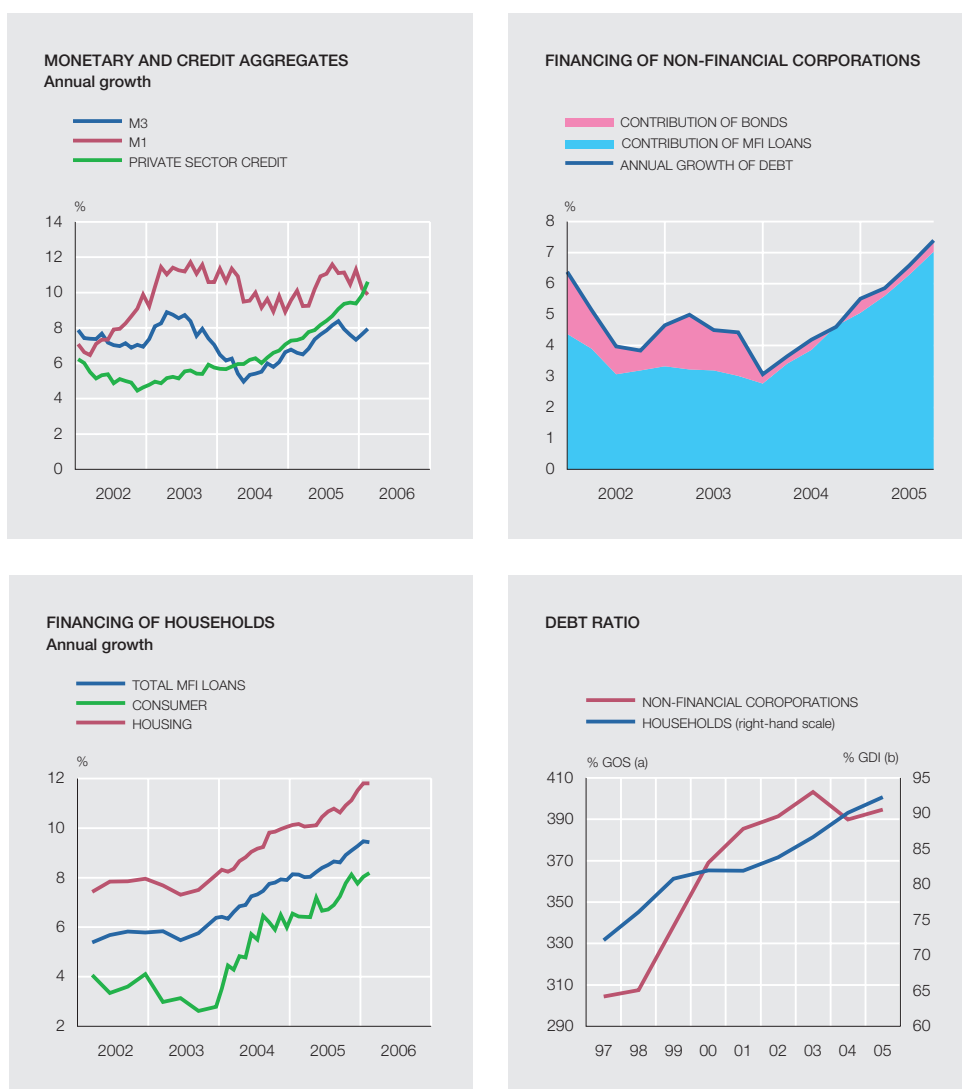
a. The NEER-23 is the nominal effective exchange rate against a basket of 23 countries: the 13 EU members that are not in the euro area and the 10 main trading partners of the EU.

In the opening months of 2006, the growth rate of the HICP rose slightly, and the announcement of future changes in administered prices and indirect taxes indicated further risks to inflation in the medium term. The growth of the monetary and credit aggregates was along the same lines, against the background of the recovery in internal demand. In the light of these developments, the ECB, taking preventive action, raised official rates once again to 2.5% (see Chart 3.5). In any event, and pending new economic data, the monetary policy stance continues to be accommodative, which will help shore up the expected progressive strengthening of internal demand and job creation.

### 3.2 FINANCIAL DEVELOPMENTS IN THE EURO AREA

Money and debt markets were influenced during 2005 by the changes in growth expectations in the area and by the uncertainty over the effects that high oil prices would ultimately have on inflation. In the period to March, the money market yield curve retained a slightly positive slope, in line with its course in late 2004. However, the delay in the expected signs of economic recovery and the perception of the absence of underlying inflationary pressures prompted a change in market expectations in Q2 about the probable course of monetary policy, which in turn led to a flattening of the yield curve at the start of the summer. The progressive improvement in the economic outlook for the area after the summer firmed expectations of a possible rise, albeit a moderate one, in official interest rates for the end of the year, as was ultimately the case. In the closing days of 2005, the slope of the yield curve up to the one-year term was 50 bp, similar to that at the start of April 2006.

Long-term interest rates continued in 2005 on the declining trend initiated in mid-2004, standing in September at around 3.1% for the 10-year term, the lowest level since the introduction of the euro in 1999. In fact, these levels are below those historically recorded in most European economies. Since long-run inflation expectations held relatively stable, the declining trend of interest rates at the highest terms may be due to the downward revision of growth prospects for the area, in a setting of growing demand for European bonds from both residents and non-residents. As regards the latter, demand from the oil-exporting countries was particularly notable. Nonetheless, from 2005 Q4, 10-year debt yields began to rise, standing at around 4% in April 2006. The trajectory of long rates in the area diverged from that in the



SOURCES: ECB and Banco de España.

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

United States, where they held relatively stable. That led to a notable widening of the spread over the European bonds up to 100 bp, the highest level recorded since 2000 (see Chart 3.6).

Equity market prices in 2005 moved on a marked rising trend, in line with the improvement in corporate profits. In terms of the broad EURO STOXX index, the cumulative gain in 2005 was 23%, although this index was still around 30% below the March 2000 peak at the end of the year (see Chart 3.6). The improvement in the overall index was shared by all sectors (especially the financial sector which rose by over 40%), with the exception of telecommunications stock, whose market value dipped by 7%.

The interest rates applied by credit and deposit institutions to their customers held fairly stable and at historically low levels for most of 2005. Only at the end of the year did the interest rate applied to loans to households and firms rise slightly, in line with the increase in market rates. The setting of favourable financial conditions for agents was also discernible in the trend of

corporate bond spreads on the fixed-income markets, which generally held at very low levels (see Chart 3.6).

On the currency markets, the exchange rate depreciated by 7% on average in 2005 in nominal effective terms (see Chart 2.7). The loss in value in the euro was particularly marked against the dollar (13.3%), which might have been related to the relative economic situation of both regions, expressed in the course of their monetary policies: the interest rate rises by the Federal Reserve, following a highly activist policy since the start of the year, contributed to the strength of the dollar, although the increase in rates by the ECB in December might have proved conducive to the correction of this trend. The favourable outlook for the US economy may have lessened international investors' concern about the high and persistent US deficit, further boosting the demand for dollar-denominated assets.

The rate of increase of the M3 monetary aggregate intensified during the year due, in part, to portfolio shifts to equities. Nonetheless, this continuous accelerating profile was interrupted from October, and the aggregates stood at 7.3% in December 2005 (see Chart 3.8). In terms of components, sight deposits, included in the narrow M1 aggregate, followed by the other short-term deposits, were those that most contributed to the growth of the aggregate. As regards agents, these developments were reflected in the strength of deposits held by non-financial corporations and by other financial institutions.

Financing extended to the private sector by monetary and financial institutions gathered momentum during 2005. In terms of agents, the acceleration in loans was discernible both in those to non-financial corporations and those to households. The improved growth outlook for the euro area in the second half of the year, coupled with historically low interest rates, led loans extended to non-financial corporations to increase to a year-on-year rate of 8.1% in December. Indeed, companies' debt ratio climbed by 5 pp to 395% of the gross operating surplus, in any event below the peak reached in 2003 (see Chart 3.8). As regards lending to households, both consumer loans and, above all, house purchase loans quickened, with their rate of change standing at 7.8% and 11.5%, respectively, in December. As a result, household debt in the euro area as a whole increased once again in 2005 to 92% of household disposable income. Country by country, the behaviour of household loans was very heterogeneous. The most dynamic lending was concentrated in those economies – Spain, Ireland and Greece – in which residential investment and house prices grew at high rates. At the other extreme was Germany, where the unfavourable cyclical position and the greater caution exercised by German banks when extending loans shaped a scenario in which credit grew at a level far below the area average.



## The Spanish economy

In 2005 the Spanish economy grew by 3.4%, 0.3 pp more than in the previous year. The expansion of output was based, as in the preceding years, on the buoyancy of national demand, which increased at a rate of more than 5%, while net exports subtracted almost 2 pp from annual GDP growth. This behaviour of the external sector contributed to a substantial increase in the nation's net borrowing, while the growth in national demand was accompanied by a strong expansion in the net borrowing of households and non-financial corporations. In contrast, the general government budgetary situation improved significantly, with the achievement of a surplus for the first time in recent decades. The growth of the economy continued to be accompanied by a high rate of job creation, and productivity gains remained at very low levels. Finally, the rate of inflation, as measured by consumer prices, rose to 3.4% on average in 2005, driven by the higher energy prices, and underlying inflation continued to display considerably higher rates of expansion than in the euro area.

The following sections describe the economic policy setting within which the Spanish economy achieved these results, and then analyse in detail the factors underlying this expansionary behaviour.

### 1 *Economic policies*

#### 1.1 MONETARY AND FINANCIAL CONDITIONS

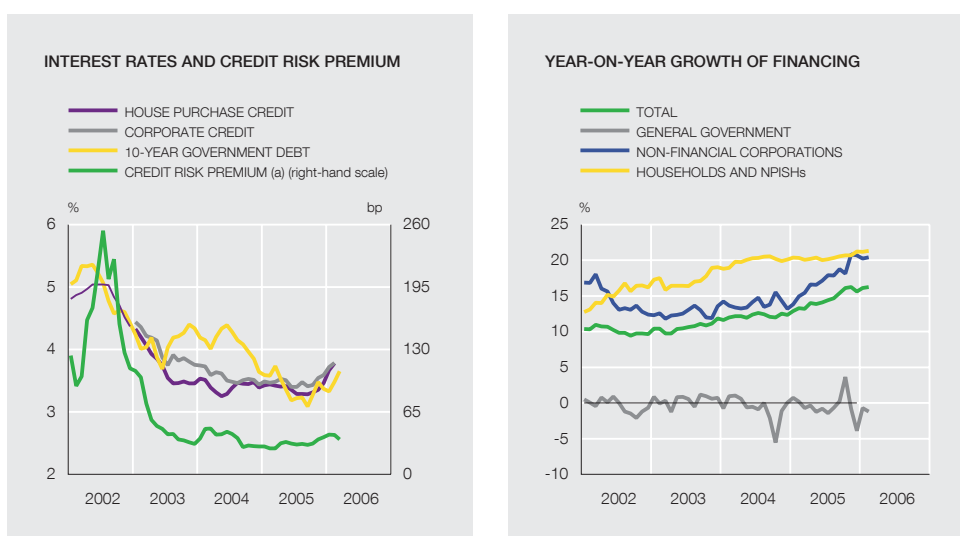
The financing conditions for Spanish households and corporations barely changed in 2005, maintaining the easiness that has characterised them in recent years. Against this background, private-sector indebtedness continued to increase at high rates, although it was compatible with a further increase in net household wealth, owing to the trend in house and stock prices.

Yields on the interbank market rose in Q4, reflecting expectations of increases in official euro area interest rates. These, as discussed in the last chapter, were subsequently confirmed with the decisions taken in December last year and in March 2006. The one-year EURIBOR stood at end-2005 at 2.8%, 0.6 pp above its end-2004 level. However, the cost of bank finance remained relatively steady during most of the year, and only registered the change in stance of monetary policy in the last few months of the year (see Chart 4.1).

The Spanish long-term government bond yield displayed a downward trend until September, when it reached historic lows. Subsequently, this trend was reversed so that in December the yield on the ten-year benchmark bond stood at 3.4% [down 20 basis points (bp) from end-2004]. The spread over German debt did not change significantly and remained close to zero. This behaviour of bond prices, along with the relative stability of corporate credit risk premiums, led to a slight reduction in the average cost of corporate bond financing in 2005 as a whole (see Chart 4.1).

On domestic and international stock markets, prices maintained the upward trend that began in 2003, while price volatility remained at historically low levels. The gains were especially strong in the case of European markets, against a background of high corporate earnings growth and an improvement in the euro area economic outlook. The Madrid Stock Exchange General Index rose by 20.6% during 2005, a similar rise to that seen in the EURO STOXX broad index for the euro area (23%) and significantly higher than that in the US S&P 500 index (3%). As a result, corporate equity fundraising conditions improved. The depreciation of the euro against the dollar during the year helped ease monetary and financial conditions still further.





SOURCES: Credit Trade and Banco de España.

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

As regards the various indicators available, house prices slowed in 2005, although they continued to grow at high year-on-year rates. In particular, according to Ministry of Housing data, the growth rate at end-2005 was 12.8%, down 4.4 pp from a year earlier. This is consistent with a scenario of orderly absorption of the current overvaluation of housing.

In this setting, corporate borrowing accelerated notably, to reach a growth rate of practically 21% in December, up some 7 pp from end-2004 (see Chart 4.1). Most of this borrowing continued to be in the form of loans from financial institutions. By branch of activity, property and construction continued to show the strongest increases in their recourse to bank finance, with rates of growth of 45% and 28%, respectively, although it should be pointed out that credit to the manufacturing sector grew by around 15% relative to the same period of the previous year, 9 pp more than a year earlier. The buoyancy of corporate debt is reflected in increases in the ratios of both the debt and debt burden of the sector relative to its earnings. This same development was observed for most of the corporations reporting quarterly data to the Central Balance Sheet Data Office, so that the favourable behaviour of their results did not prevent some deterioration in the synthetic indicators of the financial pressure on investment and employment, although these remained at moderate levels.

For its part, the volume of household financing recorded a high rate of growth (21%, at year-end), owing, once again, to loans for house purchase, which increased at a year-on-year rate of more than 24% in December. As a result of these developments, the indicators of financial pressure on the sector continued to deteriorate. However, despite the increase in liabilities, the rise in property and stock prices helped household net wealth to continue to grow.

## 1.2 FISCAL POLICY

The State budget for 2005 (the first to be prepared by the new government since the change of legislature) established a fiscal policy whose main aim was the maintenance of budgetary stability. In this respect, it set a target of mild surplus for general government in 2005 (0.1% of GDP), on the basis of a macroeconomic scenario of a certain recovery, with estimated GDP growth of 2.9% (2.4% in 2004). These figures referred to the National Accounts base 1995, which turned out to be lower than those published subsequently with the new base 2000. As

for the breakdown of this total, the central government was estimated to run a deficit of 0.5%, the Social Security system a 0.7% surplus, and the regional (autonomous) governments a small deficit of 0.1% of GDP. The budget also projected a further reduction in the debt-to-GDP ratio, to 47.7% by the year-end, and provided for a transfer to the pension reserve fund of €5,351 million.

The spending policies and measures adopted in the State budget attempted to underpin the broad aims of economic policy announced by the government: the commitment to stability and budget discipline mentioned above, the boosting of productivity by means of investment in infrastructure, research and education, and the strengthening of social policies. In 2005, in line with these aims, the spending programme linked to each of these policies grew by more than nominal GDP. As regards the specific budget measures, notable on the spending side were the improvement in the remuneration of civil servants and the increase in public-sector vacancies among certain groups (as a result of the agreement between the government and unions), the increase in minimum pensions and the rise in the amount of grants. On the revenue side the legislative changes were of little importance. Notable among those involving increases in revenue were the updating of the contribution bases and the raising of certain charges. As regards personal income tax, it was decided to index the tax brackets in line with projected inflation, but the personal and family allowances were not updated. Finally, among measures involving a reduction in revenues, the freezing of the tax on hydrocarbons, certain improvements in the tax treatment of SMEs and the reduction in the contributions payable by young people who register for Social Security as self-employed were notable.

During the year various aspects of the Spanish public sector's institutional make-up were debated. As a result, two draft budgetary stability laws were approved<sup>1</sup>, the most important provisions of which require that the budgetary stability objective be achieved over the business cycle and that the obligation to comply with this objective be extended to the State, without its position with the Social Security System being taken into account for such purpose. Also various measures were announced to increase the transparency and efficiency of government administration, although these are not yet fully in force. Thus, steps were taken to speed up and simplify administrative procedures and it was announced that a State agency was to be set up to assess public policies and the quality of public services, the aim of which will be to identify those public policies that have most impact on productivity and to develop more effective regulatory actions.

Finally, in the first few months of 2006 the Draft Law to reform personal income tax and partially amend corporate income tax and the Draft Law to promote personal autonomy and provision for dependent persons were approved. Both of these bills are currently passing through parliament and will come into force in 2007. In relation to personal income tax, the Draft Law proposes a reduction in the marginal rate (to 43%) and in the number of tax brackets in the general tax rate schedule, as well as a change in the treatment of personal and family circumstances. It also modifies the taxation of savings, proposing a uniform treatment for all income from capital (with the exception of pension schemes and housing) and net capital gains, which shall be taxed at a single rate of 18%, irrespective of the period in which such income is generated. At the same time, the Draft Law envisages a gradual reduction in the rate of corporate income tax, to 30% in 2011, and a simplification of the tax deduction rules. Finally, as regards dependence, the Draft Law establishes the bases for the introduction (over an 8-year period) and financing of a new benefit to be offered, in co-ordination, by

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1. Draft law to reform the General Budgetary Stability Law 18/2001 of 12 December 2001 and the draft organic law to reform Organic Law 5/2001 of 13 December 2001 supplementing the General Budgetary Stability Law.

## MAIN GENERAL GOVERNMENT NON-FINANCIAL TRANSACTIONS

TABLE 4.1

GDP percentages				
	2002	2003	2004	2005
1 Total revenue	38.7	38.6	39.1	39.8
Current revenue	38.0	38.0	38.3	39.2
<i>Taxes on products and imports</i>	11.2	11.5	11.9	12.2
<i>Taxes on income and wealth</i>	10.4	10.1	10.2	11.0
<i>Social Security contributions</i>	13.0	13.0	13.0	13.0
<i>Other current revenue (a)</i>	3.4	3.3	3.1	3.1
Capital revenue	0.7	0.7	0.8	0.7
2 Total expenditure	39.0	38.7	39.2	38.7
Current expenditure	34.1	34.0	34.1	33.8
<i>Final consumption</i>	17.2	17.4	17.8	17.8
<i>Social benefits (other than transfers in kind)</i>	11.8	11.7	11.7	11.6
<i>Interest (b)</i>	2.7	2.4	2.0	1.8
<i>Subsidies</i>	1.1	1.0	1.0	1.0
<i>Other transfers</i>	1.4	1.5	1.5	1.6
Capital expenditure	4.9	4.7	5.1	4.9
<i>Gross capital formation (c)</i>	3.6	3.5	3.4	3.6
<i>Other capital expenditure</i>	1.3	1.1	1.7	1.3
3 Net lending (+) or net borrowing (-) (b) (3 = 1 - 2)	-0.3	0.0	-0.1	1.1
MEMORANDUM ITEM:				
Total balance net of RENFE effect	-0.3	0.0	0.5	1.1
Primary balance	2.4	2.3	1.9	2.9
Gross debt (b)	52.7	49.1	46.6	43.4

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

a. Includes gross operating surplus.

b. According to the Excessive Deficit Procedure methodology.

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

central government and the regional (autonomous) governments, to cover situations of dependency.

When the 2005 budget was prepared it was estimated that the measures planned would entail a small increase in primary expenditure as a proportion of GDP, while the estimates of the primary structural balance, obtained from the fiscal and macroeconomic projections then available, pointed to a mildly expansionary fiscal stance. However, the fiscal results eventually obtained for 2005 were a substantial improvement on the targets set, since general government achieved a surplus of 1.1% of GDP in 2005, mainly as a consequence of buoyant revenues, so that fiscal policy was actually restrictive. This surplus of 1.1% of GDP represents an improvement of 1.2 pp in relation to the slight deficit of the previous year, against a background of higher-than-projected growth (see Table 4.1). The comparison with 2004 is, however, influenced by the restructuring of the railway industry, which affected the public-sector balance for that year, due to the assumption by the State of RENFE debt and title to part of its assets. If we adjust for this effect, which is temporary in nature, the improvement in 2005 would have been 0.6 pp of GDP (or 0.4 pp, if the comparison is made in terms of the primary balance). Public debt continued to decline as a proportion of GDP, to reach 43.4%, which was also lower than projected. In the euro area as a whole, by contrast, this ratio was 70.8% of GDP and, moreover, its trend has been upward in recent years.

By sub-sector, the surplus of the State and its agencies (0.4% of GDP) was notable. This involved not only a strong improvement over the previous year, but also a change in the sign of the balance. The Social Security System, meanwhile, recorded, as in previous years, a substantial surplus (1.1% of GDP), which was larger than initially estimated. This enabled the Reserve Fund to be increased by more than planned, to 3.1% of GDP as at end-2005. The regional (autonomous) governments recorded a small deficit (0.2% of GDP), despite the payment received from the State to cover health spending deviations, as against the balanced budget of 2004, although this was in turn made possible by the payment to the Andalusian regional government of the final settlement payable under the financing system for the period 1997-2000. For its part, local government recorded a slight deficit, which represented a deterioration relative to 2004.

By component, the improvement in the general government balance in 2005 stemmed, on one hand, from the growth of tax revenues, which increased, as a proportion of GDP, by 1 pp, maintaining the upward trend that began in 2001. On the other hand, the 0.2 pp reduction in the weight of capital expenditure, as a consequence of the restructuring of the railways, and the further fall in interest expenditure, by the same relative amount, to 1.8% of GDP, also contributed to this result (see Table 4.1).

The increase in tax revenues as a percentage of GDP in 2005 can be attributed almost entirely to the buoyancy of receipts from the taxes on income and wealth, which grew by 16% with respect to the previous year, and to the sustained high rates of growth in the taxes on production and imports (10.4%). The share of current taxes on income and wealth in fiscal revenues increased significantly from 26.4% in 2004 to 28.7% in 2005. The two main taxes involved followed relatively similar trends, recording higher growth than in 2004. On one hand, the taxes paid by corporations, in line with earnings developments, rose strongly, increasing as a proportion of GDP by 0.5 pp, which was in addition to the 0.4 pp increase that had already occurred since 2000. On the other hand, personal income tax receipts grew by around 12% (in contrast to their low growth in 2004), or by 0.3 pp of GDP. Withholdings on income from capital increased very notably in 2005, contributing significantly to the trend in personal income tax receipts. Meanwhile, the growth in house prices appears to have made a notable contribution to the trend in taxes on production and imports, in view of the large increases in VAT receipts and in the tax on capital transfers, although part of this notable growth is also explained by the strength of consumption.

Social contribution revenues grew by somewhat less than GDP (7.4%) owing to the containment of wages and despite the increase in numbers registered (4%). The latter continued to grow by more than employment, boosted by the immigrant legalisation process, which added more than half a million to the numbers registered for Social Security. However, the concentration of legalised immigrants in the domestic employee regime (33% of the total) and in the agricultural sector (14%), which have contribution rates and bases well below those of the general regime, meant that this process had a relatively small impact (estimated as less than 2%) on total social contribution revenues. As a result, as a proportion of GDP these revenues remained unchanged at 13%. Capital revenues fell last year, despite the considerable increase in taxes of this type, owing to the decline in capital transfers from the EU.

The growth in non-financial uses in 2005 stemmed, in particular, from the impact on the 2004 accounts of the restructuring of the railways, which gave rise to large capital transfers that year, and from the strong increase in public investment. As a result of the buoyancy of this latter item, investment accounted for 3.6% of GDP in 2005, a rise of 0.2 pp from a year earlier, as seen in Table 4.1. General government final consumption, meanwhile, maintained its share

in GDP at the historical high of 17.8%. Social benefits slowed significantly, which led to a fall in their weight in GDP to 11.6%. This was basically a result of the impact on the 2004 accounts of the improvement in the minimum and widow(er)s' pensions, approved that year, and of the fact that actual inflation exceeded projected inflation in 2004. These factors offset the expansionary effect of others, such as the increase in the number of contributory pensions, which was slightly higher in 2005 than in 2004. The trend in unemployment benefit was determined by the fall in registered unemployment, since the eligibility ratio rose to 61%. Finally, while subsidies grew by slightly less than nominal GDP (although they continued to amount to 1% of that variable), the fall in interest expenditure took the cumulative reduction in this item of spending since the beginning of the decade to 1.4 pp of GDP.

In short, the improvement in the general government balance in 2005 was mainly a consequence of the considerable increase in tax receipts and also of the reduction in the primary expenditure ratio, although government consumption continued to display high rates of growth and its weight in GDP remained unchanged. As discussed above, according to the primary fiscal impulse indicator, fiscal policy was contractionary in 2005, and more so than in 2004 (having adjusted for the RENFE effect). General government continued to comply, for another year, with the Stability and Growth Pact, also satisfying the operational criterion used when assessing the level of compliance, which consists of achieving a cyclically adjusted budget balance close to balance or in surplus. Finally, central government complied with the requirements of the budgetary stability law, both as regards its budgetary position and the volume of its spending, and the Social Security system maintained its degree of compliance too. However, regional and local government ran deficits which, according to the provisions of that law, must be corrected in future years.

### 1.3 OTHER ECONOMIC POLICIES

In the labour market, the year 2005 saw the continuation of the incentives previously in place, aimed at promoting stable employment and at increasing the employment and participation of the groups displaying the highest unemployment rates and lowest participation rates, respectively. These incentives basically comprise a broad set of social security contribution rebates and the stable employment-promoting contract, which was introduced in 1997 and entails lower firing costs than those of ordinary employment contracts.

The national minimum wage increased by 5.5% in 2005, as part of a process whose aim is for this wage to rise to a monthly level of €600 in 2008. As regards wage bargaining arrangements, there were no changes. Collective bargaining was essentially defined, as in previous years, by the signing of an Interconfederal Collective Bargaining Agreement, which set a base for wage growth of 2%, in step with the reference set by the government, to which an additional increase determined by the foreseeable rise in productivity may be added. The inclusion of wage indexation clauses in the face of deviations by inflation remained fairly widespread.

As regards industrial relations dialogue, the government and the social agents continued discussing possible reforms to the labour market – other than those that might affect collective bargaining – and to the Social Security System. The negotiations concluded with the signing of an agreement on 9 May this year which contains various measures aimed mainly at putting a brake on the extension of temporary hiring, through establishing limits to the renewal of temporary contracts, and at promoting permanent contracts, through the revision of some of the attendant incentives. The arrangements for rebates have been simplified and these are now linear and applicable for a period of four years. Further, the term for the conversion of temporary contracts into stable employment-promoting contracts has been extended, although the group of workers who may qualify for this type of permanent contract with lower redundancy payments has not been broadened. Finally, exceptional procedures for the regu-

larisation of foreign workers in an illegal situation in Spain were launched in 2005 and, as will be seen later, this had a significant effect on the number of Social Security registrations.

With regard to the markets for goods and services, on 1 March 2005 the government announced a set of measures, grouped in the first package of the *Plan de Dinamización de la Economía y de Impulso a la Productividad* (plan to invigorate the economy and boost productivity). This plan comprised a series of measures aimed at a wide number of sectors<sup>2</sup> (telecommunications, the information society, energy, transport, postal services, house rentals, financial markets, public sector, regulatory and tax framework), which were grouped into five legal initiatives with a view to implementation during the year, a high proportion of which has been carried out. The initiatives included most notably those whose aim is to increase the level of competition and introduce efficiency gains in the energy sectors.

There was a change of direction in housing policy aimed, on one hand, at increasing the weight of protected housing and, on the other, at promoting the rental market, although the measures adopted in the second case appear to have been rather ineffective to date. Further, plans to foment innovation and the use of ICTs were approved during the summer of 2005. These set more ambitious targets than the previous programmes, being geared to correct significantly the Spanish economy's deficit in this area. The various legislative initiatives adopted during the year were reflected in Spain's National Reforms Plan (NRP), which the government submitted to the European Commission on 1 October under the commitments acquired in connection with the revision of the Lisbon agenda. This Plan defines an overall framework that acts as the centrepiece for economic policy action by the government. Box 1.4 of this report provides a more detailed view of the NRP.

## 2 Demand

### 2.1 NATIONAL DEMAND

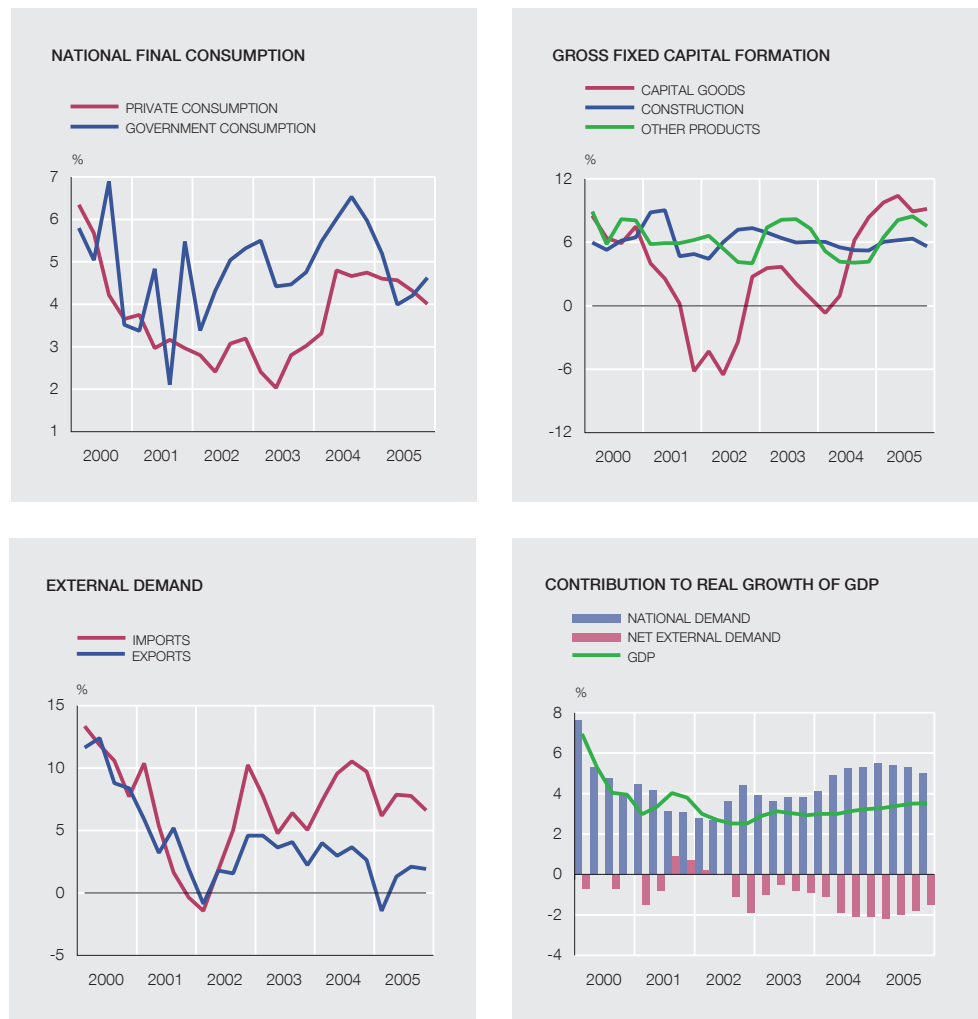
As described in the previous section, the stance of the macroeconomic policies programmed in 2005 remained conducive to the growth of national demand. This variable showed substantial robustness, with a rate of expansion of 5.1%, 0.3 pp up on 2004. This acceleration was compatible with some restructuring of growth in favour of gross capital formation, the growth of which climbed 2 pp to 6.9%, and to the detriment of government consumption, which slowed, albeit sustaining a very high rate, while private consumption continued to expand at the same rate as the previous year. All told, the profile of national demand during 2005 was characterised by a slight slowdown, to which practically all its components contributed (see Chart 4.2).

Household final consumption grew by 4.4% in 2005, moving on a slightly slower path throughout the year. Both durable and non-durable consumption posted fairly uniform growth rates, which were nevertheless the outcome of different trends (see Table 4.2). Non-durable consumption thus held in 2005 on the accelerating path on which it had embarked the previous year, while durable consumption slowed, more sharply so in the case of cars.

Among the factors contributing to sustaining consumption in 2005 were, first, disposable income, which grew at over 3% in real terms, in line with its trend in recent years, and despite the acceleration in consumer prices (see Chart 4.3). The surplus of sole proprietors, for its part, grew once again at a high rate in 2005, while wage income, though benefiting from the continuing favourable

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2. These measures took the form of five legal initiatives, which were progressively implemented during the year: Royal Decree-Law 5/2005 of 11 March 2005, on urgent reforms to boost productivity and improve public-sector procurement; the Resolution dated 1 April 2005, providing for the enactment of the Agreement of the Council of Ministers of 25 February 2005 adopting a mandate to boost productivity; Law 23/2005 of 18 November 2005 on tax reforms to boost productivity; Law 24/2005 of 18 November 2005 on reforms to boost productivity, and Law 25/2005 of 24 November 2005 regulating venture capital entities and their management companies.



SOURCE: INE.

a. Base year 2000 National Accounts. Year-on-year rates of change based on real seasonally adjusted series of volume indices.

behaviour of employment, saw its contribution to the expansion of real disposable income fall slightly, owing to the more moderate growth of compensation per employee.

As indicated in the first section, bank interest rates held relatively stable in 2005. The increase in the inflation rate meant, therefore, that real rates declined, which boosted consumption for yet another year. However, the increase in household debt led once more to a negative contribution of net interest payments to disposable income growth.

Net household wealth in 2005 exerted a notable expansionary influence on consumption owing to the rise in cumulative wealth in recent years (see Chart 4.3). However, the somewhat more moderate growth of property wealth last year, as a result of the slowdown in house prices, and the lower increase in net financial wealth were propitious to the moderate slowdown in consumer spending during the year. The slight decline in consumer confidence in the second half of 2005 and some worsening in households' perception about saving possibilities in the future would have been along these same lines, suggesting a reduction in income expectations. In any event, although total household wealth increased less in 2005 than previous years, it continued to sustain growth in consumption above that in income, which gave



	% of GDP (a)		RATE OF CHANGE (b)					
	2000	2005	2000	2001	2002	2003	2004	2005
HOUSEHOLDS AND NPISHs								
Final consumption expenditure	59.7	57.7	5.0	3.2	2.9	2.6	4.4	4.4
<i>Durable consumption</i>	6.3	5.6	1.1	1.8	-2.5	6.5	9.2	5.1
<i>Non-durable consumption</i>	53.0	51.7	5.3	3.4	3.5	2.2	3.8	4.3
Residential domestic investment (c)	7.7	11.0	10.3	6.0	6.9	9.4	6.0	6.0
CORPORATIONS								
Private productive investment (d)	15.0	14.8	7.7	2.6	-0.2	3.3	5.8	8.1
<i>Construction and other products</i>	6.1	7.1	10.6	6.0	3.4	3.2	10.2	5.5
<i>Equipment and other products</i>	8.9	7.7	7.1	0.3	-3.1	3.0	2.2	10.5
GENERAL GOVERNMENT								
Final consumption expenditure	17.2	17.8	5.3	3.9	4.5	4.8	6.0	4.5
Gross fixed capital formation	3.2	3.6	-5.7	10.3	10.3	5.0	-1.5	6.8
<i>Construction and other products</i>	2.3	2.6	-10.8	11.5	10.8	3.7	-5.7	7.5
<i>Equipment and other products</i>	0.9	1.0	10.7	7.0	8.7	8.9	10.9	4.8
MEMORANDUM ITEM								
Gross fixed capital formation	25.8	29.4	6.6	4.5	3.3	5.5	4.9	7.2
<i>Equipment</i>	8.1	7.0	7.1	0.1	-2.9	2.5	3.7	9.5
<i>Construction</i>	13.3	17.1	6.0	6.8	6.2	6.3	5.5	6.0
<i>Other products</i>	4.4	5.2	7.7	6.0	5.0	7.7	4.4	7.6

SOURCES: INE and Banco de España.

a. Base-year 2000 National Accounts, current prices.

b. Base-year 2000 National Accounts, rates of change of volume indices.

c. Excludes investment by sole proprietors.

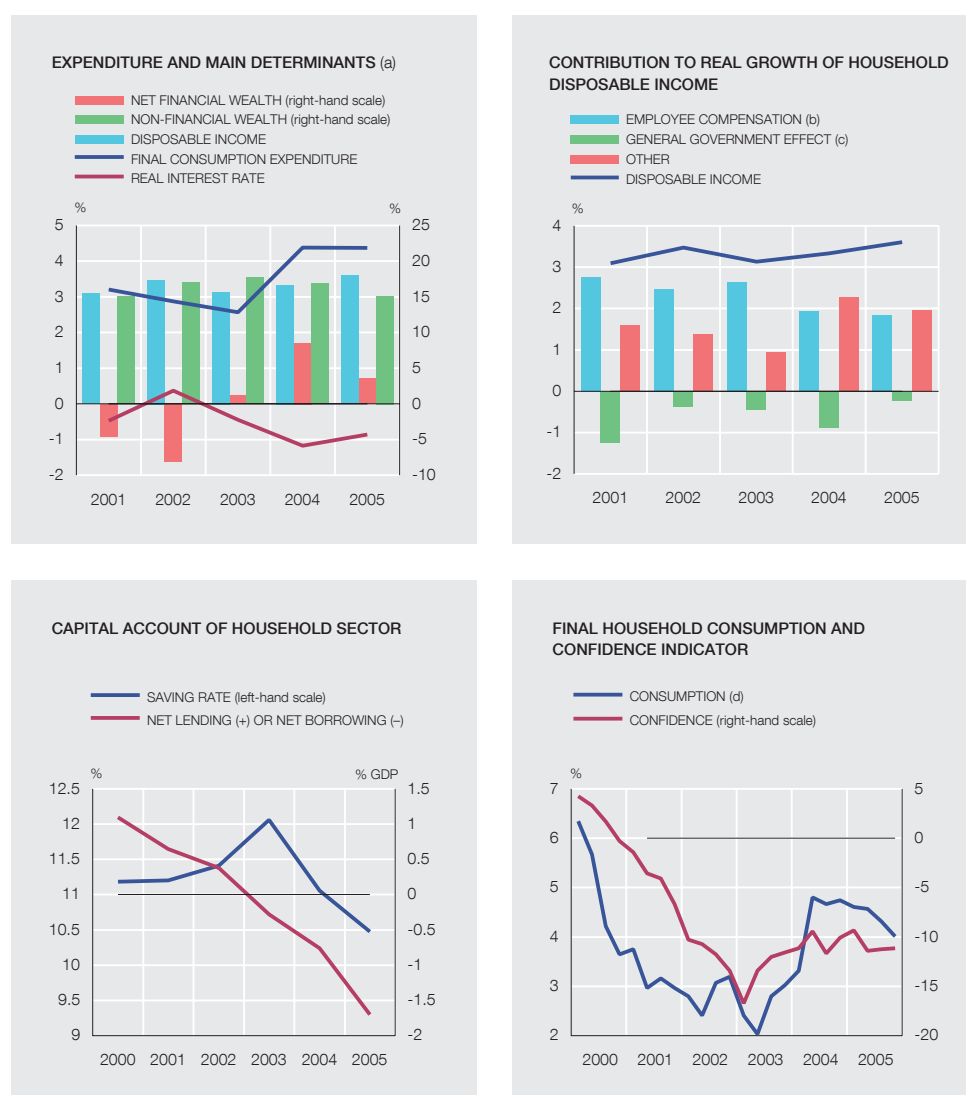
d. Includes investment by sole proprietors.

rise to a fresh reduction in the saving ratio, which is also consistent with the low level of real interest rates.

Domestic residential investment by households continued to grow at a high rate in 2005, close to the figure of 6% recorded in 2004, thanks to the buoyancy of real income and wealth (see table 4.2). By contrast, it is estimated that the user cost – which includes the effect of interest rates and expectations of the revaluation of real assets – increased and may have contributed to easing the demand for housing, since it is likely that the expected revaluation will have been sensitive to the signs of property prices slowing. Despite the lower growth of prices in this market, the estimated effort required to acquire a house continued to increase, as signalled by the indicator which proxies the proportion of disposable income that a standard household must assign to buying a house, at current prices and interest rates (see Chart 4.4).

Demographic factors have contributed to boosting the demand for principal dwellings in recent years. The creation of new households has been on a growing profile since 1997, as a result of those born in the 60s and early 70s (when the birth rate expanded strongly) reaching adulthood, and of the reduction in the average household size, due both to population ageing and to other sociological changes bearing on the traditional models of household formation. The rapid growth of the immigrant population has been a further factor behind the creation of new households, although its direct influence on house purchases is probably still limited.



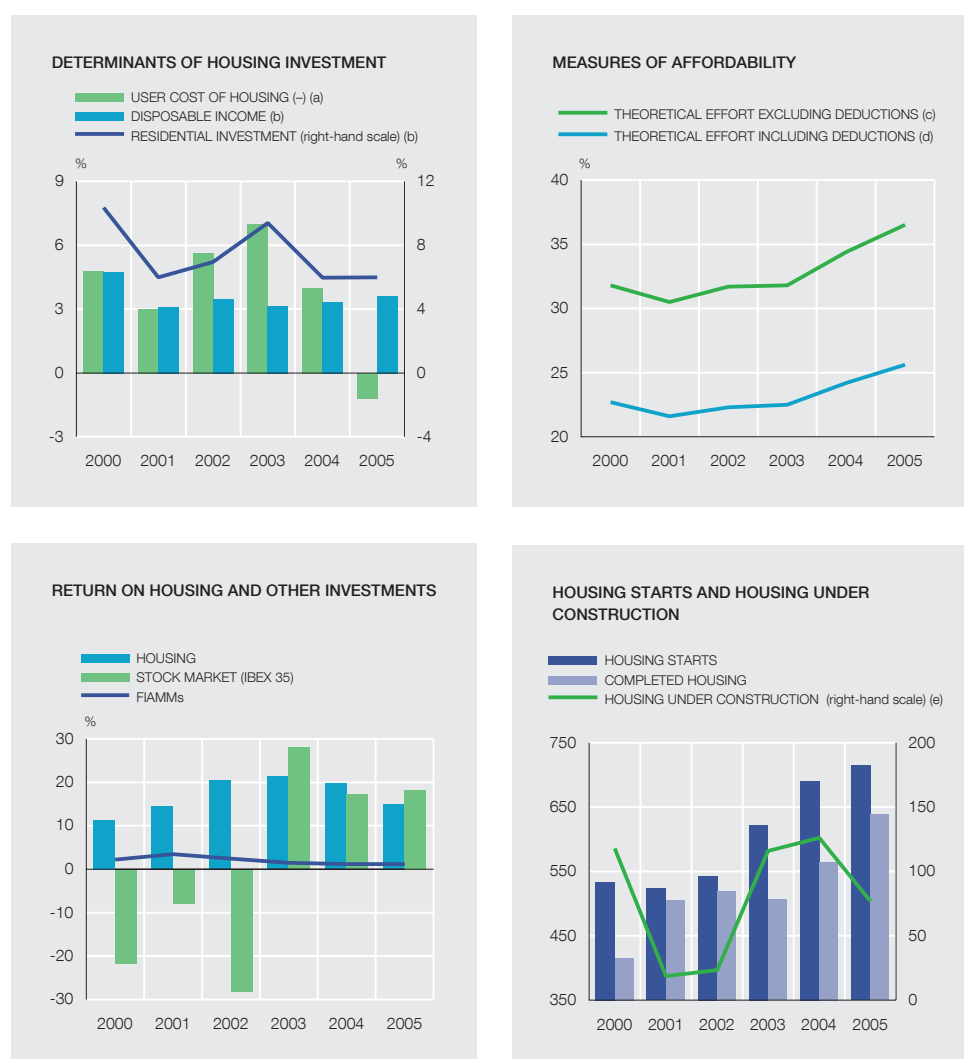


SOURCES: INE and Banco de España.

