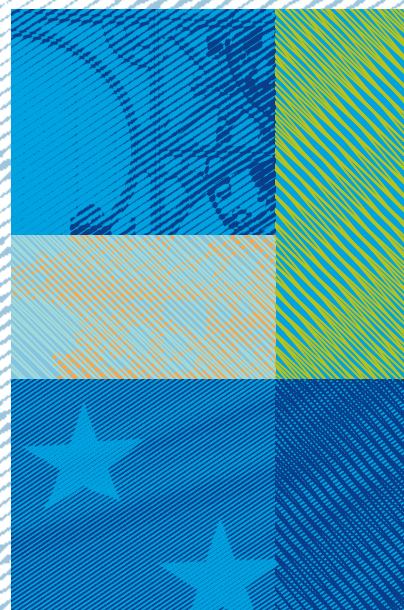


ANNUAL REPORT

2007

BANCO DE ESPAÑA
Eurosistema



The cut-off date for the information included in this report was 29 May 2007.

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ABBREVIATIONS

ABCP	Asset-backed commercial paper	GDP	Gross domestic product
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	IGAE	National Audit Office
CEBS	Committee of European Banking Supervisors	IMF	International Monetary Fund
CEIPOs	Committee of European Insurance and Occupational Pensions Supervisors	INE	National Statistics Institute
CEMLA	Center for Latin American Monetary Studies	INEM	National Public Employment Service
CEPR	Centre for Economic Policy Research	MBSs	Mortgage-backed securities
CNE	Spanish National Accounts	MEFF	Financial Futures and Options Market
CNMV	National Securities Market Commission	MEW	Mortgage equity withdrawal
CPI	Consumer price index	MFIs	Monetary financial institutions
DGS	Directorate General of Insurance and Pension Funds	MiFID	Markets in Financial Instruments Directive
EAGGF	European Agricultural Guidance and Guarantee Fund	MMFs	Money market funds
ECB	European Central Bank	MROs	Main refinancing operations
ECOFIN	Council of the European Communities (Economic and Financial Affairs)	NAIRU	Non-accelerating-inflation rate of unemployment
EDP	Excessive Deficit Procedure	NCBs	National central banks
EMU	Economic and Monetary Union	NPISHs	Non-profit institutions serving households
EONIA	Euro overnight index average	NRPs	National Reforms Programmes
EPA	Official Spanish Labour Force Survey	OECD	Organisation for Economic Co-operation and Development
ERDF	European Regional Development Fund	OPEC	Organisation of Petroleum Exporting Countries
ESA 79	European System of Integrated Economic Accounts	PPP	Purchasing power parity
ESA 95	European System of National and Regional Accounts	QNA	Quarterly National Accounts
ESCB	European System of Central Banks	RoW	Rest of the World
EU	European Union	SCLV	Securities Clearing and Settlement Service
EU-15	Countries making up the European Union as at 31/04/04	SDRs	Special drawing rights
EU-25	Countries making up the European Union as from 1/05/04	SEPA	Single European Payments Area
EU-27	Countries making up the European Union as from 1/01/07	SGP	Stability and Growth Pact
EURIBOR	Euro Interbank Offered Rate	SICAV	Open-end Investment Companies
EUROSTAT	Statistical Office of the European Communities	SIVs	Structured investment vehicles
FASE	Financial Accounts of the Spanish Economy	SMEs	Small and medium-sized enterprises
FDI	Foreign direct investment	TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
FIAMM	Money market funds	TFP	Total factor productivity
FIM	Securities funds	ULCs	Unit labour costs
FSAP	Financial Services Action Plan	VAT	Value added tax
GDI	Gross disposable income	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)
BG	Bulgaria	BGN (Bulgarian lev)
CZ	Czech Republic	CZK (Czech koruna)
DK	Denmark	DKK (Danish krone)
DE	Germany	EUR (euro)
EE	Estonia	EEK (Estonia kroon)
IE	Ireland	EUR (euro)
GR	Greece	EUR (euro)
ES	Spain	EUR (euro)
FR	France	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)
RO	Romania	RON (New Romanian leu)
SI	Slovenia	EUR (euro)
SK	Slovakia	SKK (Slovakian koruna)
FI	Finland	EUR (euro)
SE	Sweden	SEK (Swedish krona)
UK	United Kingdom	GBP (Pound sterling)
JP	Japan	JPY (Japanese yen)
US	United States	USD (US dollar)

CONVENTIONS USED

M1	Notes and coins held by the public + sight deposits.
M2	M1 + deposits redeemable at notice of up to three months + deposits with an agreed maturity of up to two years.
M3	M2 + repos + shares in money market funds and money market instruments + debt securities issued with an agreed maturity of up to two years.
Q1, Q4	Calendar quarters.
H1, H2	Calendar half-years.
bn	Billions (10 ⁹).
m	Millions.
bp	Basis points.
pp	Percentage points.
...	Not available.
—	Nil, non-existence of the event considered or insignificance of changes when expressed as rates of growth.
0.0	Less than half the final digit shown in the series.

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1 OVERVIEW

1 Introduction

The world economy remained on a dynamic path in 2007, although the slowdown in activity in the United States, the rise in commodity prices and the spread of the financial turbulence in the second half of the year prompted a change in international economic circumstances and a downward revision of growth forecasts, mainly affecting the developed economies. The financial turbulence arose in the United States, triggered by the real estate crisis beleaguering this economy, but rapidly acquired a global dimension. The strains generated on international financial markets entailed a significant change in risk valuation. They also blocked the functioning of markets essential for the wholesale financing of financial institutions and caused sizeable losses for some, which has given rise to a general lack of confidence and the emergence of signs of financial fragility. Although the effects on the real economy tend to emerge with a lag, the scale this episode has reached is checking economic dynamism, and its ultimate scope is difficult to discern. In any event, the latest macroeconomic data, for end-2007 and the opening months of 2008, are beginning to reflect the impact on some of the main developed economies, clearly so in the United States and in the United Kingdom, and less conspicuously in the euro area.

The change in the international economic climate coincided with what was practically an across-the-board deterioration in the inflationary situation (following several years of moderating inflation globally). This was linked to the sharp rises in the prices of oil, agricultural commodities and, generally, of food, against the background of strongly expanding global spending, the composition of which was biased towards the demand for these types of goods. The worsening of inflationary pressures coupled with the weakening in economic growth and financial instability has given rise to the emergence of difficult dilemmas for economic policy conduct.

During 2007 the Spanish economy moved onto a gradually slowing trajectory, reflecting the ongoing moderation in domestic demand, driven above all by the loss of momentum in residential investment. However, over the year as a whole the Spanish economy maintained a high rate of expansion, with GDP growth averaging 3.8%, only 0.1 pp down on 2006. This proved consistent with the maturation of the expansionary cycle that the Spanish economy had experienced for somewhat more than a decade, and it pointed to a mild adjustment that would allow for some alleviation of the pressures that had built up in this phase, laying the foundations for a more balanced and sustainable growth path. Nonetheless, the emergence of the episode of financial instability at the time the economy was facing a cyclical change contributed to intensifying the loss of momentum of certain spending components, prompting in particular a more pronounced adjustment in the real estate sector. In turn, the heightening of inflationary pressures in the international arena has once again laid bare the upward biases in cost and price formation that persist in the Spanish economy and which have been manifest in a marked deterioration in the inflation rate and a widening of the price differential with the euro area countries in the closing months of 2007, despite the gradual loss of steam in domestic demand. In the opening months of 2008 the ongoing deceleration of the Spanish economy steepened and the deterioration in the inflationary situation became more pronounced.

This chapter reviews the key features of the trajectory of the Spanish economy as it has moved into a slowing phase, against the backdrop of the changing international and European scenario, paying particular attention to the impact of the financial turbulence. It seeks to outline the growth outlook and the economic policy requirements stemming from the new situation,

after a long phase of continuous expansion. The behaviour of the real estate sector, which is acquiring such weight in the adjustment of the Spanish economy, along with the role that net external demand and the labour market (as a buffer against the slowdown and as a factor of adjustment in the necessary restructuring of supply and demand, respectively) must play, is addressed in much greater detail in Chapter 2, taking a selective theme-based approach and from a more analytical perspective.

2 Changes in the international economic situation

2.1 GROWTH AND INFLATION IN THE WORLD ECONOMY IN 2007

Another year of global economic expansion ...

Over the course of 2007 the world economy was once again highly dynamic. For the fourth year running, global GDP posted an increase of 4.9%, according to IMF figures, only 0.1 pp less than in 2006. That made for a four-year period showing the highest economic growth since the 1960s. Trade flows also increased more moderately than the preceding year, although they managed to grow at a rate of close to 7%.

Growth was driven by the buoyancy of domestic demand in the emerging economies (chiefly China and India), which were responsible for two-thirds of world growth. Activity in the main industrialised countries retained a degree of momentum until 2007 Q3, when clear signs of slowing began to be discernible. In the United States in particular, the marked weakening of the real estate sector – in train since mid-2006 – combined with the emergence of the financial turbulence (see Box 1.1) to prompt a clear slowdown in demand and a marked worsening in the labour market in late 2007. As a result, output increased by a meagre 0.6% in annualised quarter-on-quarter terms in 2007 Q4. Higher energy and agricultural commodities prices also contributed to cooling consumption, while pushing inflation higher, up to 4% in February 2008. The strong depreciation of the dollar and the slackness of domestic demand prompted, however, an increase in net exports. Indeed, the current account deficit narrowed to 5.3% of GDP in 2007, almost 1 pp less than in 2006. The information available on the performance of the US economy during the opening months of 2008 points to continuing slackness, with output moving at a rate of increase that might ultimately prove very weak or even turn negative. In any event, the uncertainty over the depth and duration of this phase of adjustment is very high, and will depend on factors such as the scale of the final correction in the housing market, the scope of the turbulence unleashed in the financial sector and the effect that the monetary and fiscal stimulus policies applied by the authorities will have.

GDP in the euro area in 2007 posted, for the second year running, a rate of change of over 2.5%. This dynamism in the area's potential growth, to which the favourable economic developments in Germany and in Spain contributed significantly, was based on a growth pattern very similar to that of the previous year. Thus, although exports benefited from the above-mentioned international environment, internal demand – and in particular investment – was the main driver, as private consumption remained sluggish, despite the high rate of job creation.

but with inflationary pressures...

The continuing dynamism of demand, especially in the emerging countries, along with the limited surplus capacity in production led to a fresh and generalised increase in commodities prices. The dollar price of Brent crude oil increased by around 50% on the end-2006 level and its growing trend continued in the opening months of 2008, up to record highs on occasion of over \$130 per barrel, a price four times higher than the 2002 average. Industrial metal prices underwent something of a downward correction from 2007 Q2, but resumed levels close to the highs reached the previous year in early 2008, more than 2.5 times up on 2002. Agricultural commodities also rose strongly, due largely to a structural increase in their demand, in step with higher incomes in the emerging economies, but also to adverse supply-side shocks linked to weather conditions in some important producer zones, to the increase in production costs and to the effect of export-restricting policies by some major producers. Unlike in previous years, the high growth of commodities prices on international markets had a greater im-

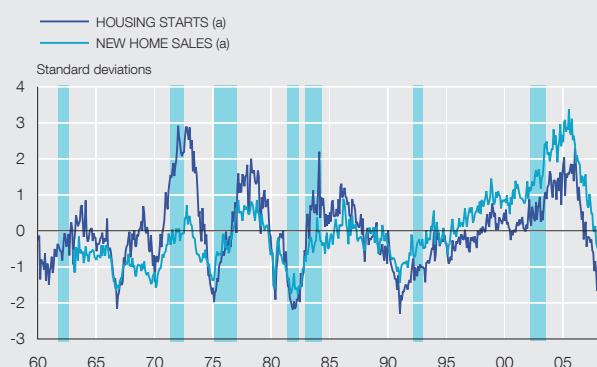
From 2002 the US economy experienced a robust and prolonged upswing, underpinned by moderately expansionary economic policies and persistently benign financial conditions, which boosted the buoyancy of domestic demand. At the beginning of 2006, the upturn in the housing market (one of the supports for consumption growth) came to an end. However, although experience indicates that housing market adjustments have a notable impact on the rest of the economy, GDP continued to grow at close to potential over the next two years. Only in the second half of 2007 did financial turbulence combine with the real estate adjustment to produce a sharp slowdown in activity in the United States from the end of that year.

The real estate market adjustment has been reflected in a sharp price correction and a reduction in residential investment and housing demand (Panel 1). Indeed, the particular economic and financial characteristics of this market in the United States mean that both prices and quantities tend to fluctuate significantly. Between 2006 Q2 and 2007 Q4, house prices fell by 10.2%. Futures on this index signal a prolon-

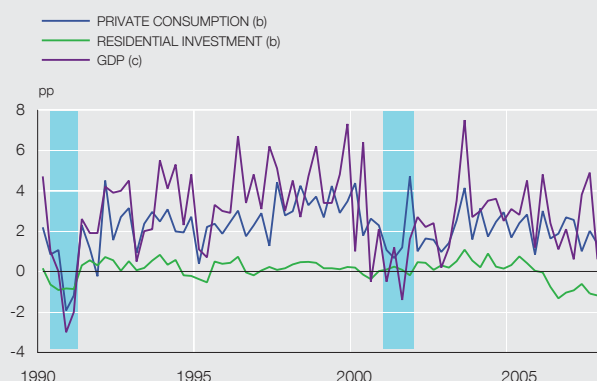
gation of the adjustment, so that the total fall may be twice as large by end-2009. Meanwhile, between the beginning of the correction and end-2007, the number of housing starts fell by 56% and building permits by 52%, while new home sales fell by 57% and second-hand ones by 32%.

Although residential investment has, on average, been deducting more than one percentage point from annualised quarterly GDP growth since 2006 Q2, the slowdown in activity was extraordinarily smooth and moderate and, until the middle of last year, accompanied by favourable growth expectations. These expectations were largely based on the assumption that the impact of the real estate sector adjustment on other sectors of the economy might be limited. Consumption should have been affected by the negative wealth effects generated by a fall in house prices; the evidence shows a lag of one to five quarters from the beginning of a real estate market correction until other components suffer contagion. However, in this cycle, private consumption remained notably buoyant for almost two years

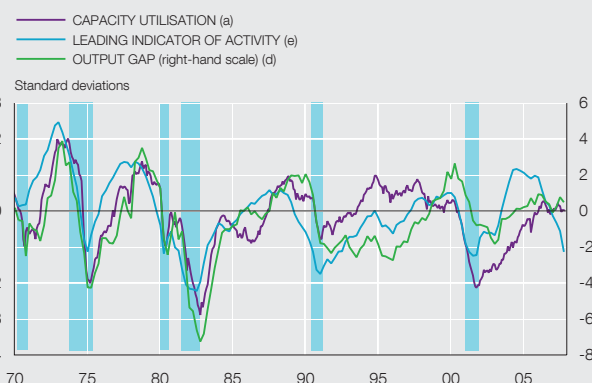
1 REAL ESTATE CYCLE



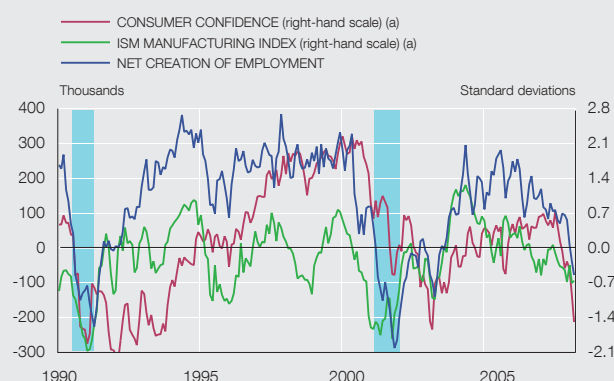
3 CONTRIBUTIONS TO GDP GROWTH



2 BUSINESS CYCLE



4 EMPLOYMENT AND CONSUMER CONFIDENCE



SOURCES: Bureau of Census, Bureau of Economic Analysis, OECD, Federal Reserve, Institute for Supply Management and Bureau of Labor Statistics.

The shaded areas indicate recessions according to the National Bureau of Economic Research classification.

a. Normalised variable, measured as the difference between the indicator and its historic average (since 1960 for Panel 1, and since 1970 for Panels 3 and 4), expressed in standard deviations.

b. Contribution to annualised quarterly growth.

c. Annualised quarterly growth rate.

d. Deviation of actual from potential GDP, as a percentage of potential GDP

e. Normalised variable, measured as the deviation of the indicator from the historic trend since 1960, expressed in standard deviations.

after the beginning of the adjustment, boosted by benign employment developments and, probably, by financial conditions that were still favourable, despite the withdrawal of the monetary stimulus over the past three years.

However, from a broader perspective, some indicators were already pointing, in 2007, to the maturation of the cycle in the United States. For instance, capacity utilisation fell back in 2005 to its historic average level for the first time since 2000 and the output gap closed in mid-2006 (Panel 2). Also, in 2006 Q1, the leading indicator of activity began to decline sharply from its historical trend.

At the same time, there were considerations suggesting that the real estate adjustment in the United States had still not come to an end and that its effects had yet to be fully felt by activity. First, the preceding upturn had been the longest and most intense in recent history. Second, the correction was insufficient in comparison with the adjustment episodes of the last 50 years.¹ In fact, the fall in the real estate market, which continues apace, has ended up being deeper and longer lasting than initially predicted, and the contribution of residential investment to GDP growth may remain negative for at least the rest of the year. Third, residential sector adjustment has historically been a good leading indicator of the business cycle; eight of the ten recessions since the Second World War were preceded by a real estate market downturn (Panel 1). In fact, the average contribution of residential investment to GDP growth is small but very volatile, increasing notably during upswings and being responsible for a large part of the adjustment during contractions² (Panel 3). These three considerations had not been incorporated into growth expectations before the start of the financial turbulence in summer 2007.

1. See R. Roubini and C. Menegatti (2007), "The housing market is still far from bottoming out", manuscript, March. 2. See E. Leamer (2007), *Housing and the business Cycle*, Federal Reserve Bank of Kansas City, Jackson Hole Symposium, September.

The financial turbulence accelerated and intensified the ongoing adjustment in the real estate sector, combining with the latter (already weighing down activity) to knock the economy onto a path of sharp deceleration. The instability gave rise, from 2007 Q3, to a pronounced deterioration in consumer and business confidence (Panel 4) and a tightening of credit conditions for both types of agent from Q4. In the closing months of 2007 and in early 2008 it was evident that there had been a drastic change in activity, highlighted by the weakening in industrial production, private consumption and the labour market. Recently, only the external sector has performed favourably, contributing somewhat more than one quarter of growth on average in 2007.

Given the weight of private consumption in US GDP (at 71% it is one of the highest in the OECD), its behaviour will be fundamental in determining the extent of the economic slowdown and, to a certain extent, financial market developments. The outlook points to a slowdown in consumption, to judge by the signs of employment weakness, a tightening of credit conditions and a sharp contraction in consumer confidence (Panel 4).

In short, the US economy displayed persistent resilience in the face of the real estate sector correction that commenced at the beginning of 2006. However, probably as a result of this, certain signals that have proved to be good leading indicators of the business cycle in the past were underestimated, as well as evidence that the real business cycle had entered a phase of maturation. Against this background, the financial turbulence of summer 2007 came on top of the ongoing correction in the real estate market to unleash a marked adjustment in economic activity in the United States. The initial resilience of private consumption has been eroded and the outlook is now one of slowdown, given the loss of the elements previously underpinning real and financial activity.

pact on overall price indices globally, especially in the second half of 2007. Over the year as a whole, the global inflation rate stood at 4.2%, compared with 3.7% the previous year, although the rise affected particularly the more volatile components of consumer price indices, namely energy and food, widening the gap between headline and underlying inflation.

2.2 FINANCIAL TURBULENCE AND THE OUTLOOK FOR 2008

and with a clearly slowing profile in late 2007, induced by the bout of financial turbulence.

The summer of 2007 saw the start of a bout of turbulence on international financial markets which is expected to prove long-lasting and intense. The strains generated have proven particularly sharp in money markets and have prompted a very notable change in the pricing of risk in capital markets. As a result, there has been a tightening of private sector financing conditions.

Although the source of the turbulence was very localised, it spread rapidly to international financial markets.

The increase in US subprime mortgage loan defaults acted as a trigger for this episode (see Chart 1.1). Despite the limited size of this US mortgage market segment (it accounted for 13% of total mortgage loans as at the end of 2007 Q3), the instability fed through swiftly to international financial markets, as a result above all of the proliferation

of complex mechanisms for transferring risks from the originating entities to other agents.

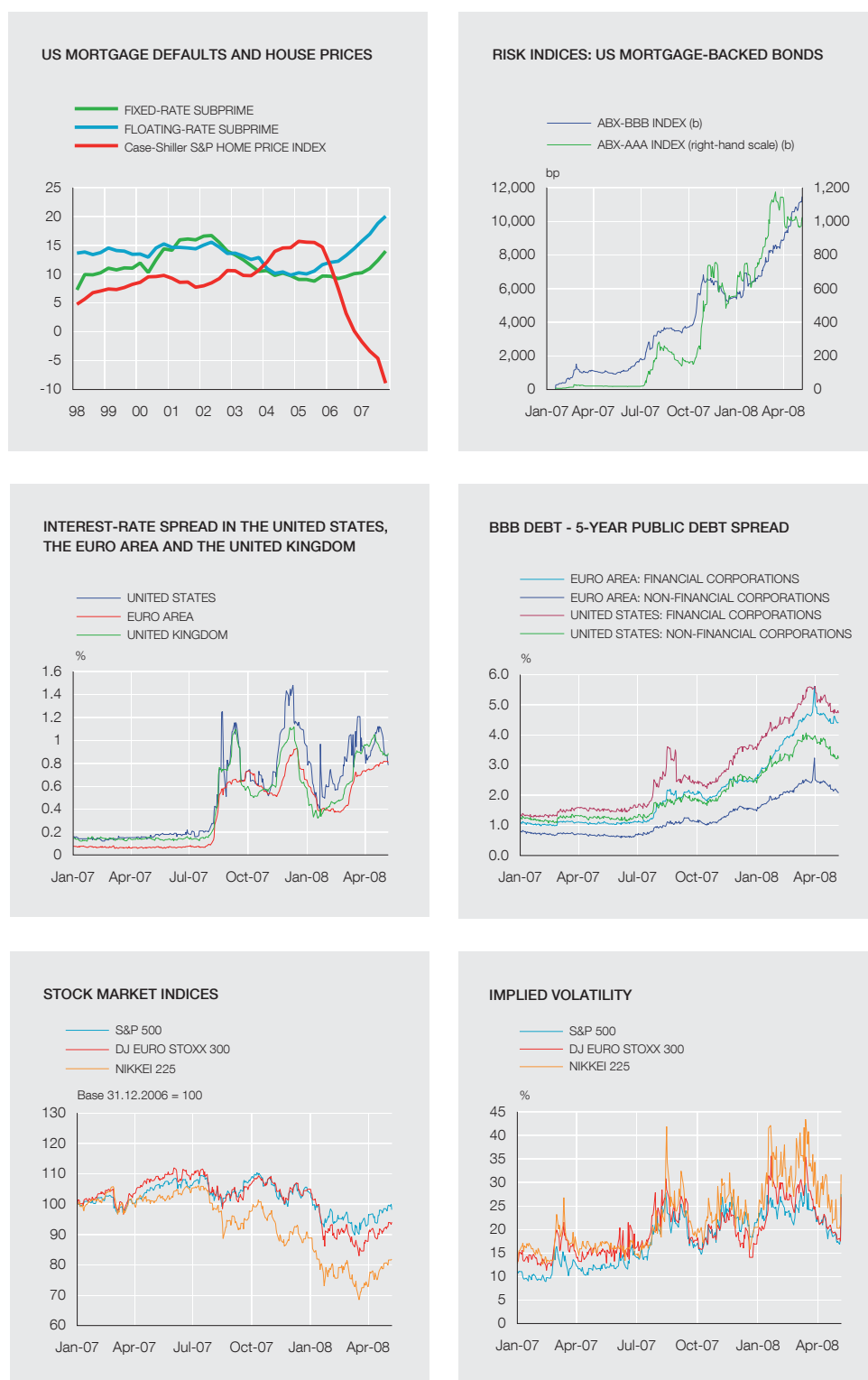
The existence of complex financial structured vehicles was conducive to the rapid pass-through of the financial turbulence to money markets...

The securitisation of bank loans has, in recent years, been one of the main drivers of the dynamism of international financial markets. The possibility of using different mechanisms to group bank loans together and repackage them as tradeable assets has opened the doors to new sources of financing for the main economies' banks. It has likewise increased investment opportunities for savers. However, the specific mechanisms used by certain banks have been based on re-securitisations where the increasingly heterogeneous assets incorporated into the process at each new stage have added further complexity to the financial instrument made available to investors. Ultimately, this chain of linkages hampers substantially the accurate identification of the links between these sophisticated final structured products and the credit quality of the borrowers at the start of the chain, and it weakens the incentives of lenders to assess borrowers' solvency with due diligence. Under these conditions, it is enormously complicated to accurately evaluate the true exposure of the holders of these securities to the effects of a shock such as that which took place in the US subprime market. If, as has actually occurred, investment banks and other credit institutions should be among these holders, it is no surprise that the consequences should take on a systemic dimension.

US and European financial institutions had created investment vehicles (conduits and other SIVs), denominated in the main in dollars, for the acquisition of structured products financed through the issuance of short-term securities. To soften the subsequent risk that the refinancing of these vehicles entailed, the sponsoring financial institutions opened liquidity facilities for them which, naturally, were activated following the rise in mortgage defaults. As a result, the strains fed through rapidly to the money markets in the form of greater demand for funds. At the same time, the lack of transparency hindered identification of the institutions most affected both by this channel and, above all, by the direct holding of securities linked to the US mortgage market, whose risk premiums rose rapidly and considerably (see Chart 1.1). A crisis of confidence thus arose among financial institutions and this, compounded by liquidity tensions, led to upward pressures on the level of interbank interest rates (see Chart 1.1) and downward pressures on activity in this market.

and central banks reacted in an attempt to prevent the strains on interbank markets from further amplifying instability.

Faced with this situation, central banks reacted by supplying funds on an extraordinary basis and, in some cases, by easing the eligibility criteria they apply to the collateral used in liquidity injection operations. There was also coordinated action by different central banks (such as the US Federal Reserve, the European Central Bank, the Swiss National Bank, the Bank of England and the Bank of Canada) and some, such as the ECB, offered liquidity in a currency other than their own. All these moves, which have been revisited in 2008, are geared to helping restore the sound functioning of interbank markets. The task performed by central banks in generating and distributing liquidity means they have a key and singular role in maintaining financial stability, particularly at times of crisis in money markets, although their ability to counter destabilising forces is, obviously, limited. The actions described helped reduce volatility at the short end of the yield curve and align very short-dated interest rates with official rates. However, at the longer-dated horizons pressures continued, stepping up in the final weeks of 2007 as a result of banks' wish to end the year in a comfortable liquidity position. Into 2008, some correction of the conditions in these markets was observed, although yield spreads widened once again in the early months of 2008 as a consequence of the persistence of the pressures and the increase in their potential scale, and they remain in any event considerably higher than was the case prior to the turbulence.



SOURCES: Datastream, Merrill Lynch, Bloomberg and JP Morgan.

a. Year-on-year growth rate.

b. Index comprising credit derivatives on a basket of mortgage-backed bonds.

c. Compiled using the unweighted average of Merrill Lynch bond indices from the industrial, utilities and telecommunications sectors.

On the capital markets, credit risk premiums reached values not seen since 2001.

As Chart 1.1 shows, the turbulence also spread to the capital markets. The problems posed by the complexity and lack of transparency of the structured products probably explain how the difficulties faced initially by bonds linked to subprime mortgages spread rapidly to virtually all mortgage-backed assets. In such an uncertain situation as this, the markets had greater difficulty in discriminating correctly between different classes of instruments. Rating agencies made a wholesale reappraisal of the risk on asset-backed bonds most clearly linked to subprime mortgages. The changes in credit ratings also affected some financial institutions, which compounded the re-pricing of risk already being undertaken by investors themselves in the bond markets. Criticism has been levelled at the role of rating agencies in the origin and subsequent development of this episode, and this has prompted a review of the processes normally followed to determine the quality of the securities they rate.

But the credit quality review was not confined to bond markets and financial institutions. The instability on the private debt markets acquired notable intensity and continued beyond year-end. This was also the case for securities issued by non-financial corporations, albeit on a lesser scale. Conversely, stock market prices initially showed high resilience, although their volatility rose. The most significant deterioration was during the early weeks of 2008, when the main bourses posted significant declines, coinciding with news pointing to a greater worsening of the US macroeconomic outlook than previously forecast.

The spread in tensions virtually across the board reveals that events in the mortgage market, besides their more direct effects, have had a greater impact on risk pricing in general relative to the situation in financial markets before last summer. Many fora and institutions had drawn attention to the possibility that these markets, globally considered, might be underestimating these risks. It is likely that the events in the summer have given substance to these warnings, whereby it will be more difficult for the price of risk to stand again at the pre-turbulence levels. Although some banks have undertaken a considerable transparency drive, confidence has not been fully restored and doubts persist over the solvency of some institutions, as manifest in the high levels credit risk premiums have maintained in 2008 to date. The possibility that the financing difficulties various lenders are facing may become considerably more severe remains a major factor of risk to international financial stability, and one that looms – with differing intensity – over the outlook for the various regions of the world economy.

Overall, there was a tightening of credit supply conditions...

Evidently, the current outcome of the strains on money markets, the weaker financial position of certain international financial institutions and, generally, the accompanying ongoing reappraisal of risk all made for a tightening of agents' financing conditions, albeit to differing degrees of intensity across the industrialised economies.

and a downward revision of growth prospects.

The period of financial instability that began in the summer of 2007 also marked a turning point for the global economic picture, beyond what would be warranted by the maturation of the expansionary cycle. Although the effects on growth were not discernible until the final stretch of the year, uncertainty increased notably from mid-2007 and the macroeconomic outlook deteriorated. At the same time, the downside risks to world growth became more acute, especially in the more industrialised regions. This revised outlook was most significant in the United States. There, the real estate market adjustment deepened at the end of the year, while signs of weakness outside this sector also emerged. That prompted an aggressive response by the US economic authorities, both in terms of a rapid easing in monetary policy and of expansionary – though predominantly temporary – fiscal measures. However, unlike in past episodes, the emerging economies, especially in Asia, showed great resilience to the change in the international economic situation, and their financial position was less affected. While the short-term growth outlook for these economies is very sound, the importance of their capital

and trade flows with the more industrialised countries might ultimately dampen the dynamism of this region.

In the euro area the real effects of the financial turbulence began to be perceptible in late 2007.

In the euro area, the continuation of the relative boom scenario which marked most of 2007 was also called into question as some of the risks that had been identified in previous months progressively materialised: the greater-than-expected slowdown in the US economy, the appreciation of the euro and higher oil and other commodities prices, in addition to the impact on confidence and on financing conditions stemming from the financial strains. Indeed, the forecasts of international organisations and private agencies were revised notably downwards, and in late 2007 and early 2008 the first signs of deceleration began to be confirmed. As a result, the year 2007 might mark the peak of a relatively brief expansionary cycle. Nonetheless, the euro area economy has sound foundations with which to face the change in the medium-term economic picture thanks to companies' favourable balance sheet situation, the high pace of job creation and the greater weight of trade with the areas least exposed to the financial crisis.

3 Monetary policy in the euro area

In the second half of 2007, the climate of uncertainty and the balance of risks to price stability and growth notably hampered monetary policy decision-making.

The joint presence of upside risks to price stability and a moderation in world economic growth, against a backdrop of great uncertainty over the scope and scale of the distortions in financial markets, led to major decision-making dilemmas for the monetary authorities of most Western economies in the second half of 2007. Indeed, the changes in the economic and financial outlook led, on the basis of each economy's conditions, to central banks pursuing differentiated measures. While the US Federal Reserve reacted aggressively with a notable cut in official interest rates and, albeit more moderately, some central banks adopted the same stance, in other areas monetary policy retained a more restrictive stance. The divergences in monetary policy outlook were, in turn, reflected in exchange rate developments. Over the year as a whole, the euro appreciated by around 11% and 9% against the dollar and sterling, respectively. In nominal effective terms, the appreciation was, at around 5%, more modest.

In the euro area, the ECB interrupted in the summer of 2007 the process of interest rate rises initiated in late 2005.

In the euro area, the strength of the economy in the first half of the year coupled with inflationary pressures had led the ECB Governing Council to further the adjustment of monetary conditions initiated in December 2005. The ECB made two additional interest rate rises, taking them to 4% in June. This process was interrupted in the summer by the start of the episode of financial turbulence, which promptly acquired a scale whose scope, duration and consequences for the area's economic outlook were difficult to predict. In the following months, the economic scenario was one of extraordinary uncertainty in which, simultaneously, the downside risks to growth in the main economies progressively intensified and the upside risks to price stability in the medium term became significant. This made decision-making by the ECB particularly complex. In this setting, in which important links of the monetary transmission mechanism had ceased to operate normally and in which – along with the sharp appreciation in the euro – there had been a de facto tightening of monetary and financial conditions in the area, it was particularly complicated to calibrate at each point in time the appropriate monetary policy stance.

In late 2007, inflation posted figures practically unprecedented since the establishment of the euro area.

Dearer commodity and food prices, along with the impact of baseline effects, were reflected in inflation figures that exceeded 3% in the closing months of the year and early 2008, while the foundations for economic expansion continued to be sound and the monetary and financial aggregates remained robust. The rise in inflation has not yet triggered second-round effects on wages and prices, and there is no evidence that long-term inflation expectations have deviated significantly from levels consistent with the price stability objective. But the risks in this connection have become increasingly evident. Against this background, the ECB governing Council reiterated its resolve to prevent upside risks to price stability in the medium term from materi-

alising and it considered that holding official interest rates unchanged, in the new conditions of financial tension, was the best monetary policy contribution to this objective.

4 The maturation of the cycle and the slowdown in the Spanish economy

The Spanish economy maintained high growth rates in 2007, but it moved onto a slowing trajectory.

The Spanish economy grew at a brisk pace over the course of 2007, posting a GDP growth rate of 3.8%, only 0.1 pp down on the previous year (see Table 1.1). This was the outcome of a less dynamic performance by national demand – which averaged 4.3% for the year – and of a substantial improvement in the contribution to output growth of net external demand, which dipped by 0.5 pp to –0.7 pp. As a result, the ongoing re-balancing of the internal and external sources of expenditure continued. But following a long expansionary phase lasting more than a decade, scarcely without any significant downturns, the Spanish economy moved in 2007 onto a slowing trajectory which was initially viewed as the natural consequence of the maturation of a long, intense cycle; however, it was subsequently influenced by the bout of turbulence on international financial markets, and a more pronounced slowdown is apparent.

In 2006 the slowdown in residential investment and in household consumption was already indicating the start of a more moderate growth phase...

The first signs that a more moderate growth phase was approaching had been observed as early as 2006. In particular, domestic demand had shown signs of a turnaround, driven by the mild slowdown in household consumption and in residential investment, although the buoyancy of investment in equipment and the recovery in net external demand, favoured by the take-off in the euro area, acted as a counterweight.

in an environment in which progressively less accommodative monetary and financial conditions...

The favourable monetary and financial conditions that had underpinned the expansion in recent years started to change in 2006; the cost of financing that households and firms had to face began to reflect the interest rate rises which the ECB had initially applied in late 2005, and expectations of rising house values slackened, in step with the progressive easing in house price increases.

would lead to a gradual slowdown and to more balanced growth, not exempt from risks.

The turnaround in financial conditions and the maturation of the cycle led to a process of deceleration based on a tendency towards the rebalancing of the different components of demand. Accordingly, the process could in principle be gradual and prove consistent with maintaining considerable dynamism. However, for this to occur, it was necessary to negotiate some of the risks that had been incubated during the long growth phase. These risks included most notably those arising from the continuing pressure exerted by spending on productive capacity, despite the notable dynamism of the population and of employment, and which had been apparent in the upward trend of costs and prices, in the rise in household and corporate debt and in the growing external deficit.

Helping moderate the slowdown was an external environment which, however, was affected by the financial turbulence in the closing months of the year.

The external environment of the Spanish economy continued to be very favourable in 2007 (see Chart 1.2). Overall, the behaviour of the world economy was still dynamic, sustained by the strength of the emerging economies, which offset the sluggishness of the US economy, while the euro area sustained levels of growth similar to those of the previous year, although in the closing months it began to show signs of slowing somewhat. Nonetheless, the continuing financial instability contributed to spreading uncertainty over economic developments, acutely so in the countries whose business cycles were more closely linked to the real estate sector and which showed greater dependence on external financing.

In Spain, the bout of financial turbulence was reflected, as in the other developed economies, in the emergence of increases in yield spreads on private debt, particularly that issued by the financial sector. Stock market prices evidenced high volatility, although they were notably resilient in the second half of 2007. Such resilience was, however, broken in the opening months of 2008, as was the case in the main international markets. The virtually zero exposure of

		2002	2003	2004	2005	2006	2007
DEMAND AND OUTPUT (b)	GDP	2.7	3.1	3.3	3.6	3.9	3.8
	Private consumption	2.8	2.9	4.2	4.2	3.8	3.2
	Government consumption	4.5	4.8	6.3	5.5	4.8	5.1
	Gross capital formation	3.4	5.2	5.2	6.5	7.0	6.0
	Fixed capital in equipment	-2.9	4.1	5.1	9.2	10.4	11.6
	Fixed capital in construction	6.3	6.2	5.4	6.1	6.0	4.0
	<i>Housing</i>	7.0	9.3	5.9	5.9	6.4	3.1
	<i>Other constructions</i>	5.6	3.5	5.0	6.3	5.5	5.1
	Exports of goods and services	2.0	3.7	4.2	2.6	5.1	5.3
	Imports of goods and services	3.7	6.2	9.6	7.7	8.3	6.6
EMPLOYMENT, WAGES, COSTS AND PRICES (c)	Total employment	2.3	2.4	2.7	3.2	3.2	3.0
	Employed as proportion of total population (d)	59.5	60.8	62.0	64.3	65.7	66.6
	Unemployment rate	11.5	11.5	11.0	9.2	8.5	8.3
	Compensation per employee	3.3	3.6	3.0	2.9	3.0	3.6
	Unit labour costs	2.9	2.9	2.4	2.5	2.3	2.7
	GDP deflator	4.3	4.1	4.0	4.2	4.0	3.1
	Consumer price index (12-month % change)	4.0	2.6	3.2	3.7	2.7	4.2
	Consumer price index (annual average)	3.5	3.0	3.0	3.4	3.5	2.8
SAVING, INVESTMENT AND FINANCIAL BALANCE (f)	Consumer price differential with the euro area (HICP) (e)	1.3	1.0	0.9	1.2	1.4	0.7
	Resident sectors: saving (g)	24.0	24.5	23.5	23.0	22.5	21.9
	<i>General government</i> (g)	3.1	3.3	3.1	4.5	5.5	6.0
	Resident sectors: investment	26.7	27.4	28.3	29.5	30.6	31.4
	<i>General government</i>	3.6	3.5	3.4	3.6	3.7	3.8
	Resident sectors: net lending (+) or net borrowing (-)	-2.7	-2.9	-4.8	-6.5	-8.1	-9.5
	<i>General government</i>	-0.5	-0.2	-0.3	1.0	1.8	2.2
	General government gross debt	52.5	48.7	46.2	43.0	39.7	36.2
MONETARY AND FINANCIAL INDICATORS (h)	ECB main refinancing rate	3.2	2.3	2.0	2.0	2.8	3.9
	Ten-year government bond yield	5.0	4.1	4.1	3.4	3.8	4.3
	Synthetic bank lending rate	4.9	4.4	4.0	3.8	4.6	5.7
	Madrid Stock Exchange General Index (DEC 1985 = 100)	723.6	706.4	863.3	1,066.1	1,344.0	1,637.0
	Dollar/euro exchange rate	0.9	1.1	1.2	1.2	1.3	1.4
	Nominal effective exchange rate vis-à-vis developed countries (i)	97.32	100.03	100.70	100.82	101.12	102.28
	Real effective exchange rate vis-à-vis developed countries (j)	99.87	103.98	106.46	107.90	109.49	111.97
	Real effective exchange rate vis-à-vis the euro area (j)	102.43	103.47	105.02	106.51	108.00	109.40
	Cash and cash equivalents	10.5	12.0	11.3	14.4	11.5	-4.3
	Liquid assets (k)	8.7	8.8	5.8	11.5	8.6	-1.6
	Households: total financing	16.3	19.1	20.2	20.9	19.6	19.1
	Non-financial corporations: total financing	12.4	13.4	13.2	21.4	27.9	27.6

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

a. The National Accounts data are calculated on the basis of base year 2000.

b. Volume indices. Rates of change, except for the unemployment rate (presented as a level).

c. Rates of change, except for the unemployment rate (presented as a level).

d. Employment rate (16-64).

e. Differentials calculated using the Eurostat series with information to December 2001.

f. Levels as percentages of GDP.

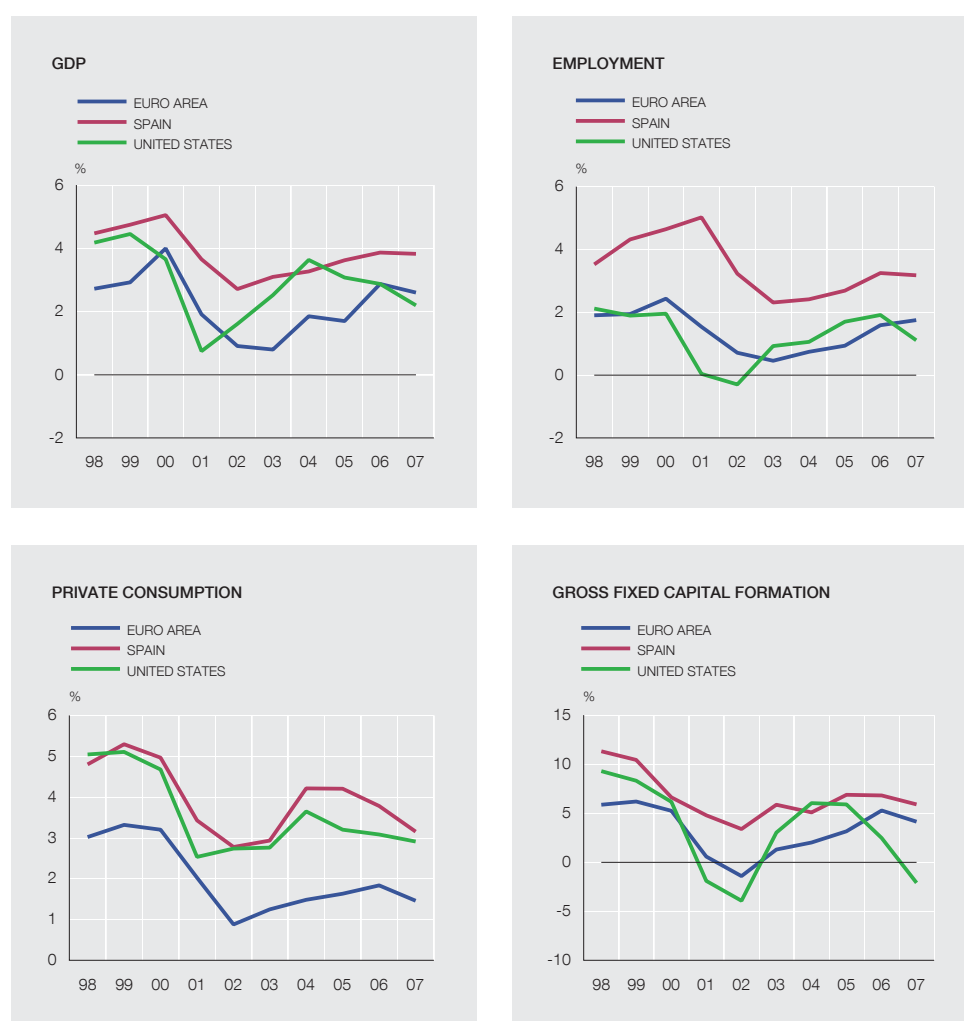
g. Includes net capital transfers received.

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

i. 1999 Q1 = 100.

j. 1999 Q1 = 100. Measured with unit labour costs.

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



SOURCES: Eurostat and national statistics.

Spanish financial institutions to US subprime mortgages contributed, along with their favourable financial position, to lessening the impact of the shocks on credit supply conditions. However, the instability on interbank markets led to an increase in interest rates on new lending business, while the criteria governing the granting of financing for certain activities and sectors became progressively more restrictive, essentially as a result of the risk reappraisal process that accompanied the turbulence. The impact of this episode on domestic financial conditions was, in any event, relatively limited in 2007 (see Box 1.2). From 2008, however, if the freeze on medium and long-term financing markets is excessively drawn out, banks' difficulties in raising sufficiently stable financing might ultimately give rise to a greater tightening of credit conditions, as discussed elsewhere in this chapter.

4.1 THE MODERATION IN DOMESTIC DEMAND

In 2007 the Spanish economy underwent a slowdown owing to the loss of momentum in domestic demand.

The Spanish economy posted a GDP growth rate of around 4% in the first half of the year, initiating as from Q2 a mild slowdown which led to an end-2007 year-on-year growth rate of 3.5%. The slowdown in the pace of activity was due to the loss of momentum in domestic demand, more markedly so in the case of households. This was partly offset, however, by successive improvements in the contribution of the external sector to output growth.

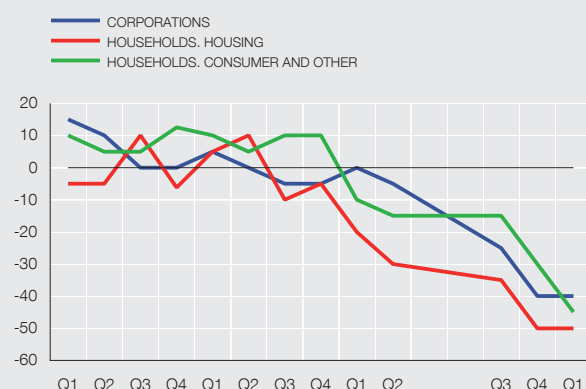
The financing conditions of households and corporations are one of the factors that help to explain the spending decisions of these sectors. The turbulence that began last summer may potentially involve a tightening of these conditions through various channels. First, through more restrictive credit standards, which may stem from the greater difficulty institutions have obtaining funds on wholesale markets, the repricing of risk and/or the possible deterioration in their financial position. Second, the cost of credit could rise if intermediaries transmit the tightening of interbank market yields to their customers and, to a greater extent, if they also increase the spread they apply to their loans. To analyse these matters this box explores the information contained in the Bank Lending Survey (BLS) and in the interest rates on new business.

The results of the BLSs conducted since the commencement of the financial turmoil show a contraction in the supply of credit (see Panel 1).

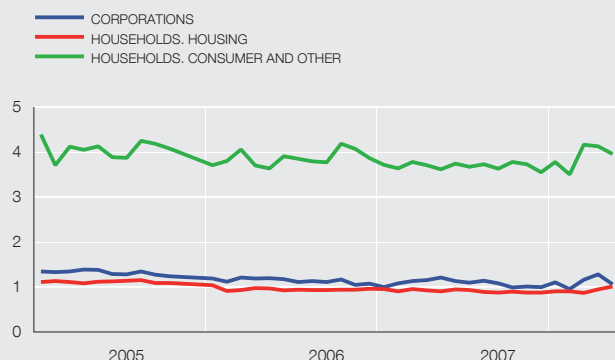
In the case of households, especially in the loans for house purchase segment, conditions had already begun to become more restrictive previously, but from 2007 Q2 this trend intensified. By contrast, in corporate transactions tighter conditions have been observed more recently, coinciding with the turbulence.

According to the responses of the institutions to the October 2007 and January and April 2008 BLSs (see Panel 2), the main factors contributing to the tightening of the supply conditions were those relating to the perception of risk (general economic expectations or the expectations in a particular sector and consumer solvency). The difficulty of obtaining funds in the markets following the turmoil had a similar, albeit weaker, effect. The moderate impact associated with the latter factor probably reflects the fact that Spanish intermediaries have found alternative ways of financing themselves at a shorter term and at a lower cost, such

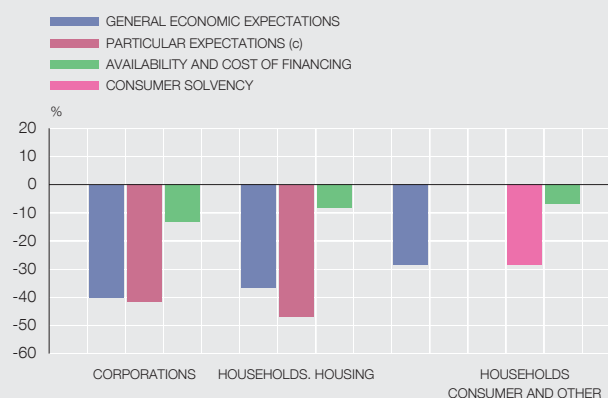
1 SUPPLY OF CREDIT (a)



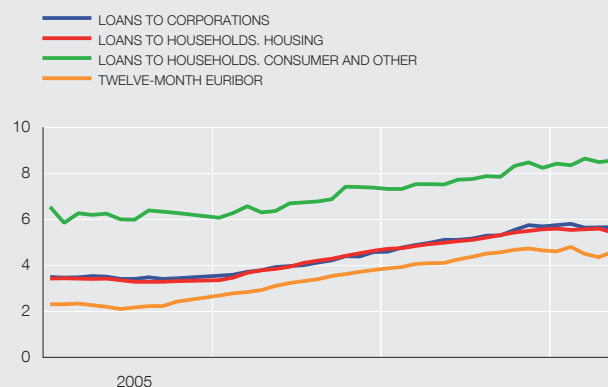
3 INTEREST RATE SPREADS (d)



2 FACTORS EXPLAINING THE SUPPLY OF CREDIT. JUNE 2007-MARCH 2008 (a) (b)



4 INTEREST RATES



SOURCE: Banco de España

a. Indicator = % of institutions that signal a considerable increase $\times 1$ + % of institutions that signal a certain increase $\times \frac{1}{2}$ - % of institutions that signal a certain decrease $\times \frac{1}{2}$ - % of institutions that signal a considerable decrease $\times 1$.

b. The data represent the average quarterly change in such factors between June 2007 and March 2008, calculated as the average of the responses to the October 2007 and January and April 2008 surveys.

c. Expectations relating to the real-estate market in the case of lending to households for house purchase.

d. The reference rate used is three-month EURIBOR in the case of loans to corporations and to households for consumption and other purposes, and average one-year EURIBOR over the two previous months in the case of loans to households for house purchase.

as issuing commercial paper, an instrument less affected by the turbulence.

At the same time, Panel 3 shows how the spreads that institutions apply to their loans to customers relative to wholesale market interest rates have, in general, not changed significantly in recent months. In the case of lending to households for purposes other than house purchase, this analysis is hampered by the high variability of the series, partly attributable to the greater heterogeneity of this instrument, which makes it difficult to draw a definitive conclusion.¹

However, the cost of financing for the private sector continued to rise in the second half of 2007, since the rise in interbank market rates was passed through to the cost of loans (see Panel 4). This transmission is not surprising given the high weight of variable rate

loans, especially in the case of housing financing, many of which are, moreover, linked to EURIBOR indices. Unlike between end 2005 and the middle of last year, rising rates did not stem from expectations of increases in official Eurosystem rates, but rather from the pressures on the interbank markets, which were reflected in higher premiums.