- a. Real rates of change.  
 b. Gross compensation per employee.  
 c. Includes social benefits, social contributions and taxes on income and wealth.  
 d. Year-on-year growth rate of the real seasonally adjusted series of final consumption expenditure of households and NPISHs.

The demand for property assets as a means of placing wealth continued to be boosted by the attractive return still provided by investment in these real assets in 2005, compared with other alternative investments. The fact that the average stock market rise in the past three years has stood at values on a scale similar to that of housing must have contributed, however, to tempering this incentive (see Chart 4.4). Lastly, a significant segment of the demand for housing, stemming from non-residents, continued to be checked, a trend drawn from the decline in net flows for property purchases in Spain in 2005.

Set against this momentum of residential investment demand, the stock of housing continued to rise rapidly in 2005, as indicated by the information on housing starts and finished houses (see Chart 4.4). This contributed to mitigating the effects derived from the pressure of demand on prices.



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

- a. Real change.
- b. Real rates of change.
- c. Estimated gross annual payment required to purchase a standard house as a percentage of annual household disposable income.
- d. As above, net of tax deductions.
- e. Annual difference: housing starts less completed housing.

Overall, the demand exerted by households, both for consumer goods and services and for residential investment, remained robust in 2005, posting very similar growth rates to those of the previous year. This behaviour translated not only into a decline in the saving ratio, as earlier indicated, but also into a further widening of the saving/investment gap in the sector, whose borrowing requirement increased once more. As a result, households, which have historically provided funds to the rest of the economy, contributed once again to increasing the nation's financing requirements.

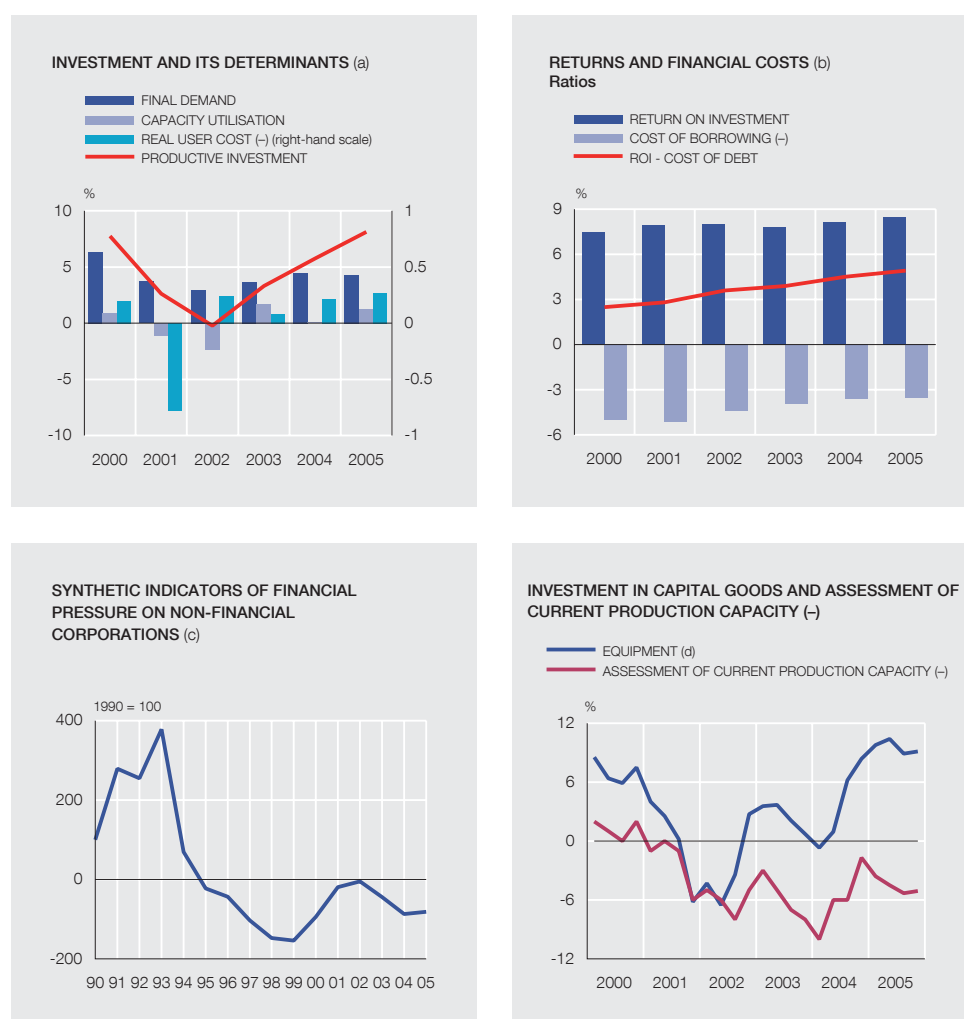
As regards the demand exerted by general government, final consumption spending grew by 4.5% in real terms in 2005, below the end-2004 figure of 6%. That said, this is a very high rate, which outpaces the expansion of GDP (see Table 4.2). In nominal terms, a slowdown in consumption was also seen from 9.5% in 2004 to 8.1% in 2005. Component by component, compensation per employee grew by 6.6%, against 7.1% the previous year, despite the fact that the indicators showed sharp job creation in the public sector, while purchases of goods and services slowed more significantly.

Public investment is estimated to have grown by 6.8% in real terms in 2005, entailing an acceleration on 2004. This figure is further affected by the restructuring of the railway industry in 2004 (mentioned earlier in this report), which involved the assumption by the State of the conventional railway network and the attendant investment. Adjusting for this effect, the rate of change of general government investment in 2005 would rise to 13.7%. In line with this growth, public procurement was very buoyant in 2005, based on the increase in general government tenders; conversely, tenders by the Fomento group of public-sector corporations – whose investment is not recorded as public but as private investment – declined, reflecting the lesser volume of works tendered by AENA (the national airport authority), Puertos del Estado (port authorities) and by RENFE-Operadora (the national railway operator). Mention may be made, however, of the significant volume of works tendered by ADIF (the national railway infrastructure manager). Railway investment is, in fact, at the top of the list envisaged in the PEIT (Infrastructure and Transport Strategic Plan), approved by the Council of ministers on 15 July 2005. The PEIT foresees an infrastructure investment programme over a long period (2005-2020), with a total estimated budget of €250 billion. Almost half the measures considered will focus on railway development, while road investment accounts for 27% of the total. In both cases it is planned to finance over 75% of the work through the budget.

Gross fixed capital formation by companies in 2005 as a whole is estimated to have increased by 8.1%, more than 2 pp up on the rate recorded in 2004 (see Chart 4.5). The considerable buoyancy of corporate investment led to high growth of over 10% in investment in capital goods, which entrenched during 2005 the recovery initiated in the second half of the previous year. Investment in construction by companies grew by 5.5% in annual average terms, although the pace of this variable eased appreciably compared with 2004. This was a result, among other factors, of the lesser momentum of the construction projects of certain public corporations, as discussed above. In sum, the thrust of corporate investment in 2005 as a whole resided, for the first time in several years, on the capital goods component, in contrast to previous years when it was underpinned essentially by construction. Under the capital goods heading, those associated with construction posted high growth rates (as the output and import figures show), as did machinery, in general, the imports of which increased by 11% in nominal terms.

Contributing to the substantial dynamism of productive investment in 2005 were its main determinants in the previous years (see Chart 4.5). Over the course of 2005, final demand increased by 4.3%, largely retaining its forceful momentum in 2004. Moreover, the rising profile of final demand in the first three quarters of the year, as a result of the pick-up in exports, propelled the level of plant capacity utilisation substantially above its historical average. The user cost of capital in real terms fell for the fourth year running, reflecting the decline in real interest rates, against a background of easy financial conditions. This variable was scarcely affected by the slight increases in interest rates from October onwards.

Data from the corporations reporting to the quarterly survey of the Central Balance Sheet Data Office showed some slowing in corporate results in 2005. This was seen in the ordinary net profit of 12.5% for the year as a whole, below the figure of 17.7% in 2004, although the return on investment rose to 9.5%, up on the previous two years. However, the increase in debt meant that the synthetic indicator of financial pressure on investment worsened slightly. According to the information from the non-financial accounts of the institutional sectors, the increase in corporate investment in 2005 translated into a rise in the financing requirements of non-financial corporations to 6.8% of GDP. The financing gap – the variable that measures the net resources needed to undertake corporate investment – widened as the year unfolded to 11.2% of GDP.



SOURCES: INE, European Commission and Banco de España.

a. Real rates of change and differences for the degree of capacity utilisation and for the real user cost of private productive investment.

b. CBA data to 2003 and CBQ data for 2004.

c. A higher (lower) value than 100 shows more (less) financial pressure than the reference level.

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

## 2.2 EXTERNAL DEMAND

On National Accounts figures, real exports of goods and services slowed to 1% in 2005 from 3.3% in 2004. This loss of steam was the result of exports of goods and services moving in different directions: while the former were notably checked in relation to 2004, the latter ended 2005 with an appreciable increase on the previous year. The diminished momentum of exports came about in an external setting marked by a moderate slowdown in world trade and by the stability of the euro exchange rate over the year on average.

The more sluggish pace of external demand in 2005, which interrupted the recovery it had been displaying since 2003 (see Chart 4.6), originated in the slowdown in activity that affected most geographical areas, although it was more marked in the developed countries not belonging to the euro area. Countering this, there was a moderate acceleration in demand in the oil producing countries, in step with their rising income, and in the Latin American countries. As a result, the increase in world trade in goods and services in 2005 stood at 7.4% in real terms, following the figure of 9.5% in 2004. Moreover, the growth of Spain's export markets was more



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

- a. Real annual rates of change.  
 b. Measured by relative export prices, proxied by deflators.  
 c. Negative values denote a gain in competitiveness, positive values a loss.  
 d. Average of GDP of countries of origin of tourists to Spain, weighted according to the relative significance of the number of visitors.  
 e. Index of competitiveness vis-à-vis developed countries.  
 f. Prices of Spanish imports in relation to the producer price index.  
 g. Contributions to growth.

moderate than that of world trade (5.8%), owing to its pattern of geographical specialisation, since more than two-thirds of total sales are to EU markets and these, once again, were less buoyant than world trade on average.

The competitiveness of the Spanish economy, which is analysed in detail in section 6 of this chapter, continued on the worsening trend in 2005 which had been seen in the previous years, owing to the bigger increase in relative prices. Export prices in particular quickened considerably, as a result of which, and despite the stability of the exchange rate, the competitiveness of Spanish exports diminished by a similar amount to that of previous years.

The deterioration in price competitiveness and the slowdown in external demand adversely affected Spanish sales abroad. Indeed, on National Accounts figures, goods exports contracted by 0.4% in volume terms in 2005, despite stronger export markets. According to information provided by the customs authorities, sales to EU countries fell by 1.7% in

volume<sup>3</sup>, in contrast to their 3.4% increase in 2004. Country by country, sales eased notably in nominal terms to Portugal, France and, to a lesser extent, to Germany, while exports to the United Kingdom and to Italy declined. Exports to non-EU countries also slowed sharply, from 10% 24.2%, despite the buoyancy of sales to other European countries, the Asian economies, the OPEC countries and, to a lesser extent, Latin America. In particular, goods exports to China increased in nominal terms at a rate of almost 30%, while those to Central and Eastern European countries climbed by 55%.

In manufacturing, and as in 2004, it was the medium/low technology-intensive branches that posted the highest growth in nominal terms (14.7%), contributing to which was the increase in exports of oil products, influenced by the rising course of oil prices. The performance of the high technology-intensive branches was much more moderate, although also more dynamic than the average, with notable momentum in pharmaceuticals. Among the medium/high technology-intensive branches, sales of machinery and electrical equipment, and of railway and other transport equipment were positive. However, motor vehicle exports, which account for almost one-quarter of Spanish manufacturing exports, shrank by 3.2%, meaning that a deficit in the trade of these goods was recorded for the first time ever in 2005. Lastly, in the low technology industries, exports grew at a very modest rate of 1.9%, affected by growing competition from the Central and Eastern European countries and, especially, from the Asian economies. Box 4.1 analyses in detail the breakdown of the trade deficit by sector.

Services exports quickened in 2005 to 4%, after growing by 1.2% the previous year, achieving their highest rate of increase since 2001. This was the outcome of the greater momentum of real tourism revenues, which grew by 1.9% after contracting slightly in 2004, and of the thrust of exports of other services, up 6.4%, with a particularly sharp acceleration in transport, financial, IT and other business services.

The fundamentals of tourism demand did not trend particularly favourably in 2005. The main economies of origin of tourists to Spain slowed, especially the EU countries, while competitiveness measured by tourist prices relative to client countries and, to a lesser extent, to competitors worsened for the fifth year running. Nonetheless, specific events – such as the terrorist attacks mid-year in Egypt and the intensity of the hurricane season in the Caribbean – favoured the demand for Spanish destinations in 2005. Along with the abnormally poor performance in 2004, this contributed to the recovery in the number of tourists to Spain, which increased by 6.1%. This rise was somewhat higher than that of worldwide tourism (at 5.5% according to preliminary World Tourism Organisation<sup>4</sup> estimates), and was in line with that of Western Europe as a whole (6.2%). As a result, the Spanish share in terms of numbers of tourists was practically stable at 7%. In terms of countries of origin, the increase in tourists was across the board, with a notable rise in those from France (after slipping for two years, an increase of 13.3% was recorded), Italy (7.3%) and the Netherlands (8.4%). Other countries, such as Germany (4.1%) and the United Kingdom (3.1%), posted more moderate increases.

Nonetheless, as in previous years, the increase in the numbers of tourists did not pass through with the same intensity to real revenues, since average spending per tourist continued to decline in 2005. The fall in average spending was in response to the new habits of tourists, who tend to stay for shorter periods, use low-cost airlines and opt for lodging off the habitual tourist circuit. These factors, along with the growing competition from the Eastern Mediterranean countries in the sun-and-sand tourist segment [as seen in the increase in tourist numbers in

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3. To construct the volume series, the customs data are deflated using the unit value indices published by the Ministry of Economy and Finance. 4. See the January 2006 *WTO World Tourism Barometer*.

In 2005 the Spanish economy's trade deficit rose to 8.6% of GDP, very close to its all-time high<sup>1</sup>. Exports were notably slack, proving weaker than they already were the previous year, while imports maintained considerable momentum. To enhance knowledge of the source of this deficit by country and by product, a matrix has been devised in which the increase in the trade balance as a percentage of GDP between 2002<sup>2</sup> and 2005 is broken down by geographical area and by branch of activity.

In the period considered, the trade deficit in nominal terms increased by 3.6 pp of GDP<sup>3</sup>. The source of 40% of this increase was in trade with the EU, especially with Germany, Italy, Portugal and the new

member countries. However, the biggest deterioration in the balance came about in trade with non-EU countries, and was driven by the increase in import penetration from the emerging countries and the rise in the energy bill.

Combining developments by geographical area with sectoral information, the balance vis-à-vis the EU worsened in virtually every branch, although it did so to a greater extent in the medium/high-technology industries, principally in motor vehicles, whose traditional surplus position has been deteriorating in recent years, becoming a deficit position in 2005. The erosion of the surplus in this branch was the outcome of the sluggishness of demand in the euro area countries and of the thrust of domestic demand in Spain, which is prompting an increase in import penetration by this product. This is because domestic production in this branch adheres to a pattern of specialisation which focuses more on export than on satisfying domestic demand. Also notable is the deterioration in the balance in the IT and electronic equipment branches, whose imports have increased in recent years, driven by the rise in investment in equipment and by the strong growth in

1. This box uses the official Customs foreign trade figures. The deficit obtained using this source is higher than that published by Spanish National Accounts, in the Rest of the World Account, and by the Balance of Payments, owing essentially to the fact that the Customs figures record imports in cif terms, while the other two sources record them fob. 2. This year marked the start of the last phase of the appreciation of the euro and of the widening of the trade deficit. 3. The final foreign trade series to 2003 have been used, while for 2004 and 2005 the series are provisional.

#### TRADE BALANCE. BREAKDOWN BY BRANCH OF ACTIVITY AND GEOGRAPHICAL AREA

% of GDP

	2005 trade balance % of GDP	Change in external balance between 2002 and 2005, as a percentage of GDP								
		World	EU 25			Rest of the world				
			Total	Euro area	Enlargement	Total	Rest of OECD	NICs (a)	ASIA5 (b)	Other
HIGH-TECHNOLOGY INDUSTRIES	-1.8	-0.4	-0.3	-0.2	0.0	-0.1	0.0	0.0	-0.1	0.0
Aircraft	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Pharmaceuticals	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Computer and electronic equipment	-1.2	-0.4	-0.3	-0.2	-0.1	-0.1	0.0	0.0	-0.1	0.0
Medical and precision instruments	-0.3	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0
HIGH/MEDIUM-TECHNOLOGY INDUSTRIES	-2.2	-0.9	-0.5	-0.3	-0.1	-0.4	-0.1	-0.1	-0.1	0.0
Machinery and electronic equipment	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Motor vehicles	-0.2	-0.6	-0.4	-0.2	-0.1	-0.1	-0.1	-0.1	0.0	0.0
Chemicals	-0.6	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Railway and other transport equipment	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Machinery and mechanical equipment	-1.1	-0.2	-0.1	0.0	0.0	-0.1	0.0	0.0	-0.1	0.0
MEDIUM/LOW-TECHNOLOGY INDUSTRIES	-0.6	-0.4	-0.1	-0.1	0.0	-0.2	0.0	0.0	-0.1	-0.1
Refined petroleum products	-0.2	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Non-metallic mineral products and boats	0.0	-0.2	-0.1	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0
Basic metals and fabricated metal products	-0.5	-0.1	0.0	0.0	0.0	-0.1	0.0	0.0	-0.1	-0.1
Basic metals	-0.3	-0.1	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	-0.1
Fabricated metal products	-0.1	-0.1	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0
LOW-TECHNOLOGY INDUSTRIES	-1.2	-0.7	-0.2	-0.2	0.0	-0.5	0.0	0.0	-0.2	-0.3
Wood, paper and miscellaneous manufacturing	-0.6	-0.3	-0.1	-0.1	0.0	-0.2	0.0	0.0	-0.1	-0.1
Food products, beverages and tobacco	0.0	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1
Textiles and textile products; leather and leather products	-0.5	-0.4	-0.1	-0.1	0.0	-0.3	0.0	0.0	-0.1	-0.1
TOTAL MANUFACTURES	-5.7	-2.4	-1.3	-0.9	-0.2	-1.2	-0.1	-0.1	-0.5	-0.4
Mining and quarrying	-3.0	-1.0	-0.1	-0.1	0.0	-0.9	-0.1	0.0	0.0	-0.8
Other	0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
TOTAL	-8.6	-3.6	-1.4	-1.0	-0.2	-2.2	-0.3	-0.1	-0.6	-1.2

SOURCE: Ministerio de Economía y Hacienda.

a. Comprising Hong Kong, Korea, Singapore and Taiwan.

b. Comprising China, Philippines, Indonesia, Malaysia and Thailand.

the consumption of this type of product. As to the remaining branches, net exports in the low-technology industries were sluggish, most likely reflecting the heightened competition from third countries in the EU markets.

As regards the balance vis-à-vis the rest of the world, the most salient change was the increase in the energy deficit which, naturally, has been concentrated in the oil producing countries. Indeed, oil products accounted for more than 40% of the widening of the deficit vis-à-vis non-EU countries (and for between 25% and 30% of the total deficit). There was also a considerable widening of the deficit in the low-technology industries, which highlights the growing petition from emerging countries. Two-thirds of the total increase in the deficit in these products was due to the rise in imports from the South-East Asian economies and from other emerging countries. Such imports include most notably textiles, clothing, leather and footwear, which account for 10% of the total deterioration in the Spanish economy's trade deficit in the period considered. However, it should be stressed that the South-East Asian countries do not compete solely in labour-intensive and low-technology products, but also in medium/high-technology (machinery and mechanical equipment) and high-technology goods (computers and electronic equipment), as highlighted by the increase in the related imports.

In short, the disaggregated analysis of the external deficit by branch of activity and by geographical area provides for identification of some of the factors that may contribute to explaining the scale of the widening of the external deficit in the recent period. Almost one-third of the increase in the nominal deficit in the period under study is attributable to the rise in energy prices. Among the factors accounting for the non-energy deficit, mention should be made of the rise in investment in capital goods since mid-2004, an expenditure component with high import penetration; that said, the significance of this factor is limited, since the deterioration in the capital goods balance (which is especially marked in machinery construction and mechanical equipment) only accounts for around 0.3 pp of GDP. In fact, the biggest deterioration in the trade balance came about in consumer goods, essentially owing to the erosion of the surplus in respect of motor vehicles vis-à-vis the EU, to the increase in consumer durables imports (especially computers and electronic equipment) and to the deterioration in the balance in respect of low-technology products, including most notably textiles, clothing, leather and footwear. By geographical area, although the deficit worsened across the board, it widened notably vis-à-vis the South-East Asian countries, in particular in the low-technology industries. As to the new EU members, the impact has so far been more limited, although their growing importance in the motor vehicle industry has increased competitive pressure in this sector.

countries such as Turkey (22.4%) and Croatia (6.9%)], are preventing a greater rise in tourist revenue.

Final demand in the Spanish economy in 2005 slowed to 4.3%, from 4.5% in 2004, as a result of the greater buoyancy of national demand and of the slowdown in exports of goods and services. This loss of steam fed through to imports of goods and services, whose growth rate fell by 2.2 pp on the previous year to 7.1%. The lesser momentum of imports was concentrated in goods purchases, while services imports rose.

On National Accounts figures, goods purchases abroad in volume terms in 2005 grew by 7%, around 3 pp down on the previous year. By geographical area, according to customs data, imports from the EU increased by 2.5% in volume, while purchases from the rest of the world rose by 12.8%, boosted by the slight appreciation of the euro against certain currencies and, above all, by the growing penetration of products from the South-East Asian economies. In terms of products, imports trended in line with the main components of demand. Capital goods purchases thus retained the marked buoyancy they had been showing since mid-2004 and quickened by 5.5 pp in volume to 20.4% in 2005. By contrast, imports of consumer goods slowed, due essentially to the lesser momentum of purchases of consumer durables, especially vehicles. As to non-energy intermediate goods, imports fell off notably, growing by only 1.6%, despite the slight improvement in industrial activity. Finally, as regards imports of energy goods, the higher growth in nominal terms (38%) was due to the rise in oil prices, since their rate of increase in real terms held virtually stable.

Again on National Accounts data, imports of services grew by 7.5%, 1.3 pp up on 2004. This acceleration was the outcome of the higher growth in tourism imports (22.2%), which had already



posted very high increases the previous year (20.6%), and of purchases of other services, which rose to 4.5%. The expansionary behaviour of tourism expenditure in 2005 was in line with the resilience of household final consumption demand and came about against the background of cheaper prices due to the proliferation of low-cost flights and the high value of the euro.

The slowdown in goods and services exports in 2005, along with the dynamism of imports, despite their easing slightly, gave rise to a greater subtraction by net external demand from GDP growth; an all-time negative high of -1.9 pp was subtracted. This partly countered the strength of national demand, curbing the acceleration in GDP, which for the year as a whole grew by 3.4%, following a figure of 3.1% in 2004. Over the course of the year, the negative contribution of the external sector eased to stand at -1.5 pp in Q4, which allowed the annual rate of expansion of GDP to increase gradually to 3.5% by the end of the year.

### **3 Activity**

The additional boost to the Spanish economy in 2005, quantified at 0.3 pp and making for GDP growth of 3.4%, enabled it to converge on its trend output level, closing the negative output gap recorded in 2004 (see Chart 4.7). The recovery was centred on the market-oriented branches, while the pace of non-market services eased, although their annual growth rate stood above that of the economy as a whole. Value added in the market economy expanded at a similar rate to that of the overall economy, namely 3.4%, 0.5 pp above the related increase in 2004.

Market activities were more buoyant across the board, although activity in the agriculture and fisheries branches fell off once again. In line with the slackness observed in the past five years, value added in these branches declined by 0.7% in 2005, a contraction 0.4 pp less than in 2004. The biggest declines were in crop yields, which were much affected by the scant rainfall in winter and spring. The pattern of rainfall generally affected vegetable produce, with the exception of fruit, prompting double-digit declines in most yields. Animal production picked up in relation to 2004 owing to the increase in the livestock component.

Activity in the industrial and energy branches showed some signs of fresh life in 2005, accelerating by 0.5 pp to growth of 1.1%. However, as can be seen in Chart 4.7, value added held on the moderate path of recent years, with rates of increase at around 1%. The acceleration in industrial production was buoyed by the increase in the demand for inputs from the construction industry and, to a lesser extent, from market services, and by the rise in final consumption. Despite the recovery in investment in capital goods, the production of such goods fell in 2005. Looking at the characteristics of the different sectors, the momentum of activity was concentrated in the medium/low-technology industries, while the rest, especially the medium/high and high-technology industries, saw their output cut. The manufacturers of cars, electronic equipment, artificial and synthetic fibres, and the textile and leather industries, the two latter branches being greatly affected by the liberalisation of the international trade in these goods, performed particularly poorly in 2005. Mention may also be made of the recovery in the labour-intensive industrial branches, which provided for a net generation of jobs, following several years of reductions in industrial employment.

The growth of construction activity in 2005 was 5.5%, 0.4 pp up on 2004. This sector, which has been growing at over 5% for eight years, thus remains the most dynamic one in the Spanish economy. In terms of types of work, residential building remained most buoyant, as in the previous year, owing to the strong increase in starts undertaken in 2004, since those in 2005 showed a slowdown. Building intended for non-residential purposes was the only type of work to quicken, owing to the momentum of construction intended for industrial uses and for services. Finally, civil engineering works lost steam in 2005 following the appreciable increase the previous year.



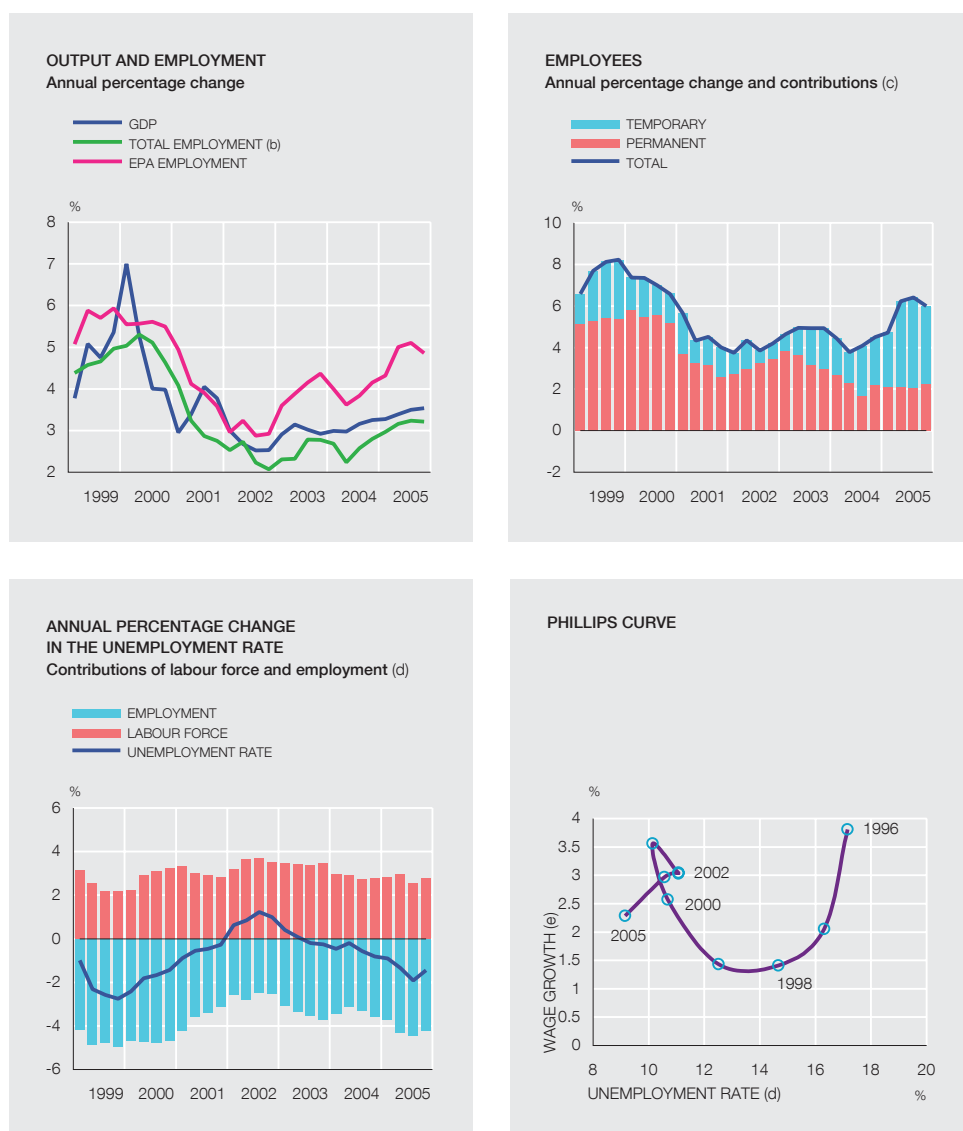
SOURCES: INE and Banco de España.

Value added in market services, which started 2005 sluggishly, progressively showed greater momentum over the course of the year, posting growth of 4% in 2005 as a whole, 0.4 pp up on 2004 (see Chart 4.7). The behaviour of the branches was expansionary, with the exception of trade and repairs. Specifically, the sale of fuels, vehicles and their repair – following several years of high growth – and retail trade displayed a more pronounced slowdown. Wholesale trade, by contrast, showed greater momentum in 2005. The pick-up in tourism reinvigorated the branches most closely connected to it, such as the catering trade and passenger transport. In this latter variable, the most significant increases were in railway, urban and air transport. Freight transport was less dynamic than in 2004, while postage and telecommunications activities quickened appreciably. Finally, business activities and, above all, real estate activities and rentals expanded substantially.

#### 4 The labour market

Employment held in 2005 on the mildly accelerating path initiated two years earlier, running in parallel to economic activity. In QNA terms, the pace of net job creation<sup>5</sup> both in the economy as a whole and in the market economy was 3.1%, 0.5 pp up on the previous year in both cases (see Chart 4.8). Apparent labour productivity once again expanded at a very low rate

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



SOURCES: INE and Banco de España.

- a. EPA series linked on the basis of the 2005 Q1 control survey.  
 b. QNA. Seasonally adjusted series. Equivalent employment.  
 c. EPA.  
 d. EPA. Linked by the Banco de España due to the change in the operational definition of unemployment in 2001.  
 e. QNA. Compensation per employee in the market economy.

(0.3%) and indeed slowed by 0.2 pp in relation to the previous year; in the case of the market economy, apparent productivity grew by 0.2%, 0.1 pp down on 2004. As in previous years, these limited increases in productivity were accompanied by a reduction in unit labour costs, in real terms, which was the outcome both of the smaller increase in nominal wages and of the higher growth of the value-added deflator.

The pattern of employment growth in 2005 at the sectoral level was similar, in general terms, to that in the two previous years, with greater buoyancy in construction and in the services branches. However, unlike since 2003, agriculture and industry did not see net falls in employment. In agriculture, employment stagnated at the end of the year, although its quarterly profile was on a rising course. The number of employees in industry increased by 0.3%, although the progressive recovery in employment in this sector was interrupted in Q4. Employment accelerated in construction, posting an average rate of increase of 8.5%, which entailed a marked

decline in apparent labour productivity in this sector (-2.7%). Finally, the growth rate of employment in services stabilised at 3.1%, with non-market services playing a greater role and displaying a rate of expansion of 3.2% (compared with 2.4% in 2004).

The EPA (Labour Force Survey) data<sup>6</sup> showed greater dynamism in employment than that estimated by QNA figures. Specifically, the number of employed according to the survey rose by 4.8%, almost 1 pp up on the growth recorded in 2004. The increase was centred on employees with temporary and part-time contracts. In particular, the growth of wage-earners with a temporary contract climbed to 11.8%, almost double the rate the previous year (see Chart 4.8), while the annual increase in wage-earners with a permanent contract eased slightly to 3.1%. Consequently, the ratio of temporary to total employees increased for the second year running to 33.3%, far above the levels in other EU countries. The renewed dynamism of temporary hiring would suggest that the efficiency of the current arrangements to encourage permanent employment has diminished and that it is necessary to launch additional measures geared to significantly reducing the current duality in the labour market.

As regards working day duration, most jobs created in 2005 were among part-time contract employees. The EPA revealed growth of 26% for this group, up on the figure of 11% for 2004. By contrast, the number of full-time employees slowed, with growth of 2.4%, 0.7 pp less than the previous year. This difference in behaviour prompted a rise of 2 pp in the ratio of part-time to full-time employees to 12.4%. Nonetheless, the strong increase in part-time hires reflected by the EPA may be related, at least in part, to the methodological changes introduced into this survey in 2005 Q1.

The growth of Spanish-national employees quickened in 2005 to 3%, compared with 2% in 2004, while the growth of immigrant workers was notably higher (23%), though somewhat more moderate than in 2004 (27.6%). As a result, foreign employees accounted in 2005 for 10.9% of total employment, 1.6 pp more than in 2004. Although there was an extraordinary regularisation process in 2005 for immigrant workers in an irregular situation, concluding with the approval of 572,961 applications<sup>7</sup>, this process would not, in principle, have influenced EPA estimates.

With regard to labour supply, the trend of new labour market entrants was as robust as in previous years. The labour force increased by 2.2% owing to the sustained growth of the working-age population and to the fresh increase in the participation rate. According to the EPA, the over-16 population grew by 1.7%, as in the two previous years, and the participation rate rose to 57.4%, although the annual change (0.8 pp) was somewhat lower than that of the preceding years. The contribution of immigration to the increase in the labour supply continued to prove decisive. The immigrant population climbed by 22.1%, compared with 0.1% for Spanish nationals, accounting for two-thirds of the growth of the labour force in 2005. By sex, the growth of labour market participation was sharper among women, whose participation rate edged up from 45.4% in 2004 to 46.4%. Conceivably, immigration may be providing for the increase in the Spanish female participation rate. The male participation rate also rose, but the increase was smaller (by 0.6 pp), to 68.8%. As analysed in detail in Box 4.2, the abundant labour available has made for a very labour-intensive growth pattern and, therefore, one con-

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6. Using the series linked by the Directorate General Economics, Statistics and Research based on the EPA control survey conducted by INE in 2005 Q1 to adjust for the effect of the methodological changes introduced into this survey in this period. 7. This process directly affected Social Security registrations, the growth rate of which in 2005 rose to 4.4%, compared with 2.8% in 2004. However, it is difficult to specify whether this process affected the EPA or QNA estimates of employment since what was involved was the emergence with a new legal status of workers who were already employed in Spain.

Between 1998 and 2005, the population of Spain rose by almost 4.3 million, i.e. an average annual increase of 1.5%, with an accelerating trend during this period that took the 2005 growth rate to 2.1%. These rates contrast with demographic developments in the EU15, where the population only increased at an average rate of less than 0.5% over the same period. Over 75% of the population increase in Spain is due to the rise in the foreign population (see chart). More than three million immigrants have arrived in the country over the last seven years, putting the total foreign population at 10% on 1 January 2005, according to the latest figures from the Municipal Census of Inhabitants. The majority of foreigners arriving in Spain have been of working age, a population group where already 12% are non-Spaniards.

These migratory flows, attracted by the momentum of the economy, have markedly increased the growth potential, providing a considerable boost to the labour market and helping to sustain a very intensive pattern of economic growth in terms of job creation. However, the concentration of migrant workers in lower than average productivity sectors has had a negative composition effect on the level of productivity (see chart). Furthermore, migrant workers are, on average, younger, with less work experience and a lower level of education than national workers employed in the same sector, factors that tend to lower their productivity vis-à-vis national workers.

In order to show the significance of these factors in the productivity differential between native and migrant workers, the attached table gives an estimate of wage differentials according to nationality<sup>1</sup> and

shows the extent to which these differentials decrease as the above-mentioned characteristics are taken into account. Wages are used as a proxy of productivity, it being understood that productivity determines wages, at least in part, and given the lack of direct data on productivity. Any other factor that were to determine wages and that differed between migrant and native workers would add a source of error to this interpretation. In the table it can be seen that the wage differential between native and migrant workers is high (around 30%<sup>2</sup>) when the wage regression only includes gender, region and the sector in which the worker is employed<sup>3</sup>. It can also be observed that immigrants' lower level of education, youth and, above all, shorter work experience explain for the most part the difference in salary, given that this is reduced to less than 10% by controlling for the differences in these variables in wage equations. In this respect, the importance of work experience in explaining wage differentials according to nationality indicates the importance of immigrants' assimilation and integration into the workforce in explaining the impact of immigration on medium- and long-term productivity.

All things considered, immigration has helped to raise the growth potential of the Spanish economy, although, in turn, the characteristics of immigrants and their greater weight in the workforce of very labour intensive sectors have caused a negative short-term effect on productivity. Nevertheless, this effect can be expected to disappear as the process of integration and assimilation of the foreign population progresses smoothly.

1. According to the Wage Structure Survey 2002.

2. This is not the case for immigrants from EU Member States, who earn an average of 11% more than native workers. 3. Region and gender must be included to take into account the greater spatial concentration of immigrants and the higher percentage of men within the foreign population.

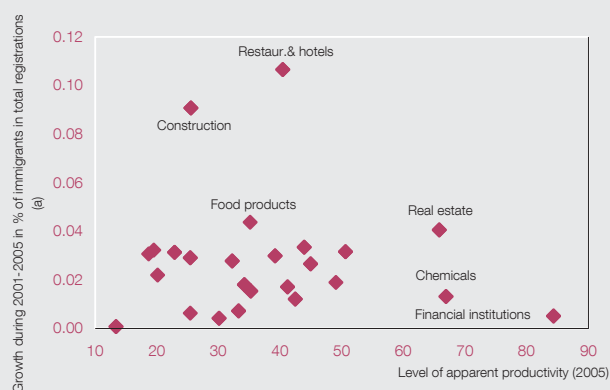
1 CHANGE IN POPULATION BETWEEN 1998 AND 2005



SOURCES: INE and Banco de España.

a. Social Security registrations, broken down into 26 subsectors of the general system and of the special (coal mining) system.

2 PRODUCTIVITY AND IMMIGRATION BY SECTOR BETWEEN 2001 AND 2005



WAGE DIFFERENTIAL WITH RESPECT TO NATIVE WORKERS, CONTROLLING FOR DIFFERENCES IN SEX AND REGION

	BY SECTOR OF EMPLOYMENT	(1) + AGE AND EDUCATION CHARACTERISTICS	(2) + EXPERIENCE WITHIN THE COMPANY
	(1)	(2)	(3)
EU 15	11.0	5.7	13.4
Rest of Europe	-27.2	-17.7	-6.8
Latin America	-31.1	-20.3	-9.2
Africa	-34.1	-19.0	-9.3

SOURCE: Banco de España, using figures from the EES-2002.

sistent with very small productivity gains. These reflect, in part, the incorporation of less skilled and less experienced immigrant workers.

Higher job creation, along with a sustained labour force, led the number of unemployed to decline sharply in 2005. Specifically, on EPA data, unemployment fell by 10.5%, following the mild decline the previous year (see Chart 4.8). Over the year as a whole, the unemployment rate dipped by 1.4 pp compared with 2004, reaching an average level of 9.2% and a floor of 8.4% in Q3. This fall in joblessness placed the unemployment rate at a level not seen in the Spanish economy since 1979, and allowed the sizeable gap with other European countries, which had historically characterised our economy, to be virtually closed. By sex, the performance among women was better as their unemployment rate fell by more than 2 pp, though it held far above the related male rate (12.2% against 7%). The registered unemployment rate according to INEM (National Employment Office) figures showed a substantially more moderate fall (-2.1%).

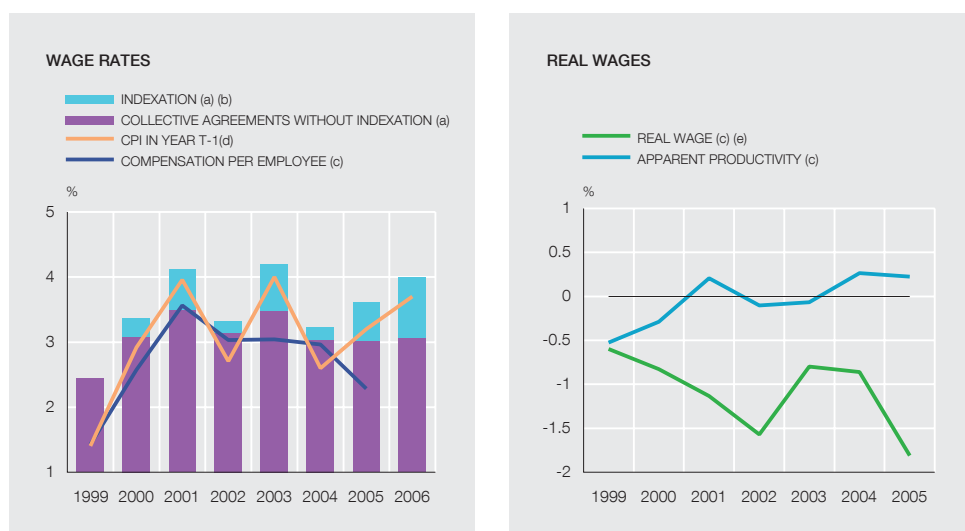
The various methodological changes in the EPA and the QNA hamper the estimation of the structural component of unemployment. Among the habitual indicators, the weight of the long-term unemployed in total unemployment stood in 2005 at 28.9%, clearly below the level estimated in 2004 (36.1%), but the methodological changes to the EPA may have affected this estimate. Nonetheless, the Phillips curve shown in Chart 4.8 would suggest that recently the NAIRU (non-accelerating-inflation rate of unemployment) has tended to fall, since the sharp decline in unemployment in 2005 was not accompanied by greater wage pressures. Likewise, the as-yet preliminary estimates available would place the NAIRU only slightly above the actual unemployment rate. These developments would, in historical terms, entail a marked reduction in the structural component of unemployment from a level of more than 15% a decade ago, which would have contributed decisively to the prolonged growth experienced by the Spanish economy.

As to wages, the agreed increases in 2005 under collective bargaining arrangements held at 3%, despite the rise in inflation, as can be seen in Chart 4.9. This wage rise was within the margins defined in the renewed Interconfederal Agreement for Collective Bargaining (IACB). Newly signed agreements, however, reflected to some extent the upward course of inflation and rose to 3.2%, compared with the figure of 2.9% for agreements signed in prior years with effect in 2005. Further, the deviation in inflation from official forecasts (1.7 pp with the December 2005 figure) will pass through to wage growth in 2006 by means of the activation of the indexation clauses, which are present in 75% of the agreements signed to December 2005. This percentage has held stable in the most recent period, despite the fact that in successive renewals of the IACB the presence of these clauses has been recommended in collective bargaining agreements. However, it seems there has been a decline in the inflation threshold above which the clauses are activated, which would be drawing close to 2%. This change would tend to intensify the impact on wages the following year. It is estimated that the activation of the 2005 indexation clauses will have a bearing of almost 1 pp on wages received in 2006.

In QNA terms, the growth rate of compensation per employee in the economy as a whole fell appreciably in 2005 to 2.5%, against 3.3% in 2004. Likewise, growth in compensation of 2.3% was recorded in the market economy, following three years of very stable increases of around 3%. This trend in wage costs means there was negative wage drift<sup>8</sup> in 2005 of more than 1 pp,

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8. Defined as the difference between the increase in wage rates agreed under collective bargaining, including the effect of the indexation clauses, and the increase in compensation per employee according to QNA figures.



SOURCES: INE and Ministerio de Trabajo y Asuntos Sociales.

- a. Information based on collective agreements registered up to March 2006.
- b. Including the previous year's indexation clause.
- c. Market economy.
- d. Annual rate of change in December.
- e. Compensation per employee divided by the value added deflator.

above that seen in recent years. Against the background of strong job creation marking the current upturn in the Spanish economy, negative wage drift would be reflecting the presence of composition effects, derived from the fact that the new jobs created – which are on average less productive than existing jobs – also receive wages below the average wage. In this respect, this negative drift is indicative of a greater degree of wage flexibility which, however, is concentrated in a specific labour market segment where temporary employees and immigrants are predominant. The characteristics of the collective bargaining system mean that, in more general terms, wage developments continue to be far removed from productivity, at the sectoral level and at firm level, this being an aspect that should desirably be reviewed.

In real terms, real labour costs borne by companies<sup>9</sup> fell sharply in 2005, as shown in Chart 4.9. This undoubtedly contributed to the sound behaviour of employment, both in 2005 and throughout the last business cycle, in which declines in real wages were recurrent. Nonetheless, it should be stressed that wage moderation in real terms is proving compatible with nominal wage increases above those recorded in our main trading partners, with adverse consequences for the competitiveness of Spanish products. The extension of the IACB for 2006 entails maintaining the wage-setting procedure in force since 2002. This type of agreement may contribute to keeping initial wage increases tethered in a high-inflation environment such as the present one, but, once the influence of the indexation clauses is taken into account, this adds great persistence to wage increases and to inflation rates. Moreover, this system is conducive to establishing uniform wage growth across the different sectors of the economy, irrespective of their specific situation.

## 5 Prices and costs

In 2005, the average growth of the consumer price index (CPI) rose to 3.4%, 0.4 pp up on the two previous years, moving on a rising course throughout the year (see Chart 4.10). In 2006 Q1, growth rates of around 4% were recorded, with a figure of 3.9% posted in March. The CPI

9. That is to say, using the value-added deflator as a price index.



SOURCES: INE and Banco de España

a. Year-on-year growth rates.

b. Merchandise import unit value indices.

excluding energy and unprocessed goods increased by 2.7% in 2005, unchanged on 2004, although it worsened in the closing months, ending the year at an annual rate of 2.9%. To date in 2006 it has firmed at a higher rate of around 3%.

In terms of components, energy prices once again climbed substantially in 2005 by 9.6%, owing to dearer oil prices on international markets. The rise in crude oil prices in euro (42%) fed through to fuel prices and to natural gas and butane rates, the basic component of which is tied to oil costs. The price of non-energy industrial goods also quickened slightly, affected by the greater momentum of domestic producer prices, as did that of services, with the respective average increases for the year standing at 1% and 3.8%. Among non-energy industrial goods, there was a smaller increase in clothing prices, probably due to stiffer competition from the Asian countries, while prices of household electrical goods and computer equipment were once again considerably cheaper. Under services, transport and, in particular, air transport prices were higher owing to dearer oil.

Food prices showed lower rates of increase than in 2004. Specifically, processed food prices slowed by 0.2 pp on average to 3.4%, despite the increase in olive oil prices (10%) and in tobacco prices (6.6%, reflecting the increase in indirect tax). Finally, unprocessed food prices



posted a rate of increase of 3.3% in 2005, 1.3 pp down on 2004, although they moved on a rising trajectory throughout 2005, in parallel with that of prices at source.

From the National Accounts standpoint, the final demand deflator increased by 4.3% on average in 2005, 0.8 pp above the related rate a year earlier. The higher growth of prices was across the board in demand components, with the exception of investment. The household final consumption expenditure deflator grew by 3.5%, in step with the CPI. Capital goods prices rose by 3.2%, compared with 2.1% in 2004, against a background of quickening import and domestic prices. The rate of change of the construction deflator outpaced the figure for 2004, posting growth of 7.4% average for the year. This once again reflected the rising trend of house prices. Lastly, the goods exports deflator increased by 5.2%, against 1.7% in 2004, which entailed a loss of competitiveness of Spanish exports vis-à-vis both the euro area and the rest of the world.

The imports deflator increased by 4.1% in 2005, more than 2 pp above the previous year's rate. This was largely due to dearer imports of energy products (26.1% according to the unit value indices) and to the price increases in other intermediate goods (3.5%). The prices of consumer and capital goods imports held at moderate rates of increase, albeit higher than those in 2004.

Inflation of domestic origin, proxied by the GDP deflator, rose by 4.4% in 2005, 0.3 pp up on the previous year. This was partly due to the strong increase of 8.4% in indirect taxes net of subsidies per unit of output, despite the fact that there were no significant changes in indirect taxation last year. The changes in the relative significance of the different tax bases involved here, against a background of highly dynamic residential investment, might explain these developments. Nonetheless, the GVA deflator – the other component of the GDP deflator – quickened to a growth rate of 4%. This behaviour, against a backdrop of slowing unit labour costs, reflects the notable widening of margins in the Spanish economy in 2005. As analysed in Box 4.3, this is a fundamental factor for explaining the inflation differential between Spain and the euro area in recent years.

Focusing on labour costs and margins in the market economy, where the GVA deflator increased by 4.2% (up on 2004), there was a notable slowdown in labour costs per unit of value added, which grew by 2.1%, 0.6 pp less than the previous year. The sound behaviour of unit labour costs was the result of the significant slowdown in compensation per employee, which offset the slight loss of steam in apparent labour productivity (see Chart 4.10). In any event, the slowdown in labour costs, in contrast to the bigger increase in the GVA deflator, allowed for a notable widening of unit margins, building on the developments in previous years. Although the increase in margins was across the board in the different branches of activity, the intensity differed according to the sectoral differences in the degree of demand pressure and the influence of external competition.

In industry, the value-added deflator grew by 3.3% in 2005, slightly up on 2004, while the rate of change of unit labour costs held stable, giving rise to a widening of margins (see Chart 4.11). However, this was not generalised among the manufacturing branches, as business margins were squeezed in activities where foreign competition is stiff, such as textiles and clothing, and timber and cork. The energy value-added deflator accelerated to growth of 2%, and unit labour costs eased significantly, owing partly to the productivity gains derived from job destruction, giving rise to the widening of the unit operating margin.

In the construction industry, the value-added deflator accelerated once again, rising to an average growth rate of 10%. This was linked to the continuing buoyancy of house prices dur-

Since the mid-90s the Spanish economy has run an inflation rate, in terms of the gross value added deflator, that has persistently exceeded the rate observed for the euro area as a whole, with a differential averaging 1.8 pp. Throughout this period, inflation rates in the sectors least exposed to competition - services and construction - have regularly been higher than those in industry and agriculture. The price measure used in this box, namely the gross value added deflator, reflects this heterogeneity across the productive branches and it is, moreover, an appropriate proxy of the domestic-based inflation differential, compared with other more frequent measures such as those made drawing on the HICP (the differential using this indicator would have been approximately 1 pp). Further, the use of the deflator allows a detailed analysis of the differential through its breakdown into the relative contributions of labour costs and of the gross operating surplus per unit of output. This variable includes both profits in the strict sense of the term and the return on capital. According to the information in the adjoining table, wage costs, labour productivity and surpluses have all contributed positively to the inflation differential with the euro area.

Between 1996 and 2005, Spanish unit labour costs outgrew those in the euro area owing to the bigger increase in compensation per employee and to lower productivity gains. Specifically, compensation per employee posted annual average growth of 2.9% between 1996

and 2005 in Spain, while productivity rose by scarcely 0.2%, giving rise to a 2.7% increase in unit labour costs, clearly above the average growth in the euro area (1.1%). The latter figure was the outcome of lower wage increases (1.9%) and somewhat higher labour productivity growth (0.8%). In terms of the contribution to the inflation differential, unit labour costs account for 1.1 pp (60%) of the total differential of 1.8 pp recorded on average over the past 10 years. The unit operating surplus also contributed decisively to the inflation differential in the past decade, explaining the remaining 0.8 pp of the total differential. As in the case of wages, its growth was higher than that in the euro area in all productive branches.

The adjoining table shows that the inflation gap with the euro area has widened by 0.4 pp over the past five years, compared with the previous five-year period, to 2 pp. This increase is essentially the consequence of a greater contribution of the unit operating margin, which has offset, albeit only partly, a lower contribution of unit labour costs. Under labour costs, the contribution of compensation per employee to the differential has held at 0.6 pp, while that of the apparent labour productivity differential has diminished. This improvement in the contribution of relative productivity has been the outcome of the slow-down in productivity in the euro area and not of an improvement in productivity gains in Spain, although the negative gap in Spanish productivity growth relative to that in the euro area persists.

## CONTRIBUTIONS TO THE INFLATION DIFFERENTIAL

	Sectoral deflator			Total deflator		
	1996-2000	2001-2005	1996-2005	1996-2000	2001-2005	1996-2005
CONTRIBUTION TO THE INFLATION DIFFERENTIAL BY SECTOR						
TOTAL				1.6	2.0	1.8
Unit labour cost				1.2	0.9	1.1
<i>Compensation per employee</i>				0.6	0.6	0.6
<i>Apparent labour productivity</i>				0.6	0.2	0.4
Unit operating surplus				0.3	1.2	0.8
AGRICULTURE	0.2	2.0	1.1	0.0	0.1	0.0
Unit labour cost	0.9	0.3	0.6	-0.1	0.0	0.0
<i>Compensation per employee</i>	1.6	-0.8	0.4			
<i>Apparent labour productivity</i>	-0.9	1.1	0.1			
Unit operating surplus	-0.7	1.7	0.5	0.1	0.1	0.1
INDUSTRY AND ENERGY	0.9	1.4	1.2	0.2	0.3	0.2
Unit labour cost	0.9	0.8	0.9	0.2	0.1	0.2
<i>Compensation per employee</i>	-0.4	0.4	0.0			
<i>Apparent labour productivity</i>	1.3	0.4	0.9			
Unit operating surplus	0.0	0.6	0.3	0.0	0.1	0.1
CONSTRUCTION	2.7	4.3	3.5	0.2	0.6	0.4
Unit labour cost	2.5	1.9	2.2	0.3	0.3	0.3
<i>Compensation per employee</i>	0.8	0.5	0.6			
<i>Apparent labour productivity</i>	1.6	1.3	1.4			
Unit operating surplus	0.3	2.4	1.4	0.0	0.3	0.1
SERVICES	1.8	1.8	1.8	1.2	1.1	1.2
Unit labour cost	1.5	0.6	1.0	1.0	0.4	0.7
<i>Compensation per employee</i>	0.9	0.7	0.8			
<i>Apparent labour productivity</i>	0.6	-0.1	0.3			
Unit operating surplus	0.4	1.2	0.8	0.2	0.8	0.5

SOURCES: INE and Eurostat.

On analysing the contributions to the aggregate inflation differential by branch of activity, most of the differential can be seen to be due to the sectors sheltered from foreign competition, mainly construction and services. Overall, these account for 90% of the total differential with the euro area. In terms of developments over the most recent period, the bigger inflation differential has been due to the widening of the differential in construction, the contribution of which has doubled, essentially owing to the increase in the unit operating margin, which arose from a zero contribution to one of 0.3 pp.

In sum, the inflation differential (measured by the GVA deflator) with the euro area countries has widened in the most recent period to 2 pp on average for the past five years. A series of factors may have contributed to this differential, such as the greater resilience of the upturn in Spain or the singular performance of the construction industry, although the persistence of such high levels for this differential points to the presence of structural rigidities in the Spanish econo-

my's price and wage-setting processes. These shortcomings should be eliminated so as to bring about a significant reduction in the differential that enables the losses in competitiveness in recent years to be restricted, if not offset. Labour costs have sustained higher growth rates than those in the euro area countries, both in the sectors exposed to and, above all, in those sheltered from foreign competition. This feature reinforces the need for a reform of collective bargaining arrangements geared to allowing a greater adjustment of wages to the specific conditions of firms and industries and, at the same time, to reducing the high nominal inertia of the current arrangements. That said, the significant role that margins also play in this process and, especially, the fact they have accelerated recently in construction and in services highlights the need to revise first, the degree of competition in the markets for products and services, and further, the cost-to-price pass-through mechanisms. The timeliness of applying the necessary reforms to liberalise the markets least exposed to international competition should be studied.

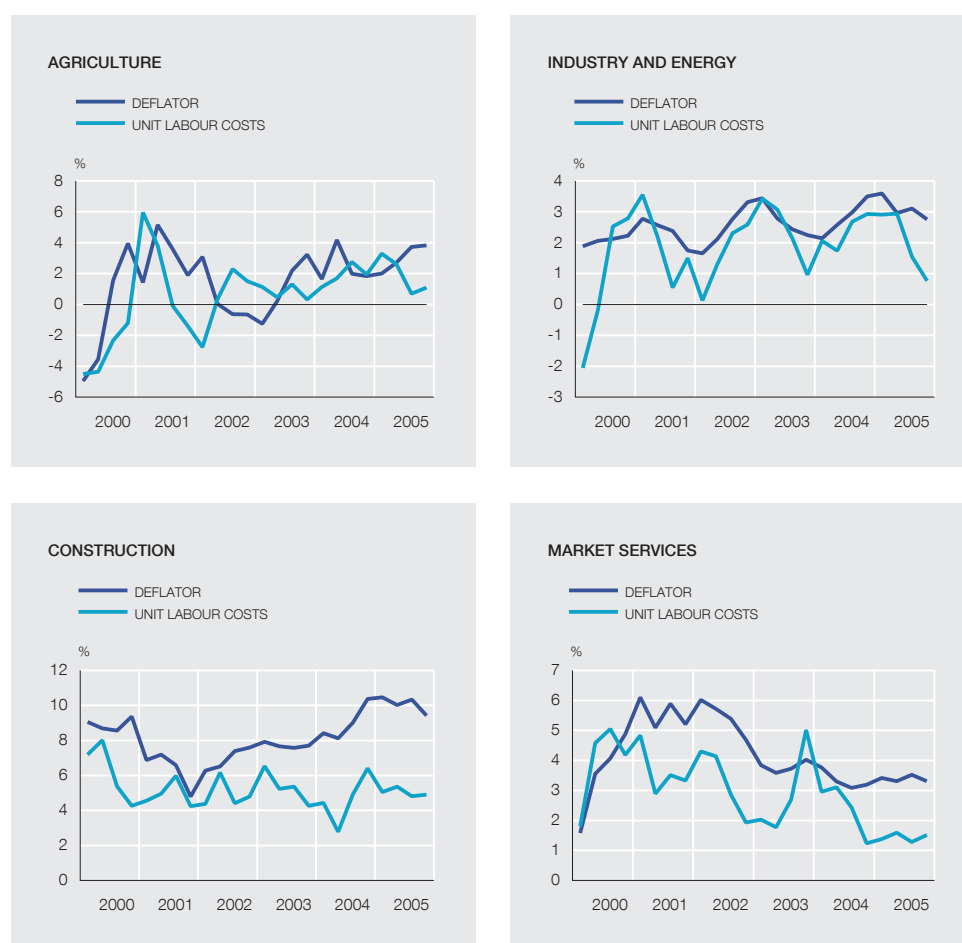
ing 2005. Against this background, the unit operating margin widened significantly once again, despite the fact that unit labour costs continued to grow at a very high rate (5%). This increase in costs reflects the marked decline in apparent labour productivity, which was only partly offset by the slowdown in compensation per employee, the growth of which (2.2%) was in line with that of the market economy as a whole. The market services deflator increased by 3.4%, a similar rate to the previous year, while unit labour costs slowed substantially, in a setting of recovering apparent productivity, despite high job creation. Overall, costs grew at a lower rate than the deflator, prolonging the ongoing widening of margins seen in recent years, and which in 2005 was fairly widespread across the various activities in this branch. Box 4.4 examines the particular case of the distribution sector in Spain, which has been performing very sluggishly in terms of productivity and has seen a significant widening in margins.

## 6 Competitiveness and the external balance

### 6.1 COMPETITIVENESS

As indicated in previous sections, the deterioration in the trade balance in 2005 was not only the outcome of developments in demand, but also of the worsening in the economy's competitive position, owing to the upward course of prices and relative costs. Other structural or non-price competitiveness factors associated with the economy's productive specialisation likewise affected trade figures.

As regards price and cost competitiveness, the indicators calculated taking the developed countries as a reference pointed to a widespread deterioration in 2005, despite the fact the exchange rate held relatively stable, over the year on average, following three consecutive years of notable rises (see Chart 4.12). The index calculated with relative consumer prices rose by 1.5%, while that compiled with industrial manufacturing prices posted an increase on a somewhat greater scale (1.9%), against the background of a notable acceleration in these prices in Spain. In turn, the indicators compiled with unit labour costs continued to display a deterioration in competitiveness, albeit one somewhat more moderate than that seen in 2004. Specifically, relative unit labour costs vis-à-vis the developed countries as a whole increased by 1.2% and 3%, in the economy as a whole and in manufacturing, respectively.



SOURCES: INE and Banco de España.

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

The index compiled with relative export prices showed a worsening in competitiveness that contrasted with its performance in previous years, when the containment of these prices had allowed the losses in competitiveness to be checked. Specifically, according to National Accounts data, the goods exports deflator grew by 5.2%, outpacing domestic prices and costs, compared with 1.7% in 2004. As a result, the declining trend of Spanish companies' export margins seen since 2001 was interrupted. This is in step with the historical pattern whereby exporters opt to squeeze their operating margins in periods of exchange-rate appreciation in order to maintain their competitive position in foreign markets. The course of export prices in 2005 suggests that, coinciding with the stabilisation of the exchange rate, and set against dearer imported inputs and an incipient increase in the cost of capital, exporters decided partly to recover their margins, albeit at the expense of losing competitiveness abroad (see Table 4.3).

By geographical area, there was a generalised loss in competitiveness in 2005, although this was somewhat more marked vis-à-vis the euro area countries. The consumer prices differential in respect of these countries widened by 1.4%, while relative export prices, which had scarcely changed in 2004, increased considerably. Relative to the developed countries not belonging to the euro area, there was an appreciation in effective terms of 0.5%, below that recorded in previous years. Along with a somewhat lesser worsening in relative prices and costs than that seen in 2004, this entailed a less marked deterioration in the competitiveness indicators.

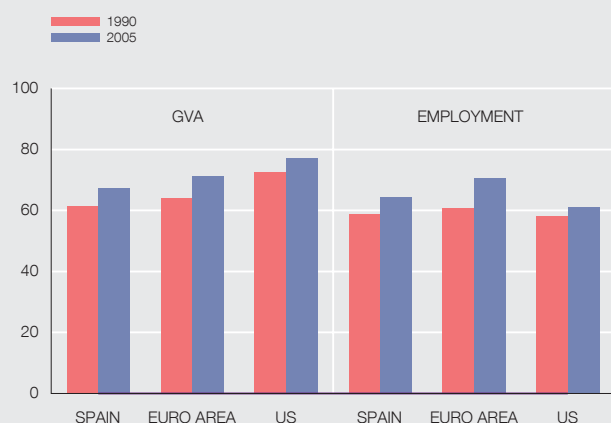
Studies seeking to explain the growing divergence between productivity growth in the United States and in Europe indicate that what is at issue is not an aggregate phenomenon but a localised one, especially in the services industry and, within this, more markedly, in the wholesale and retail distribution sector. Given the leading role that this type of activity generally plays in determining the degree of efficiency of economies, and bearing in mind that their weight in output and employment has increased substantially in recent decades (see panels 1 and 2), two avenues of enquiry may be explored. First, what lies behind the acceleration in productivity in the US distribution sector, and why has there not been a similar trend in the EU? And second, how has the commercial distribution sector in Spain performed in relation to these issues?

Several studies attribute the sound US performance to the introduction of new technologies, along with improvements in staff training and busi-

ness structuring during the 80s and 90s. In Europe, these changes were made somewhat belatedly due largely to the excessive regulatory burden on the sector, which varies greatly, moreover, from one country to another. This would have restricted competition and hampered access to other European markets, making it difficult for companies to gain sufficient size to enjoy economies of scale. The stricter nature of regulation in Europe relative to the United States can be seen in panel 3, which shows the indicators of regulation in the wholesale and retail distribution sector calculated by Copenhagen Economics<sup>1</sup>, along with the OECD-estimated indicator for the whole economy. In any event, these indicators should be viewed with due caution.

1. These indicators are in the report *Economic Assessment of the Barriers to the Internal Market for Services* (2005), prepared by Copenhagen Economics in order to assess the potential effects on the economy of the Services Directive (known as the Bolkenstein Directive) proposed by the European Commission.

### 1 WEIGHT OF SERVICES SECTOR IN THE TOTAL ECONOMY



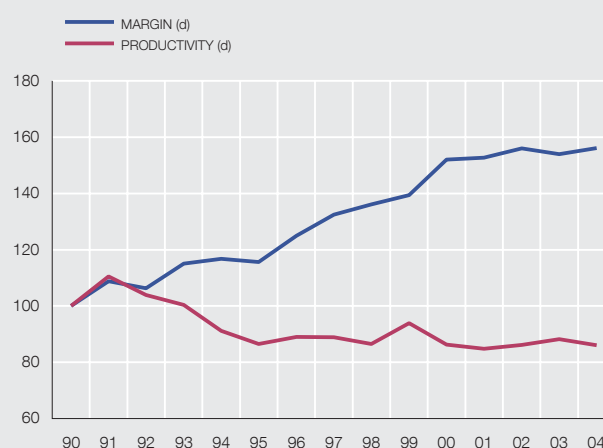
### 3 COMPETITION IN THE SERVICES SECTOR

	Wholesale trade (b)	Retail trade (b)	PMR (c)
Luxembourg	0.08	0.08	1.28
Germany	0.08	0.11	1.43
Netherlands	0.09	0.14	1.37
Ireland	0.11	0.12	1.12
Finland	0.14	0.19	1.32
Belgium	0.15	0.18	1.37
Greece	0.15	0.18	1.83
Austria	0.15	0.18	1.38
Italy	0.16	0.18	1.87
Portugal	0.17	0.14	1.56
France	0.19	0.20	1.70
Spain	0.19	0.21	1.61
Euro area	0.14	0.16	1.49
United States	—	—	1.03

### 2 GROWTH OF APPARENT LABOUR PRODUCTIVITY (a)

	SPAIN	EURO AREA	US
TOTAL ECONOMY			
1990-1995	1.59	1.79	1.31
1996-2005	0.34	0.91	2.01
MARKET SERVICES			
1990-1995	0.53	1.26	1.08
1996-2005	-0.57	0.60	3.53
DISTRIBUTION SECTOR			
1990-1995	-0.39	1.53	1.62
1996-2004	-0.38	1.03	5.34

### 4 DISTRIBUTION IN SPAIN



SOURCES: Eurostat, INE, AMECO, GGDC, Copenhagen Economics, OECD and Central Balance Sheet Data Office (Banco de España).

a. Average growth in the period of value added per employee. For the US, the second period is 1996-2004 in the total economy and 1996-2003 in the other two cases. For the euro area, in the distribution sector the average refers to the period 1996-2003.

b. Indicator of barriers to the internal market for services, prepared by Copenhagen Economics (2005) for 20 EU countries, the value of which ranges from 0 (minimum restriction) to 1 refers to 2004.

c. Indicator of Product Market Regulation. This index, prepared by the OECD, reduces to a single figure all the regulations that may affect the level of competition in the product market (the higher the value, the lower the competition). Value refers to 2003.

d. Major retailers of food and beverages. Change relative to the total economy (1990=100).

In a recent report by the European Central Bank<sup>2</sup>, in which euro area productivity and services prices are analysed together with their relationship to the degree of competition, one of the specific results obtained for the distribution sector is the adverse impact that the related regulation has on productivity in the sector. Although these results have been obtained at the aggregate level (for the euro area), they would infer that the restrictiveness of regulation in this sector in certain countries, such as France, Italy or Spain, and the progressive tightening of such regulation in some cases would account, at least in part, for the poor performance of sectoral productivity in recent years.

For the Spanish economy there is some complementary evidence that would confirm the foregoing point. The process of liberalisation of trading hours set in train by the government in the mid-80s slowed following the assumption by the regional governments of the responsibility for internal trade. In some cases, the administrative requirements for establishing large retail outlets were increased (through the revision of the threshold above which a commercial establishment came to be considered as a large retail outlet, which entailed a requirement for a second licence, etc.). Justifying this relative tightening of regulations was the aim of providing traditional establishments with a period of transition in which to make the necessary changes to improve their ability to compete in an environment which was under-

going deep-seated structural change. Subsequently, the central government attempted in 2000 to give fresh momentum to the liberalisation of the sector through the approval of a new law establishing a gradual increase in the permitted minimum number of hours establishments could open, up to the full liberalisation of opening hours in 2005, conditional upon agreement with the regional governments. This objective was not achieved; rather, after that date an even stricter floor in respect of trading hours than that in place was established.

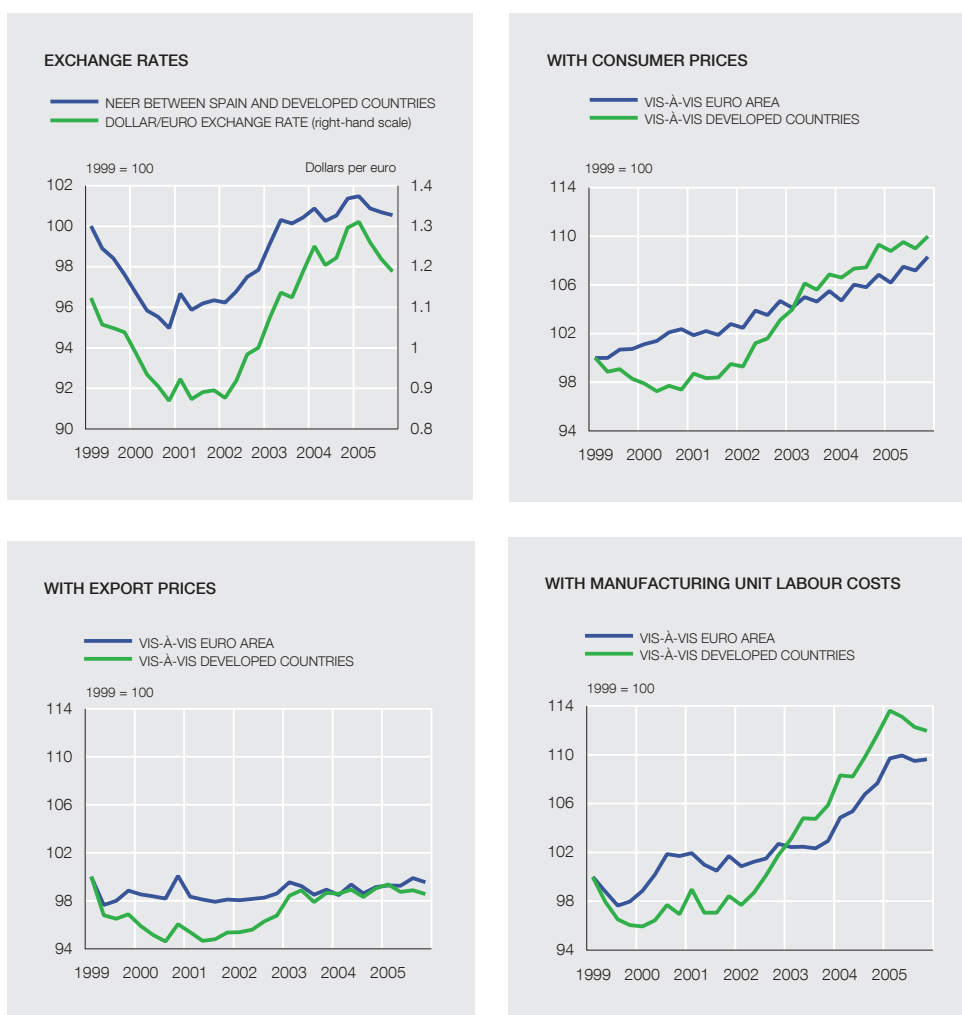
In order to attempt to illustrate the impact of the regulatory changes on the efficiency of and competition in the retail distribution sector in Spain, panel 4 plots the course since 1990 of apparent labour productivity and of margins for a representative sub-set of companies (made up of food and beverages distribution corporations, based on information from the Central Balance Sheet Data Office), comparing this with the trend of these same variables for the economy as a whole. As can be seen, productivity gains in the sector have been lower than in the rest of the economy, while relative margins have increased notably. Given the caution required in interpreting this information, it cannot be concluded that this trend has been caused in full by the regulatory changes set out above. But the aggregate results obtained in the ECB report call for reflection on the suitability of the current regulatory framework for the distribution sector in Spain.

2. See ECB Occasional Working Paper no. 44, April 2006.

As to import prices, the goods imports deflator grew by 3.7% in 2005 on National Accounts data, following the figure of 1.8% in 2004. Contributing to this increase was the notable rise in oil prices, which increased by 42% in dollar terms over the year as a whole. However, the developed countries' export prices also rose, both those of the euro area and, in particular, those of other countries which, in national currency terms, accelerated by 1 pp to 3.3%. Adding to this widespread increase in international prices was the stability of the euro exchange rate, set against its behaviour in previous years, when the rise in the European currency had exerted downward pressure on import prices. Overall, the course of import prices led to a slight loss in the competitiveness of domestic as opposed to imported output, although this deterioration was somewhat less than in previous years.

One factor that has gained considerably in importance in recent years, regarding price and cost competitiveness, is the growing presence of certain emerging countries, in particular China, on international markets. These countries' labour costs are far lower than those of the developed economies, which gives them strong competitive advantages, especially in the most labour-intensive sectors. In this respect, the rapid increase in the weight of the emerging economies in world trade in recent years<sup>10</sup> has heightened competition on international markets, exerting downward pressure on the average price of tradeable goods in many industries. As a result, there has recently been a substantial increase in the penetration of products from

10. According to IMF figures, the share of developing countries in world trade has increased by almost 15 pp since the early 90s and currently accounts for almost 45% of world trade.



SOURCE: Banco de España.

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

these countries, which in Spain has been particularly patent in the lower-technology-intensive sectors, as can be seen in Box 4.5.

In sum, the very process of growth in the Spanish economy and the sluggishness of the nearest export markets, the loss in price and cost competitiveness vis-à-vis the Spanish economy's traditional competitors and the growing competitive pressures exerted by the emerging countries, which have coincided with trade liberalisation in the industries with the biggest comparative advantages, all restricted headway in sales abroad and were propitious to an increase in imports. In addition to these aspects, there are other more structural factors which also contributed to increasing the external deficit. Exports were affected by the scant diversification in foreign markets of the Spanish industrial products being supplied, which were excessively geared to more mature markets and industries, where enlargement countries and other emerging economies exert intense competitive pressures. Furthermore, on the imports side, Spanish industry's dependence on abroad, which is manifest in the high share of imports in investment in equipment and in the high presence of imported inputs in the most export-geared productive processes.

All these factors were reflected in the flatness of goods exports in 2005. On National Accounts figures, sales of goods declined by 0.4% in volume terms, clearly below the increase in world



**EXPORT MARGINS**  
**Rate of change**

TABLE 4.3

	Average 1993-1998	1999	2000	2001	2002	2003	2004	2005
<b>TOTAL ECONOMY</b>								
1. Goods and services export margins (1.1/1.2)	1.0	-1.8	4.4	-1.4	-2.1	-3.0	-0.8	2.6
1.1 Goods and services export deflator	3.0	0.0	7.3	1.9	0.8	-0.2	2.0	4.9
1.2 Total economy unit labour costs	2.1	1.9	2.8	3.3	3.0	2.9	2.8	2.3
Total economy unit margin (a)	1.3	0.7	0.6	0.9	1.4	1.0	1.2	2.1
Relative return on exports (1/2)	-0.4	-2.5	3.7	-2.2	-3.4	-4.0	-2.0	0.4
<b>SPAIN/EU15</b>								
4 Relative export margins vis-à-vis EU 15 (4.1/4.2)	1.3	0.9	2.1	0.4	0.8	0.1	-0.9	2.1
4.1 Relative goods and services export prices	2.2	0.8	3.2	1.2	1.3	0.7	0.9	2.7
4.2 Total economy relative unit labour costs	0.9	-0.1	1.0	0.7	0.5	0.6	1.8	0.5
<b>MANUFACTURES</b>								
1. Goods export margins	1.8	0.0	3.8	-2.5	-2.8	-4.1	-1.8	1.1
1.1 Manufactures export prices	3.0	-1.7	4.8	-0.1	-1.0	-1.9	0.6	3.7
1.2 Unit labour costs in industry	1.1	-1.7	1.0	2.5	1.8	2.3	2.5	2.5
2. Unit margin on manufactures (a)	1.8	2.2	1.4	0.3	0.5	0.4	0.6	0.7
3. Relative return on exports (1/2)	0.1	-2.2	2.4	-2.8	-3.3	-4.5	-2.4	0.4
<b>SPAIN/EU15</b>								
4. Relative export margins vis-à-vis EU 15 (4.1/4.2)	0.7	1.5	-1.2	-2.5	-1.3	-1.0	-3.9	-0.8
4.1. Relative manufactures export prices	2.1	-0.7	0.8	-2.3	-1.0	-0.5	-0.4	2.6
4.2. Relative unit labour costs in industry	1.4	-2.2	2.0	0.3	0.3	0.5	3.7	3.5

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

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

trade, meaning that the real share of Spanish exports declined for the second year running (see Chart 4.13). In the current setting, marked by the rapid incorporation of the emerging economies into the world trade scene, it is normal to some extent that the developed economies – such as Spain – should lose weight in world markets. However, the loss of share in 2004 and 2005 ran counter to the previous years when Spain's share on international markets held stable or even increased, at the same time as the share of the main developed economies – except Germany – fell. Further, the reduction in the share of Spanish exports in 2005 was greater than that recorded by other developed economies. On the imports side, the deterioration in the competitiveness of the Spanish economy was manifest in an increase of almost 2 pp in the weight of imports in final demand, between 2003 and 2005, up to 27%.

**6.2 THE EXTERNAL BALANCE  
AND FINANCING REQUIREMENTS**

The domestic demand-led growth pattern of the Spanish economy and the rate of expansion of activity, which far exceeds that of our EU neighbours, have resulted, together with the build-up in losses in competitiveness discussed in the previous section, in spending by Spanish economic agents continuing to far exceed their capacity to generate income, meaning this has had to continue being sustained by foreign saving. Indeed, according to National Accounts figures, the Spanish economy's financing requirements reached a new peak in 2005, at 6.5% of GDP, following the figure of 4.8% the previous year, in contrast to the relative stability from 2000 to 2003. The current account deficit widened notably in 2005, its weight in GDP increasing by 1.6 pp to 7.4%, while the surplus on capital transac-



A complete diagnosis of the competitiveness of an economy requires an analysis not only of its capacity to export, but also of the ability of national firms to maintain or increase their presence in the domestic market and not be displaced by imports. The first panel of the adjoining chart shows that the last few years have seen an increase in the rate of import penetration in final demand. This, along with the moderate growth of exports, helps to explain the rising trade deficit.

The buoyancy of imports has unquestionably been boosted by the worsening price competitiveness of national products with respect to imports. In fact, between 2000 and 2005 the cumulative growth of the GDP deflator amply outpaced that of the imports deflator, against a background of appreciation of the euro. However, the behaviour of the aggregate indicators of competitiveness does not seem to be sufficient to explain the buoyancy of imports.

In this respect, certain structural characteristics of Spanish industry may help to explain the high sensitivity of Spanish imports to changes in final demand. First, the dependence on foreign energy derives from the fact that the relative importance of oil as a primary energy source is higher in Spain than in other developed economies. Second, the weakness of Spain in generating its own technology is reflected, among other factors, in the high importance of the purchases of technology incorporated in imports. This feature is common to most developed economies, although it is more marked in the case of the Spanish economy, as evidenced by the high and growing share of

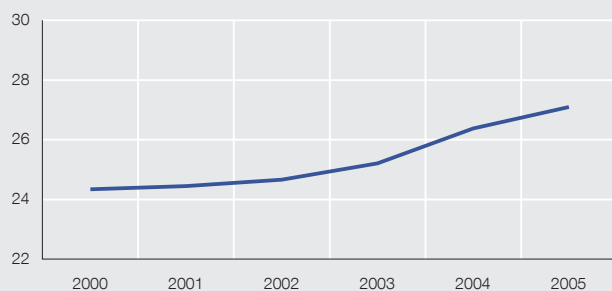
capital goods imports in gross fixed capital formation shown by the input-output tables (see third panel of adjoining chart). This explains why the recovery of investment in capital goods since mid-2004 has led to strong growth of imports of these goods.

The third characteristic relates to the trend in international trade, increasingly characterised by the spatial division of production chains. Consequently, the production processes of most firms use a growing percentage of imported intermediate inputs, making for a closer correlation between export growth and import growth. In the case of Spain, the calculations based on the input-output tables reveal that the presence of imported intermediate inputs<sup>1</sup> in exports is higher than in other developed economies because of the marked specialisation of exports in certain branches, such as transport equipment, which is highly dependent on imported intermediate inputs. In Spain, the share of imported intermediate inputs in goods exports increased to 39.9% in 2000 from an estimated 30.9% in 1995. In the latter year, for which homogeneous information is available for other countries, the share of imported intermediate inputs in exports stood at around 21-23% for Germany, France and Italy.

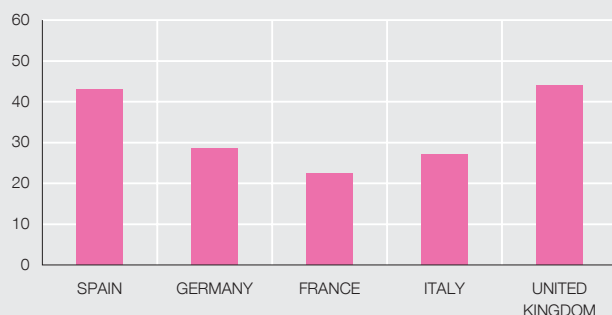
These three factors help to explain why the traditional sensitivity of Spanish imports to economic growth is greater than that of other

1. OECD (2003), STI Scoreboard, p. 110 gives a detailed explanation of how this indicator is prepared.

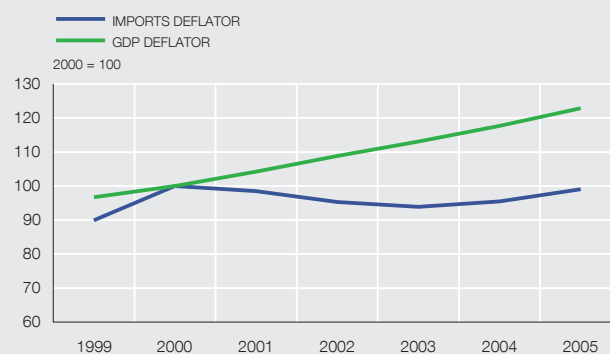
**1 IMPORT PENETRATION IN FINAL DEMAND**  
Constant prices



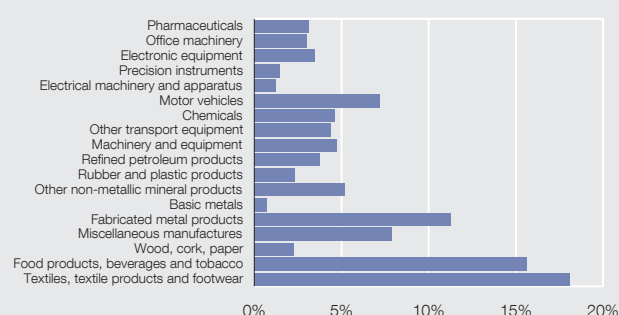
**3 PERCENTAGE OF GFCF CARRIED OUT USING IMPORTS (a)**  
2000 (except UK, 1995)



**2 IMPORTS DEFLATOR AND GDP DEFLATOR**



**4 CONTRIBUTION OF EACH SECTOR TO THE INCREASE IN IMPORT PENETRATION BETWEEN 2000 AND 2005**



SOURCES: INE, OECD and Banco de España.

a. Excluding taxes, real estate and other construction.

developed economies. However, in the last two or three years, their contribution to the increase in import penetration has been rather limited because of the weakness of exports and the high oil prices, which suggests that energy usage per production unit has not increased. The only factor that may have had a bearing on the higher import penetration is the recovery of investment in equipment.

Sectoral analysis of import penetration casts some additional light on this buoyancy. The fourth panel of the adjoining chart shows that the branches of activity that most contribute to explaining the higher import penetration in recent years are the low-technology ones, most notably textiles, clothing and textile products<sup>2</sup>. In this case, the growing competition from the emerging economies of Asia, which enjoy clear comparative advantages in labour-intensive industries of this type, and the removal of trade quotas on textile products in early 2005, explain why imports have displaced national products.

2. Indices of import penetration by branch of activity in real terms are prepared as the quotient resulting from dividing the imports index of each branch by a weighted average of industrial production (P), less the exports (X) plus the imports (M) of that branch. The weights are based on the weight of each of these components in the apparent demand ( $P - X + M$ ) of year 2000. All series are expressed at constant prices.

The food products, beverages and tobacco branch also makes a strong contribution to import penetration, possibly associated with the poor agricultural results and the more moderate import prices of goods of this type. Other sectors that contribute significantly to the higher import penetration are the manufacture of metallic products and of other non-metallic mineral products, which include many of the materials used in construction. Finally, the increased import penetration in motor vehicles is related to the specialisation of this industry in the mid-range and low-end segments, the produce of which is exported, while domestic demand is met largely with imported high-end vehicles<sup>3</sup>.

In sum, apart from the deterioration of prices and costs relative to those of Spain's traditional trading partners, the factors helping to explain the increase in import penetration in recent years are the growing competition from low-cost countries, the recovery of investment in equipment, the demand for construction-related materials and the specialisation of certain industries in products aimed at foreign markets, while domestic demand is met with imported products.

3. In a context of weak motor vehicle production and exports, the import of components, which could also help to explain a higher import penetration, showed moderate growth.

tions declined, albeit to a lesser extent, to 0.9% of GDP, from 1.1% the previous year (see Chart 4.14).

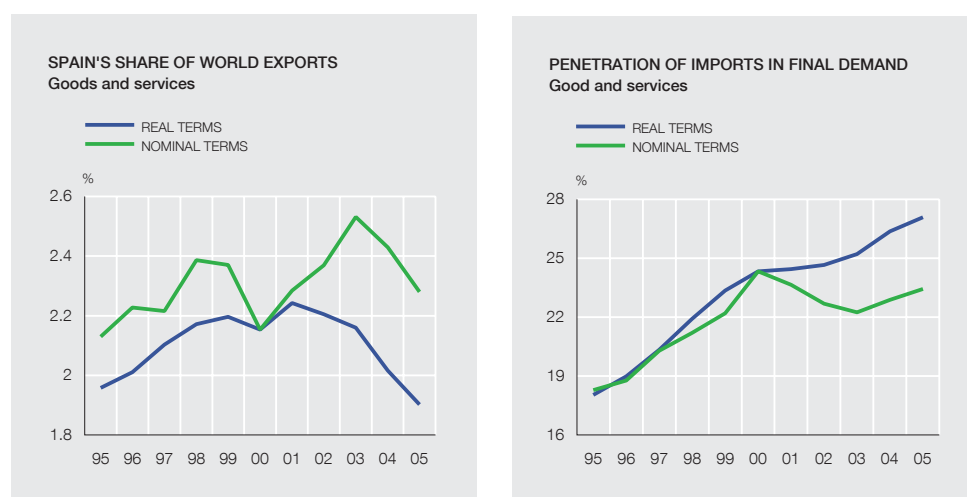
The merchandise trade deficit increased for the second year running at a rate of close to 30%. As a result, its weight in GDP has increased in the past two years by 1.2 pp in each year, which has compounded the cumulative deterioration of earlier years (especially in the period 1997-2000), taking it in 2005 up to 7.5% of GDP. As discussed in previous sections, the robustness of real import flows and the sluggishness of exports, against the background of the widening growth differential with our trading partners, combined with the deterioration in the terms of trade to prompt this unfavourable trend in the trade deficit.

During 2005, and for the fifth year running, the weight of the tourism surplus in GDP continued to diminish, to 3.2%. Tourism receipts tended more favourably than in the last five-year period, although they grew below nominal GDP, while tourism expenditure increased at a rate of over 20% for the second consecutive year. Non-tourist services transactions ran a deficit of 0.9% of GDP, a similar percentage to that seen the previous year, with both receipts and expenditure notably buoyant. Across the different groups of services, the deterioration in the balance on transport services and financial services was offset by the improvement in the other components.