In short, the information available suggests that the financial turbulence has so far involved a certain increase in the cost of financing for the private sector, linked to the increase in interbank market rates, but not to a widening of the spreads applied by institutions to those rates. Also, a tightening of credit standards has been observed, especially as a result of risk repricing, but not so much as a result of the difficulty of obtaining financing on wholesale markets. The negligible exposure of Spanish intermediaries to assets and institutions most affected by the turbulence and their favourable initial financial position has limited the impact of these events on the supply of loans. However, should the pressures persist for a prolonged period, a more pronounced effect cannot be ruled out in future.

¹ In particular, the composition of loans according to their risk profile may vary over time, which introduces an element of variability, insofar as the average interest rate will change.

The growth rate of household consumption eased and drew closer to that of disposable income...

The growth rate of household consumption eased in 2007, averaging 3.2% for the year and continuing on the path of mild adjustment initiated the previous year. In the second half of the year, this trend became more pronounced as a result of the deterioration in consumer confidence in the face of the instability on international financial markets. The strength of employment and, therefore, of compensation per employee provided significant support in maintaining the dynamism of income and offsetting the increases in interest payments. In turn, the growth of household consumer spending tended to move into line with the increase in disposable income, after having outgrown this latter variable for several years, due to the lesser increase in wealth and, probably, to the decision to delay certain consumer expenditures, in a setting of rising real interest rates. Overall, the declining path of the household saving rate observed in recent years eased.

while residential investment underwent a sharper slowdown.

Residential investment underwent a sharper slowdown, posting a rate of increase of 3.1% in 2007 as a whole, compared with 6.4% the previous year. The pattern of residential investment in the opening months of the year pointed to a mild and moderate adjustment, in which higher borrowing costs and curbed expectations about increases in property values would have a gradual impact on the demand for housing. But in the closing months of 2007 a more pronounced fall-off in housing demand began to be discernible further to the deterioration in agents' confidence and the international climate of uncertainty. That led to a swifter reaction on the supply side, given the mismatch that might arise between the downturn in demand and the high rate at which housing was being built.

The growth rate of lending to households eased and their net borrowing stabilised.

The easing off of the increase in household spending and wealth over the course of 2007 and the rise in interest rates contributed to prolonging the decelerating path of household demand for credit that had begun in 2006. The year-on-year rate of change of this variable was almost 7 pp down at around 13% at the end of the year. Despite this, household debt continued to expand more quickly than household income, meaning the debt ratio increased once more, albeit more moderately. Household net borrowing stabilised at a simi-

lar level to that of the preceding year (2.8%), following several years of uninterrupted growth.

Business investment, underpinned by the momentum of investment in equipment, remained dynamic...

Business investment remained dynamic in 2007, although – here too – it moved on a slowing profile in the second half of the year. The momentum of investment in capital goods, which increased at a rate of 11.6% over the year as a whole, was underpinned by the strength of domestic demand, the favourable economic outlook then in place and the dynamism of corporate earnings. Investment in other construction posted lower growth than in 2006, moving on a declining trajectory throughout the year.

and corporate demand for credit also slowed.

Corporations' demand for financing slowed in 2007, more sharply than households, especially in the second half of the year. As a result, at the end of 2007 the borrowed funds received by corporations were growing at a year-on-year rate of close to 18% (28% at end-2006). This slowdown, linked to the dearer cost of capital and of financing, was mainly driven by the diminished dynamism of funds earmarked for the construction and real estate services branches, since the financing raised by other activities showed considerable buoyancy. Despite this, the high rate of expansion of debt led to further increases in non-financial corporations' debt ratio in 2007. The sector's net borrowing reached an all-time high (of 10.6% of GDP). In this financial situation, corporations' spending plans and their dynamic investment are particularly sensitive to possible adverse changes in credit accessibility conditions or in the other determinants of the cost of capital.

The expansion of general government spending was sustained in 2007 by investment in civil engineering projects...

The general government sector contributed in 2007 to the expansion of spending, both through government consumption and gross capital formation, and in particular through civil engineering projects, which were boosted by the strong investment activity of the regional governments, most particularly in the months prior to the holding of regional and local elections in May.

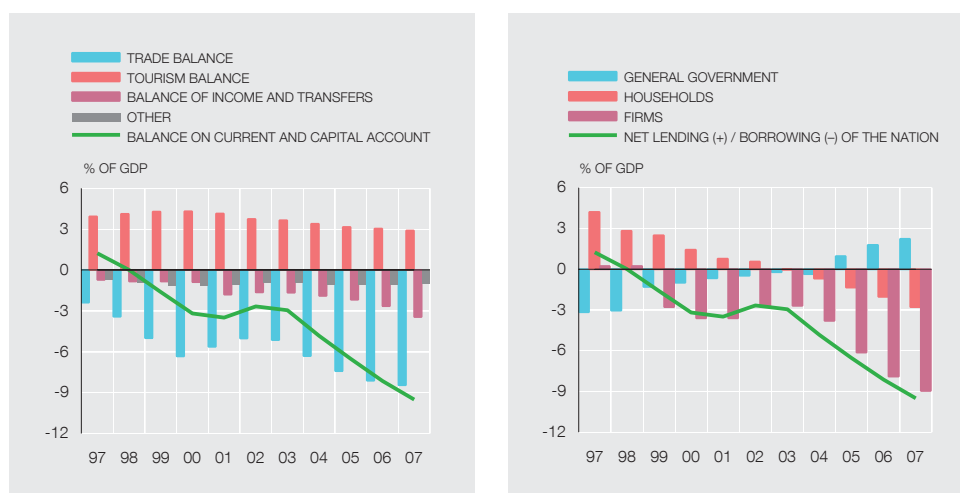
while tax revenue remained buoyant.

The moderation in domestic demand had a very limited effect on tax revenue, the weight of which in GDP rose overall by 0.7 pp. However, there were relatively significant changes in the composition of this revenue, with a decline in the weight of taxes linked to real estate activity and an increase in direct tax takings, despite the entry into force of the personal and corporate income tax reform. In fact, the buoyancy of tax revenue meant that, despite the upward deviation in primary expenditure, the general government balance showed a surplus equivalent to 2.2% of GDP, up on the previous year (1.8%) and far above the Stability Programme target (0.9%). The public debt ratio fell to 36.2%, from 39.7% in 2006.

4.2 THE IMPROVEMENT IN EXTERNAL DEMAND

In 2007 the rebalancing between national and external demand continued. The contribution of external demand to GDP growth improved by 0.5 pp, the result of a higher increase in exports than that of the previous year, despite the appreciation of the euro and somewhat lower growth in export markets...

The contribution of net external demand to GDP growth improved in 2007. This was a result of the real growth of goods and services exports which, with a rate of increase of 5.3%, was slightly up on the previous year, and of the slowdown in imports to 6.6%, compared with 8.3% in 2006. The growth of goods exports in 2007 was higher than what its fundamentals might in principle have inferred, since the slowdown in world trade and the further deterioration in the price-competitiveness indicators, on a similar scale to that in 2006, would in fact warrant somewhat lower growth than that actually recorded. This was so because there was a notable increase in sales of Spanish products to certain non-EU emerging economies, which show greater expansion potential. That meant that the Spanish export share in these markets ceased to fall. Conversely, exports to the EU slowed, prompting a fresh loss of market share in this area, albeit less than in previous years. Exports of non-tourist services (mainly business, IT, financial and construction services) remained notably dynamic, in line with what was seen in other countries, against the background of the liberalisation of international trade in these types of activity and of technological advances in the marketing of such services. Exports of tourist services, on



SOURCES: INE and Banco de España.

the other hand, once again evidenced the difficulties this sector faces in maintaining its weight in an expanding world market. These exports posted a virtually zero increase over the year as a whole, possibly as a result of growing competition from other lower-price tourist destinations, a development exacerbated by the substantial appreciation of the euro in 2007.

and of some slowing in imports, in line with the behaviour of final demand.

The loss of momentum in goods imports is consistent with the mild slowdown in final demand during the year, although in 2007 there was, in addition, a smaller rise in import penetration, particularly imports from emerging countries. That might reflect some normalisation in trade with this group of countries, following the notable impact exerted by the strong penetration by China and other emerging countries in the EU markets in the central years of the decade. Services imports were, like services exports, highly expansionary.

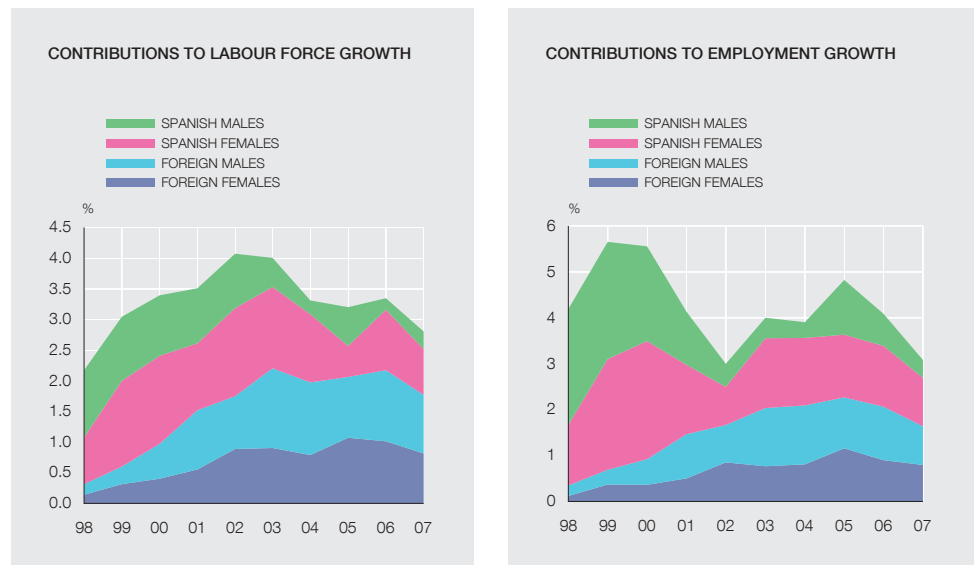
Despite this, the external deficit continued to widen, albeit at a somewhat more moderate rate.

Overall, the external deficit continued to widen in 2007, albeit at a somewhat more moderate rate. As a result, the nation's net borrowing rose to an amount equivalent to 9.5% of GDP (8.1% the previous year) (see Chart 1.3). The increase in net borrowing essentially reflects the widening of the current account deficit and, to a lesser extent, the reduction in the capital account surplus. The current account components that contributed to the above-mentioned increase in the deficit were the income balance, the travel heading and trade in goods. The growth rate of the trade balance deficit slackened by 0.4 pp owing to the energy component, the rate of increase in which declined significantly in the first half of the year, to the resilience of exports and to the slowdown in imports. The deficit on the income balance worsened markedly, standing in 2007 at 2.8% of GDP, 0.9 pp more than 2006. The dynamic of this balance of payments component further hampers the possibility of significantly reversing the rising trend of net borrowing, even in a scenario of an improved foreign trade balance in goods and services.

4.3 CONTAINMENT OF THE DYNAMISM OF ACTIVITY AND EMPLOYMENT

The slowdown in value added was due to the diminished dynamism of residential construction and industry.

On the supply side, the slowdown in value added during the year was largely due to the diminished dynamism of activity in the construction sector and, particularly, in the residential construction segment, in the face of the moderation in the demand for housing. In view of its importance in the slowdown in the economy, this matter is addressed in greater detail and depth in Chapter 2 of this Report, which adopts a selective theme-based approach and a more analytical perspective. The rest of the construction sector, which includes non-residential building and civil engineering projects, continued to be expansionary in 2007. The dynamism shown by industry (excluding energy) in 2006 continued into 2007 Q1. Thereafter, however, it slowed



SOURCES: INE and Banco de España.

significantly, a development related to some easing in final demand and, above all, to the change in cycle in the construction industry, which may have led to an appreciable decline in the demand for certain industrial products. Conversely, market services activities displayed notable strength, and have only shown any sign of slowing in the opening months of 2008.

And the deceleration in GDP was reflected in employment, where reductions in the pace of growth were located in these two productive branches.

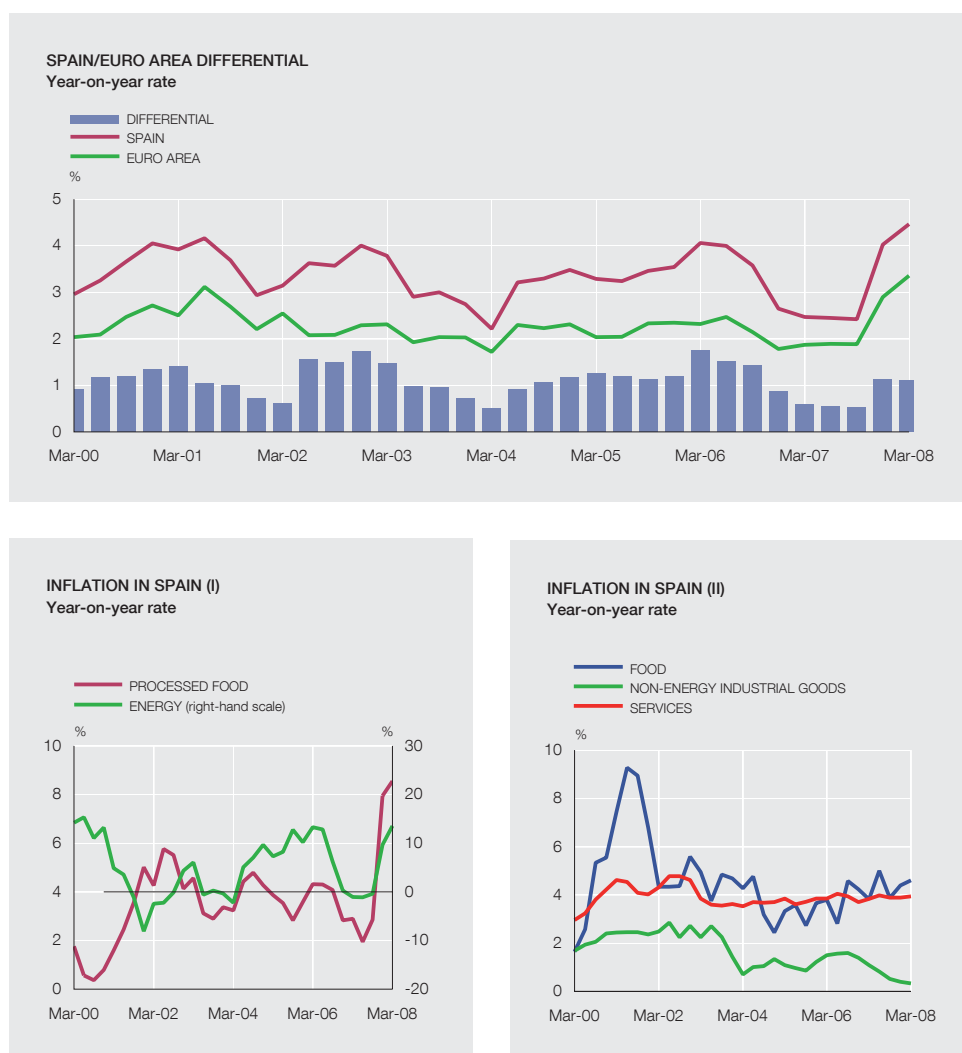
In the setting described, employment progressively adjusted to the moderating profile of GDP in the second half of the year. Employment growth was lower in the last two quarters in construction and, to a lesser extent, in industry. That said, the increase in employment averaged 3% in 2007, only 0.2 pp below the previous year, and actual productivity edged up to 0.8% for the whole economy. Despite the slowing profile described, the construction sector was, among market activities, the most dynamic, with an increase in employment of 5.8% over the year as a whole, followed by market services, where employment rose at a rate of 3.1%. Set against this, the rate of job creation in industrial activities was, for the year as a whole, zero, with minor declines in numbers employed observable as from Q2. This has been a prevalent characteristic throughout the recovery phase in industrial activity, which began in late 2005.

Labour supply continued to expand, albeit at a lesser pace than in recent years, and the labour market began to show a loss of steam.

This behaviour of employment was against a background in which labour supply continued to expand, albeit at a somewhat lesser pace than in the past two years. The increase in the working population was underpinned, as has habitually been the case since the start of this decade, by fresh increases in migrant worker flows and by further rises in the female participation rate, since the related rate for foreign workers fell slightly (see Chart 1.4). In sum, some loss of steam in the labour market began to be discernible during 2007, affecting both labour supply and demand. But it was compatible with further cuts in the unemployment rate in the first three quarters of the year. Over the year as a whole, the unemployment rate edged down by 0.2 pp to 8.3%, and long-term unemployment continued on the declining trajectory of recent years, standing at 23.7%.

The loss of momentum in employment coincided with a rise in compensation per employee.

Despite the lesser momentum in the labour market, developments in labour costs during the year led to a rise in compensation per employee in the market economy, which was of greater intensity in services activities and moved on a growing profile throughout the year. For the first time in the last decade, the increase in compensation per employee (3.4%) was close to that



SOURCE: Eurostat.

in wages under collective bargaining agreements, once updated by the indexation clauses. As a result, wage drift, which had been negative until this year, is expected to have ceased to act as a factor of wage containment, despite the fact that in 2007 there were no significant changes in the characteristics of new labour market entrants. Unit labour costs also rose in 2007, breaking with the slowing trajectory of recent years. In the manufacturing branches, however, the rise in these costs was practically zero, thereby narrowing the gap with the countries with which Spain competes internationally. The increase in labour costs has continued in the opening months of 2008, which is not in step with the cyclical change the Spanish economy is facing, as it may ultimately bear adversely on firms' hiring decisions, accentuating the employment adjustment when the economy slows.

4.4 THE RISE IN INFLATION

Inflationary pressures re-emerged in 2007.

The shocks that affected the prices of food commodities and oil in the second half of the year impacted Spain more intensely than the other euro area countries, given the underlying factor of higher wage increases and the continuous widening of business margins. Against this backdrop, the improvements in the inflation rate and in the related differential with the euro area during the first half of the year were reversed at the end of 2007; a fresh bout of inflation ensued with the CPI posting a growth rate of over 4%, and the differential stood at somewhat over 1 pp, holding in the opening months of 2008 (see Chart 1.5).

The rapid deterioration in inflation as from the second half of 2007 was due to the significant climb in processed food and energy product prices, which rapidly reflected the rise in oil and agricultural commodity prices on international markets. This worsening in inflation – whose source was chiefly external – compounded a situation in which services inflation remained at high levels as a result of a combination of continuous expenditure pressure and a business environment that was not sufficiently competitive in certain branches and which was beset by comparatively high labour cost growth. As a counterpoint to this, the prices of non-energy industrial products slowed significantly during the year, posting year-on-year rates that were less than 0.5% in the second half of the year and close to zero in the closing months. The substantial moderation over the course of the year in the CPI, which stood at 2.8%, masks the persistence of upward biases in cost and price formation processes, which prevent lasting reductions in core inflation from coming about. Indeed, there is a risk that the deterioration in inflation seen in the closing months may spread to the rest of the economy as a result of the nominal rigidity-generating mechanisms in place (in particular wage indexation), which might hamper job creation and deepen the economic slowdown.

5 Growth outlook and economic policies

The slowdown that began in the Spanish economy in the course of 2007 has become more pronounced in the opening months of 2008.

In the early months of 2008 the Spanish economy has been less dynamic than was foreseen before the bout of financial stability began, and its growth prospects for the rest of the year have been revised downwards. The causes of this revision lie in a less favourable international environment, for the reasons set out in this chapter, and in a more pronounced adjustment of housing investment in Spain, influenced – as has likewise been stated – by the financial instability. The diminished momentum of the real estate sector will entail less dynamism in job creation, along with the disappearance of the stimuli stemming from the increase in wealth; accordingly, the remaining components of domestic demand may also be expected to participate in this lower-growth environment. However, the external sector will foreseeably cushion in part the loss of dynamism in domestic demand, in a setting in which exports should adapt to the lower growth of world markets, but in which, at the same time, imports may be expected to slow significantly. Despite this diminished cyclical momentum, the inflation outlook points to high price rises in 2008, meaning the private consumption deflator might stand at around 3.6%. In the absence of further shocks on commodities markets, a significant reduction in this deflator may be expected during 2009.

But the transformations undergone provide for elements that may act as supporting factors against the slowdown.

The slowdown that began in the Spanish economy in 2007 has become more pronounced in the opening months of the current year. However, there are some factors in place that may act as a buttress against the slowdown, alleviate its scope and, in the wake of the adjustment, bring the economy back onto a path of potential growth in the medium term. Among these factors are, first, the elements of macroeconomic stabilisation provided by monetary union membership and which are manifest in a setting of moderate interest rates and benchmarks that should anchor inflation expectations. Adding to this are demographic dynamism, the expansion of labour supply, the increases in the stock of capital, the greater flexibility of factor and product markets and healthy public finances, which provide a sound basis for increasing potential output and for macroeconomic workings that make high economic dynamism compatible with the maintenance of the necessary equilibria.

Although the financial turbulence has heightened some of the existing risk factors...

Set against these elements, the emergence of the financial turbulence at the time of a change in cycle in the economy has heightened certain factors of risk accompanying the maturity of the cycle, as well as adding further factors. The materialisation of such risks might detract from the effectiveness of the supportive factors available to the economy to moderate the scope of the slowdown and to sustain the dynamism of activity over the medium term. This is the case, above all, with the possible weakening of the external environment and with the effect of the financial strains on the ability to raise external resources to finance growth.

such as the diminished dynamism of our export markets...

If the recent episode of financial stability and heightening international uncertainty were significantly to affect our export markets, the ability of external demand to contain the adverse impact of the slowdown in domestic spending would be diminished. Were this the case, the intensity of the slowdown would depend to a greater extent on the capacity of Spanish companies to make up for this weakening in demand through further improvements in their competitive position in the face of the sharp adjustment taking place in the structure of world trade. In 2007, the behaviour of foreign trade in goods suggests that certain steps in this direction are already being taken, harnessing the opportunities arising in some emerging economies and in other markets. Progress along these lines will require improvements in the quality of exports and greater containment in cost formation by means of more moderate wage increases and additional productivity gains, as analysed and indicated in Chapter 2 of this Report. At the same time, it must be acknowledged that, in a scenario of a sharper slowdown, the lesser momentum of final demand should be manifest in a slowdown in imports, which would reduce the leakage in expenditure to the external sector and would improve net external demand.

and the effect of the financial strains on the Spanish economy's capacity to raise external financing.

In normal conditions, the financing of the external deficit within a monetary union does not pose problems per se, since it depends exclusively on the credit quality of borrowers. In Spain, it was credit institutions which had been raising the external funds that the economy's high-growth needed, and these institutions had resorted to the international markets backed by their sound financial position. However, in the wake of the financial strains that arose in the summer of 2007, the scope and duration of which is proving far greater than initially expected, international markets specialising in the trading of the medium and long-term assets most commonly issued by Spanish banks have practically ground to a halt, and in some cases may even be said to have collapsed. In these conditions, the degree of financial soundness of borrowers becomes a secondary consideration and high solvency does not suffice to ensure that new resources are obtained. To date, Spanish financial intermediaries have managed to sidestep these obstacles by substituting shorter-dated instruments for long-term securities and by raising more funds on interbank markets, including recourse to the Eurosystem. These are, however, temporary solutions, while awaiting the restoring without too much delay of market capacity to efficiently intermediate financing flows. The possibility of the situation becoming excessively protracted is, therefore, a factor of risk for the economy's external financing, for the supply of funds to the private sector and for the very dynamic of the cyclical adjustment of the economy.

Economic policies must ensure that the supportive factors work and prevent the risks from materialising.

It is the task of economic policies to ensure that the supportive factors available to the Spanish economy work properly, and to prevent the risks present in the current economic situation from materialising. The relevant monetary policy stance for Spain is determined by the requirements stemming from maintaining price stability over the medium term in the euro area, and the decisions adopted by the Eurosystem are the response to this. As a result, the monetary and financial conditions in which Spanish households and firms operate have become progressively less comfortable and have contributed to the orderly slowdown in spending and in credit, although interest rates have held at moderate levels, despite the increases in risk premiums generated by the turbulence. The new monetary policy stance is more in step with the need to tether the inflationary pressures in the Spanish economy and it contributes more to containing inflation expectations, particularly at the start of a cyclical downturn.

Budgetary policy is suitably positioned to enable the stabilising mechanisms to operate in the new cyclical phase...

Budgetary policy is favourably positioned to allow the automatic stabilisers – channelled through the public revenue and spending headings that are most closely linked to economic growth – to operate and offset, to the extent necessary, the effects of the cyclical weakening on agents' spending. This is one of the major advantages arising from the fiscal consolidation drive made during the expansion and one which, unlike in past slowdowns or, more recently,

in some European countries, enables fiscal policy leeway to be regained. This leeway is essential in a setting in which monetary policy is set having regard to the economic conditions and the inflation outlook in the euro area. The fact these instruments are automatic means they are the most suitable ones for stabilisation purposes, as they respond rapidly to the change in cycle and help agents form the correct expectations about government action, thereby building confidence.

but generalised conduct of an expansionary nature that may generate uncertainty should be avoided...

On the other hand, fiscal conduct of an expansionary nature entailing an increase in public spending or a reduction in taxes beyond the action of the automatic stabilisers should be avoided. And this for several reasons. Firstly, owing to the difficulty of accurately estimating the real room for manoeuvre to apply expansionary policies. This is always a difficult task. But it is an especially complex one at present, due to the fact that much of the restructuring of public finances in Spain has been based on high economic growth and, in particular, on the buoyancy of the real estate sector, which made for a strong increase in tax revenue, above what had traditionally been seen in other economic upturns. This increase in revenue therefore has a temporary component which may be of a considerable scale, although difficult to quantify, and may therefore disappear rapidly in a situation of economic deceleration. Moreover, as past evidence shows, the effectiveness of these types of measures is uncertain owing to the lags with which their effects spread. Nor should it be ruled out that, in an economic situation such as the present one, marked by the high volatility of financial markets and a widespread increase in the risks bearing on economic developments, general expansionary fiscal policy measures may generate uncertainty for economic agents, giving rise to a fall-off in private spending. This may be the case in a setting in which, in addition to uncertainty, agents perceive the presence of risks to continuing sound public finances in the medium term, derived from future obligations arising due to the impact of population ageing on public spending on pensions and health. For all these reasons, discretionary measures of this type may compromise continuing budgetary stability over the medium and long term and erode the fiscal policy room for manoeuvre to face sharper slowdowns.

Maintaining a stance of budgetary stability during the economic slowdown is, in any event, compatible with measures which, while potentially altering the composition of revenue and expenditure, do not give rise to a permanent deterioration in the fiscal situation. And this is particularly so if what are involved are measures that contribute to improving the quality of public finances and the economy's efficiency. But for this to occur, efforts to contain public spending must be made, with compensatory measures in those items offering greater scope to tackle cost reductions, at all levels of the general government sector.

bearing in mind, moreover, the medium and long-term challenges public finances face.

Lastly, it should not be forgotten that Spanish public finances face considerable challenges over the medium and long term as a result of the pressure on public spending that foreseeable population ageing will exert. If further reforms to pension systems – increasing the degree of contributiveness and promoting the development of complementary systems – are not promptly made, the long-term sustainability of public finances will prove increasingly costly and difficult.

Headway in structural reforms will prove decisive.

Headway in structural reforms will be decisive. In respect of financial systems, the events since last summer have clearly highlighted the need to review certain aspects of the regulatory framework in which growing innovation and integration must evolve, in the light of the lessons that may be drawn from experience. The reforms needed are, in this case, of an eminently European – if not global – dimension; however, it is for the national authorities to ensure that their implementation is sufficiently swift and, above all, effective. From a more general perspective, it is particularly important in the slowing phase now beginning that the moderation and

change of composition of demand should be harnessed to reorganise and strengthen the productive structure, so that the foundations are laid for a prompt recovery of sustainable dynamism. For this process to prosper, it is vital to push through structural reforms providing for the elimination of obstacles to effective competition in product markets and of those that may hamper the reallocation of productive resources, and to enhance the flexibility of wage and price-setting mechanisms. The degree of flexibility achieved will determine whether the adjustment falls on prices and wages or whether it shifts to activity and employment, generating greater economic and social costs. Fostering an appropriate industrial relations climate may provide the necessary flexibility within companies to make the organisational changes in the management of productive activity needed to adapt to the new cyclical phase and to achieve gains in efficiency in the medium and long run. Progress within companies in this connection may contribute to reducing the need for the adjustment to be made through job cuts, to softening the scope of the slowdown and to facilitating the recovery in economic dynamism. Structural reforms do not only raise the economy's potential growth through productivity gains, employment and productive efficiency, which is key to achieving greater levels of welfare; they also help the economy adjust to macroeconomic shocks and they reduce the risk of these adjustment processes being protracted and costly.

The functioning of the labour market will largely determine the economy's adjustment capacity...

In this respect, as addressed in detail in Chapter 2 of this Report, the greater flexibility achieved in the labour market in recent years has largely been the result of the galvanising effect exerted by new entrants (essentially immigrant workers) in this market. These workers show greater wage flexibility, higher regional and sectoral mobility, and a more active attitude to job loss. Conversely, changes have not been made to collective bargaining or labour hiring arrangements that would herald an adjustment in wages on the scale needed to prevent – in an economic slowdown – the adjustment from falling mainly on temporary employment, which continues to account for more than 30% of total employment. It is thus of paramount importance to pursue labour market reforms, progressively eliminating the nominal and real rigidities in place, aligning wage increases to higher productivity, in a differentiated way across industries and firms, and tackling some of the reforms pending in the field of hiring, so that the current segmentation is eliminated. The fact that the cyclical change in the Spanish economy is occurring at a time of wage rises and with a significant deterioration in the inflationary situation makes it all the more pressing to address this set of reforms.

In parallel, these measures should be accompanied by better training for employees that raises their productivity and helps them adapt to changes in demand requirements and, therefore, that provides for the reassignment of workers across industries and professions. This aspect is also vital over the medium term, when population ageing may curtail the availability of skilled employees. Continuous training for workers must thus be promoted and, in general, both secondary education (the early school leavers' rate is still among the highest in the developed countries) and higher education must be improved, ensuring their adaptation to companies' new needs. Regional mobility might be promoted through the development of a sufficiently deep housing rental market in which legal security should be improved for owners, amending those aspects of rental legislation that may be restricting entry into the market for empty dwellings. These aspects include, for example, the minimum duration of contracts, promoting officially subsidised housing on a rental basis and reviewing the housing-related tax incentives that favour owner-occupation rather than rental.

along with increased competition, further liberalisation...

In addition, the degree of competition in the various sectors of the economy must continue to be increased, by means of liberalisation and deregulation policies. This will be pivotal to improving efficiency in the allocation of resources in the economy and may also contribute to lessening price rises.

According to economic theory, in the absence of market failures, perfect competition guarantees an optimal allocation of resources. As a result, deviations from this situation (monopoly, oligopoly, monopolistic competition, etc) tend to generate an equilibrium price above that of perfect competition, which reduces the quantity of output exchanged and produced by the firms participating in the market. Consequently, the lower the level of competition in an economy, the further its level of production, and hence employment, will be from the potential level to which it could aspire. Moreover, competition not only has positive effects on the country's aggregate wealth, but also a redistributive effect; rivalry between producers forces firms to reduce prices and mark-ups, and thereby to transfer income and the benefits of technical progress and innovation to consumers.

Also, more recent studies show that greater competition may have additional effects on activity without any need for an increase in the economy's factor endowment, since it may affect factor productivity. This is because greater competition: a) gives firms incentives to move closer to their production possibility frontier, thereby reducing so-

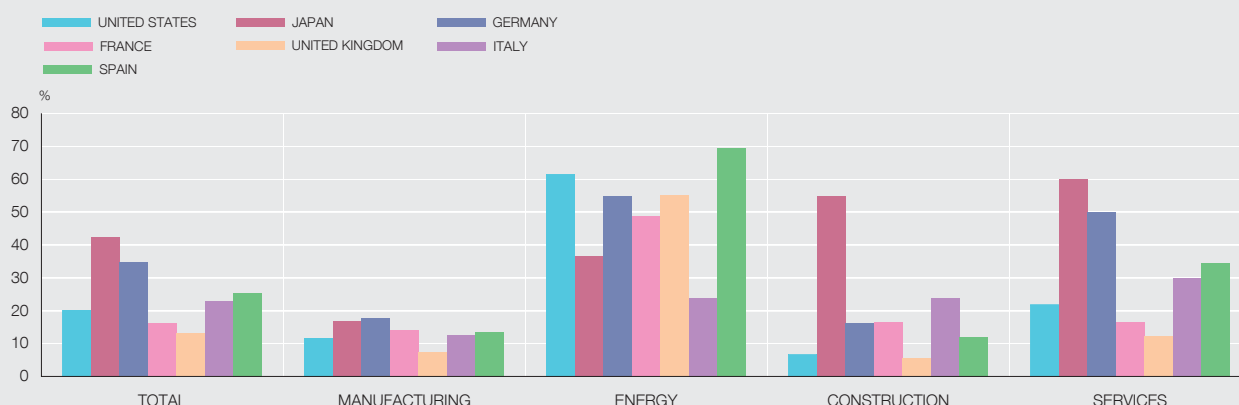
called X-inefficiency;¹ b) causes the most efficient firms to grow and to displace the less efficient ones, which may even disappear, so that they can be replaced by new more productive entrants; and c) may provide incentives for firms to research and innovate.²

One way of estimating the extent to which a market departs from the perfect competition paradigm is to calculate the mark-ups³ of the

1. X-inefficiency refers to efficiency losses arising from the behaviour of individuals that form part of organisations not subject to market discipline, as a result of a lack of adequate control and incentive mechanisms. **2.** This latter effect is much more controversial, both at the theoretical and empirical levels. On one hand, it may be thought that the greater the competition the larger will be the gains to be obtained from reducing production costs, improving output and differentiating oneself from competitors (and the higher the pressures to do these things); on the other hand, it may be argued that as investment in R&D&I usually involves high fixed costs and requires a certain time to obtain the returns, in a world of deficiencies in information transmission only firms with monopolistic profits will have the necessary financial resources to undertake such investment. **3.** Mark-ups are defined as the revenues obtained by a firm over the remuneration it pays its workers, the cost of supplies and of operating the firm generally and the remuneration of productive capital.

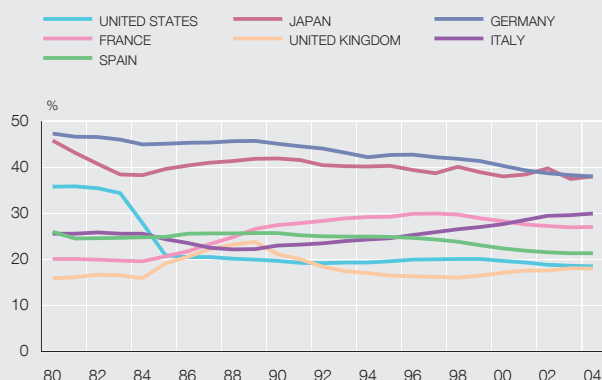
1 ESTIMATED MARK-UPS.

As a percentage of gross output (2000-2004)



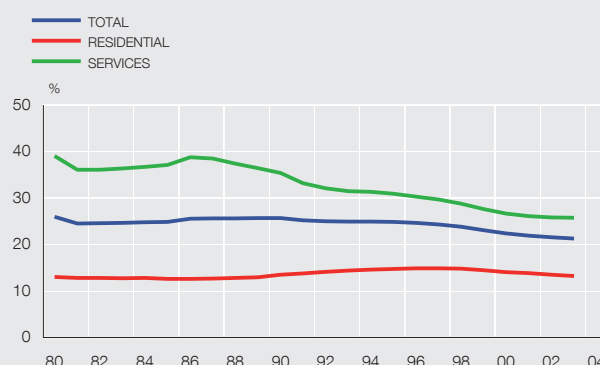
2 EVOLUTION OF MARK-UPS IN THE MAIN DEVELOPED ECONOMIES.

As a percentage of gross output (1980-2004)



3 EVOLUTION OF MARK-UPS IN SPAIN AND SECTORAL BREAKDOWN.

As a percentage of gross output (1980-2004)



SOURCE: Banco de España, on the basis of EU-KLEMS data.

LIBERALISATION (cont'd)

firms operating in it. This box presents an estimation of mark-ups in the Spanish economy for several branches of activity, comparing them with those of the six largest developed countries (United States, United Kingdom, Japan, Germany, France and Italy). The methodology used for this purpose is that introduced by Hall (1988)⁴, various aspects of which have been improved subsequently in order to increase the robustness of the results. Given that there may also be problems of lack of competition in factor markets to be taken into account, the developments of Dobbelaere and Mairesse (2007)⁵, which make it possible to allow for the fact that workers' wages are set through collective bargaining, have also been borne in mind.

In this estimation, mark-ups are approximated, intuitively, as the ratio between firms' revenues and the cost of the factors used in production. Since it is assumed that all factors of production can be adjusted immediately, these estimates can only be considered to be an approximation of long-term mark-up levels. In any case, it should be noted that fixed costs have not been considered, and it is therefore more advisable to draw inferences regarding the level of competition in the same sector in different countries, on the basis of the size of their mark-ups, than in different sectors of a single country.

Panel 1 shows the mark-ups estimated for the seven most developed countries in the first half of the current decade. As can be seen, in Spain the average level of mark-ups in the economy as a whole is around 20%, above the level of 16% estimated for the United Kingdom, the country with the smallest mark-ups. At the level of the major branches of activity, mark-ups seem to be lower in manufacturing than in other branches, probably because the former is more exposed to international competition. In Spain the highest mark-ups are found in the services sector (26%), where they are practically double the 14% level estimated for the United Kingdom. Meanwhile, long-term mark-ups in construction are relatively low in Spain (12%). Significantly, supply has been more dynamic in those countries with the smallest mark-ups in this sector (United Kingdom, United States and

Spain). At a higher level of disaggregation, the results suggest that mark-ups are particularly high in agriculture, recreational and personal services, health, hotels and restaurants, transport, electricity and transport equipment. In contrast, Spain has the lowest mark-ups of all the countries considered in electrical equipment and business services.

Panels 2 and 3 show the evolution of mark-ups over the past three decades. It can be seen how the level of competition in the developed economies has tended to increase in recent decades, except in Italy and France, whose mark-ups were higher in 2004 than at the beginning of the 1980s. Notable among the other countries were the significant reductions in the United States (in the mid-1980s) and in Germany (albeit from very high starting levels, so that it is still the country showing the lowest levels of competition). In Spain, mark-ups have fallen by around five percentage points since the beginning of the 1980s. This reduction has primarily been a consequence of the notable adjustment in services, a process that seems to have halted at the beginning of the new millenium. In the case of manufacturing, there was little change until the beginning of the 1990s and subsequently there has been a clear increase.

To illustrate the potential gains to society of a policy of promoting competition in the economy, various studies have attempted to estimate the increase in output that would be obtained if the level of competition were to be increased. For instance, Bayoumi et al. (2004)⁶ found that the GDP of the euro area could increase significantly if the level of competition were raised to that in the United States. Given that the level of mark-ups in Spain, according to the estimates of this box, in recent years is below that of the largest countries of the euro area, but still higher than in the United Kingdom and United States, the gains in output (and, consequently, employment), to be obtained by bringing competition into line with these two countries, would be sufficiently significant. More specifically, the largest gains would be generated in services and electricity, while there would be no significant gains in either manufacturing or construction.

4. R. Hall (1988), "the Relation between Price and Marginal Cost in US Industry", *Journal of Political Economy*, No 39. 5. S. Dobbelaere and J Mairesse (2007), *Panel Data Estimates of the Production Function and Product and Labor Market Imperfections*, ECB Working Papers Series, No 782.

6. T. Bayoumi, D. Laxton and P. Pesenti (2004), *Benefits and spillovers of greater competition in Europe: a macroeconomic assessment*, ECB Working Papers Series, No 341.

As can be seen in Box 1.3, the degree of competition has, generally, increased significantly in recent decades. In some sectors, though, it is still less than that in other developed countries. Firstly, there is scope to deepen the liberalisation processes already under way in some network industries and, in particular, in the energy sector. Recent developments in terms of the liberalised market segment, prices and market shares in each of the gas, electricity and liquid hydrocarbons marketing sectors show mixed results, which suggest a need to boost competition. As regards transport, the delay in the scheduled liberalisation of the railway industry, in particular in setting up an independent regulator to supervise the functioning of this market, has put back the introduction of effective competition. It should be borne in mind, moreover,

that these two branches of activity – transport and energy – are, as in most developed economies, the main sources of CO2 emissions. Accordingly, action in this area is vital for Spain to comply with the environmental commitments undertaken in Kyoto. Turning to the telecommunications industry, although the price and market share indicators point to further progress in its competitive environment, there nevertheless remains a significant gap between the weight of information technologies compared with the situation in other developed countries, which may be symptomatic of underlying problems in the industry. Finally, in the case of retail trade, the degree of regulation has become progressively more restrictive, which is a cause for concern given the role that distribution channels play in the behaviour of productivity and in price-formation processes. Consequently, it is necessary to reverse this trend and move, in particular, towards lowering the barriers to the entry of new establishments in this sector.

an improved regulatory
framework and productivity
boosts.

Liberalisation policies should be accompanied by the defining of more straightforward, transparent and stable regulatory frameworks. Although accurate estimates are not available, Spain is one of the European countries where the administrative burden on business activity is heaviest, hampering business competitiveness to a greater extent. In this respect, an ambitious transposition of the services directive and specific measures to achieve the objectives set out in this connection in the National Reforms Programme, in particular in the field of R+D+i, might play a very important role in effectively reducing companies' costs and in shaping a setting more conducive to business start-ups, thereby making the economy more dynamic and flexible.

Lastly, the above-mentioned policies should be complemented with further measures aimed at promoting long-term growth. That will require increased investment in physical capital, technology and infrastructure, greater innovation – with the appropriate incorporation of its results into productive processes – and improved public-sector efficiency. All tiers of government should contribute to these objectives, particularly the regional autonomous governments, in view of the substantial powers they have acquired in the different areas of economic activity, as should too the social partners, each from their respective area of responsibility.)

2 ADJUSTMENT OF THE SPANISH ECONOMY: THE REAL ESTATE CYCLE AND THE FUNCTIONING OF THE LABOUR MARKET

Adjustment of the Spanish economy: the real estate cycle and the functioning of the labour market

1 Introduction

Following a long expansionary phase driven by buoyant domestic demand and supply...

During the long expansionary phase of the last decade, growth in the Spanish economy benefited from concurrent and significant expansionary impulses, on both the demand and supply sides. These impulses prompted a notable increase in consumption and investment (residential investment in particular), while a parallel increase in labour supply, linked partly to the phenomenon of immigration, allowed for greater demand to be translated into highly buoyant activity and employment. Over time, however, some of the initial impulses have gradually lost momentum, while the particular growth pattern followed has been characterised by low productivity gains, growth in domestic demand outpacing that of the economy's potential and a marked concentration of productive resources in the residential construction sector. This has given rise to certain imbalances, such as growing household and corporate debt, which has produced a bigger current account deficit, and a persistently higher inflation rate than in the rest of the euro area. The combination of all these factors has opened the way for a gradual slowdown which has progressively taken root during 2007 and which should allow for a move to a new growth pattern based on more balanced fundamentals and one, therefore, more sustainable in the long run.

the exhaustion of the real estate cycle has marked the start of a slowdown...

The first signs of slowdown emerged in the real estate sector in mid-2006 and gradually firmed over the course of 2007. Higher interest rates, lower expectations of property appreciation derived from the maturation of the cycle in this market (in fact, the growth rate of the prices of these real assets has been declining since late 2004) and a more moderate outlook for the growth of household disposable income all progressively led to a slowdown in the demand for housing. As a result, activity in the residential construction sector began to lose steam. In the second half of last year, moreover, the episode of international financial turbulence added further uncertainty over how this process might unfold.

whose transmission to the other sectors depends on developments in employment and in competitiveness...

The effects of the reduction in real estate activity on GDP depend on their scope and intensity and on the extent of the transmission of this reduction to the rest of domestic demand. Although this transmission is through various channels, employment, which is a crucial determinant of household gross disposable income and, therefore, of household consumer spending, is the most influential link in the final result of the impact on domestic demand. The behaviour of external demand and, in particular, its capacity to counter the diminished momentum of internal demand is also particularly relevant. Accordingly, when the main recipient countries of our exports are also immersed in a deceleration, competitiveness takes on particular importance when it comes to fomenting the re-balancing of domestic and external demand and, thereby, attaining a path of sustainable growth.

and, therefore, labour market flexibility is of great importance.

The importance that the behaviour of employment and of competitiveness has in the adjustment of the economy and for anchoring new underpinnings for economic dynamism means that the functioning of the labour market takes on a particularly significant role. The scale of the job losses caused by diminished activity in the real estate sector and by the possible aggregate effects of the slowdown on the other sectors will hinge essentially on the sectoral and occupational mobility of the labour factor and on the degree of wage flexibility. Further, it will be difficult for net external demand to sufficiently offset domestic demand if cost and price differentials with the other euro area countries hold at the levels recorded since the start of monetary union. Correcting this persistent gap requires a greater containment of labour costs than in our fellow euro area Member States and a likewise more significant increase in productivity.

On these premises, this chapter firstly seeks to analyse in depth the causes and consequences of the slowdown in the real estate sector. As the key aspects of the financial turbulence and its influence on the Spanish economy have been addressed in detail in Chapter 1 of this *Annual Report*, the focus here will be on the fundamentals that have underpinned the expansion of the sector and which have led to the maturation of the cycle, and on the channels of transmission of the reduction in real estate activity to the rest of the economy. Under this approach, a detailed analysis will then follow of the central role that the labour market should play in cushioning the aggregate impact of the real estate slowdown, providing both for sectoral and regional mobility of labour and for the substitution of external demand for domestic demand. In particular, there will be an emphasis on the institutional elements of this market that may influence the extent and duration of the current process of deceleration and of moving the economy towards more sustainable growth patterns.

This approach does not mean that the behaviour of the labour market is the only - and not even the most significant - determinant of the intensity and duration of the process of adjustment in which the Spanish economy is immersed. Other variables, such as increased competition in the goods and services markets and the development of structural policies aimed at promoting the efficiency of production factors, will be enormously relevant, and of significance too for improving labour market efficiency and flexibility, as indicated in Chapter 1 of this report. The penetration of Spanish goods and services in foreign markets will also depend on companies' capacity to enhance the quality of their products and to reduce costs. That said, against the background of a slowdown in consumption and in residential investment originating in the real estate adjustment, employment will prove crucial for sustaining aggregate demand and, therefore, economic activity in the short run. This is the main reason why this chapter focuses on the labour market, while competition and structural policies are addressed in detail elsewhere in this *Annual Report*.

2 The real estate cycle

2.1 EXPANSION, DECELERATION AND STRUCTURAL SUPPORTS OF THE REAL ESTATE SECTOR

Among the various specific factors that have contributed to the real estate expansion, strong demographic dynamism has been to the fore...

Between 1998 and 2007, there was an increase of around 5.7 million units (29.6%) in the housing stock. One initial explanation for this strong rise lies in the increase in the resident population in Spain, boosted by high immigrant flows, which amounted to 5.3 million people (13.4%) in this period. This expansion in the resident population was accompanied, moreover, by significant changes in its composition, which also influenced the greater demand for housing. The number of households rose by a greater proportion (4 million, i.e. 32.3%), as a result of the reduction in the average household size, from 3.25 to 2.8 members. This decline in the average household size is essentially due to the increase in the number of single-person and single-parent households, which rose from 366,000 in 1998 (24.6% of the total) to over 540,000 (36.3% of the total) in 2005.¹ Also, the change in the breakdown by age of the population has contributed to the increase in the real estate stock. As the findings of Box 2.1 show, around 60% of the increase in the number of dwellings between 2002 in 2005 might be attributed to the rise in population and to the greater weight of groups more disposed to occupy one or several dwellings.

The foregoing demographic developments are rather singular when compared with other countries which, like Spain, have experienced a substantial upward cycle in house prices since the late 1990s and which, subsequently, have performed much less dynamically, with these prices even sliding. Another idiosyncratic factor of the Spanish cycle is the significant role that the demand for property by non-resident households may have played. Unfortu-

1. These data are drawn from the Encuesta Continua de Presupuestos Familiares (Spanish Household Expenditure Survey), the latest available results for which are for 2005.

The housing stock in Spain has expanded notably in recent years: from 2002 to 2005 it increased by more than 2.1 million units. This growth has coincided with two significant developments: more accommodative financial conditions and an increase in the size of the population. This box offers an estimate of the change in the housing stock between 2002 and 2005 due to demographic factors.

A simple life cycle model predicts that the aggregate demand for housing depends, as well as on the size of the population, on its composition by age. In the first stage of the life cycle, young people are more likely to live with their parents or to demand rental housing, instead of being owner-occupiers. As individuals grow older (and, normally, as they achieve a higher level of income and family size grows), there is a greater probability they will demand additional housing, both as a main residence and for holiday purposes.¹ Finally, following retirement, individuals scale down their real estate assets and some share the residence with family members. The information available in the EFF-2002 (Spanish Survey of Household Finances-2002) confirms these patterns of house ownership (see panel 1). It can be seen that, both in the early stages of the life cycle (between

18 and 45 years of age) and in the last stage (over 65 years of age), individuals are more inclined to live with other family members, and that the probability of owning a main residence and a second home peak in the middle phase of the life cycle (between 46 and 65 years of age).

Between 2002 and 2005, the Spanish population underwent a sizeable increase from 41,135,500 to 43,500,520 inhabitants (up 5.75%). Moreover, growth was sharper in the age segments spanning the time of the life cycle in which individuals are more inclined to own houses. The effects of these demographic changes on the demand for property can be quantified using estimates based on data from the EFF-2002 and on the use of multinomial logit discrete-choice models. More specifically, an estimate is made in this box of the probability that, as a result solely of their age, individuals conform a specific type of household (living as a couple or in other situations) and rent or acquire their main residence or additional homes. Once these probabilities are obtained, and given the size and composition of the Spanish population in 2005, the stock of housing for that year derived exclusively from demographic developments can be estimated. By comparison with the actual stock observed, it can then be calculated which portion of the change from one year to the next is attributable to demographic changes and which (the rest) responds to the behaviour of the other determinants of house ownership (income, job status, property prices, etc.).

15. One specific feature of the Spanish economy is the high propensity of individuals to possess a second home for holiday purposes. The average age at which this second home is purchased has been surprisingly stable since 1990: 44 years of age.

1 THE DEMAND FOR HOUSING THROUGHOUT THE LIFE CYCLE (a)

		DWELLING OCCUPANCY STATUS					
		Rent habitual dwelling (b)	Own habitual dwelling (b)	Own house other than habitual dwelling (c)			Live with family members
				One	Two or three		
18-35 years old	Live as couple	0.064	0.226	0.025	0.001	0.635	
	Other	0.021	0.022	0.006	0.001		
36-45 years old	Live as couple	0.137	0.536	0.095	0.006	0.125	
	Other	0.028	0.061	0.010	0.001		
46-55 years old	Live as couple	0.088	0.542	0.153	0.026	0.070	
	Other	0.029	0.082	0.009	0.001		
56-65 years old	Live as couple	0.053	0.561	0.172	0.031	0.054	
	Other	0.025	0.087	0.015	0.002		
Over 65 years old	Live as couple	0.054	0.431	0.096	0.013	0.175	
	Other	0.041	0.166	0.021	0.002		

SOURCE: Banco de España.

a. Prepared drawing on data from the EFF-2002. The figures show the probabilities of house-occupancy and marital status for each age group. The predictions are obtained using a regression in which the explanatory variables are the age group and sex of each survey respondent over 18.

b. These individuals do not own any dwelling other than that in which they reside.

c. The dwellings demanded by these groups exclude houses rented out to other households or provided free of charge. They include dwellings used by individuals that do not own their habitual residence, but possess a second home.