As a proportion of GDP, the incomes deficit declined by 0.1 pp to 1.9%, although it continued worsening in absolute terms. According to detailed Balance of Payments figures, there was a sharp deterioration in the balance of income tied to portfolio investment and to other investment (essentially loans, deposits and repos) and, on a lesser scale, in the direct investment income deficit. Net current transfers posted a deficit of 0.3% of GDP in 2005, after having held

## EXPORT SHARES AND IMPORT PENETRATION

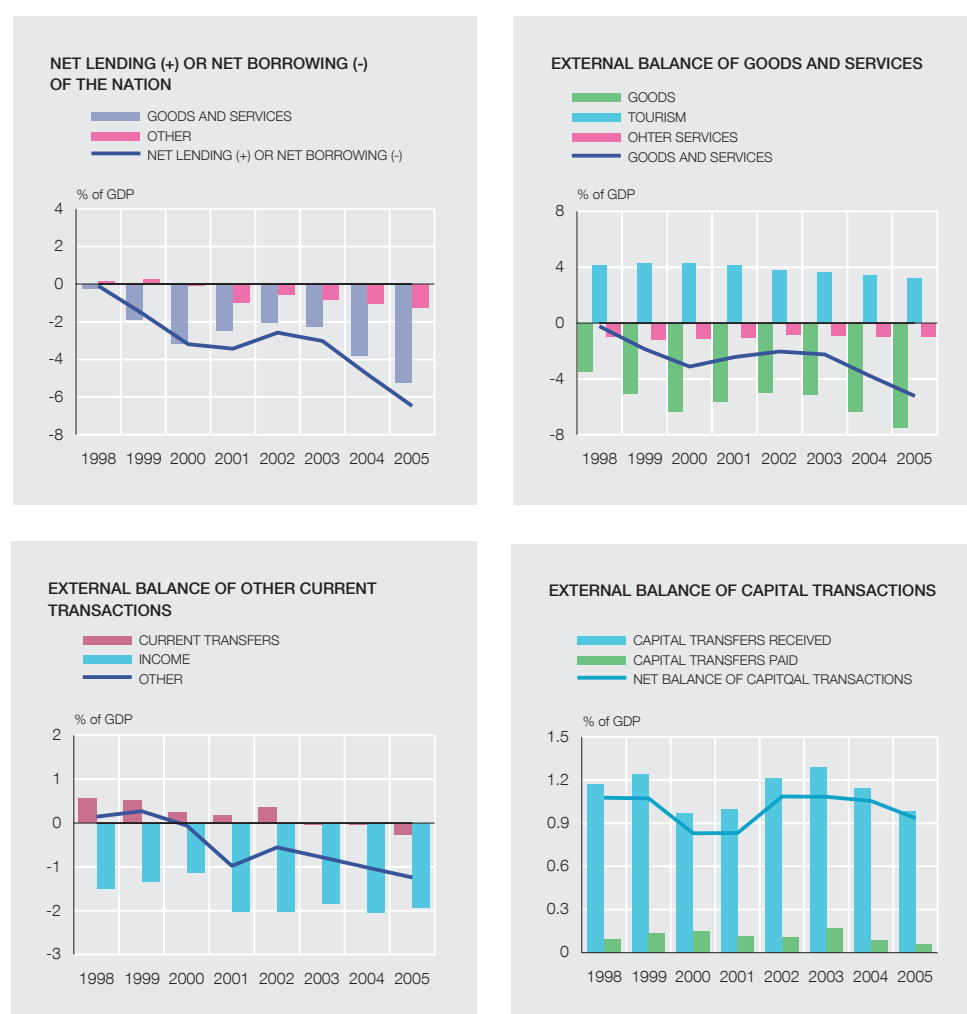
CHART 4.13



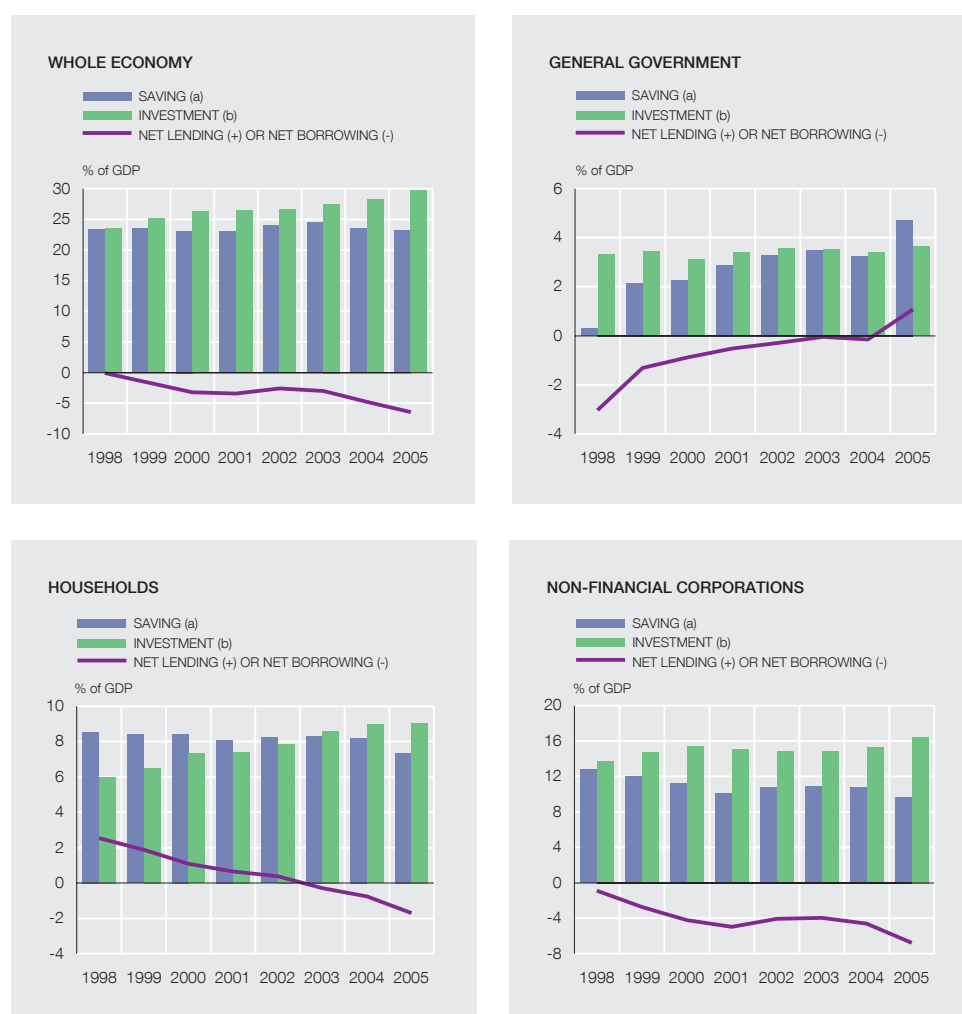
SOURCES: IMF, OECD, INE, Departamento de Aduanas, Ministerio de Economía and Banco de España.

## REST OF THE WORLD ACCOUNT

CHART 4.14



SOURCE: INE.



SOURCES: INE and Banco de España

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

practically in balance during the two previous years. Revenue continued to show very moderate increases, the result of the slackness of transfers in connection with the EAGGF-Guarantee (1.4%) and the European Social Fund (0.6%). Expenditure, however, was very dynamic, reflecting the momentum of payments to the EU budget, especially under the GNP-resource and the VAT resource, and the vigour of emigrants' remittances. The latter increased by 10.2% and now account for more than 21% of total current transfers payments, which is consistent with the sharp growth in the immigrant population in recent years.

Finally, the surplus on capital transactions as a proportion of GDP diminished by 0.2 pp to 0.9%. It was affected by the decline in Community transfers, especially under the ERDF, the most important item in quantitative terms, and the Cohesion Fund, while the flows relating to the EAGGF-Guidance moved on a rising trend.

From the standpoint of the resident sectors' saving and investment decisions, the increase in the Spanish economy's financing requirements in 2005 to 6.5% of GDP was the result, above all, of the momentum of investment. The share of this variable in GDP increased notably to almost 30%, intensifying the uptrend of the two previous years. The weight of gross national saving in output fell slightly to 23.2%. Sector by sector, general government achieved a his-

	1995		2005		Latest figure
	SPAIN	SPAIN/EU15	SPAIN	SPAIN/EU15	
GDP PER CAPITA AND COMPONENTS					
GDP per capita (a)	13.6	78.8	23.0	90.7	2005
GDP per capita (b)	17.7	83.6	23.0	90.7	2005
Population aged 16-64/Total population	68.1	102.3	68.7	104.4	2005
Employment rate (c)	50.6	81.2	63.5	94.4	2005
Labour productivity (d)	51.3	101.0	52.6	92.7	2005
TOTAL FACTOR PRODUCTIVITY AND CAPITAL STOCK					
TFP (e)	100.0	100.0	99.0	96.8	2005
Total capital stock/Employment	114.2	89.7	154.7	87.3	2005
Technological capital/Capital	3.2	44.0	4.1	49.3	2004
Human capital/Population aged 16-64	34.2	56.4	46.2	71.1	2005
OTHER SUPPLEMENTARY INDICATORS					
R&D expenditure/GDP	0.8	43.1	1.1	54.9	2004
ICT GVA (f)	3.7	77.7	3.7	66.9	2002
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 aged 20-24 years with tertiary education/Total population	59.0	85.3	61.3	82.3	2005

torical result, as mentioned at the start of this chapter, in recording for the first time in several decades a surplus that amounted to 1.1% of GDP. However, the financing requirements of both households and non-financial corporations increased to -1.7% and -6.8% of GDP, respectively (see Chart 4.15).

The favourable trend of public finances was a consequence of the increase in saving capacity (to 4.7% of GDP). This enabled the increase in general government investment, which rose to 3.6% of GDP in 2005, to be more than offset. Conversely, households and non-financial corporations both saw their saving levels decline to 7.4% and 9.7% of GDP, respectively, while they boosted their investment to 9.1% and 16.4% of GDP. Household investment in housing continued to be most resilient, in a year in which financial conditions remained favourable. Likewise, corporate productive investment picked up sharply in 2005, against the background of improved corporate earnings and notably easy financing conditions. In any event, these financial conditions began to tighten slightly in late 2005 as part of a process which continues in train in 2006.

To help the deterioration in the external deficit, it will be necessary to promote adjustments in relative prices and to engineer productivity gains. Despite high investment flows, labour productivity vis-à-vis the most developed of our trading partners has fallen off in relative terms, restricting headway in real convergence which, to date, continues to be underpinned by favourable labour market and working population developments. Further, as can be seen in Table 4.4, the Spanish economy continues to display a sizeable lag in respect of endowment of human capital and, most especially, of technology compared with other developed countries. Accordingly, achieving the objectives set in the *Ingenio 2010* plan, which establishes the R+D+i strategy and the measures geared to improving human capital and fomenting entrepreneurialism, are essential for further progress in real convergence.

In short, correcting the external imbalance should be compatible with maintaining the momentum of investment, which could be achieved through gearing capital formation towards more

productive uses. Progress in the degree of capitalisation of the economy is vital for enhancing the capacity of Spanish companies to harness the potential of certain emerging markets and to orient industrial production towards those high-quality segments where the competitive pressures from these new markets are not as great. This would further help check the speed with which expenditure pressures feed through to the external sector, allowing higher growth to be sustained over a longer period.



## Financial developments in Spain

There was no tightening of financial conditions in 2005, so that one of the main factors behind the ongoing expansion in the Spanish economy remained in place. Thus, in line with the stability of interest rates in money markets and with the slight decline in long-term public debt yields, both the cost of loans from credit institutions to households and companies and that of fixed-income security issuance hardly changed, remaining notably low. At the same time, continuation of the upward trend in stock prices that began in 2003 was conducive to the raising of funds through capital increases. In the final quarter, however, coinciding with the improvement in the economic outlook for the euro area and with the expectations of a change in the monetary policy stance, there were rises in short and long-term market interest rates, which were passed through to the cost of debt financing faced by the private sector. These movements, which continued in the first few months of 2006, were nonetheless moderate and, moreover, accompanied by further rises in share prices.

In 2005, the upward trend in net household wealth was maintained, thanks to the rise in value of the financial portfolio and, especially, the trend in house prices, which continued to rise at a high rate (12.8% in December, year-on-year), albeit 4 percentage points (pp) lower than at the end of 2004. The reduction in the rate of growth of the value of real estate, which continued in 2006 Q1, to 12%, involves a change in trend and, as indicated in Chapter 1, increases the likelihood that the overvaluation of these assets can be absorbed gradually over the coming years.

Both the private sector's higher wealth and the low cost of debt help to explain why its spending was more dynamic than its income, underpinned by a significant amount of external financing. The latter continued to expand at a high rate, and has continued to do so during the first few months of 2006. Thus, financing received by households grew last year at a rate of around 21% (slightly higher than in 2004), driven again by loans for house purchase, which increased by more than 24%. The upward path of debt and the associated debt burden was thus extended, while the sector's ability to save after meeting its financial obligations was further reduced.

In the case of companies, the year-on-year growth rate of borrowed funds rose more than 7 pp, to stand at the end of the year at close to 21%. The breakdown by productive activity of the loans granted by resident institutions, the main component of these funds, reveals that, although the acceleration was broad based, the branches that continued to display greater buoyancy were those linked to property development and construction. Against this background, the debt and associated debt burden of the sector as a whole, as in the case of households, followed a clearly upward path. Meanwhile, profit developments were favourable, especially in the case of large companies, although the improvement was not sufficient to reduce the degree of financial pressure on investment and employment. Thus, the synthetic indicators available that approximate such pressure rose slightly, although they remained at moderate levels.

The growth in the net borrowing of firms and households was not offset by the greater net generation of financial resources by general government and, to a lesser extent, by financial institutions, so that the nation had to increase its recourse to savings of the rest of the world. The bulk of these funds was channelled by financial institutions through instruments such as interbank loans and, especially, securities, which were issued mainly by securitisation special purpose entities and are linked to mortgage lending. The recourse to capital markets by finan-



cial institutions was facilitated by their high degree of financial solidity, based on results that again improved notably, by a comfortable average solvency ratio, well above the minimum required, and by the high degree of coverage of doubtful assets.

As a result, the overall financial position of resident sectors continues to be compatible with maintenance of the Spanish economy's current level of buoyancy. However, the strong growth of the financial commitments of households and firms and the high concentration of their investments in the real-estate sector continue to increase the sensitivity of consumption, investment and employment decisions to changes in interest rates and house prices. This sensitivity is especially important given the increase in the probability that the euro area's relaxed monetary policy stance will be progressively corrected in the near future and that the slowdown in house prices that has already begun will continue or even intensify. Also, although part of their risks is being transferred to other domestic and foreign investors, credit institutions are expanding their exposure to property market developments at a hardly sustainable rate. In any case, the strength of bank balance sheets tends to cushion the potential scope of the risks of a financial nature that may have a bearing on the economy's spending in the medium term.

## **1 Financial flows in the Spanish economy**

The net financial resources generated by general government (and financial institutions) were insufficient to finance the gap between the spending of Spanish non-financial corporations and households and their income. The consequent recourse to foreign savings increased with respect to the previous year, to over 6% of GDP, a high for the recent history of the Spanish economy and among the highest levels recorded in the main developed countries.

### **1.1 HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS**

Since the mid-1990s, the net financial saving of Spanish households has represented a declining proportion of GDP, against a background marked by notably generosity financing conditions. This trend, which resulted in the abandonment in 2004 of the sector's traditional role as a supplier of funds, continued last year, so that households' net financial transactions had a debit balance equivalent to 1.4% of GDP (see Chart 5.1). This was the result of both a contraction in the gross savings ratio and the continued buoyancy of residential investment.

As is to be expected in such conditions, households' liability-side transactions expanded strongly, to reach a volume of close to 12% of GDP (as against 10.3% in 2004). The funds raised by the sector grew at a year-on-year rate of over 21%, driven for another year by the rise in the value of real-estate assets (the collateral for a significant proportion of the loans obtained), by the growth in employment and household income and by low interest rates. By purpose, both credit for house purchase and consumer and other credit accelerated, to growth rates of around 24% and 13% respectively.

There was also a marked increase in the net borrowing requirements of non-financial corporations, against a background of recovery in their gross capital formation. Thus, the debit balance of their net financial transactions exceeded 7% of GDP. However, to put this figure in perspective, it is important to remember that the 2004 figure was affected by a one-off episode (the assumption of RENFE debt by the State) which reduced the debit balance of the sector that year by 0.7 pp of GDP.

In gross terms, borrowing requirements were further boosted by the growth in transactions for the acquisition of financial assets, which represented 18.4% of GDP (up more than 2 pp from 2004). This increase was seen across most of the components of the corporations' portfolio, although it basically reflects the growth in cash and cash equivalents. There was a mild recovery in investment in shares and other equity that should also be noted. This recovery was



SOURCE: Banco de España.

- a. For transactions, four quarter data. For balances, year-end data.  
 b. A negative (positive) sign indicates that the rest of the world grants (receives) financing to (from) the counterpart sector.  
 c. Insurance companies and collective investment institutions.  
 d. Not including insurance companies or mutual funds.

concentrated in domestic companies and, against a background of rising listed share prices, such investment rose to 6.6% of GDP.

The *financing gap*, an indicator that approximates the funds needed to cover the difference between gross saving and gross capital formation plus foreign investment of a permanent nature, increased to over 11% of GDP (see the memorandum item of Table 5.1). This percentage is below the highs recorded in 2000 and its growth was similar to that in the amount of the sector's net transactions. Trade credit was also notably buoyant, although it should be noted that this item is not shown in net terms in the *Financial Accounts of the Spanish Economy* and that its counterpart in the liabilities of corporations also increased significantly (see the item "other" of Table 5.1).

Thus, the funds raised by non-financial corporations increased significantly, to more than 25% of GDP (up more than 5 pp from 2004). As befits an economy in which the banks play an im-

% GDP	2002	2003	2004	2005
HOUSEHOLDS AND NPISHs				
Financial transactions (assets)	8.6	9.0	9.7	10.4
Cash and cash equivalents	3.5	4.1	4.0	4.4
Other deposits and fixed-income securities (a)	2.0	-0.3	1.3	2.0
Shares and other equity (b)	0.6	0.6	0.5	0.1
Mutual funds	0.2	2.3	1.5	1.9
<i>FIAMM</i>	<i>0.7</i>	<i>0.6</i>	<i>-0.2</i>	<i>0.2</i>
<i>FIM</i>	<i>-0.5</i>	<i>1.7</i>	<i>1.6</i>	<i>1.5</i>
Insurance technical reserves	2.5	1.8	1.8	1.8
Of which:				
<i>Life</i>	<i>1.4</i>	<i>0.7</i>	<i>0.7</i>	<i>0.8</i>
<i>Retirement</i>	<i>0.9</i>	<i>0.9</i>	<i>0.8</i>	<i>0.8</i>
Other	-0.3	0.5	0.7	0.2
Financial transactions (liabilities)	8.0	8.8	10.3	11.8
Credit from resident financial institutions (c)	7.2	9.2	10.8	12.5
<i>House purchase credit (c)</i>	<i>5.1</i>	<i>7.0</i>	<i>8.7</i>	<i>10.3</i>
<i>Consumer and other credit (c)</i>	<i>2.1</i>	<i>2.2</i>	<i>2.0</i>	<i>2.3</i>
Other	0.8	-0.3	-0.5	-0.7
NON-FINANCIAL CORPORATIONS				
Financial transactions (assets)	14.6	15.9	15.8	18.4
Cash and cash equivalents	1.6	0.9	1.0	2.1
Other deposits and fixed-income securities (a)	1.6	1.2	0.4	1.3
Shares and other equity (b)	6.6	7.5	6.4	6.6
Of which:				
<i>Vis-à-vis the rest of the world</i>	<i>4.6</i>	<i>4.5</i>	<i>3.8</i>	<i>3.8</i>
Other	4.7	6.4	8.0	8.3
Financial transactions (liabilities)	18.9	20.3	20.5	25.5
Credit from resident financial institutions (c)	5.4	6.1	8.4	12.9
Foreign loans	2.7	2.7	0.7	2.0
Fixed-income securities (a)	-0.4	-0.2	0.0	0.0
Shares and other equity	5.9	5.2	4.6	3.2
Other	5.3	6.5	6.8	7.4
MEMORANDUM ITEMS:				
Financing gap of non-financial corporations (d)	-8.6	-8.5	-9.0	-11.3
Financing gap of non-financial corporations excluding ETVEs (e)	-6.4	-6.9	-8.5	-11.0
YEAR-ON-YEAR GROWTH RATES (%):				
Financing (f)	14.0	15.9	16.2	21.0
Households and NPISHs	16.2	19.0	20.1	21.2
<i>House purchase</i>	<i>17.1</i>	<i>21.6</i>	<i>23.6</i>	<i>24.5</i>
<i>Consumer and other</i>	<i>14.4</i>	<i>13.7</i>	<i>12.2</i>	<i>13.3</i>
Non-financial corporations	12.4	13.5	13.2	20.8

SOURCE: Banco de España.

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

b. Excluding mutual funds.

c. Including securitised loans.

d. Financial resources that fill the gap between broad gross capital formation (real investment plus personal investment) and gross saving.

e. Excluding the direct investment made by foreign-equity holding companies.

f. Defined as the sum of bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation SPEs.

portant role, a significant part of the flows was in the form of loans from resident institutions (13% of GDP). Foreign loans also accelerated, but the amounts raised remained very moderate (around 2% of GDP). The role of fixed-income securities, by contrast, was still limited. Taken together, these components of financing, which are those that have an explicit associated cost, accelerated sharply, their year-on-year growth rate rising to around 21%, as against 13% the previous year (see the memorandum item of Table 5.1). However, the buoyancy of own funds fell, so that the issuance of shares and other equity represented approximately 3.2% of GDP.

It should be noted that the breakdown of bank financing by branch of activity continued to reveal the strong momentum of lending to construction and, especially, to real-estate services, which grew at rates of 28% and 45%, respectively, in year-on-year terms (up 9 and 1 pp from 2004). There was a sustained acceleration in loans to industry over the year, so that their growth in 2005 as a whole was close to 15% (5% in 2004). This was similar to the growth in lending to the other services branches, which grew by more than 15%, up 5 pp from a year earlier.

## 1.2 GENERAL GOVERNMENT

The fiscal consolidation process that has characterised the behaviour of general government in recent years was finally manifest in the change of sign of the sector's net balance, which turned into net lending of more than 1% of GDP (see Chart 5.2). It should be recalled, however, when assessing this change that the 2004 figure was adversely affected by the State's assumption of RENFE debt.

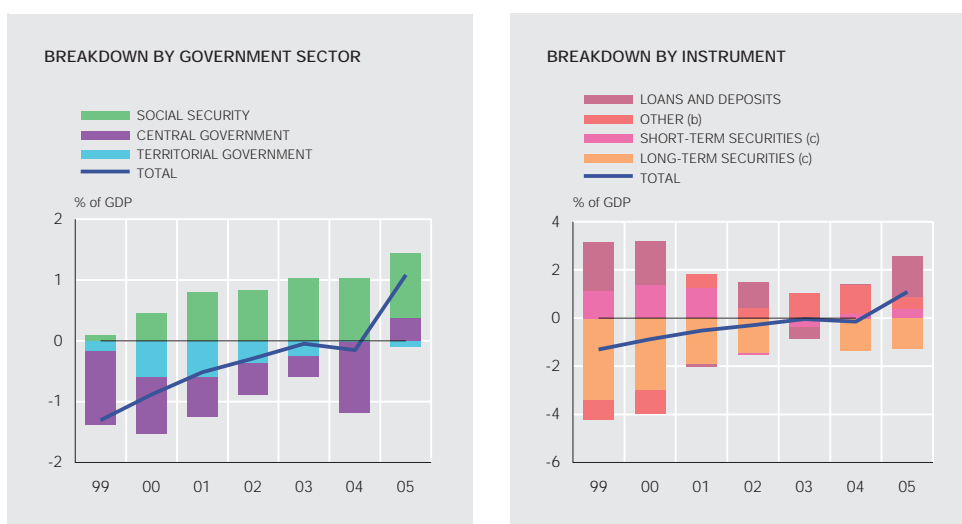
The generation of saving in 2005 was, in any event, largely the result of the behaviour of the Social Security system and for the first time, although to a lesser extent, of central government. Territorial government (regional and local government), by contrast, recorded a small deficit. The surplus of the former enabled provisions to the Reserve Fund, set up in 2000, to be increased to €7 bn, raising its balance to over €27 bn.

Central government and territorial government made a net issuance of securities of approximately €6.7 bn, marking a natural retreat from the previous year. This figure was the result of the increase in bonds of €10.2 bn and the redemption of short-term securities amounting to €3.5bn. By subsector, the funds raised on the markets by central government fell to €3.9 bn, and the greater weight of long-term instruments again increased the average term of its debt, which stood at year-end at 6.6 years. By contrast, the net issuance of the regional (autonomous) governments amounted to €2.8 bn, up 80% from its volume in 2004.

A significant part of the securities issued by the State and territorial government went towards funding the Social Security Reserve Fund, an amount that appears in Chart 5.2 under the heading "other". In fact, somewhat more than half of the gross acquisition of assets by such Fund was in the form of Spanish public debt (which represents, moreover, around 80% of the portfolio). Chart 5.2 also shows how the funds raised through general government issuance also increased its deposits, net of credits.

## 1.3 INVESTMENT AND FOREIGN FINANCING OF THE SPANISH ECONOMY

One of the developments that best reflects the progressive internationalisation of the Spanish economy is the trend in its investment and financing flows with the rest of the world. As seen in Table 5.2, not only was there a significant increase in fund raising operations last year, which was to be expected given the increase in the nation's borrowing requirement to over 6% of GDP, but this growth was also driven by the increasing acquisition of assets abroad by resident agents, which amounted to approximately 18% of GDP (14% in 2004).



Source: Banco de España.

- a. A positive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilities.  
 b. Includes unpaid accrued interest on bonds and net investment by the Social Security System in assets issued by other general government sectors.  
 c. Only liabilities-side transactions included.

Households and non-financial corporations, despite their net financial resource requirements, increased their net direct acquisitions of foreign assets by 2% of GDP (see Chart 5.1). They also increased their indirect holdings through institutional investors, whose purchases abroad amounted to 2.8% of GDP. Even general government made a positive contribution here in 2005, since the Social Security Reserve Fund acquired euro-area sovereign debt amounting to 0.5% of GDP, while the balance of Spanish public-debt securities held by non-residents showed no significant change. Against this background, credit institutions and other financial institutions increased their role in the channelling of foreign funds. The net capital inflows intermediated by these institutions grew notably, to more than 12% of GDP, up almost 4 pp from 2004.

The breakdown by instrument of the acquisition of assets (see Table 5.2) reveals the significant buoyancy of securities other than shares (8.7% of GDP, as against 1.8% in 2004), which is largely explained by the larger volume of purchases by credit institutions (6.6% of GDP). Purchases of shares and other equity represented around 5% of GDP, down almost 2 pp, partly because of a large transaction in 2004 by a Spanish institution<sup>1</sup>. However, although outflows of direct investment declined, Spain continued to be one of the most dynamic economies in Europe as regards this type of operation (see Box 5.1). According to Investment Register information, having excluded foreign-equity holding companies (ETVEs)<sup>2</sup>, the main destination of funds was the European Union, which accounted for more than 74% of the total. The new EU countries, in particular the Czech Republic and Hungary, received more than 25% of the flows. The activity of ETVEs, meanwhile, continued to decline, as the boost provided by the fiscal reform in 2000 faded.

1. The SCH group acquired the British institution Abbey National Bank. 2. Holding companies that use Spain as a platform for their investments in third countries, in order to benefit from the relative advantages of the Spanish tax regime in this area.

% GDP	2002	2003	2004	2005
NET FINANCIAL TRANSACTIONS	-2.6	-3.0	-4.8	-6.5
FINANCIAL TRANSACTIONS (ASSETS)	12.9	13.5	13.8	17.7
Gold and SDRs	0.0	0.0	0.0	0.0
Cash and deposits	3.3	0.7	3.2	2.4
Of which:				
<i>Interbank (a)</i>	2.3	0.5	0.7	3.2
Securities other than shares	4.1	6.5	1.8	8.7
Of which:				
<i>Credit institutions</i>	0.5	3.5	1.0	6.6
<i>Institutional investors</i>	2.7	3.5	0.3	2.1
Shares and other equity	5.0	4.7	6.8	4.9
Of which:				
<i>Non-financial corporations</i>	4.6	4.5	3.8	3.8
<i>Institutional investors</i>	-0.1	1.1	0.8	0.8
Loans	0.1	0.3	0.8	1.1
FINANCIAL TRANSACTIONS (LIABILITIES)	15.5	16.5	18.5	24.2
Deposits	4.0	6.9	1.7	5.3
Of which:				
<i>Interbank (a)</i>	3.1	5.3	5.0	7.2
Securities other than shares	4.3	5.3	12.4	15.5
Of which:				
<i>General government</i>	1.2	-1.0	2.7	0.0
<i>Credit institutions</i>	1.3	3.5	4.6	6.3
<i>Other non monetary financial institutions</i>	1.8	2.8	5.1	9.3
Shares and other equity	4.0	1.1	2.7	0.8
Of which:				
<i>Non-financial corporations</i>	3.3	1.3	1.7	1.0
Loans	3.0	2.8	1.3	2.0
Other, net (b)	-0.1	-0.8	-0.6	-0.1
MEMORANDUM ITEMS				
Spanish direct investment abroad	4.8	3.1	5.8	3.4
Foreign direct investment in Spain	5.7	2.9	2.4	2.0

SOURCE: Banco de España.

a. These correspond to credit institutions only, and include repos.

b. Includes, as well as other items, the asset-side caption reflecting insurance technical reserves and the net flow of trade credit.

Capital inflows, meanwhile, continued to be mainly in the form of purchases of securities other than shares issued by the private sector. Funds amounting to more than 15% of GDP (up 3 pp from 2004) were raised through this channel. Credit institutions and, above all, securitisation special purpose entities and issuers of preference shares (included in the aggregate "other non-monetary financial institutions") were the main issuers of these securities, and funds equivalent to approximately 6% and 9% of GDP respectively were channelled through them. It should be noted that a high percentage of these assets is associated with mortgage loans, so that this source of financing is linked to developments in the domestic property market.

Funds raised on the interbank market continued to be relatively significant, amounting in net terms to 4% of GDP. However, direct investment in Spain declined as a result of the lower activity of ETVEs. Disregarding the operations of the latter companies, the growth in these flows was similar to the economic growth of the country, representing 2% of GDP. Notable in terms of instruments, was the fall in financing from related companies, to 0.5% of GDP, while

In 2005, the Spanish economy continued to invest abroad. Measured in terms of net flows of foreign direct investment<sup>1</sup> (FDI), this investment amounted to 1.2% of GDP, in line with the average ratio observed since 1997, but down 2 pp from 2004 (see the left-hand panel of the chart). The euro area as a whole and most of the member states (the exceptions being Finland, Portugal and Belgium) also recorded positive net outflows of FDI. By contrast, the EU enlargement countries became larger net recipients of this type of funds, while the net volume of FDI received by the United States and United Kingdom turned positive in 2005. Thus, the US economy again recorded a debit balance comparable to that maintained in the second half of the 1990s, while last year's data show the United Kingdom moving further from its traditional role as an exporter of this type of capital.

The behaviour of net flows of FDI was, however, the result of disparate movements in assets and liabilities in each of the regions (see adjoining table). In general, FDI picked up somewhat in Europe in 2005, against a benign background characterised by generous financing conditions, an improved international economic outlook and favourable trends in corporate profits and asset prices. Also, progress on European economic integration and the recent expansion of the EU continued to stimulate this activity.

The capital flows received by the Spanish economy represented 2% of GDP. This was close to the average for the period 2001-2004 and

similar to the figure for the euro area as a whole (in unconsolidated terms). FDI also grew in step with GDP in the euro area countries<sup>2</sup>, and only Ireland and Belgium recorded significant declines in this type of investment. In the area as a whole activity between member countries predominated, so that the resources obtained from the rest of the world remained on the downward path they have followed since 2001. Meanwhile, as one would expect following EU enlargement in 2004, the flow of funds towards new members continued to increase last year. Finally, the recovery that commenced in 2004 continued in the United Kingdom and, much more timidly, in the United States.

On the assets side, capital outflows from the Spanish economy in the form of FDI declined, although their volume was still above the 2001-2003 average. Spain was, moreover, in terms of GDP, the fifth largest exporter of FDI in the euro area, coming behind only the Netherlands, Ireland, Belgium and France. In the euro area, by contrast, there was a significant increase in investment activity, whether the sum of the transactions of the member countries is considered or the area is analysed in consolidated terms, reversing the downward trend observed since 2001. Contributing to these developments was the more expansionary behaviour of these flows, particularly in the Netherlands, France and Finland. Finally, while the United Kingdom's outward FDI grew in line with its GDP, it fell significantly in the United States.

1. All the figures referring to Spain exclude the activity of foreign-equity holding companies (ETVEs).

2. Excluding Luxembourg, a country that usually acts as a financial centre for these transactions, FDI inflows for the area as a whole grew at a higher rate, rising from 1.2% of GDP in 2004 to 1.7% in 2005.

% GDP

#### FDI flows

	Capital inflows			Capital outflows		
	Average 2001 - 2003	2004	2005	Average 2001 - 2003	2004	2005
Spain, excl. ETVEs	2.5	2.1	2.0	2.1	5.3	3.2
France	2.9	1.2	2.4	3.2	2.3	4.7
Italy	1.2	1.0	0.9	1.0	1.1	2.4
Germany	1.9	-0.5	0.8	0.6	0.1	1.6
Portugal, excl. tax havens	0.9	1.6	1.8	1.2	2.4	1.1
Netherlands, excl. SPEs	4.9	0.1	6.6	7.8	2.8	20.0
Ireland	19.2	6.0	-11.4	6.3	8.6	6.5
Greece	0.2	0.7	0.3	0.2	0.3	0.7
Finland	4.0	1.9	2.4	2.2	-0.6	1.4
Belgium	8.4	11.8	6.4	8.6	9.4	6.2
Austria (a)	1.5	1.4	2.1	2.8	2.5	2.3
Unconsolidated euro area	4.3	2.0	2.0	4.4	3.0	4.4
Euro area vis-à-vis rest of the world (b)	2.3	1.1	0.7	2.1	1.7	2.6
United Kingdom	1.6	3.6	7.5	3.3	4.5	4.6
EU enlargement countries	4.4	4.7	5.6	0.4	0.6	...
United States	0.7	0.9	1.0	1.4	2.2	0.2

SOURCES: AMEC, OECD, UNCTAD and national central banks.

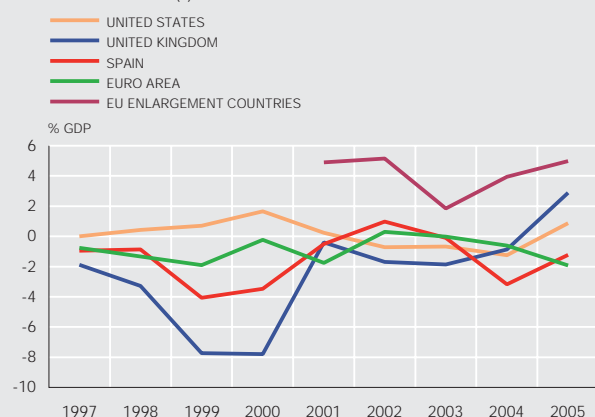
a. Annualised data to September 2005.

b. Unconsolidated euro area includes flows between member countries. Note that, owing to the different statistical sources used, there is a certain discrepancy between the net FDI flows for consolidated and unconsolidated data.

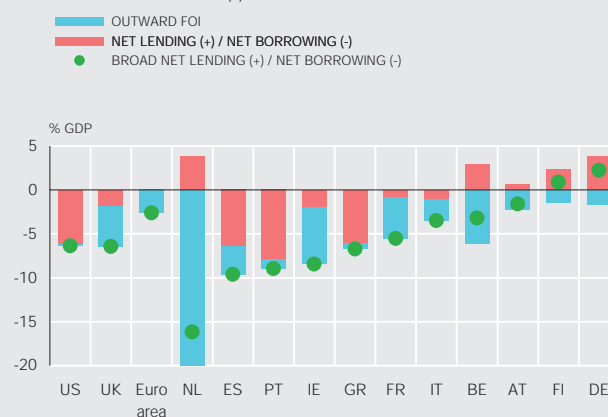
In order to make this investment, the Spanish economy needed to increase its recourse to foreign capital, given the insufficiency of domestic saving. Thus, broad net lending or net borrowing, which includes the funds needed to finance the deficit on current and capital account and the outflows of FDI, recorded a debit balance of close to 10% of GDP (see the right-hand panel of the chart).

This is one of the highest levels in the world, and is basically a result of the strength of domestic spending relative to saving. The situation was similar in the United States, Portugal and Greece, while in the United Kingdom, the Netherlands and Ireland it was capital exports that explained the high requirement for foreign funds.

1 NET FLOWS OF FDI (a)



2 BROAD NET BORROWING (a)



SOURCES: AMECO, OECD, UNCTAD and national central banks.

a. The data for the Netherlands, Portugal and Spain exclude, respectively, the activity of SPEs, the tax havens of Madeira and Santa Maria and foreign-equity holding companies (ETVEs). The data for Austria are annualised data to September 2005.

the capital inflow in the form of shares recovered, albeit modestly (0.3% of GDP), following three years of divestment of this type of security. Also of note was the decline in the acquisition of property for the second year running, to 0.6% of GDP (0.8% in 2004).

According to the Investment Register, the origin of the funds attracted in the form of direct investment was, in order of importance, France, the United States, the United Kingdom and Germany, which together accounted for 78% of the gross investment (excluding the activity of ETVEs). Among the target sectors telecommunications, the chemical industry, motor vehicle manufacturing and property activities were notable.

The capital flows discussed above led to a further increase in the debit position vis-à-vis the external sector (see Chart 5.1), which was naturally also affected by changes in asset prices and in the euro exchange rate. Net external liabilities stood at close to 47% of GDP (43% a year earlier). This level is high compared to most euro area countries. In 2004 (the latest available figures) only Greece and Portugal were in a less favourable situation (60-70% of their respective GDPs), while Germany and France actually had a positive net balance. The deterioration in the Spanish case basically stemmed from the behaviour of the financial sector (excluding institutional investors) which, as explained above, channelled the bulk of the resources necessary to finance the nation's excess spending. In addition, the composition of capital inflows led to a notable growth in foreign debt (including only outstanding liabilities), which reached almost 126% of GDP. This level, however, is moderate compared with other EU



EUR millions	2002	2003	2004	2005
Net issuance by residents (a)	44,990.9	77,741.2	146,720.4	184,371.8
Fixed income	41,233.4	75,966.0	129,158.1	180,139.8
<i>Central government</i>	7,586.2	327.7	6,650.1	3,890.0
<i>Territorial government</i>	3,169.5	1,784.3	1,533.0	2,792.0
<i>Monetary financial institutions</i>	13,656.6	42,910.9	61,363.6	78,039.9
<i>Other financial intermediaries</i>	19,098.3	31,892.6	59,591.0	95,455.1
<i>Non-financial corporations</i>	-2,277.3	-949.6	20.3	-37.2
Equities	3,757.5	1,775.2	17,562.3	4,232.0
<i>Monetary financial institutions</i>	1,725.0	248.2	15,786.9	1,272.4
<i>Other financial intermediaries</i>	140.8	62.4	486.3	-4.7
<i>Non-financial corporations</i>	1,891.7	1,464.5	1,289.1	2,964.3
Public offerings	1,009.4	417.4	2,557.0	157.1
<i>Privatisations</i>	0.0	0.0	0.0	0.0
<i>Other</i>	1,009.4	417.4	2,557.0	157.1
MEMORANDUM ITEMS:				
Net issuance by foreign subsidiaries	14,778.1	12,473.2	-30,336.2	-20,652.3
Financial institutions	13,078.9	8,325.1	-26,744.3	-15,496.9
Non-financial corporations	1,699.2	4,148.1	-3,591.9	-5,155.4

SOURCES: CNMV and Banco de España.

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

economies (in France and Germany the level is similar, while in the United Kingdom, for instance, it exceeds 300% of GDP). As to be expected, the highest growth occurred in the case of financial institutions, which accounted for more than 60% of these obligations.

## 2 The Spanish financial markets

The main trends observed in 2004 in Spanish primary and secondary markets were maintained in 2005 and have even extended into the first few months of 2006. Thus, fixed-income issuance continued to predominate heavily over that of equities and that of financial institutions, in particular, remained notably buoyant. Volumes traded grew at high rates, especially in the case of financial sector debt, and the prices of listed share increased again, against a background in which the interest rates on long-term public debt remained at historically low levels, despite the small rise in towards the end of the year.

### 2.1 PRIMARY MARKETS

The net issuance of fixed-income instruments totalled more than €184 bn (see Table 5.3). This figure was 39% higher than in the previous year and represents approximately a quarter of the new supply of this type of security in the euro area as a whole. If the figure is broken down by issuing sector, the importance, for another year, of financial institutions is clear. The latter have tapped this market intensively to finance directly or indirectly the continuing widening of the gap between bank lending and the funds raised from the traditional deposits of companies and households. As in previous years a significant proportion of these assets was acquired by non-residents.

In 2005, however, the issuance of non-monetary financial institutions (€94 bn) exceeded that of credit institutions (€78 bn) for the first time. The activity of the former, basically in the form of asset-backed securities, preference shares and other similar securities, was boosted by the approval of Law 19/2003, which encouraged the issuance of these types of security by domestic companies (see Box 5.2). This also explains the negative value of the net issuance of their foreign subsidiaries.

Over the last five years, the outstanding balance of securities other than shares issued by non-monetary financial institutions (non-MFIs) has grown at high rates, of over 40% in annual terms, reaching 90% in 2005<sup>1</sup> (see Chart 1). These transactions have mostly been undertaken by companies related to credit institutions, in order to obtain funds that are eventually passed on to the latter.

The two main instruments issued by these institutions are asset-backed securities and preference shares and similar securities. By means of securitisation, special purpose entities (SPEs), which are not independent legal entities, issue marketable securities backed by the mortgage loans of a credit institution (mortgage securitisation) or by present or future receivables (asset securitisation). From the viewpoint of the credit institution concerned, the advantage of these operations is twofold. First, it obtains funds that enable it to finance the growth of its activity, and second, it can transfer risk from its loan portfolio, thereby reducing its capital requirements<sup>2</sup>. Mortgage-backed securities, which at end-2005 represented 73% of the outstanding balance of this type of security, are all issued at a variable interest rate, generally taking EURIBOR as the reference rate. However, only a quarter of the outstanding balance of the rest of these securities had this characteristic. In both cases, the term of the issue varies widely, from one month to more than 15 years,

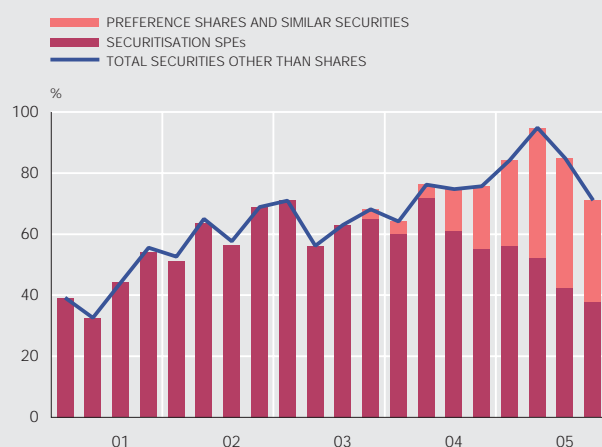
with an average of around 8 years, although it should be noted that redemptions of these securities take place throughout their life.