The results of this exercise are summarised in panel 2. As can be seen, the changes in the size of each of the population groups considered explain fairly well the direction and, to a lesser extent, the scale of the change in the stock of housing used as the main residence. As might be expected, however, in the case of houses other than the main residence, the exclusively demographic factors leave a major portion of the increase between 2002 and 2005 unexplained, particularly if the number of these houses is greater than two. This result would corroborate the fact that, unsurprisingly, the ownership of houses that are not the main residence depends to a greater extent on non-demographic factors that this model does not include. The aggregation of the estimated ownerships for the different types of houses suggests that the growth of the stock between 2002 and 2005 that could be justified exclusively on the basis of the changes in this period in the size and composition of the Spanish population is 1,142,112 dwellings. The increase actually observed was 2,040,450 dwellings, according to the (provisional) data of the EFF-2005 and, therefore, the demographic changes would account for around 56% of the increase in the housing stock over that period.

Following the same approach, an estimate can also be made of what the housing stock relating to the size and to the composition of the

population projected for 2010 would be (once again, this would ignore the effects of the behaviour of the other fundamental determinants of this variable). The result, which is also shown in panel 2, entails an increase in the housing stock of 1,564,865 dwellings between 2005 and 2010, which would mean that the annual growth rate of the demand for housing due exclusively to demographic reasons would be slightly lower as from 2005 (315,000 units) than that observed between 2002 and 2005 (380,000 units). This difference is attributable to the fact that, although the size of the population is expected to increase to a greater extent in the period 2005-2010, the increase will be relatively concentrated on this occasion in the age groups exhibiting lower-than-average demand for housing (specifically the age groups between 0 and 17 years of age and the over-65s).

In any event, it should be recalled that these results need to be viewed with some caution, since the statistical procedure used does not allow for the possibility that the behaviour of youths today may differ from that of their parents when they grow older. Moreover, the EFF-2002 offers no precise knowledge of the use of real estate properties held by households when more than three units are involved.

2 CONTRIBUTION OF DEMOGRAPHIC CHANGES IN 2002-2010 TO THE INCREASE IN THE HOUSING STOCK (a)

Dwellings (000s) (b)

			Actual data			Estimated demand with population structure for:		Demographic explanation
			2002 (1)	2005 (2)	Difference 2002-2005 (3)=(2)-(1)	2005 (4)	2010 (5)	% change 2002-2005 (4)-(1)/(3)
Couples	Rent their habitual residence (c)		944	1,163	219	1,003	1,090	0.27
	Own their habitual residence (c)		1,312	1,423	111	1,403	1,515	0.82
	Own dwelling other than their habitual residence (d)	One	2,564	3,091	527	2,725	3,015	0.31
		Two or three	6,894	7,133	240	7,390	8,023	2.07
Other	Rent their habitual residence (c)		759	1,031	272	807	880	0.18
	Own their habitual residence (c)		2,978	3,572	594	3,208	3,504	0.39
	Own dwelling other than their habitual residence (d)	One	145	236	92	154	166	0.10
		Two or three	602	587	-14	649	711	-3.38
Total dwellings			16,197	18,238	2,040	17,339	18,904	0.56

SOURCES: INE and Banco de España.

- a. In-house estimates drawing on the EFF-2002 and the EFF-2005 and on INE's short-term population projections for the central scenario.
b. The figures for dwellings only include the main residence and the three second homes among the three real estate properties of most value reported by households in the EFF-2002 and the EFF-2005.
c. These individuals do not own any dwelling other than that in which they reside.
d. The dwellings demanded by these groups exclude houses rented out to other households or provided free of charge. They include dwellings used by individuals that do not own their habitual residence, but possess a second home.

nately, the lack of more accurate statistics prevents a precise quantification of the true weight of this factor.²

along with low interest rates,
favourable credit conditions and
favourable growth
expectations...

Other factors conducive to the real estate expansion are of a more general nature, though it is likely that their effects have been amplified to some extent by the marked preference of Spanish households for real estate assets. Firstly, mention may be made of the low levels of nominal and real interest rates, households' expectations of higher income and the greater availability of credit. As dwellings are long-lasting assets, their production and acquisition are normally characterised by high levels of leverage, meaning that activity in the sector is especially sensitive to credit conditions. As Chart 2.1 shows, interest rates for house purchases by households moved on a declining trend, until reaching lows between 2002 and 2005. In addition, the improved terms of access to financing brought about by higher employment and by stiff competition and financial innovations in the mortgage lending segment, among other factors, boosted the extension of credit to households for house purchases. This credit grew at a year-on-year rate of around 20% in the 2000-2003 period, and at 24% in 2004-2005.³ Loans to builders and property developers also increased significantly, with growth rates of around 19% and 36% in the first half of the decade.

The fact that real estate properties can typically be used as a guarantee generates some feedback between household debt and housing demand and prices: a greater facility for indebtedness is conducive to an increase in the demand for houses and in house prices, but an increase in the latter variable also prompts greater indebtedness, given the use of this asset as collateral for the debts.

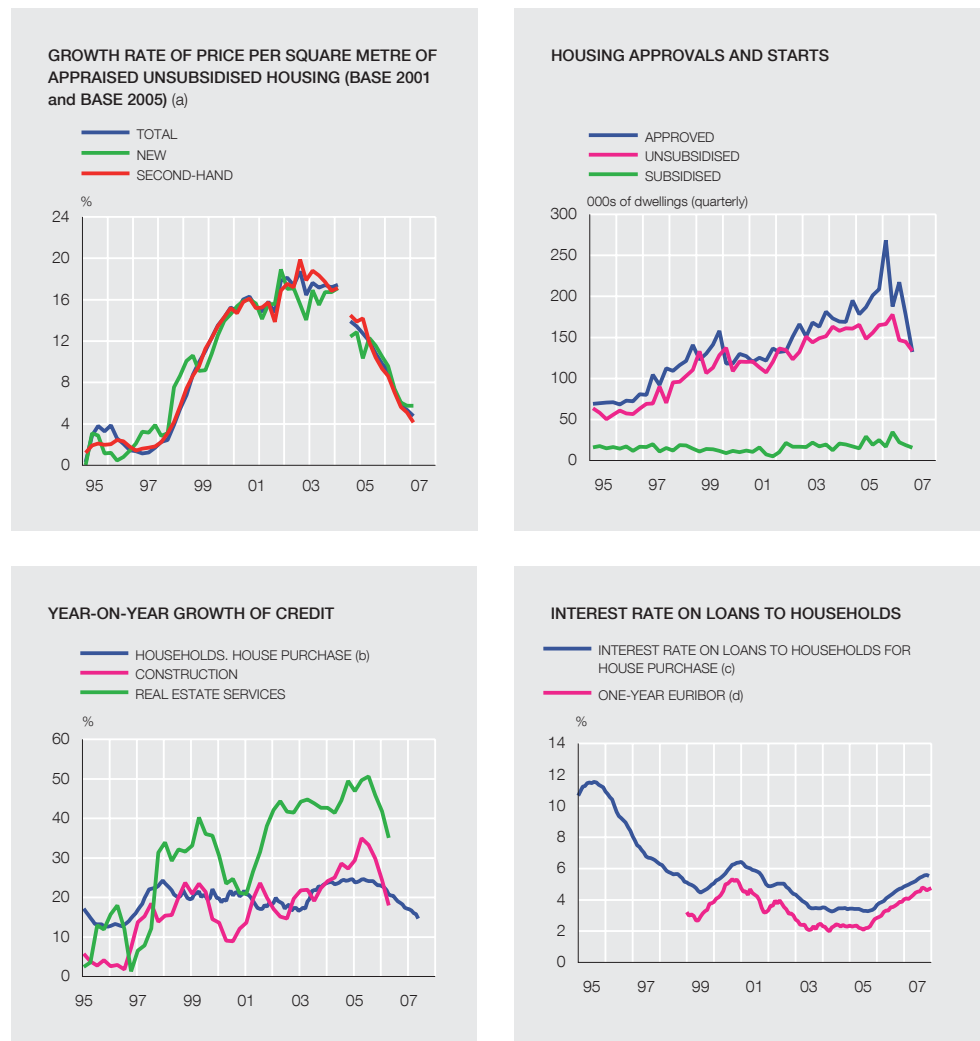
and high supply capacity in the
construction sector to
accommodate the increase in
demand with the construction
of new houses.

On the supply side, the sector has also shown notable responsiveness. As Chart 2.1 shows, the construction of new houses moved on a rising trend between 2000 and 2006, peaking at 760,000 housing starts in this latter year.⁴ Among the factors that have made for this high dynamism of supply, three stand out: the availability of buildable land which, though it may have delayed to some extent the response by supply to the momentum of demand, does not appear to have entailed such a significant constraint as in other countries more densely populated or strictly regulated in terms of urban planning; readier accessibility by property developers to credit; and, finally, the increase in labour supply, fuelled by immigration, which has prevented this factor from limiting the construction of new houses. Hence, on considering the countries that have seen the biggest increases in house prices in recent years, Spain stands out as one with the most significant increases in residential investment and in employment in the construction industry, both in absolute terms and relative to the rise in house prices.⁵

Following the exhaustion of a
rather singular real estate
cycle...

As Chart 2.1 shows, financial conditions began to become less accommodative from mid-2005. Interest rates on loans to households began to rise as from this date, which bore on the behaviour of credit, the slowdown in which is also evident from early 2006 in the case of households, and from somewhat later in that of builders and property developers. Property prices, as

2. Foreign direct investment in real estate increased by 102% between 1998 and 2006. Bearing in mind the developments in average house prices and assuming that all real estate acquired by non-residents consisted of houses gives a figure of around 45,000 units per year. However, in 2006, the only year for which this figure is available, the Property Register shows a substantially lower volume of purchases: approximately 17,000. 3. For greater details on the determinants of household credit, see Fernando Nieto (2007), *The determinants of household credit in Spain*, Documentos de Trabajo, no. 0716, Banco de España. 4. This figure, however, may be distorted as a result of the implementation of the new Technical Building Code, which undoubtedly quickened the start of works in the period immediately prior to its entry into force. 5. A recent paper by Olympia Bover and Juan F. Jimeno (House prices and employment reallocation: International evidence, Documentos de Trabajo, no.0705, Banco de España) estimates the elasticity of employment in the construction sector to house prices in several Western countries. Spain is among the countries with the highest values for this elasticity.



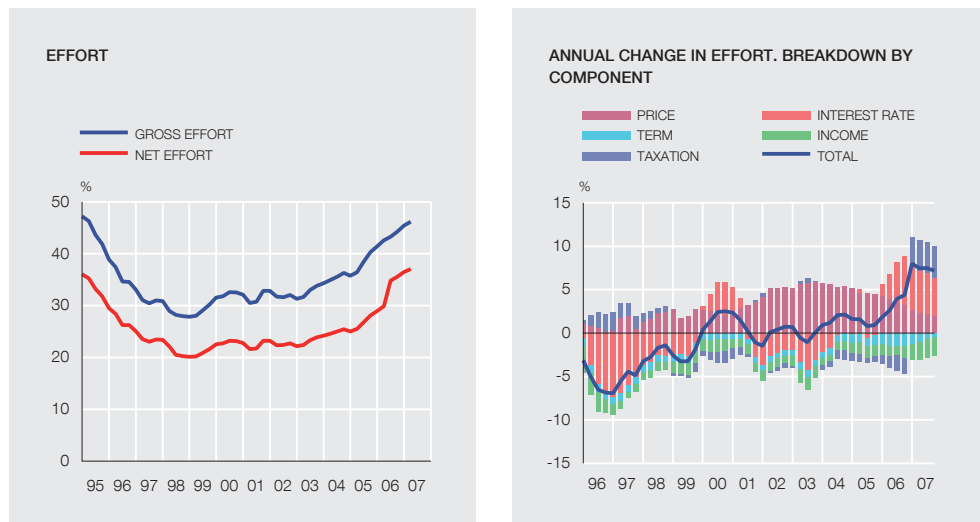
SOURCES: Ministerio de Fomento, Ministerio de Vivienda and Banco de España.

- a. New statistic from 2005.
- b. Includes blaance sheet and securitised credits.
- c. This corresponds since January 2003 to the rates reported under Circular 4/2002.
- d. Series published since January 1999.

earlier indicated, moved as early as late 2004 onto a slowing course towards rates more compatible with their fundamentals, thereby influencing expectations of property appreciation. However, the average rate of change of prices continued to be positive which, combined with the turnaround in the cost of financing, has made access to housing less affordable. As observed in Chart 2.2, the habitual indicators of affordability – the instalment payable on a standard mortgage loan for the purchase of a new house relative to average household income⁶ – reached a minimum in 1999 and began to rise moderately to 2005 (accumulating growth in this period of around 1 pp) and somewhat more sharply (5 pp) in the 2006-2007 period.

A scenario of more contained growth forecasts progressively took shape in 2007 both in Spain and in the EU countries, whose residents may have contributed to a greater extent to the demand for housing in Spain. Taken as a whole, the foregoing factors point clearly to the dimin-

6. For an explanation of the methodology underlying the construction of these indicators, see Jorge Martínez Pagés, «Indicadores de accesibilidad y esfuerzo en el mercado de la vivienda», Boletín Económico, May 2005, Banco de España.



SOURCE: Banco de España.

ished momentum of the demand for property in Spain. The eminently idiosyncratic nature of many of the factors behind the upturn means that the recent experience of countries such as the United States, for example, does not provide valid references for gauging the potential course and scale of the new phase. Analysis of the factors that will determine the behaviour of the real estate sector during the process of adjustment must therefore be tackled from an eminently domestic perspective.

demographic dynamism...

The first such factor is demographic dynamism. As indicated above, the real estate expansion in Spain, unlike in other countries such as the United States or the United Kingdom, has been strongly boosted by the growth of the population and by the changes in its composition. On available demographic projections, population growth is expected to hold at a high rate in the coming years, underpinned by significant migratory flows; however, the change in business cycle poses some uncertainty over the net flow of immigrants assumed in these forecasts. As Box 2.1 illustrates, maintaining the patterns of house ownership by population group observed in 2002, the demographic projections for 2010 would entail the need to increase the housing stock, as a result exclusively of population changes, by around 315,000 units a year, compared with an equivalent figure of approximately 380,000 a year during the 2002-2005 period. Moreover, these calculations fail to consider the foreseeable increase in demand arising from the likely permanence of some of the demographic factors that have driven the reduction in the average household size, as is the case, for instance, of the growing incidence of marital separations. In this respect, it is illustrative to point out that, despite its rapid decline, the average household size in Spain (2.8 members) still remains considerably greater than in most EU countries (2.4 on average; 2.1 in Germany; 2.4 in France; 2.6 in Italy; 2.3 in the United Kingdom).

the behaviour of house prices...

Even under easy credit conditions, house buyers normally have to pay out a certain amount from their own funds. Accordingly, the growth of house prices during the cyclical upturn has limited the purchasing capacity of the population groups with the least own resources. Indeed, drawing on data from the Spanish Survey of Household Finances, in the 2002-2005 period the percentage of households that were owners of their main residence fell among households with a head under 35 years old (from 68.3% to 62.1%) and among households belonging to the bottom two deciles of the income distribution (from 74.1% to 70.7%).⁷ In the deceleration phase, however, if the ratio

of income to the price of real assets were to increase for a portion, at least, of this group of potential purchasers, then their access to the market might be easier, thereby reactivating, to some extent, the demand for housing among specific segments of the population.

and labour flexibility in the construction sector...

According to the Labour Force Survey, between early 1996 and late 2007 employees in the construction sector⁸ increased from 1.17 million to 2.72 million. Almost half of these jobs (43.9%) were occupied by foreigners, the relative weight of whom in this sector rose from 1.1% to 24.4% over the same period. In addition, the proportion of temporary to total employees in construction stands at around 55%. The greater occupational and regional mobility associated with the characteristics of construction workers might mean, firstly, that the adjustment may come about with fewer job losses in the medium term in the sector and, secondly, that wages and, therefore, labour costs in the sector might play a more a relevant role in this adjustment than in previous episodes of deceleration.

might contribute to limiting the intensity and duration of the slowdown in real estate activity...

The foregoing elements might lead to the deceleration in the residential sector encountering a line of support that was to limit its scope and duration. In this same vein, some of the possible measures related to the sector might be conducive to house price developments moving on a trajectory without abrupt oscillations. Thus, for instance, when there is some segmentation between those demanding residential services who take up ownership of a property and those who rent, the measures aimed at favouring the profitability of house rentals might redirect a portion of these properties towards this market and, therefore, contribute to lessening the pressure of supply on house prices.

although some current risks may detract from the functioning of these supporting factors.

However, the uncertainty at present over the future course of many of the variables that may wield an influence in the adjustment of the real estate sector is high and, therefore, the ultimate functioning of the aforementioned supporting factors is subject to rather sizeable risks. A portion of these risks stems directly from the difficulties of gauging the true extent of the possible mismatches built up during the expansion, in terms both of prices and quantities. For example, estimates of the excess supply in the residential property market require precise details on the behaviour of numerous socio-economic factors, and the degree of segmentation of this market in several facets (geography, income strata and wealth); consequently, they generally offer a range that is overly wide and excessively dependent on the assumptions made. Further, the particular characteristics of the Spanish real estate cycle mean, as earlier mentioned, that the patterns observed in episodes of deceleration in other countries or in previous periods are not very informative. Finally, the coincidence of the change in cycle in the sector with a period of financial instability whose final effects have yet to emerge in full make it extremely complicated to estimate the most likely adjustment dynamic.

2.2 THE TRANSMISSION CHANNELS OF THE REAL ESTATE DECELERATION AND THE RE-BALANCING OF AGGREGATE DEMAND

The real estate adjustment affects the rest of the economy

Any reduction in economic activity in one sector affects the rest of the economy. In the case of residential construction, these effects essentially arise through changes in household wealth and disposable income, which are the basic determinants of their spending decisions.

In a world in which markets functioned smoothly and without uncertainty, and with similar house-ownership and consumption patterns for individuals from different income and wealth levels, the effects of the changes in real estate wealth on expenditure would be zero. The presence of frictions, uncertainty and heterogeneity, however, and the significant role that property plays as potential collateral for loans, mean that changes in house prices may affect household

7. See «Survey of household finances (EFF) 2005: methods, results and changes between 2002 and 2005», Economic Bulletin, January 2008, Banco de España. 8. The statistics available do not allow the residential and non-residential segments to be separated under this sector.

through two fundamental channels: the wealth effect on consumption...

whose extent would be contained if house prices were to move on a gradual path...

and those arising directly from the reduction of activity in the real estate sector.

consumption and residential investment (and even corporate spending, if this depends on loans collateralised by real assets). In this respect, it is important to recall that, for this channel to operate, capital gains or losses need not materialise, since the mere possibility they may do so in the future if necessary may be sufficient motive for reducing or increasing the need for precautionary saving. In any event, the possibilities the financial markets offer to make increases in property value liquid will evidently have an influence on the potential extent of the effects. Likewise, perceptions as to the permanent or transitory nature of the changes observed in the value of wealth will have a bearing on the scale of the impact.

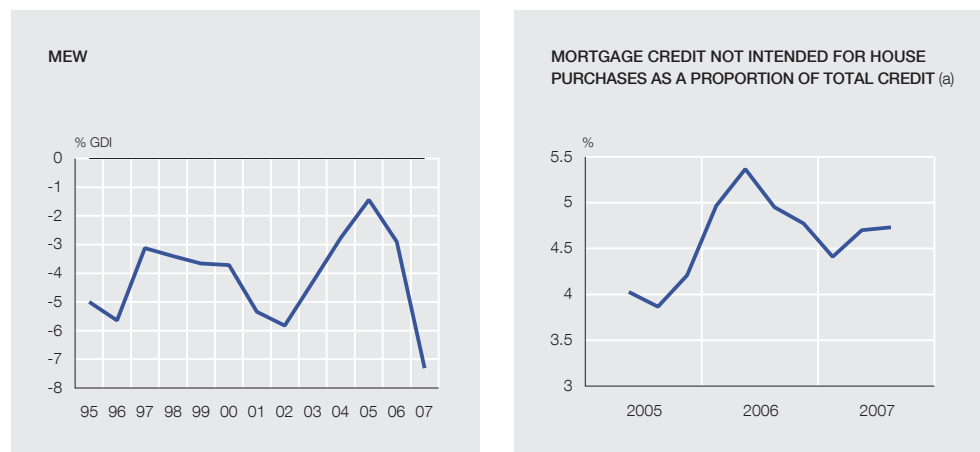
The estimates available drawing on the use of the data of the 2002 Survey of Household Finances suggest that the propensity to modify consumer spending in the face of changes in real estate wealth is 0.03 in Spain.⁹ That is to say, an (exogenous) reduction of €100 in the value of household real estate property would lead to a reduction in their annual level of consumption of €3. Nonetheless, these figures mask significant differences across household groups. Specifically, this effect would be greater (around 0.06) for households whose head is aged between 35 and 44. Moreover, they would vary from 0.035 for the lower part of the real estate wealth distribution to 0.004 at the upper levels of this distribution.

These results tend to confirm that in Spain the value of real estate wealth affects consumption principally, because households consider it as a potential source of resources with which to withstand future contingencies if necessary. That is to say, the main channel through which the wealth effect on consumption is transmitted is precautionary saving and not the transformation of the capital gains associated with the revaluation of their assets on additional spending decisions (through the mortgage lending channel for ends other than house purchase). The evidence available therefore suggests that the use of secured loans by Spanish households to finance consumption decisions is scant, as can be seen in Chart 2.3.

Overall, given the sizeable weight of housing in the Spanish household asset portfolio¹⁰ and the wealth effect estimate discussed above, each percentage point of decline in the real value of property wealth might translate into a reduction in consumption of approximately 0.15 pp. The interaction between the heterogeneous component of property prices by geographical area and by type of dwelling and the differences detected in marginal propensities by age and income strata might mean that, for a specific group of agents, the effects would be greater. That said, the wealth effect would only prompt a considerable impact on overall household consumer spending and, therefore, on the level of economic activity in the other sectors if there were a very abrupt adjustment in prices.

Apart from the wealth effect, potentially the most significant transmission channel in Spain's case is that operating through the impact of less housebuilding on the dynamism of employment and of the wage income generated in the real estate sector. Diminished activity tends to reduce disposable income and, therefore, consumer spending by households with members employed in this sector. The scale of the effect will naturally depend on the perception these households may have of the permanent or transitory nature of the changes in their income

9. See Olympia Bover (2005), Wealth effects on consumption: microeconomic estimates from the Spanish survey of household finances, Documentos de Trabajo, no. 0522, Banco de España. Taking aggregate data, it is estimated that the annual marginal propensity to consume is 0.02 for real estate wealth (see Carmen Martínez-Carrascal and Ana del Río (2004), Household borrowing and consumption in Spain, Documentos de Trabajo, no. 0421, Banco de España). If a distinction is drawn between durable and non-durable consumption, the respective estimated propensities to consume are 0.01 and 0.08 [see Teresa Sastre and José Luis Fernández (2005), Un modelo empírico de las decisiones de gasto de las familias españolas, Documentos de Trabajo, no. 0529, Banco de España]. 10. According to data from the 2005 Survey of Household Finances, real estate assets accounted for around 80% of Spanish households' total assets as at that date.



SOURCE: Banco de España.

a. Loans granted by OMFIs to households.

which, in turn, will be linked to the capacity of the labour market to reabsorb the excess supply, if any, in the sector. In any event, lower consumer spending by these households – should this come about – might ultimately affect, to a greater or lesser degree, the economy's overall domestic demand, as a result of the multiplier effect.

To assess the aggregate effects that the real estate slowdown may exert through this channel, it is necessary to resort to a general equilibrium model that allows for quantification of the adjustments needed in relative prices in the face of a reduction in demand in a specific sector. To this end, the left-hand panel of Table 2.1 offers some illustrative simulations with the BE-MOD¹¹ model. More specifically, to assess the effects of the real estate slowdown, a negative transitory shock in the Spanish non-tradeable goods sector is considered, the magnitude of which has been calibrated to prompt, at the time the shock occurs, a decline in employment in this sector of 0.5% in quarterly terms. So that this simulation may better represent the impact of the slowdown in residential construction, the weights of the non-tradeables sector in output and in total employment have been adjusted accordingly.¹² Consequently, this simulation did not take into account the possibility that the non-residential component may gain in relative weight and counter, at least partially, the adverse effects derived from lower demand for housing.

The effects of the shock obviously depend on their degree of persistence, which is why two scenarios have been considered: the first is a low-persistence scenario in which, after two quarters, the magnitude of the shock has been halved; and the second, one of high persistence, in which this average life runs up to two years. While in both scenarios the impact in the first quarter is very similar (–0.17 pp or –0.18 pp of deviation from GDP in relation to the base scenario), at longer horizons the differences are notable. In the first scenario, after one year, the cumulative losses in GDP and in employment relative to the base scenario are, respectively, –

11. The BEMOD is a dynamic stochastic general equilibrium model that represents the behaviour of consumers and of tradeable and non-tradeable goods producers in the Spanish economy, of consumers and producers in the rest of the euro area, of governments in both areas and of the common monetary policy [see Javier Andrés, Pablo Burriel and Ángel Estrada (2006), BEMOD: A DSGE model for the Spanish economy and the rest of the Euro Area, Documentos de Trabajo, no. 0631, Banco de España]. 12. Thus, in the simulation, the weights of the non-tradeable goods sector in output and in employment have been respectively set at 0.487 and at 0.591.

	Low persistence		High persistence			In a more flexible economy (a)			With additional adjustment of unit labour costs (a) (b)		
	One quarter	One year	One quarter	One year	Two years	One quarter	One year	Two years	One quarter	One year	Two years
OUTPUT											
Tradeable goods	0.06	0.19	0.07	0.44	0.70	0.08	0.50	0.83	0.27	1.40	2.38
Non-tradeable goods	-0.42	-0.75	-0.43	-1.63	-2.30	-0.42	-1.56	-2.12	-0.22	-0.85	-1.24
Total	-0.18	-0.27	-0.17	-0.57	-0.76	-0.17	-0.50	-0.60	0.03	0.31	0.62
EMPLOYMENT											
Tradeable goods	-0.04	0.03	-0.03	0.13	0.29	-0.02	0.23	0.50	0.32	1.40	2.20
Non-tradeable goods	-0.50	-0.86	-0.50	-1.87	-2.61	-0.50	-1.77	-2.38	-0.19	-0.81	-1.35
Total	-0.31	-0.50	-0.31	-1.05	-1.43	-0.30	-0.95	-1.20	0.00	0.00	0.00
INFLATION DIFFERENTIAL (SPAIN-EURO AREA) (%)											
INFLATION DIFFERENTIAL (SPAIN-EURO AREA) (%)	-0.03	-0.01	-0.04	-0.05	-0.03	-0.05	-0.05	-0.04	-0.05	-0.05	-0.04
TRADE DEFICIT (WITH EURO AREA) (%)											
TRADE DEFICIT (WITH EURO AREA) (%)	-0.01	-0.03	-0.02	-0.11	-0.17	-0.02	-0.12	-0.18	0.05	0.04	-0.10

SOURCE: Banco de España.

a. These results are for the simulation with high persistence.

b. Under this scenario the responses of total employment are zero by definition of the shock.

0.27 pp and -0.50 pp; in the high-persistence scenario, these losses would be -0.57 pp and -1.05 pp. As can be seen in the table, this shock generates a slight improvement in the inflation differential which leads output in the tradeable goods sector to rise and reduces the trade deficit in relation to the euro area. But these effects are minor and do not prevent some job destruction from occurring in the tradeable goods sector during the initial quarters.

The capacity of external demand to offset these effects depends on the improvement in competitiveness...

The effects of the deceleration in the real estate sector on GDP might be cushioned if, in parallel, it were possible to increase the dynamism of external demand. Given the deceleration in our main export markets, the possibility of re-balancing rests, above all, on improving the competitive position of domestic output.

Changes in the competitiveness of an economy depend on numerous factors. First, there are all those that influence the relative prices of national products compared with those produced abroad, suitably adjusted by the related differences in quality. Further, there are those that cause changes in the relative demand for both types of products, such as changes, for instance, in consumer preferences or in the world productive structure, which may act in favour or against the country's specialisation. Hence, an increase in competitiveness may come about, broadly speaking, through several channels: i) improvements in the quality of national products; ii) a relative demand shock in favour of national products; iii) a depreciation of the currency, and iv) a reduction in the domestic inflation rate below the inflation rate abroad.

which, among other factors, is affected by unit labour costs...

Among all these factors, the inflation differential with the euro area, given the high weight of Spain's foreign trade with the area's member countries, is of particular importance. This is all the more so in a situation such as the current one marked by the deceleration in international

	To the branch deflator			To the total deflator		
	1996-2001	2002-2007	1996-2007	1996-2001	2002-2007	1996-2007
CONTRIBUTION OF THE DIFFERENTIAL BY BRANCH OF ACTIVITY						
TOTAL	1.6	1.8	1.7	1.6	1.8	1.7
Unit labour costs	1.1	0.8	1.0	1.1	0.8	1.0
Compensation per employee	0.6	0.6	0.6			
Apparent productivity	0.6	0.2	0.4			
Unit surplus	0.5	1.0	0.7	0.5	1.0	0.7
AGRICULTURE	0.3	2.0	1.2	0.0	0.1	0.0
Unit labour costs	0.5	-0.3	0.1	-0.1	0.0	0.0
Compensation per employee	1.1	-0.6	0.2			
Apparent productivity	-0.8	0.4	-0.2			
Unit surplus	-0.1	2.3	1.1	0.1	0.1	0.1
INDUSTRY AND ENERGY	1.0	2.6	1.8	0.2	0.5	0.3
Unit labour costs	0.9	1.0	0.9	0.2	0.2	0.2
Compensation per employee	-0.2	0.4	0.1			
Apparent productivity	1.1	0.7	0.9			
Unit surplus	0.1	1.5	0.8	0.1	0.3	0.2
CONSTRUCTION	2.6	3.0	2.8	0.2	0.5	0.4
Unit labour costs	2.6	1.3	2.0	0.3	0.3	0.3
Compensation per employee	1.2	1.1	1.1			
Apparent productivity	1.3	0.3	0.8			
Unit surplus	0.0	1.7	0.9	0.0	0.3	0.1
SERVICES	1.8	1.3	1.6	1.1	0.8	1.0
Unit labour costs	1.3	0.6	0.9	0.9	0.4	0.6
Compensation per employee	0.8	0.6	0.7			
Apparent productivity	0.5	0.0	0.2			
Unit surplus	0.5	0.7	0.6	0.3	0.4	0.4

SOURCES: INE and Eurostat.

demand. The behaviour of this differential is the result both of the growth of unit labour costs (which, in turn, can be broken down into increases in labour costs and labour productivity) and of the operating margin, both expressed in relation to those of the euro area. Table 2.2 shows that, during the 1996-2007 period, the factor that most contributed to the persistence of a positive inflation differential (1.6 pp per year on average from 1996 to 2001 and 1.8 pp per year from 2002 to 2007) was the unit labour costs differential. However, during the second part of the period (2002-2007) there was a reduction in the relative weight of this differential and a widening of that relating to business margins. In sectoral terms, as can be seen in Chart 2.2, the inflation differential in the first part of the period (1996-2001) could be attributed essentially to the services sector, which contributed 1.1 pp of a total of 1.6 pp, while during the period 2002-2007 both industry and construction and services made significant contributions to this differential (0.5 pp, 0.5 pp and 0.8 pp, respectively), and in the three cases the unit labour costs differential accounts for approximately half of the contribution of each sector to the total inflation differential.

This relationship between competitiveness and relative unit labour costs highlights the significance of developments in the labour market for helping to push through the necessary repositioning of Spanish final demand and for shoring up the supporting factors that may limit the slowdown in the economy.

and by the level of competition and the dynamism of the goods and services markets.

The moderation of unit labour costs is a necessary condition for promoting the competitiveness of the Spanish economy and, therefore, for increasing the contribution of external demand to its growth. But the level of competition of the goods and services markets and, in particular, the lifting of obstacles to business start-ups are equally important in the current setting. Indeed, greater labour market flexibility and growing competition in the goods and services markets are complementary in many respects. For instance, in a labour market with restrictions on job mobility and rigid wages, an increase in competition in the markets for goods and services does not guarantee the generation of new economic activity in expanding sectors, as there will be obstacles to the necessary reallocation of the labour factor towards these sectors. Likewise, in an economy with lacklustre markets for goods and services, with scant possibilities of new business start-ups and with monopoly power in the hands of the firms in place, a flexible labour market providing for mobility and the appropriate behaviour of unit labour costs do not ensure that advances in competitiveness translate into growth in economic activity and not into a widening of business margins.

3 The labour market

There are, then, two facets, at least, in which the labour market is called upon to play a fundamental role:

The institutional elements of the labour market that influence wage formation, condition productivity gains and affect the sectoral and occupational mobility of workers will all be particularly important for narrowing the unit labour costs differential vis-à-vis our trading partners and for bringing about a sectoral reallocation of employment.

the reduction of the unit labour costs differential...

Within a monetary union, the relative behaviour of unit labour costs is determined by developments in nominal wages and in labour productivity, relative to the developments arising in the other member countries. For this differential to narrow, nominal labour costs must either grow less, or labour productivity grow more, than in the other countries. Mechanisms that induce rigidity in real wages, i.e. that lead to price changes feeding through automatically to nominal wages, will mean that any increase in inflation higher than that in our trading partners, even on a temporary basis, will prompt an increase in the unit labour costs differential which, in turn, will tend to feed back into the inflation gap. This prompts systematically higher growth rates in prices, without necessarily generating gains in wage purchasing power.

and sectoral and occupational job mobility.

In parallel, to efficiently bring about a significant reallocation of employment across sectors and occupations, it is crucial that hiring conditions and social protection mechanisms should not lead transition situations to be more costly and durable than necessary. The Spanish labour market currently has a higher degree of flexibility than was the case in previous episodes of sectoral readjustment of employment. Moreover, the inflow of immigrants has increased the market's dynamism, owing to the greater regional, sectoral and occupational mobility of this group. Nonetheless, it should not be forgotten first, that flexibility in the employment adjustment stems essentially from the significance temporary hiring has acquired, which entails certain costs in terms of economic efficiency and of workers' labour stability; and further, that the dynamism generated by the presence of immigrants is not equally extensive to all market segments.

3.1 UNIT LABOUR COSTS AND NOMINAL INERTIA

The reduction in relative unit labour costs hinges on a reduction in the growth differential of nominal labour costs...

Since the mid-1990s wage developments both in Spain and in the other euro area countries have been characterised by considerable restraint. However, regarding the behaviour of the inflation differential, it should be stressed that wage restraint, while notable, has been less intense in Spain than in the euro area as a whole. Accordingly, the growth of labour costs has been pushing the inflation differential upwards over the past decade (around 0.6 pp on average). In the last five years, moreover, there has been some quickening in nominal wages (compensation per employee grew more quickly during the period 2003-2007 – 3.1% in annual

average terms – than in the period 1998-2002 – 2.4% in annual average terms –), despite the fact that wage drift subtracted 0.8 pp per year from the increase in wages between 1998 and 2002 and 1 pp on average in the four following years. The growth of compensation per employee rose to 3.4% in 2007, the highest figure of the last 15 years. And, for the first time since the 1980s, a positive contribution by wage drift (0.2 pp) was recorded.

which calls for reconsideration of the wage indexation mechanisms...

The regulation of collective bargaining plays a crucial role in determining the degree of flexibility of labour costs. Certain elements of this regulation give rise to an intermediate degree of centralisation of collective bargaining which hampers the necessary adjustment of labour costs in a situation in which, as is currently the case, temporary deviations from the inflation target pass through to wages as a result of wage indexation clauses. Thus, for instance, the contribution of wage indexation clauses to labour cost growth in 2008 might exceed 1 pp. Evidently, the combination of positive temporary deviations by inflation with generalised wage indexation clauses that make these deviations permanent is particularly harmful in the current circumstances and hinders the objective of increasing external demand. As described in Box 2.2, the evidence available is that the persistence of inflation is greater in Spain than in the rest of the euro area and that high indexation (along with other forms of wage rigidity) is prominent among the determinants of this greater persistence.

The price and wage rigidities that generate inflation persistence entail a significant cost in terms of the loss of activity and, therefore, of employment that arises following a negative demand shock. The right-hand panel of Table 2.1 illustrates these costs drawing on simulations performed with the BEMOD. More specifically, the exercise conducted in the previous section is repeated. This consists of simulating the effects of a negative transitory shock in the Spanish non-tradeable goods sector that were to produce a reduction in employment in this sector similar to that observed in 2007 Q4. But now, instead of adjusting the model so that it replicates the rigidity of prices and wages actually observed in the Spanish economy, it is calibrated to reproduce the behaviour of an economy in which there is no indexation and in which the frequency of adjustment of wages doubles that considered in the first case, maintaining the same frequency of adjustment of prices. The results show that, in this more flexible economy, the effects of this same negative shock on the non-tradeable goods sector on growth and employment would be notably less: it would reduce the loss of GDP by around 21% and the loss of jobs (over a two-year horizon) by 16%. The sectoral reallocation of production and employment would, moreover, be swifter, although the adjustment of the inflation differential would not be significantly greater.

Alternatively, it is also worth calculating what the adjustment of unit labour costs in the Spanish economy should be so that external demand may offset the same negative demand shock in the tradeable goods sector, in such a way that employment holds constant (left-hand panel of the bottom panel of Table 2.1). This correction of unit labour costs works out, respectively, at 0.2 pp in Q1, at 0.43 pp in the first year and at 0.66 pp at two years, and, combined with the elimination of indexation to past inflation, it would produce considerable gains in activity and in employment in the tradeable goods sector.

and for a sufficiently significant recovery in the growth rate of productivity.

The growth of labour productivity in the Spanish economy rose slightly in the 2006-2007 period (from 0.3% in annual average terms in 2003-2005, to 0.8% in the two following years). This increase came about both in manufacturing industry (from 1.9% to 2.5%) and in the market services sector (from -0.1% to 0.9%), but not in the construction sector, where activity fell off. However, the contribution of the productivity differential to the inflation differential continued to be positive, on average, between 2002 and 2007 (0.2 pp), although down on the average for the 1996-2002 period (0.6 pp).

In the neo-Keynesian model habitually used for the macroeconomic analysis of inflation, firms form their prices on the basis of the expected inflation rate and of real marginal costs. The greater the frequency with which they revise their prices, the greater the impact of these costs on the aggregate inflation rate. In an extended version of this model some firms adjust their prices, suboptimally, only on the basis of observed inflation in the past. In this case, the inflation rate may be represented by the following equation:

$$\pi_t = \gamma_b \pi_{t-1} + \gamma_f E_t \pi_{t+1} + \lambda mc_t$$

where π is the inflation rate, $E_t \pi_{t+1}$ represents the expected value of the inflation rate, mc are real marginal costs and γ_b , γ_f and λ are parameters that depend on the frequency of adjustment of prices, on the relative weight of firms that set their prices on the basis of the past inflation rate and on other determinants, such as the time discount rate.

This theoretical approach allows a distinction to be drawn between two sources of inflation persistence, understood as the resistance to resume its equilibrium level after being affected by a transitory shock: *intrinsic* persistence, which is due to the decisions taken on the basis of past inflation and which may be associated with the value of γ_b , and ii) *extrinsic* persistence, which originates in the behaviour of real marginal costs. In turn, there are three main sources of persistence of these costs. One is the inertia of the real income on production factors, such as wages, capital income or commodities prices. Another is the persistence of the real shocks that may affect companies' costs, such as changes in productivity or in taxes, for instance. Lastly, marginal costs may also be persistent owing to the very inertia of monetary policy.

The empirical evidence available confirms that, overall, inflation in Spain is more persistent than in the euro area. For example, if it is measured by the value of the coefficient ξ in the equation¹:

$$\pi_t = \xi \pi_{t-1} + \sum_{j=1}^k \phi_j \Delta \pi_{t-j} + \varepsilon_t$$

1. The estimate is with monthly data, seasonally adjusted with TRAMO-SEATS, for harmonised price indices. The sample is January 1998-December 2007. This specification is that proposed by Andrew Levin and Jeremy Piger (2004), *Is Inflation Persistence Intrinsic in Industrial Economies?*, ECB working paper no. 334. The test evidence of structural change in different papers shows the presence of structural changes for almost all the countries analysed, but before the dates used in our estimate.

it is 0.52 for Spain and 0.07 for the euro area. Combined in this coefficient are the effects of the two sources of persistence indicated in the previous paragraph. The empirical results available suggest that the intrinsic persistence of inflation in the Spanish economy is not greater than in the other EU countries. In fact, a recent paper² finds that the parameter of intrinsic persistence of inflation is less in our economy (between 0.10 and 0.18) than in the other euro area countries (between 0.19 and 0.5). This means that the persistence of real marginal costs is the main cause of the greater aggregate persistence of inflation in Spain.

Among the causes of the persistence of real marginal costs, productivity shocks or those caused by the common monetary policy may be expected to have similar characteristics in all the euro area countries as regards their duration. Accordingly, the most plausible explanation for the greater degree of inflation persistence in Spain compared with the rest of the euro area resides in the existence of greater rigidity in the adjustment of real wages.

In fact, wage agreements that envisage indexation clauses based on actual inflation the previous year are frequent in the Spanish economy. Although it depends on how collective bargaining unfolds each year, approximately 70% of wage-earners are covered by this type of clause. Conversely, other major European countries are far removed from these levels of indexation. In France, for example, this percentage is around 15%, and in many other countries, such as Germany, Portugal, the Netherlands, etc., these clauses simply do not exist.

Consequently, the so-called "second round" effect, involving inflation feedback due to its effect on future wages and, therefore, on costs and future inflation is greater in Spain than in the rest of the euro area. To analyse the overall dynamic of inflation and of wage growth, a vector autoregression of these two variables can be estimated. This allows for a measure of the extent to which temporary deviations in inflation are reflected in wages, creating a spiral of cost increases and generating, in this way, inflation persistence. The outcome of this estimate indicates that the medium-term effect (two years) of this shock on wages is approximately five times higher in Spain than in the euro area.³

2. Fabio Rumler (2005), *Estimates of the Open Economy Phillips Curve for Euro Area Countries*, ECB working paper no. 496. 3. The data are from Eurostat. Wages are measured as the seasonally adjusted labour cost index. In both cases, the estimated standard error for both coefficients is 0.11.

The increase in labour productivity needed to reverse the growing trend in the ratio of domestic to international prices over the past decade is substantially greater than the rise observed in the past two years. But this increase hinges on a resolute implementation of structural policies that allow growth potential to be increased, on bringing about an improvement in the economy's adaptability and on promoting the efficient allocation of its resources. The policies aimed at making the factor and product markets more flexible should make an essential contribution to these objectives and they should be complemented, moreover, with measures geared towards improving the quality of the labour factor, through a boost to educational policy and towards improving its efficiency, through increased investment in physical and technological capital, and through a boost to innovation. It is true, however, that the effect of these policies tends to emerge in the medium and long run, whereby there is a more pressing need to achieve improvements in the unit labour costs differential through a greater containment in the short term in wage determination.

3.2 LABOUR FLEXIBILITY AND SECTORAL REALLOCATION

To smooth the sectoral
reallocation of employment, labour
flexibility must be promoted...

In processes involving the sectoral and occupational reallocation of employment, the mechanisms governing hiring decisions play a fundamental role. More specifically, of crucial importance are the legislation on employment protection, which determines the costs and different forms of hiring and firing arrangements, and social protection mechanisms, which influence job offer decisions and therefore affect the frequency of labour flows between different jobs and from situations of inactivity to job-holding status.

As regards legislation on employment protection, after several reforms of limited scope the Spanish labour market continues to have a dual structure, with a clear segmentation between permanent and temporary employment. This means that a substantial portion of adjustments come about through the rotation of workers with a temporary contract. Shortcomings are also observable in the provision of unemployment insurance and in the effectiveness of active labour market policies. As a result, the trade-off between flexibility and labour security currently provided by the Spanish labour market is not fully satisfactory. Improving this trade-off becomes particularly important when, as is currently the case, sectoral mobility is one of the main factors that may influence the scale and duration of the slowing phase on which the Spanish economy has embarked.

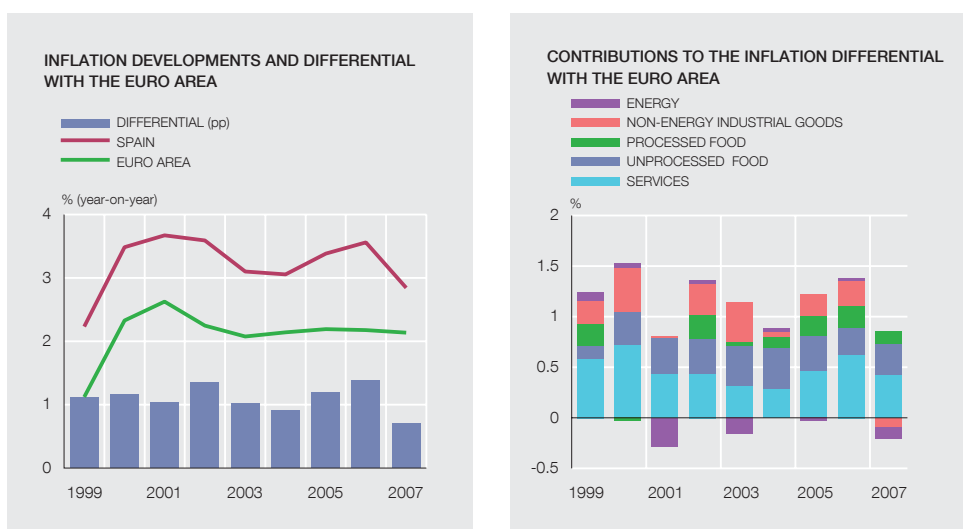
beyond what may be offered by
temporary hiring
arrangements...

The information available on labour flows denotes the presence of high labour market dynamism, although the main mechanism through which changes in employment and in unemployment come about is temporary employment. Thus, quarterly flows of unemployment entries and exits are on a considerable scale, around 4.5% of the labour force.¹³ As regards entries, approximately half of these are from inactivity, owing especially to women and youths joining the labour market; but 35% stem from temporary employment. A significant portion of exits is also directed towards inactivity (42%), although an even bigger percentage is towards temporary employment (approximately 47%).

Concerning employment entries and exits, temporary hiring also plays a predominant role. Entries account for around 8.8% of the labour force. 32% are from unemployment, 38% from inactivity and 30% from another job. Most (75%) are towards a temporary job. Employees with a temporary contract account for around 70% of employment exits, involving a move to unemployment (27% of cases), towards inactivity (42%) and towards other jobs (32%).

Moreover, the main differences between branches of activity in the behaviour of these flows are closely related to their different temporary employment rates. Hence, construction work-

¹³ This information is drawn from the Spanish labour force survey.



SOURCE: Eurostat.

ers, where the proportion of temporary to total employees is higher, have a greater probability of moving from employment to unemployment, of changing job or of exiting unemployment.

and immigration...

Employment in the construction sector (2.7 million employed in 2007) is predominantly male (almost 95%) and with a high incidence of foreigners (25% in total, 7.5% are from the EU, 1% from the rest of Europe, 11.5% from Latin America and 5.5% from the rest of the world). In principle, the immigrant population may be expected to be more inclined to labour mobility than nationals, at least during their initial years of residence in the host country. The evidence available on geographical mobility confirms this (see Box 2.3). For example, population movements between municipalities, which stood at 2% of total inhabitants in 1996, quickened to 4% in 2006. This increase is largely due to the contribution of immigrants. While the regional mobility of the Spanish population does not exceed 3%, that of the foreign population is almost fourfold this figure at 11%, meaning that this group has contributed almost 1 pp to the aforementioned increase in internal mobility in Spain. As regards sectoral mobility, which is counted taking labour flows among 10 major sectors of activity, that of the immigrant population is 50% greater than that of nationals.¹⁴

and wage inertia mechanisms that hamper the adjustment of relative wages must be eliminated.

The greater mobility of workers in the construction sector should prove conducive to the process of sectoral reallocation of employment. However, for other sectors to absorb the excess labour supply, an adjustment in relative wages across the different sectors and occupations will be necessary. Past experience shows that the collective bargaining structure, based on the prevalence of provincial agreements with a wider-than-firm-level scope, is not the most appropriate one for accommodating these changes. The wage indexation mechanisms do not only generate, as discussed, real wage rigidities at the aggregate level but also hamper the

14. These 10 sectors are the following: agriculture, forestry and fishing (codes 01, 02 and 05), Manufacture of food products and beverages, textiles, leather, wood and paper (NACE 93 codes: 15-22), Mining and quarrying, oil refining, manufacture of chemicals, manufacture of rubber, basic metals, energy and water (NACE 93 codes: 10-14, 23-28, 40 and 41), Manufacture of machinery, electrical equipment, transport equipment, manufacturing n.e.c. (NACE 93 codes: 29-37), Construction (NACE 93 code: 45), Wholesale and retail trade, and hotels and restaurants (NACE 93 codes: 50, 51, 52 and 55), Transport (NACE 93 codes: 60-64), Financial intermediation, real estate activities (NACE 93 codes: 65-67 and 70-74), Public administration, education, and health and social work (NACE 93 codes: 75, 80 and 85) and Other services (NACE 93 codes: 90-93, 95 and 99).

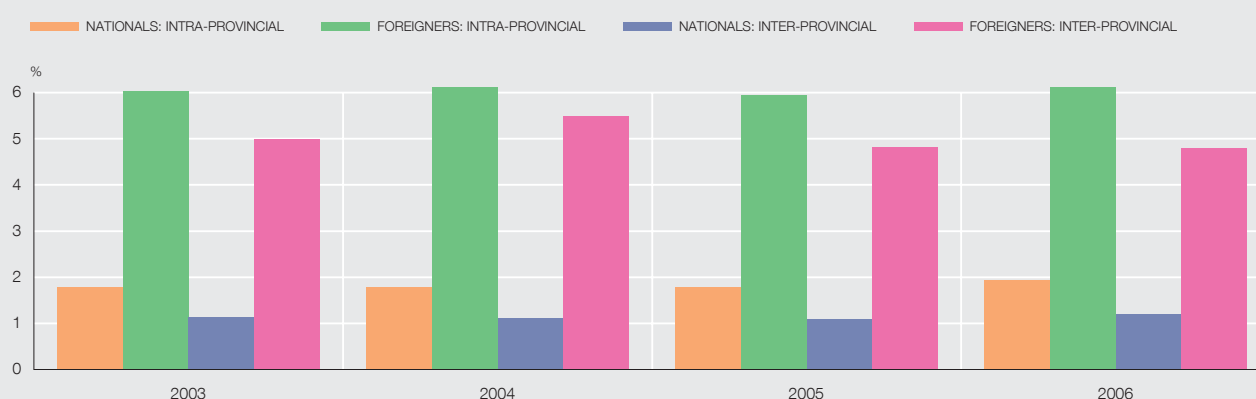
The Spanish economy faces a slowdown in economic activity, which is translating into net job destruction in some sectors, especially in construction, and generally into less dynamism in job creation. Against this background, the capacity of the labour market to provide new employment rapidly and effectively to people who lose their initial job is one of the key mechanisms for limiting the extent and duration of the deceleration process and for providing for a rebound in activity. This adjustment capacity depends essentially on the flexibility of the labour market. Several recent papers showed that this flexibility may have increased in recent years owing to the weight attained by foreign workers, who account for over 13% of total employment, which might mark a fundamental difference with previous phases in which the buoyancy of activity in the Spanish economy had diminished.