Preference shares and similar securities are marketable securities that are hybrid in nature, combining elements of shares and bonds. In the event of non-payment their claims come between those of bonds and shares, they do not generally give their holders voting rights and their remuneration is pre-determined, depending on the existence of distributable profits and almost always linked to an index. In the case of those issued by subsidiaries of credit institutions, the funds raised are deposited with the latter and, in the case of preference shares, computed as own funds of the consolidated group. A quarter of the outstanding balance of these securities at end-2005 consisted of preference shares, which are perpetual debt, while the average maturity of the rest was around 4 years. Last year, the rate of growth of this type of instrument was even higher than that of asset-backed securities, so that at year-end they represented 25% of the outstanding balance issued by non-MFIs.

Among the factors that have contributed to the growth of issuance by these institutions is the high net borrowing of credit institutions, resulting from an expansion in their loans that has been accompanied by much more moderate growth in deposits from the non-financial sector. Also, the low level of interest rates has favoured the use of fixed-income instruments over alternatives. In the case of preference shares and similar securities, the influence of the changes made in the prudential regulations and in the tax treatment of the entities has also been very important. These changes have encouraged a shift in the issuance of these instruments from abroad, where it was carried out by subsidiaries of domestic companies, to Spain.

1. In this box, insurance companies and pension funds are not included in non-MFIs since their issuance of securities other than shares is residual. Also, in the case of preference shares and similar securities, it should be noted that part, albeit a residual one, of the increase in the outstanding balance since the entry into force of Law 19/2003 does not correspond to new issues but to the fact that some non-resident issuers transferred their registered office to Spain. 2. In practice, institutions usually retain part of such risks.

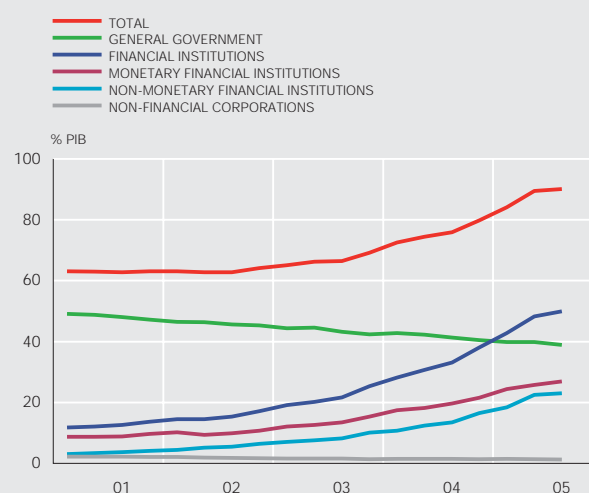
1 SECURITIES OTHER THAN SHARES ISSUED BY OTHER FINANCIAL INSTITUTIONS (a). CONTRIBUTIONS TO ANNUAL GROWTH



SOURCE: Banco de España.

a. Excluding insurance companies and pension funds, whose activity in the issuance of these securities is marginal.

2 OUTSTANDING BALANCES OF SECURITIES OTHER THAN SHARES ISSUED BY RESIDENTS



The growth of non-MFI issuance has some important implications. First, it has contributed to the development of Spanish private fixed-income markets when the size of the public-debt markets was in decline (see second panel of adjoining chart). At the end of 2005 the outstanding balance of assets issued by the financial system was equivalent to 50% of GDP (exceeding the 40% of GDP represented by the corresponding liabilities of general government), almost half of which corresponded to instruments linked to non-MFIs. As a result, transactions on the AIAF market, where almost all asset-backed secu-

rities and more than a third of preference shares are traded, have expanded at a high rate. In 2005, these two types of security accounted for more than 40% of the outstanding balance of that market and 36% of its trading volume. Second, the growth in these types of issues, which have been mainly acquired by non-residents, has facilitated the financing of the Spanish economy's large borrowing requirement, which stems from insufficient domestic saving. Finally, in the particular case of asset securitisation, the growth in this activity has enabled lending risks to be redistributed among a larger number of agents.

The growing importance on Spanish primary markets of securities with mortgage collateral should be noted. For example, the issuance of asset-backed securities, among which those linked to the property market have a prominent place, represented somewhat more than 27% of that carried out in the euro area as a whole, which put Spain in second place in the area after the Netherlands. Also, credit institutions continued to raise a large volume of funds through the sale of mortgage covered bonds.

The volume of net issuance of fixed-income securities by general government, as indicated above, was somewhat less than €7 bn. The importance of territorial government grew, to the detriment of the State, and average maturities progressively lengthened. In any event, the Treasury maintained its tendency to reduce the number of tenders in order to increase the volume of each and thereby boost secondary market liquidity. It also used the syndication procedure again to issue the new thirty-year benchmark bond, although most of the financing programme continued to be covered through the regular tender procedure.

The net financing raised by non-financial corporations through the issuance of fixed-income securities was negative, although, as in the previous year, the amount was barely significant. Their foreign subsidiaries also made net redemptions amounting to some €5 bn, a slight rise compared to the previous year.

This buoyancy of the primary fixed-income markets contrasts with the relative slackness of equity markets, in which capital increases totalled some €4 bn and public offerings barely exceeded €150 million. Against this background of scant activity, the increase in equity issuance by non-financial corporations (to €3 bn) was notable, reversing the downward trend of recent years. It should be noted, however, that in the case of issuance by financial institutions, the comparison with 2004 is affected by a large one-off transaction that year<sup>3</sup>.

## 2.2 SECONDARY MARKET ACTIVITY

In step with the expansionary behaviour of fixed-income issuance, trading volume on the AIAF market increased by over 50% (see Table 5.4), mortgage-backed securities and commercial paper being particularly prominent in this growth. The total (around €900 bn) was slightly greater than that recorded on the equity market, where the sustained rise in prices helped to boost trading, which increased by a significant 33% from 2004. The highest growth, by sector of activity, was in construction and electricity. As regards the different types of operation, the greater buoyancy of takeover bids was notable, driven mainly by the renewed strength of venture capital companies.

3. The acquisition of Abbey National Bank by the Spanish group SCH.

EUR millions	2002	2003	2004	2005
Public-debt book-entry market (a)	18,805,433	21,290,331	22,833,682	22,219,946
<i>Spot (b)</i>	<i>2,310,943</i>	<i>2,246,882</i>	<i>2,136,698</i>	<i>2,338,208</i>
<i>Repos</i>	<i>16,475,994</i>	<i>18,979,902</i>	<i>20,584,242</i>	<i>19,571,854</i>
<i>Forward (b)</i>	<i>18,496</i>	<i>63,547</i>	<i>112,743</i>	<i>309,884</i>
AIAF fixed-income market (b)	264,974	380,197	566,580	872,297
<i>Commercial paper</i>	<i>204,883</i>	<i>261,526</i>	<i>286,468</i>	<i>404,380</i>
<i>Ordinary and asset-backed bonds and mortgage certificates</i>	<i>56,289</i>	<i>115,269</i>	<i>276,019</i>	<i>465,149</i>
<i>Matador bonds</i>	<i>3,802</i>	<i>3,403</i>	<i>4,093</i>	<i>2,767</i>
Stock exchange: fixed-income (b)	69,820	74,346	82,790	93,191
<i>State debt</i>	<i>40</i>	<i>55</i>	<i>44</i>	<i>37</i>
<i>Territorial government debt</i>	<i>69,171</i>	<i>73,260</i>	<i>82,269</i>	<i>88,753</i>
<i>Other</i>	<i>609</i>	<i>1,031</i>	<i>478</i>	<i>4,401</i>
Stock exchange: equities	445,071	499,745	643,542	853,971
MEFF derivatives markets (c)	356,413	292,539	393,666	583,839
<i>Fixed-income</i>	<i>5,473</i>	<i>138</i>	<i>5</i>	<i>0</i>
<i>Equities</i>	<i>350,939</i>	<i>292,401</i>	<i>393,661</i>	<i>583,839</i>
<i>Ibex 35</i>	<i>320,051</i>	<i>268,879</i>	<i>371,494</i>	<i>544,064</i>
<i>Stock options</i>	<i>20,668</i>	<i>12,714</i>	<i>12,014</i>	<i>16,861</i>
<i>Stock futures</i>	<i>10,220</i>	<i>10,808</i>	<i>10,153</i>	<i>22,914</i>

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

a. Only includes transactions with State securities.

b. Nominal turnover.

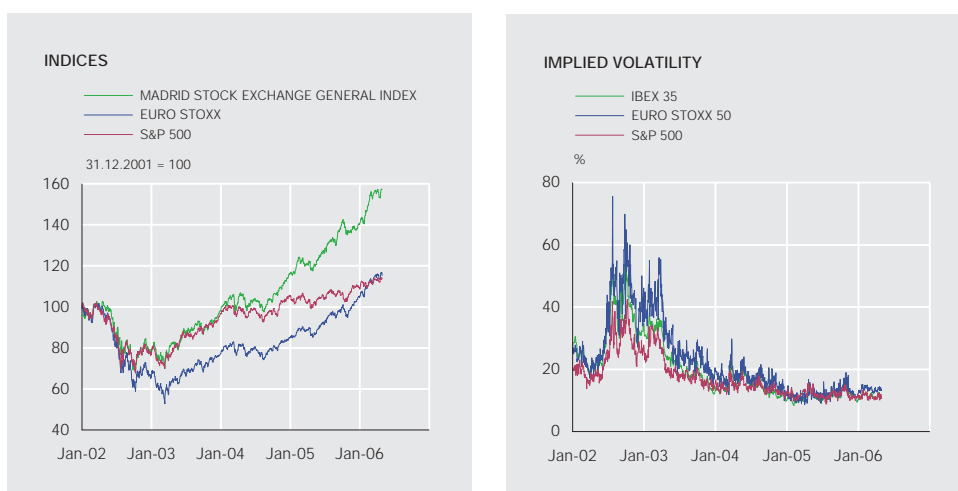
c. Turnover is expressed in monetary units and has been obtained by multiplying the number of contracts traded by their size.

Trading volumes on the derivatives market, where contracts based on equity instruments are virtually the only ones traded, also grew at high rates. Activity in 2005 was again concentrated in contracts based on the Ibex 35 index and, among these, in futures. Trading also increased in the fixed-income market, where the main securities listed are territorial government ones.

The sole exception to this scenario of growing activity was in the book-entry debt market, where volumes traded were slightly down from 2004, although the breakdown by type of dealing gives a varied picture. Thus, outright spot and forward transactions recorded some growth, while sell and buy-back transactions and repurchase agreements fell.

The growth in trading on Spanish secondary markets makes them more liquid, which may help to increase their attractiveness to non-resident investors, who last year accounted for a significant proportion of the activity on domestic markets in line with the previous year. The ongoing efforts to promote these platforms by reducing the costs of operating on them are especially relevant in an environment like the current one, characterised by greater competition between trading centres, and when the Spanish economy is significantly increasing its financing requirements.

Finally, in the institutional sphere, in January 2005 the CADE platform was migrated from the Banco de España to the IT environment of Iberclear, the Spanish central securities depository, and in May 2006 the *Mercado Alternativo Bursátil*, a new dealing segment designed to meet the requirements of securities issued by SICAVs (open-end investment companies) and by low capitalisation companies, commenced operations.



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

### 2.3 SECONDARY MARKET PRICES

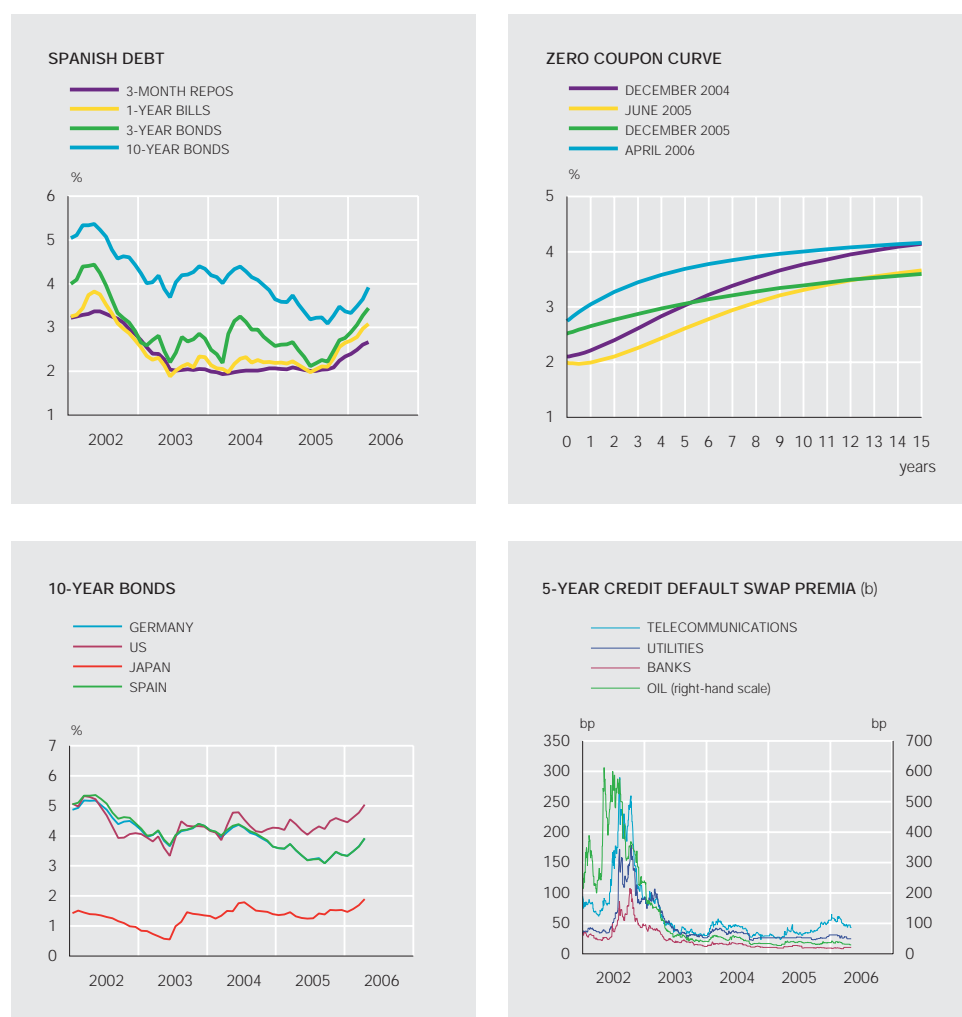
For most of the year Spanish stock markets sustained the upward trajectory of the previous two years, with only temporary interruptions at the end of the first quarter and during August, that coincided with oil price rises (see Chart 5.3). Thus, the Madrid Stock Exchange General Index (IGBM) gained almost 21% (around 19% in 2004), similar to the change in the EURO STOXX broad index of euro area markets (23%), but well above the rise in the US S&P 500 (3%).

Various factors helped to explain these price developments, notable among them being the favourable domestic and international macroeconomic environment, which was reflected in a notable increase in listed company profits (40% in relation to 2004) and in expectations that the trend will be sustained next year. Also, prices were favoured by the decline in interest rates, against a background in which implied volatilities barely moved from the low levels of the previous year. Finally, it should be pointed out that certain one-off corporate transactions also had an effect on the market value of some companies. Specifically, as mentioned above, there was an increase in the number and volume of takeover bids in 2005.

The upward movement in share prices took place across virtually all sectors, although the largest gains were made in the materials, industrial and construction branches (43%) and in oil and energy (28%). Consumer goods (24%) and financial and real-estate services (23%) also increased notably. The only group to record falls was technology and telecommunications (-7%).

Medium and long-term interest rates on the Spanish public-debt market, as on other European markets, followed a downward path during the first nine months of the year, to reach historic lows (see Chart 5.4). However, in the final quarter they rose. Following these movements, the ten-year bond yield stood at 3.3% in December, a fall of around 30 bp relative to its 2004 levels. The spread over the German bond with the same maturity held at close to zero throughout the period.

Short-term interest rates, in step with unchanged key ECB interest rates, barely moved in the first three quarters. However, the expectations of a tightening of the single monetary policy stance, and their confirmation in December, were reflected in reductions in the price of short-term instruments. The slope of the yield curve thus declined over the year, although it remained positive.



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%).

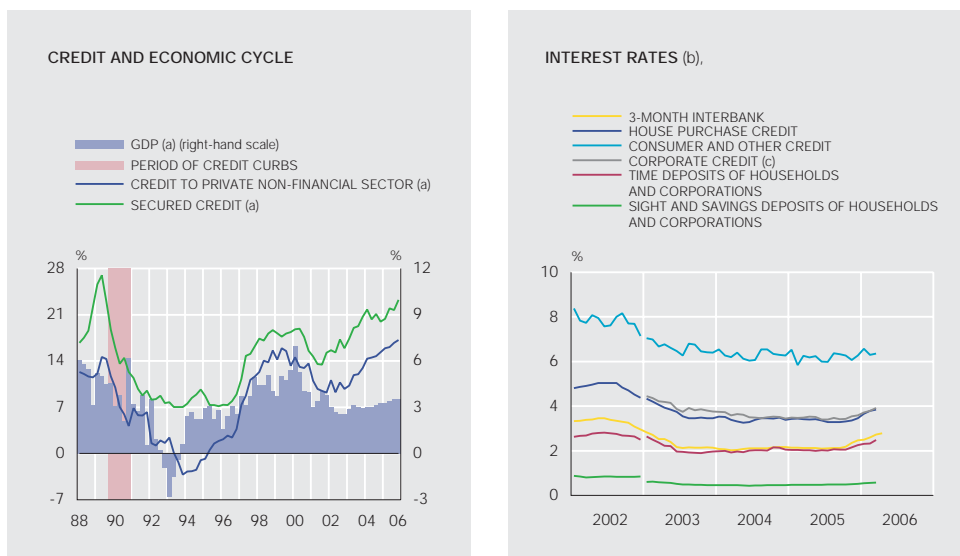
Finally, the credit default swap premia of Spanish companies on the derivatives market remained close to their low end-2004 levels (see Chart 5.4). Along with the moderate decline in long-term interest rates mentioned above, this led to a slight decline in the average cost of financing with fixed-income instruments by firms issuing this type of security.

### 3 Spanish financial intermediaries

#### 3.1 CREDIT INSTITUTIONS

Financial intermediation sustained the buoyancy of previous years, with credit institutions having an especially prominent role in this performance. The sum of asset and liability flows vis-à-vis other resident agents grew by 39% in 2005, while that vis-à-vis non-residents almost doubled. Transactions between institutions in the financial sector also grew notably, now accounting for almost one third of the total, a fourfold increase over the last three years.

In a financial system like Spain's, in which banks are still highly important, it has been credit institutions that have directly financed the gap between the spending and income of resident households and corporations. The total credit extended to these sectors (including that which has been securitised and removed from the balance sheet) accelerated again in 2005, reaching growth rates that exceeded, in real terms, even those of the mid-1980s expansion (see



SOURCES: ECB and Banco de España.

a. Real year-on-year rates. Base 1995 data to December 1995 and base 2000 data thereafter.

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.

Chart 5.5). This was the main factor behind the expansion of balance sheets at the individual (unconsolidated) level (see Table 5.5), although debt securities also increased significantly. Meanwhile, the favourable behaviour of the world economy and the depreciation of the euro exchange rate helped to stimulate foreign business, which also grew notably.

Although the increase in lending to resident corporations and households basically stemmed from demand pressure, according to the responses of Spanish institutions to the Eurosystem Bank Lending Survey, the degree of competition existing and the favourable outlook for economic activity in general also led to a certain increase in the supply of funds. However, the margins between average interest rates on new lending business and interbank rates remained practically unchanged until the final quarter, when the rise in interbank rates was transmitted with a lag to the rates institutions charge their customers.

As previously mentioned, secured loans (basically linked to construction and property development and to household's housing acquisitions) continued to expand at very high rates, without any clear signs of a slowdown. Consequently, there was an increase in the concentration of institutions' portfolios in these business segments, which came to represent around 60% of total lending in 2005. Also notable was the growth in variable-rate transactions, whose relative weight continued to rise, to 72% of total on-balance-sheet lending.

Since the growth of deposits (12% year-on-year in December 2005)<sup>4</sup> was rather more moderate than that of lending, institutions were forced to raise a larger volume of financing on the

4. The deposits of other financial institutions are not included. The latter have grown considerably in recent years as a consequence of the issuance of singular covered bonds and, more recently, of the securitisation of loans that are not derecognised and of the expansion of the issuance of preference shares and similar securities by the institutions' subsidiaries.

STRUCTURE OF BALANCE SHEET AND INCOME STATEMENT (a)  
CREDIT INSTITUTIONS

TABLE 5.5

	CONSOLIDATED			INDIVIDUAL		
	Dec-04 (% TA)	Dec-05 (% TA)	Year-on-Year rate (%)	Dec-04 (% TA)	Dec-05 (% TA)	Year-on-Year rate (%)
<b>ASSETS</b>						
Cash and central bank deposits	1.7	1.8	37.1	1.2	1.1	15.8
interbank deposits (b)	9.5	8.9	15.9	14.4	13.8	16.7
Lending	61.1	61.9	25.2	58.4	59.5	24.0
<i>General government</i>	2.4	2.1	6.3	2.3	1.9	3.1
<i>Private sector</i>	58.7	59.8	25.9	56.1	57.6	24.8
<i>Of which: residents in Spain</i>				53.9	55.2	24.5
Debt securities	15.0	15.4	26.8	13.2	13.5	24.2
General government and central banks	8.5	8.3	20.6	6.9	7.1	25.0
<i>Of which: residents in Spain</i>				5.7	4.5	-4.0
Other	6.5	7.1	34.9	6.3	6.4	23.3
<i>Of which: residents in Spain</i>				3.0	3.1	25.7
Other capital instruments and equity interests	4.4	4.2	17.8	6.2	5.9	14.8
Other assets	8.3	7.7	120.0	6.6	6.2	15.2
<b>LIABILITIES AND EQUITY</b>						
Banco de España and other central banks	1.8	2.3	53.9	1.7	1.8	34.4
interbank deposits (b)	16.8	17.3	27.6	21.1	21.6	24.9
Customer deposits	52.0	48.7	15.7	52.1	50.8	18.7
<i>General government</i>	2.5	2.7	30.9	2.6	2.8	30.9
<i>Private sector</i>	49.5	46.0	14.9	49.5	48.0	18.0
<i>Of which: non-financial residents in Spain (c)</i>				32.8	30.3	12.3
Marketable securities	12.2	15.3	54.8	8.7	10.4	46.6
Subordinated liabilities (d)	3.4	3.0	9.5	3.3	2.9	6.8
Other liabilities	7.6	7.5	21.9	6.5	6.4	19.0
Equity	6.2	6.0	18.2	6.7	6.1	10.0
<b>INCOME STATEMENT (e)</b>						
(+) Interest income	3.9	4.1	38.1	3.6	3.6	18.2
(-) Interest expenses	2.0	2.3	58.3	1.7	1.9	31.4
Net interest income	2.0	1.7	17.7	1.9	1.7	5.9
(+) Net commissions	0.9	0.8	20.6	0.6	0.6	14.0
(+) Profits on financial operations and from investors	0.3	0.4	60.2	0.1	0.1	36.3
Gross income	3.2	2.9	23.0	2.6	2.4	9.2
(-) Operating expenses	1.7	1.5	15.6	1.4	1.2	5.6
Net Income	1.4	1.4	32.2	1.2	1.1	13.4
(-) Write downs and provisions	0.5	0.4	10.4	0.4	0.3	8.8
(+) Other income	0.1	0.2	76.4	0.1	0.1	37.8
(-) Taxes	0.2	0.2	59.3	0.1	0.1	38.0
After-tax profit	0.8	0.9	45.2	0.8	0.7	14.0
Group net profit	0.8	0.9	45.8			
<b>RATIOS (%)</b>						
Net interbank position / TA (f)	-9.1	-10.6		-8.4	-9.7	
Solvency	10.9	10.3				
Doubtful assets / TA	0.7	0.6		0.6	0.5	
Coverage of doubtful assets	191.3	214.0		214.4	245.6	
Foreign operations / TA	23.1	23.6				
Efficiency (OE/GI)	56.1	52.9		55.8	54.4	
ROE	14.0	16.7		12.5	12.2	
<b>MEMORANDUM ITEM</b>						
Total assets at end of period (€m)	2,049.9	2,533.2	23.6	1,748.3	2,127.8	21.7

SOURCE: Banco de España.

- a. Data compiled in accordance with Circular 4/2004.
- b. Includes money market operations through counterparties.
- c. Operations in Spain.
- d. Includes preference shares and other capital with the nature of a financial liability.
- e. As a percentage of average total assets.
- f. Includes liabilities with central banks.



	2001	2002	2003	2004	2005	2005 Balances (a)
Total (b)	15,502	19,038	26,471	23,060	23,781	433,749
Pension funds						
<i>Net contributions (c)</i>	<i>6,260</i>	<i>6,827</i>	<i>4,653</i>	<i>4,822</i>	<i>5,207</i>	<i>72,629</i>
Life assurance						
<i>Premiums net of claims (d)</i>	<i>9,435</i>	<i>10,936</i>	<i>2,406</i>	<i>3,248</i>	<i>3,875</i>	<i>116,176</i>
Mutual funds						
<i>Net share purchases</i>	<i>-194</i>	<i>1,274</i>	<i>19,413</i>	<i>14,989</i>	<i>14,698</i>	<i>244,945</i>
<i>FIAMM</i>	<i>9,798</i>	<i>8,327</i>	<i>3,830</i>	<i>-744</i>	<i>-3,881</i>	<i>54,751</i>
<i>FIM (e)</i>	<i>-9,991</i>	<i>-7,053</i>	<i>15,583</i>	<i>15,733</i>	<i>18,579</i>	<i>190,194</i>
<b>MEMORANDUM ITEM:</b>						
Deposit institutions: change in accounts payable						
<i>Non-financial private sector</i>	<i>52,522</i>	<i>34,803</i>	<i>25,127</i>	<i>38,354</i>	<i>58,250</i>	<i>646,418</i>

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 of 2005 figure based on the change in the net asset value and annual yield of the funds.  
d. The 2005 figure is provisional (based on ICEA assuming the same ratio of premiums to claims as in the previous year).  
e. The data for 2003 onwards are estimates correcting for the double-counting associated with funds of funds.

capital and interbank markets at a comparatively high cost. Thus, the issuance of covered bonds and the securitisation of mortgage loans taken together increased by 50% last year, while the net debit position on the interbank market rose by one percentage point (as a percentage of total assets), to 9.7% at the consolidated level, and to 10.6% at the individual level (see Table 5.5).

The recourse to capital markets was facilitated by the solidity of the financial position of Spanish institutions, whose results again grew apace (see Table 5.5), underpinned by the increase in assets, the drive to contain operating costs and lower impairment losses in the income statement arising from asset deterioration. The latter was basically attributable to the stage of the cycle in Spain and in certain other countries in which these institutions have a significant presence, such as Latin American ones. In total, the net profit of parent companies grew by 14% (45% at the consolidated level) and the ROE at the group level rose to 16.6%. This favourable scenario is completed by an average solvency ratio that, although declining slightly, is at comfortable levels (of over 10%, according to national regulations, and 11%, according to the Basel rules); more than sufficient coverage of doubtful assets (245%, at the individual level; 214%, in consolidated groups) and a ratio of doubtful assets to total lending that fell again in 2005, to below 1% (both at the individual and consolidated levels).

In these conditions, Spanish credit institutions are clearly in a favourable position to compete with other intermediaries inside and outside Spain and to absorb the impact of possible shocks with negative effects on the ability of resident borrowers to meet their payment obligations. Maintaining or improving this position requires pressing ahead with policies for controlling and managing risk and achieving greater sectoral diversification of the latter.

As seen in Table 5.6, institutional investors in 2005 raised a larger net volume of funds, with the exception of FIAMMs which recorded a greater net withdrawal than in 2004. Even so, and although the supply of financial products continued to be expanded, bank deposits were still the main destination of the savings of the domestic private sector.

Net contributions to pension funds and life assurance premiums grew by 8%, yet their importance relative to the size of the Spanish economy remained below the European average. Growth was also recorded in the net asset value of capital market mutual funds and, in particular, in that of real-estate mutual funds and investment companies, which again recorded a very high growth rate (over 50%), although they continued to represent a small part of total collective investment (2%).

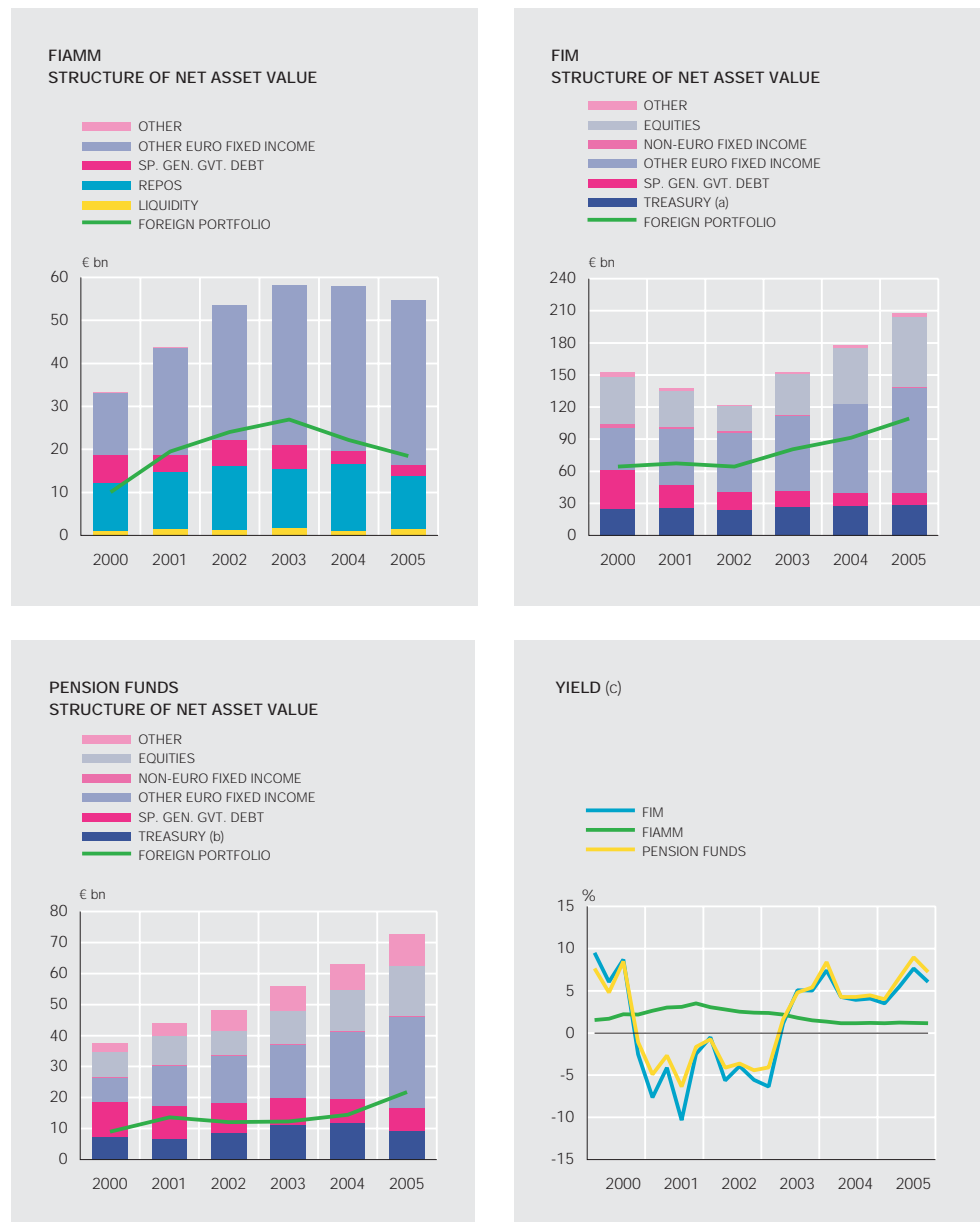
Worthy of special mention is the growing introduction into Spain of foreign investment vehicles, which at end-2005 already represented 10% of the total net assets of the collective investment institutions operating in this country. The degree of foreign penetration increases to 18% if the holdings of domestic funds in foreign institutions are included, or even to 27% if the assets managed by Spanish institutions belonging to foreign groups are also added. This significant share for institutions from the rest of the world reflects the ongoing international diversification of the portfolios of Spanish investors, against a background of increasing competition in this segment of the financial industry at the global level.

Likewise notable was the increase in the activity of venture capital entities whose investments and funds raised were practically double those recorded a year earlier. The bulk of these resources, however, came from international funds and the scant information available suggests that the weight of this type of investment in the portfolios of Spanish institutional investors is still very small.

Analysis of the structure of the portfolios of the main institutional investors (see Chart 5.6) shows, first, a decline in the relative weight of the liquid assets held by pension funds and, second, a general increase in that of the private fixed-income securities issued in Spain. The latter represented 40% of the total increase in the net assets of pension funds, FIMs and FIAMMs in 2005, continuing the process of diversification of their assets that has been taking place in recent years. Insurance companies, by contrast, still maintain a very conservative portfolio composition, a high proportion of their investments being in the form of securities issued by general government. According to the most recent information available (June 2005), variable-income instruments (including index-linked securities and shares in mutual funds) made up less than 10% of their holdings of financial assets and their exposure to the property market was also very small (less than 3% of total assets).

In terms of results, as in the case of credit institutions, there was significant growth in 2005 in the net profit of insurance companies, the institutional investors with the greatest systemic implications. Specifically, according to provisional ICEA (Investigación Cooperativa entre Entidades Aseguradoras y Fondos de Pensiones) estimates, profits were up 20% from the previous year. This performance was a result of favourable developments in both the life and non-life businesses and it was accompanied by an increase in the aggregate solvency margin, to 268% of the required minimum.

Approval of the new regulations for collective investment institutions and of the new rules for venture capital entities may entail a further boost to institutional investment as a result, for



SOURCES: CNMV, Banco de España and INVERCO.

a. Includes repos.

b. Includes repos and money market assets.

c. Cumulative return over last 12 months.

example, of the setting up of new entities such as funds and companies investing in venture capital entities, exchange traded funds and hedge funds. Also, the activity of this sector will probably be affected by the changes in the taxation of savings that are eventually contained in the final draft of the new personal income tax law.

#### 4 The financial position of the non-financial private sector

##### 4.1 HOUSEHOLDS

As already indicated, Spanish households continued to resort to credit institutions to finance a higher volume of spending than permitted by the growth in their income. In this way, they continued to increase the sector's main debt indicators (see Chart 5.7) and, at year end, their aggregate debt exceeded 110% of their gross disposable income (GDI), a rise of more than 10 pp from the same period of the previous year and around 20 pp above the average value of this variable in the euro area.



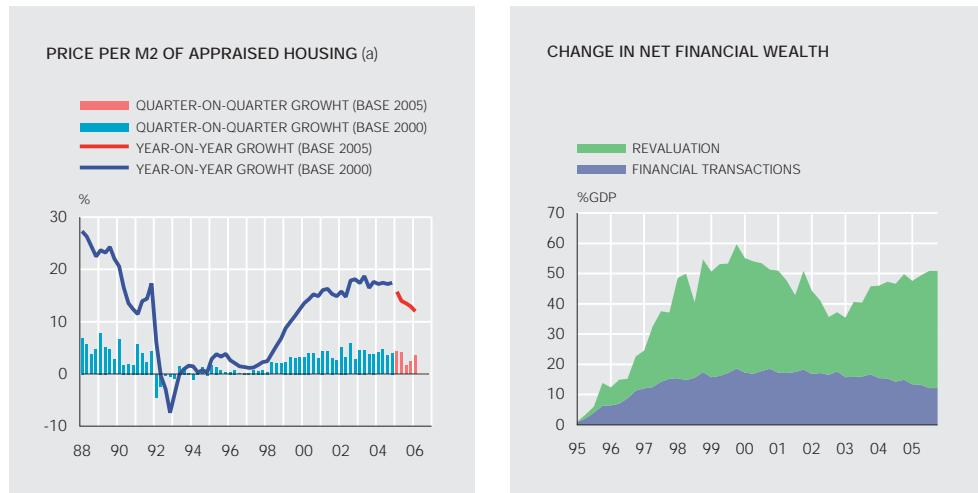
Source: Banco de España.

- a. The sectoral national accounts data to 2000 correspond to the CNE base 1995. Thereafter they correspond to the CNE base 2000.
- b. Includes bank credit and derecognised securitised credit.
- c. Assets 1 = total financial assets – "other".
- d. Assets 2 = assets 1 – shares (excluding mutual fund shares) – shares in FIM.
- e. Estimated interest payments plus debt repayments.
- f. Balance of households' use of disposable income account.
- g. Gross saving less estimated debt repayments.
- h. 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. New house price statistic from 2005.
- i. CNE base 2000.

The debt burden associated with these liabilities increased for the second year running, so that households used more than 14% of their GDI to cover payments of interest and principal on their debts. The buoyancy of lending combined with the decline in the sector's gross saving ratio led to a further decline in net saving after the payment of financial obligations, which actually turned negative.

Despite the increase in liabilities, net household wealth sustained its gradual growth of recent years to reach 600% of GDP. This outcome was a result of the increase in the value of the financial portfolio and especially, of the further rises in house prices, which grew at a rate of close to 13%, down some 4 pp on 2004 (see Charts 5.7 and 5.8).

The financial components of wealth remained mainly in the form of the most liquid low-risk assets, although as in previous years the weight of these items continued to decline. The



SOURCES: Ministerio de Vivienda and Banco de España.

a. New statistic from 2005.

percentage of equities and shares in mutual funds, in whose portfolio these assets have the highest weight, increased slightly, basically as a result of the performance of share prices. Finally, there was a moderate decline in the proportion of wealth represented by insurance investments.

In short, despite the growth in their wealth, the increase in the debt and debt burden of households and the reduction in the savings buffer they have available to absorb adverse shocks without having to reduce spending have again raised their exposure to unfavourable changes in their income, in asset prices and in financing costs. In particular, given the high proportion of variable rate loans, any significant rise in interest rates would tend to increase significantly the percentage of income that the sector would need to assign to the payments associated with its liabilities. As seen in Box 5.3, these effects may be more acute in the case of low income households which, in principle, have a higher marginal propensity to spend.

## 4.2 NON-FINANCIAL CORPORATIONS

There was a rise in the funds needed by non-financial corporations to finance their real investment (which, as mentioned in Chapter 4 of this report, was very dynamic) and acquisitions of shares and other equity, whose relative weight in their portfolio increased.

Own funds continued to be the main source of financing, although their weight in the balance sheet fell slightly, despite the rise in share prices. Borrowing was thus the most dynamic component, leading to a further increase in the ratio of external liabilities to profits, to 460% at end-2005, up 50 pp from end-2004 (see Chart 5.9). In the case of firms reporting to the Central Balance Sheet Data Office, among which large ones predominated, this ratio was less expansionary, especially in the case of large groups, for which it even fell slightly.

The growth in company borrowing meant that, although there was no change in the average cost of financing, the proportion of earnings assigned to the payment of interest increased for the first time since 2001, to around 19%. Again, CBSO information points to a less unfavour-

## RATE RISES

Lending to Spanish households has grown at a high rate in recent years, which has exceeded the growth rate of their income and the rates observed in other European economies. As a result, the sector's debt ratio has risen from below the euro area average at the end of the 1990s to stand clearly above it. At the same time, the debt burden associated with this debt has increased to a lesser extent, on account of the decline in the cost of financing and the lengthening of maturities.

However, to assess the financial situation of households it is important to analyse not only the indicators at the aggregate level, but also their distribution according to various criteria such as income levels<sup>1</sup>. In this respect, panel 1 of the adjoining chart shows how the debt ratio of Spanish households is inversely related to their income. This situation contrasts with that in other countries, such as the United

Kingdom and United States, where precisely the opposite situation is observed, but is similar to that in Italy, although the differences between the different brackets are much smaller there than in Spain<sup>2</sup>.

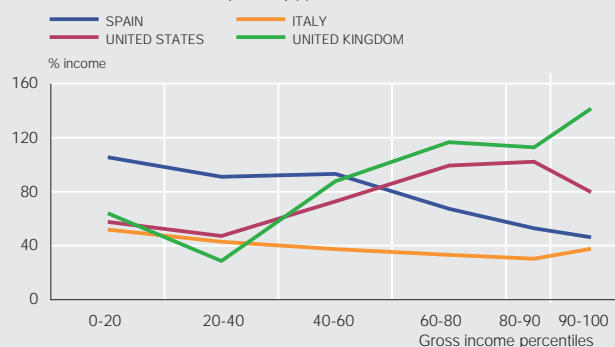
The distribution of the debt burden of Spanish households according to income has the same profile as that of debt, but the differences in this case are somewhat more acute (see panel 2 of the adjoining chart). In the United States, the only country besides Spain for which data are available to calculate these indicators at the microeconomic level, no significant differences are observed between the different brackets, in contrast to the positive correlation mentioned above between the debt ratio and income. In both countries, therefore, the combined evidence of panels 1 and 2 of the chart seems to indicate that households with less resources may face less favourable financing conditions.

Given the higher relative indebtedness of lower-income Spanish households, one might expect that these would be more ex-

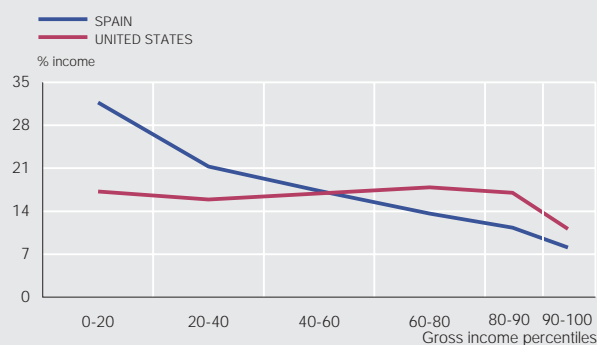
1. The distribution according to other relevant criteria such as the age of the household head, wealth and the existence of property-related debt is analysed in Bover, Martínez Carrascal and Velilla (2005) 'The wealth of Spanish households: a microeconomic comparison with the United States, Italy and the United Kingdom, *Economic Bulletin*, July, Banco de España. This article shows that in Spain and, in general, in other countries, the debt ratio is inversely correlated with the age of the household head, as life-cycle theory would suggest.

2. This chart was compiled using the information in the article cited above, updating that relating to the EFF with definitive data.

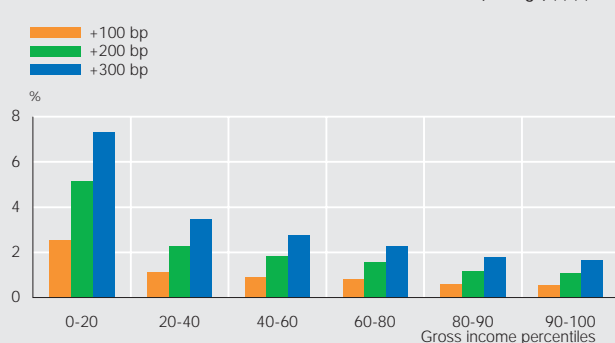
1 HOUSEHOLD DEBT RATIO (median) (a)



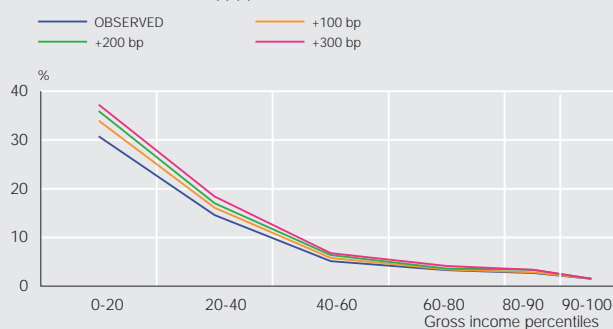
2 HOUSEHOLD DEBT BURDEN (median) (a)



3 DECLINES IN HOUSEHOLD INCOME NET OF DEBT SERVICE (average) (a) (b)



4 % OF HOUSEHOLDS WITH DEBT BURDEN OF OVER 40% OF THEIR GROSS INCOME (a) (b)



SOURCES: EFF(2002), SCF (2001), IBF (2002) and BHPS (2000).

a. Calculated for households with outstanding debt.

b. Various interest rate scenarios are presented, increasing the rates observed in the survey, when they are variable, by 100, 200 and 300 basis points.