This greater flexibility would be associated with various characteristics of immigrants in the labour market, such as the high proportion of temporary (to total) employment accounted for by this group (at 54% it is double the related proportion for Spanish nationals). Foreign workers also evidence greater labour mobility. Specifically, as panel 1 shows, immigrant workers show a rate of regional mobility that is al-

most fourfold that of the Spanish population.¹⁹ Likewise, inter-sectoral mobility is higher among immigrant workers²⁰ and their enterprising nature is more accentuated than among nationals²¹. It is also worth noting immigrant workers' keener attitude to job search when they are unemployed, meaning that they exhaust to a lesser extent than nationals the maximum period of unemployment benefits to which they are entitled, and their long-term unemployed incidence is less than half that of Spanish nationals. Overall, therefore, this greater flexibility might allow for a better adjustment of the labour market,

1. This has contributed decisively to explaining the increase seen in regional migration flows in the Spanish population over the past 10 years. In terms of the relationship between this internal mobility and the differences seen in labour markets at the provincial level, foreign workers appear to respond to a greater extent to the labour conditions of local markets, thereby contributing to reducing the marked differentials in regional unemployment rates and, as a result, in the equilibrium unemployment rate of the Spanish economy as a whole. 2. 8.1% of immigrants employed were so in a different sector of activity a quarter earlier, while this percentage was 5.4% for Spanish nationals. 3. Specifically, more than 20% of new self-employed workers last year were foreigners.

1 AVERAGE PROPENSITY TO DOMESTIC MIGRATION BASED ON NATIONALITY
As a percentage of the related population group



1 LABOUR FLOWS BASED ON NATIONALITY

	Employment exits (a)	Employment entries (b)	Unemployment exits (a)	Unemployment entries (b)
SPANISH NATIONALITY WORKERS				
2005	8.7	4.9	31.2	4.5
2006	8.3	4.6	31.4	4.1
2007	8.4	4.6	33.3	4.3
FOREIGN WORKERS				
2005	13.8	10.8	42.0	5.5
2006	14.7	10.5	39.4	6.3
2007	15.2	10.7	40.0	7.0

2 EMPLOYMENT EXITS BASED ON NATIONALITY AND TYPE OF CONTRACT (a)

	Permanent workers		Temporary workers	
	Nationals	Foreigners	Nationals	Foreigners
2005	3.7	7.7	21.8	18.7
2006	3.5	8.1	21.4	19.9
2007	3.7	8.4	22.8	22.5

SOURCE: Banco de España.

a. Percentage of group of origin.
b. Percentage of labour force.

since immigrant workers appear to be more prepared to change industry, occupation or region.

An analysis of gross labour market flows offers a relevant and complementary perspective of this matter, as it enables the transitions arising between the different situations in which individuals in the labour market may find themselves – inactivity, unemployment and employment – to be isolated. As can be seen in panel 1, foreign workers generally display greater mobility between the different labour market situations. Thus, for instance, the employment exit rate²² in a specific quarter amounts to 15%, almost doubling that seen among Spanish workers. If unemployment entry flows are analysed, something similar is observed. In each quarter, some 7% of the foreign labour force enters into unemployment status, while this percentage is around 4% for Spanish workers. Nonetheless, as can be seen in panel 2, most of these differences can be explained by the higher proportion of temporary employment among immigrant workers, since the likelihood of losing a job in a quarter is high, around 20%, and very similar for both groups of workers with temporary contracts. In any event, an appreciable difference is also seen among the group of workers with permanent contracts, since exits from employment are significantly higher among foreign workers. In this case, it would seem that the protection afforded employment by the higher firing costs that permanent contracts entail is less effective in the case of foreign workers, probably as a result of their fewer years of service, on average, in the firm.

Accordingly, foreign workers exhibit greater employment exit and unemployment entry flows than Spanish workers. And this, in the current setting of economic deceleration and given the high proportion accounted for by foreign workers in total employment, entails a risk that the current phase of deceleration in activity may translate into a brisker employment adjustment than in similar past periods. The impact on unemployment, at least in the short run, might also be greater. This is because immigrant workers, when they lose their jobs, are more likely to take up unemployment status, while among Spanish workers exits towards inactive status,

i.e. to a situation in which they do not actively seek employment, are higher.²³

An analysis of employment entry and unemployment exit flows also highlights the fact that immigrant workers return to a situation of employment more quickly than nationals. As panel 1 shows, immigrant workers' employment entries amount to 10% of the group of origin, around double the entries observed among Spanish workers. As to unemployment exits, the situation is similar, with exit rates around 10 pp higher in the case of immigrant workers. That is to say, this group of workers, who display a higher probability of entering into unemployment, spend less time in this situation once they are jobless, probably as a result of their greater readiness to accept changes in conditions in new jobs. This is what justifies the fact that long-term unemployment among immigrants is only 10%, a lower figure than for countries such as Denmark and Sweden.

In sum, the impact of immigration on the labour market may translate into a swifter adjustment of employment than seen in other similar slowdowns, giving rise to a higher increase in unemployment in the short term. Yet insofar as, on one hand, the sharper increase in unemployment contributes to wage restraint and, on the other, the process of reallocation of employment across sectors, occupations and regions proves more nimble than in previous periods of decelerating activity, there might be a smaller increase in the structural component of unemployment in the economy, adding flexibility to the necessary adjustment of the labour market and raising its capacity for recovery following the current phase of deceleration. Finally, it is nevertheless necessary to draw attention to the uncertainty associated with the analysis conducted, since it is based on the behaviour of the labour market in a period characterised by strong economic growth and by intense immigration inflows. In a deceleration such as the present one, where it is moreover possible that immigrant flows will slow²⁴, the patterns of behaviour observed to date by immigrants in the labour market may change.

4. That is to say, the percentage accounted for by workers ceasing to work in a specific quarter relative to total employees.

5. This is the case even if the different age structure of the national and foreign populations is controlled. 6. Or that, at least, their composition will change. In 2007 a sizeable increase in immigrant inflows due to family reunification was already detected. This group might, in principle, exhibit different behaviour in the labour market.

adjustment of relative wages across sectors and occupations, and even across individual firms in the same sector, but subject to heterogeneous shocks. In fact, as Chart 2.5 shows, the sectoral differences in gross labour costs per employee or in their average wages and salaries have held approximately constant throughout the period 2001-2006 (the changes relative to the related average growth have been scant). However, the supply and demand shocks received by each sector have probably been very varied, given that the impacts of immigration and of globalisation have certainly not been similar. Indeed, as the chart also reveals, apparent labour productivity developments in this period evidence higher sectoral dispersion, which



SOURCE: Banco de España.

a. Nominal growth rate in each sector during the period 2001-2006 in terms of deviations from the economy-wide growth rate. Activities are as listed in the INE CNAE-93 (National Classification of Economic Activities):

- C: Mining and quarrying.
- D: Manufacturing.
- E: Electricity, gas and water supply.
- F: Construction.
- G: Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods.
- H: Hotels and restaurants.
- I: Transport, storage and communication.
- J: Financial intermediation.
- K: Real estate, renting and business activities.
- M: Education.
- N: Health and social work.
- O: Other community, social and personal service activities.

suggests that the adjustment of relative labour costs comes about slowly, hindering the sectoral reallocation of labour.

In sum, this chapter has offered a detailed analysis of the main causes and consequences of the maturation of the real estate cycle in Spain. It helps clarify the importance of flexibility in the economy to ensure the transition to a more sustainable growth pattern in the medium and long term, with particular emphasis placed on the functioning of the labour market. Increases in the sectoral and occupational mobility of labour, improvements in the degree of wage flexibility and the correction of the labour costs growth differential relative to the other EU members will undoubtedly influence the intensity and duration of the adjustments that have begun. However, the functioning of the labour market is closely related to other factors which will also bear on the re-balancing of the Spanish economy. Advances in the efficiency of factors of production that can be attained through deeper structural reforms and the gains in competitiveness achieved in the markets for goods and services will also be as or more pivotal in this respect. The overall analysis of these and other conditioning factors, however, is addressed from the general perspective of the remaining chapters in this Report, while the more thoroughgoing treatment given in this chapter to some of these factors is in response to its selective approach.

3 THE EXTERNAL ENVIRONMENT OF THE EURO AREA

1 Overview

1.1 THE WORLD ECONOMY IN 2007

Growth of the world economy remained high in 2007, but global financial turmoil substantially clouded the economic outlook.

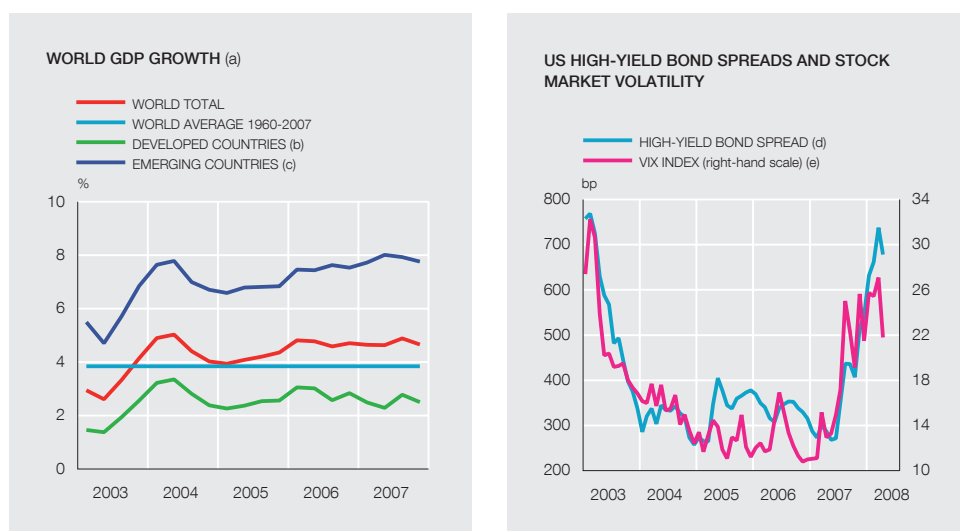
In 2007, the world economy retained the inertia of the strong growth posted in previous years (see Chart 3.1), although in the second half of the year there was a substantial change in the global economic and financial outlook. This turning point was not the result of the cyclical slowdown already noted in some developed economies, especially the US, following a lengthy phase of growth, but was mainly associated with the financial turbulence in the world economy from summer onwards. This turbulence began with the problems on the US subprime mortgage market, but its importance has spread far beyond this market. Consequently, it has given rise to an extended period of financial volatility and liquidity problems (see Chart 3.1), the repricing of risks and tension in a growing number of financial market segments. The new economic and financial environment following this episode is in stark contrast to the long phase of extraordinarily benign financial conditions in the world economy in recent years and, to a large extent, it is a direct consequence of the previous stage.

In this scenario, the estimates for world growth in 2008 have been revised downwards considerably in recent quarters across the board – albeit to a greater extent in advanced economies –, indicating a sharp slowdown in activity, which is projected to grow at rates of less than 4%. Furthermore, the risks to this projection are on the downside. The rise in inflation rates fuelled by considerable increases in the price of certain commodities, and coupled with the high uncertainty over the impact of financial turbulence on real activity represent a challenge for economic authorities. In particular, central banks may have to face complex economic policy dilemmas if inflationary pressure continues at the same time as economic activity slows.

In 2007 the buoyancy of emerging economies continued, while in the advanced economies most affected by the turbulence, activity tended to slow towards year-end.

Nevertheless, the world economy once again posted a high growth rate in 2007 of approximately 5%, similar to that of the four previous years (see Table 3.1 and Chart 3.1). This marked the culmination of the four-year period of highest widespread economic growth since the sixties (averaging 4.8% per year). In 2007 the contribution of the industrialised economies to this high rate of activity exceeded expectations at the beginning of the year, given the advanced phase of the cycle and the interest rate rises which had been implemented by most central banks. Growth in this group of economies – which was underpinned especially by domestic demand, except in Japan and some euro area countries – stood at 2.7% in 2007, 0.3 pp less than in the previous year. Growth in the US (down from 2.9% to 2.2%) felt the impact of the strong adjustment in residential building, while the slowdown observed in Japan (from 2.4% to 2.1%) was due to flat private consumption. Activity in the advanced economies remained very dynamic until Q3 and only in the final months of the year did it begin to slow, albeit to differing degrees, in most of these economies.

Emerging economies continued to grow at a very high rate (7.9%), similar to that of the previous year. This also surpassed expectations and was increasingly based on internal demand and, in the case of commodity exporters, on the high prices of these products. China contributed one-quarter of world growth, while India and the major oil exporting countries contributed a further 25%. Overall, emerging economies accounted for nearly 70% of world growth. This figure was calculated on the basis of new estimates of GDP at purchasing power parity published at the end of 2007, which substantially cut the share of emerging economies in world GDP, compared with previous estimates.



SOURCES: National statistics, International Monetary Fund and Datastream.

- a. In-house estimates, based on data from 56 countries representing 91% of world GDP. The aggregates were calculated using the weight of the countries in the world economy in ppp, according to IMF information.
 b. Western Europe, the United States, Canada, Japan, Australia, New Zealand, Israel and Slovenia.
 c. Latin America, emerging Asia, Central and Eastern Europe (except for Slovenia) and South Africa.
 d. Spread between Lehman Brothers' high-yield bond and the 10-year treasury bond.
 e. S&P 500 implied volatility index.

International trade slowed in 2007 and the Doha Round negotiations came to a standstill.

Although global activity remained buoyant, international trade decelerated somewhat during 2007, since it grew 6.8% in volume, 2.4 pp less than in 2006. Import growth in the main developed areas slowed (from 7.4% in 2006 to 4.2% in 2007), especially in the US. On the other hand, emerging economies' exports remained very strong overall with growth of 8.9% (in comparison with 10.9% in 2006), although they eased slightly in all regions. The Doha Round negotiations remained at a standstill in 2007, which is unfavourable for the international trade outlook.

Strong growth in commodity prices...

Commodity prices continued to grow at a strong pace in 2007, fuelled by the buoyant demand of emerging economies and other supply-side and financial factors, especially from the second half of 2007 (see Chart 3.2 and Box 3.1). The price of Brent oil ended the year at approximately \$90 per barrel, 50% up on the price at end-2006. This price rise continued into the early months of 2008 and reached an all-time high of more than \$120 at the beginning of May, double the price at the beginning of 2007. The upward trend in oil prices and their volatility are also accounted for by low spare production and refining capacity, low stock levels and other seasonal, geopolitical and financial reasons. The prices of precious metals also posted hefty gains, especially gold, although other industrial metals like copper – which are more closely linked to the economic cycle – showed downward corrections but held at historically high levels. Agricultural commodity prices, which are analysed in detail in Box 3.1, rose significantly due to demand factors, some of which are structural, and to restrictions on the expansion of supply.

triggered a widespread rise in inflation rates throughout the year.

There was a sharp and widespread rise in inflation rates (see Chart 3.2), especially from the second half of the year, to which emerging economies – particularly China – contributed significantly against a backdrop of upward pressure on commodity and, specifically, food prices. Conversely, core inflation rates remained relatively stable at moderate levels and inflation ex-

	2003	2004	2005	2006	2007
UNITED STATES					
GDP	2.5	3.6	3.1	2.9	2.2
CPI (a)	2.3	2.7	3.4	3.2	2.8
Current account balance (% of GDP)	-4.8	-5.5	-6.1	-6.2	-5.3
General government balance (% of GDP)	-4.8	-4.4	-3.6	-2.6	-2.5
JAPAN					
GDP	1.4	2.7	1.9	2.4	2.1
CPI (a)	-0.2	0.0	-0.3	0.2	0.1
Current account balance (% of GDP)	3.2	3.7	3.7	3.9	4.8
General government balance (% of GDP)	-8.0	-6.2	-5.0	-3.8	-3.4
UNITED KINGDOM					
GDP	2.8	3.3	1.8	2.9	3.0
CPI (a)	1.4	1.3	2.1	2.3	2.3
Current account balance (% of GDP)	-1.3	-1.6	-2.5	-3.9	-4.2
General government balance (% of GDP)	-3.3	-3.3	-3.5	-2.8	-2.9
CHINA					
GDP	10.0	10.1	10.4	11.6	11.9
CPI (a)	1.2	3.9	1.8	1.5	4.8
Current account balance (% of GDP)	2.8	3.6	7.2	9.4	11.1
General government balance (% of GDP)	-2.5	-1.5	-1.2	-1.0	0.7
LATIN AMERICA (b) (c)					
GDP	2.3	6.2	4.5	5.4	5.8
CPI (a)	10.7	6.0	6.3	5.2	5.2
Current account balance (% of GDP)	1.0	1.3	1.7	1.8	0.7
General government balance (% of GDP)	-2.0	-1.0	-1.0	-0.7	-0.5
NEW EU MEMBERS NOT IN EURO AREA (b) (d)					
GDP	4.4	5.8	4.9	6.5	6.2
CPI (a)	3.8	5.3	3.6	3.2	4.1
Current account balance (% of GDP)	-4.5	-6.1	-4.9	-6.5	-7.2
General government balance (% of GDP)	-4.9	-3.8	-3.4	-3.3	-1.9
PRO-MEMORIA: GDP GROWTH					
World	3.6	4.9	4.4	5.0	4.9
Euro area	0.8	2.1	1.6	2.8	2.6

SOURCES: Banco de España, International Monetary Fund and national statistics.

a. Annual percentage change in CPI index.

b. 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.

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

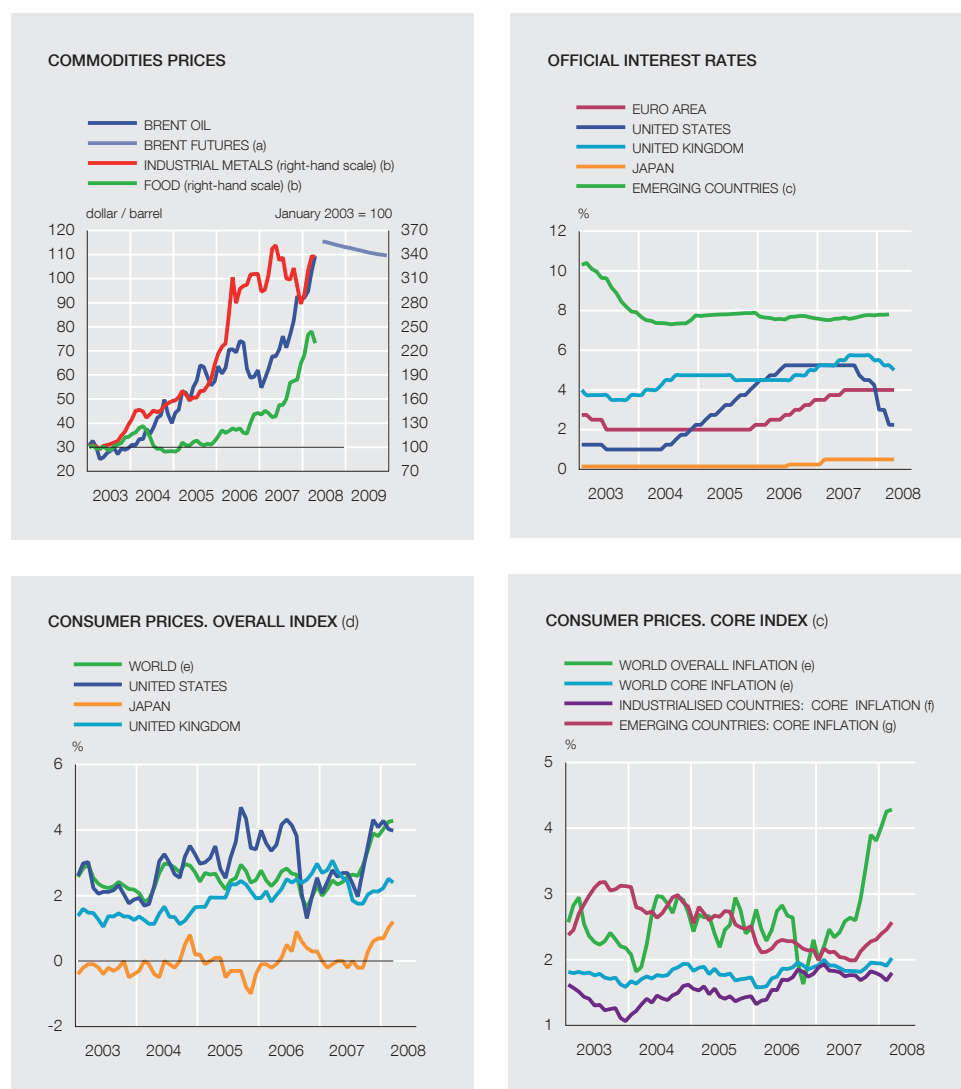
d. Latvia, Lithuania, Estonia, Czech Republic, Hungary, Poland, Slovakia, Cyprus, Malta, Bulgaria and Romania.

pectations continue to be anchored, although they have climbed notably in recent months in certain cases, such as in the US.

The monetary policy stance became tighter in the advanced economies but the financial turmoil put an end to this trend.

In this context, certain central banks in developed economies gradually toughened their monetary policy stance in the first half of the year in order to withdraw the accommodating bias that still persisted (see Chart 3.2). A notable exception was the US, where the cycle of withdrawing the monetary stimulus ended in 2006. The behaviour was different for emerging economies since certain countries like Brazil and Turkey continued to reduce their high interest rates.

The downturn in the economic and financial outlook stemming from the market turmoil had a sharp impact on the monetary policies of the main industrialised nations in the second half of



SOURCES: Datastream, Goldman Sachs and Banco de España.

- a. Brent futures from the week of 21 - 25 April 2008.
- b. Goldman Sachs indices.
- c. Aggregate of 20 emerging countries.
- d. Annual rates of change.
- e. Aggregate calculated drawing on the data from 31 countries, accounting for 71% of world GDP.
- f. United States, Canada, Japan, euro area, United Kingdom, Denmark, Norway and Sweden.
- g. Brazil, Chile, Mexico, Poland, Hungary, China, South Korea, Thailand and South Africa.

the year. This change went beyond interest-rate decisions and affected liquidity provision mechanisms, as detailed in the next section. The Federal Reserve began a process of interest rate cuts in September 2007, which was stepped up in 2008 Q1, in response to increasing downside risks to growth. The official interest rate was cut by 325 bp from 5.25%, the level prevailing from mid-2006, to 2%. The United Kingdom joined in this process of interest rate cuts a few months later and implemented three 25-bp cuts between December 2007 and April 2008, while in Japan and the euro area official interest rates remained stable. By contrast, in other developed economies, like Sweden or Australia, official interest rates were increased in response to inflationary pressures. Also, unlike other bouts of financial instability, in most emerging economies the turbulence did not dominate the stance of their monetary policies and these, in general, have tightened, thus remaining focused on price stability in the face of growing inflationary pressure.

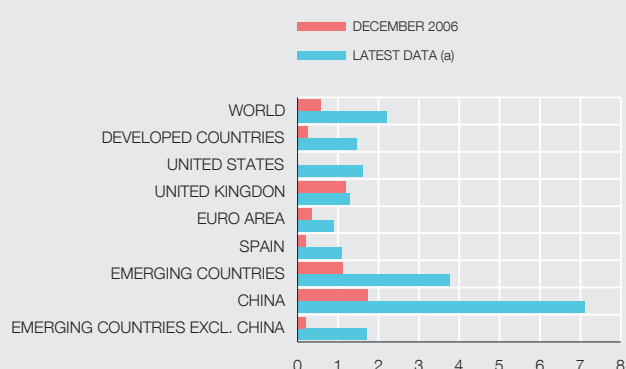
One characteristic of the rise in inflation at world level during 2007 was that it was centred on the overall index, while the core inflation rate (which excludes food and energy) remained relatively stable. This pattern was replicated in most countries and regions with the result that the widening of the gap between headline and core inflation was widespread, yet particularly pronounced in some countries such as China and the United States (see Panel 1).

Commodity prices – which have a very direct influence on CPI energy and food components – are behind these inflation developments and lock in the substantial change in relative prices worldwide in recent years. In 2007, unlike previous years, the increase in international commodity prices was driven by changes in food prices, although the prices of energy and industrial components have continued to rise (see Chart 3.2). The international food price index increased by 18% in real terms in 2007, double the average of the annual maximum rises of the last 25 years, although still a long way off the record highs in real terms.

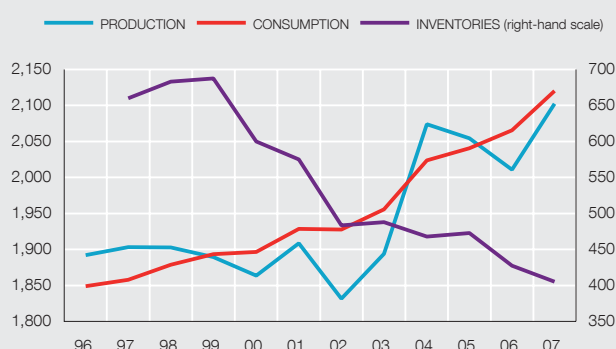
An analysis of the factors which have contributed to the increase in global inflation reveals that food has played a key role. For a broad sample of countries, the weight of food in the consumption basket is a variable which is statistically significant in explaining the rise in inflation in 2007, while in the case of energy the relationship is positive but not significant (see Panel 2). This result is generally robust to other considerations, such as the initial inflation rate – which tends to be higher in countries with a lower GDP per capita and, hence, with a heavier food weight in their CPI –, and despite the fact that in many developing economies food prices are subject to administrative controls.

Given the significance of food commodity prices in relation to the rise in inflation, it is important to consider the outlook for them. Conceivably, in a scenario of a global slowdown, high rates of increase are improbable; but it is vital to point out that food prices showed a negative correlation to world GDP in the last decade in contrast with the positive correlation of close to 0.5 in other commodities, which raises interest in this issue.

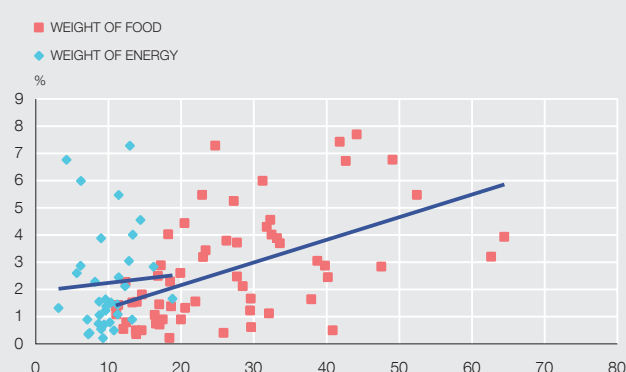
1 SPREAD BETWEEN OVERALL AND UNDERLYING INFLATION



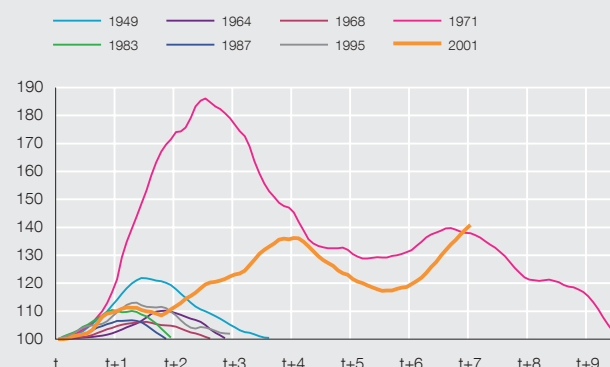
3 WORLD CEREAL PRODUCTION, CONSUMPTION AND INVENTORIES



2 CHANGES IN INFLATION AND WEIGHT OF FOOD AND ENERGY IN CPI (x-axis) (b)



4 REAL FOOD PRICE CYCLES (c)



SOURCES: International Monetary Fund, FAO, CRB, national statistics and Banco de España.

a. The latest data relate to March 2008, except in the case of the data for the "World", "Developed Countries", "Emerging Countries" and "Emerging Countries Excluding China" aggregates which relate to January 2008.

b. The change in inflation represents the difference between the year-on-year CPI rate in the last available month of 2007 and the year-on-year CPI rate in December 2006. The sample includes 66 countries with data on the weight of food and 35 countries with data on the weight of energy.

c. The index is deflated by the US CPI. The lows of the food price index series in terms of annual moving averages are taken as the beginning of each cycle and assigned a value of 100.

The food which most contributed to the increase in food prices were cereals (mainly wheat and corn) and soya beans. Although the supply of cereals, following a few years of decline, outgrew demand last year, the gap between the two has not closed, which has led the drop in inventories to last longer (Panel 3). Behind the increase in demand for cereals is the development of emerging countries such as China and India (with slightly more than one-third of the world's population). This has given rise to a significant expansion of their middle classes, boosted migration from the countryside to cities and had substantial implications for diet, focusing on a larger intake of proteins, which requires higher cereal consumption. These factors could be considered structural factors which came into play before 2007 and which are expected to exert ongoing upward pressure on demand.

As for food production, the attendant supply usually shows high price elasticity and reacts more swiftly to demand than other commodities such as energy, due both to the speed at which acreage can be adjusted and the potential increase of yields. Although the area of land for growing cereals has increased to record levels, supply grew 4.6% in 2007, a high yet insufficient rate given demand pressures. Certain supply-side shocks, such as bad weather in Australia and exporters' restrictive trade policies in Argentina, Russia and the Ukraine to guarantee self-sufficiency and uphold domestic prices, contributed to this insufficiency. While some of these factors may be transitory, there seems to be a certain limit on the room for increasing yields and extending acreage, which may mean that the elasticity of supply in the short and medium term may have decreased to some extent.

Another important factor notably affecting the food commodity market has been the growing demand for bio-fuels. This stems from several factors, such as the rising trend in traditional fuel prices and increasing concern about climate change, which has also triggered a proliferation of subsidies for bio-fuel development. The emergence of bio-fuels adds notable pressure to the demand for corn, sugar cane and oils, and impacts relative prices, tending to reduce the appeal –and, consequently, the potential increase in supply – of other basic products, such as wheat. The effect of bio-fuels on the supply of and

demand for agricultural products in the medium term is uncertain and will depend on the policies associated with bio-fuel development, on energy prices and on technological innovation in this industry. But it is a factor which may also have a persistent effect on the food commodities market.

In this scenario, the development of food futures markets and the exceptional increase in non-commercial positions may have played an important role in the rise of food prices since these types of positions tend to increase price volatility and temporarily intensify underlying trends, which in this case are rising. The weak dollar¹ and the fall in real interest rates are other financial factors which may have brought upward pressure to bear on prices.

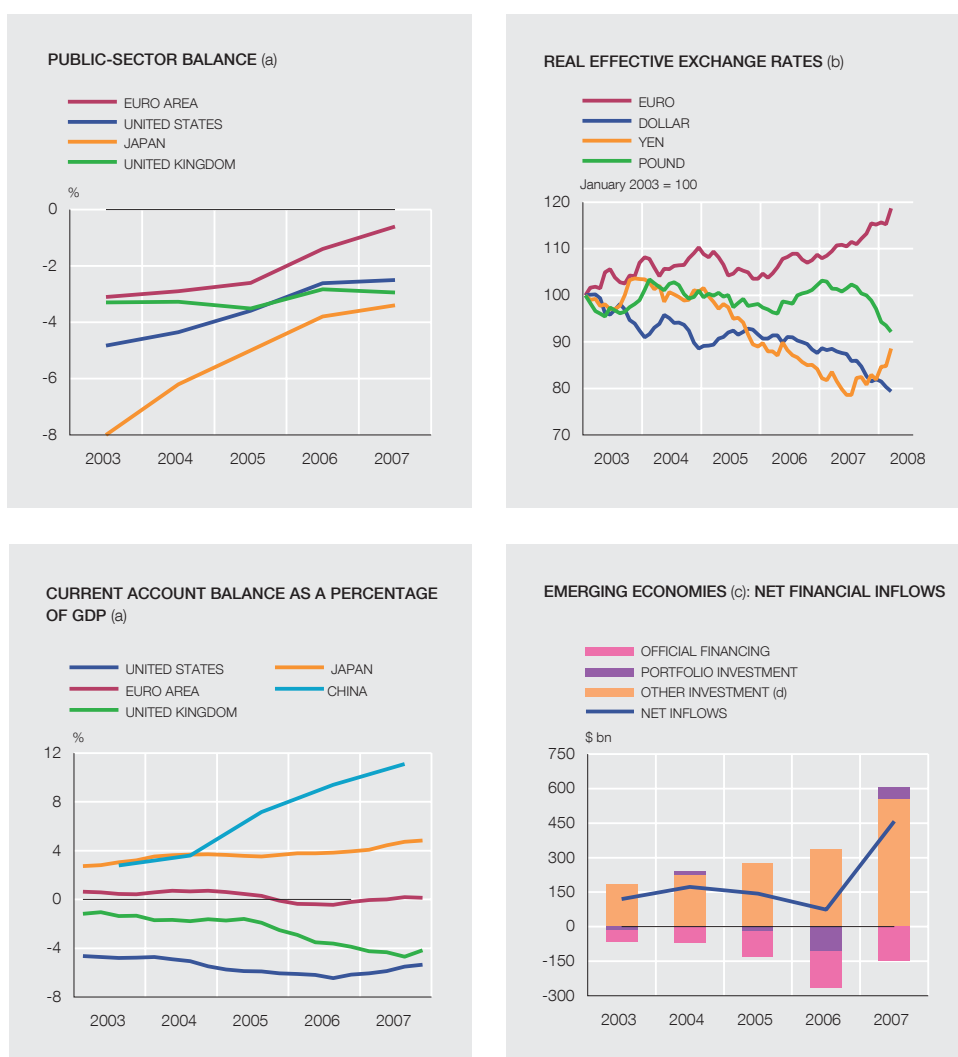
Admittedly, some of the factors that have affected supply could be considered conjunctural and the responsiveness of food supply is significant; but there have been major structural changes in these markets and a substantial potential increase in food demand. The distinguishing feature of this expansionary cycle is underlined when it is compared with previous cycles (see Panel 4). The current period of rising prices has run for seven years, when on average in the last 70 years these upward cycles have lasted for approximately three years, which emphasises the specific nature and longer duration of the current expansionary cycle.

In short, food commodity prices may be expected to remain high, even if there is a moderate slowdown in world growth. The restructuring of inventories and proliferation of measures to restrict exports of basic foods are additional factors which may make the upward pressure on the prices of these products longer-lasting. Although growth rates of prices such as those seen recently are unlikely to persist, this pressure poses a global upside risk to inflation.

1. See the World Economic Outlook of the IMF (April 2008, Box 1.4). Among the channels mentioned are the financial channel and the rise in demand through the higher purchasing power that a depreciation of the dollar generates in countries not pegged to it.

Fiscal balances continued to improve and in the US fiscal policy reacted to the prospect of a slowdown.

In the year as a whole, there was an across-the-board improvement in public finances in the major industrialised and emerging economies alike (see Charts 3.3 and 3.7). Behind this improvement was, as in previous years, the strong increase in revenue, in excess of what would be attributable to the position of the economies in the cycle. The apparent rise in the elasticity of tax revenue with respect to GDP was shown in a parallel improvement in the cyclically adjusted structural balance; thus, in developed economies the structural deficit fell from 2.6% to 2.3% of GDP. However, uncertainty remains about the permanent or temporary nature of the increase in revenue and, in some cases, substantial increases in public spending and tax cuts were observed. In this context, there is uncertainty about the room for manoeuvre of fiscal policies to soften the impact of the probable economic slowdown without jeopardising the sustainability of the long-term fiscal position, although there are notable differences between countries according to their budgetary situation. The change in economic outlook from sum-



SOURCES: Datastream, JP Morgan and International Monetary Fund (WEO).

- a. (+) surplus, (-) deficit.
 b. CPI-based. An increase (decrease) denotes an appreciation (depreciation) of the currency.
 c. Africa, Latin America and Caribbean countries, Central and Eastern Europe, Confederation of Independent States, the Middle East and emerging Asia.
 d. Including FDI and bank loans.

mer prompted the US authorities to react swiftly to expectations of a slowdown and led to the approval of an expansive fiscal package at the beginning of 2008, amounting to more than 1 pp of GDP.

The market turmoil quickened the depreciation of the dollar against most currencies and inverted the depreciating trend of the yen...

Developments on currency markets were marked, like other financial markets, by the turbulence. The depreciating trend of the dollar, observed as early as 2006, intensified in the second half of the year with the result that its real effective exchange rate depreciated by 10% between the beginning of 2007 and March 2008 (see Chart 3.3). The euro reached an all-time high of \$1.59/euro in April 2008, underpinned by the relatively steep inversion of short-term interest rate spreads against the dollar and the sharper decline in growth expectations for the US. The yen, which had moved on a depreciating trend in the first half of the year, appreciated noticeably against both currencies from the beginning of the turbulence, as many carry-trade positions had been closed in reaction to increasingly

volatile financial markets. Sterling, which had managed to reach a parity of two dollars mid-2007, depreciated considerably at end-2007 against other major currencies. The currencies of emerging economies (see Chart 3.7) tended to appreciate against the dollar – further to ongoing strong capital inflows –, a trend which was briefly interrupted when financial volatility heightened. Nevertheless, in real effective terms the appreciation was much more limited, particularly in Asian countries. Noteworthy was the gradual rise in the rate of appreciation of the renminbi to 11.5% against the dollar between the beginning of 2007 and April 2008, although in real effective terms this appreciation only amounted to 2.3%.

which favoured a narrowing of the US current account deficit although the Japanese and Chinese surpluses widened.

The depreciation of the dollar real exchange rate and the restructuring of domestic demand in certain key countries was conducive to a slight correction of global imbalances. Changes in current account balances (see Charts 3.3 and 3.7) tended to mirror those of trade balances. In the US the current account deficit fell from 6.2% to 5.3% of GDP. At the same time, the surpluses of some regions – Latin America and the oil exporting countries – narrowed (in some cases, notably), as the result not so much of changes in their currencies as the strength of their domestic demand. However, in China and Japan the current account surpluses increased, whereas in the United Kingdom the external deficit widened notably.

Private capital inflows to emerging economies and international reserves grew substantially.

Private capital inflows to emerging economies reached a record high in 2007 of more than \$600 billion, almost triple the previous year's figure (see Chart 3.3). Strong capital inflows have consolidated the buoyancy of these economies during recent years but, in many cases, they have also contributed to exacerbating inflationary pressures. In fact, considerable challenges have arisen in relation to monetary and exchange rate policy management, especially in emerging economies with inflexible exchange rates. The authorities have reacted in different ways: some have opted for measures to discourage capital inflows (for example, Brazil and Colombia) or for lowering obstacles to capital outflows (Chile, Peru and China); in other cases, as in certain Asian and Latin American countries, more exchange rate flexibility has been permitted. However, these measures have not prevented substantial capital inflows, which triggered the strong accumulation of reserves, mainly in China and in other oil exporting countries, totalling more than one billion dollars (see panel 2 in Box 3.2.). This ongoing accumulation of reserves indicates that the appreciation of these countries' currencies, when it has occurred, has reflected only to a small extent the changes in their economic fundamentals.

1.2 THE TURNING POINT: FINANCIAL TURMOIL

In the first half of the year, financial developments were favourable...

In the first half of 2007 the favourable trends of previous years continued on financial markets although at the end of February there was a fleeting episode of volatility, partly related to the growth of subprime mortgage defaults in the US, which already gave a highly veiled indication of the difficulties that would come to light in the second half of the year.

As shown in Chart 3.4, in the first half of the year the rising trend on stock markets continued and the main indices accumulated gains of approximately 8%, while volatility remained relatively contained. The credit spreads of corporate bonds and bonds of emerging issuers stood at low levels, in some cases reaching all-time lows (300 bp for high-risk bonds in the US, 75 bp for bonds with the best credit rating and 180 bp for emerging countries' sovereign bonds). Long-term interest rates recovered slightly and reached the highest level of the last four years. In the US they stood in June at above 5% for ten-year maturities, which was a more suitable level for the cyclical situation at that time. Sustained activity and high productive capacity utilisation levels even lent support to expectations of a rise in official interest rates in the US at the end of the first half of the year.

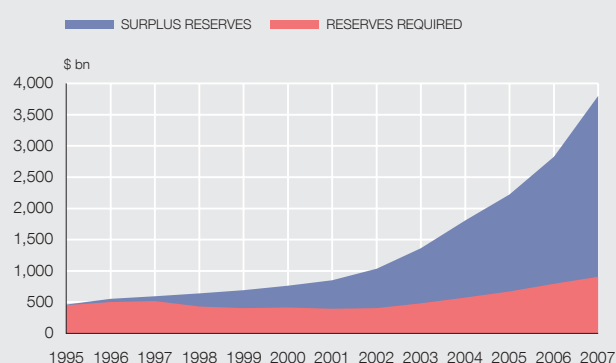
One of the most characteristic features of the international economy in recent years is the financing of industrialised economies – notably the United States – by developing economies and, more specifically, by China and the oil exporting countries, as shown in Panel 1. In this setting, emerging countries' sovereign wealth funds have become increasingly important, especially further to the financial turbulence, when they became one of the few sources of global financial liquidity.

State-owned sovereign wealth funds manage public-sector assets other than international reserves. This term covers, among others, fiscal stabilisation funds, savings funds, public investment funds or central banks' foreign assets. The existence of these funds is not new: in Norway, certain Gulf states and Singapore, stabilisation funds were set up several decades ago and their main objective has been to invest, in accordance with long-term profitability criteria (and in many cases for future generations), fiscal surpluses and to diver-

1 GLOBAL NET BORROWING (-) / LENDING (+)



2 INTERNATIONAL RESERVES IN EMERGING ECONOMIES (a)



3 PRINCIPAL SOVEREIGN WEALTH FUNDS

COUNTRY	FUND NAME	ESTIMATED ASSETS	PERCENTAGE OF GDP
		\$ bn	%
Oil and commodity exporting countries			
United Arab Emirates	Abu Dhabi Investment Authority	500-875	265-465
Norway	Government Pension Fund-Global	329	83
Saudi Arabia	Assets managed by the Saudi Arabia Monetary Agency	289	77
Kuwait	Kuwait Investment Authority	213	195
Russia	Reserve Fund	125	11
	National Wellbeing Fund	32	2.5
Australia	Australian Future Fund	54	6
Qatar	Qatar Investment Authority	50	82
Lybia	Libyan Investment Authority	50	84
Algeria	Reserve Fund/Revenue Regulation Fund	43	33
Alaska (US)	Alaska Permanent Reserve Fund	40	0
Kazakhstan	National Fund	21	20
Chile	Economic and Social Stabilisation Fund	14	8.3
	Pension Reserve Fund	1.5	0.9
Nigeria	Excess Crude Account	11	8
Botswana	Pula Fund	5	41
Azerbaijan	State Oil Fund	3	9
Oman	State General Reserve Fund	2	5
Asian countries			
		\$ bn	%
Singapore	Government Investment Corporation	100-330	66-220
	Temasek Holdings	108	72
Hong Kong	Investment Portfolio (HKMA)	100	49
China	Central Huijin Investment Company	67	2
South Korea	Korea Investment Corporation	19	2
Malaysia	Khazanah Nasional	18	10
TOTAL		≈ 2.200-2.800	

SOURCES: IIF, WEO and national statistics.

a. Surplus reserves = total reserves - short-term external debt

sify their sources of national wealth. Nevertheless, their importance in the international arena has gradually increased due to the sizeable rise in their number – more than thirty countries currently have sovereign wealth funds – and in the volume of assets under management, and also in view of their high concentration on emerging economies. In fact, the volume of assets managed has soared in recent years and is estimated to be between \$2 trillion and \$3 trillion. The assets they manage are still notably less than those of international reserves (the latter are approximately \$5 trillion), but they have a specific and significant weight in international financial markets (assets managed by institutional investors in the advanced economies amount to approximately \$53 trillion).

Sovereign wealth funds are predominantly in two types of countries: oil exporting economies – Persian Gulf states (such as the United Arab Emirates, Kuwait and Saudi Arabia), Russia and Norway – and, to a lesser extent, commodity exporting countries (Australia or Chile); and countries which, though not rich in natural resources, hold extremely large reserves. This latter group of countries is located mainly in South East Asia, and includes Singapore, Hong Kong and, more recently, China. The table shows the main countries with sovereign funds, their estimated volume and the percentage of GDP they represent, which in some cases is more than 100%.

High oil and commodity prices have boosted the tax revenue of the first group of countries, contributing both to the emergence of new funds and to the growth of previously existing ones. In the second group, rigid exchange rate regimes and resistance to the appreciation of their currencies have triggered a huge rise in reserves, far beyond that required for precautionary motives (see Panel 2).¹ International reserves are traditionally invested in highly liquid external assets and, consequently, with relatively low returns. The ongoing need to sterilise reserve growth – in order to maintain control of the money supply – puts upward pressure on the cost of the sterilisation instruments. This strategy has tended to generate rising costs for the central bank and, consequently, the countries involved, most notably China last year, have created sovereign wealth funds by segregating part of the reserve assets in order to achieve higher returns on the resources available.

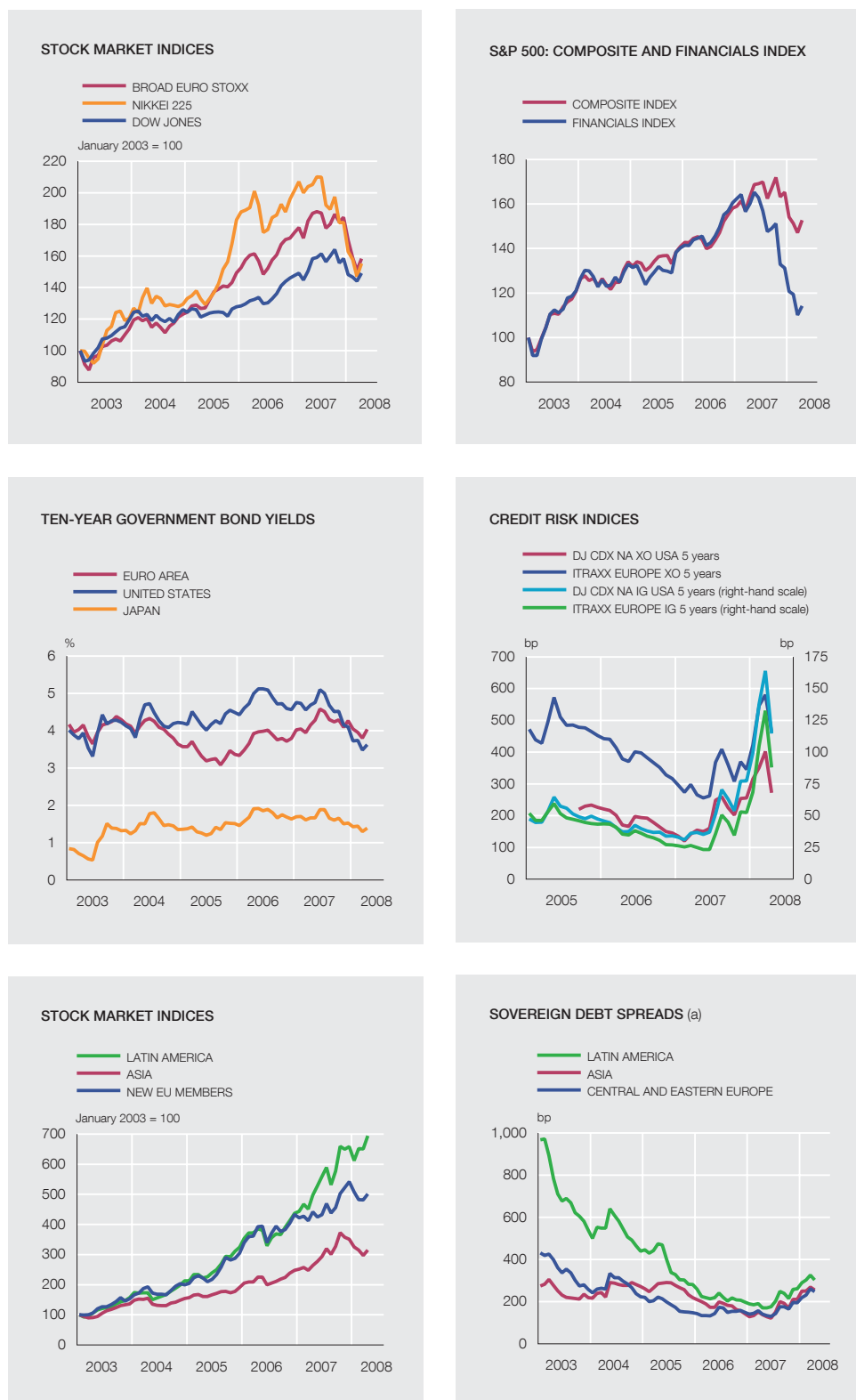
Information on sovereign wealth fund management is relatively scant and not very precise. A small portion of the assets is in-

vested internally in foreign or domestic currency, but the bulk is invested abroad following profitability criteria. A significant share of their investment portfolios is held in equities, bonds with various gradings and, in general, other risky assets which are sometimes not very liquid. The investment portfolios are also more diversified in terms of currencies and countries than international reserves. The expansion of the funds and growing segregation of a portion of the assets from international reserves towards sovereign wealth funds could have considerable effects on international asset prices, although it is difficult to assess the potential magnitude or the sign of this process. In certain cases, the investments of sovereign wealth funds are targeted at gaining control of a firm. In recent months, the capital requirements of certain ailing Western financial institutions have been met by sovereign wealth funds, thus contributing to mitigating the financial impact of the turbulence. Specifically, sovereign wealth funds contributed, until 2008 Q1, more than \$30 billion to recapitalising US financial institutions (approximately 40% of the total).

However, sovereign wealth funds' investments meet with resistance in recipient countries, in particular in developed economies, since they involve in some cases the transfer of decision-making and controlling rights of private companies – sometimes in strategic sectors – to foreign State-owned or partly State-owned entities. This resistance arises from the lack of transparency or of good corporate governance practices, in general, of these entities and the limited development of the institutions and market economy of certain countries of origin. This situation has triggered several international initiatives on sovereign wealth funds such as the establishment of a code of conduct, aimed particularly at improving their transparency and institutional design.

The persistence of high oil and commodity prices and the ongoing (though recently more moderate) upward trend in international reserves in many emerging economies point to the creation of new funds and an increase in the volume of assets managed by existing funds. Consequently, in the coming years the importance of sovereign wealth funds will continue to mount and will contribute to better prospects of future development in the countries in which such funds have been established. Although sovereign funds have become the suppliers of resources essential for balancing financial needs on global markets, it is appropriate to set in place the internal conditions (corporate governance of the funds) and external conditions (supervision by international agencies) to ensure that their investment decisions are strictly based on profitability and risk.

1. See E. Alberola and J. M. Serena, «Una evaluación de los límites a la acumulación de reservas en las economías emergentes», *Boletín Económico*, April 2007, Banco de España.



SOURCES: Datastream and Bloomberg.

a. EMBI + for Latin America and Global EMBI for Asia and Central and Eastern Europe.

but the outlook changed drastically for reasons linked to the extended earlier period of financial boom.

The outlook changed drastically and abruptly in summer with financial problems linked to the subprime sector. Nevertheless, the ultimate causes behind the turbulence lie in the prior period of financial boom, which had lasted for four years and had been characterised by very slack financing conditions, abundant liquidity, a strong appetite for risk and low volatility. This context favoured the strong appreciation of real assets (homes) and financial assets (stock markets and bonds), and extraordinary growth in the issuance of increasingly sophisticated financial products and credit derivatives. All these factors triggered far-reaching changes in the financial arena which merit analysis.

In recent years a risk distribution model has prospered on financial markets...

Recent years have seen an increase in the importance of the “originate-to-distribute” banking model, an alternative to the traditional model in which banks retain the risks arising from extending loans. Under this new model credit institutions grant loans and package them into marketable securities (whose collateral is the loan) which have become highly complex, in order to place them on financial markets.

In the US and in Europe (but not in Spain), special investment vehicles (SIVs and conduits) have played a pivotal role in the transfer of risks from the originator institution (which extends the loans) to the final investor (commercial or investment banks, hedge funds and institutional investors) and in how the final investors become exposed to such risks. SIVs are legal entities which are linked to the originator banks or, as the case may be, to the final investors through contractual and/or reputational links and include in their assets the loans or securities with long-term collateral, thus removing the credit risk from originator and investor entities' balance sheets. In order to finance themselves they issue commercial paper or generally short-term bonds, ABCP and MBS, respectively, secured by these assets or mortgages; also, they sometimes arrange contingent credit lines with the entities to which they were linked. The use of these vehicles contributed to generating the perception – which has ultimately proved to be wrong – that the risks were not assumed by the entities.

which has heightened the financial accelerator effect, but also made it difficult to monitor risks and diluted incentives for prudent risk management.

This mechanism for the distribution of and investment in risky assets, which on many occasions is supplemented with highly sophisticated credit derivative products, makes the valuation, monitoring and location of risk extremely complicated. On one hand, the link between the risk originator and holder is diluted and obscured, which gives no incentives for the suitable monitoring and prudent management of risk. On the other, the valuation of many of these complex instruments lies in the credit rating assigned by rating agencies, which is based on assumptions that *a posteriori* have proved inadequate. Thus, over-optimistic ratings supported the perception that they were safe instruments and led to them being distributed widely, even among conservative institutional investors. All these characteristics, coupled with stiff competition in the financial system, the search for yields and obtaining higher fees in the risk distribution process favoured the growth of these instruments, the relaxation of due diligence by investors and, ultimately the growth of the “originate-to-distribute” model to disproportionate limits.

In short, the leverage capacity of financial institutions multiplied, it permitted a strong expansion of credit, boosted the generation of liquidity in the system and heightened the financial accelerator effect. However, the incentives also increased for imprudent behaviour and inadequate valuation and monitoring of the risks being generated, which was not met by a swift enough response from regulators and supervisors.

All the weaknesses of this model crystallised in the US subprime market which

It is well known that this process was more significant in the US mortgage market and, in particular, the subprime segment. 60% of mortgages in the US were securitised in 2006 in comparison with 10% in the euro area, and the subprime market grew spectacularly in recent years

ultimately triggered the turbulence.

to account for more than 20% of the volume of the new mortgages granted in 2006 (in comparison with 8.5% in 2003). These aggregates were not compatible with prudent loan concession standards, and were only possible against a backdrop of continuous rises in house prices and strong job creation. However, the correction of the property sector in the US from the beginning of 2006, which deepened in 2007 with falling house prices, prompted a substantial and ongoing increase in subprime mortgage default rates (see Box 1.2). However, only the interweaving of this market segment, of relatively small importance on the world stage (less than 4% of the non-financial debt in the US), with a broad spectrum of complex financial instruments and the strong exposure of the banking system to them can account for the subprime crisis unleashing global financial turbulence.

In July the turbulence materialised, against a backdrop of loss of confidence in and uncertainty over structured financial instruments.

Thus, a new episode of volatility materialised in July with its epicentre focused on the high-risk mortgages in the US, which put a definitive end to the earlier favourable dynamics. The loss of confidence in the structured financial instruments associated with these mortgages (ABCP, MBS, etc.) triggered a drastic fall in demand for these financial instruments, hampering the refinancing of many debts based on them and generating a sudden liquidity shortage on credit markets and a strong increase in credit risk premiums (see Chart 3.4.). Some financial institutions refrained from subscribing these structured products and, subsequently, due to the uncertainty regarding their financial exposure, restricted credit to other customers and institutions. Also, for legal or reputational reasons they had to activate credit lines with SIVs and conduits, or include the latter's assets in their balance sheets, which entailed the recognition of heavy potential or actual losses.

Liquidity dried up on interbank markets prompting a swift reaction from central banks...

The growing uncertainty and greater (immediate or potential) liquidity requirements facing banks led them to hoard money. The interbank and money markets dried up, the difference between long-term and short-term interest rates widened notably, as did that between the interest rates at which institutions lend each other money without collateral (depo rates) and interest rates on collateralised loans (repo rates). Initially, the major central banks reacted by supplying liquidity to interbank markets – occasionally in a coordinated manner – and there was a notable change in the outlook for monetary policy, mainly in the United States where a downward cycle in interest rates began. The Federal Reserve and the Bank of England created new liquidity supply lines, unlike the Eurosystem where liquidity injections could be incorporated into the established implementation framework. Through these lines access to funds was made easier for institutions and the maturity, the range of securities which could be used as collateral in financing transactions and the types of institutions with market access were extended. Also, currency swap lines were set up between the major central banks to make it easier for banks to obtain currency.

that was not enough to restore confidence.

In spite of these measures, the worsening financial situation and uncertainty continued to filter through the global financial system and began to make themselves felt in the real-sector leading indicators. In the financial arena, following a short period of calm, the turbulence resurfaced from November in the face of growing concern about the financial soundness of institutions. The reporting of losses by financial institutions and the difficulties identified in new market segments, such as bond insurers, were combined with a rapidly deteriorating outlook for economic growth (which was more acute in the US). This decline was largely caused by the perception that corporate and household financing conditions were tighter, reflecting the feedback between financial and real factors in the development and consolidation of the turbulence. In this scenario, the Federal Reserve quickened the process of monetary easing, and cut official rates by 125 bp in just under one week in January and by a further 100 bp in March and April to 2%, at the same time as it reduced in various stages the spread between the federal funds target and discount rate to 25 bp.

Financial indicators deteriorated in the second half of the year and the financial difficulties filtered through to real variables.

The serious ongoing financial turbulence may serve to adjust the imbalances accumulated in the previous period...

but it is also going to have consequences for the real economy and, therefore, is an essential factor for evaluating the economic outlook.

1.3 OUTLOOK AND RISK FACTORS

The central scenario includes a clear slowdown in the world economy that is sharper in the advanced than in the emerging economies.

Risks relating to growth projections continue to be on the downside.

Events on financial markets from July 2007 have obviously been highly conditioned by the unfolding of the above-mentioned turbulence and its impact has gradually passed through, with varying levels of intensity, to other segments as shown in Chart 3.4. Thus, the spreads of low-grade corporate bonds doubled in the US; those of emerging countries' sovereign bonds experienced a notable but relatively moderate rise, if the secular vulnerability of these markets is taken into account; stock markets continued to hold up to a certain extent against the turbulence until year-end – the impact was limited to the sectors with the highest exposure (property and finance) –, but underwent a far-reaching correction at the beginning of 2008, especially after growth projections were revised sharply downwards. The smaller appetite for risk resulted in a flight to safe-haven assets such as public debt and in a notable reduction in long-term rates in the US and in other countries, ending their previous upward trend.

The persistent turbulence and stagnation of activity in broad market segments can be justified, on one hand, by continued uncertainty linked to the risks of new financial instruments and institutions' actual exposure to them and, on the other, by the ongoing decline in property markets in the United States and the gradual spreading of difficulties to financial segments which are increasingly wider and removed from the subprime focal point.

From a broader standpoint, it can be considered that the turbulence not only draws to a close a very favourable financial phase but that it is a direct consequence of that period in which financing conditions have been extraordinarily lax, against a backdrop of relatively accommodative, yet tighter, monetary policies. The perception that risk premiums did not reflect fundamentals or the ease of tapping liquidity were signs of a situation that could require a more or less sharp correction which was already indicated in recent years. Accordingly, the turbulence may contribute to correcting the excesses of the previous phase, readapting the global financial system to make it more stable in future. It may also serve as a guide for future initiatives on regulations and on implementing monetary policy, which in any event ought to be consistent with the necessary development of new products and financial services. Only in this way is it possible to maximise the positive impact of these financial innovation processes which, in the long term, deepen markets and provide better allocation of financial resources at world level.

In any event, this adjustment is having substantial consequences for the financial system which are increasingly evident for the real sector, and, therefore, it is a factor of concern and an essential element for evaluating the global economic outlook, as set out below.

The economic outlook for 2008 forecasts a widespread slowdown, one sharper in the main developed economies than in the emerging economies which, led by China, will continue to record relatively high growth rates. On the projections available the world economy will expand by less than 4% in 2008, more than 1 pp below the rate in 2007.

This scenario of global deceleration only includes the downturn already experienced by global financial conditions; consequently, given the continued financial turbulence, the greatest risk to the projections not being fulfilled is the possibility of a sharp, protracted and widespread credit squeeze. Furthermore, there are other significant factors of risk to the outlook stemming in part from the financial turmoil and which could interact with it. Firstly, economic developments in the US could be much more negative than anticipated, especially if the adjustment in the real

estate sector is sharper than expected, and they could have a greater effect on the rest of the world; secondly, there is the possibility of a disorderly correction of global imbalances; and, lastly, continued inflationary pressure represents another risk, especially to the extent that expectations of higher inflation may take root and restrict the room for manoeuvre of monetary policies.

The biggest risk is widespread credit restrictions...

Severe and widespread credit restrictions – in geographical and sectoral terms – cannot be ruled out, and their repercussions on global activity would be on a large scale, especially if the two major channels for obtaining finance, banks and capital markets, are affected. The longer the financial market strains and lack of confidence continue, the higher this risk becomes.

which might combine with the risk of a larger-than-expected slowdown in the United States.

The outlook for the US economy – and, in particular, whether it goes into recession or experiences a slowdown in activity – is closely related to the continued adjustment in the real estate sector and the latter's connection to the financial turbulence. In recent months the adjustment of the real estate sector has intensified and there has been no clear indication of an end to this process. The buttresses of real activity, such as the labour market, have weakened sharply. In this setting the outlook for activity in the United States is highly uncertain and the probability of a larger-than-expected real adjustment is significant.

The resilience of other economies is also a factor of uncertainty.

The risks surrounding the US economy raise greater doubts as to the resilience of other developed and emerging economies. In addition to direct effects passed through the trade channel (which are possibly less intense now in comparison with previous periods, due to the growing relative weight of other areas in trade) are more worrying effects in the financial sphere and relating to agents' confidence. Most developed economies have already experienced considerable negative effects through both channels and there is still room for these effects to continue. However, one aspect that may be particularly important for propping up the global economy is the resilience of emerging economies which, to date, have been relatively unaffected by events in developed economies, especially in comparison with previous episodes. Several factors have contributed to these positive developments in emerging economies, such as the improvement in their economic and financial fundamentals (partly stemming from the favourable international situation in recent years), increasingly strong domestic demand, better terms of trade in commodity exporting countries and greater trade diversification. But given a sharper slowdown in the advanced economies and continued strains on financial markets, it will be difficult for emerging economies to be substantially unaffected both from the point of view of activity and of borrowing costs. In particular, those regions (like Eastern Europe), which are reliant on sizeable capital inflows to maintain their momentum, would be especially vulnerable.

Despite the incipient correction of global imbalances, financing the US deficit may be more difficult.

Global imbalances are being corrected slightly. Nevertheless, financing the US external deficit could become more complicated if foreign investors require higher returns on dollar-denominated assets, which could prompt a disorderly adjustment on financial markets. This process might step up if certain countries, which have invested their international reserves heavily in low-return dollar-denominated assets, were to tend to diversify their investments towards other currencies, for example through sovereign wealth funds (see Box 3.2), or if they were to unpeg their currencies from the dollar.

Oil prices are another significant factor for the outlook, against a backdrop of economic slowdown ...

Another ongoing risk for the world economic situation are oil prices and commodity prices in general. Crude prices could moderate, yet remain high, if global demand slowed more than projected. However, high volatility will probably continue, prompted by limited spare production and refining capacity, along with financial factors or possible supply distortions. In a setting of strong economic growth, the increases in oil prices since 2003 have not apparently affected

global activity. However, it is possible that in a scenario of a sharper slowdown the impact of the oil price rise might be amplified in view of its negative effect on consumer confidence and inflation expectations. While there are structural factors behind the strong growth of agricultural commodity prices, they are not expected to continue to rise at previous rates (see Box 3.1).

and inflationary pressures, which might complicate monetary policy management.

Inflation risks are biased upwards in the short term as a result of the rise in commodity prices and, in some cases, especially in emerging economies, as a result of demand pressures on production capacity. Nevertheless, the inflation rate is projected to ease in the second half of 2008, as the year-on-year pace of growth in commodity prices decreases. In this scenario, anchoring inflation expectations is vital. It cannot be ruled out that a combination of weaker activity, continued inflationary pressure and rising inflation expectations may occur in certain developed countries and – even more sharply – in certain emerging economies. This may give rise to monetary policy dilemmas and restrict central banks' capacity to act, especially in those emerging economies with rigid exchange rate regimes and strong capital inflows.

In any event, the world economy can draw on certain significant factors of resilience.

Nevertheless, certain factors of resilience can be pinpointed which would support the global economy's ability to accommodate the market turbulence and favour a swifter recovery in global activity than in similar episodes in the past. First, there are favourable factors which may limit the effects of the financial turmoil on the real sector. In this respect, mention must be made of the initial economic situation, which was characterised by an extended period of robust widespread growth at world level, relatively contained inflation in recent years and the healthy state of companies' balance sheets. Also, the buoyancy and increased importance of emerging economies, in many cases with a comfortable external position, may significantly counter the slowdown. Further, globalisation – and the international competitive pressure which it has encouraged – has made economies perform more flexibly, increasing their ability to combat adverse shocks, with lower costs in terms of activity and employment. Finally, the process of globalisation has also made the world economy more flexible and efficient, increasing its ability to react to unfavourable situations.

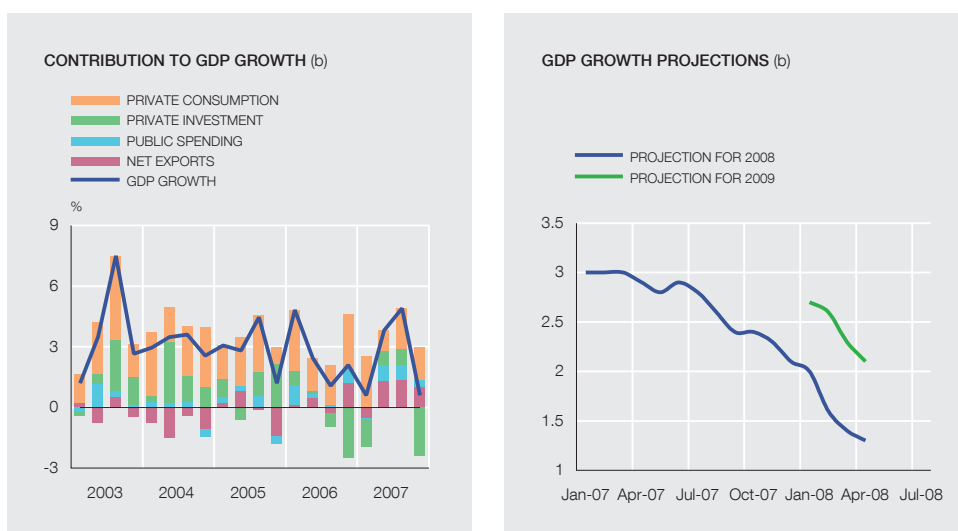
2 United States

US GDP slowed in 2007, weighed down by the adjustment of the real estate market.

In the United States, GDP slowed in 2007, to post the lowest growth of the last five years (2.2% in comparison with 2.9% in 2006). However, although the economy was at an advanced stage of the economic cycle at the beginning of the year, activity was notably buoyant for most of 2007. The most noteworthy development continued to be the far-reaching adjustment of the real estate market, which intensified beyond expectations, with the result that residential investment subtracted 1 pp from GDP growth in 2007. By contrast, private consumption remained stronger than projected, mainly supported by the favourable performance of employment despite the negative effect on household wealth arising from the adjustment in the housing market (see Chart 3.5 and Box 1.1). It was only in the closing months of the year that private consumption indicators deteriorated in the face of an increasingly weak labour market (the unemployment rate rose from 4.4% in March 2007 to 5.1% twelve months later), the fall in confidence resulting from the financial turbulence and the loss of purchasing power triggered by higher consumer prices. Business investment also performed favourably until the last quarter, when some signs of a slowdown emerged. The external balance improved over the year and net external demand made a positive contribution to GDP growth for the first time since 1995, due in particular to the sharp slowdown in imports. Consequently, the current account deficit eased from 6.2% of GDP in 2006 to 5.3% in 2007.

Inflation rose in the second half of the year...

As for prices, inflation remained moderate for most of 2007, averaging 2.8% in comparison with 3.2% in 2006. However, the increase in food and energy prices caused headline inflation to rise substantially towards the end of 2007 and early in 2008, reaching 4% in March. Core inflation remained contained, although recently it has tended to rise above 2%.



SOURCES: Datastream, Federal Reserve and Consensus Economics.

a. Contributions to annualised quarterly GDP growth.

b. Projections of Consensus Economics. The horizontal axis includes the date the projections were made.

although economic policies have been increasingly geared to countering financial turbulence and risks to economic growth.

In any event, the economic outlook for 2008 has deteriorated substantially.

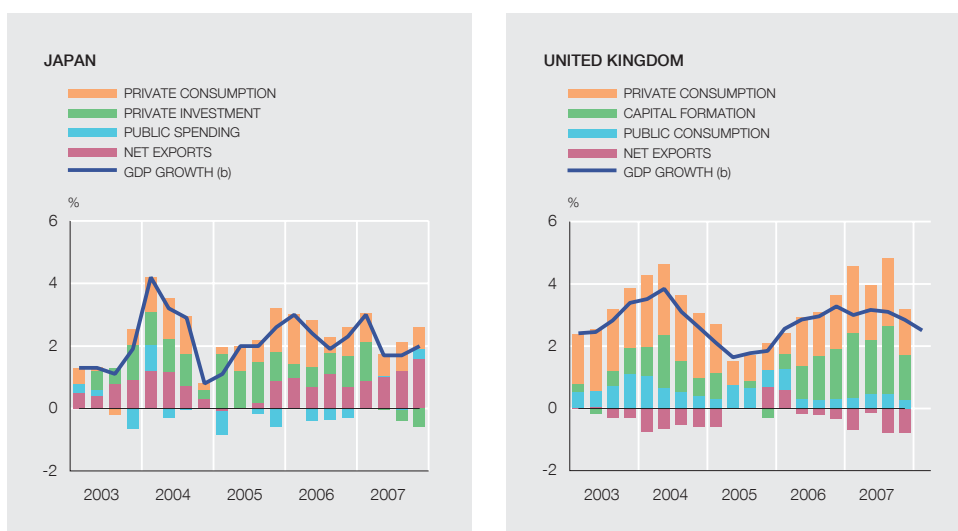
The Federal Reserve held official interest rates unchanged in the first half of 2007. As a result of the financial turbulence and its impact on the US economy, it changed its monetary policy stance and made a series of interest rate cuts totalling 325 bp from an initial 5.25% to 2% in April this year. Also, the Federal Reserve sequentially applied a barrage of measures to provide liquidity to the system (see section 1.2). At the beginning of 2008 a temporary fiscal stimulus package amounting to \$168 billion (approximately 1.2% of GDP) was approved, to help withstand the economic slowdown which, in conjunction with the lower pace of activity, will foreseeably push the budget deficit (2.5% of GDP in 2007) considerably higher in 2008.

Growth projections for 2008 have been cut drastically since the beginning of the turbulence (see Chart 3.5), and when this report went to press, growth of less than 1% was expected in 2008. This annual rate points to a notable weakening profile in the first half of the year, when activity could even shrink, and a slight recovery from Q3 as a consequence especially of the effects of the economic policy measures which have been adopted. The expected weakness is based on tighter financing conditions and a further deepening of the correction of the real estate sector. The consequent reduction in household wealth, given the fall in asset prices, and the weaker labour market are expected to put considerable downward pressure on private consumption. Therefore, the principal risks for this scenario continue to be on the downside in view of the possibility that there will be greater credit restrictions, that the deepening of the adjustment of the real estate sector and the worsening of the labour market will be more pronounced, and that business investment could also be affected. Despite the ongoing short-term upside risks, inflation is expected to ease in tune with the economic slowdown, although the recent increase in inflation expectations has given rise to concern.

3 United Kingdom

The UK economy remained buoyant although it was also affected by the financial turbulence.

In the United Kingdom GDP grew 3% in 2007 in comparison with 2.9% the previous year thanks to the momentum of domestic demand, while the contribution of net external demand became more negative (see Chart 3.6), which was associated with a rapid deterioration of the current account deficit from 3.9% to 4.2% of GDP. Nevertheless, towards the end of the year economic growth eased, due in part to the effect of the financial turmoil on mortgage lending and housing markets, which began to show signs of a sharper-than-expected adjustment. A



SOURCE: National statistics and Datastream.

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

particularly significant episode occurred when Northern Rock, a large mortgage specialist, had to apply for emergency liquidity support, forcing intervention by the Bank of England, which until then had been cautious about its support for the financial system. Northern Rock was ultimately nationalised by the British government.

Inflation eased during the year and the Bank of England, which had raised official interest rates in the first half of the year, cut them in view of the effects of the financial turbulence.

Activity is expected to slow down in 2008, with downside risks.

4 Japan

In Japan growth eased slightly due to weak private consumption...

and it did not definitively emerge from a period of deflation, with the result that the Bank of Japan left the official interest rate unchanged from February.

Inflation rose from the beginning of 2007 to 3.1% in March. Subsequently, prices eased and inflation ended the year at 2.1%, although it had begun to quicken at the beginning of 2008 (it stood at 2.5% in February), as a result of rising energy prices. The Bank of England raised the official interest rate three times by 25 bp to 5.75% in the first half of the year; however, in view of the effects of the financial turbulence, it cut it on three occasions between December 2007 and April 2008 to 5%. The budget deficit widened in 2007 from 2.6% to 2.8% of GDP.

The economic outlook for 2008 points to a steep slowdown and growth of under 2%, due above all to less buoyant private consumption. The biggest risks to this projection include the possibility of further difficulties for a specific segment of the financial system and the risk of a sharp contraction in the property market, which might affect other demand components.

The Japanese economy grew 2.1% in 2007, compared with 2.4% in 2006. This slowdown reflected the fall in residential investment —prompted by legislative changes in the sector— and the ongoing weakness of private consumption (see Chart 3.6), held back once again by the scant buoyancy of household income, despite the increase in employment. GDP growth was underpinned equally by domestic and external demand, although the latter became increasingly significant as the year unfolded. The current account surplus increased for yet another year to 4.8% of GDP.

The consumer price index remained at a slightly negative year-on-year rate, although it rose in recent months due to the increases in oil and food prices, ending the year at 0.7% and climbing to 1% in February 2008. However, other significant indicators such as the GDP deflator and unit labour costs remained negative, reflecting continued deflationary tensions, although urban land prices were comfortably positive. The Bank of Japan scarcely altered its monetary policy stance in the whole of 2007: it only increased the official interest rate in February 2007

by 25 bp to 0.5%, and, subsequently, left it unchanged due to slack inflation indicators and hesitant activity from the second quarter. The financial turbulence had little impact due to the lower exposure of the Japanese financial system to the markets where it arose, and liquidity injections were not very significant. As for fiscal policy, the budget deficit narrowed from 3.8% to 3.4% of GDP, due to strong corporate income tax receipts and the ongoing cut in public investment; however, no progress was made with public expenditure and fiscal reform. Net public debt continued to grow to 91% of GDP, 2 pp more than in 2006.

Prospects of an economic slowdown in 2008 despite the lower impact of the turbulence.

The prospect for 2008 is of a slowdown in activity to a rate of around 1.5%. The main risks to this scenario are excessive reliance on the external sector, the ongoing weakness of private consumption – which should become increasingly important so as to make growth more independent and resilient –, insufficient progress with structural reforms and the possible impact of turbulence, albeit to a lesser extent than in other countries.

5 China and the rest of Asia

In China, GDP quickened in 2007 and the trade surplus and foreign reserves increased once again.

China's GDP remained strong in 2007 with a growth rate of 11.9%, 0.3 pp up on 2006, supported by buoyant domestic demand and the significant contribution of external demand (see Chart 3.7). Although the appreciation of the renminbi accelerated gradually, the trade surplus continued to increase, which pushed the current account surplus up to 11.1% of GDP. However, at year-end a weakening of exports could be seen. This surplus, together with rising capital inflows, favoured the continued sharp build-up of foreign reserves, which amounted to \$1.5 trillion at year-end. Associated with the management of these reserves was the creation of a sovereign wealth fund with initial capital of \$200 billion (see Box 3.2).

Inflation also increased very steeply despite restrictive monetary measures.

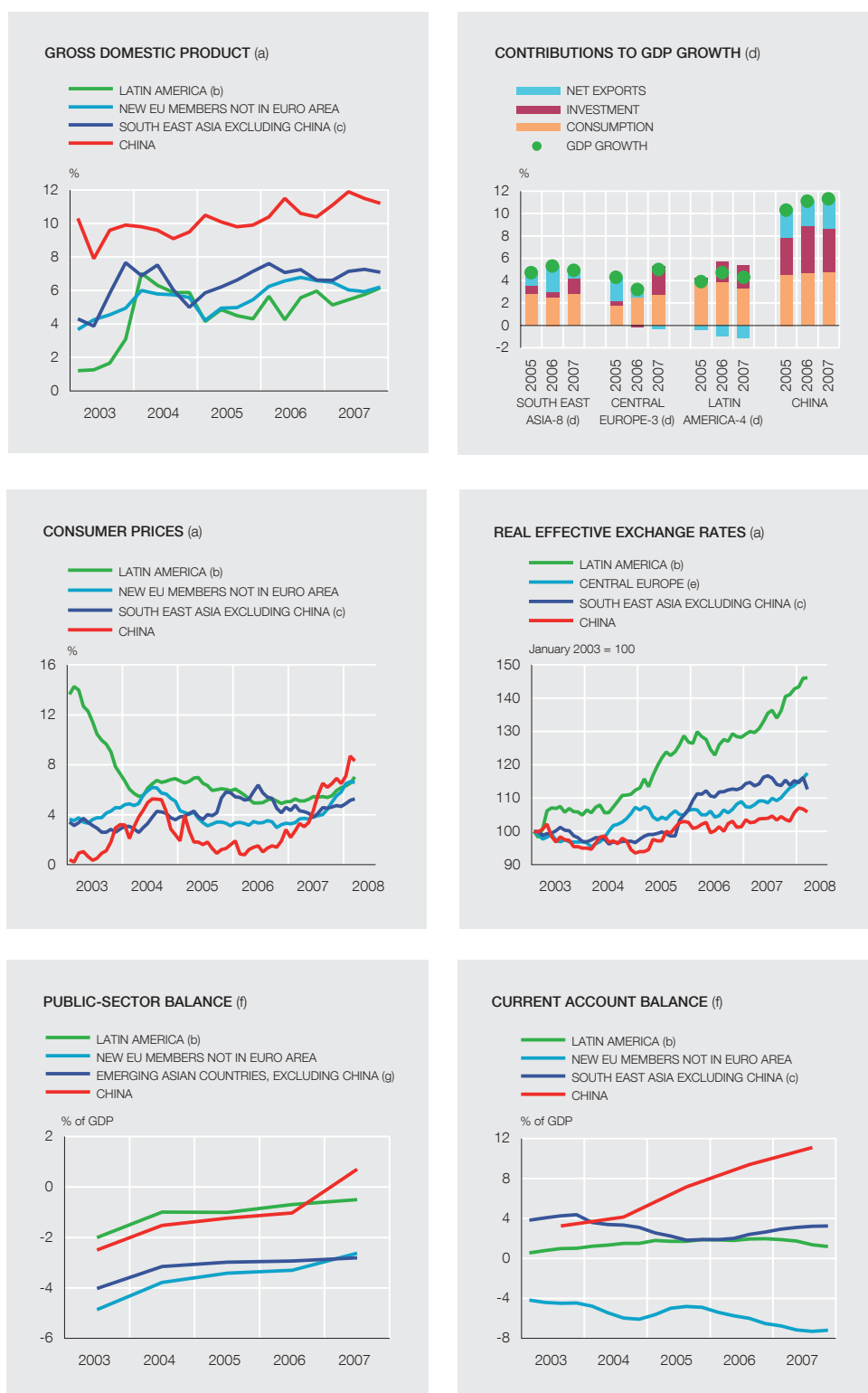
China's inflation grew significantly in 2007 from 2.2% in January to 6.5% at year-end (peaking at 8.7% in February 2008), driven by the food component and also affected by supply shocks, although core inflation scarcely grew. In the face of concern about inflationary pressures and the risk of overheating, the monetary policy stance was less accommodative, and was accompanied by a series of administrative measures to control prices at year-end and a gradual increase in exchange rate flexibility which resulted in a sharper appreciation of the renminbi against the dollar, from the closing months of the year. In fact, the benchmark interest rates for one-year loans have been raised on six occasions since January 2007 to 7.47% (a 135 bp increase), although real interest rates turned negative. Similarly, the bank reserve requirement was increased on thirteen occasions from 9% to 16%, in addition to restrictions being placed on lending conditions.

Economic growth in the rest of Asia was also strong, as was the rise in inflation.

Overall, the other major Asian economies posted notable economic growth in 2007 of approximately 7%, similar to that in 2006, and which was also supported by domestic demand albeit with signs of decelerating activity in several countries in Q4. Against a backdrop of few changes in monetary policy, inflation climbed higher especially in the second half of 2007, as a result of the rise in food and energy prices. The principal exception here was India, where inflation eased in the second half. This trend of rising inflation continued across the board in the early months of 2008.

The outlook for the region in 2008 is relatively favourable, although there are risks from the external sector, inflation and capital flow management.

The outlook for 2008 for the region as a whole is relatively favourable, in particular in China and in India, although growth will be slightly lower. Against a backdrop of greater international uncertainty, downside risks will persist, especially in economies that are more reliant on the external sector. Inflation and the possible second-round effects stemming from upward price pressure pose a challenge for Asia's economies, especially those where monetary policy actions are limited by exchange rate decisions or the management of capital inflows, in particular in China.



SOURCES: Datastream, Bank for International Settlements and International Monetary Fund (WEO).

a. Annual percentage change.

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

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

d. Areas analysed: South East Asia-8 (Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines), Central Europe-3 (Czech Republic, Hungary and Poland) and Latin America-4 (Argentina, Brazil, Chile and Mexico).

e. Czech Republic, Hungary, Poland and Slovakia.

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

g. Country aggregate based on IMF (WEO) definition.

6 Latin America

Economic growth continued for the sixth consecutive year, supported by domestic demand.

Inflation rose due to higher food and energy prices, but also to core inflation.

The outlook for 2008 continues to be positive, especially because financial vulnerability in the region is lower.

In Latin America, GDP growth stood at 5.8% in 2007, slightly above 5.4% in 2006, marking the consolidation of one of the longest phases of growth in its recent history. Supported by high commodity prices and favourable financing conditions, even after the turbulence began, economic growth was driven by the expansion of domestic demand, while the foreign sector's negative contribution increased (see Chart 3.7). This robustness of domestic demand triggered a slight deterioration in current account balances, although the region as a whole continued to show a surplus, as in the last five years. On this occasion the surplus amounted to 0.5% of GDP.

From 2007 Q2, overall inflation rose significantly – up from 5% at the end of 2006 to 6% at the end of 2007 and to 6.1% in February 2008 – and core inflation also tended to increase. Nevertheless, the inflation rate for the whole region still remains at a historically very low level. In this setting, monetary policies, which until March had followed diverging trajectories, tended to tighten, while in Brazil the downward cycle in interest rates was interrupted from October. As for fiscal policy, budget balances continued to improve, although it was more due to the favourable economic situation and higher commodity prices than to greater fiscal discipline. In the area of structural reforms, progress continued to be relatively limited in most countries, although the fiscal reform in Mexico could be a notable exception.

The economic outlook for 2008 remains relatively favourable, with growth expected to be slightly lower; however, there is uncertainty, mainly on the external front. The worsening global growth outlook could affect Mexico and central American countries in particular through the trade channel (due to a decrease in their exports to the United States) and also bear on commodity exporting countries (should commodity prices fall). The decrease in remittance flows from migrants in advanced economies, as seen in Mexico last year, is another factor to be considered. Lastly, the financial channel could affect those countries with poorer fundamentals and higher short-term financing requirements to a greater extent. In any event, it is important to underline the resilience in the face of global financial turbulence, which is in stark contrast to other episodes; this change is at least partly attributable to the improvement in economic fundamentals and lower financial vulnerability in a setting of greater macroeconomic stability.

7 The new EU Member States

Activity in the new EU Member States remained notably buoyant in 2007...

although with clear signs of overheating, a substantial increase in inflation and very high current account deficits.

Stability of currencies participating in ERM II, with some exceptions.

GDP in the new EU Member States grew 6.2%, slightly lower than 6.5% in 2006, and underpinned once again by strong domestic demand. The highest growth rates were posted in the Baltic states, Slovakia, Poland, the Czech Republic and the two new EU members, Bulgaria and Romania. Conversely, the growth rate of the Hungarian economy fell by 2.6 pp to 1.3%, due to the impact of the fiscal adjustment programme on private consumption.

There was a notable rise in inflation, which also affected core inflation rates, against the backdrop of the overheating of several economies. In some cases, from the second half of the year, double-digit inflation rates were reached (the Baltic states and Bulgaria). There was a substantial further deterioration of current account deficits which exceeded 10% of GDP in the Baltic states and in the two new Member States. Noteworthy were the current account deficits of 20% of GDP in Bulgaria and 25% of GDP in Latvia. In this setting, most countries – except for Slovakia – chose to tighten their monetary policy stance from the second half of the year onwards. In the fiscal field, public balances improved slightly against a background of strong revenue growth. The decline in the Hungarian budget deficit from 9.2% to 5.2% of GDP was particularly significant.

The exchange rates of currencies participating in the Exchange Rate Mechanism (ERM II) remained stable against the euro, with the exception of the Slovak koruna, whose central parity appreciated by 8.5% in March 2007, and the Latvian lats, which experienced an episode of

turbulence. Of the currencies not participating in ERM II, the Hungarian authorities decided in February 2008 to leave the fluctuation band of $\pm 15\%$ against the euro and to let the exchange rate float freely. Lastly Cyprus and Malta joined the euro area on 1 January 2008.

Outlook of a moderate deceleration with upside risks to inflation and, especially, risks in the face of turbulence due to heavy external financing requirements.

The outlook for 2008 is of a moderate deceleration in activity in the region as a whole, which could be affected by weaker growth in the euro area and tighter financing conditions, especially in those countries more reliant on external financing. The risks to inflation remain on the upside but the principal risk for these countries – which is the main feature that differentiates them from other emerging areas – is the high financing requirements arising from the large external deficits in certain economies. These financial needs have been increasingly covered by greater recourse to loans from abroad, most of which are denominated in foreign currency in some countries.

1 Economic conditions in the euro area

In 2007, euro area GDP grew by 2.6%, slightly above the most commonly accepted rate of growth of potential output. Activity growth followed a smooth downward course over the year, but it was in the final quarter that the effects on spending of the various shocks that had been affecting the world economy began to become apparent: the slowdown in the US economy, the financial turbulence that broke out in the summer, the notable rise in energy and food commodity prices, and the ongoing appreciation of the euro. The impact of these shocks seems to have precipitated the end of an expansionary cycle in the euro area that has been not only brief, but also incomplete; following the initial impulse from external demand and the subsequent buoyancy of investment and employment, private consumption remained weak (see Box 4.1).

During the year as a whole, euro area inflation was slightly lower than in 2006, although it remained above 2%. Its profile during the year was determined by the increase in indirect taxes and, especially, by the behaviour of the most volatile components (energy and, in the final quarter, food), which reflected the escalation of international commodity prices. These shocks led to a significant deterioration in short-term inflation expectations which, along with the strength of the labour market, has notably increased the risks of second round effects on price and wage formation, although so far wage moderation has been maintained.

In the first half of 2007, the ECB Governing Council increased official interest rates by 25 bp on two occasions, so that they stood at 4% in June, continuing the process of reduction of the accommodative bias of monetary conditions that it initiated in 2005. The financial strains of the summer produced a de facto tightening of the economy's financial conditions, and their extension into 2008 gave rise to a complex scenario of extraordinary uncertainty, exacerbated by the intensification of the upside risks to medium-term price stability and the downside ones to growth. In these circumstances, the monetary authority decided to leave official interest rates unchanged during the second half of 2007 and in 2008 to date. In addition, as explained in Box 4.2, the strains in the interbank market required the ECB to supply funds on an extraordinary basis, in order to stabilise the very short-term interest rate at around the official rate and to contribute to the sound functioning of the money market.

Most countries in the area improved their budget balances, so that in 2007 the deficit did not exceed the limit of 3% of GDP in any of them. However, the budget consolidation efforts do not appear sufficient and the current economic situation may make further progress difficult. The achievement of sustainable public finances in the long term requires decisive progress in fiscal consolidation and an increase in efficiency in all areas of public spending, as well as structural reforms to promote growth and employment. Significant advances have been made in this area during the first three years of the renewed Lisbon strategy which have doubtless contributed to the favourable performance of employment. However, the achievements are still insufficient and Europe is facing major challenges arising from economic globalisation, technological change and population ageing, which require additional efforts, even in a context of economic slowdown.

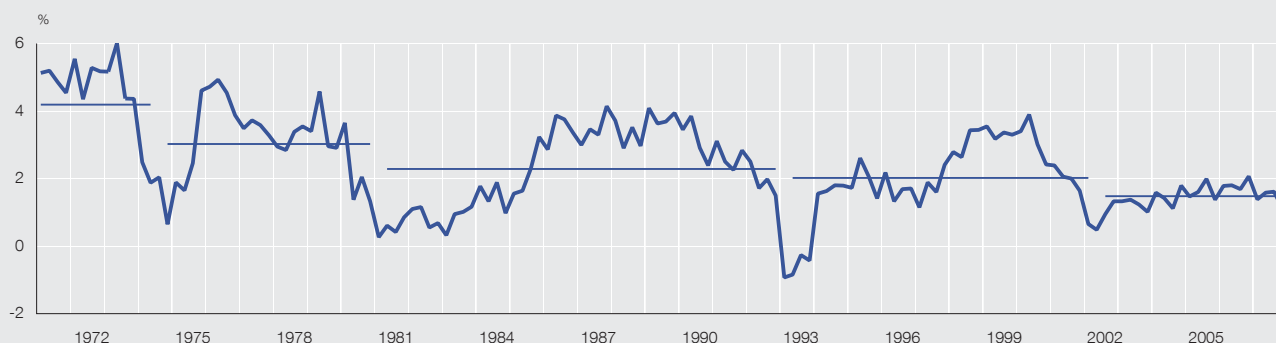
The outlook for growth in 2008 (a year in which Cyprus and Malta have become part of the euro area) has deteriorated notably in recent months and is, moreover, subject to downside risks, basically arising from the high degree of uncertainty regarding the actual impact and

Private consumption growth in the euro area has been relatively moderate in recent years in comparison with other similar points in the cycle (see Chart 1). Between 2002 and 2007⁴ it grew at a somewhat lower rate than GDP, against a background of weakness in households' gross

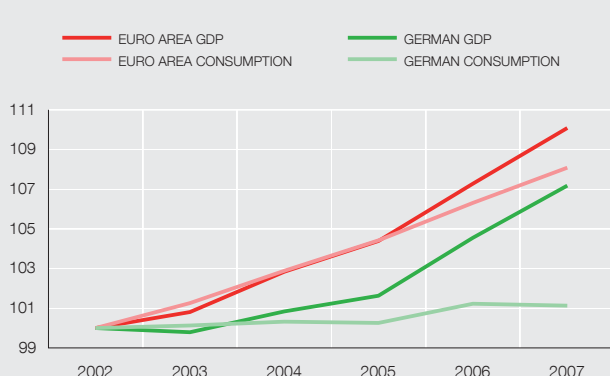
disposable income (GDI). During this five-year period, consumption grew by 8% in real terms, while GDP grew by 10% and income by 6%, giving rise to a decline in the household savings ratio (see Charts 2 and 3). In 2007 consumption was still slack, growing by 1.5% year-on-year, despite the recovery in employment and the consequent acceleration of GDI, which is estimated to have grown by 1.9%. The downward path of saving was thus interrupted by a slight recovery.

3. All the data are from the National Accounts, except for GDI in 2007, which is an estimate

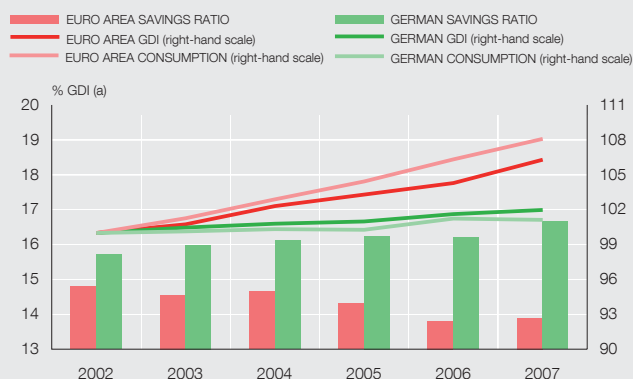
1 HISTORICAL PATH OF REAL CONSUMPTION. YEAR-ON-YEAR GROWTH



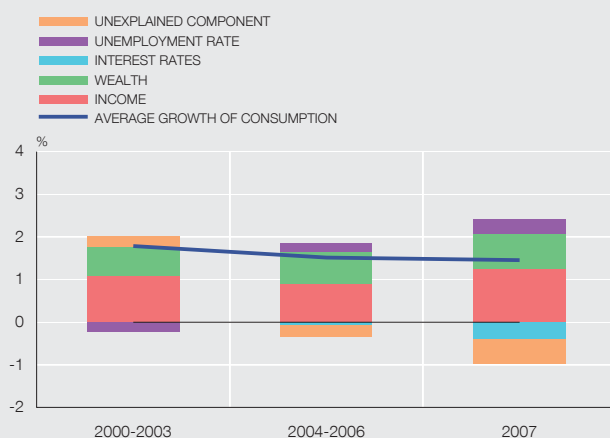
2 PRIVATE CONSUMPTION AND GDP



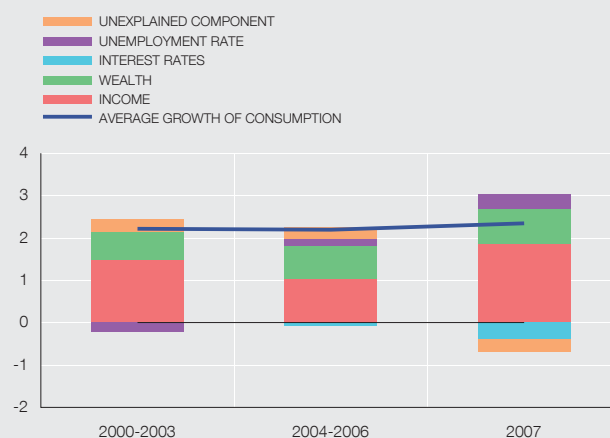
3 CONSUMPTION, INCOME AND SAVINGS RATIO



4 CONTRIBUTION OF THE DETERMINANTS OF CONSUMPTION (b)



5 CONTRIBUTION OF THE DETERMINANTS OF CONSUMPTION, EXCLUDING GERMANY (b)



SOURCES: Banco de España, European Commission and OECD.

- a. Gross disposable income.
b. Using the parameters of the euro area consumption equation of the Area-Wide Model.

The country breakdown shows exceptionally weak private consumption in Germany. Over the last five years, while German GDP grew by 7%, private consumption rose by only 0.8%, which was even less than the meagre 1.5% increase in GDI. Last year, despite the notable acceleration in persons employed, with an increase of more than 600,000, consumption spending was even lower (1.5%) than in 2006, with virtually zero income growth in real terms.⁵ This behaviour by German household consumption increased the divergence between its high levels of saving and the average euro area levels.

Although the weakness of German consumption is largely attributable to the lack of momentum in its main determinant (disposable income), other factors have also played a part. In 2007, the VAT increase was a significant damper on spending, although its effect is difficult to quantify precisely. In addition, the lower consumption by German households in recent years seems to be related to higher saving for precautionary motives, against a background of labour market transformation and greater uncertainty over future income. Indeed, the prolonged process of adjustment of the German economy to restore competitiveness has entailed very moderate real wage growth up until 2007. Also, employment fell during the period 2002-2005, except for the odd year, when part-time contracts (*minijobs*) predominated. In late 2005 a change of trend began to be seen which has continued up to the present, characterised by a sustained recovery in full-time employment, that should have stimulated consumption in this economy. Finally, other factors may also have helped to reduce spending, such as the stability of wealth owing to house-

price stagnation and the higher saving required to supplement the public social welfare system.

Using the consumption equation of the Area-Wide Model,⁶ it is possible to approximate the contribution of each of the various determinants of consumption growth in the euro area. As seen in Chart 4, between 2004 and 2006, despite the lack of vigour of GDI, consumption would have been driven by a wealth effect and, more recently, by favourable labour market developments, which would have begun to restore consumer confidence and income expectations. In 2007, the contribution from employment and income increased, although the negative impact arising from the rise in euro area interest rates, already visible in 2006, also grew. Since 2004 consumption growth has been below the level indicated by its determinants, 2007 being the year in which the unexplained negative component was at its largest, probably as a result of the impact of the VAT increase in Germany. When the equation is applied to a hypothetical euro area excluding Germany, the negative residual is significantly reduced, by around 40% in 2007, although consumption is still more moderate than its determinants would indicate (see Chart 5). This seems to confirm that the weakness of consumption in the euro area is not only the result of the behaviour of this variable in Germany. It may also be related to the deterioration in consumer confidence in the second half of the year or to the notable increase in inflation which, although expected to be temporary, has reduced household purchasing power. In addition, from a more structural viewpoint, the uncertainty over the sustainability of public pension systems in the face of population ageing may also be giving rise to greater saving for precautionary motives and producing a slowdown in consumption.

2. If Germany is excluded, the increase in consumption in the euro area was 3% in 2007, which is also relatively moderate compared with income growth (of around 2.7%).

3. See Fagan, Henry and Mestre (2001), *An area-wide model (AWM) for the euro area*, ECB Working Paper No. 42.

duration of the financial turbulence. The deterioration in the international environment, financial conditions and agents' confidence will lead to significantly lower growth than in 2007.

1.1 ACTIVITY AND EMPLOYMENT

For the second consecutive year, GDP growth was robust...

In 2007, the GDP growth rate exceeded 2.5% for the second consecutive year, the composition of growth being very similar to that of the previous year (see Table 4.1). Thus, although the highly buoyant international environment favoured exports, domestic demand continued to be the main engine of expansion. In particular, momentum basically stemmed from investment, since household consumption increased by barely 1.5%, below the growth of household real disposable income, which accelerated, largely as a result of the favourable employment developments. This discrepancy, which resulted in a rise in the household savings ratio, may be attributed to various factors, such as the effect of the rise in VAT in Germany at the beginning of 2007 on consumption in that country, the rise in interest rates, the deterioration in consumer confidence in the second half of the year and the rise in perceived inflation, which are analysed in detail in Box 4.1.

driven by the strength of investment, while private consumption remained weak.

Gross fixed capital formation grew vigorously in 2007, although less so than in the previous year. By agent, private productive investment grew in 2007 at a similar rate to the previous year, driven by the sustained (albeit somewhat lower) growth in final demand, and

	2004	2005	2006	2007			
				Q1	Q2	Q3	Q4
DEMAND AND OUTPUT							
Gross domestic product	1.7	2.9	2.6	0.7	0.3	0.7	0.4
<i>Private consumption</i>	1.6	1.8	1.5	0.1	0.6	0.5	-0.1
<i>Government consumption</i>	1.4	2.0	2.2	1.0	0.2	0.6	-0.1
<i>Gross fixed capital formation</i>	3.1	5.3	4.2	1.3	0.0	1.1	0.8
— Non-residential private investment	2.8	5.4	5.4	1.1	0.9	1.2	0.9
— Residential investment	3.0	6.0	1.9	1.5	-1.6	0.0	-0.3
— Public investment	2.8	2.4	5.0	4.9	-1.3	-0.1	0.9
<i>Exports</i>	4.9	8.1	6.0	0.8	0.9	2.0	0.6
<i>Final demand</i>	2.8	4.3	3.4	0.9	0.3	1.2	0.2
<i>Imports</i>	5.7	7.8	5.2	1.3	0.3	2.5	-0.3
Contributions to GDP growth (b)							
<i>Domestic demand</i>	1.9	2.6	2.2	0.5	0.4	0.7	0.1
<i>Change in stocks</i>	0.0	0.1	0.0	0.4	-0.3	0.2	-0.1
<i>External demand</i>	-0.3	0.2	0.4	-0.2	0.3	-0.2	0.4
PRICES AND COSTS (c)							
Consumer prices (annual average)	2.2	2.2	2.1	1.9	1.9	1.9	2.9
Final demand deflator	2.3	2.3	1.8	1.6	1.7	1.6	2.3
GDP deflator	1.9	1.9	2.2	2.1	2.2	2.1	2.2
Unit labour costs	1.0	0.9	1.5	1.0	1.4	1.4	2.0
Compensation per employee	1.8	2.2	2.3	2.4	2.2	2.2	2.5
Labour productivity	0.8	1.3	0.8	1.4	0.8	0.8	0.5
GENERAL GOVERNMENT (d)							
Total expenditure	47.4	46.8	46.3				
<i>Current expenditure</i>	43.6	43.0	42.5				
— Interest payments	2.9	2.9	3.0				
<i>Public investment</i>	2.5	2.5	2.6				
Total receipts	44.9	45.4	45.6				
Primary deficit (-) / surplus(+)	0.4	1.6	2.3				
Deficit (-) / surplus (+)	-2.5	-1.3	-0.6				
LABOUR MARKET							
Total employment	0.9	1.6	1.8	0.6	0.5	0.4	0.2
Unemployment (e)	8.8	8.2	7.4	7.6	7.5	7.4	7.2
BALANCE OF PAYMENTS (d)							
Current account	0.2	0.0	0.3	0.2	-0.1	0.6	0.5

SOURCES: ECB, European Commission and OECD Economic Outlook.