## RATE RISES (cont'd)

posed to changes in interest rates. In any event, the effects of such changes also depend on other characteristics such as the fixed or variable nature of the interest rates applied to the loans and the residual maturity. To analyse these questions, the impact on the debt burden of Spanish households of increases in the cost of financing of 100, 200 and 300 basis points (bp) has been simulated, using information from the Survey of Household Finances (EFF) on the individual characteristics of the loans granted, such as the volume of debt, the residual maturity, the interest rate and the nature of the loan agreement (fixed or variable-rate)<sup>3</sup>.

Panel 3 of the adjoining chart shows the average decline in gross household income after debt service for the different interest rate scenarios considered. The effects of rises in the cost of financing are not distributed equally across the different segments of the population. In particular, the strongest impact occurs in the case of medium and low-income households. Thus, for households situated below the 20th percentile of the distribution, income after payments associated with debt falls by 2.5 pp, 5.1 pp and 7.3 pp for rises of 100 bp, 200 bp and 300 bp, respectively, as against 0.5 pp, 1.1 pp and 1.6 pp in the case of households above the 90th percentile.

3. It was assumed in the exercises that the type of instalment of the loans remains unchanged, while the instalments of variable rate loans are altered.

It is also interesting to study what the impact of the above shocks would be on the proportion of households that exceed certain thresholds. For this purpose, panel 4 of the adjoining chart shows for various income brackets and for the different interest rates scenarios, the percentage of indebted households whose debt burden exceeds 40% of their gross income. The effects are especially evident in the lower part of the distribution. Thus, in the case of households below the 20th percentile, the percentage would increase from an initial observation of 30.7% to 34%, 35.9% and 37.2, with increases of 100 bp, 200 bp and 300 bp in financing costs, respectively.

In sum, the results of this box suggest that, on average, the interest rate rises considered in this box have a relatively moderate impact on the financial position of households with outstanding loans. However, the impact in question is not distributed evenly across the population. Some households, with a significant level of debt and low income, would be comparatively more vulnerable to this type of shock. Given that these groups probably have a higher propensity to spend, one might expect that the response of national demand to increases in financing costs would be greater than implied by the aggregate indicators for the sector. It should be noted, moreover, that the upward path of the debt ratio from 2002, a reference year for the EFF, and the growing weight of variable rate loans means that the effects are probably less favourable now than those inferred when the analysis was carried out.

able trend in this indicator, linked to the slower growth in the debt of the reporting corporations.

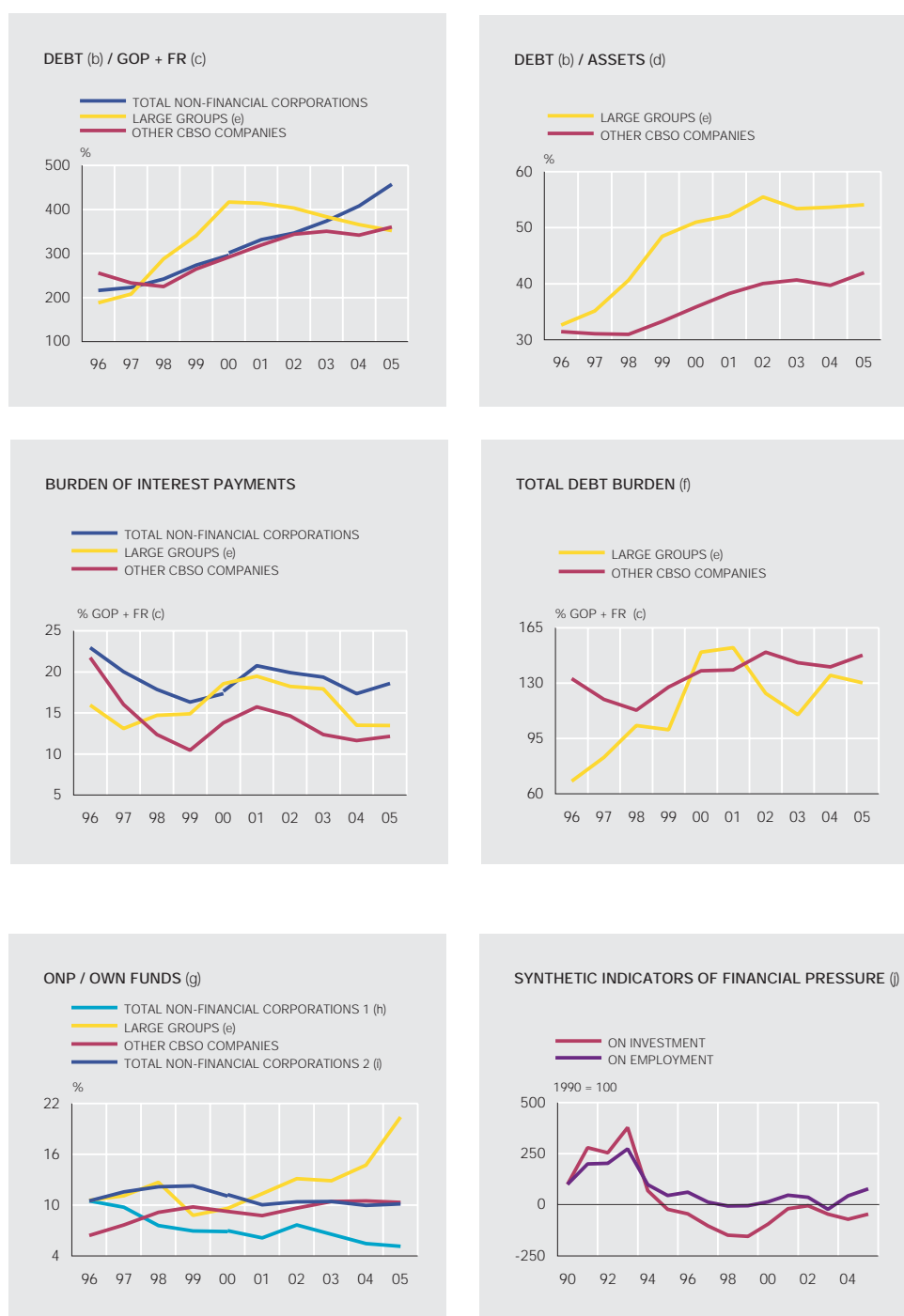
The financial results of Spanish companies were rather favourable last year, especially in the case of large companies. The sector's gross operating profit (GOP) grew by almost 9%, while its ordinary net profit (ONP), which is approximated by adding net financial revenue to GOP and deducting depreciation, increased by somewhat less. Despite this growth, the ratio of the sector's ONP (obtained in the above manner) to own funds valued at market prices declined, basically on account of the notable increase in share prices. In fact, when price effects are eliminated from the calculation of the denominator (giving a trend in the indicator that is more comparable with that studied in the usual business analyses), stability is observed, in contrast to the notable recovery in this same ratio, calculated using CBSO data, for the large-group aggregate.

The overall trend in debt, the debt burden and profitability led to a rise in the synthetic indicators of financial pressure on investment and employment based on CBSO information. However, from a historical perspective these indicators are still at low levels.

Meanwhile, the market value of Spanish companies relative to GDP reached its highest level since 1995, basically as a result of the increase in share prices, since capital increases were small (see Chart 5.10). The rise in share prices occurred against a background in

# INDICATORS OF THE FINANCIAL POSITION OF NON-FINANCIAL CORPORATIONS.

CHART 5.9



SOURCE: Banco de España.

a. Indicators calculated on the basis of CBSO annual and quarterly survey data, except the series "total non-financial corporations", which was obtained from the national accounts (CNE and FASE). To 2000, the income of the sector corresponds to the CNE base 1995. Thereafter it corresponds to the CNE base 2000.

b. Interest-bearing borrowed funds.

c. Gross operating profit plus financial revenue.

d. Defined as total inflation-adjusted assets less non-interest-bearing liabilities.

e. Aggregate of all the firms reporting to the CBSO belonging to the groups Endesa, Iberdrola, Repsol and Telefónica. Adjusted for intra-group financing to avoid double counting.

f. Includes interest plus interest-bearing short-term debt.

g. For total non-financial corporations, ONP = GOS + interest and dividends received - interest paid - fixed capital consumption.

h. Own funds valued at market prices.

i. Own funds calculated on the basis of the 1996 figure and cumulative flows since.

j. Indicators estimated on the basis of CBSO annual and quarterly survey data. A value of more (less) than 100 indicates a higher (lower) financial pressure than in the base year.



The analysis of the financial position of firms is a significant element of any assessment of the economic outlook and the solidity of the financial system, given the contribution of firms to aggregate demand and their weight in the financing extended by credit institutions. In such an analysis, it is important to supplement the use of aggregate indicators with a more disaggregated perspective, since the former focus may hide situations of vulnerability in certain segments that can only be identified using the latter<sup>1</sup>.

This box compares the developments in the debt ratios, debt burdens and profitability of small firms (up to 50 employees) with those

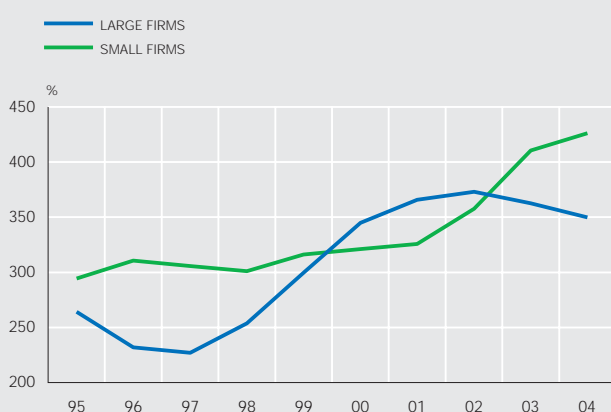
of the largest firms (with 250 employees or more, plus those that form part of one of the large Spanish corporate groups). The standard indicators of financial position presented in the adjoining chart have been constructed on the basis of information contained in the Banco de España's Central Balance Sheet Data Office and in the Mercantile Register<sup>2</sup>.

The upper left-hand panel of the chart shows developments in the ratio of debt to profits. As can be seen, over almost the entire sample period and, in particular, in recent years, smaller companies were more

1. The empirical evidence available shows that the disaggregated analysis is crucial for analysing how the financial position governs firms' investment and hiring decisions, as well as the probability that they will default on their payment obligations. For more details see, for example, Hernando and Martínez-Carrascal (2003), The impact of firms' financial variables on firms' real decisions: evidence from Spanish firm-level data, Working Paper No. 0319, Banco de España, and Benito et al. (2004), A synthetic indicator of financial pressure for Spanish firms, Working Paper No. 0411, Banco de España.

2. The indicators for large firms have been constructed from the information contained in the Banco de España's Central Balance Sheet Data Office (CBSO). For small firms this source of information has been combined with that of a sample of the accounts filed with some of the Mercantile Registries that collaborate with the CBSO, the latter applying a number of filters to exclude from the analysis firms whose data are not reliable. On average, information from the accounts of some 240,000 small firms was used (for each year). At the time of publication of the *Annual Report* the latest available data corresponded to 2004.

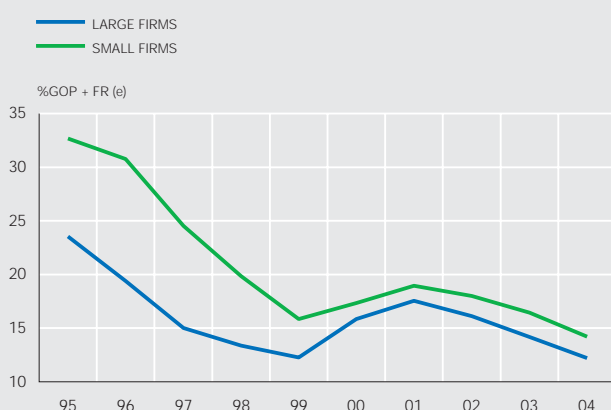
1 DEBT RATIO (a)



2 PROFITABILITY (b)



3 INTEREST-SERVICE BURDEN (c)



4 TOTAL DEBT BURDEN (d)



SOURCES: Central Balance Sheet Data Office and Mercantile Register.

a. Interest-bearing debt divided by gross operating profit plus financial revenue.

b. Ordinary net profit divided by own funds.

c. Interest paid on financing received.

d. Interest paid plus short-term interest-bearing debt.

e. Gross operating profit plus financial revenue.

indebted than large companies. Also, the difference between the developments in this indicator in the two groups is notable. While in the case of large firms it increased by more than 60% between 1997 and 2001, in line with the expansion and internationalisation of their business, in the case of small firms it was relatively stable. Between 2002 and 2004, by contrast, this ratio increased notably for small firms, while the opposite was the case for large firms, reflecting the balance sheet restructuring they were carrying out which, according to the information available for 2005, may have now been concluded.

Profitability developments have also differed between these two groups (see upper right-hand panel of the adjoining chart). Thus, while the ratio of profits to own funds moved more favourably for small firms in the second half of the 1990s, the opposite has been the case in the current decade. Specifically, for small companies the indicator fell, while for large companies it increased by 3.5 pp from the low recorded in 1999-2000, to stand close to 15% in 2004. Thus, at the end of the sample period, the profitability gap between these two types of companies was at its widest. Among small firms, profitability developments were least favourable among those in the industrial sector, which are exposed to more foreign competition.

In both groups of firms, interest payments followed a downward trend relative to profits (see lower left-hand panel of the adjoining chart), which was more pronounced in the case of small firms. In 2004, the ratio was at similar levels for both types of firm. The total debt burden indicator (interest plus short-term debt), meanwhile, held steady for small firms in the second half of the 1990s, increasing in recent years to stand at the end of the sample period at higher levels than for large companies, owing to the higher relative indebtedness of small firms and their larger proportion of short-term liabilities.

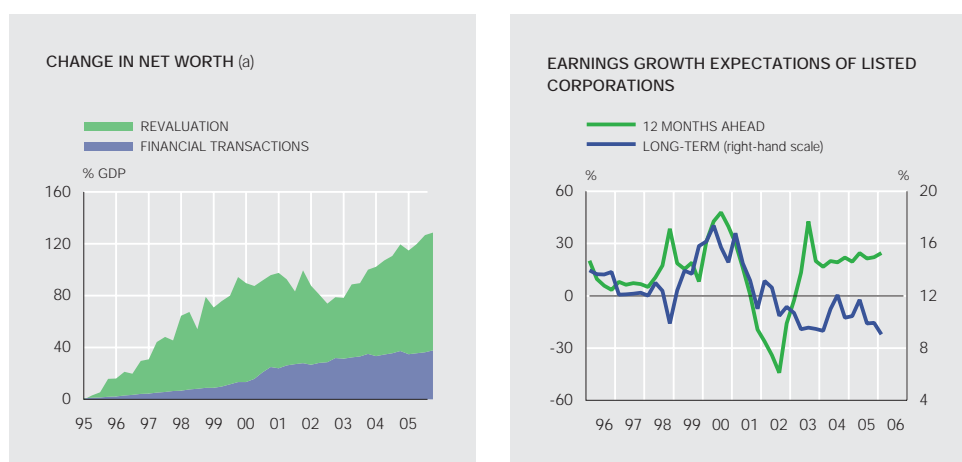
Overall, the analysis of this box shows that in 2004, the latest period for which information is available, the financial pressure on small Spanish companies was greater than that on large firms, as they had higher levels of debt, higher debt burdens and lower profitability. Moreover, the trend in the ratios analysed in the most recent period has in most cases been less benign than for larger firms. These results, together with the comparatively low level of resilience to unfavourable developments that small companies might, in principle, be expected to have, indicate that the exposure of the sector to adverse shocks in the macroeconomic environment is probably greater than indicators based on aggregate data would suggest.

which analysts were forecasting a notable improvement in short-term earnings growth (to around 20%), although there was a slight reduction in expected growth rates at longer horizons.

In short, the financial position of the sector as a whole still showed no significant signs of weakness. Thus, doubtful assets ratios remained at very low levels and even declined somewhat in 2005, there were scant changes in the credit ratings of Spanish firms that issue securities and credit risk premiums stood at moderate levels.

#### OTHER FINANCIAL INDICATORS FOR NON-FINANCIAL CORPORATIONS

CHART 5.10



SOURCE: Banco de España.

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

The solidity of firms considered together cannot hide, however, the existence of certain elements of uncertainty that need to be considered when analysing the future of their spending and hiring decisions. As in the case of households, the increase in debt has raised the sector's exposure to adverse shocks. Also, it should be noted that the indicators calculated from aggregate data do not enable the implications of the fact that the financial position varies across companies to be fully assessed. Indeed, as Box 5.4 shows, smaller companies tend to bear a higher degree of pressure. At the same time, the greater buoyancy of debt in some sectors such as construction and real-estate activities suggests that the companies in them are more sensitive to changes in variables such as interest rates and house prices.



## **1 Introduction**

This chapter of the *Annual Report*, devoted to the management of the Banco de España, is an overall summary of the most notable aspects of the institution's activity in 2005, some of which will be addressed in greater detail in the monographic reports published annually by certain departments of the Bank (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**

For the European System of Central Banks, 2005 was the first year of full functioning with the twenty-five central banks of the European Union Member States. Against this background, the institutional framework within which the single monetary policy is implemented was affected by two particularly important events.

First, the process of ratification of the Treaty establishing a Constitution for Europe came to a halt, owing to the negative results of the referendums in France and the Netherlands. Although this situation is a setback for the process of European construction, it has no direct implications for the normal functioning of the Monetary Union.

Second, the experience gained in applying the rules existing until now and, in particular, the institutional problems arising in the course of the Excessive Deficit Procedures opened against Germany and France inspired the revision of the Stability and Growth Pact, whose modification was ratified by the European Council in March. As the ECB Governing Council has been indicating, it is crucial that the new framework be applied as strictly as possible and that the countries show greater commitment to compliance than in the past.

As in previous years, the Banco de España's activity in 2005 as a member of the Eurosystem was intense. The Governor participated in the meetings of the Governing Council and of the General Council of the European Central Bank (ECB) at which, among others, decisions were taken to change official interest rates. For most of 2005 the Governing Council held monetary policy interest rates at 2%, until at its meeting of 1 December it approved a rise in such rates to 2.25%, as explained in detail in Chapters 1 and 3 of this report.

Meanwhile, an extensive group of professionals from the Banco de España participated in various committees, working groups and task forces of the Eurosystem to prepare for the taking of decisions by the governing bodies of the ECB. The Bank also participated in the Banking Supervision Committee (BSC), where work continued on preparation of the six-monthly Financial Stability Review and on the publication of the annual reports on the stability of the EU banking sector and on EU banking structures. In 2005, the BSC also published reports on banking structures in the new EU countries and on large banks' exposures to hedge funds.

In the context of the operational framework of the Eurosystem's monetary policy, the general documentation on monetary policy instruments and procedures was amended in 2005 to clarify the criteria for the eligibility of asset-backed securities for use in Eurosystem credit operations. In the past, the Eurosystem has not applied specific criteria to asset-backed securities, but has used the general tier one eligibility criterion. In order to increase the general transparency of the collateral system, amendments have been introduced defining the precise criteria to be satisfied by asset-backed securities, as well as those applicable to fixed-income instruments in general.

The Governing Council decided that bank loans will be included in the single list of collateral eligible for Eurosystem credit operations in all euro area countries from 1 January 2007, when common eligibility criteria and the Eurosystem Credit Assessment Framework (ECAF) will be implemented.

In 2005, progress was made on implementing the “Framework for the detection of counterfeits and fitness sorting of euro banknotes by credit institutions and professional cash handlers” with the adoption on 15 December 2005 by the Governing Council of a manual of internal rules supplementing the aforesaid Framework. The manual contains common rules on the testing of banknote handling machines by Eurosystem NCBs and the publication on the ECB’s website of the types of machine that have successfully passed the test.

In relation to the setting up of the new shared platform for Eurosystem payment systems known as TARGET 2, the Governing Council decided to set a date for commencement of operations of 19 November 2007. A key element in the ability to comply with the new timetable has been approval this year of the User Detailed Functional Specifications document. Also, the Eurosystem has drawn up a migration plan, which provides for the successive migration of four groups of countries to the new platform. With regard to the financing of the project, a single price structure for the basic TARGET 2 services to be applied from 19 May 2008 has been proposed. Finally, the Governing Council decided that the new system will have the same decentralised structure as the current TARGET 1 system.

### **3 International activities**

In 2005, the Banco de España continued to intensify its international presence and projection. Section 2 above referred to activity within the Eurosystem, so this section will focus on other fora in which the bank was an active participant, bilateral relations, technical cooperation with other central banks and seminars and conferences organised.

#### **3.1 INTERNATIONAL RELATIONS**

In the European Union, the Banco de España has continued to participate actively, as part of the Spanish delegation, in diverse Community working groups and committees. Notable here were the Economic and Financial Committee (which prepares ECOFIN Council meetings) and the Economic Policy Committee. The most important items on the agenda of these committees in 2005 were development of the various technical aspects of the reformed Stability and Growth Pact and implementation of the Lisbon structural reform agenda, which has also been revised.

The Bank for International Settlements (BIS) is the main centre for co-operation between central banks, so a large part of the Banco de España’s international activity takes place under its auspices. The Bank attended BIS governors’ meetings, high-level meetings (those of the Committee on Global Economy, the Committee on the Global Financial System and the Markets Committee being notable) and meetings of economists on matters of particular relevance to central banks and supervisors.

As regards banking regulation and supervision, the work carried out to prepare the new solvency rules known as Basel II should be noted. This involved the active participation of the Banco de España in the committees and working groups of the Basel Committee on Banking Supervision (BCBS), chaired by the Governor of the Banco de España.

The publication in June 2005 by the Basel Committee of the New Capital Framework (known as Basel II) did not mark the end of this work. In 2005, the Committee continued to work on the treatment of the risks included in the trading book, the treatment of so-called double default effects and the review of counterparty risk.

At the same time, the transposition of this New Capital Framework to Community law has required a twofold effort on the part of European institutions and of national supervisors and regulators, including the Banco de España, which has resulted in approval of the reform of the directives that regulate the solvency of credit institutions and investment firms by the European Parliament on 28 September 2005 and by the Council of Ministers on 11 October 2005.

Also significant was the Banco de España's participation in the important work carried out to facilitate the introduction of the new rules, both in the Accord Implementation Group (AIG) and in the committees reporting to the European institutions, in particular, the Committee of European Banking Supervisors (CEBS), chaired until January 2006 by the Director General Banking Regulation of the Banco de España. The aim is to ensure sufficient co-ordination between supervisors with responsibilities in relation to banking groups with international activity and consistent application of the new solvency rules in all countries.

The Banco de España has also participated in other work of the Basel Committee relating to accounting issues that affect credit institutions, like the publication of guidance on the use of the fair value option and a consultative document on the valuation of assets. Also noteworthy was the participation of the Bank in the work that concluded with the publication of a document with recommendations in the area of corporate governance. Meanwhile, in the Joint Forum (which co-ordinates banking, securities and insurance supervisors) work was carried out on matters relating to the outsourcing of operating functions, the management of liquidity risk and the transfer of credit risk.

Relations with the International Monetary Fund continued to be strengthened, as was the backing of the Banco de España, in close collaboration with the Ministry of Economy, for Spain's representation in this international agency. The discussions of the most relevant issues by the Executive Board and annual meetings of the IMF were supported and closely monitored. Particularly relevant in this period were the discussions of the so-called "strategic review", which aims to update the IMF's mission, organisation and operating mechanisms.

With regard to the Center for Latin American Monetary Studies (CEMLA), the Banco de España participated in meetings of its Governing Board and its Alternates Committee, as well as in various special meetings. Particularly relevant were the contributions and initiatives of the Bank in meetings for treasurers and accountants, and the organisation in Madrid of those relating to payment systems and systematisation. Also, the Bank is a collaborating member of the Association of Supervisors of Banks of the Americas (ASBA) and participates actively in its annual Assembly. In March 2006 it was proposed as an associate member.

Collaboration with the Multilateral Development Banks has been further stepped up, mainly with the World Bank, and the Inter-American Development Bank and, more recently, with the Asian Development Bank (ADB), with which various meetings have been organised and projects carried out on matters of common interest. In addition, together with the Ministry of Economy, the Bank has taken part in meetings of the Paris Club and in various working groups of the Organisation for Economic Co-operation and Development (OECD).

In parallel with its collaboration with international agencies through its active participation, referred to above, in different working fora, the Bank has continued to strengthen its bilateral relations with other central banks and banking supervisors. In this respect, high-level meetings have been held with several of them, some of which have now become regular events.

Another activity contributing decisively to the Bank's external projection is the transfer of know-how arising from the provision of international technical co-operation, which was up by 39% from the previous year. Notable here was the significant work carried out in Latin America, through the twin channels of stimulating the demand for co-operation from interested institutions and the supply of training by the Bank itself, by means of the organisation of seminars and courses. Despite being on a smaller scale, the collaboration offered by the Bank to geographically closer countries, such as the recent EU entrants and candidates for membership, Turkey, Russia and the republics of the Community of Independent States, is also beginning to be significant, although in these cases the Bank plans its activities with other central banks and supervisory agents, in projects usually co-ordinated within the Eurosystem and structured around the facilities provided by the European Union (TACIS, PHARE, CARDS, etc.)

It is also important to highlight the Bank's systematic collaboration with various bodies for the provision of international technical assistance, especially with CEMLA, the Central American Monetary Council and the International Monetary Fund, as well as the stepping up of co-operation with bodies such as the Spanish National Securities Market Commission (CNMV) and the Latin American Institute of Securities Markets. The Bank has also collaborated with the BIS Financial Stability Institute on training and support for banking supervisors from all over the world. Notable here is the collaboration on FSI Connect, an on-line training application to foster knowledge of the New Capital Framework among supervisory authorities worldwide, thereby helping to improve awareness thereof among Latin American supervisors.

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

In 2005, various international conferences and seminars were held at the Bank. This type of activity decidedly helps to boost the Bank's prestige abroad, especially in Latin America, and to disseminate its knowledge on central banking and financial supervision.

It is also important to underline the role played by this type of event in bringing Europe and Latin America closer together. In this respect, the Bank organised, together with the European Central Bank and the Central Bank of Brazil, a *High-Level Seminar*, the second of its kind to be held, which brought together the governors of most of the central banks of these areas. This seminar was preceded by a technical workshop organised in conjunction with the Bank of Portugal.

Another high-profile event was the *Eleventh LAC meets the market: Prospects for Latin American Emerging Economies*, organised jointly with the World Bank. This encounter assembled prominent representatives of the public and private sectors and academia. The main themes were the global economic and financial outlook, the challenges involved in reducing financial vulnerabilities in emerging markets and the current trends and determinants of the capacity to attract FDI of the three main emerging regions: Latin America, Asia and Eastern Europe.

Likewise aiming to bring Europe and America closer together was the *Third Seminar on Emerging Markets*, an occasion for an exchange of views, in an informal environment, on issues relating to emerging markets of common interest to European and Latin American central-bank researchers.

The Bank also organised a *Seminar on Validation of Advanced Credit Risk Models and the Basel II Implementation Process*, for Latin American supervisors. The aim was to communicate the experience of the Spanish supervisory authority in this area and to promote an exchange of views on the best way of confronting the process of transition to Basel II.



In collaboration with the CEMFI, the Banco de España also organised the XIII Foro de Finanzas, an annual congress that aims to facilitate the dissemination of financial research and interaction and strengthening of ties between researchers in the field of finance from the academic world, the official sector and business.

Other notable events organised by the Banco de España were the presentation of the reports of the IMF on international financial stability (*Global Financial Stability Report*) and of the Inter-American Development Bank on China and its impact on Latin America (*The Emergence of China. Opportunities and Challenges for Latin America and the Caribbean*), as well as the organisation of a panel of the 10th Annual Meeting of the Latin American and Caribbean Economic Association on foreign participation in the financial systems of emerging economies.

#### **4 Economic analysis and research**

In 2005, the analysis and research into the Spanish Economy and its international environment continued to be conducted by several departments of 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.

The scope of research at the Banco de España was broadened significantly in several dimensions in 2005. First, there was an increase in the number of subjects analysed, although the analysis of macroeconomic and financial factors continues to predominate. Second, the production and publication of documents with an analytical content also increased. Thus, 42 Working Papers and 7 Occasional Papers were published in 2005, while a total of 70 papers on research carried out by Banco de España staff appeared in academic reviews and specialised books<sup>1</sup>. The reviews in question included the *Journal of Monetary Economics*, *Economic Policy*, *Journal of Public Economics*, *European Economic Review*, *Economic Theory*, *International Journal of Industrial Organization*, *Journal of Banking Regulation*, *Journal of Computational Statistics and Data Analysis*, *International Journal of Forecasting*, *Journal of Finance*, *Investigaciones Económicas* and *Moneda y Crédito*.

##### **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. 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 conjunctural and structural factors that may affect the workings of the economy. Against this background, the main lines of research pursued in 2005 can be grouped into four categories: i) macroeconomic issues and monetary policy, ii) structural factors of the Spanish economy, iii) financial issues, and iv) econometric and statistical methods.

As regards macroeconomic issues and monetary policy, the lines of research pursued in previous years were maintained. These related to analysis of the effects of monetary policy under different scenarios, defined in accordance with the behaviour of economic agents and interrelations with other macroeconomic policies, and to the identification of the sources of cyclical divergences in the euro area. At the same time, the emphasis in the analysis of some of the factors that mark the recent functioning of the Spanish economy, such as the productivity slowdown, has been increased.

With respect to financial issues, priority continued to be given to the housing market and analysis of the financial decisions of Spanish households and firms, while in the international area, financial stability and factors of vulnerability in emerging Latin American countries and

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1. For further details of these publications, readers may consult the 2005 issue of the Research Memorandum of the Banco de España, available at the Banco de España's website ([www.bde.es](http://www.bde.es)).

	31.12.2005
CREDIT INSTITUTIONS	349
Banks	75
Saving banks	47
Credit co-operatives	83
Branches of foreign credit institutions	65
Specialised credit institutions	78
Official credit institutions	1
OTHER	140
Mutual guarantee and reguarantee companies	24
Currency-exchange bureaux	57
Appraisal companies	59

Asia were further analysed. A new area of analysis here was issues relating to the international financial architecture, like the evaluation of the IMF's financial facilities. As for the banking sector, research was carried out on prudential regulation and the existence of credit cycles, the role of asymmetric information and signalling in credit markets, and banking competition and integration.

#### 4.2 RELATIONS WITH THE ACADEMIC COMMUNITY

In 2005, the Banco de España continued to forge 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 at domestic and international seminars, congresses and academic conferences and is published through the profession's usual channels.

Second, the Banco de España has established several series of seminars, in which members of the domestic and international academic community participate, and organises, sometimes in collaboration with other agencies, domestic and international conferences. Last year, the Banco de España organised by itself or in conjunction with other institutions, five academic conferences, and 42 sessions were held in its economic research seminar cycles. Third, the Banco de España co-operates with the research networks organised within the Eurosystem to analyse the euro area economy, as was the case in 2004 and 2005 with the Inflation Persistence Network. Also, there are regular external visitors' and fellows' programmes to boost projects that may be considered strategic in different areas of analysis and research.

Also worthy of mention is collaboration on research and training with the Centro de Estudios Monetarios y Financieros (CEMFI), a foundation set up by the Banco de España dedicated to teaching and research in economics.

#### 4.3 DISSEMINATION AND COMMUNICATION OF ECONOMIC ANALYSIS AND RESEARCH

As mentioned above, the three main channels for the dissemination and communication of the Banco de España's research findings are the Working Paper and Occasional Paper series and the monthly Boletín Económico which, along with regular articles on the economic situation, includes summaries of research carried out or under way. In 2005, the Spanish version of the book *The analysis of the Spanish economy* (which appeared in English in 2006) was published, offering an overview of the different models and approaches used to analyse the Spanish economy. Along with these publications, the review *Estabilidad Financiera*, launched in

2001, continued to serve as a channel of communication between the Banco de España and the Spanish financial sector on issues relating to prudential regulation and supervision, and also to communicate the results of research in these areas. The *Financial Stability Report*, published in May and December 2005, analysed Spanish deposit institutions' risk, profitability and solvency developments, an additional element of complexity in the 2005 analyses being the change entailed by Accounting Circular 4/2004, which affected the comparability of the figures.

## **5. Banking supervision and regulation**

### **5.1 SUPERVISORY MEASURES**

As at 31 December 2005, a total of 489 entities were subject to supervision by the Banco de España, 349 of which were credit institutions (see Table 6.1). As the supervisor on a consolidated basis of groups that have a Spanish credit institution at their helm, the Bank is also the supervisor of 115 foreign financial institutions

Following the landmark regulatory and accounting changes arising from the adoption of the New Basel Capital Framework (which is still being adapted to Community and Spanish Law) and the International Accounting Standards in 2004, 2005 was marked by a drive to implement and adapt to these changes, which will need to be continued for several years. This work obviously concerns not just the supervised institutions, but also the Banco de España itself.

In this respect, among many other tasks, the Banco de España has had to design the procedures for approval of the credit risk models that can be used by institutions, a necessary step prior to developing the plans to implement the most innovative methodologies contained in the New Capital Framework.

The process is in practice highly complex since, beyond the indications of a general type contained in the regulatory principles, it is necessary to address a large number of circumstances relating to the quality of the data, estimation methodologies, documentation, evidence of use, etc. Also, the process should be managed in an orderly fashion, giving the participant entities reasonable certainty as to the level of the threshold that will be applied by the supervisor. The basic interest of the Banco de España is to ensure at all times that the successive steps taken by the institutions entail no prejudice to their stability or solvency. Thus, from the outset the Bank has been seeking to act with the utmost rigour, only allowing the most advanced approaches for calculating capital to be used by institutions that are genuinely ready to use them.

Implementation of the new accounting and solvency rules has also required a notable drive to expand and train the human resources assigned to supervisory tasks, whose basic working tools have been subject to significant modifications. For some time now, and especially over the last two years, the Bank has been developing a number of internal training initiatives, in addition to ordinary training, which is extensive in itself.

Supervisory activity in 2005 involved the sending of 111 recommendation and requirement letters. Of these, 110 were sent to registered entities, these being either the institutions ultimately addressed or the heads of consolidated groups, in accordance with the distribution in Table 6.2.

In addition, a letter was sent to an unregulated company which serves as a vehicle for a number of credit institutions that are its exclusive customers and shareholders, and to which it provides services that are a prolongation of its activity. Excluding that vehicle company, the letters sent to institutions supervised in the strict sense contained a total of 473 observations, relating to the matters set out in Table 6.3.

## REQUIREMENT AND RECOMMENDATION LETTERS TO SUPERVISED INSTITUTIONS

TABLE 6.2

	2005
Credit institutions	87
Banks	26
Saving banks	19
Credit co-operatives	24
Branches of foreign credit institutions	5
Specialised credit institutions	13
Other	23
Mutual guarantee and reguarantee companies	6
Currency-exchange bureaux	7
Appraisal companies	10

## SUBJECT MATTER OF LETTERS SENT TO SUPERVISED INSTITUTIONS

TABLE 6.3

Accounting for credit risk and borrower weakness	115
Quality of credit risk controls (granting and monitoring procedures, etc.)	56
Lending policies	22
Shortfall in provisions for other risks	10
Deficiencies in information reported to the CCR	19
Failure to comply with rules on transparency and customer relations	19
Capital market activities	25
Solvency coefficient	31
Breach of quantitative limits on concentration and the like	12
General quality of internal control	80
Requirements for authorisation of non-credit institutions	18
Other aspects	66
	473

As usual, credit risk, in its different forms, was the main subject of the recommendations, accounting for around 41% of the total. Notable here were the reprimands made by the Bank not so much in relation to specific risks or borrowers as to lending policies in general, and in particular, those relating to the financing of property projects in the construction phase, when the risk incurred by institutions is accentuated.

The second most common group of recommendations, albeit a long way behind the first (80 recommendations, or around 17% of the total) referred to the internal control of the entities in general. This group includes requirements to strengthen internal audit, when deemed necessary, a function long considered essential by the Banco de España and due to become even more important in the immediate future.

In 2005, it was not necessary to take any precautionary measures in relation to the supervised institutions. Meanwhile, the proceedings initiated in 2003 with the placing of Eurobank del Mediterráneo, SA under administration were successfully concluded, since there were suffi-

cient assets available to meet commitments to creditors, the outstanding debt being repaid along with the agreed interest.

## 5.2 IMPOSING OF SANCTIONS

As regards *sanctioning proceedings* initiated in 2005, 15 cases were opened against supervised institutions or individuals and 56 cases against the directors or managers of such institutions. Specifically, and with regard to the different types of institution supervised, the aforementioned 15 sanctioning proceedings were initiated against 1 bank, 1 savings bank, 5 appraisal companies and 5 currency exchange bureaux, to which should be added the 3 proceedings initiated and conducted for failure to comply with the ECB minimum reserve requirement.

The aforementioned figures show the variety of institutions against which the Banco de España brought sanctioning proceedings, reflecting the scope of the supervision duties with which the Bank is charged. As can be seen, sanctioning proceedings were initiated against practically all types of supervised institutions, ranging from credit institutions, like banks and savings banks, the entities that have traditionally been supervised, to other institutions also subject to supervision by the Banco de España, such as appraisal companies and currency-exchange bureaux.

No less important than the number of proceedings commenced is how many *sanctioning proceedings were resolved during 2005*. In this connection, in 2005 the Banco de España resolved a total of 11 sanctioning proceedings against supervised institutions and a total of 24 proceedings against their directors or senior management. As for the type of infringements found to have been committed in the proceedings resolved in this period, something that is normally directly related to the complexity of their management and conduct, the competent authorities imposed sanctions, on one hand, on supervised institutions for the commission of 5 very serious infringements, 16 serious ones and 2 minor ones and, on the other hand, on directors and senior management of the same for the commission of 14 very serious infringements and 47 serious ones. Also imposed were 3 sanctions due to non-compliance with the ECB minimum reserve ratio, 1 sanction for engaging in activities restricted to credit institutions and 1 sanction for engaging in cross-border money transfers without authorisation.

The sanctions for *very serious infringements* were applied, in the case of credit institutions, for conduct relating to resistance to inspection, and carrying out transactions without the knowledge of the intervention bodies to which a specific institution was subject. In the case of a specialised credit institution, the very serious infringement consisted of conduct defined as a serious infringement, when an unappealable sanction had already been imposed on such institution in the previous five years for the same type of infringement. Finally, in the case of a currency-exchange bureau, the conduct that was deemed to be very serious consisted of the failure to keep the legally required accounting records or keeping them with fundamental irregularities preventing the entity's net worth and financial position from being known, and the failure to report data or documentation that has to be sent to the competent administrative body in its capacity as such or the lack of veracity of such reports.

The *serious infringements* include a varied range of conduct that largely depends on the nature of the institution concerned, although a substantial number of them are closely related to the solvency of the institutions, the recording, documentation and registration of their transactions, transparency in their customer relations, reporting to the Banco de España as a fundamental element in supervisory activity and, in short, the general compliance of their activities with the law applicable.

Sanctions for *minor infringements* which, according to the provisions of Law 26/1998, cannot be imposed on directors and managers of institutions, are restricted, by their very nature, to isolated or insignificant breaches of the law that cannot be classified as serious infringements.

Finally, along with the sanctioning activity in the strict sense, and owing to the obvious links and similarities to it, this section also includes data on the initiation, processing and resolution of the *proceedings to withdraw authorisation* brought against supervised institutions. In 2005 a total of 164 proceedings of this type were initiated, consisting of 1 proceeding to withdraw authorisation to operate an appraisal company and 163 proceedings to withdraw authorisation to carry on the professional activity of foreign currency exchange in establishments open to the public, owing to inactivity of the defendants. In this respect, and to complete the information offered on the proceedings conducted in this particular area of activity, it can be said that *in 2005 a total of 284 proceedings were resolved*, of which 283 related to currency-exchange bureaux and 1 to an appraisal company. Of these, 273 resulted in a decision to withdraw the authorisation previously granted, while in 11 cases it was decided not to do so but to suspend the proceeding due to absence of the grounds envisaged in the applicable regulations.

### 5.3 REGULATORY CHANGES

As regards the organisational and disciplinary rules to which credit institutions and other financial intermediaries are subject, the relatively scant changes in the law in 2005 did not entail significant changes in the legal framework.

Among the main legal changes in the domestic arena the following are notable:

- With regard to the solvency of credit institutions, of particular importance was the establishment of a specific supervision regime for financial conglomerates<sup>2</sup>. The latter are understood to be economic groups made up of financial institutions belonging to the banking or investment services sector, on the one hand, and to the insurance sector on the other, whose activity, in consolidated terms, is significant in both sectors. This supervision regime, which replaces the one that regulated the solvency of so-called unconsolidable mixed groups of financial institutions from 1995, introduced a number of prudential requirements that must be satisfied at the level of the financial conglomerate;
- Within the prudential supervision framework, the treatment envisaged in Community regulations for credit institutions in crisis has been incorporated into Spanish law<sup>3</sup>. This treatment, which is based on the principles of competence and law of the Member State in which the credit institution has been authorised, includes reorganisation measures and winding up proceedings that differ from those, with the same name, that may be adopted by credit-institution deposit guarantee funds;
- Among the rules for protection of the market and investors, it is only necessary to highlight, for these purposes, the establishment of the structure and content of the annual report on corporate governance of savings banks that issue securities admitted to trading on official markets<sup>4</sup>.

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2. Law 5/2005 of 22 April 2005 on the supervision of financial conglomerates, amending other laws of the financial sector; And Royal Decree 1332/2005 of 11 November 2005 which implements Law 5/2005. 3. Law 6/2005 of 22 April 2005 on the reorganisation and winding up of credit institutions. 4. CNMV Circular 2/2005 of 21 April 2005 on the annual report on corporate governance and other information of savings banks that issue securities admitted to trading on official securities markets.

Along with these regulatory changes, other fine-tuning measures have modified diverse aspects of the legal framework for the financial system in order to make it more competitive. These measures include notably the adaptation of the solvency rules for credit institutions to the new accounting environment<sup>5</sup>; the assumption, under Banco de España supervision, of the management of the National Electronic Clearing System (SNCE) by Sociedad Española de Sistemas de Pago (SESP)<sup>6</sup>; the modification of the regulatory development of the legislation on the prevention of money laundering<sup>7</sup>; or the determination of future receivables that can be incorporated into securitisation special purpose entities<sup>8</sup>.

Among regulations that, although not specifically for credit institutions, nevertheless have a particular impact on them and, especially on those that issue securities listed on official markets, one should distinguish, albeit generically, those that, implementing Community law, have continued to promote the transparency and harmonisation of such markets.

Within the Community arena, 2005 was not an especially prolific year as regards financial and credit regulations. Worthy of note were only various initiatives taken in order to prevent the use of the financial system for money laundering and the financing of terrorism, and to facilitate cross-border mergers between limited-liability companies.

#### 5.4 FINANCIAL AND PRUDENTIAL INFORMATION

In 2005, Circular 4/2004 of 22 December 2004 on Public and Confidential Financial Reporting Rules and Formats came into force. This Circular regulates the annual accounts and other financial information published by credit institutions and their groups, and all the financial information that institutions are required to report to the Banco de España to enable it to perform its supervisory and statistical functions.

Institutions began to report financial information using the new formats and accounting criteria with effect from the June 2005 statements. In addition, they also had to resend particular statements relating to 2004 and to months prior to June 2005, prepared in accordance with the formats and criteria of Circular 4/2004, to facilitate data comparisons.

As was foreseeable, the changes introduced by the Circular involved significant work both for the institutions and for the Banco de España throughout 2005, since it was necessary to modify all the data-processing systems to be able to provide and verify the new information and to prepare previous statements on the basis of the new criteria. Accordingly, the rectifications to the statements in 2005 were much more extensive than in previous years, since each time an error was identified in a statement it was necessary to modify the data for previous years. Rectifications continued up to the December 2005 statements, since incorrect applications of the accounting rules were detected in audits.

Also since June 2005, a pilot group of credit institutions has begun to report all their public financial information to the Banco de España in the XBRL computer language, thereby continuing the project of gradual application that commenced in 2003 with appraisal companies. Owing to the success of this experience, the use of this language for reporting public information is being extended to all credit institutions in 2006 as a prior step to its introduction for reporting the confidential statements.