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

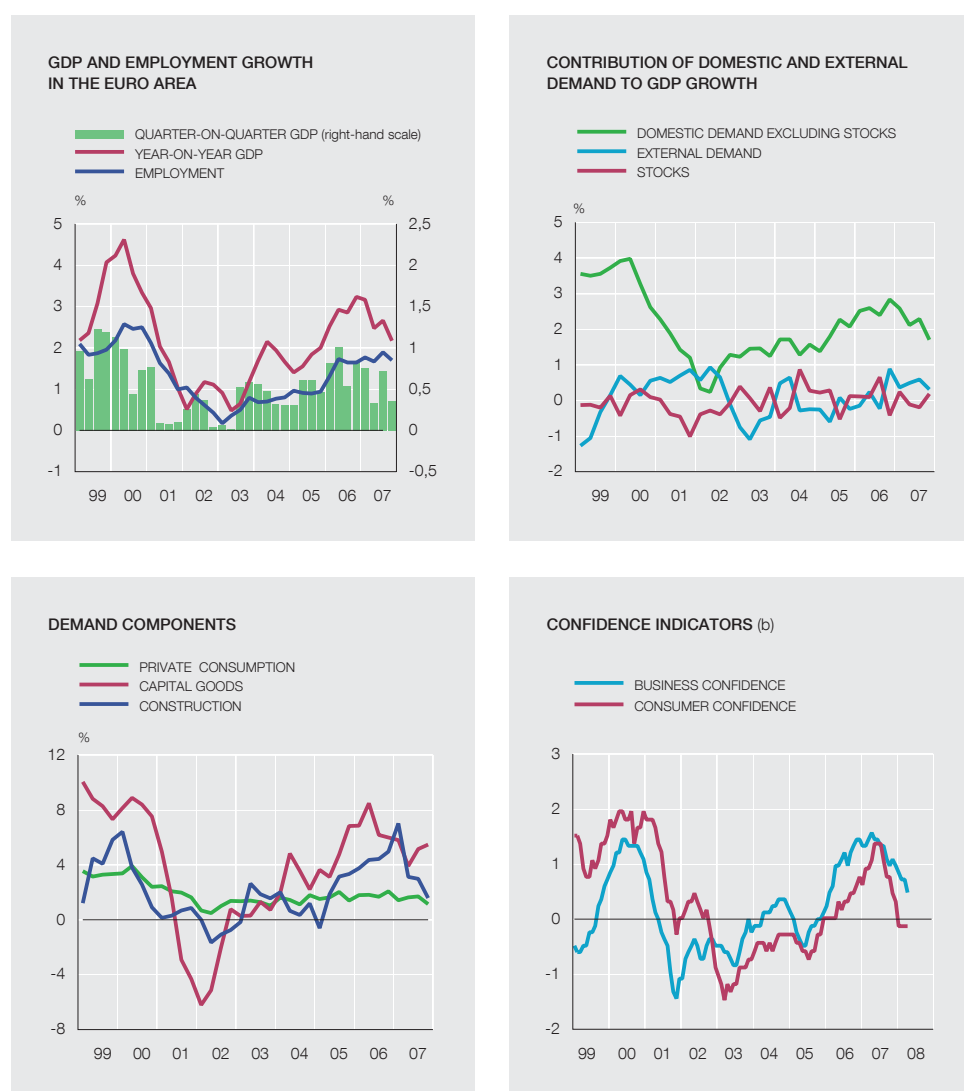
b. Percentage points of the percentage change in GDP.

c. Year-on-year rates.

d. As a percentage of GDP.

e. As a percentage of the labour force.

by the solid financial position of non-financial corporations and the favourable developments in their present and expected earnings (see Chart 4.1). These factors offset the effects of the progressive tightening of financing conditions linked to the increase in interest rates and, in the second half of the year, in corporate bond spreads, as a result of the instability on financial markets. This increase in the cost of financing also affected residential investment, which decelerated sharply during the year, influenced by the end of the upswing in some countries, discernible in property price moderation and the decline in the demand for credit for house purchase. Finally, there was a significant increase in public investment.



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

a. Annual percentage changes, unless otherwise specified.

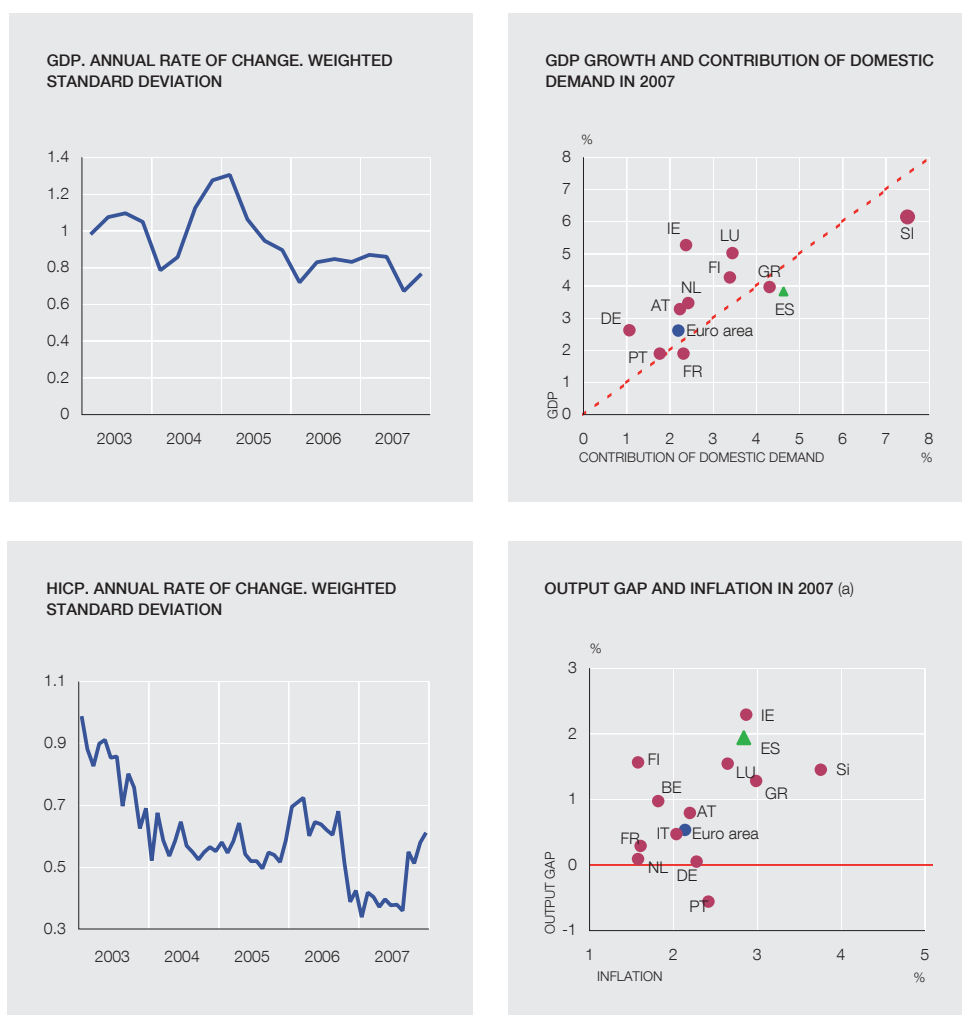
b. Balance statistic. Normalised series.

Net external demand also contributed positively to growth.

The reduced buoyancy of world trade and the gradual appreciation during the year of the real euro exchange rate affected exports, which grew at a lower rate than in the previous year, while the euro area's export share declined further. However, the rate of expansion of imports contracted to a greater extent than that of exports, in line with the behaviour of final demand, so that the net external balance made a positive contribution to GDP, which was larger than a year earlier.

Activity grew at above potential in most countries in the area, the favourable developments in Germany and Spain being especially notable.

In 2007, most of the euro area member countries recorded GDP growth rates of over 2%. The most significant contribution, among the larger countries, arose from the favourable performance of economic activity in Spain, given its high growth rate, of close to 4%, and in Germany, where it increased at above potential for the second consecutive year, according to the available estimates. The French and Italian economies, by contrast, remained weak. As for the composition of this growth, domestic demand drove the expansion in the main economies of the area, except in Germany, where the contribution of net



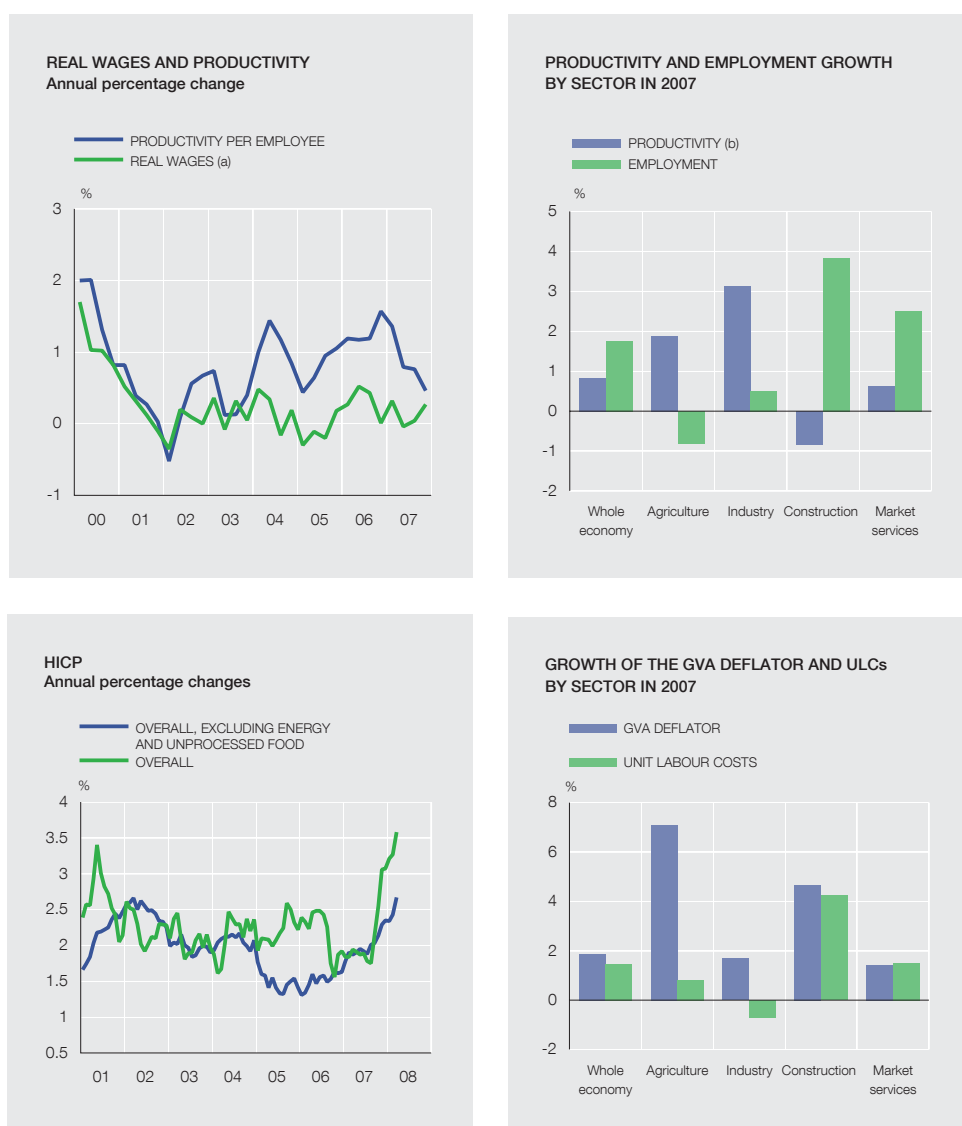
SOURCES: European Commission, Eurostat and Banco de España.

a. The output gap is defined as the difference between actual and potential GDP, as a percentage of potential GDP. European Commission estimates.

external demand was decisive. Finally, the acceleration of GDP in Portugal, following its slackness in recent years, along with the slowdown in some of the more buoyant economies, such as Ireland and Finland, led to a certain reduction in the dispersion of growth rates (see Chart 4.2).

Brisk employment creation and slowing productivity.

Despite the slowdown in activity, the euro area labour market was very dynamic in 2007 and the average rate of employment creation rose to 1.8%, its highest value since 2000. This improvement extended to the main productive sectors (see Chart 4.3). Thus, industrial employment rose for the first time since 2001, albeit modestly, while in market services and, especially, in construction employment accelerated significantly to high growth rates. At the same time, the rate of unemployment continued to decline, falling by 0.8 pp from its average level in 2006, to 7.4%, the lowest level for more than two decades. This relatively employment intensive growth pattern led to a notable decline in the growth of apparent labour productivity in 2007, to 0.8%. The simultaneous achievement of low unemployment and moderation of both nominal and real wage costs may also be associated with the introduction of structural reforms in the labour markets of various euro area countries in recent years.



SOURCES: Banco Central Europeo, Eurostat and national statistics.

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

b. Difference between the change in GDP and employment for the whole economy and between the change in GVA and employment for the various sectors.

The outlook for 2008 has deteriorated significantly, with risks tilted to the downside.

1.2 PRICES AND COSTS

In 2007, inflation fell slightly on average, although it displayed a marked upward trend from the summer ...

A high degree of uncertainty persists regarding the magnitude of the effects on real activity in 2008 of the prolonged financial market instability. In addition, the worsening of the international environment (in particular, of the US economy), the tightening of financing conditions and the deterioration in real disposable income as a consequence of the high inflation rates are likely to result in a rather smaller increase in euro area activity than in 2007. Indeed, that is what most international organisations and private analysts are expecting; their current forecasts for GDP growth in 2008 in the euro area, following successive downward revisions, are around 1.5%.

The euro area harmonised index of consumer prices (HICP) grew on average by 2.1% in 2007, 0.1 pp less than in the preceding year. However, there was a notable contrast between the first half of the year, when inflation held steady below the reference rate used in the definition of the price stability objective, and the marked upward trend of the final four-month period, which continued into early 2008 (see Chart 4.3). In the first few months of 2008, the base effects

arising from the falls in the energy component twelve months earlier, the fresh escalation in the oil price and the impact of the notable rise in food commodity prices¹ took the euro area inflation rate to over 3%, for the first time since the start of Monetary Union.

owing largely to the escalation of processed food prices, which pushed up underlying inflation.

As in 2006, underlying inflation (which excludes unprocessed food and energy) displayed a smooth upward trend during 2007, which intensified in the final months of the year (to take the rate to 2.3%, as against 1.6% in December 2006) as a consequence of the strong acceleration in the processed food component (which was growing at year-end at a rate of 5.1%, up 3 pp from a year earlier). By contrast the growth rate of the prices of non-energy industrial goods and services remained relatively stable throughout the year, although the annual average increased, largely due to the impact of the VAT increase in Germany at the beginning of 2007.

Country by country, the average increase in the HICP in 2007 was higher than in the previous year in Germany, Austria, Finland, Ireland and Slovenia, while it was lower in the rest of the countries, most of which started with inflation rates above the euro area average. This led to a decline in the average dispersion of inflation rates within the area, although the notably heterogeneous impact of the food commodity price increases raised it again in the final months of the year (see Chart 4.2).

The slowdown in import prices counteracted the rise in domestic costs...

The annual growth rate of the final demand deflator fell significantly (by 0.5 pp to 1.8%), as a consequence of the decline in the contribution of the external component which was, in turn, a result of the notable slowdown in the import deflator, given the strong appreciation of the euro. By contrast, the growth rate of the domestic component, approximated by the GDP deflator, increased, owing to the acceleration in unit labour costs (ULCs) and the higher growth rate of the gross unit surplus, which was only partially offset by the more moderate behaviour of net indirect taxes.

which reflected higher margins and unit labour costs

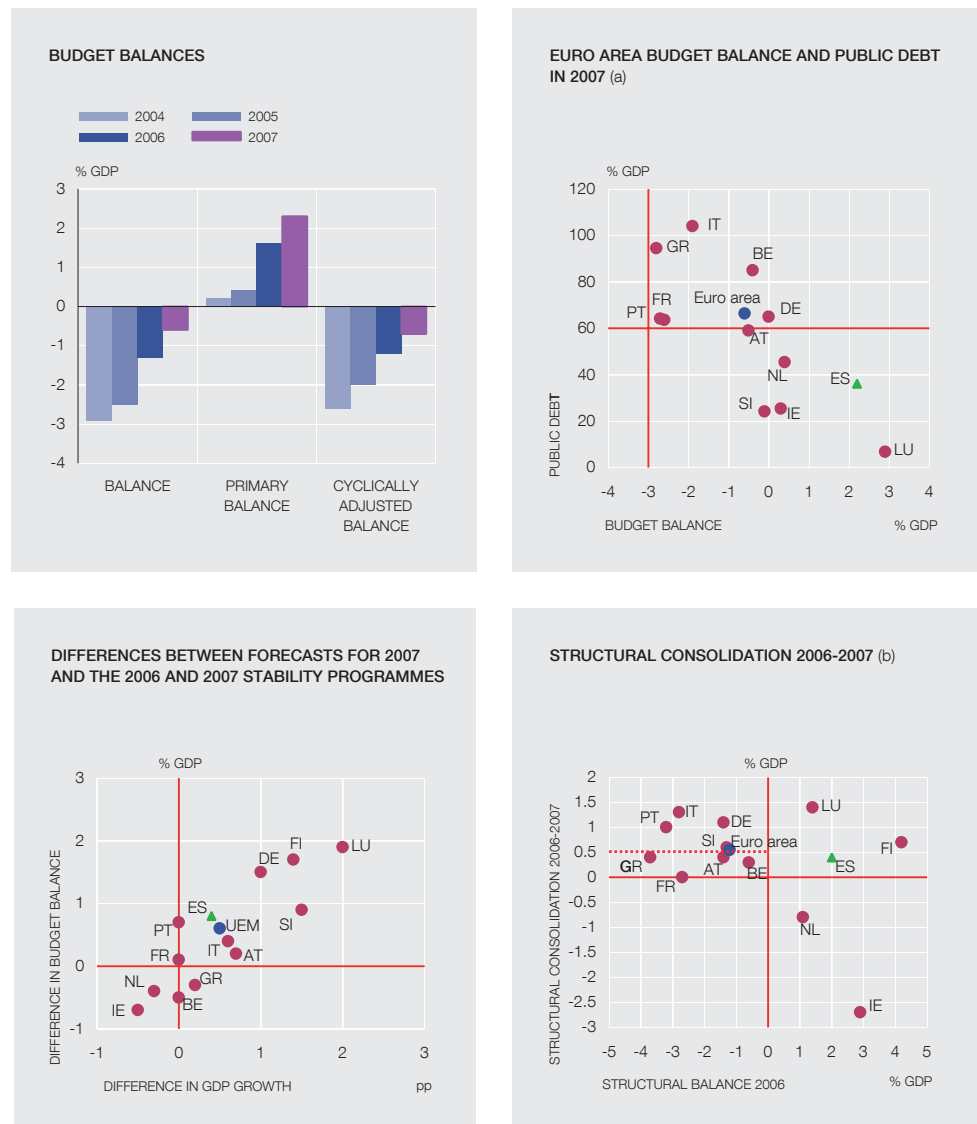
In the euro area as a whole wages once again behaved moderately in 2007. Real wages grew more slowly than labour productivity, giving rise to a further slight reduction in the labour share in total income (see Chart 4.3). Also, the rate of growth of compensation per employee remained stable, so that the significant acceleration in ULCs during the year was primarily a consequence of the progressive decline in the rate of growth of labour productivity. This behaviour was seen in all euro area countries (except in Italy and the Netherlands), although in Spain and Belgium the higher growth of ULCs (at well above the average euro area rate) was basically a result of the notable acceleration in compensation per employee.

Profit margins (approximated by the ratio of the GVA deflator to ULCs) expanded at a similar rate to 2006 (0.7%). In sectoral terms, their strong acceleration in the agricultural sector and, to a lesser extent, in industry was especially notable. In the construction sector the growth rate of margins fell significantly with respect to the previous year.

The inflation outlook is for rates to remain above 3% during most of 2008.

Euro area inflation is likely to remain above 3% for most of 2008 and to fall very gradually only in the final months of this year, as the growth rate of the energy and processed food components moderates. On average, the inflation forecasts of public and private organisations are already above this figure, having been revised successively upwards in recent months. The risks of these forecasts are, moreover, on the upside, mainly due to the possibility of the emergence of second round effects (of past increases in energy and food prices) on wage and price setting, against a background of sustained labour market buoyancy. Also, further rises in the

1. See Box 3.1 of this report.



SOURCE: European Commission.

a. Provisional data.

b. European Commission calculations. The dotted line represents the minimum annual structural consolidation agreed in the Stability and Growth Pact for countries with fiscal imbalances (structural deficit reduction of at least 0.5% of GDP).

prices of oil and agricultural products or unanticipated increases in indirect taxes and administered prices cannot be ruled out. Conversely, the sharp slowdown in the US economy and, in general, the projected slowdown in world economic growth (and euro area growth in particular) may mitigate these inflationary factors.

2 Economic policies

2.1 FISCAL POLICY

The euro area budget deficit fell for the fourth consecutive year, due in part to the dynamism of activity...

although the structural balance also improved.

In 2007, the budget deficit of the euro area was again significantly reduced, to 0.6% of GDP, 0.7 pp less than in 2006 (see Chart 4.4). This improvement in the budget balance, for the fourth consecutive year, reflects certain consolidation efforts in the form of spending reductions, but also the notable dynamism of economic activity (0.5 pp higher than the forecasts contained in the stability programmes published at end-2006), which led to higher than expected tax revenues as well as to a significant reduction in current expenditure.

According to European Commission calculations, the cyclical and structural components contributed 0.2 and 0.5 pp, respectively, to the reduction of the deficit in 2007 in the euro area as

a whole. Given the zero net contribution of temporary measures, this involved an improvement in the structural deficit of 0.5 pp, to -0.7% of GDP.

No country exceeded the deficit limit of 3% of GDP...

Most of the countries of the area improved their fiscal position in 2007, although it worsened in Belgium, France, Greece and, especially, Ireland. In particular, the correction was substantial in Italy and Portugal, the two countries subject to excessive deficit procedures (EDPs), reducing the deficit below the limit of 3% of GDP established in the Stability and Growth Pact (SGP). Thus, for the first time since 2000, no country in the euro area exceeded this limit. Also, the EDPs for four countries (France, Germany, Greece and Malta) were abrogated and the Commission is expected to recommend the Council to close those for Italy and Portugal.

but progress in reducing the structural deficit was limited...

In contrast to the success involved in the implementation of the corrective arm of the SGP, the results of its preventive arm were more limited. Of the six euro area member countries that were not in an excessive deficit situation at the beginning of 2007, but which continued to have budget imbalances, only Germany and Slovenia managed to reduce their structural deficit by at least 0.5% of GDP (see Chart 4.4). Moreover, the fiscal position of the Netherlands and Ireland, which started off with a structural surplus in 2006, worsened significantly, contrary to the recommendation to avoid pro-cyclical fiscal policies.

and the new stability programmes do not prefigure greater fiscal consolidation efforts in 2008...

According to the objectives contained in the national stability programmes submitted last autumn, the aggregate budget deficit of the euro area will be 0.9% of GDP in 2008, as a result of a decline in revenues as a percentage of GDP, due to certain tax cuts (principally, corporate income tax in Germany and social security contributions in Germany and France), which is only partially offset by a reduction in spending (0.3 pp of GDP). At the country level, the latest stability programmes of France and Italy project scant correction of their fiscal deficits (which will remain at around 3% in 2008) and a delay in fiscal consolidation efforts until 2009, postponing the achievement of the medium-term budgetary objectives (MTOs) to 2011 in the case of Italy and to 2012 in that of France. Also, the progress in other countries that have still not met their MTOs will, on average, be limited, and in some cases the fiscal position will even deteriorate.

in spite of the commitments acquired last year to reinforce the preventive arm of the SGP.

The insufficiency of the member countries' fiscal consolidation efforts weakens the commitments made in 2007 to strengthen the preventive arm of the Stability and Growth Pact. In particular, on 20 April last year, the economy and finance ministers reaffirmed their adherence to the sound fiscal policy principles of the SGP and their commitment to make full use of periods of economic growth and unexpected tax revenues in pursuit of that objective. Also, the euro area countries undertook to achieve their MTOs by 2010, at the latest. On 9 October 2007, ECOFIN adopted conclusions to improve the effectiveness of the SGP. Notable among these were the priority of ensuring progress towards sustainable fiscal positions and the need for long-term fiscal sustainability to be better taken into account in the MTOs.

The fiscal outlook for 2008 is subject to the uncertainty associated with the financial turbulence and the economic slowdown.

The need to rigorously implement the commitments made in relation to the strengthening of the preventive arm of the SGP is even greater if it is taken into account that the stability programmes published in the autumn did not fully incorporate the latest deterioration in the euro area's economic prospects. The fiscal outlook is particularly uncertain, on account of expectations of weaker growth and the existence of large downside risks, whose impact on public revenues and spending is hard to anticipate.

The achievement of long-term fiscal sustainability requires further fiscal consolidation, greater spending efficiency and structural reforms.

Moreover, sound public finances are essential to ensure their long-term sustainability given the challenges stemming from population ageing. Thus, the need for further fiscal consolidation and structural reforms that promote growth and employment, as well as improvements in efficiency in all areas of public spending is reaffirmed.

2.2 STRUCTURAL POLICIES

The first cycle of the renewed Lisbon strategy has ended and European and national structural reforms are beginning to bear fruit.

In 2007, the first three-year cycle of the renewed Lisbon strategy came to an end. When it was relaunched in 2005, sustainable economic growth and employment were adopted as priorities and a clearer division was established between Community and national responsibilities. Overall, the structural policies pursued in this period gave rise to a more intensive use of labour and contributed to an improvement in the economic outlook. In that regard, the European Commission has made a positive global assessment of the implementation of the National Reform Programmes (NRPs) for the period 2005-2008, in particular as regards the commitment of national governments to the objectives of the renewed Lisbon strategy. However, the achievements more at different speeds in the four major areas of action: boosting labour market participation, increasing competition (particularly in services), promoting entrepreneurial initiative and investing in knowledge and innovation.

Employment progress confirmed, partly attributable to structural reforms.

As regards the labour market, in 2007 there was again robust employment growth (more than 2.3 million jobs) and the rate of employment stood at 66%, approaching the Lisbon objective of 70% in 2010.

Part of these achievements is attributable to the structural reforms undertaken in recent years, which have aimed to modify tax and social security systems and, to a lesser extent, social benefits. For example, as far as tax policies are concerned, the countries have attempted to reduce the tax wedge (the difference between the gross wage cost borne by the employer and the net income received by the worker), with reductions in tax rates in Italy, Spain and the Netherlands and deductions in the tax payable on the lowest brackets of income in France and Ireland. In addition, social security contributions have been reduced in a large number of countries.

With regard to the priority social groups for employment promotion, the female employment rate has improved, to 58%, close to the 60% target. In the case of older workers, despite the pension and early retirement system reforms in certain countries, the employment rate stands at 44%, still a long way from the objective of 50% for 2010. Finally, the youth employment rate is still low, standing at around 38%.

Common principles agreed regarding the *flexicurity* model in labour markets.

Flexicurity (a strategy to improve both flexibility and security in labour markets)² has developed into a fundamental challenge to achieve more open labour markets with a greater capacity to adapt. Following the recommendation of the European Council, in 2007 the European Commission established the common principles that shall be a reference for the preparation of national NRPs, taking into account that the labour conditions and institutional framework of each country make some adaptation in the application of these principles necessary. More specifically, the measures should promote: more flexible contractual agreements; career-long continuous training strategies; active employment policies conducive to worker adaptability; and, finally, modern social security systems that encourage employment and worker mobility without prejudice to social protection.

Until now, the euro area countries have made uneven progress in these four fields. Austria, Finland, Ireland and the Netherlands, in particular, have made progress towards an integrated *flexicurity* approach. As regards contractual agreements, measures have been approved to promote greater flexibility in working hours and wage bargaining decentralisation, albeit modest and in few countries. With respect to active policies, countries such as Austria and Belgium have boosted training for the unemployed, job-search assistance programs and incentives to

2. See "Flexicurity as a model for European labour markets", *Economic Bulletin*, January 2008.

hire the long-term unemployed. Finally, improvements have been made to social security systems, although they have been timid and concentrated in pension systems (for example in Germany and Belgium).

Low cross-border worker mobility prompted Community initiatives.

The lack of progress on cross-border worker mobility led to the launch of two initiatives at the Community level in late 2007: first, the *European Job Mobility Action Plan*, with specific measures to increase the number of citizens working outside their Member States (currently around 2%); and second, the *European Qualifications Framework*, to which national qualifications systems should be related by 2010, which seeks to adapt education and training plans to labour market necessities.

Competition improvements will require greater efforts in the services sector.

A second element necessary to achieve a higher growth potential is the promotion of competition, to improve productive efficiency, put downward pressure on prices and generate incentives to invest and innovate. For this purpose, extending and deepening the European internal market continues to be a priority, particularly in the services sector, which accounts for around 70% of the economy's employment and value added. Following the definitive boost entailed by adoption of the Services Directive in 2006, to be applied by all Member States by December 2009, the countries have already made some progress, although there is still a long way to go.

The drive to open up network industries and services is still limited and the European Commission is giving fresh momentum to European energy policy.

The opening up of network industries and services to competition has been slow and there are still significant barriers to entry in this market. With regard to network services, certain significant measures have been taken in the railway and energy industries in the Netherlands and in telecommunications in Greece, Finland and Slovenia. At the community level, in September 2007 fresh momentum was given to European energy policy with the adoption by the European Commission of a package of measures designed to ensure energy supply, strengthen competition and promote environmental sustainability and combat climate change. The legislative proposals include the separation of energy transmission and generation activities in order to strengthen competition.

Certain rather unambitious reforms are being implemented in the retail and professional services sectors.

Certain measures have been taken in the retail sector, although there are notable differences between countries, particularly in the regulation of opening hours. However, competition in professional services is still insufficient.

Progress in financial market integration is more significant, including notably the creation of the SEPA.

Finally, in the financial area there has been obvious progress, although the Commission, in the context of assessment of NRPs, has recommended additional efforts to promote full financial market integration and competition in retail financial services.

The *Payment Services Directive* was adopted in April 2007. Its main objective is to ensure that payments in the EU through transfers, direct debits and credit cards) are made with the same ease, efficiency and safety as domestic ones, establishing the legal framework necessary for the creation of the *Single Euro Payments Area* (SEPA). At the same time, the application of the *Financial Services Action Plan* (FSAP) by the Member States has almost been completed. The *Markets in Financial Instruments Directive* (MiFID) came into force in November 2007 and the *Transparency Directive* has still to be transposed in some countries.

The financial turbulence has highlighted certain weaknesses in market functioning, which have given rise to initiatives such as the roadmap proposed by the ECOFIN Council.

The period of financial instability has revealed certain weaknesses in the functioning of financial markets. It is important to address these in order to re-establish confidence and promote the smooth functioning of financial markets. In this respect, the October ECOFIN Council established a roadmap identifying the following priorities: enhancing transparency; improving valuation criteria for illiquid instruments; strengthening the prudential framework for supervision; and improving the unorganised debt markets and the role of credit rating agencies.

To encourage entrepreneurship, some steps have been taken, albeit timid ones.

The third element to stimulate growth relates to the promotion of entrepreneurship, which has a fundamental impact on productivity and innovation, particularly in high-technology industries. In a large number of euro area countries it is already possible to register a business within a week, through arrangements such as one-stop shops, and significant steps have been taken to improve regulations. In addition, the cost of setting up a business has been considerably reduced in the EU-15, standing at €485 on average, as against €813 in 2002. However, there is still room to reduce administrative charges, especially for SMEs.

Promotion of innovation will also require a substantial increase in national resources...

Product and labour market reforms require policies that help to disseminate technological change and innovation. In this respect, R&D expenditure in the euro area is unsatisfactory (1.9% of GDP in 2006). There are significant cross-country differences, but these are difficult to assess owing to the divergences in industrial specialisation. Only Finland exceeds the objective of 3.3% of GDP, while Germany, France and Austria spend more than 2%.

This is also the background to the need to improve the quality of public finances with a shift of spending towards productive investment, while surveillance mechanisms are improved to ensure the efficiency of R&D expenditure. Also, in order to make this investment more effective, it is necessary to improve the education and training of the labour force.

although some significant initiatives were taken at the European level in 2007.

In the European Union, the *Seventh Framework Programme for Research and Technological Development* promotes pro-innovation policies and is the basic instrument for financing these activities in the period 2007-2013, including incentives for the participation of SMEs. In this respect, the *Risk Sharing Financing Facility* (RSFF) will promote research and innovation in Europe. At the same time, a network was set up in 2007, which will be operative in 2008, to facilitate SMEs' access to the benefits of the single market.

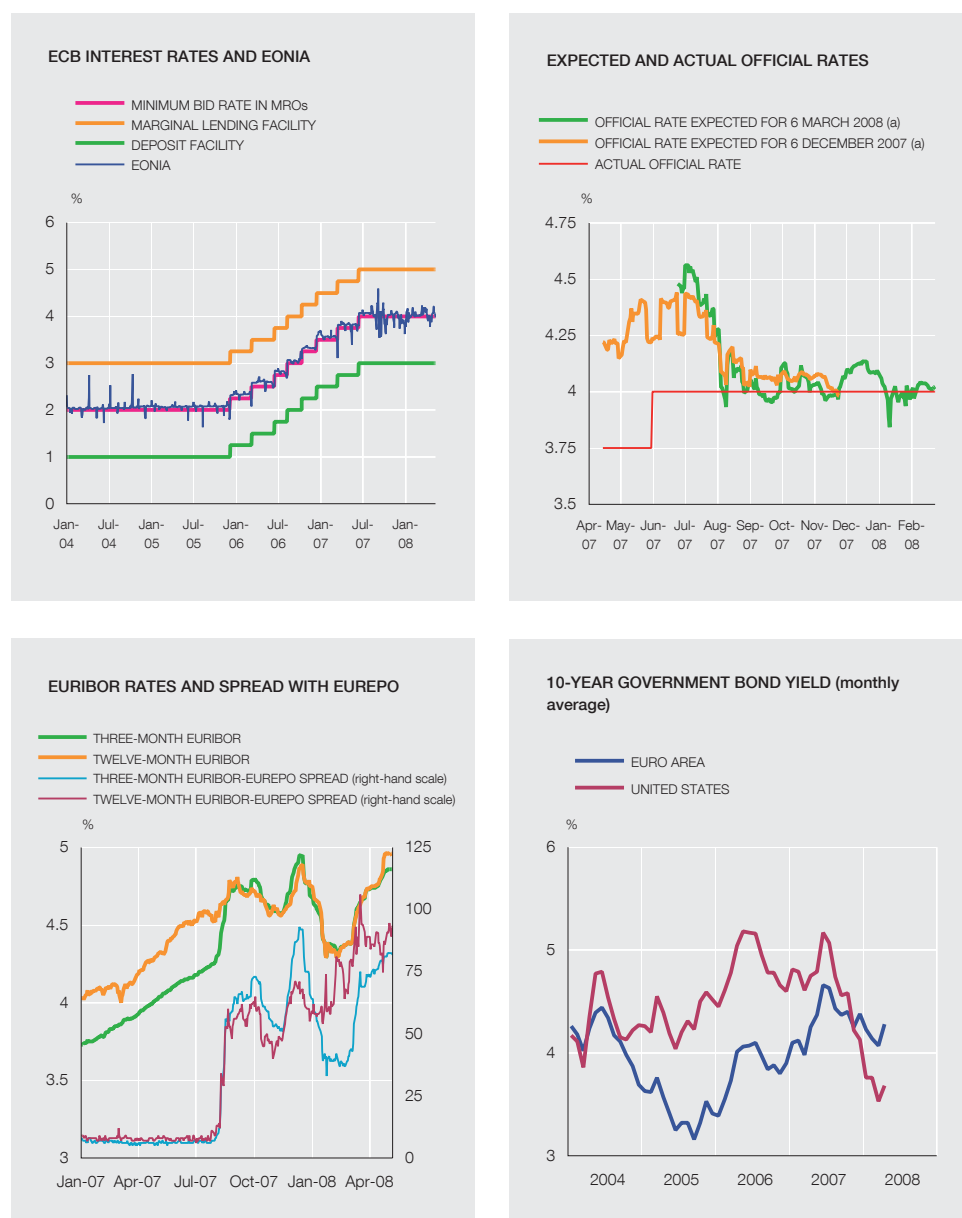
Some tough targets were agreed in the fight against climate change.

Finally, many countries have failed to make progress in meeting the Kyoto targets and will have to make considerable efforts to achieve the ambitious targets agreed at the Spring 2007 European Council. In relation to these commitments, on greenhouse gas emissions, renewable energy and energy efficiency, the Commission presented a European Strategic Energy Technology Plan in November.

In short, national and European structural policies are on the right track, although there is still a long way to go.

Accordingly, the structural reforms undertaken in the euro area have contributed to the achievement of significant progress in areas such as market regulation, wage taxation reform and, more timidly, policies to boost innovation. However, not all countries have undertaken reform with the same resolution. In particular, hardly any measures have been introduced in relation to the opening up of markets and the fight against labour market segmentation.

The second cycle of the renewed Lisbon strategy, spanning the three year period 2008-2010, already has Integrated Growth and Employment Guidelines, approved at the March 2008 European Council, and a Lisbon Community Programme, setting out the new EU-level initiatives. Achievements in this new stage will be important to minimise the impact of international financial instability and rising prices, in an environment that is less favourable due to the global economic slowdown, which should not be to the detriment of structural reforms. Securing more flexible and efficient labour and product markets is a fundamental requirement for the smooth functioning of the Monetary Union and, in the current context, to respond to the challenges and opportunities arising from economic globalisation, technological change and population ageing.



SOURCE: ECB.

a. Based on EONIA futures quoted for that date, deducting a premium.

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

3.1 MONETARY POLICY DECISIONS

In the first half of the year, the ECB continued to tighten monetary conditions.

During the first half of 2007 the process of adjusting monetary conditions that had commenced in late 2005 continued, against a background characterised by the strength of the euro area economy and the emergence of inflationary pressures. The ECB's Governing Council raised official interest rates by 25 bp at its March and June meetings, so that the minimum bid rate on main refinancing operations stood at 4% in the middle of the year (see Chart 4.5)

Financial strains halted the rise in official rates and created an environment of extraordinary economic uncertainty.

The growth outlook in the euro area eventually moderated, although the position remained sound, while upward risks to price stability continued to be identified.

Since June, the ECB has left official interest rates unchanged at 4%.

3.2 FINANCIAL DEVELOPMENTS IN THE EURO AREA

Financial strains in the summer cut short the favourable capital market performance.

The money markets were particularly affected, with a loss of liquidity and a sudden rise in risk premia that forced the ECB to intervene.

Public debt acted as a safe haven, and the financing conditions for the private sector became more restrictive.

The outbreak of financial strains in the summer led to a period of extraordinary economic uncertainty arising from the difficulty of determining the scope and seriousness of the episode, as well as its effects on the European economy. The money market, a key element in the implementation and transmission of monetary policy, was particularly affected in the unsecured segment, where there was a sudden loss of liquidity and an increase in risk premia. In addition, as highlighted in the following section, corporate bond spreads widened and banks tended to tighten their credit standards. This, along with the appreciation of the euro, led to a de facto tightening of euro area monetary conditions, despite the dispelling of expectations of successive interest rate rises. In these circumstances it was very complicated to gauge the correct monetary policy stance.

The European economy started in a sound position to withstand the change in the international situation, but the prolongation of the financial instability, the sudden slowdown in the US economy and the appreciation of the euro eventually led, in late 2007 and early 2008, to a deterioration in the euro area's economic growth outlook.

At the same time, the upward risks to medium-term price stability intensified. However, the rise in inflation which, given its characteristics, was expected to be temporary, did not seem to have unleashed second round effects on wages and prices, and long-term inflation expectations remained anchored at levels compatible with the price stability objective.

Against this background, the ECB's Governing Council did not change interest rates in the second half of 2007 or at the first few meetings of 2008. In conditions of heightened uncertainty and upward risks to price stability, the Council reiterated its firm intention to act to prevent the materialisation of these medium-term risks and insisted on the importance of keeping inflation expectations sufficiently anchored. Holding official interest rates unchanged in the new conditions of financial tension, will contribute to the achievement of these objectives.

In the first half of the year, the euro area financial markets were characterised by a climate of optimism, which was interrupted in the summer by the problems in the US mortgage market and their rapid transmission to the capital markets. As in other international markets, the price of financial assets in the euro area began to reflect the sudden reappraisal of risk and certain segments suffered an abrupt loss of liquidity. Apart from unsecured interbank deposits, the instruments most affected by this process were private fixed-income securities in general, and issues of financial firms and of lower credit quality in particular. There was a temporary improvement in the episode of instability in September and at the beginning of October, but the situation worsened towards the end of the year and has, with varying intensity, persisted in 2008, spreading to other markets and financial instruments.

In the first half of 2007 interbank market yields displayed an upward trend at all maturities, reflecting the more restrictive monetary policy stance and the outlook of further rises in official interest rates. The financial turbulence dispelled these expectations, while also causing volatility and yields on the unsecured interbank deposit market to surge. The spread between the rates of unsecured deposits (EURIBOR) and secured ones (EUREPO) became very wide, reaching 90 bp in the case of three-month transactions (see Chart 4.5). The ECB had to intervene to stabilise the shortest rates, although in the case of the longer maturities instability has persisted in 2008 (see Box 4.2).

In the public debt markets, the favourable economic outlook prompted a slight rise in yields in the first half of the year, from low levels (4.1% in the case of the 10-year bond). Subsequently, the outbreaks of financial instability caused volatility to increase and boosted the demand for public debt as a safe haven. As the year elapsed, the reduction in yields also began to reflect

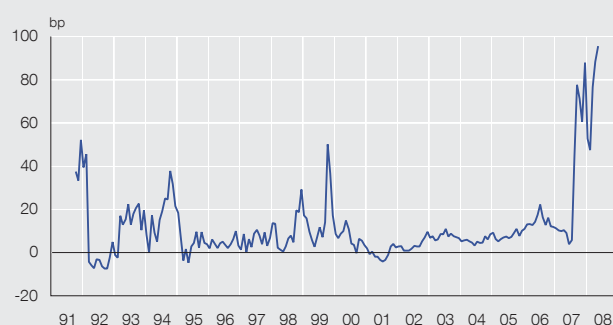
The operational framework for the monetary policy of the ECB is designed to permit control of very short-term interest rates at around the main refinancing operations (MROs) minimum bid rate.¹ For this purpose, the central bank determines its supply of liquidity according to the banking system's fund requirements, which are basically deter-

mined by the minimum reserves requirements and by the behaviour of the so-called autonomous factors. Hence, the money markets are the first link in the monetary policy transmission chain. Their smooth functioning is, thus, an indispensable requirement for monetary policy impulses to be transmitted along the yield curve (until the interest rates relevant to saving and investment decisions are affected) and, ultimately, for the price stability goal to be achieved.

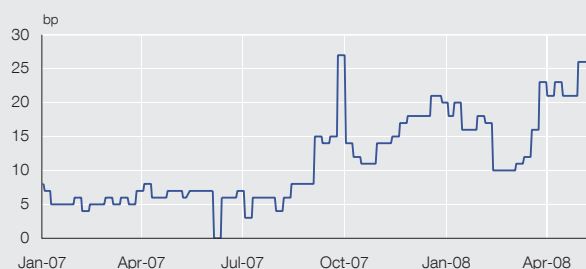
The financial tensions that emerged in summer 2007 had a sudden and evident impact on money market activity in the countries af-

1. The Eurosystem's operational framework defines the instruments and procedures that enable such control to be exercised through management of the banking system's liquidity. For a detailed description, see *The implementation of monetary policy in the euro area*, an ECB document of September 2006.

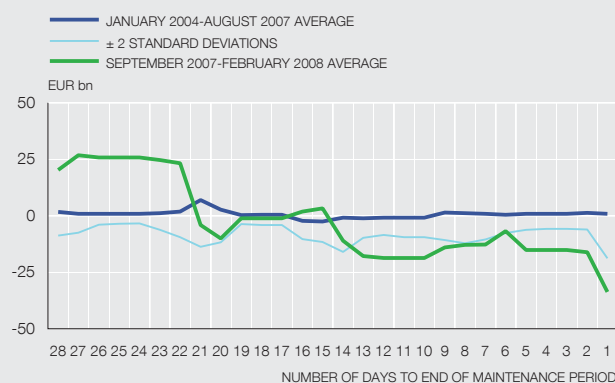
1 SPREAD IN GERMANY: 3-MONTH INTERBANK RATE/3-MONTH TREASURY BILLS



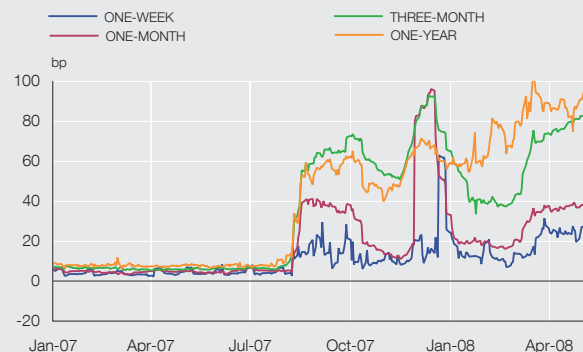
3 MAIN REFINANCING OPERATIONS: MARGINAL RATE/MINIMUM BID RATE SPREAD



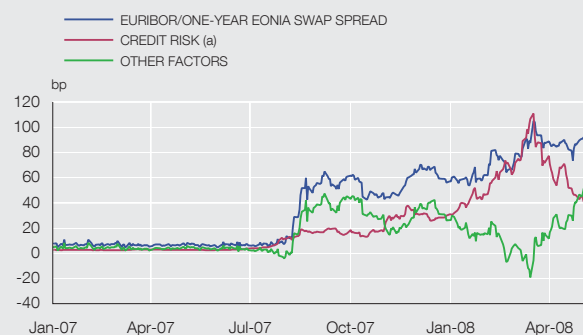
5 EXCESS RESERVES WITHIN THE MAINTENANCE PERIOD



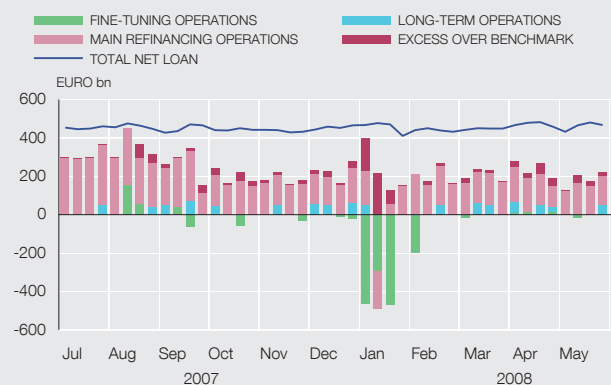
2 EURIBOR/REPO SPREAD



4 BREAKDOWN OF THE 12-MONTH INTERBANK SPREAD



6 OPEN MARKET OPERATIONS: VOLUME ALLOTTED (b)



SOURCES: ECB, Datastream and Bloomberg.

a. Average estimated one-year Credit Default Swap premium drawing on a sample of banks that determine the EURIBOR interest rate.

b. Weekly data. Discretionary fine-tuning operations usually have an overnight maturity. When there is more than one tender during a week, the allotted volumes are accumulated, even in the case of roll-overs that do not affect the net loan.

affected by this episode, including the euro area. Institutions refused to lend each other funds, against a background of mistrust, high demand for liquidity and extraordinary uncertainty over the need for and availability of funds in the future. As a result, the interbank market suffered a notable increase in volatility and risk premia surged to historical highs (see Chart 1). The instability affected the whole spectrum of market maturities, including the shortest terms, although deposits over one month were more strongly impacted (see Chart 2). The greater liquidity needs were also evident in the increase in the marginal rate in the MROs (see Chart 3). This situation was aggravated in December when institutions feared that they would be unable to cover their higher end-year fund requirements and, with certain fluctuations, the tensions have persisted up until the present. It is interesting to note moreover that although the liquidity problems helped to explain the rise in yields, as the turmoil continued the increase in counterparty risk had a significant influence on market developments (see Chart 4).

In this situation, and as is fitting for a central bank that controls very short-term interest rates, the ECB accommodated its supply of funds to the requirements of the banking system, thereby minimising the effects of the turbulence on banks' liquidity management. This policy was accompanied by a communication strategy that transmitted the ECB's readiness to satisfy the demand for reserves, thus eliminating this element of uncertainty and helping to ease prices. Thus, for example, institutions' preference to accumulate reserves relatively early in maintenance periods led the ECB to allot a relatively high volume of funds at these times, fine tuning operations being necessary subsequently to eliminate the excess liquidity, which was apparent in the downward pressure on very short-term interest rates (see Chart 5). The ECB provided funds through both discretionary operations and regular tenders which, in the case of MROs, were characterised by liquidity allotments in excess of what are considered neutral or benchmark amounts (see Chart 6)². Finally,

the ECB also acted in co-ordination with other central banks and entered into an agreement with the Federal Reserve to provide dollar financing through a swap facility. This agreement was extended in March and May 2008 as a consequence of renewed strains in international money markets.

Unlike in other countries, the Eurosystem did not need to modify its operational framework in order to address the situation, showing that its design is adequate at times of stress. The existence of a large number of counterparty institutions and instruments eligible as collateral in open market operations meant that these aspects did not interfere in its management. On the contrary, they contributed to a more effective and wider distribution of liquidity. It is important to stress that comparisons between the magnitude of Eurosystem interventions and of those in other countries may be misleading. The relatively large amounts of the allotments in the euro area is not related to the episode of instability, but to certain institutional characteristics of the European system that mean that, in normal circumstances, liquidity needs are greater than in the United States.