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5. Circular 3/2005 of the Banco de España of 30 June 2005 on credit institutions amending Circular 5/1993 of 26 March 1993 on the determination and control of minimum capital requirements. 6. Resolution of 30 June 2005 of the Executive Commission of the Banco de España authorising the assumption by SESP of the management of the SNCE with effect from 30 June 2005. 7. Royal Decree 54/2005 of 21 January 2005 amending the implementing regulations of Law 19/1993 of 28 December 1993 on certain measures to prevent money laundering approved by Royal Decree 925/1995 of 9 June 1995 and other provisions regulating the banking, financial and insurance systems. 8. Ministerial Order EHA/3536/2005 of 10 November 2005 on the determination of future receivables that can be incorporated into securitisation special purpose entities.



## 5.5 CENTRAL CREDIT REGISTER

The Banco de España compiles, using data from its Central Credit Register (CCR), individual information on the credit exposure of reporting institutions (basically credit institutions) to their customers. This information is used by the institutions themselves for granting and monitoring exposures and, in conjunction with the accounting statements of credit institutions, by the Banco de España itself, maintaining the confidentiality of the individual data, as a source for work connected with its supervisory and statistical functions.

As at December 2005, more than 28 million direct and indirect exposures (the latter arising from guarantees of direct exposures) were recorded by the CCR (up 9.3% from 2004), with a total amount of €2.51 billion (up 25%), corresponding to 15.7 million different borrowers (up 7%). In June 2005, data on exposures to legal persons began to be exchanged between the CCR and other European credit registers (Germany, Austria, Belgium, France, Italy and Portugal), with quarterly data being supplied from November to the reporting institutions. Finally, the Banco de España plans to publish this year, for the first time, a specific report on the CCR, which is expected to contribute to greater awareness thereof.

## 5.6 PROCESS OPTIMISATION PROJECT

In April 2005, as part of a comprehensive project that will gradually be extended to the whole of the Bank, the Directorate General Banking Regulation (DGBR) began to implement process optimisation in order to improve the service offered to other directorates within the Bank and to the general public. The first phase of the project was to identify all the essential processes used by the DGBR to achieve its objectives. The second phase, which began in September, focused on the design of different types of initiative of varying complexity to improve the quality and increase the efficiency of the processes. At the same time, a continuous improvement process was commenced, with measurement and comparison of the results achieved. Scorecards were designed for the key indicators associated with the various processes of the DGBR to measure the volume of activity by task and the quality gains achieved in the period referred to, and these form the basis for discussion by the DGBR's monthly management committee. Finally, a team was set up to co-ordinate the whole process of optimisation known as Project Office, its purpose being to ensure that the initiatives agreed are properly implemented and to promote new initiatives to ensure continuous improvement.

## 5.7 PARTICIPATION IN THE FINANCIAL SECTOR ASSESSMENT PROGRAMME FOR SPAIN CARRIED OUT BY THE IMF

In 2005, the Banco de España participated prominently in the financial sector assessment programme for Spain carried out by the IMF at the invitation of the Ministry of Economy and Finance made in early 2004. This programme, known internationally as the FSAP, applies a methodology developed by the IMF and World Bank, and vouched for by the fact that it has already been applied in more than one hundred countries. The aim is to assess the stability of national financial systems and, if possible, to increase such stability by proposing measures to remedy any weaknesses that the exercise may reveal. This assessment was made over the course of two visits to Spain by IMF missions, from 22 June to 5 July and from 2 to 14 November. These visits were preceded by periods for completion of detailed questionnaires and followed by others for the review and exchange of viewpoints and clarification of opinions gained by the members of the assessment missions, so that the exercise as a whole lasted from February 2005 to January 2006.

The Spanish legal framework grants a prominent role to the Banco de España in the three areas corresponding to the three pillars on which the stability of every financial system rests. The first pillar consists of an adequate legal and institutional infrastructure for the pursuit of financial activity. The second pillar is represented by a solid regulatory and supervisory environment for the institutions that make up the institutional blocks of the financial system, with the credit system constituting a fundamental core in Spain, in both quantitative and qualitative terms. The third pillar is an adequate set of techniques to measure and control the significant



risks that financial institutions have to manage. The identification and quantification of such risks in terms of their impact on the solidity of the system is carried out through various types of stress test performed on institutional blocks and individual institutions that are systematically significant. The individual results of these tests are adequately protected in all cases.

Reflecting the foregoing, the Bank has played a central role in three of the seven international codes of good practice whose observance was assessed in the FSAP for Spain: the core principles for effective banking supervision, core principles for systematically important payment systems and the responsibilities of the central bank in their application, and the code of good practices on transparency in monetary and financial policies. It has also collaborated in the assessment of three of the other four: objectives and principles of securities regulation, recommendations for securities settlement systems and anti-money laundering and combating the financing of terrorism. At the same time, it has helped to define and has performed stress tests for the system of credit institutions as a whole and has co-ordinated those carried out by individual institutions, subsequently aggregating the results. Finally, it supported the realisation and participated intensively in the discussion of the results of four of the five technical notes prepared by the IMF mission, on housing prices, household debt and related risks, on the non-financial equity investments of credit institutions, on the regulation and governance of savings banks and on stress testing.

## **6 Operational functions**

### **6.1 MANAGEMENT OF THE BANCO DE ESPAÑA'S ASSETS**

Central banks are responsible for the implementation of monetary policy. In the euro area, this function is performed in a co-ordinated fashion by the European Central Bank and the national central banks; the former takes the monetary policy decisions and the latter formalise the related liquidity-providing operations with the credit institutions within their spheres of competence. The average amount extended under lending transactions by the Eurosystem to Spanish institutions was €28,584 million in 2005.

The demand for euro banknotes continued to expand in this period, leading to an increase in the size of the balance sheet, with an increase in euro-denominated investments on the assets side. In addition, 65.6 tonnes of gold were sold in 2005, within the terms of the Central Bank Gold Agreement, the proceeds also being invested in euro-denominated bonds. As a result, the average balance of the euro-denominated fixed-income portfolio reached €40,668 million. The holdings of foreign currency assets remained at similar levels to those at end-2004, the average balance in 2005 being €9,556 million.

Other non-manageable assets, such as intra-Eurosystem accounts and the general government debt in euro, which in the past represented a significant part of the Bank's balance sheet, continued to decline. In the case of the intra-Eurosystem accounts, very significantly, since the net balance has turned negative (net liabilities instead of net assets), while debt in euro, which continues to be repaid annually, declined as a proportion of the balance sheet total.

As at 31 December 2005, manageable assets in euro, foreign currency and gold totalled €65,250 million.

### **6.2 MANAGEMENT OF PAYMENT SYSTEMS**

The process of reform of the Spanish payment system was concluded in 2005, the result being that it is currently structured around two systems: the Banco de España Settlement Service (SLBE) for large-value payments and the National Electronic Settlement System (SNCE) for processing retail payments.

The Banco de España directly manages the SLBE, which is a real-time gross settlement system and one of the components of the TARGET system, the operational mainstay of the Euro-

pean System of Central Banks. As a consequence of the reform referred to and of the absorption of a significant number of wholesale payments that were previously managed by the SNCE, the number of transactions increased by more than 60% in 2005, to almost 8 million, with a total amount of more than €80 billion.

As for the SNCE, the most significant event was finalisation of the transfer of powers relating to the management of the system from the Banco de España to Sociedad Española de Sistemas de Pago (SESP, SA), a new company owned by the participants. The Banco de España, in accordance with the provisions of Law 41/1999, is charged with oversight of the system, and has the power to authorise its rules. In 2005, the SNCE processed a total of 1,277 million transactions initiated with diverse payment instruments, principally direct debits, transfers, cheques, promissory notes and trade bills. The amount settled totalled €1.7 billion.

As an integral part of the Eurosystem, the Banco de España continued to participate during 2005 in the work to develop TARGET 2, the new generation of the current TARGET system, which is planned to come on stream in the final quarter of 2007. The migration of the Spanish banking community to TARGET 2 is planned for 2008 Q1 (see Section 2).

With regard to retail payments, work continued at the Community level to set up a Single Euro Payments Area, for which two main milestones have been established. The first is January 2008, when pan-European payment instruments will be available to European citizens, alongside the national ones, to carry out their transactions. The second milestone, which will mean the culmination of the project in late 2010, will involve most retail payments being made with pan-European instruments and the existence of full operational compatibility between the various infrastructures dedicated to the processing of this type of transaction.

#### 6.2.1 Payment system oversight

Given that the oversight of payment systems is an important tool in promoting their smooth operation, the Banco de España has considered it appropriate to publicise its functions and responsibilities in this area. Accordingly, in 2005 the Bank published a document on the legal mandate that assigns these responsibilities to the Banco de España, with details of its objectives, its scope of application and the instruments available to the Bank to carry it out.

Notable among these instruments were, first, the application of international standards, principally those of the BIS and the IMF, owing to their great usefulness for comparing the solidity and efficiency of payment systems and, second, co-operation with other institutions, both at the national and international level. In this respect, the Protocols signed for co-operation and information exchange under normal circumstances and in crisis situations are particularly important.

In 2005, in addition to its regular monitoring of Spanish payment systems, the Banco de España carried out a comprehensive analysis of the SLBE, completed the assessment of the SNCE that it began in 2004 and published a report on recent developments in the market for bank payment cards. In order to make its oversight more transparent, the Bank intends to prepare regular reports detailing the activities carried out in this area, and the most notable events and developments with regard to national payment systems.

#### 6.3 BANKNOTE MANAGEMENT

As an integral part of the Eurosystem, the Banco de España issues euro banknotes and also withdraws them from circulation. In 2005, the Banco de España delivered 1,834 million banknotes, up 9% from the previous year. At the same time, the number of notes deposited with the Bank grew by 9% relative to the previous year, to 2,038 million.

At the beginning of the year, the Banco de España set up an ancillary network for depositing banknotes distributed throughout the national territory, where credit institutions can obtain and deliver banknotes. It is called “ancillary” because it supplements the cash service provided by the Banco de España through its own branches. This system collected 318 million notes during nine months, contributing positively to the number of banknotes deposited with the Bank, which facilitates the control of circulation and enables their quality to be improved.

In overall terms, especially in the case of the €10 and €20 denominations, there continued to be a net deposit of notes, which translated statistically into a “negative net issuance” determined by two factors whose intensity was sustained: the relatively higher growth of €500 banknotes and the deposit of notes generated by tourism (migration).

In 2005, more than two billion banknotes were handled at the Bank, an increase of 5.4% with respect to the previous year. Of these, 830 million were destroyed in view of their damaged condition, 27% more than in the previous year, leaving 1,170 million ready to be returned into circulation. The destruction figures are rising significantly in Europe, and Spain is now the second largest destroyer, in terms of relative importance. The policy of improving the quality of low-denomination banknotes and the reception of foreign banknotes in poor condition are the two factors that help to explain Spain's high rate of destruction.

The Banco de España carried out various actions that affected the general public: a) it continued its efforts to improve the quality of the €5 banknote, collecting banknotes in poor condition, so that there was a significant improvement in the quality of the banknotes in circulation; b) the opening hours of the Bank's counters were extended; and c) the channels of communication with the public have been improved, with information on cash being published on the Bank's website.

With regard to coins, the Banco de España places into and withdraws from circulation euro coins issued by the Spanish state, acting as its financial agent. In 2005, on behalf of the Treasury, it placed 1,637 million coins into circulation and withdrew 187 million from circulation. There was an increase in the net circulation of all the denominations (1,450 million coins), but the overall net positive issuance represented a slightly lower percentage than in the preceding year.

The first commemorative €2 coin was issued in 2005, in honour of Miguel de Cervantes, to commemorate the fourth centenary of the first edition of his best-known work, *Don Quixote*. The production of 8 million coins was approved.

In 2005, 1.6 million peseta banknotes with a value of €47 million were exchanged. This represented a decline relative to 2004 of 37%, in terms of the number of notes, and of 34% in their amount. Also, 23 million peseta coins with a value of almost €5 million were exchanged. In this case, the decline relative to 2004 was 37%, in terms of the number of coins, and of 27% in their amount.

## **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 [the Spanish National Securities Market Commission (CNMV), and the Spanish Directorate General of Insurance (DGS)]. The statistics compiled and disseminated under the National Statistical Plan (2005-2008) are the Balance of Payments and the International Investment Position, the Financial Accounts of the Spanish Economy, the Survey of Household Finances and Public Debt according to the Excessive Deficit Protocol (EDP). 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 based on questionnaires completed voluntarily by the reporting firms. The aforementioned statistics are published in the *Boletín Estadístico*, in monographic publications and on the Bank's website.

The foregoing does not fully define the statistical function of the Banco de España. The Bank's services not only prepare statistics, i.e. compile by means of specific circulars addressed to the units subject to its supervision (and by means of access to accounting and administrative records generated by the Bank in the performance of the functions that it has been assigned) the information that is used to produce statistics, but also use statistics produced by other national (INE, IGAE, ministries, CNMV, DGS, etc.) and international agencies and supervisors. In some cases, they use these statistics to complete their studies on the financing of the various institutional groupings (e.g. public debt statistics for the purposes of the Excessive Deficit Procedure), but generally the aim is to make this information available to the Bank's own analysts and other experts, 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, the OECD, etc.] and in the maintenance of databanks and databases, which make it possible to study the changes over time in all the variables.

## 7.2 MAIN CHANGES INTRODUCED DURING 2005

In 2005, the statistics for which the Banco de España is responsible were updated in accordance with normally accepted quality levels and the data released on pre-announced dates, in accordance with a calendar that began to be published on the Bank's website in May 2005. Each of the updates referred to incorporates the methodological changes and improvements outlined in the related publications.

### 7.2.1 Monetary and financial statistics and financial accounts

In relation to the statistics collected within the framework of the National Statistical Plan, the following work was carried out in 2005:

1. Publication, in accordance with the pre-established calendar, of the Quarterly Financial Accounts of the Economy and other accounting aggregates and monetary and financial indicators for which the Banco de España is the source.
2. Commencement of the data-collection work for the 2005 Survey of Household Finances. This survey, which is the only statistical source in Spain that enables the income, assets (financial and non-financial), debt and spending of each household unit to be related, is by nature non-periodic, and the 2005 survey is the second to be performed (the first related to 2002).
3. Dissemination of data for Public Debt according to the Excessive Deficit Procedure. In the January 2005 issue of the *Boletín Estadístico* data series began to be published for the debt of municipalities with more than 500,000 inhabitants, and in the September 2005 issue for the debt of the public enterprises of each regional (autonomous) government.

As regards the work carried out within the ESCB and monetary and financial statistics in general, the following should be noted:

1. The start in 2005 of the second phase of the establishment of the Centralised Securities Database (CSDB), which will provide individual information on the most important features of all the securities issued by the various institutional groupings of the EU countries and of those that are most heavily traded on international markets issued by residents in third countries.
2. Also within the ESCB, resources were dedicated during 2005 to the preparation of the new ECB guideline on other financial intermediaries (OFIs) and work began on the regular production of statistics for this sector.
3. In the December 2005 issue of the *Boletín Estadístico* information began to be published on the activity and accounting statements of appraisal companies inferred from data compiled by the Banco de España on the basis of CBE 3/98.

#### 7.2.2 Balance of payments and international investment position statistics

The main changes in this area were as follows:

1. The revision of the 1995-2004 balance of payments series, in co-ordination with the change in the National Accounts base year. This revision involved improved measurement of certain foreign trade transactions, tourism and services relating to goods transport, the inclusion for the first time of the undistributed profits of direct investment enterprises and a more correct distinction between current and capital transfers. As a consequence of these revisions, the net errors and omissions figure in the balance of payments was reduced significantly in all the years of the revised period.
2. The publication, for the first time, of quarterly data for the disaggregated services headings of the balance of payments and for their geographical breakdown by main counterpart countries and areas.
3. The signing of a collaboration agreement with the Directorate General for Trade and Investment of the Ministry of Industry, Trade and Tourism in March 2005, which has led to an increase in the quality of the direct investment data and, specifically, the correct assignment to the direct investment heading, in all the tables of the balance of payments, of non-residents' transactions for the acquisition on the stock exchange of shares representing more than 10% of the capital of Spanish companies. Previously, these transactions were included in portfolio investment and were only reassigned to direct investment in a memorandum table containing quarterly data in the annual publication.
4. The increase in the breakdowns of balance of payments data by geographical area and by sector of activity and the publication, for the first time, of a geographical breakdown of the international investment position in the annual publication on the Spanish Balance of Payments and International Investment Position.

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

The CBSO continued to collaborate in 2005 with Asociación XBRL España in relation to accounting taxonomies and on the introduction at the national and international level of the new International Accounting Standards (IAS), a subject connected with the adoption of the XBRL language and linked to the efforts that the Bank is making basically vis-à-vis the credit institutions that send it their accounting statements. In addition, work continued on databases managed by the CBSO, with specific improvements in the definition of debt ratios, in the calcula-

tion of the discount rate used to estimate the market-price value of unlisted shares in the Financial Accounts of the Spanish Economy, etc. Finally, the annual (CBA) and quarterly (CBQ) databases, which depend on the voluntary collaboration of firms, are now regularly based on completed questionnaires received from more than 8,500 medium and large-sized firms [whose gross value added (GVA) exceeds 30% of the total GVA of the sector] and from more than 800 large firms (with a coverage of close to 15%), respectively. The database with data on small firms supplied to the CBSO by the Mercantile Registries is now based on consistent data for more than 300,000 firms (a coverage of around 12%).

### 7.3 STATISTICAL EFFECTS OF THE CIRCULAR (CBE 4/2004) ON PUBLIC AND CONFIDENTIAL FINANCIAL REPORTING RULES AND FORMATS

The new accounting circular CBE 4/2004, which came into force in 2005, regulates (as Circular 4/1991 did previously) the information that credit institutions are required to send to the Banco de España for statistical and supervision purposes. The data compiled pursuant to this Circular constitute a basic source for all the statistics of the Banco de España that incorporate, directly or indirectly, information on credit institutions, except for balance of payments and interest rate statistics. Data collection, in the case of the latter two types of statistics, is regulated by specific circulars that were not amended in 2005. CBE 4/2004, issued in December 2004, required information from June 2005, the date on which more detailed information adapted to the IAS became available on the balance sheet of monetary financial institutions. For the changes in the accounting regulations, see section 5.4.

## 8 Complaints Service

In 2005, the Complaints Service was significantly modernised and streamlined. First, the statistical information included in its annual report was improved, with a greater breakdown of information and a more complete financial analysis.

In addition, as part of the Bank's efforts to improve users' knowledge of financial services and their rights and obligations in relation to the purchase of such products, a space was created within the Banco de España website containing useful information on the procedure for making a complaint, the subjects in relation to which most complaints are made, with the opinions of the Service and up-to-date information on the queries and questions that are most frequently received.

The functions traditionally performed by the Service were reorganised, with an increase in their content. They include the resolution of enquiries (commenced in 2004), the compilation of new statistics for subsequent publication in the Service's annual report, the provision of information and the compilation of the Service's views on matters that form the basis of complaints for dissemination through the Banks' website.

Enquiries and suggestions can now be made online. Two mail boxes have been created for this purpose, which can be accessed through the Banco de España website. Telephone enquiries, meanwhile, increased sharply thanks to technical improvements in the switchboard that have improved the service offered.

Work continued on the simplification of internal procedures to reduce still further the time of response to enquiries, complaints and claims. A new computer program has been designed for this purpose which will allow the processes to be fully automated in 2006.

In the international arena, the Service's work was of additional importance in 2005, since it formed part of a working group set up by the members of the FIN-NET network (of which Spain is a founding member) with the task of reviewing the work of the network and taking the measures necessary to facilitate the promotion and development of its work of settling cross-border banking and insurance disputes within the European space.



There was an increase in the number of complaints received largely as a result of the growth in and greater complexity of the market for financial products, and of the larger number of institutions operating therein. Most notable was the continuing rise in complaints in relation to fees, commissions and expenses, a trend that was already apparent in 2004. For the first time, complaints relating to deposit transactions exceeded those relating to lending, which have traditionally given rise to most complaints. This was because of the larger number of complaints relating to the profitability of new banking products, and of the growing weight of bank fees and commissions in consumers' disposable income in 2005.

Complaints relating to the robbery, theft and fraudulent use of credit and/or debit cards continued to increase, with those relating to card duplication becoming particularly significant. Complaints and claims relating to bank fraud perpetrated via the internet are also beginning to be seen, with the use of systems to illegally obtain personal passwords giving access to online banking, which are subsequently used fraudulently. Finally, the growth in the relative weight of claims and complaints against savings banks vis-à-vis those against commercial banks continued, owing to the increasing similarity between these two types of institution as regards the products they offer, and to the charging of new or higher fees or commissions for services traditionally offered by savings banks free of charge or at lower rates.

## **9 External communications**

The Banco de España, as an institution belonging to the ESCB, with functions defined by the Law of Autonomy, applies a communications policy that aims to inform Spanish society of its activities and objectives, in order to ensure confidence in the institutions and financial system as a whole. The importance of information in the so-called knowledge society requires each institution to develop a communications policy as one more management tool. In this respect, communications for the Banco de España are the necessary complement to its obligation to perform the functions assigned to it by the legal framework and its membership of the ECB.

### **9.1 MEDIA RELATIONS**

Within the communications strategy established by the Bank, its media relations in 2005 had the basic objective of improving information professionals' knowledge of its activities, with particular emphasis on the impact of two important legal developments that attracted most media attention: the practical application to the banking sector of the new international accounting standards and the future implementation of the New Capital Framework, known as Basel II.

Against this background, the economic and financial training programme for journalists continued with numerous informative meetings, in which it was sought to combine explanation of the work of various departments of the Bank with other topical issues that aroused the interest of the media, relating to the financial system, the Spanish economic situation in the context of the euro area and international economic developments.

In 2005, there continued to be a high demand for news from international media specialising in banking supervision and regulation. The Governor granted 11 interviews to international publications to explain the progress made in implementing the New Capital Framework and the functioning of the Spanish financial system.

Also, other representatives of the Bank gave a total of 18 interviews to the media (mostly national and regional) on various topical matters.

Along with the dissemination of the Bank's regular publications, the public speeches made by its management and, especially, the Governor's regular appearances before Parliament (in June and October) and the Senate (November) were once again a fundamental channel for

communicating the institution's views on the economic situation and the financial system. In 2005, the members of the Bank's governing bodies participated in more than 80 national and international fora, most of which were widely covered by the media.

The events organised by the Bank in collaboration with various international agencies also received significant media coverage.

Finally, the plan for communication through the branch network, which seeks to extend the Bank's communications activities to all its establishments and to promote relations with local and regional media, was approved in July. Under this plan, the 22 branch managers have given 15 interviews to the local press, have organised numerous school visits to their branches and have actively participated in the simultaneous presentation throughout Spain of the ECB's educational materials on price stability (see Section 9.3).

## 9.2 INSTITUTIONAL COMMUNICATIONS PROGRAMME

In 2005, the Banco de España's institutional communications programme focused on two basic projects: the implementation and monitoring of the new visual identity and the preparations for the 150th anniversary of the name Banco de España, which is being celebrated in 2006.

The Bank worked hard during the year to consolidate its new institutional image. New devices continued to be designed and those already existing adapted to the Bank's new graphic identity. Also, a manual of the visual identity of the Banco de España was compiled, this being the first time that the institution has had an asset of this kind. In all, 60 new projects were implemented. As part of the strategy of establishing the new image of the Bank, training sessions were held to inform employees of the new developments in the visual identity, which a large proportion of the staff attended voluntarily.

As regards the 150th anniversary, the Communication Department developed a specific image for the various events planned: two exhibitions, one on the building and the other on the history of the Banco de España; the issuance of a commemorative stamp; the opening of the new extension designed by Rafael Moneo; an international conference on the role of central banks in the 21st century that will assemble in Madrid the highest-level representatives of numerous international institutions, and a concert in honour of the Bank's staff. Also worth mentioning is the project developed in collaboration with IBM and the Complutense University of Madrid to set up a virtual classroom on financial and monetary stability aimed at young people, to be launched in September 2006, along with a competition for upper secondary students.

As part of the process of making the Bank more accessible to the public, the book on the history of the Bank was republished and a booklet entitled "*Bienvenido al Banco de España*" (Welcome to the Banco de España) was prepared, which seeks to improve citizens' knowledge of the nature, functions and internal organisation of the institution.

Two glossaries on the monetary policy of the Eurosystem (one brief and the other more extensive) were republished in 2005. These informative publications were distributed to 6,300 secondary schools, to the members of the *Colegio de Economistas* (Economists' Association) and of the *Asociación de Periodistas de Información Económica* (Economic Journalists' Association), to business schools and to university and economics and business studies faculty libraries.

In addition, in close collaboration with the Cash and Issue Department, preliminary studies have been carried out for conducting a survey on notes and coins. Also in relation to banknotes, the Communication Department designed the materials (posters and stickers) for a campaign



to preserve the condition of lower denomination banknotes, launched by the Cash and Issue Department in collaboration with the financial sector.

The programme of institutional visits to the Bank's building was continued, with numerous representatives of the media, universities, business and public institutions participating in 2005.

### 9.3 THE BANK CUSTOMER'S PORTAL

The bank customer's portal, an initiative that involved a large amount of work in 2004 and that is intended as an instrument for the Banco de España to maintain direct contact with bank customers, was launched on 28 February 2005.

The objective is to inform and guide non-business bank customers on certain basic practical elements of their relationship with credit institutions and other supervised entities, also informing them of the role played by the Banco de España in those aspects of its concern linked to such relationship, the limits of these functions and the role of the public authorities in this area.

The portal has a home page, which includes a brief description of its objective, a contents area and various tools and ancillary areas, notably an e-mail address for enquiries regarding the portal's content.

The contents area is divided into eight sections, on supervised institutions, banking products, interest rates, fees, complaints and claims, customer rights, deposit guarantees and the Central Credit Register. Notable here is the detailed description of the features of the most common banking products, ranging from mortgage and personal loans to sight deposits, via typical services such as cards and transfers.

In 2005, the team responsible for the portal published 30 notices on issues considered of interest to bank customers, various statistics (such as the average amounts of the most common fees), new features of the simulators and comments on card fraud and on legal decisions on abusive clauses in banking contracts; the risks of variable-rate mortgage loans; debt-consolidation offers made by non-bank intermediaries; express credit offers; and new types of bank deposit.

The first ten months of the portal can be considered to have been a great success. Without any publicity other than its public presentation the number of hits (480,060) and enquiries received by e-mail (1,172) indicates extensive awareness of its existence. Also, the printed media have frequently reported news or articles published on the portal.

### 9.4 CO-OPERATION WITH THE ESCB

In 2005, the Banco de España engaged in numerous communication activities connected with its membership of the European System of Central Banks. Besides contributing to the definition and implementation of the Eurosystem's communication strategy through its participation in the External Communications Committee and publishing ECB notes and statements on its website, it has carried out various initiatives that come within the Eurosystem Communication Plan.

In December, the project "Price stability: why is it important for you?" began to be distributed to around 7,000 Spanish schools. This is an educational project designed by the ECB to raise awareness among European secondary school students of the importance of price stability. The Banco de España organised simultaneous presentations of the informative materials to the press and educational authorities in all the regions of Spain. The Bank also arranged the translation and adaptation of these materials to the co-official Spanish languages.

Finally, the Banco de España co-operated with the ECB in organising the ceremony to award the 2004 Germán Bernácer Prize to Stephanie Schmitt-Grohé an economics professor at Duke University, North Carolina (USA).

## **10 Internal organisation and administration**

### **10.1 HUMAN RESOURCES POLICIES**

The restructuring that began in 2002 with the agreement on branch closures and voluntary early retirement was concluded in 2005, the Bank's total workforce having been reduced by around 15%. Along with this reduction, there has been significant workforce renewal, both in terms of the number of employees and in their qualifications. 118 new employees were hired in 2005, of which 78% are performing specialised tasks. The proportion of female staff has increased, especially among university graduates, with an increase of 7.8% from the previous year. The total staff as at 31 December was 2,642 employees, the most highly qualified group accounting for 54% and women 35%.

The Human Resources and Organisation Department participated very actively in various international working groups that aim to implement the Eurosystem's strategic intents and organisational principles, both in the performance of their duties by the employees of the Banco de España, and in the area of co-operation between National Central Banks and co-ordination of their activities. Domestically, work was done to promote good governance, with the establishment of more effective and efficient work structures and methods. At the European level, work continued on co-operation projects to develop specific functions, so as to capitalise on synergies and avoid the duplication of resources in the organisational sphere.

In relation to training and human resource development, in addition to the usual activities of recent years, a number of seminars began to be held on the internal operation of the Bank, in order to enhance employees' knowledge of the main activities carried out by the different departments, and to promote co-operation between them. In addition, in order to make it easier for the employees concerned to present such seminars, a cycle of training courses was commenced, in which they were instructed how to give their talks and how to develop their skills in this area.

One of the actions taken in 2005 to make training more accessible to a larger number of employees was the introduction of blended learning. This combines computer-assisted learning with support channels for resolving queries and face-to-face sessions. When the new *Circular 4/2004 on Public and Confidential Financial Reporting Rules and Formats* came into force, its content was made available to Bank employees using this tool, with an online course involving face-to-face support and telephone assistance.

With regard to skills training, a number of actions were commenced to improve the quality of attention given to members of the public and businesses that come into contact with the Bank, the first phase concentrating on the activities of the Central Balance Sheet Data Office. Also, the specific content of each individual training plan for High-Potential Specialists began to be implemented, through attendance at seminars, courses and master's degrees at universities and prestigious institutions, and working visits to national and international agencies.

### **10.2 ADMINISTRATION AND PROPERTIES**

Work on the new building that will complete the Bank's headquarters complex in Madrid continued to plan, so that its opening remains scheduled for the first half of 2006.

Renewal and updating of the Bank's buildings continued in 2005. Work extended to the general installations and the specific security and fire-prevention installations, the garages for cash-transit vehicles, and the modernisation of working areas, with the introduction of open-plan arrangements.

Various rooms were equipped with complex audiovisual installations in 2005. As a result, in 2006 the Bank will have four rooms in which videoconferences can be held, both between the two Madrid buildings and with the outside world.

The landmark Madrid building saw the commencement of the second phase of complete restoration of the zinc roofing and other singular refurbishment work, such as the cleaning and restoration of the stained glass windows of the imperial staircase and the facade.

#### 10.3 DISSEMINATION OF THE BANK'S HISTORIC HERITAGE

The Banco de España is an institution with a long history and tradition. As a result, it has built up over time an invaluable historic and artistic heritage, on account of the foresight of its managers in conserving its documents and other property.

In response to the social trend for cultural activities to multiply, the Banco de España is opening its doors to allow the public access to its cultural heritage. As a result of this policy, and harnessing new technologies, the Bank has undertaken the project of digitalising its most important documents, so as to facilitate access to them by researchers and experts and the general public, while preserving at all times their physical integrity and state of conservation. So far, the minute books of the Banco Nacional de San Carlos corresponding to the period 1782 to 1828 have been digitalised and may be consulted by computer. This is the oldest complete collection of a commercial company's minute books to have been preserved.

In order to facilitate their consultation and dissemination while preserving their state of conservation, the Bank's collection of Spanish banknotes, corresponding to the period from 1783 until the peseta ceased to be legal tender in Spain, has also been digitalised. The collection is made up, in many cases, of unique items. It includes banknotes issued on Spanish territory by all banks of issue, as well as local issues made during the Civil War.

Finally, the bank has undertaken the publication of a complete catalogue of its collection of Spanish banknotes. It consists of three volumes, of which two have already been published, corresponding to the periods 1874-1939 and 1940-2001, and includes all banknotes issued, even notes that were never put into circulation, some proofs for notes that were never actually manufactured and a selection of currency issued during the Civil War.

#### 10.4 CORPORATE DOCUMENTARY MANAGEMENT

In 2004, the Banco de España began the ambitious project of modernising the treatment of documentation by its administrative units, through the introduction of a corporate documentary management system. This is a global project, to create a new, modern, unified, corporate environment, the ultimate purpose of which is to simplify the institution's working processes and increase efficiency.

In 2005, the preparatory work of defining the model and searching for appropriate solutions was completed, and the new system was introduced in the pilot units. Initial introduction in the pilot units, in which diverse and complex types of documents were selected in order to cover a very broad range, will enable the model, having been tested, to be extended to the rest of the Bank's administrative units within a reasonable period of time, despite the diversity of documentary activities carried out within the institution.

#### 10.5 INFORMATION SYSTEMS

The year 2005 saw intense activity in the information systems and processes area, with completion of the third year of the information systems Master Plan. This plan, which began to be implemented in 2002, has involved 300 projects in all areas of the Bank.

Notable among the projects in the IT administration and security area was the launch of the corporate PKI (identification key), the purpose of which is to lay the technological foundations for business processes to be able to incorporate new security elements, such as electronic signatures and encoding. The design of this PKI took into account all the requirements necessary to generate a recognised electronic signature, defined in Law 59/2003 on electronic signatures, so that the electronic signatures generated using the Banco de España's PKI infrastructure are, for legal purposes, fully equivalent to written signatures.

As regards user management, work continued on the constant improvement of the user help desk and new controls were incorporated to improve problem monitoring. The total number of incidents handled was 28,366.

The programme of donating obsolete computer hardware to employees and NGOs also came into operation in 2005. A total of 189 computers and 135 monitors were given away.

Among other activities in the area of new technologies, e-learning (training using the Network) was experienced at the Banco de España for the first time, in connection with Circular 4/2004.

Among the activities relating to management systems, the transfer to Iberclear of the Spanish public-debt book-entry system (CADE) was completed, marking the successful culmination of a complex job that took more than four years. Also work began to adapt the Bank's applications to TARGET 2, the most significant part of the definition of functional requirements having been concluded.

In relation to the exchange of financial information based on the XBRL language, an ambitious project was undertaken with 7 large financial institutions for the transmission of 8 public financial statements (individual and consolidated).

With regard to statistical information, regular use of the data warehouse system to compile the balance of payments commenced, significant work was undertaken on the Central Credit Register, involving the introduction of new automated systems for the management of borrowers and exposures, and data exchange with other European registers and substantial progress was made in redesigning the Central Balance Sheet Data Office. As regards supervision, work focused on the new system for integrated management of supervisory activity and on the new infrastructure for data centralisation and software distribution for the Directorate General Banking Supervision.

In relation to infrastructure and technology, the project of changing the database of the central computer that supports critical bank applications was commenced, to avoid future technological risk. A disaster recovery solution has been developed for the distributed environments, Windows and UNIX platforms, which are increasingly important to the Bank, for the event that one of the two data processing rooms is out of operation. Also, the development and pilot phase of communication with financial institutions in relation to payments systems, the ECA project, which makes extensive use of the SWIFTnet network and navigator presentation, has been completed.

Finally, a framework for the comprehensive management of operational risk in the Bank to ensure operational excellence was defined and implemented in two departments. The chairmanship, jointly with the Federal reserve, of an international working group on operational risk, made up of 18 central banks from all over the world, is especially important in this framework. Other focal points have been the design and implementation of the Banco de España Business Continuity Plan.

The aim of internal auditing, according to the Statute approved by the Executive Commission on 28 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 (DAI), which reports directly to the Governor and, by delegation, to the Deputy Governor. In addition, the DAI must afford the Governing Council Audit Committee all such assistance as it may request and provide it with any information it may need.

The DAI and its audit staff shall adhere to the principles of objectivity, impartiality, confidentiality and the absence of conflict of interests, 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 DAI's audit activity is subject to an Annual Plan approved by the Governor/Deputy Governor, and reported to the Executive Commission. Under the Plan for 2005, the main audits performed by the DAI related to the following: the annual accounts of the Banco de España; the report envisaged in Law 44/2002 on financial system reform measures; logistics operations with euro banknotes; counting the strategic reserves deposited by the European Central Bank; the system for monitoring banknote counterfeiting; the ESCB teleconference system; the Cebamail system (secure e-mail); the security policies for ESCB information systems; the functioning of the exchange rate mechanism in Stage Three of EMU; compliance with the Eurosystem definition of the segregation of functions in monetary policy operations; statistical information systems; and inspection of the Palma de Mallorca, Badajoz, Murcia, Ceuta, San Sebastián, Pamplona and Logroño branches.



## 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 29 of the Bank's internal rules and 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 2004 are given solely for comparison with 2005. 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 2005. 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 the preceding sections.

# 1 Balance sheet and profit and loss account

## BALANCE SHEET OF THE BANCO DE ESPAÑA AS AT 31 DECEMBER 2005

(EUR m)

	NOTE NUMBER	2005	2004
<b>ASSETS</b>			
<b>1. Gold and gold receivables</b>	<b>1</b>	<b>6,399.79</b>	<b>5,410.70</b>
<b>2. Claims on non-euro area residents denominated in foreign currency</b>		<b>8,192.89</b>	<b>9,035.87</b>
2.1. Receivables from the IFM	2	1,067.17	1,540.94
2.2. Balances with banks and security investments, external loans and other external assets	3	7,125.72	7,494.93
<b>3. Claims on euro area residents denominated in foreign currency</b>	<b>4</b>	<b>2,331.17</b>	<b>440.56</b>
<b>4. Claims on non-euro area residents denominated in euro</b>		<b>1,926.30</b>	<b>1,287.25</b>
4.1. Balances with banks, securities investments and loans	5	1,926.30	1,287.25
4.2. Claims arising from the credit facility under ERM II		—	—
<b>5. Lending to euro area credit institutions related to monetary policy operations denominated in euro</b>	<b>6</b>	<b>31,930.55</b>	<b>23,408.39</b>
5.1. Main refinancing operations		29,377.70	20,723.01
5.2. Longer-term refinancing operations		2,552.72	2,684.45
5.3. Fine-tuning reverse operations		—	—
5.4. Structural reverse operations		—	—
5.5. Marginal lending facility		—	—
5.6. Credits related to margin calls		0.13	0.93
<b>6. Other claims on euro area credit institutions denominated in euro</b>	<b>7</b>	<b>3.82</b>	<b>4.48</b>
<b>7. Securities of euro area residents denominated in euro</b>	<b>8</b>	<b>46,401.37</b>	<b>28,044.91</b>
<b>8. General government debt denominated in euro</b>	<b>9</b>	<b>7,979.12</b>	<b>8,541.93</b>
<b>9. Intra-Eurosystem claims</b>	<b>10</b>	<b>17,425.78</b>	<b>32,286.36</b>
9.1. Participating interest in ECB		432.70	432.70
9.2. Claims equivalent to the transfer of foreign reserves		4,326.98	4,326.98
9.3. Net claims related to the allocation of euro banknotes within the Eurosystem		—	—
9.4. Other claims within the Eurosystem (net)		12,666.11	27,526.68
<b>10. Items in course of settlement</b>		<b>0.85</b>	<b>0.97</b>
<b>11. Other assets</b>		<b>2,269.15</b>	<b>2,063.29</b>
11.1. Tangible and intangible fixed assets	11	203.97	195.30
11.2. Other financial assets	12	69.18	51.94
11.3. Off-balance sheet instruments revaluation differences	13	—	44.11
11.4. Accruals and prepaid expenses	14	951.47	678.13
11.5. Sundry	15	1,044.53	1,093.81
<b>TOTAL ASSETS</b>		<b>124,860.80</b>	<b>110,524.69</b>



	NOTE NUMBER	2005	2004
<b>LIABILITIES</b>			
<b>1. Banknotes in circulation</b>	<b>16</b>	<b>56,558.34</b>	<b>50,158.28</b>
<b>2. Liabilities to euro area credit institutions related to monetary policy operations denominated in euro</b>	<b>17</b>	<b>16,531.07</b>	<b>13,090.90</b>
2.1. Current accounts (covering the minimum reserve system)		16,531.07	13,085.97
2.2. Deposit facility		—	—
2.3. Fixed-term deposits		—	—
2.4. Fine-tuning reverse operations		—	—
2.5. Deposits related to margin calls		—	4.93
<b>3. Other liabilities to euro area credit institutions denominated in euro</b>		<b>—</b>	<b>—</b>
<b>4. Debt certificates issued</b>		<b>—</b>	<b>—</b>
<b>5. Liabilities to other euro area residents denominated in euro</b>		<b>15,627.89</b>	<b>15,908.16</b>
5.1. General government	18	13,277.69	13,972.89
5.2. Other liabilities	19	2,350.20	1,935.26
<b>6. Liabilities to non-euro area residents denominated in euro</b>	<b>20</b>	<b>28.08</b>	<b>30.36</b>
<b>7. Liabilities to euro area residents denominated in foreign currency</b>		<b>3.55</b>	<b>1.54</b>
<b>8. Liabilities to non-euro area residents denominated in foreign currency</b>		<b>126.29</b>	<b>15.72</b>
8.1. Deposits, balances and other liabilities	21	126.29	15.72
8.2. Liabilities arising from the credit facility under ERM II		—	—
<b>9. Counterpart of special drawing rights allocated by the IMF</b>	<b>22</b>	<b>361.52</b>	<b>340.52</b>
<b>10. Intra-Eurosystem liabilities</b>	<b>23</b>	<b>23,667.70</b>	<b>21,503.24</b>
10.1. Net liabilities related to the allocation of euro banknotes within the Eurosystem		23,667.70	21,503.24
10.2. Other liabilities within the Eurosystem (net)		—	—
<b>11. Items in course of settlement</b>	<b>24</b>	<b>240.86</b>	<b>44.87</b>
<b>12. Other liabilities</b>		<b>457.27</b>	<b>1,539.64</b>
12.1. Off-balance-sheet instruments revaluation differences	25	12.31	-
12.2. Accruals and income collected in advance	26	123.31	89.50
12.3. Sundry	27	321.65	1,450.15
<b>13. Provisions</b>	<b>28</b>	<b>2,706.65</b>	<b>2,794.26</b>
<b>14. Revaluation accounts</b>	<b>29</b>	<b>5,786.33</b>	<b>4,283.72</b>
<b>15. Capital and reserves</b>		<b>4.54</b>	<b>4.54</b>
15.1. Capital	30	1.37	1.37
15.2. Reserves	31	3.17	3.17
<b>16. Profit for the year</b>	<b>32</b>	<b>2,760.72</b>	<b>808.95</b>
<b>TOTAL LIABILITIES</b>		<b>124,860.80</b>	<b>110,524.69</b>

**PROFIT AND LOSS ACCOUNT OF THE BANCO DE ESPAÑA FOR THE YEAR ENDING 31 DECEMBER 2005**

(EUR m)

	NOTE NUMBER	2005	2004
Interest income	1	2,449.71	2,044.24
Interest expense	2	-865.40	-689.97
<b>Net interest income</b>		<b>1,584.31</b>	<b>1,354.26</b>
Realised gains/losses arising from financial operations	3	817.24	223.97
Write-downs on financial assets and positions	4	-189.63	-507.99
Transfer to/from provisions for foreign exchange rate and price risks	5	-1.16	199.90
<b>Net result of financial operations, write-downs and risk provisions</b>		<b>626.44</b>	<b>-84.12</b>
Fees and commissions income		11.91	10.50
Fees and commissions expense		-4.19	-3.87
<b>Net income from fees and commissions</b>	<b>6</b>	<b>7.72</b>	<b>6.63</b>
<b>Income from equity shares and participating interests</b>	<b>7</b>	<b>18.83</b>	<b>12.41</b>
<b>Net result of pooling of monetary income</b>	<b>8</b>	<b>11.36</b>	<b>-145.03</b>
<b>Other income and losses</b>	<b>9</b>	<b>1,026.39</b>	<b>45.75</b>
<b>TOTAL NET INCOME</b>		<b>3,275.04</b>	<b>1,189.91</b>
Staff costs	10	-195.54	-214.77
Administrative expenses	11	-102.98	-88.79
Depreciation of tangible and intangible fixed assets	12	-27.15	-25.65
Banknote production services	13	-52.36	-31.26
Other expenses		-2.41	-2.67
<b>TOTAL OPERATING EXPENSES</b>		<b>-380.44</b>	<b>-363.14</b>
<b>Transfers and additions to other funds and provisions</b>	<b>14</b>	<b>-133.88</b>	<b>-17.82</b>
<b>PROFIT FOR THE YEAR</b>	<b>15</b>	<b>2,760.72</b>	<b>808.95</b>

 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>

Repurchase agreements involving securities	<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>
Doubtful debtors	<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>Special loans to the State and the Social Security System</p>	<p>These are valued at their nominal amount.</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>
Shares and participating interests	<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>
Tangible and intangible fixed assets	<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.</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 2005, the depreciation percentages applied to the various fixed assets were the same as those applied in 2004, and were as follows:</p>

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

#### Banknotes in circulation

The ECB and the 12 participating NCBs, which together comprise the Eurosystem, have issued euro banknotes since 1 January 2002<sup>1</sup>. The total value of euro banknotes in circulation is allocated on the last working day of each month in accordance with the banknotes allocation key<sup>2</sup>.

The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation from 2002, whereas the remaining 92% has been allocated to the NCBs according to their weightings in the capital key of the ECB. The share of banknotes allocated to each NCB is disclosed under the balance sheet liability item “*Banknotes in circulation*”.

The difference between the value of the euro banknotes allocated to each NCB in accordance with the banknote allocation key and the value of the euro banknotes that it actually puts into circulation also gives rise to remunerated intra-Eurosystem balances. These claims or liabilities, which incur interest<sup>3</sup>, 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 to 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*”.

1. Decision of the European Central Bank of 6 December 2001 on the issue of euro banknotes (ECB/2001/15), OJ L 337, 20.12.2001. 2. “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. 3. Decision of the European Central Bank of 6 December 2001 on the allocation of monetary income of the national central banks of participating Member States from the financial year 2002 (ECB/2001/16), OJ L 337, 20.12.2001.

In accordance with ECB Decision of 17 November 2005 (ECB/2005/11) on the distribution of the income of the ECB on euro banknotes in circulation to the national central banks (NCBs) of the participating Member States, this income arising from the 8% share of euro banknotes allocated to the ECB belongs to the NCBs and shall be distributed to them annually. This Decision stipulates that the ECB's Governing Council may decide before the end of the financial year to transfer part or all of this income to a provision for foreign exchange rate, interest rate and gold price risks. The ECB Governing Council may also decide before the end of the financial year not to distribute part or all of this income if it expects that the ECB will incur a loss or that its net profit for that year may be less than the amount of seignorage income on its euro banknotes in circulation. Finally, the distribution of this income may be reduced in accordance with any decision by the ECB's Governing Council in respect of expenses incurred by the ECB in connection with the issue and handling of euro banknotes. Under the quarterly distribution stipulated by Decision ECB/2002/9 of 21 November 2002 previously regulating this matter, in 2005 the NCBs have received the seignorage income for the first three quarters of the year, so the ECB can require them to return part or all of this interim income distribution.

#### 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 TARGET<sup>4</sup> 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.

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4. Trans-European Automated Real-time Gross settlement Express Transfer system.

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.

#### Pension Scheme

The Pension Scheme is a defined-contribution occupational scheme, while the Fund is external and closed-end. The contributions made by the Banco de España on behalf of the employees who, having joined the Bank after 31.1.1986, are eligible to and do participate in the Scheme, are established at 7.5% of the so-called "regulating salary",<sup>5</sup> consisting of the salary items determined in the Scheme Rules. The amounts contributed by the Bank are recognised as a current expense in the year to which they relate.

#### Off-balance sheet positions<sup>6</sup>

Foreign exchange forward transactions and forward legs of foreign exchange swaps are included in the net foreign currency positions in order to calculate foreign exchange gains and losses.

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

Profits and losses arising from off-balance-sheet positions are recognised and treated in a similar manner to those arising from on-balance-sheet assets and liabilities.

#### Post-balance-sheet events

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

### Notes on the balance sheet

#### 1 GOLD AND GOLD RECEIVABLES

The Banco de España's gold holdings amount to €6,399.79 million, consisting of 14.717 million troy ounces<sup>7</sup> of fine gold valued at €434.86 per ounce. This amount is €989.09 million more than in 2004, as a result of both the rise in the market price (at end-2004 the price per ounce was €321.56) and the reduction in holdings due to sales during the year (the number of troy ounces of fine gold at end-2004 was 16.826 million).

#### 2 CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY.- RECEIVABLES FROM THE IMF

These include: a) Special Drawing Rights (SDRs) within the reserve tranche (€636.39 million), which include the net International Monetary Fund (IMF) position (€636.39 million) and the euro tranche position and its balancing account (€3,047.87 million, with a positive and negative sign); b) SDRs at the IMF (€280.81 million), and c) other claims against the IMF (€149.96 million). In total, receivables from the IMF decreased by €473.77 million with respect to end-2004, as a result of the net effect of the following: a) net purchases and sales of SDRs (€-554.82 million), b) variation in the market exchange rate (€58.94 million) and c) interest received in SDRs (€22.10 million). Spain's IMF quota remained unchanged in 2005 at SDR 3,048.90 million.

SDRs are valued at the year-end market rate, calculated by the ECB for all the Eurosystem national central banks, of €1 = SDR 0.8265.

5. This contribution was set at 6.5% until the signature of the collective agreement entered into in 2004 for the years 2002/2005, which set it at 7.5% with effect from 1.1.2003. 6. The net position under foreign exchange forward transactions and swaps, and the foreign-exchange gains and losses generated by such position are shown in the balance sheet under sub-items 11.3 on the assets side and 12.1 on the liabilities side, depending on their sign. 7. One troy ounce is equal to 31.1035 grams.



3 CLAIMS ON NON-EURO AREA  
RESIDENTS DENOMINATED IN  
FOREIGN CURRENCY.- BALANCES  
WITH BANKS AND SECURITY  
INVESTMENTS, EXTERNAL LOANS  
AND OTHER EXTERNAL ASSETS

This sub-item includes security investments, balances with banks, loans and other claims on non-euro area residents denominated in foreign currency. Their total amount as at 31.12.2005 is €7,125.72 million, with the following breakdown:

EUR m				
	Type of asset	2005	2004	Change
	Balances with banks	1,355.72	1,912.67	-556.95
	Security investments (a)	5,768.63	5,434.13	334.50
	External loans and other external assets	-0.03	147.20	-147.23
	Non-euro area banknotes	1.41	0.93	0.47
	Total	7,125.72	7,494.93	-369.21

a. As at 31 December 2005, repurchase agreements were constituted over part of the USD-denominated securities portfolio with a market value of USD 190.03 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.

At end-2005, 99.90% 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 1.1797).

The decrease in the balance of this sub-item (€369.21 million) was due to the net effect of the factors listed in the following table:

EUR m		
	Reason for change	Amount
	Net purchase/sale of foreign currency	-1,500.98
	Increase in repos in direct security loans	95.84
	Interest received	269.99
	Price-based losses on sale of securities and futures	-35.82
	Adjustment to market prices as at December 31	-45.01
	Adjustment to market exchange rates as at December 31	846.74
	Other	0.03
	Total	-369.21

4 CLAIMS ON EURO AREA  
RESIDENTS DENOMINATED IN  
FOREIGN CURRENCY

This balance sheet item may include 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-2005 to €2,331.17 million. This is an increase of €1,890.61 with respect to 2004, basically due to the increase in fixed-term deposits denominated in US dollars.

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 (€1,926.30 million), substantially all (€1,925.73 million) relate to fixed-income securities issued in euro by international agencies, which increased by €639.13 million with respect to 2004 due to purchases during the year.

6 LENDING TO EURO AREA  
CREDIT INSTITUTIONS RELATED  
TO MONETARY POLICY  
OPERATIONS DENOMINATED IN  
EURO

This item includes the amount of the euro-denominated lending to euro area credit institutions through which monetary policy is implemented. The breakdown is given in the following table:

EUR m				
Type of operation	2005	2004	Change	
Main refinancing operations	29,377.70	20,723.01	8,654.69	
Longer-term refinancing operations	2,552.72	2,684.45	-131.73	
Fine-tuning reverse operations	—	—	—	
Structural reverse operations	—	—	—	
Marginal lending facility	—	—	—	
Credits related to margin calls	0.13	0.93	-0.79	
Total	31,930.55	23,408.39	8,522.17	

Its balance as at 31 December 2005 is 36.41% higher than in 2004, since the average daily flow of financing extended during the year rose by 12.91% (€28,592.20 million in 2005 against €25,322.51 in 2004).

90.21% of the average daily financing balance was extended through “Main refinancing operations” and 9.78% was granted under “Longer-term refinancing operations”. Only 0.01% of the average annual balance was financed through other instruments.

a. Main refinancing operations

These operations play a pivotal role in pursuing the aims of steering interest rate, managing market liquidity and signalling the monetary policy stance. They are executed through liquidity-providing reverse transactions with a weekly frequency and a maturity of one week, by means of standard tenders.

The balance of this sub-item was €29,377.70 million as at 31.12.2005. This was €8,654.69 million more than at 31.12.2004.

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 €2,552.72 million as at 31.12.2005. This was €131.73 million less than in the previous year.

c. Fine-tuning reverse operations

The purpose of these operations is to smooth the effects on interest rates caused by unexpected market fluctuations. Owing to their nature, their frequency is not standardised.

Their balance at end-2005 was zero, as it was at the previous year-end. Three fine-tuning reverse operations took place in the Eurosystem during the year. Financing by Spanish credit institutions was not requested in any 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-2005 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-2005 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 31.12.2005 this sub-item had a balance of €0.13 million, down €0.79 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 €3.82 million as at 31.12.2005, which includes the amount of the correspondent accounts in euro with euro area credit institutions, is €0.66 million lower than in 2004.

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, as follows:

EUR m				
	Securities	2005	2004	Change
	Domestic portfolio of book-entry State debt	10,245.79	8,944.28	1,301.51
	Issued by non-Spanish general government	33,647.60	19,100.63	14,546.97
	Issued by Spanish monetary financial institutions	888.84	—	888.84
	Issued by non-Spanish monetary financial institutions	1,619.14	—	1,619.14
	Total	46,401.37	28,044.91	18,356.46

Its balance as at 31.12.2005 was €46,401.37 million, of which 94.6% (€43,893.39 million) relate to securities issued by general government and the remainder (€2,507.98 million) to fixed-income securities of euro-area monetary financial institutions. Of the securities issued by general government, €33,647.6 million were non-domestic and €10,245.79 were book-entry State debt.

Overall, the securities of euro area residents denominated in euro increased by €18,356.46 million in 2005. Specifically, non-Spanish general government fixed-income securities rose by

€14,546.97 million, book-entry State debt by €1,301.51 million and securities issued by monetary financial institutions by €2,507.98.

The changes were for the reasons reflected in the following table:

EUR m		
	Reason for change	Amount
	Net purchases of securities	18,777.98
	Net unrealised gains at year-end	-165.01
	Accrued implicit interest	-256.51
	Total	18,356.46

It should be noted that all purchases of debt issued by general government are in the secondary market, none being direct subscriptions of security issues.

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 2005 of the loans granted to the State amounted to €6,901.69 million, broken down as follows:

EUR m			
	2005	2004	Change
Treasury. Law 3/1983 special account	1,854.89	1,952.51	-97.63
Treasury. Law 4/1990 special account	4,516.18	4,863.58	-347.40
Treasury. Credits arising from subscription for participating interests, contributions and quotas in international agencies	530.62	571.44	-40.82
Total	6,901.69	7,387.53	-485.84

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 (€1,077.43 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.

The reduction in the balance of this sub-item (€76.96 million) corresponds to receipt of the sixth repayment instalment on the aforementioned loan.

10 INTRA-EUROSISTEM CLAIMS

This item includes the amounts of the following sub-items:

EUR m			
Type of asset	2005	2004	Change
Participating interest in the ECB	432.70	432.70	—
Claims equivalent to the transfer of foreign reserve assets to the ECB	4,326.98	4,326.98	—
Net claims related to the allocation of euro banknotes within the Eurosystem	—	—	—
Other claims within the Eurosystem	12,666.11	27,526.68	-14,860.58
Total	17,425.78	32,286.36	-14,860.58

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, unchanged in the year, corresponds to the Banco de España in accordance with the capital key established using European Commission data on the basis of Spain's population and GNP relative to those of the total ESCB countries.

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. Their end-2005 balance amounted to €4,326.98 million, the same as at the end of 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 €12,666.11 million as at 31.12.2005 represents the 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-2005 balance of the transfers via TARGET amounted to €12,725.93 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 second component, i.e. the position vis-à-vis the ECB in respect of the pooling and allocation of monetary income among the Eurosystem national central banks, had a debit balance of €9.18 million at end-2005.

Finally, the position vis-à-vis the ECB relating to the distribution of income arising from the seignorage of euro banknotes issued on its behalf by the NCBs is a credit balance of €69.01 million, since the ECB Governing Council decided to retain the 2005 banknote seignorage

income in order to set up a provision for foreign exchange rate and interest rate risks. Consequently, the national central banks had 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 €69.01 million as mentioned above. This amount was returned on 3 January 2006.

## 11 TANGIBLE AND INTANGIBLE ASSETS

The balance of this sub-item amounted to €203.97 million at end-2005, of which €440.89 million related to cost and €236.92 to accumulated depreciation.

The breakdown of this sub-item into its components, together with their accumulated depreciation, is as follows:

EUR m					
	2005	2004	Change		
			Total	Additions	Disposals
Properties and facilities	199.97	211.74	-11.77	9.47	21.24
Furniture and equipment	126.50	122.47	4.03	12.73	8.70
Fixed assets under construction	36.70	19.83	16.87	27.52	10.64
Other fixed assets	77.71	69.99	7.72	8.33	0.61
<b>Total</b>	<b>440.89</b>	<b>424.03</b>	<b>16.86</b>	<b>58.05</b>	<b>41.19</b>

EUR m			
Accumulated depreciation	2005	2004	Change
Properties and facilities	111.82	116.21	-4.40
Furniture and equipment	92.18	85.12	7.06
Fixed assets under construction	—	—	—
Other fixed assets	32.93	27.40	5.52
<b>Total</b>	<b>236.92</b>	<b>228.73</b>	<b>8.18</b>

The increase in fixed assets in 2005 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 2004 as part of the restructuring of its branch network.

## 12 OTHER FINANCIAL ASSETS

The balance of this sub-item at end-2005 (€69.18 million) basically includes the Banco de España's participating interest in Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros S.A. and in the Bank for International Settlements.

The total balance of this sub-item increased by €17.24 million due to the net effect of the following events: a) the subscription of shares of the Bank for International Settlements by the Banco de España in response to a share offering by the BIS to certain central banks (€24.75 million), and b) the decrease in the underlying book value of the shares of Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros S.A. (€-7.58 million), basically due to the distribution of dividends with a charge to reserves.

## 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. Its balance as at 31.12.2005 was zero because there was a net creditor position at that date. When the position is a creditor one, it is recorded under the same heading in liability sub-item 12.1 (see Note 25).

14 ACCRUALS AND PREPAID  
EXPENSES

The main components of this sub-item, the balance of which amounts to €951.47 million, are as follows:

EUR m			
Accruals and prepaid expenses	2005	2004	Change
Accrued coupon interest receivable	771.49	489.55	281.94
<i>On securities denominated in foreign currency issued by non-euro area residents</i>	28.91	38.60	-9.69
<i>On securities denominated in euro issued by non-euro area residents</i>	27.34	22.46	4.88
<i>On securities denominated in euro issued by euro area residents</i>	715.24	428.49	286.75
Other accrued interest receivable	168.94	175.61	-6.67
<i>On forward foreign exchange transactions</i>	—	-1.88	1.88
<i>On swaps</i>	-9.98	—	-9.98
<i>On deposits and other assets denominated in foreign currency</i>	64.92	50.26	14.66
<i>On claims equivalent to the transfer of foreign reserves to the European Central Bank</i>	77.24	75.72	1.52
<i>On other intra-Eurosystem claims arising from TARGET transactions</i>	25.01	44.47	-19.46
<i>Other</i>	11.74	7.04	4.70
Accrued commissions receivable and prepaid expenses	11.05	11.12	-0.07
Accrued dividends receivable	—	1.85	-1.85
Total	951.47	678.13	273.34

As can be seen from the foregoing table, the most significant account is accrued coupon interest receivable on securities denominated in euro issued by euro area residents (€715.24 million), most of which (€543.41 million) relates to securities issued by non-Spanish euro area general government.

15 OTHER ASSETS.- SUNDRY

The most significant component is the transfer made to the Treasury on 2 November 2005 of €734.11 million, equivalent to 70% of the Bank's distributable profits earned to 30 September 2005.

The other main components are the accrued coupon interest as at the purchase date of fixed-income securities, amounting to €126.72 million and the home loans granted to employees of the Bank amounting to €124.12 million.

16 BANKNOTES IN CIRCULATION

The balance of banknotes in circulation (€56,558.34 million) represents 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, set at 10.0065% of the total issue by all the central banks after deducting those corresponding to the ECB (8% of the total). This balance was €6,400.06 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 €16,531.07 million at end-2005, €3,440.17 million more than in the previous year. This increase 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. The average balance of these deposits increased from €13,322.18 million in 2004 to €15,064.76 million in 2005.

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 31.12.2005 there were no deposits of any of these types. However, during 2005 Spanish credit institutions participated in four liquidity absorbing operations through the placement of fixed-term deposits.

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 €13,277.69 million, which breaks down as follows:

EUR m			
	2005	2004	Change
Central government (State)	3,756.92	3,478.35	278.57
<i>Treasury current account</i>	300.20	299.93	
<i>Other central government agencies and similar bodies</i>	3,456.72	3,178.43	
Territorial government	133.76	87.76	46.00
<i>Regional (autonomous) governments, administrative agencies and similar bodies</i>	128.19	83.59	
<i>Local government</i>	5.57	4.17	
Social security funds	9,387.01	10,406.78	-1,019.77
<i>Social Security System</i>	8,821.78	8,832.75	
<i>Other</i>	565.24	1,574.03	
Total	13,277.69	13,972.89	-695.20

The decrease in the balance of this sub-item (€695.20 million) was basically due to the decline in the balances held with the Banco de España by social security funds not forming part of the Social Security System .

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 "Other resident non-financial sectors". The balance at end-2005 was €2,350.20 million, an increase of €414.94 million on end-2004, basically due to the increase in the balances of the current accounts of "State agencies—Regional agencies—Other resident sectors" (€370.52 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 €28.08 million was €2.28 million less than a year earlier.

21 LIABILITIES TO NON-EURO  
AREA RESIDENTS DENOMINATED  
IN FOREIGN CURRENCY.-  
DEPOSITS, BALANCES AND  
OTHER LIABILITIES

Substantially all of the €126.29 million balance of these liabilities at end-2005 related to securities repurchase agreements (€125.79 million), the balance of which was €14.95 million as at 31.12. 2004. The total amount of this sub-item decreased by €110.57 million, due to the increase in these operations and to the change in the exchange rate.

22 COUNTERPART OF SPECIAL  
DRAWING RIGHTS ALLOCATED BY  
THE IMF

This item of €361.52 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 €21.01 million with respect to the previous year, due basically to the variation in the exchange rate.



23 INTRA-EUROSISTEM LIABILITIES	This sub-item, the balance of which amounted to €23,667.70 million at end-2005, consists of the claims and liabilities of the Banco de España vis-à-vis the Eurosist in relation to the allocation of euro banknotes within the Eurosist (see “ <i>Banknotes in circulation</i> ” and “ <i>Intra-Eurosist balances</i> ” in the notes on accounting policies).
a. Net liabilities related to the allocation of euro banknotes within the Eurosist	
b. Other liabilities within the Eurosist (net)	This sub-item had a net debit balance in 2005. Therefore, the explanation is given in note 10.d above.
24 ITEMS IN COURSE OF SETTLEMENT	Of the total balance of this item (€240.86 million), €139.28 correspond to transfers ordered by credit institutions pending payment at year-end, and €99.60 million relate to transfers received on 30 December 2005 by the Sistema Nacional de Compensación Electrónica (National Electronic Clearing System) that have been settled and are pending payment. The increase in this item with respect to 2004 (€195.99 million) was basically due to the aforementioned transfers ordered and pending payment at year-end (€134.66 million).
25 OFF-BALANCE-SHEET INSTRUMENTS REVALUATION DIFFERENCES	This sub-item includes the amount of the net creditor position arising from foreign-exchange forward and swap transactions valued at the exchange rates prevailing at the end of the year. When the position is a debtor one, it is recorded under the same heading in asset sub-item 11.3. Its balance of €12.31 million as at 31.12.2005 is the net value of the outstanding forward transactions at that date.
26 LIABILITY ACCRUAL ACCOUNTS AND INCOME COLLECTED IN ADVANCE	The most significant component of this sub-item totalling €123.31 million relate to interest accrued but not yet paid (€116.22 million). The increase in this sub-item (€33.81 million) mainly results from the higher interest incurred on intra-Eurosist accounts relating to the adjustment of banknotes in circulation.
27 OTHER LIABILITIES.- SUNDRY	The main component of this sub-item, which amounted to €321.65 million as at 31.12.2005, is “Banco de España employee social welfare scheme ( <i>Mutualidad de empleados</i> ).- Contributions payable” (€265.16 million). The decrease of €1,128.50 million in the balance of this sub-item with respect to the previous year arose basically from the Executive Commission’s resolution of 3 February 2006 to credit to the profit and loss account the total amount of the peseta banknotes withdrawn from circulation as a result of the introduction of the euro and not yet exchanged (€1,032.97 million).
28 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

	2005	2004	Change
For exchange rate and interest rate risks	2,423.30	2,422.14	1.16
For exchange of withdrawn peseta banknotes	125.70	3.53	122.17
For ECB losses – Contributions arising from monetary income	—	147.92	-147.92
For early and regular retirement	84.96	107.06	-22.10
For sundry liabilities and charges	72.69	113.37	-40.68
For other risks	—	0.24	-0.24
Total	2,706.65	2,794.26	-87.61

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 31.12.2005 amounted to €2,423.30 million. This resulted from the use of €189.63 million and the addition of €190.79 million to reach a level of risk coverage considered adequate in accordance with the Executive Commission's resolution of 3 February 2006.

On 3 February 2006 the Executive Commission also resolved to increase by €122.50 million, with a charge to profit and loss, the provision for exchange of withdrawn banknotes in order to provide for the estimated future exchanges of peseta banknotes withdrawn from circulation as a result of the change-over to the euro.

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. This provision did not have to be recorded in 2005.

Finally, the decrease in the provisions for sundry liabilities and charges (€40.68 million) was due basically (€48.25 million) to the use of the provision recorded as a result of the commitments assumed under the Collective Agreement for 2002/2005.

## 29 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	2005	2004	Change	
Gold	5,017.56	3,830.38	1,187.19	
Foreign currency	552.03	—	552.03	
Securities	180.83	409.90	-229.07	
<i>Issued in foreign currency by non-euro area residents</i>	9.65	32.34	-22.69	
<i>Issued in euro by non-euro area residents</i>	3.14	7.31	-4.17	
<i>Issued in euro by euro area residents</i>	168.05	370.25	-202.21	
Other	35.90	43.44	-7.55	
Total	5,786.33	4,283.72	1,502.61	

As can be seen from the above table, the revaluation accounts increased by €1,502.61 million in 2005. The main change was in gold, the unrealised gains on which increased by €1,187.19 million due to the rise in its market price in euro in 2005. The revaluation account that reflects foreign currency exchange rate movements increased by €552.03 mil-

lion due to the changes in the US dollar and SDR exchange rates. The revaluation accounts based on the price of securities denominated in foreign currencies decreased by €22.69 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 revaluation accounts of euro-denominated securities decreased by €206.38 million (of which €131.98 million related to the book-entry State debt portfolio) because securities prices were depressed by the trend in interest rates.

### 30 CAPITAL

The capital of the Banco de España, constituted in accordance with the provisions of Royal Legislative Decree 18/1962 of 7 June 1962, totalled €1.37 million and remained unchanged during the year.

### 31 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.

### 32 PROFIT FOR THE YEAR

The net profit for 2005, after deducting the transfer to the Beneficent-Social Fund (€2.54 million), amounted to €2,760.72million, up 241.3% on 2004. Of this amount, €734.11 million was paid to the Treasury on 2 November 2005, in accordance with Royal Decree 1198/2005 of 10 October 2005 and with the Council of Ministers resolution of 29 July 2005 (see Note 15 to the profit and loss account).

On 12.8.2005, once the balance sheet and profit and loss account for the year 2004 had been approved by the Council of Ministers, €1.06 million, representing the rest of the profit for 2004, were paid to the Treasury.

The details of the various components of the profit for 2005 are given in the following section, relating to the profit and loss account.

## Notes 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 2005 and 2004, as follows:

### 1 INTEREST INCOME

EUR m			
	2005	2004	Change
Foreign currency	359.73	245.44	114.29
Securities	178.00	171.18	6.82
Other assets	181.73	74.26	107.47
Euro	2,089.97	1,798.79	291.18
Securities	1,061.63	758.41	303.22
Monetary policy operations	604.34	522.03	82.30
Intra-Eurosystem balances	422.51	515.70	-93.19
Other assets	1.49	2.65	-1.16
Total	2,449.71	2,044.24	405.47

€178.00 million (49.48%) of the €359.73 million of interest on foreign-currency investments arose from investments in fixed-income securities denominated in US dollars, which had an average balance of USD 5,711.87 million and an average yield of 3.8% in 2005, compared with USD 7,961.49 million and 2.6%, respectively, in 2004. Also, under "Other assets" in foreign currencies, €100.60 million related to term deposits, substan-

tially all in US dollars, and the rest to investments denominated in US dollars (repos, etc.) and in SDRs.

The interest on euro-denominated investments (€2,089.97 million) arose from the following assets:

EUR m	Interest income			Average investment in 2005	Average yield in 2005
	2005	2004	Change		
Loans to institutions related to monetary policy operations	604.34	522.03	82.30	28,592.20	2.1
Net balance with the ECB arising from TARGET transactions	345.27	439.98	-94.71	16,467.52	2.1
Claims equivalent to the transfer of foreign reserves	77.24	75.72	1.52	4,326.98	1.8
Securities portfolios	1,061.63	758.41	303.22	40,687.83	2.6
Other	1.49	2.65	-1.16	—	—
<b>Total</b>	<b>2,089.97</b>	<b>1,798.79</b>	<b>291.18</b>	<b>90,074.53</b>	<b>2.3</b>

The increase in euro-denominated interest income (€291.18 million) was due to the higher average investment (€78,870.05 million in 2004) and to the slightly higher average return (2.2% in 2004).

## 2 INTEREST EXPENSE

This item includes interest expenditure on liabilities, with the following breakdown:

EUR m	Interest expense			Average financing in 2005	Average cost in 2005
	2005	2004	Change		
Remuneration of minimum reserves	-314.86	-271.88	-42.98	15,064.76	2.1
General government deposits	-208.66	-227.50	18.83	10,238.54	2.0
Intra-Eurosystem liabilities.- Net liabilities related to allocation of euro banknotes within the Eurosystem	-270.97	-181.41	-89.56	12,897.66	2.1
Liabilities denominated in foreign currency	-10.97	-6.81	-4.16	384.47	2.8
Other liabilities	-59.93	-2.37	-57.56	—	—
<b>Total</b>	<b>-865.40</b>	<b>-689.97</b>	<b>-175.43</b>	<b>38,585.42</b>	<b>2.1</b>

The increase in the expense compared with the previous year (€175.43 million) was due to the higher average balance incurring interest (€33,955.36 million in 2004) and the higher average cost (2.0% in 2004), and to the increase in the expense incurred on "Other liabilities", basically on foreign currency swap and forward transactions (€2.26 million in 2004, against €59.69 million in 2005).

## 3 REALISED GAINS/LOSSES ARISING FROM FINANCIAL OPERATIONS

This item includes the profits and losses arising from dealing in financial assets. In 2005 the gains in this connection amounted to €817.24 million, arising from the following sources:

EUR m

	2005	2004	Change
Foreign currency	713.39	88.79	624.59
<i>Sale of gold</i>	<i>585.00</i>	<i>0.11</i>	<i>584.88</i>
<i>Sale of foreign currency (exchange gains)</i>	<i>164.21</i>	<i>99.08</i>	<i>65.13</i>
<i>Sale of securities (price losses)</i>	<i>-33.84</i>	<i>-10.44</i>	<i>-23.40</i>
<i>Other gains/losses</i>	<i>-1.98</i>	<i>0.05</i>	<i>-2.02</i>
Euro	103.85	135.18	-31.33
<i>Sale of securities (price gains)</i>	<i>103.85</i>	<i>135.18</i>	<i>-31.33</i>
Total	817.24	223.97	593.26

- The gains on the sale of gold amounted to €585.00 million in 2005, against practically none in 2004.
- The net gains arising from exchange rate differences on the sale of foreign currency amounted to €164.21 million, mostly from sales of US dollars (€139.23 million) and of SDRs (€26.64 million), slightly offset by the losses on the sale of other foreign currencies (€1.66 million).
- The net price-related gains arising from the sale of foreign securities amounted to €33.84 million and related in full to the sale of securities denominated in US dollars.
- €79.24 million of the income from euro-denominated financial transactions (€103.85 million) related to the sale of domestic public debt securities, and the remainder to sales of securities issued by non-Spanish euro area residents (€21.15 million) and by non-residents in the euro area (€3.46 million).

Compared with the previous year, the total net realised gains arising from financial operations increased by €593.26 million, basically due to higher gains on the sale of gold (€584.88 million) and to exchange gains (€65.13 million), partly offset by a decrease in gains on the sale of fixed-income securities (€54.73 million).

- The rise in net exchange rate gains on the sale of foreign currency with respect to the previous year (€65.13 million) came mostly from the sale of US dollars (€272.36 million) and, to a lesser extent, of SDRs, as a result of the trend in the exchange rate of the US dollar compared with the euro, offset by the absence of any forward transaction adjustment in 2005 (€226.98 million in 2004).
- The decrease in gains on the sale of securities (€-54.73) was a result of the higher loss on the sale of foreign currency-denominated securities in 2005 (€33.84 million, as opposed to €10.44 million in 2004) and of the lower gains on the sale of euro-denominated securities (€103.85 million in 2005, against €135.18 million in 2004). The variation in exchange gains was due to the overall effect of developments in securities market prices and to the higher volume of sales (up from USD 11,820.32 million in 2004 to USD 21,439.26 million in 2005). Meanwhile, the decrease in gains on the sale of euro-denominated securities with respect to the previous year was basically due to the higher interest rates and the resulting fall in price, partially offset by the higher overall volume of sales and redemptions.

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. The breakdown in 2005 and 2004 is as follows:

EUR m			
	2005	2004	Change
Foreign currency	-22.40	-505.32	482.92
Gold	—	—	—
Foreign currency	-0.02	-488.75	488.74
Securities	-22.32	-16.29	-6.03
Other	-0.06	-0.27	0.21
Euro	-167.23	-2.68	-164.55
Securities	-167.23	-2.68	-164.55
Total	-189.63	-507.99	318.36

Unrealised losses in 2005 amounted to €189.63 million, of which €22.32 million were price-related losses on US dollar-denominated securities and €167.23 million were losses on euro-denominated securities, principally those issued by essentially non-Spanish euro area residents (€152.44 million) and, to a lesser extent, domestic public-debt book-entry securities (€11.60 million).

5 TRANSFERS TO/FROM  
PROVISIONS FOR FOREIGN  
EXCHANGE RATE AND PRICE  
RISKS

In 2005 provisions covering exchange rate and price risks for an amount of €189.63 million were reversed to income to cover the unrealised losses on financial assets and positions described in the preceding section. Also, a transfer of €190.79 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		Change	Expenses		Change
	2005	2004		2005	2004	
Foreign operations	0.34	0.16	0.18	-2.42	-2.49	0.07
Domestic operations	11.57	10.34	1.23	-1.77	-1.38	-0.39
TOTAL	11.91	10.50	1.41	-4.19	-3.87	-0.32

The higher net fee income in 2005 (up 16.34%) was due above all to the fees and commissions received on securities transactions.

7 INCOME FROM EQUITY  
SHARES AND PARTICIPATING  
INTERESTS

Of the total amount of €18.83 million recorded, €16.55 million was from the participating interest in Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistema Financieros, SA and €2.28 million from interests in international agencies. Also, in 2005 the ECB Governing Council decided to retain the banknote seignorage income in order to set up a provision for foreign exchange rate and interest rate risks and, accordingly, as in 2004, the Banco de España did not receive a dividend from the ECB in this connection. In 2005 the Banco de España did not receive an ordinary dividend from the ECB.

## 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 in 2005, amounting to €1,056.87 million, and that reallocated to it, amounting to €1,066.05 million, is the net result arising from the calculation of monetary income. To this amount must be added €2.18 million returned by the ECB in March 2005 due to the excess monetary income retained in 2004 to provide for its loss in that year.

This result was €156.39 million higher than in 2004, basically due to the recording in 2004 of the Banco de España's contribution to the provision for the ECB's loss (€147.92 million).

## 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			
	2005	2004	Change
Extraordinary profit	1,057.91	75.23	982.68
Other	-31.52	-29.47	-2.05
Total	1,026.39	45.75	980.63

The increase of €980.63 million in this item with respect to the previous year was basically due to the €1,032.97 million credited to profit and loss for the peseta banknotes withdrawn from circulation as a result of the introduction of the euro and not yet exchanged as at 31.12.2005, in accordance with the Executive Commission's resolution of 3 February 2006, and, to a lesser extent, to the gains of €24.79 million on the sale of the buildings of branches closed in 2004, which was a similar amount to that recorded in 2004 for the branches closed in 2003 (€22.46 million). This increase was partly offset by the fact that the last loan instalment relating to the recovery of the outstanding prior years' interest payable by the Social Security System was received in 2004 (€50.19 million) and by the gain recorded in 2004 as a result of the reduction in the Banco de España's relative participating interest in the capital of the ECB (€4.60 million).

## 10 STAFF COSTS

The decrease of €19.23 million in staff costs is basically due to the addition to the 2004 cost recorded as a result of the signature in that year of the collective agreement for 2002 to 2005.

#### 11 ADMINISTRATIVE EXPENSES<sup>8</sup>

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 €56.84 million, and costs relating to premises, which amounted to €18.90 million.

It breaks down as follows:

EUR m			
	2005	2004	Change
Office expenses	-56.84	-46.04	-10.80
Property expenses	-18.90	-18.25	-0.66
Transport and communications	-7.04	-6.32	-0.73
Surveillance and security	-6.13	-5.98	-0.15
Training and grants	-3.24	-2.86	-0.38
Sundry operating expenses	-9.90	-8.49	-1.41
Local taxes	-0.93	-0.88	-0.05
Total	-102.98	-88.79	-14.18

“Sundry operating expenses” include €126,932.45 (including VAT) relating to the fees of the external auditors PricewaterhouseCoopers, S.L. for the audits in 2005 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 €805,490.96 for the purchase of IT 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			
	2005	2004	Change
Depreciation of property	-7.91	-8.26	0.35
Depreciation of transport equipment	-1.09	-0.64	-0.44
Depreciation of furniture and office equipment	-13.74	-13.23	-0.51
Depreciation of computer applications	-4.42	-3.51	-0.91
Total	-27.15	-25.65	-1.50

#### 13 BANKNOTE PRODUCTION SERVICES

This amount (€52.36 million) corresponds to payments made by the Banco de España to purchase banknotes, basically from the National Mint. The increase with respect to the previous year (€21.10 million) was attributable to the lower volume of euro banknotes acquired by the Bank in 2005.

#### 14 TRANSFERS AND ADDITIONS TO OTHER FUNDS AND PROVISIONS

The transfers in 2005 amounted to €133.88 million, compared with €17.82 million in 2004. This change (€116.06 million) is primarily due to the recording in 2005 of a provision of €122.50 million for exchange of the peseta banknotes that may be presented in the future and to the

8. 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.



smaller amount set aside in 2005 for death and retirement assistance provided for in Article 190 of the Banco de España Conditions of Employment.

Since the Banco de España provides financial services, it is not an institution with a high environmental risk. In 2005 it was not considered necessary to record any provision for environmental liabilities and charges.

## 15 PROFIT FOR THE YEAR

As detailed and explained in the preceding notes, the net profit for 2005 amounted to €2,760.72 million, up 241.3% on the previous year. The distributable profit is determined by application of the Council of Ministers resolution of 29 July 2005 authorising the Banco de España to exclude from payment to the Treasury the following 2005 income of the Banco de España: a) the total of that recorded for amortisation of the peseta banknotes not expected to be exchanged, and b) that arising from the net gains on the sale of gold, up to the limit, when summed with that referred to in a) above, of €1,495,462,597.67.

In application of this resolution and of Royal Decree 1198/2005 of 10 October 2005, the payments to the Treasury of distributable 2005 profit of the Banco de España are as follows:

EUR m	
1 Total profit for 2005:	2,760.72
<i>Profit excluded from distribution</i>	1,495.46
<i>Total distributable profit</i>	1,265.26
2 Payments to the Treasury:	
<i>On 2.11.2005. 70% of distributable profit as at 30.09.2005</i>	734.11
<i>On 1.3.2006. Difference between the above amount and 90% of distributable profit as at 31.12.2005</i>	404.62
3 Distributable profit payable to the Treasury:	
<i>At date of approval of the 2005 accounts</i>	126.53

### 3 Specific information required by Article 4.2 of the Law of Autonomy of the Banco de España of 1 June 1994

#### **Contributions made by the Bank to the Deposit Guarantee Funds**

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 2005 the Banco de España made no contributions whatsoever to the Deposit Guarantee Funds.

#### **Loss of profit**

The table below shows the loans outstanding in 2005 with interest rates below the reference rates used, in order to estimate the loss of profit for the year pursuant to the provisions of Article 4.2 of Law 13/1994 of 1 June 1994 of Autonomy of the Banco de España.

#### **AVERAGE BALANCES OF LOANS OUTSTANDING IN 2005, WITH INTEREST RATES BELOW THE REFERENCE RATES**

EUR m				
	Estimated average balance in 2005	Interest rate received (%)	Reference interest rate (%)	Estimated loss of profit
Net State debt	7,065.49	0.00%	2.07%	146.53
Loans to the Social Security System	1,153.97	0.00%	2.07%	23.93
Housing loans and repayable advances to employees	136.71	1.07%	2.07%	1.37
<i>Housing loans</i>	115.35	1.27%	2.07%	0.92
<i>Repayable advances</i>	21.36	0.00%	2.07%	0.44
Total	8,356.18	0.02%	2.07%	171.83

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 2005, 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 2005 figures, those for the previous year for each balance sheet and profit and loss account item. Our opinion refers solely to the 2005 annual accounts. Our audit report issued on 27 May 2005 on the 2004 annual accounts contained an unqualified opinion.

In our opinion, the attached 2005 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 2005 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 3.1 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

30 May 2006


## 2 Report of the Audit Committee

We the undersigned, 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 2005.

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 2005, 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 2005, 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 2005 give a true and fair view of the net worth and financial position of the Banco de España.

Madrid, 23 May 2006



D. ÁNGEL LUIS LÓPEZ ROA



D. JESÚS LEGUINA VILLA

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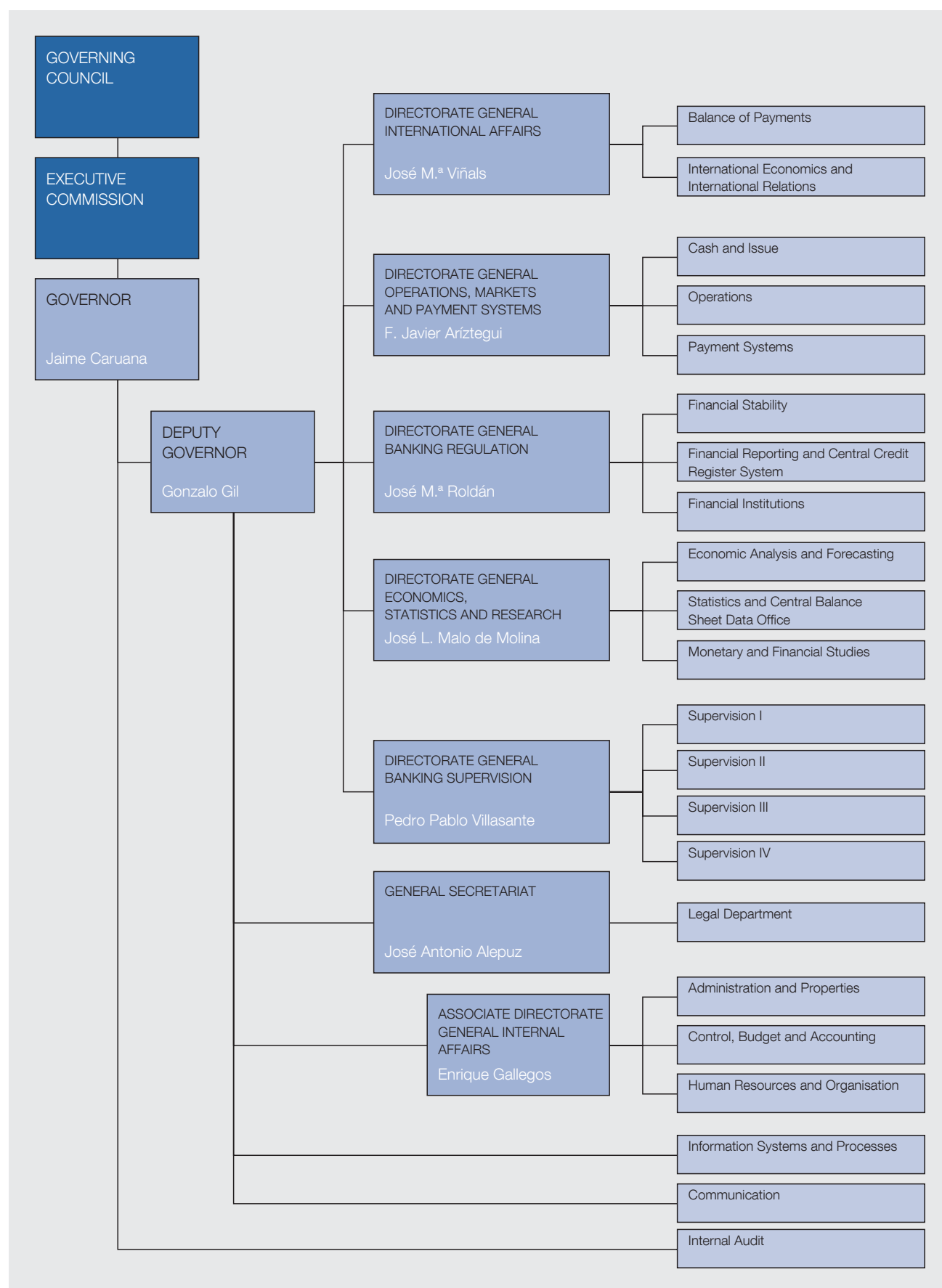


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COMPOSITION OF THE GOVERNING BODIES  
OF THE BANCO DE ESPAÑA

## ORGANISATION CHART



## Governing Council

GOVERNOR	Jaime Caruana
DEPUTY GOVERNOR	Gonzalo Gil
COUNCIL MEMBERS	Jesús Leguina Ángel Luis López Roa Guillem López Casanovas José María Marín Miguel Fernández Ordóñez Vicente Salas
DIRECTOR-GENERAL OF THE TREASURY AND FINANCIAL POLICY	Soledad Núñez
VICE-PRESIDENT OF THE NATIONAL SECURITIES MARKET COMMISSION	Carlos Arenillas
DIRECTORS-GENERAL OF THE BANK (Without a right to vote)	José Luis Malo de Molina F. Javier Aríztegui Pedro Pablo Villasante José María Roldán José María Viñals
SECRETARY (Without a right to vote)	José Antonio Alepuz
REPRESENTATIVE OF THE BANK'S PERSONNEL (Without a right to vote)	Luciano Murias

## Executive Commission

GOVERNOR	Jaime Caruana
DEPUTY GOVERNOR	Gonzalo Gil
COUNCIL MEMBERS	Ángel Luis López Roa Miguel Fernández Ordóñez
DIRECTORS-GENERAL (Without a right to vote)	José Luis Malo de Molina F. Javier Aríztegui Pedro Pablo Villasante José María Roldán José María Viñals
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