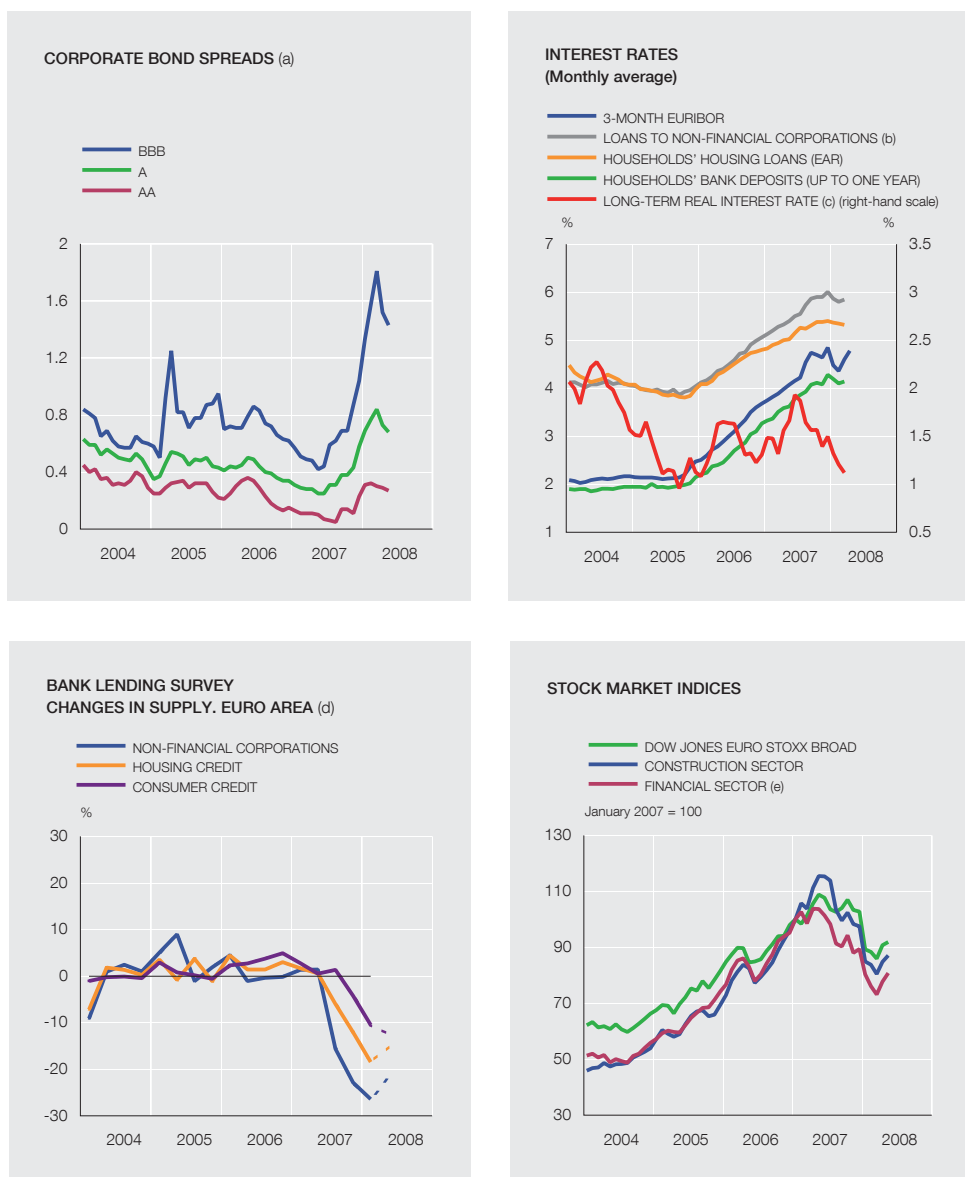
Moreover, the flexibility provided by the operational framework has been a key element in the rapid response to the demand for funds by the banking system and in ensuring that intervention has not had an undesired expansionary effect on monetary conditions in the area, but has rather been conducive to market stabilisation. Thus, the supply of liquidity was combined flexibly with liquidity absorbing operations, so that the total amount lent to the banking sector did not change in terms of volume, although its time profile and maturity did. As mentioned above, banks tended to accumulate reserves relatively early in maintenance periods and showed greater interest in longer-term operations in order to reduce future liquidity needs. The flexibility of the operational framework was also demonstrated when the maturity of the MRO of 19 December was lengthened to two weeks so that it extended into the New Year.

The announcements and implementation of these actions succeeded in reducing upward pressures on the interest rates on unsecured interbank deposits, especially at the shortest maturities. However, there is still a high credit risk premium on the interbank market, particularly at the longest maturities, which is associated with the prolongation of the financial turbulence and the lack of confidence. A reduction in this premium can only occur with a recovery of confidence among institutions.

2. For example, between 9 and 14 August the ECB carried out successive overnight fine tuning operations, allotting almost €95 billion on the first day and €8 billion on the last. On 23 August and 12 September it carried out two extraordinary longer-term refinancing operations, providing €40 billion and €75 billion, respectively, which have been rolled over up until the present. Finally, the MRO of 19 December was preceded by an announcement that all bids equal to or above the weighted average rate of the previous tender, i.e. 4.21%, would be accepted, which involved an allotment of €218 billion.

the worsening of the macroeconomic scenario and the emergence of expectations of a monetary policy loosening, especially in the United States. The yield curve flattened and the ten-year rate stood at 4.4% at end-2007, while the US-euro area yield spread turned negative. The search for credit quality and liquidity also caused public debt spreads to widen within the euro area.

The rise in risk premia made financing conditions in the private debt markets became more restrictive (see Chart 4.6). At the same time, bank interest rates continued the trend seen in



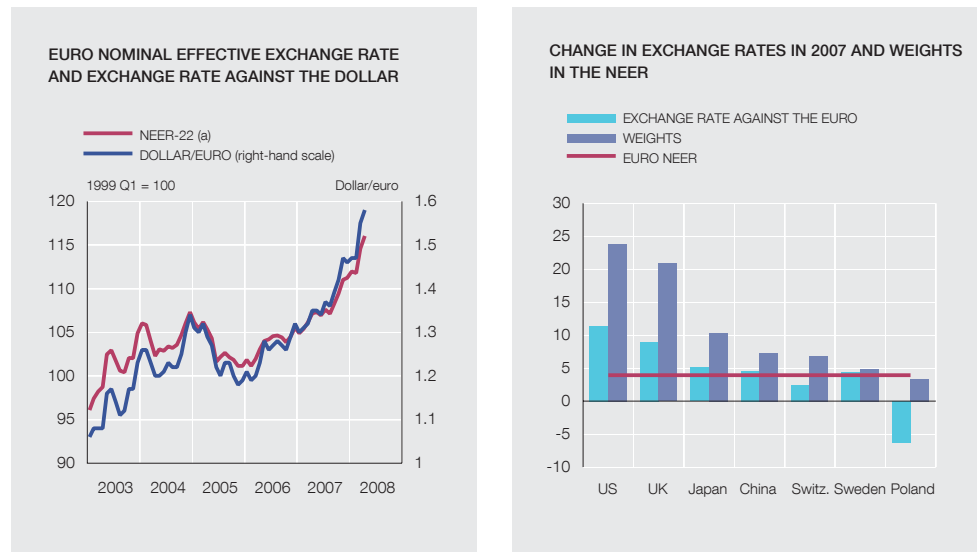
SOURCES: ECB and Banco de España.

- a. Issued by non-financial corporations and denominated in euro. Spread over AAA-rated bonds.
- b. New business; loans of up to €1 million.
- c. Difference between ten-year nominal interest rates and the centred average inflation rate in the last five years.
- d. Indicator = % institutions that report a considerable increase + % institutions that report a certain increase x 0.5 – % institutions that report a certain fall x 0.5 – % institutions that report a considerable fall. A positive (negative) value denotes an increase (decrease) in the supply of loans from institutions with respect to the previous quarter. The dotted lines indicate the forecasts for the following quarter.
- e. Calculated as the average of banks, insurance and financial services.

2006, with gradual increases during the year, reflecting the transmission of a less accommodative monetary policy and also, in the second half of the year, the impact of the turbulence. In addition, as a consequence of the financial strains, banks tended to tighten their credit standards at the end of the year, although (as seen below) this was compatible with relatively large increases in financing.

Stock markets were also affected by the strains, albeit differently according to the sector.

In the first half of 2007 a climate of optimism prevailed, with significant increases in stock prices. However, financial strains led to substantial adjustments as early as the summer, especially in construction and financial services, amid high levels of volatility. That said, the most



SOURCES: ECB AND European Commission.

The NEER-22 is the nominal effective exchange rate of the euro against 22 countries: non-euro area EU-27 countries (in 2008) plus United States, Canada, Australia, Norway, Switzerland, Japan, China, Hong Kong, South Korea and Singapore.

significant correction occurred at the beginning of 2008, as the outlook of economic agents was affected by the financial instability. In 2007 as a whole, the EURO STOXX broad index rose by around 5%, although the sector indices for financial services and construction fell by more than 6% and 3%, respectively.

The euro appreciated significantly.

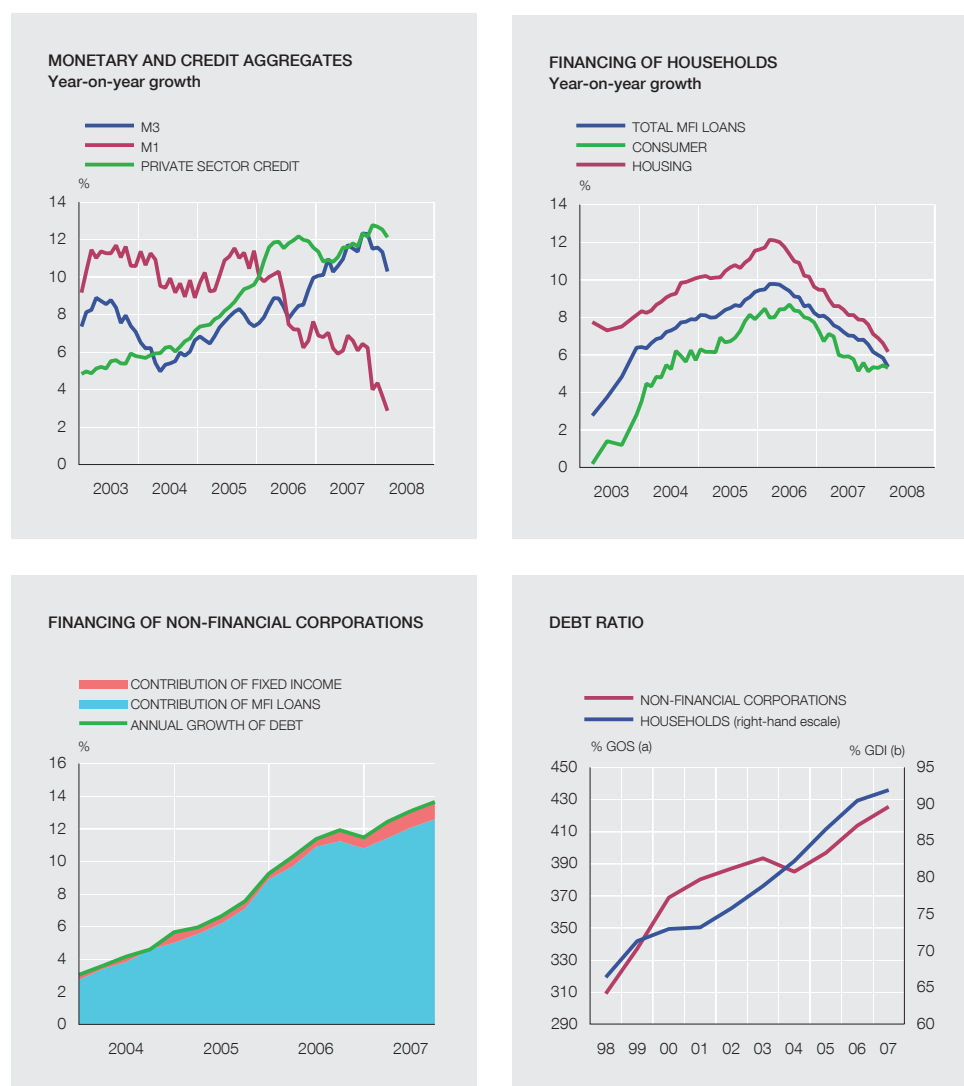
The upward path of the euro exchange rate that began in late 2005 continued, helping to tighten monetary conditions in the area (see Chart 4.7). The rise in the euro intensified with the financial strains as the slowdown in the US economy was confirmed and the interest rate outlook revised. During the year as a whole, the euro appreciated by approximately 5%, in nominal effective terms, showing particular strength against the dollar and the pound sterling, with rises of around 11% and 9%, respectively.

Monetary aggregates were highly buoyant.

The monetary aggregates were again highly buoyant in 2007, although the most liquid assets slowed in line with the rise in interest rates (see Chart 4.8). By contrast, the flatness in the yield curve and, in the second half of the year, the climate of uncertainty helped to explain the large flows of investment into time deposits and short-term securities. At the same time, the turbulence complicated the analysis of the changes in M3, since some components were directly affected. For example, redemptions were generated in money market funds with (actual or supposed) links to structured products, which are at the epicentre of the tensions. In addition, MFIs resorted to a greater extent to short-term securities, partly on account of the greater difficulty of placing long term issues.

Lending to households slowed, while loans to corporations displayed considerable vigour, which contrasted in Q4 with the tightening of bank credit conditions.

Lending to the private sector was highly vigorous in 2007, although the growth path differed according to the type of loan. The growth rate of loans to households slowed gradually, both in the case of loans for house purchase and consumer loans, in step with the rise in interest rates and the slowdown in the property market in some countries. In any event, the sector's indebtedness increased.



SOURCES: ECB and Banco de España.

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

Lending to non-financial corporations, in contrast, was highly dynamic in 2007, even in Q4 when credit conditions tightened, according to the bank lending survey (BLS). The BLS shows that demand strengthened in all four quarters, albeit less intensively in the second half of the year, in all the euro area countries except Ireland and Spain. Among the determinants, investment in fixed capital and in inventories was notable throughout the year. However, with the financial turmoil mergers and acquisitions ceased to sustain the demand for bank loans, which was instead driven by the greater difficulty of issuing securities. That said, the funds obtained by non-financial corporations through securities in fixed income markets were relatively high, although the trend was one of gradual slowdown. All this contributed to increasing the indebtedness of this sector.

The Spanish economy

As analysed in Chapters 1 and 2, activity in the Spanish economy progressively lost momentum as 2007 unfolded. This was firstly due to the gradual adjustment of real estate investment, following a long boom, and secondly to the adverse effects generated by the bout of financial instability that arose last summer. As a result, after growing at a rate of over 4% in Q1, the economy posted a figure of 3.5% in Q4. In the opening months of 2008, GDP slowed more markedly to a year-on-year growth rate of 2.7% in Q1. That said, in 2007 as a whole output continued to show considerable dynamism, growing at a rate of 3.8%, only 0.1 pp below the previous year's figure. Moreover, this expansion in GDP was compatible with a re-balancing of the sources of growth, with an improvement in the contribution of the external sector and with a slowdown in household expenditure, while corporate investment remained fairly robust. As in previous years, the dynamism of the Spanish economy in 2007 continued to be underpinned by a substantial increase in the population which, in turn, was again a relevant factor for explaining the momentum of both supply and demand. The rate of increase in the labour force remained high, somewhat below 3%, yet the notable increase in employment not only enabled this increase to be absorbed but also allowed unemployment to fall slightly, to 8.3% in annual average terms, the lowest rate for the past two decades, although it rose in Q4 and, more significantly, in 2008 Q1 to 9.6%. The budget surplus stood at 2.2% of GDP, 0.4 pp up on the 2006 figure. Despite the improvement in the external contribution, the Spanish economy's net borrowing continued to increase in 2007, up to 9.5% of GDP. Finally, inflation for the year on average fell to 2.8%, from 3.5% in 2006, although the CPI showed two clearly differentiated phases: up to the summer its rate was below 2.5%, but at year-end and in the opening months of 2008 it was above 4%, as a result above all of dearer food and energy.

1 *Economic policies*

1.1 MONETARY AND FINANCIAL CONDITIONS

Monetary conditions tightened in 2007...

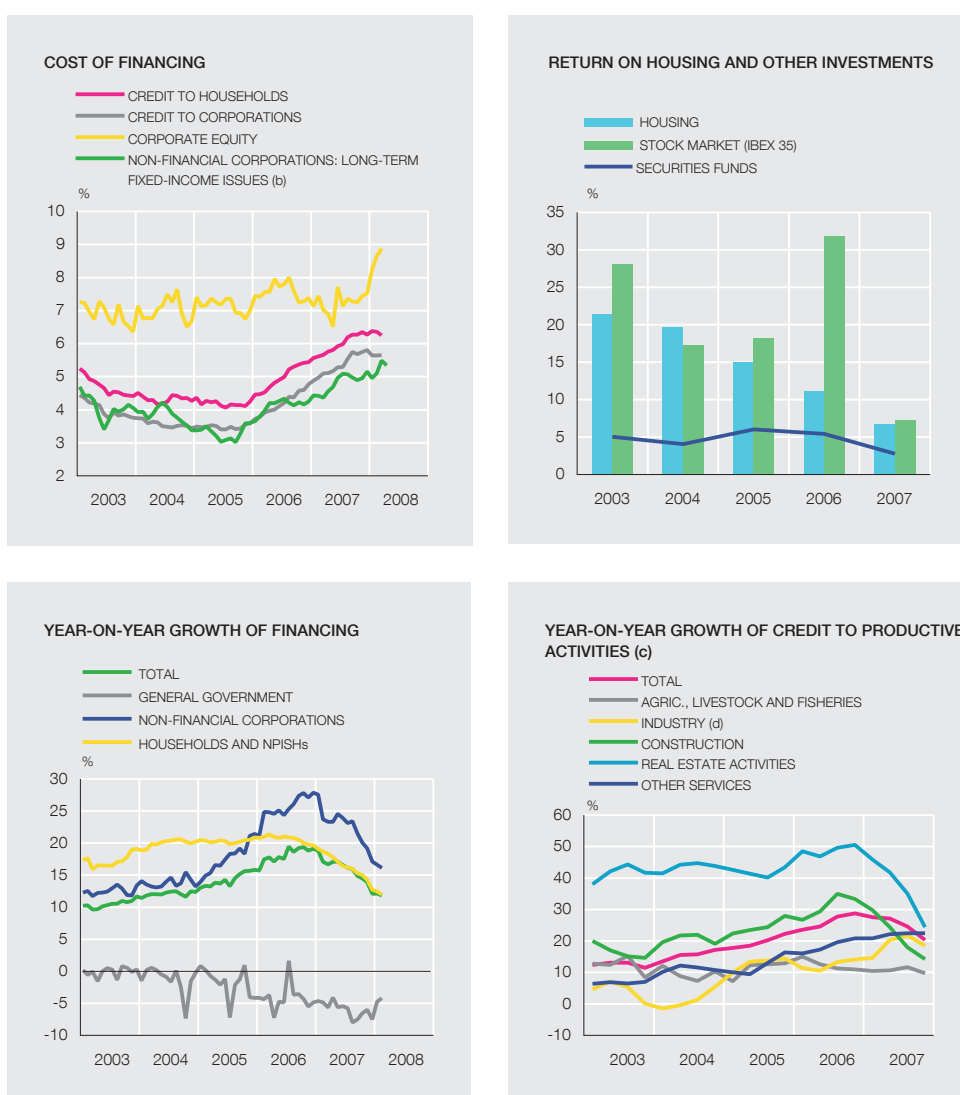
During 2007, household and corporate financing conditions continued to tighten, as a result of the rise in the ECB's official rates in the first half of the year and of the increases in market rates prompted by the episode of financial turbulence as from the summer (see Chart 5.1). In line with developments on interbank markets, lending interest rates rose by around 1 pp during the year. Moreover, banks were somewhat more restrictive when extending new loans, especially in the wake of the turbulence and chiefly as a result of the process of risk re-pricing accompanying it. The cost of corporate issues of medium and long-term bonds also rose, owing to the increase in public debt yields and to the rise in credit risk premiums observed during the second half of the year. Conversely, the cost of corporate own funds stood in December 2007 at a similar level to that a year earlier, although it subsequently rose notably. The tightening of monetary conditions was likewise driven by the appreciation of the euro, which climbed particularly sharply against the dollar.

which, along with the slowdown in net household wealth, contributed to the diminished dynamism of expenditure.

The growth rate of net household wealth continued to ease as a result of the lesser revaluation of financial assets and, especially, of the slowdown in house prices (these showed a year-on-year growth rate of 4.8% in December 2007 compared with 9.1% in the same period in 2006), which contributed to checking the increase in private-sector spending.

The growth of household and corporate debt eased off.

Against this background of tightening financial conditions and slowing household wealth, the gradual deceleration in household borrowed funds, which began in 2006, continued. The year-



SOURCES: Datastream, MSCI Blue Book and Banco de España.

- a. The cost of equity is based on the three-stage Gordon dividend discount model.
 b. The interest rate on long-term fixed income is calculated as the sum of the 5-year euro swap rate and the weighted average of the credit risk insurance premia of Spanish non-financial corporations at that same term.
 c. Securitisation is included in the total series, but not in the different sectors, since there is no information to assign it to the latter.
 d. Excluding construction.

on-year growth rate of liabilities fell in 2007 by more than 6 pp, standing below 13% at year-end, which contributed to tempering the increase in the debt ratio. The pace of financing to companies declined more sharply (by somewhat more than 10 pp), although at the end of the year it continued to display a high level of close to 18% year-on-year. This was essentially the result of the slowdown in loans granted to the construction and real estate services branches, where risk re-pricing by credit institutions was more marked; in other sectors, such as manufacturing and other services, there was even something of a rise in financing extended in 2007 as a whole. In any event, the dynamism of borrowed funds meant that the sector's debt ratio continued to rise, albeit to a lesser extent than in previous years.

1.2 FISCAL POLICY

In the design of fiscal policy for 2007, the main change introduced on the revenue side was the entry into force of the personal and corporate income tax reforms. In the case of personal in-

The fiscal policy measures envisaged for 2007 were essentially expansionary, as a result of the reform of both personal and corporate income tax...

come tax, the deductions for income from employment and the minimum personal and family allowances were increased, and the number of brackets in the schedule was reduced. The reform of corporate income tax involved a reduction of 2.5 pp in the standard rate (to 32.5%) and of 5 pp for SMEs, along with a gradual reduction in certain tax credits. These cuts to potential revenue were offset in part by an increase from 15% to 18% in the tax rate levied on most capital income and gains. The impact of these reforms is expected to be reflected in the 2007 figures already via withholdings and payments on account. As to other taxes, the main amendments included in the 2007 budget were confined to freezing excise tax rates, with the exception of the tax on hydrocarbons, which was raised by 3%. Moreover, the so-called CUNA programme was set in place during the year, which grants €2,500 to families on the occasion of the birth or adoption of children.

and of the budgeted increase in public spending.

On the spending side, the growth rate of the State expenditure ceiling for 2007 rose to 9.6%, if compared with the outturn for 2006, notably above the growth of nominal GDP. The regional government budgets were along the same lines, projecting a 9.4% increase in expenditure compared with the figures set out in the initial budget for 2006. In terms of the distribution by expenditure item, these increases fed through both to current and capital expenditure. Specifically, the State budget maintained the policy priorities in social spending (with additional increases in minimum pensions), infrastructure, education and research.

However, the strong growth in tax revenue provided for a further increase in the surplus.

Despite this expansionary stance, the general government surplus finally amounted to 2.2% of GDP (see Table 5.1), 0.4 pp above the previous year's result. This was the outcome of high tax receipts, whereby the weight of total revenue in GDP increased by 0.6 pp. As envisaged, total general government spending once again outgrew nominal GDP. By sub-sector, the surpluses were centred on central government (1.3% of GDP) and on Social Security (1.2% of GDP). Conversely, territorial government posted small deficits: 0.2% of GDP in the case of the regional (autonomous) governments, and 0.1% of GDP in that of local governments. As a result, the relative size of public debt remained on a declining path, standing at 36.2% of GDP (3.5 pp of GDP less than in 2006), and the Reserve Fund increased further with the Social Security surplus, amounting to €45,716 million (4.4% of GDP) at the close of 2007.

The improvement in revenue was centred on direct tax, despite the tax reforms...

Unlike in previous years, the increase in tax takings was centred exclusively on income and wealth taxes, the weight of which in GDP exceeded that of taxes on production and imports for the first time since 1996. The strength of these taxes was due, firstly, to the increase in the income-from-work tax withholding, since the rise in the number of taxpayers combined with the increase in wage income more than offset the impact of the personal income tax reform. The above-mentioned rise in the tax withholding rate on most capital income and capital gains added, against a backdrop of financial turbulence, to the increase in stock market profit-taking in 2007 further to the gains accumulated in recent years, driving the revenue relating to this item upwards. Likewise, the favourable course of business profits favourably influenced corporate income tax revenue. However, as 2007 unfolded, a mild slowdown in income-from-work takings under personal income tax and of prepayments under corporate income tax could be seen, as a result of the gradual impact of the reform and of the application of the CUNA childbirth programme.

The weight of social security contributions in GDP held steady, reflecting the still-robust growth in the number of affiliations and in wage income, despite the residual impact in 2007 of the reduction in employers' contributions (in connection with unemployment and FOGASA [Wage Guarantee Fund]) introduced in mid-2006.

MAIN GENERAL GOVERNMENT NON-FINANCIAL TRANSACTIONS

TABLE 5.1

% of GDP	2002	2003	2004	2005	2006	2007
1 NON-FINANCIAL RESOURCES	38.7	38.5	38.9	39.9	40.8	41.4
Current resources	38.0	37.8	38.1	39.1	40.2	41.0
— Taxes on products and imports	11.9	12.2	12.4	11.8	11.7	11.6
— Current taxes on income and wealth	10.2	10.9	11.7	12.9	12.9	13.1
— Social contributions	13.0	12.9	13.0	13.0	13.0	13.1
— Other current resources (a)	3.1	3.0	3.2	3.4	3.4	3.5
Capital resources	0.9	0.8	0.6	0.4	0.5	0.4
2 NON-FINANCIAL USES (b)	39.2	38.7	39.3	38.9	39.0	39.2
Current uses (b)	34.1	33.9	34.0	34.0	33.9	34.1
— Final consumption	17.2	17.4	17.8	18.0	18.1	18.4
— Social benefits other than social transf. in kind	11.8	11.7	11.7	11.6	11.5	11.6
— Subsidies	1.1	1.0	1.0	1.0	1.0	1.0
— Interest (b)	2.7	2.3	2.0	1.8	1.6	1.6
— Other transfers	1.4	1.5	1.5	1.5	1.6	1.5
Capital uses	5.1	4.8	5.2	4.9	5.2	5.1
— Gross capital formation	3.5	3.6	3.4	3.6	3.8	3.8
— Other capital uses (c)	1.5	1.3	1.9	1.4	1.4	1.3
3 NET LENDING(+) OR NET BORROWING (b) (3=1-2)	-0.5	-0.2	-0.3	1.0	1.8	2.2
MEMORANDUM ITEM:						
Primary surplus	2.2	2.1	1.7	2.8	3.4	3.8
Gross debt (b)	52.5	48.7	46.2	43.0	39.7	36.2

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.

while indirect tax revenue was impacted by the real estate slowdown.

Conversely, taxes on production and imports slowed markedly, in particular the captions most directly linked to the real estate market. Stamp and registration duties, which had posted growth of over 20% in 2006, slowed drastically, ending the year with a decline of around 10%. The rate of increase of VAT also fell substantially, and its growth stood below 3% at year-end.

As a proportion of GDP, public spending increased, in particular the government consumption and social benefits items...

The weight of public spending in GDP increased by 0.2 pp to 39.2%. This increase was centred on current expenditure, in particular on final consumption and social benefits, in a setting in which the interest rate rises observed appeared to have interrupted the declining trend of interest payments as a proportion of GDP. Hence, in line with the recent past, final consumption grew strongly, and its share in GDP stood at 18.4%, 0.3 pp up on a year earlier, and 1.3 pp of GDP higher than its low in 2001. Social benefits, following their containment in the two previous years, increased slightly as a proportion of GDP (to 11.6%). In this respect, there was a strong rise in pension payments due, above all, to the greater compensation entailed by the sizeable deviation of inflation in November 2007 from the rate envisaged at the start of the year. There was some quickening in unemployment benefits, prompted by the strong increase in the replacement ratio, given that the number of unemployed registered with the SPEE (National Public Employment Service) remained virtually flat. The increase in the replacement ratio, however, has a strongly cyclical component given that, following a prolonged period of robust growth, workers who lose their jobs enter unemployment status with greater benefit entitlements.

while public investment increased more moderately.

Turning to capital expenditure, general government gross capital formation slowed notably in relation to 2006 although, following two years of strong increases, its weight in GDP held at 3.8%, the highest level since 1995. This is consistent with the close relationship with the electoral cycle observed in this item in recent years, whereby strong growth occurs in the two central years of local and regional legislatures, and there are substantial slowdowns in the election year and in the subsequent year, since some time elapses between the completion of investment programmes and the start-up of new projects.

The general government accounts complied with the commitments entered into in the Stability and Growth Pact.

Once again in 2007, the general government sector comfortably complied with the Stability and Growth Pact, meeting the operational criterion that the cyclically adjusted balance should be close to zero or in surplus. Central government complied with the requirements of the budgetary stability law, posting a surplus, irrespective of that recorded by the Social Security. The State observed the spending ceiling set. Territorial government, in contrast, ran a slight deficit, which can only be explained in part by the headroom granted by the reform of the stability law in relation to investment expenditure, whereby the regional governments behind the failure to comply are obliged to present economic and financial re-balancing plans spanning a three-year period.

The temporary nature of some revenue, the deterioration in the regional government balance and the high growth of public spending pose risks to maintaining the public surplus in the future.

Looking ahead, it should be stressed that a portion of government revenue recorded in recent years might have a high temporary component, linked to the real estate and stock market expansion, which entails a high risk for the course of revenue in the coming years, against the background of the adjustment of the residential market. Indeed, this risk has already materialised partly in 2007, as shown by the figures for takings of taxes on production and imports. The deterioration of the regional government balance in 2007 and the high growth of public spending in recent years, in a setting of strong economic growth, give rise to uncertainty over the future trend of tax variables, especially against the backdrop of deceleration. In this respect, although the general government surplus posted in 2007 is a favourable starting point, the foregoing factors of uncertainty advise managing fiscal policy with caution in the coming years.

1.3 OTHER ECONOMIC POLICIES

In 2007 the main objectives laid down in the National Reforms Programme were attained, as a result of the sound performance of employment.

During 2007 the Spanish economy met the two main objectives in the National Reforms Programme (NRP) for the horizon to 2010. These involved achieving convergence in per capita income with the EU-25 and placing the employment rate above 66%. Their attainment once again resided on very favourable developments in employment, while the Spanish economy's labour productivity remained far off the Community average. However, something of a turnaround in the trend of apparent labour productivity has been discernible in the past two years, as a result both of the higher capital/labour ratio and of the increase in the growth rate of total factor productivity.

In the areas of education and technology, the Organic Laws on Education and on Universities were approved, along with the new National R+D+i Plan.

As regards human capital, the latest indicators show scant progress in recent years. Accordingly, the attainment of the objectives laid down in the NRP in terms of reducing the early school leavers rate and raising the percentage of the population aged 20-24 with at least higher secondary education does not seem feasible. More favourable progress appears to have been made in the primary schooling rate and in the indicators of participation in continuous training courses. The R+D indicators show that the weight of this type of investment in GDP increased slightly to 1.2%, a figure still far off the targets set in the NRP and the average for the other European countries (1.8% in the EU). To speed progress in educational and technological policy, several measures were adopted in 2007. These included the approval, firstly, of the Organic Law on Education (whose main objectives include increasing schooling at the higher – and non-compulsory – secondary education and early primary levels, and reducing the school-leaving rate); and, secondly, the Organic Law on Universities, which seeks to im-

prove the quality of teaching and research. Finally, the new National R+D+i Plan for the period 2008-2011 establishes the coordination framework for all policies in this field. However, the impact of these reforms will only be visible in the medium term.

The new Law on Competition Protection entered into force...

Regarding the measures aimed at liberalising the economy, mention should be made of the entry into force of the new Law on Competition Protection, which introduces several significant changes. To promote its independence, the new law postulates an institutional reorganisation, creating a single competition protection agency, the CNC (National Competition Board), separate from the government. The law, however, maintains the possibility that the government may, in cases of general interest, amend the decisions on economic concentrations delivered by the CNC when the latter has prohibited an operation or authorised it subject to compliance with specific conditions. The new rules provide for several measures aimed at promoting greater procedural flexibility and effectiveness, including most notably the introduction of a clemency programme, which reduces the fines for companies that collaborate with the CNC before proceedings are initiated.

while the measures introduced in relation to policies to deregulate and liberalise sectors were minor.

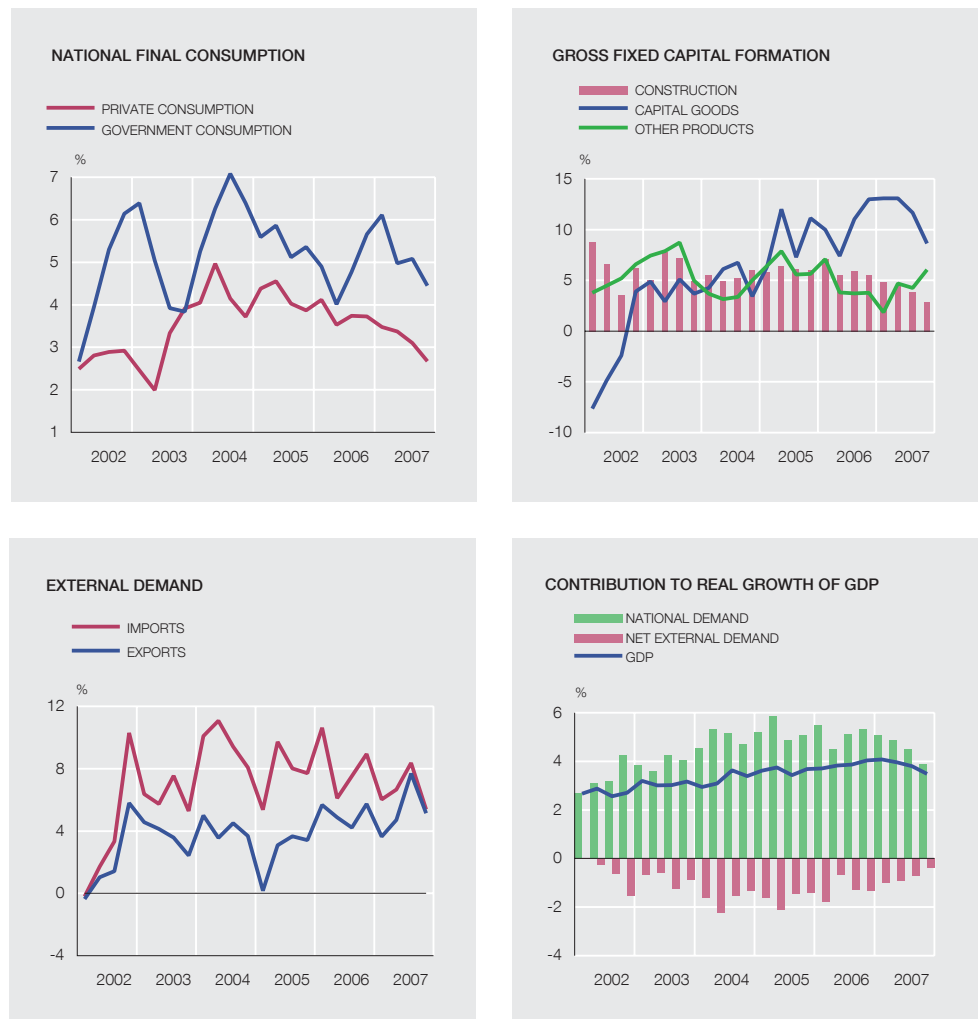
There were few sectoral liberalisation and deregulation measures in 2007, despite the fact that the indicators proxying the degree of competition suggest the need to further these policies. Of note in the telecommunications sector was the incorporation of a fourth traditional operator and of new virtual mobile operators. That should allow for further cuts in the still-high prices and market share of the main operator in this industry. In the energy sector, the latest changes in prices, market shares and proportion of the market that is liberalised do not show satisfactory results in all cases, which suggests that the liberalisation measures undertaken in recent years should be deepened. Likewise, in some sectors – the retail trade in particular – the degree of regulation has increased in recent years, and this trend should be reversed.

Under housing policy, the new Law on Land-Use came into force and the plan to support youth independence and boost the rental market was approved.

In connection with housing policy, the most relevant economic policy measures were the entry into force of the new Law on Land-Use and the approval of the plan to support independence of youth and boost the rental market. The law makes notable changes including the introduction of a regime of valuations based on the current status of the land and not on its expected value, and an increase (up to 30%) in the minimum reservation of new residential land for subsidised housing. The package to encourage rentals includes measures to boost the supply of housing for rent, and subsidies and/or deductions for tenants meeting certain requirements. Some of these proposals, in particular those aimed at making evictions more flexible, might improve the legal security of owners and have an expansionary effect on supply, which would enhance the effectiveness of the measures adopted on the demand side. However, for the measures to come into the effect may take some time (since they require the reform of the procedural legislation and the creation and start-up of new courts), meaning that they would only provide for a significant increase in the stock of houses for rent in the medium term. Moreover, there has been no amendment of certain aspects of rental legislation – such as the minimum duration of contracts – that may be restricting empty houses from coming onto the rental market.

Collective bargaining remained under the guidelines laid down by the AINC (Inter-Confederal Collective Bargaining Agreement) and the minimum wage was raised once again.

Lastly, regarding policies relating to the labour market, collective bargaining followed the general guidelines laid down in the AINC (Inter-Confederal Collective Bargaining Agreement), which has been renewed once again for the year 2008. This type of agreement, which may have proven useful in the past for anchoring wage growth, cannot be considered a substitute for a far-reaching reform of the collective bargaining mechanism in Spain that would add greater flexibility to wage formation and allow a greater adjustment of wages to the specific conditions of firms, such as their productivity or their profits. The minimum wage rose by 5.5% in 2007 to a monthly amount of €570.60, reaching the objective set by the



SOURCE: INE.

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

government of €600 (in 14 payments) in 2008, following the fresh increase of 5.1% approved at the beginning of this year. The rises in the minimum wage since 2004 do not so far appear to have had a significant direct effect on the functioning of the labour market, since they affect a smaller number of workers. Nonetheless, they might have given rise to an expansionary effect on wage increases agreed under collective bargaining, especially for the groups of workers with wages closest to the minimum wage. As a result, and bearing in mind the new setting of slowing activity, further rises in the minimum wage might reduce the employment possibilities for certain groups of workers and, therefore, slow the process of job creation.

2 Demand

2.1 NATIONAL DEMAND

The slowdown in national demand continued in 2007, due chiefly to the lower growth rate of household spending.

The slowdown in national demand, which had begun in a muted fashion in 2006, continued in 2007, with its growth rate declining by 0.5 pp to 4.3%. This was the outcome, above all, of the smaller increase in household spending (both on consumption and on residential investment), following a period in which it had posted substantial growth rates. Conversely, investment in equipment and government consumption quickened in 2007 (see Chart 5.2).

	%GDP (a)		RATE OF CHANGE (b)					
	2000	2007	2002	2003	2004	2005	2006	2007
HOUSEHOLDS AND NPISHs								
Final consumption expenditure	59.7	56.9	2.8	2.9	4.2	4.2	3.8	3.2
<i>Durable consumption</i>	6.3	5.2	-4.6	4.5	9.4	4.4	5.7	4.8
<i>Non-durable consumption</i>	53.4	51.6	3.6	2.8	3.7	4.2	3.6	3.0
Housing	6.1	9.3	7.0	9.3	5.9	5.9	6.4	3.1
CORPORATIONS								
Private productive investment (c)	16.6	18.0	0.6	4.5	6.4	7.2	6.6	7.7
<i>Construction</i>	4.8	5.8	3.1	3.3	11.4	5.8	3.8	5.7
<i>Equipment</i>	7.3	7.0	-4.2	3.6	4.3	9.2	10.9	12.2
<i>Other products (d)</i>	4.4	5.2	5.0	7.2	3.8	6.4	4.6	4.2
GENERAL GOVERNMENT								
Final consumption expenditure	17.2	18.4	4.5	4.8	6.3	5.5	4.8	5.1
Gross fixed capital formation	3.2	3.8	10.2	4.8	-2.6	7.7	8.6	4.5
<i>Construction</i>	2.4	2.8	10.6	3.7	-6.7	7.3	9.2	3.8
<i>Equipment</i>	0.8	0.9	8.8	8.6	11.0	9.0	6.8	6.8
MEMORANDUM ITEM								
<i>Equipment</i>	8.1	8.0	-2.9	4.1	5.1	9.2	10.4	11.6
— <i>Machinery</i>	5.7	5.4	-2.2	1.9	3.5	5.8	10.9	12.8
— <i>Transport</i>	2.4	2.6	-4.5	9.4	8.7	16.1	9.3	9.1
<i>Construction</i>	13.3	17.9	6.3	6.2	5.4	6.1	6.0	4.0
— <i>Housing</i>	6.1	9.3	7.0	9.3	5.9	5.9	6.4	3.1
— <i>Other constructions</i>	7.2	8.6	5.6	3.5	5.0	6.3	5.5	5.1
<i>Other products (d)</i>	4.4	5.2	5.0	7.2	3.8	6.4	4.6	4.2

SOURCES: INE and Banco de España.

a. Base 2000 National Accounts, current prices.

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

c. Includes investment by sole proprietors.

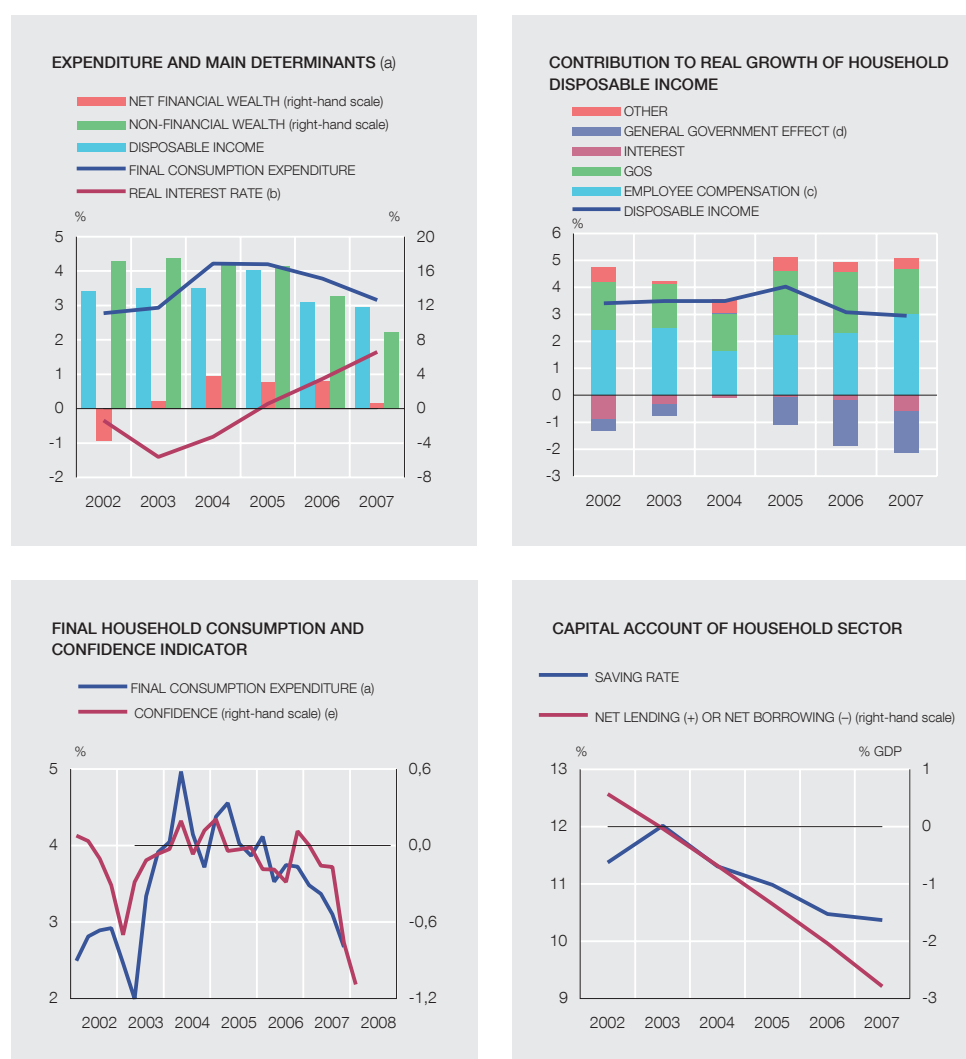
d. This investment includes real estate, legal, accounting, consultancy and software services, among others.

Private consumption eased off gradually during 2007.

After growing by around 4% in the period 2004-2006, private consumption progressively slowed during 2007, reaching an annual rate of 3.2%, with a somewhat sharper slowdown in the second half of the year (see Table 5.2). The growth of spending both on consumer durables and on non-durables, where services are included, declined in relation to 2006, although the purchase of durable goods continued to display a relatively high rate of expansion of close to 5%. Although car purchases fell in 2007, the demand for other durable goods continued to be driven by factors which had become manifest with greater intensity in previous years, such as real estate dynamism (which encourages the purchase of specific products, such as household equipment) and immigrants' expenses in establishing themselves with the intention of taking up permanent residence in Spain. The moderate growth of the prices of these durable goods – which even posted negative rates of change in some cases – might also help explain the intense demand for them in recent years.

Real household income grew at a similar rate to that of 2006.

The growth rate of private consumption drew close to that of real disposable income, which increased by around 3% in 2007, a similar figure to that of the previous year. The acceleration in wage income, driven by the rise in employment and by the greater increase in compensation per employee, was offset by the negative impact of interest rates on income growth (due to the increase in interest payments) and by the lower growth of the surplus of sole proprietors (see Chart 5.3). The purchasing power of households' current revenue was favoured by average



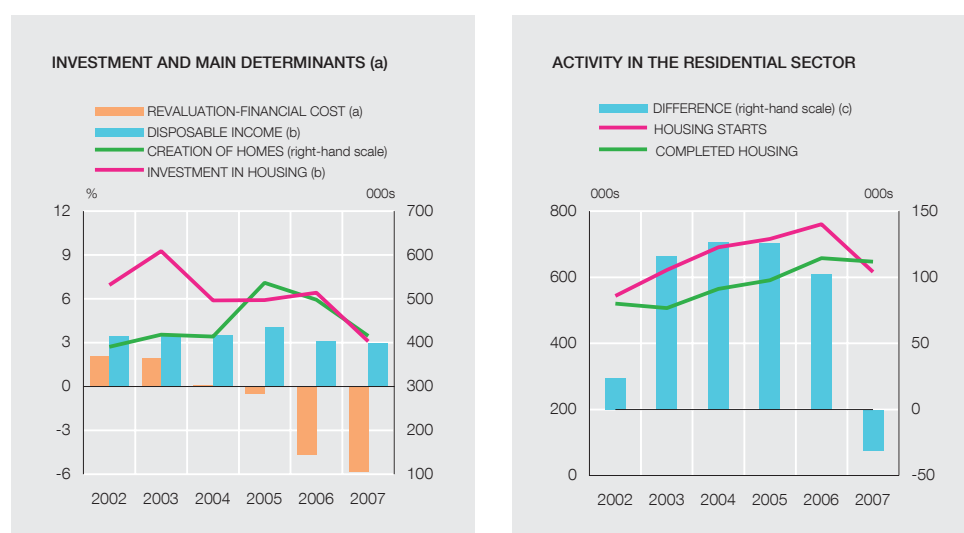
SOURCES: INE and Banco de España.

- a. Rate of change of volume indices.
 b. Change in interest rate on loans for house purchase less growth of the private consumption deflator.
 c. Gross compensation per employee.
 d. Includes social benefits, social contributions and taxes on income and wealth.
 e. Normalised data (difference between the series and its mean value divided by its standard deviation).

growth in consumer prices that was lower than that of 2006, despite the rise in inflation in the closing months of the year. Finally, the influence of general government on household income – through the counteracting effects of taxation and social benefits – was similar to that in 2006.

The increase in real interest rates, along with the lower growth of wealth and the deterioration in confidence, tempered consumer spending.

Set against income growth, several factors have contributed to the moderation of consumption. Real interest rates, proxied ex-post (deflating mortgage interest rates with developments in consumer prices), increased significantly in 2007 (1.7 pp over the year as a whole), as a result of the rise in nominal rates and of the decline in annual average inflation. Net household wealth continued to slow in 2007 as a consequence of the slowdown in house prices and in net financial assets. Finally, the outlook for households deteriorated during the year, especially in the final quarter and in the opening months of 2008, in view of the course of consumer confidence. This was affected by the general climate of uncertainty brought about by the finan-



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

a. Change in the growth of price of housing less the change in the interest rate on loans for house purchases. This approximates to the change in user cost with the sign reversed.

b. Real rates of change.

c. Approximation to houses under construction taking the annual difference between housing starts less completed housing.

cial turmoil, the strong rise in consumer prices and the evidence of a sharper adjustment in the real estate market. All these factors contributed to moderating private consumption growth and to curbing the slowdown in the household saving ratio.

The increase in borrowing costs and lower expectations of appreciation reduced the growth of investment in housing.

Following a prolonged expansion in the last decade, the growth rate of investment in housing eased significantly in 2007, as a result both of the downward revision in expectations of the appreciation of residential assets and of the increase in borrowing costs (see Chart 5.4). However, the demographic factors that boosted the setting up of new homes during the expansionary phase remain in place. Thus, the intensity of migratory flows in 2007, along with the reductions seen in the average size of households and the arrival at adulthood of the “baby boomers”, contributes to firming a relatively high potential demand for housing. Despite the diminished dynamism of residential investment, household net borrowing as a percentage of GDP increased by 0.8 pp to 2.8%.

General government demand remained notably dynamic...

General government demand remained strongly dynamic in 2007, in line with recent years. In particular, final consumption spending quickened slightly to a growth rate exceeding 5%. Behind this was the increase in compensation per employee, which has displayed high wage drift in recent years, and which more than offset the slowdown in net purchases of goods and services. General government investment in real terms also advanced notably, albeit on a slowing profile, as the projects programmed by territorial governments in the previous legislature were progressively completed. Box 5.1 examines the role of public investment, and that of business investment, in the dynamism of construction in recent years and the extent to which these components might cushion the impact of lower investment in housing in the future.

and the momentum of business investment continued, although it lost steam in the second half of the year.

The dynamism of Spanish firms' investment continued in 2007, with average growth in real terms of 7.7%, against 6% the previous year, meaning that this demand component contributed 1.3 pp to GDP growth. The thrust of business investment was underpinned by the strength of both national and external demand, set against a favourable economic outlook and

Investment in construction in Spain posted growth of 4% in 2007, thereby extending the long expansionary cycle that began in 1997. Nonetheless, symptoms of diminished dynamism started to emerge over the course of the year, associated with the adjustment initiated by the residential component, which is the subject of detailed analysis in other sections of this Report. During this period of expansion, investment in construction has outgrown GDP for a protracted length of time, with a differential of 2 pp on average (see Chart 1). As a result, its relative weight in the economy as a whole has increased substantially. Compared with the figure of 11.5% of GDP that investment in construction represented in nominal terms in 1997, last year this proportion rose to around 18%, accounting for almost one-quarter of GDP growth in this period. Its contribution has been similar in the case of net job creation, amounting to a share of 14% in overall employment (against 9.5% in 1997).

One of the characteristic features of construction activity is the comparatively more intensive use in its productive process of goods and services generated in other branches of activity. Hence, drawing on the input-output tables of the Spanish economy, while inputs from other branches account in the case of market services and of industry for 13% and 20%, respectively, of their gross output, in the case

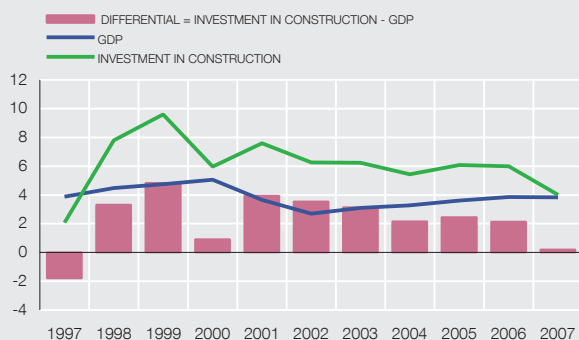
of construction this proportion amounts to 34%. As a result, this sector exerts a significant drag effect on the rest of the economy. Moreover, from the standpoint of demand, residential investment is a driver of durable goods consumption, insofar as the purchase of new houses entails the acquisition of various house furnishings.

In comparison with the previous upturn, between 1985 and 1991, construction activity has posted more moderate annual rates of increase in the recent period (6% in annual average terms, compared with 9% in the previous episode), although the length of this period has been five years more, whereby the growth that has built up has also been higher (see Chart 2).

Another very significant differential factor of the recent expansionary phase has been the bigger role played by housebuilding: the contribution of this component to the growth of total construction was 25% in the previous episode, compared with 55% in this latest period. However, other construction has also played a significant role in the expansion of the sector. Its average growth rate in the period (5.2%) was less than that of housing (7.3%), but it exceeded the rate of expansion of output as a whole (see panel 3). A disaggregated analysis of other construction, based on the public or private status of the agents tak-

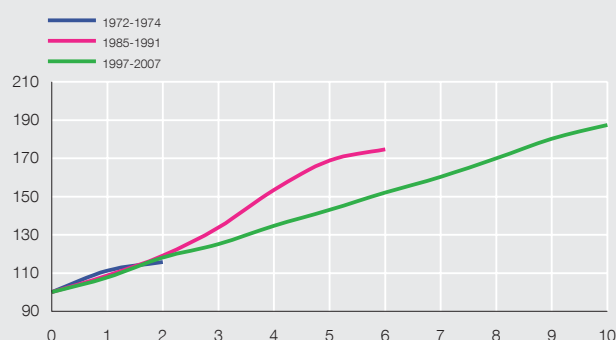
1. INVESTMENT IN CONSTRUCTION AND GDP

Year-on-year rates



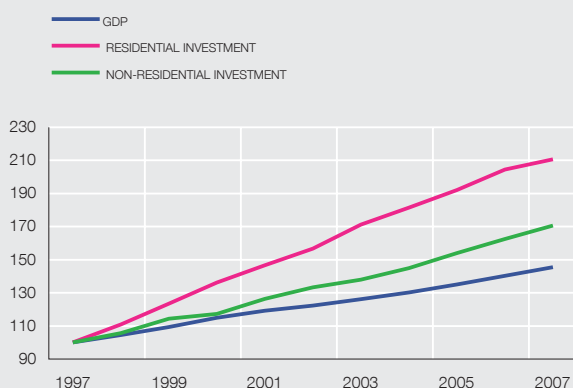
2. INVESTMENT IN CONSTRUCTION IN EXPANSIONARY PHASES

Initial year of expansion = 100

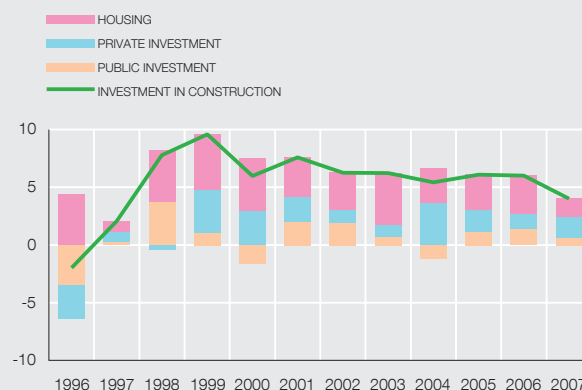


3. GDP AND TYPES OF CONSTRUCTION IN THE LAST EXPANSIONARY PHASE

1997 = 100



4. CONTRIBUTION TO THE GROWTH OF INVESTMENT IN CONSTRUCTION BY AGENT



SOURCES: AMECO, INE and Banco de España.

ing investment decisions, shows how its average growth has been similar, although the contribution of business investment to total construction growth (30%) doubled that of public investment, reflecting their respective weights.¹ These components have followed different patterns: while the oscillations in business investment in construction matched those of the general business cycle, public investment was more variable and showed less correlation to activity, with its path very strongly determined by the electoral calendar so that, in the years 1996, 2000 and 2004, for example, it made a negative contribution to the growth of construction as a whole (see panel 4).

1. The availability of bilateral data on goods exports by country of destination and by type of product means nominal-terms data must be used. The data on EU countries are from the Eurostat database, while the Spanish figures are from the Customs Department.

It may be inferred from this analysis that, despite the importance attained by residential investment in the construction total, other types of works also play a relevant role. In this respect, the growth of the business and public components of non-residential investment might partly counter the impact on activity of the foreseeable slow-down in investment in housing. Nonetheless, in the current circumstances this cushioning role appears limited. On one hand, the slow-down in economic activity precludes auguring a particularly robust performance by non-residential business investment in the immediate future. On the other, if public investment were to maintain the dynamic of recent years (closely linked, as indicated, to the electoral cycle), this component would not show greater vigour in the coming quarters, although stricter compliance with lead times, in line with the measures recently approved by the new government, might soften this effect.

The vigour of investment resided on capital goods, particularly machinery.

sound business earnings. Nonetheless, business investment progressively lost steam in the second half of the year, mainly in the capital goods component, against a backdrop of deteriorating business confidence and the diminished momentum of activity.

The vigour of business investment resided on the capital goods component and, to a lesser extent, on investment in non-residential construction, while spending on other products slowed (see Chart 5.5). Of note under capital goods was the increase in the machinery component (12.8%), which continued on the path of expansion initiated two years earlier and which is linked to the recovery in manufacturing activity, the sector which accounts for around 40% of the demand for this component. Investment in transport remained dynamic, with a similar growth rate to that of the previous year (around 9%). Finally, the mild acceleration in private investment in non-residential construction in 2007 was underpinned by the investment projects of certain State-owned companies, which channel a significant portion of civil engineering works, while non-residential building posted a moderate growth rate, drawing on the number of approvals for this type of project.

As regards the productive branches, investment in the services sector was once again highly dynamic, accounting for around two-thirds of total business investment in 2007, and investment by the industrial branch continued picking up, with growth of 8.5% in 2007. Finally, the weight of the construction branch in business investment remained small, which limits the direct impact of diminished dynamism in this branch on productive investment as a whole.

The financial environment became less favourable, as a result of the tightening of financial conditions and the increase in net borrowing.

Financial conditions tightened in 2007. This was reflected in an increase in the user cost of capital in real terms, as a result of the rise in interest rates, although from a historical perspective the former remains at a low level. Spanish companies' results continued to be favourable during 2007, with an increase in the share of the gross operating surplus in value added. Nonetheless, having stripped out interest paid, corporate earnings slowed in the past two years owing to the rise in interest rates and to growing debt. Moreover, the increase in the business investment ratio and lower cash flow led in 2007 to a rise in non-financial corporations' net borrowing, which climbed to a historical high of 10.6% of GDP. And that, against a background of tightening credit conditions, might adversely affect the launch of new investment plans.



SOURCES: INE and Banco de España.

a. Real rates of change and changes in the real user cost of investment. The user cost is obtained as the difference between the cost of corporate financing and the change in price in the investment good.

b. Profit is obtained by adding interest and dividends received and other net current transfers to the gross operating surplus, and subtracting interest paid. Thus, the profit in question is after interest and before tax.

c. Rate of change of volume indices.

2.2 EXTERNAL DEMAND

The improvement in the contribution of external demand to growth continued in 2007.

The increase in sales to the emerging economies sustained goods exports, despite the appreciation of the euro and the slowdown in world trade.

The contribution of net external demand to GDP growth intensified the path of improvement recorded in the two previous years in 2007 to stand at -0.7 pp, 0.5 pp higher than the previous year. This result was the consequence of the behaviour of goods and services exports which, in a more adverse international setting, posted real growth similar to that of the previous year (5.3% against 5.1%), and, to a greater extent, of the slowdown in imports, which increased by 6.6% compared with 8.3% the previous year.

Real goods exports posted a rate of increase of 5% in 2007, virtually unchanged on the previous year. And this despite the fact that the change in the international economic climate prompted a slowdown in world trade of 3 pp, to a rate of increase of 6.2% in 2007, and that price-competitiveness deteriorated once again on a similar scale to that in 2006 (see Chart 5.6). This result is the outcome of the increase in sales to certain non-EU emerging econo-



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

- a. Real year-on-year rates of change.
 b. Deflator of Spanish exports in relation to rest-of-the-world export prices, exchange rate-adjusted.
 c. Positive values denote a loss in competitiveness of exports, imports and the Spanish tourism industry, negative values a gain.
 d. Average of GDP growth of the main countries of origin of tourists to Spain, weighted according to the relative significance of the number of visitors.
 e. Real effective exchange rate, measured with consumer prices, vis-à-vis OECD.
 f. Ratio of Spanish imports deflator to the producer price index.

mies, including most notably China, Russia and the Maghreb countries (Morocco, Algeria and Tunisia). The result is also associated with the dynamism of domestic demand in these economies in recent years. This favourable behaviour, despite the strength of the euro, suggests that factors other than the traditional determinants might be playing a relevant role when it comes to explaining the geographical diversification of exports (in this connection, see Box 5.2).

Sales to the developed countries were more moderate and export shares in these markets continued to fall off.

In contrast to the buoyancy of sales to the emerging markets, exports to the EU slowed, prompting a fresh decline in the share in this area, albeit one lower than that recorded in the previous years. Meanwhile, exports to the United States and Japan remained virtually flat, reflecting both the progressive slackness of demand in these economies as the year advanced and the strength of the euro against both these countries' currencies (see Chart 5.7).

Real goods exports maintained a growth rate in 2007 similar to that of the previous year, despite the notable loss of steam in world trade and the further deterioration in the price-competitiveness shown by the habitual indicators. As can be seen in panel 1, which displays the contribution of these determinants to the recent path of Spanish exports in accordance with the Banco de España quarterly model, whereas sales of goods abroad performed worse in the 2004-2006 period than its determinants would have suggested, in 2007 these explanatory variables described exports to the euro area reasonably well, but underestimated those to the rest of the world, an area of growing importance and which in recent years has accounted for more than 50% of total Spanish export growth. As a result of the favourable course of real exports outside the euro area, the loss of share of Spanish products in these markets has been checked (see Chart 2). Given the difficulties, using the variables habitually included in econometric models, of capturing both the changes taking place in world demand and the different aspects of competitiveness, it is

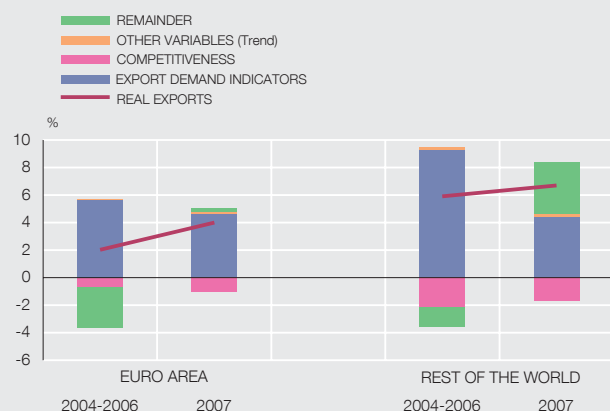
worth performing an analysis of goods exports with a greater level of disaggregation.

In this respect, panel 3 provides information on the geographical pattern of Spanish goods exports in 2007 (the area in the bubbles¹), the changes this pattern has undergone since the start of the decade (the horizontal axis) and the growth posted by Spanish export markets in this period in relation to world trade (vertical axis).² Thus, a value higher than zero on the horizontal axis would denote that exports to this area have gained in weight in relation to total Spanish

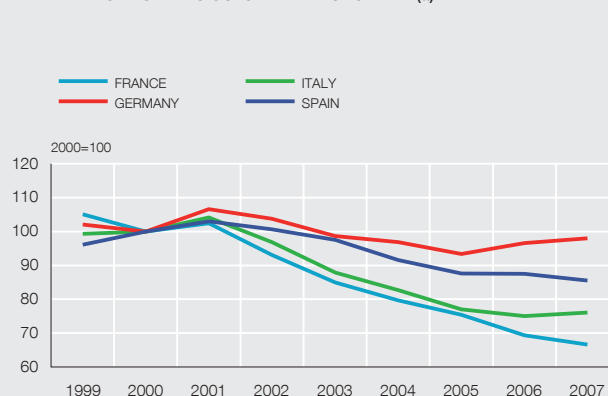
1. The size of the bubble is defined as the weight of Spanish goods exports, in nominal terms, to a specific country or area relative to total Spanish exports to the world in 2007. 2. The availability of bilateral data on goods exports by country of destination and by type of product means nominal-terms data must be used. The data on EU countries are from the Eurostat database, while the Spanish figures are from the Customs Department.

1 TOTAL REAL GOODS EXPORTS

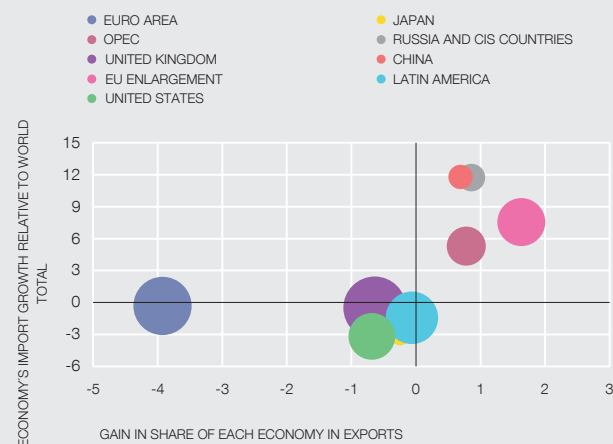
Contribution of the different determinants. 2004-2007



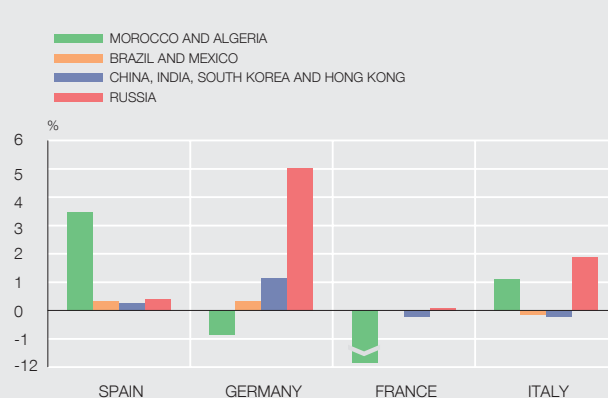
2 REAL EXPORT SHARES OUTSIDE THE EURO AREA (a)



3 GEOGRAPHICAL BREAKDOWN OF SPANISH EXPORTS (b) 2000-2007



4 EXPORT SHARES IN THE COUNTRIES UNDER THE COMPREHENSIVE MARKET DEVELOPMENT PLAN



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

a. 2007 data to November.

b. The size of the bubble is proportional to counterpart economy's weight in Spanish total exports in 2007, except for the euro area which is not representative.

c. Nominal export data to September 2007.

exports in the period from 2000 to 2007, while a value lower than zero would indicate the opposite. Likewise, a value higher than zero on the vertical axis would indicate that Spanish exports have been directed to markets that have outgrown world markets. The panel data highlight the fact that Spanish exports have been geared in recent years to countries outside the euro area, raising the share accounted for in total Spanish exports by sales to the EU enlargement countries, to Russia and the CIS countries, and to China. Diversification has been towards areas that have shown economic dynamism greater than the global average, as shown by the fact that their imports have shown far higher rates than those posted by world trade between 2001 and 2007 (15.3% and 5.5%, in annual average terms, respectively).³

Moreover, this geographical diversification of Spanish exports has been accompanied by a re-gearing of sales, in general, towards products for which demand is dynamic (drugs, metal semi-manufactures and industrial machinery), to the detriment of low-demand products (cars, food and textiles).⁴ Nonetheless, geographical diversification, though it has intensified in recent years, has come about with some delay compared with other euro area countries. In 2007, exports to the EU enlargement countries, Russia and the CIS countries, and China accounted for around 7% of total Spanish sales, somewhat more than 3 pp up on the 2000 figure, but still far below the proportion accounted for by exports to other areas in other EU countries, especially Germany (17.3%) and Italy (13.5%), although closer to France (8.8%, on data for 2006). Reflecting this is the fact

that Spain's share in these markets remains very small compared with that of other euro area countries, although there have been advances in the penetration of Spanish products in China and in Russia.

These two countries are part of the group of economies for which Spain has set in train comprehensive market development plans, in order to promote trade and economic relations.⁵ The results at aggregate level suggest these plans may have played a significant role in re-directing Spanish exports towards new markets. The pace of Spanish export penetration has been particularly considerable in the Maghreb area (3.5 pp), compared with the loss of share in France and Germany (11.9 pp and 0.9 pp, respectively) (see Chart 4). In the other areas considered, progress has been more modest, although better than that observed in France and in Italy.

Analysis of the geographical structure of Spanish goods exports suggests that there has been a re-gearing in recent years towards more dynamic markets and products, with greater medium and long-term growth potential. This, along with the foreseeable slowdown in domestic demand, might enable Spanish exports to benefit in the future from the changes in world demand and to face the increase in competition via costs in better conditions than in the past. Nonetheless, these changes have been launched with some delay and progress is as yet limited if the low starting level in relation to other euro area countries is taken into account. Moreover, the weight of certain sectors, in which competition via prices is fundamental, remains high. Accordingly, it is of paramount importance to build on and deepen the headway made and to prevent further losses in competitiveness via costs such as those that have built up in recent years.

3. Although the redirecting of exports towards these markets can also be seen in the main euro area countries, this has proven particularly intense in Spain in recent years, with the exception of sales to the EU enlargement countries. 4. In the period 2000-2007, the share of the textiles branch has gained in weight in total Spanish exports and in share in the EU-15 markets and in the rest of the world, unlike what was observed in Italian and Portuguese exports, and despite the competition from the newly emerging economies, with clear cost advantages. This suggests that Spain might be specialising in a higher-quality segment, where the competition from the emerging economies is less.

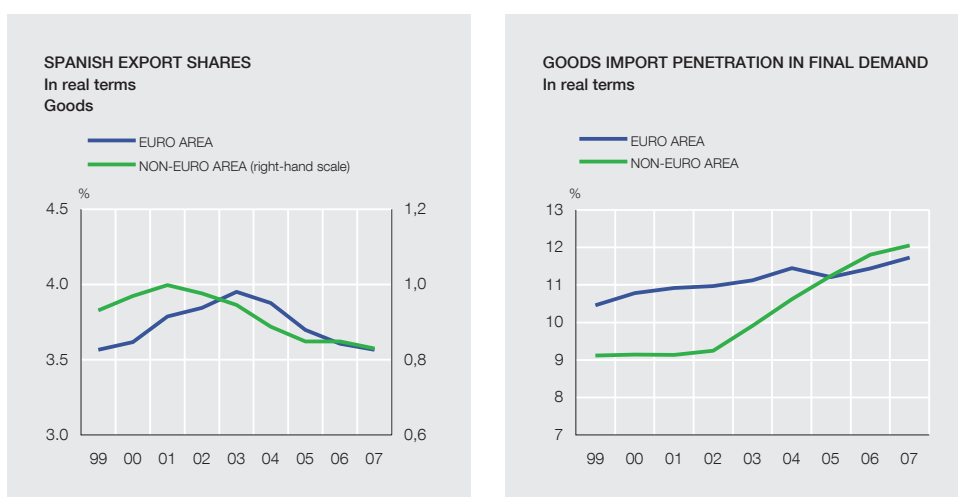
5. The comprehensive market development plans, which have been set in train by the Spanish Ministry of Industry, Tourism and Trade, include some of the countries to which Spanish goods exports most increased in 2007, such as Russia, China, India, Brazil, Algeria and Morocco. Conversely, exports to Japan, the United States and Mexico, for which these plans are also in place, were significantly slack last year.

Intermediate industrial goods were the most dynamic component of exports.

An examination of the breakdown of foreign sales by product shows that intermediate industrial goods were the most dynamic component of exports. The expansion of sales of minerals and metallic products to the emerging economies was particularly prominent. In contrast, other exporting sectors geared much more markedly to the developed countries, such as the automobile or pharmaceuticals sectors, posted moderate growth. Mention should also be made, first, of the increase in certain low-technological-intensity sectors, which in recent years have redirected their production towards higher quality segments as in the case of the clothing industry; and further, of the increase in sales of capital goods, such as machinery.

The expansion in services exports seen in recent years steepened...

The expansionary trend of services exports (other than tourism) seen in recent years steepened, increasing by 13.1% in real terms in 2007. This result shows the sharp growth of services provided to companies and of IT, financial and real estate services, the development in which is common to many other countries and is being driven by the liberalisation of the inter-



SOURCES: IMF, Eurostat, OECD, INE and Ministerio de Economía y Hacienda.

national trade in these activities and by technical progress, which extends the attendant marketing possibilities.

but tourism receipts scarcely increased, despite the dynamism of international tourism.

In contrast, tourism receipts posted what was practically a zero increase over the year as a whole. Tourist inflows were also moderate, with an increase of close to 2%, despite the fact that the growth of world tourism (measured by the number of tourists) was 6.2% in 2007. This discrepancy is partly due to the importance acquired last year by tourists from the emerging Asian economies, for whom Spain is not a preferred destination. Moreover, the improved political situation in other Mediterranean destinations that compete with Spain in the sun and beach segments and the appreciation of the euro, which has a significant influence on inflows of British tourists (who account for almost one-third of total tourists visiting our country), also contributed to checking the increase in tourism receipts. Yet despite the slackness of aggregate results, one positive feature is that the buoyancy of the business and urban tourism segments, made up by travellers who generally have greater spending capacity, although their stays are shorter, appears to be firming.

Imports slowed, although there was a fresh increase in their penetration in final demand.

The deceleration in goods imports, which increased by 6% in 2007, 2 pp less than the previous year, contributed significantly to the improvement in the external contribution. This slowdown, which was more sharply discernible in the second half of the year, was associated with the diminished dynamism of final demand. This was because the marked inclination of industrial activities towards imported inputs and the high share of capital goods imports in corporate capital enlargement processes justify a close relationship between investment in equipment and industrial production, on one hand, and purchases from abroad, on the other. But perhaps the most notable aspect was the slowdown in purchases of consumer goods from outside the EU, which meant that overall imports from the EU increased by only 6.7% in 2007, after posting real growth of over 10% in the four previous years. That said, there was once again a fresh increase in import penetration as a proportion of final demand, albeit somewhat lower than that observed in previous years.

Services imports were very dynamic in 2007, both in the case of tourism expenditure, which was driven by the boost given by the appreciation of the euro to international travel by Spaniards, and in that of other services where, as under exports, there was notable momentum in business services, in addition to financial, insurance and real estate services.



SOURCES: INE and Banco de España.

a. The output gap is defined as the percentage difference between actual GDP and potential GDP. Regarding different estimates of the output gap, see the article "Estimates of the potential growth rate of the Spanish economy", by M. Izquierdo and J. Jareño, Banco de España, Economic Bulletin, January 2007.

3 Activity

Activity continued to show considerable dynamism in 2007, slightly higher than estimated growth potential.

Agriculture gathered momentum in 2007...

as did industry, which behaved soundly over the year as a whole, albeit on a diminishing path...

Despite the slight slowdown in activity, GDP continued to grow at a rate somewhat higher than its potential, meaning that the output gap became more positive (see Chart 5.8). In late 2007, by contrast, growth in activity drew progressively closer to its potential rate, and this movement has intensified in the opening months of 2008.

The market economy posted a similar slowdown to that in GDP, growing at a rate of 3.7%. As was already the case in 2006, only the manufacturing and agriculture and fisheries branches showed greater dynamism in 2007. In this latter branch, the improved rainfall pattern allowed for an expansion in vegetable output, although some adverse weather phenomena reduced the yields of certain products. The growth rate of value added in this productive branch stood finally at 3.8%, 1.4 pp up on the related rate in 2006.

The starting point for industry in 2007 was positive, after having ended the previous year with a recovery which, apparently, had a sound base. However, after commencing 2007 with high dynamism, industrial activity weakened over the course of the year, posting a rate of 1.4% in the final

quarter. In 2007 as a whole, then, the growth of value added in the sector was 3.1% (2.9% the previous year). Just as the recovery in 2006 had been based on the greater demand for industrial products to cover various ends (export, domestic consumption, investment and output in other branches of activity), in 2007 the gradual loss of momentum in industry corresponded likewise to all these. Lastly, if regard is had to the technological content of production, the industrial slowdown affected all categories. However, on a positive note, industries with medium-high and high technology were those which showed, as they did in 2006, greater relative dynamism.

while residential construction saw the end of its expansionary cycle...

Following almost a decade in which construction activity outgrew the rest of the economy as a whole, it posted a slowdown of 1.2 pp in 2007 which took its growth rate to 3.8%, similar to that of GDP. Even though construction linked to civil engineering works and to business investment was also somewhat less buoyant in 2007 (with a growth rate of 5.1%, compared with 5.5% in 2006), the loss of steam in housebuilding was chiefly responsible for the diminished dynamism of the sector as a whole (down 3.3 pp to growth of 3.1%). In particular, the decline in the demand for housing, the determinants of which have been analysed in section 2.1, led to a downward revision in new project starts. As a result, supply has adapted, with something of a lag, to this diminished momentum of demand, as reflected in the fall in the number of houses being built in 2007 (see Chart 5.4). In the opening months of 2008, the loss of dynamism in this branch has become more patent, with a substantial slowdown in employment – where a process of job destruction is beginning to emerge – but appears to be centred on the residential segments, in view of the heavy fall in the number of new housing projects.

and market services remained notably dynamic.

Despite the diminished dynamism of private consumption and tourism, market services held at a growth rate of 4% in 2007, similar to that of the previous year. The sound behaviour of business services and, in general, the dynamism seen in services exports account in part for this strength.

4 The labour market

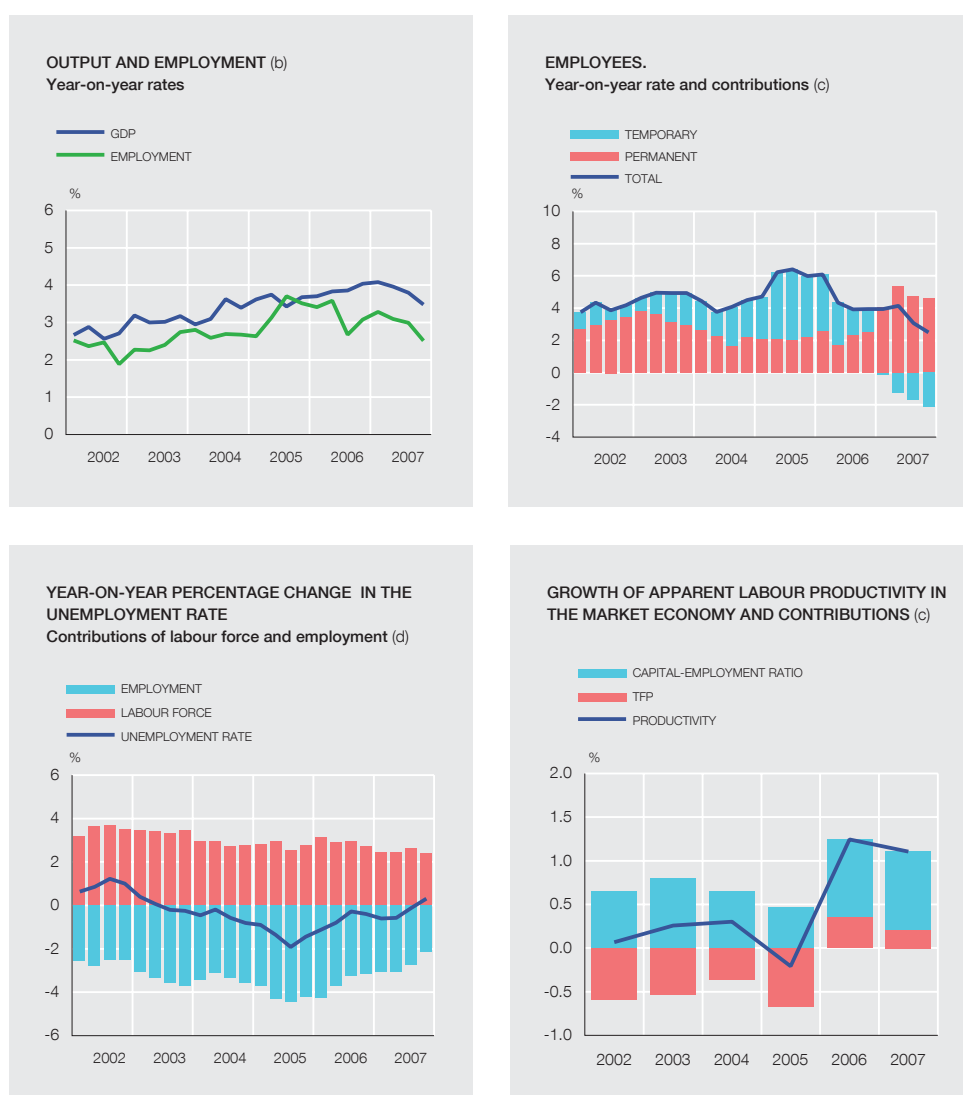
Employment ran in parallel to activity, with a slowing profile during the year.

Employment slowed slightly in 2007 to a year-on-year growth rate of 3%, 0.2 pp down on 2006. Apparent labour productivity recovered slightly to 0.8% (see Chart 5.9). Productivity growth was somewhat higher in the market economy (1.1%), underpinned by improvements in total factor productivity (TFP) during the past two years, as discussed at the start of this chapter.

At the sectoral level, the pattern of growth in employment in 2007 was very similar to that seen in recent years, since the bulk of job creation was centred on construction and on services. Specifically, agriculture posted a negative rate of change in employment over the year as a whole, though less so than in 2006, while in industry employment was cut in net terms following the muted recovery seen the previous year. On EPA (Spanish Labour Force Survey) data, this reduction in industrial employment was fairly widespread, particularly affecting sectors such as textiles and clothing, the manufacture of IT equipment and wood and paper. In construction, employment grew by 5.7%, 0.3 pp up on 2006, albeit on a marked slowing profile throughout the year. Finally, employment in market services increased at a similar rate to that of the previous year (3.1%). Branch by branch, apparent productivity posted high growth in industry (3%) and in market services (0.9%), underpinned by a rise in TFP in both cases, while the declines in productivity in construction, habitual in recent years, stepped up.

The labour reform approved in 2006 and the slowdown in employment during the year contributed to a reduction in the ratio of temporary to total employees.

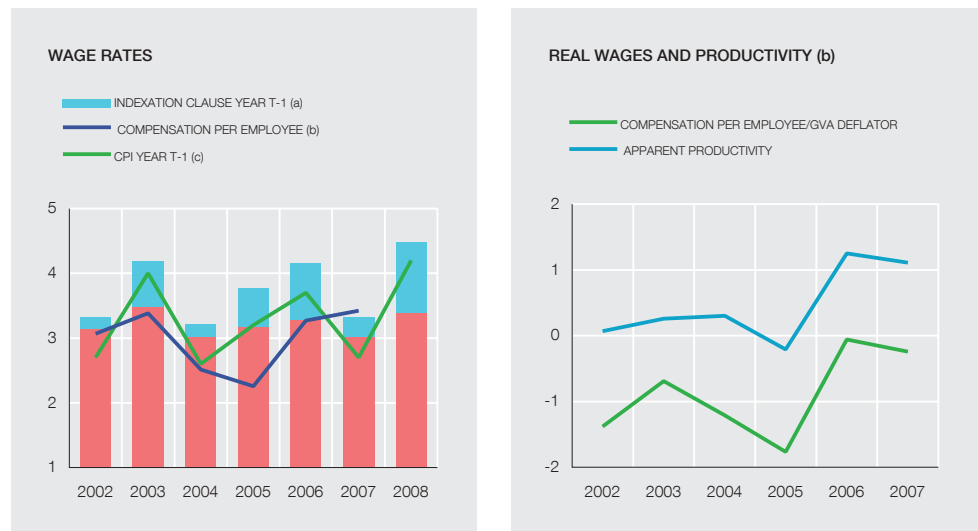
In terms of the composition of employment, based on contract duration, numbers of wage-earners with a permanent contract grew by 7.1%. This meant that, for the first time in recent years, the growth rate of this group outpaced that of workers with a temporary contract, numbers of whom fell by 3.8% in 2007. This placed the ratio of temporary to total workers at 31.7%, more than 2 pp below the 2006 level. This reduction is associated, at



SOURCES: INE and Banco de España.

- a. The EPA (Spanish Labour Force Survey) series are linked on the basis of the 2005 Q1 control survey.
- b. Seasonally adjusted QNA series. Full-time equivalent jobs.
- c. EPA.
- d. EPA. Link by the Banco de España owing to the change in the operational definition of unemployment in 2001.
- e. QNA. Compensation per employee in the market economy.

least in part, with the effects of the labour reform approved in mid-2006, which prompted a considerable rise in the conversion of temporary to permanent contracts at the end of that year. However, the scope of this reform does not appear to be enough to reduce in a significant and durable fashion the aforementioned ratio in the Spanish economy. Accordingly, there is a continuing need to address a far-reaching reform of the hiring mechanisms currently in place. Contracts registered with the SPEE (National Public Employment Service) broadly corroborate this diagnosis since permanent contracts as a proportion of total contracts stood at 11.9% in 2007, only slightly above their level before the entry into force of the labour reform. During the year the temporary employment ratio was fairly stable in Q2 and Q3, and only in Q4 did it fall significantly, which might be related to the rise in unemployment and to the marked slowdown in job creation in the construction sector, where the ratio is very high.



SOURCES: INE and Ministerio de Trabajo y Asuntos Sociales.

- a. Information on collective bargaining agreements recorded to March 2008.
 b. Market economy.
 c. Year-on-year rate of change in December.

Despite the continuing dynamism of immigrant inflows, the growth of the labour force slowed.

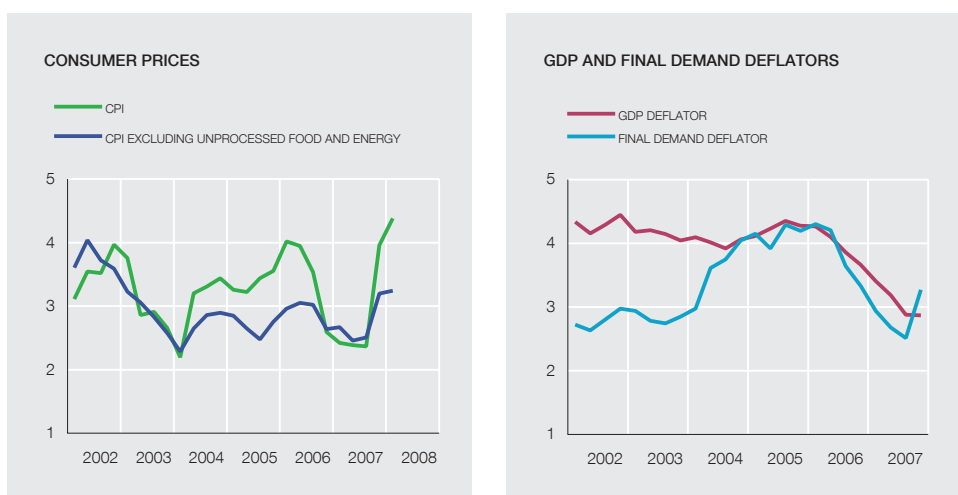
The growth of the labour force eased off to a rate of increase of 2.8%, below the related figure in the previous years. This slowdown in labour supply came about despite the fact that the growth of the population of working age retained a high rate of expansion (1.8%), owing to an increase in the foreign population on a similar scale to that of previous years, in a setting in which economic dynamism prevailed. However, the participation rate stood at 58.9%, with a year-on-year increase of only 0.6 pp, compared with increases of close to 1 pp in previous years. This lower increase in the number of participants in the labour force is chiefly attributable to the immigrant population, the participation rate for whom declined by 1 pp in 2007. Among the Spanish population, women continued to progressively join the labour market, and their participation rate rose by 0.9 pp.

Over 2007 as a whole, the unemployment rate reached an all-time low, although it rose at the end of the year.

Unemployment held virtually stable, with a slight decline in the unemployment rate (of 0.2 pp to 8.3% in 2007 as a whole), although the slowing course of employment during the year led to a rise in the unemployment rate in Q4 to 8.6%. The structural component of unemployment is estimated to have fallen very slightly or to have stabilised, according to the different estimates available, remaining slightly above the actual unemployment rate. While the estimated level of the NAIRU or structural unemployment rate is low in historical terms, it remains a relatively high level compared with other economies. That highlights the need to make further improvements to the structural functioning of the labour market, enabling further sustainable cuts to the unemployment rate to be achieved.

Wages rose slightly...

As regards wage developments, wage settlements under collective bargaining agreements stood at 2.9% in 2007, below the average increase in 2006. This reflects, at least in part, the improved inflation performance in the opening months of the year. The wage increases appear to be in line with the implicit guidelines laid down by the AINC (Inter-Confederal Collective Bargaining Agreement) which, in principle, relate wage rises above the nominal benchmark of 2% to increases in productivity. Moreover, the deviation by inflation in 2006 from the 2% reference (0.7 pp) was less than the preceding year, meaning that the impact of the indexation clauses on wages paid in 2007 (0.3 pp) was lower than last year (see Chart 5.10). However, despite the favourable behaviour of wage bargaining, QNA estimates of compensation per



SOURCES: INE and Banco de España

- a. Year-on-year growth rates.
b. Merchandise import unit value indices.

employee exhibited a slight rise in 2007 to 3.4%. This wage rise is also seen in other indicators, such as the quarterly labour costs survey, which estimates growth in labour costs of 4% in 2007, 0.5 pp above the 2006 figure. In real terms, labour costs borne by companies¹ fell in 2007, albeit less sharply than in previous years.

giving rise to positive wage drift, which generates risks of bigger rises in labour costs in the future.

The trend of wage costs entails slightly positive wage drift² in 2007, which had not been observed in the past decade. In principle, the composition effects explaining negative drift in this period – linked to the process of strong job creation, with average wages lower than those previously in place – have not altered with sufficient intensity in 2007 to explain this change in sign in drift. In any event, this shows that the relatively modest wage increases observed in recent years have been influenced by these composition effects whereby, in their absence, the behaviour of wages may be more unfavourable in the current phase of deceleration in the economy. Indeed, with a view to 2008, an appreciable rise in labour costs is expected as a result of the bigger wage increases agreed under collective bargaining (3.4% to March) and, above all, of the greater impact of the indexation clauses, estimated at somewhat over 1 pp, owing to the sharp rise in inflation in late 2007.

5 Prices and costs

Inflation slowed in 2007 as a whole, but exhibited a widely differing profile over the course of the year.

The consumer price index (CPI) posted moderate growth rates for much of 2007, allowing average inflation to fall by 0.7 pp compared with the previous year to 2.8%. But it underwent a sharp rise late in the year, which has run into 2008 to date, placing this rate at 4.5% in March (see Chart 5.11). This trend reflects, above all, the impact of the energy and food commodities shocks on world markets. Moreover, the effects of the shocks were more intense in Spain than in the euro area, as is explained below, meaning that the inflation differential (measured with the HICP) widened to 1.2 pp in December 2007. In addition to inflation originating externally, the Spanish inflationary process was driven by the greater dynamism of labour costs and by the widening of business margins, and this despite the lesser momentum of household consumer spending.

1. That is to say, using the value added deflator in the market economy as a price index. In purchasing power terms, wage growth was higher than the average consumer price index over the year. 2. Defined as the difference between the increase in wage settlements under collective bargaining, including the effect of the indexation clauses, and the increase in compensation per employee in QNA.



SOURCES: INE and Banco de España.

a. Year-on-year rates calculated using seasonally adjusted base 2000 National Accounts series.

The rise in inflation was brought about by dearer oil...

For the year on average, Brent oil prices increased by \$8 per barrel compared with 2006 to \$73. However, in the closing months of 2007 there was a marked rise in oil, which exceeded \$90, and which was only partly offset by the appreciation of the euro against the dollar. These trends have stepped up in the opening months of 2008. In comparison with the euro area, the greater relative weight in Spain of liquid fuel expenditure in the basket of consumer goods and the lesser weight of excise duties on these products have meant that the changes in their prices have had a greater effect on Spanish price indices than on the related indices in the euro area. That largely explains both the narrowing of the differential with the euro area in the first half of 2007 and its widening in the final months of the year. The pass-through of oil price rises to the prices of non-energy products was relatively limited (in line with the econometric estimates available), essentially affecting some transport services. Conversely, the pace of regulated gas and electricity prices eased in 2007, contributing to mitigating the differential with the euro area.

and by the marked increases in food prices.

The rise in inflation likewise reflects the course of prices of certain foodstuffs, such as bread and milk. The higher cost worldwide of these products is a result of a significant contraction in their production, caused by weather-related factors, against a background of low stock levels, whereby the latter have lost their ability to act as a buffer for supply and demand mismatches. There has also been a marked rise in the demand for some foodstuffs, particularly in the emerging countries that have posted high increases in their per capita income, whose con-

sumers are shifting their expenditure to food products with a higher protein content. This global phenomenon in dearer food products is likewise affecting other European countries. The fact that the magnitude of this phenomenon is notably greater in Spain is partly the outcome of the greater weight of these products in the Spanish household consumer basket, but it may also reflect idiosyncratic elements, such as the existence of an insufficient level of competition in certain markets.

Services prices continued to post very high growth rates, while non-energy industrial goods showed lower rates of increase in their prices than in the euro area.

In 2007, services prices continued to rise at a rate of close to 4%. This high and persistent growth might reflect the insufficient degree of competition in certain activities, although some sectors, such as the hotel and restaurant trade, have persistently been exhibiting price increases of close to 5%, which considerably hampers any slowdown in prices in services. On the positive side, the rate of increase of non-energy industrial goods prices eased markedly during 2007, assisted by the appreciation of the euro and by the greater competition in some markets (such as clothing and footwear), with rates below those of the euro area. The prices of other products, such as those related to the car industry, also posted lower rates in the face of weakening demand. Finally, the prices of regulated drugs were substantially cheaper.

The GDP deflator declined notably in 2007.

The GDP deflator increased at a rate of 3.1% in 2007, almost 1 pp below the previous year's rate. The decline in the investment in construction deflator – amounting to more than 3 pp, and linked to the moderation of house prices and of civil engineering costs – and in the export deflator were two of the main factors behind this slowdown. In contrast, the market economy value added deflator rose slightly in 2007 to 3.7%.

Despite the fact unit labour costs rose, margins continued to widen.

In the market economy as a whole, the acceleration in the GVA deflator was accompanied by a rise on a similar scale in unit labour costs (see Chart 5.11), the result of greater compensation per employee and of lower growth in apparent labour productivity. The combination of these trends was consistent with a further widening of unit operating margins, similar to that in previous years.

Margins widened in industry and narrowed in construction.

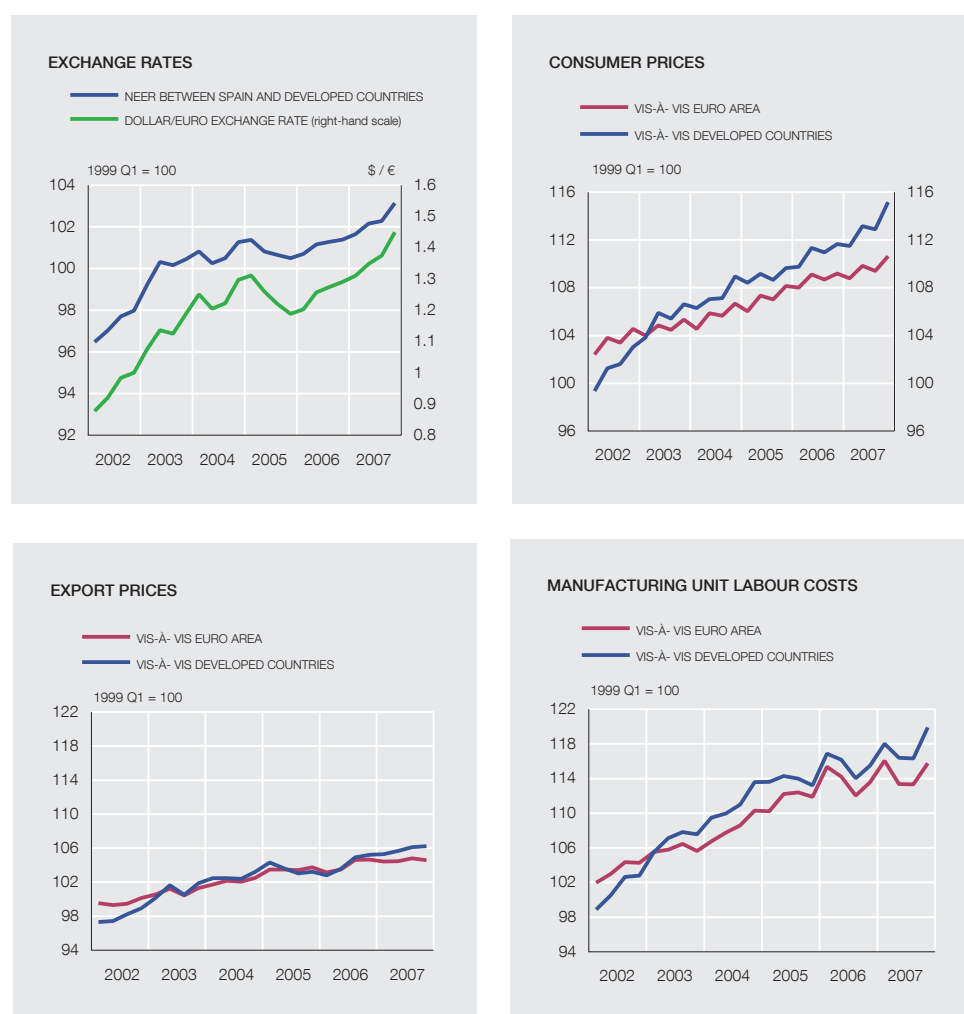
The behaviour of these variables in the various branches of activity was mixed. In industry, the improvement in productivity made for a slowdown in unit labour costs, while the value added deflator held at high levels, which translated into a considerable widening of margins. Margins also increased in market services, but more moderately, against a background of quickening unit labour costs. The diminished dynamism of the construction sector was reflected in a reduction in its deflator which, combined with high unit labour costs, due partly to the low productivity in this branch, made for a contraction in its unit margins.

The Spanish economy's main price indicators continued to point in 2007 to a loss of competitiveness.

The price-competitiveness indices underwent a further deterioration in 2007 which affected unevenly the relative position vis-à-vis the different markets (see Chart 5.13). Outside the euro area, the losses in price-competitiveness were of a greater intensity than the previous year, since the narrowing of price and cost differentials was more than offset by the appreciation of the euro during the year. In contrast, vis-à-vis the euro area the deterioration in the price-competitiveness indicators was generally more contained, with the inflation differentials of export prices and of unit labour costs in manufacturing holding steady.

6 Net borrowing of the nation and the capital account of the institutional sectors

The net borrowing of the Spanish economy continued to increase in 2007 up to 9.5% GDP, 1.4 pp up on the previous year. This deterioration in the external balance (see Chart 5.14) was essentially due to the increase in the current account deficit, which stood at 10% of GDP, and, to a lesser extent, to the decline in the surplus on capital transactions, the weight of which in



SOURCE: Banco de España.

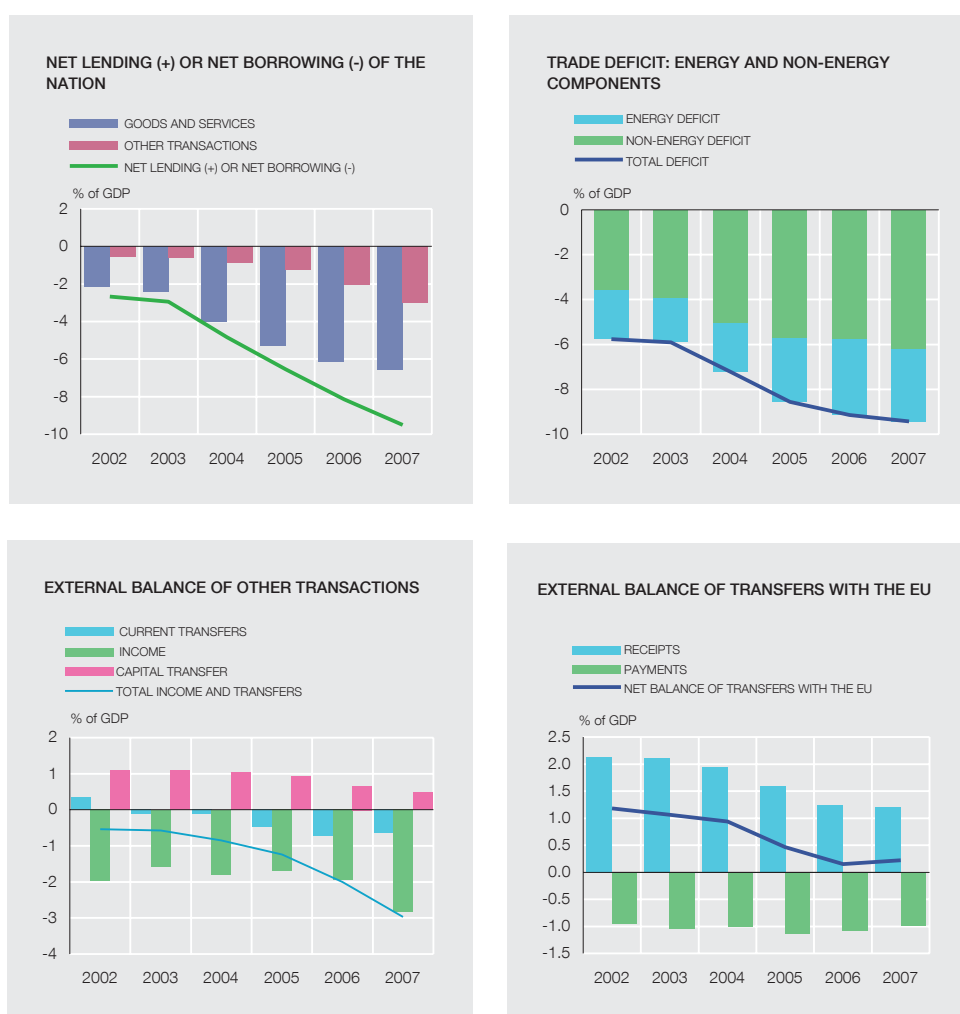
a. An increase in the index denotes a loss of competitiveness, and viceversa.

Net borrowing continued to increase against the background of the moderating rate of increase of the trade deficit.

GDP fell by 0.2 pp to 0.5%. The appreciable widening of the income deficit, of the order of 0.9 pp of GDP, was the factor that most contributed to the deterioration in net borrowing. As a proportion of GDP, the trade deficit increased by 0.3 pp to 8.4%, less than half the increase in 2006. This reflected the slowdown in the nominal energy deficit, the contribution of which to the increase in the trade deficit was small, while the rate of increase of the non-energy balance stepped up. By geographical area, the deficit with the non-Community countries slowed, while that with the EU increased significantly. The export coverage rate fell by 0.9 pp, accounting for 67.5% of nominal imports.

The weight of the tourism surplus in GDP continued to move on a declining course, with receipts and expenditure less dynamic.

During 2007, and for the seventh year running, the weight of the tourism surplus continued to diminish. It fell to 2.9% of GDP against a backdrop of less dynamic receipts and of some deceleration in expenditure. The slowdown in receipts was less marked than that in the number of incoming tourists, which points towards an increase in average spending per tourist. In this respect, in 2007 hotel stays recouped some of their relative weight in the sector's receipts, with a favourable trend in urban destinations and in business tourism, where average daily expenditure is higher. As to other services, exports increased with less intensity than imports, with dynamic behaviour in both cases, which has prompted a slight correction in the attendant deficit to 1% of nominal GDP.



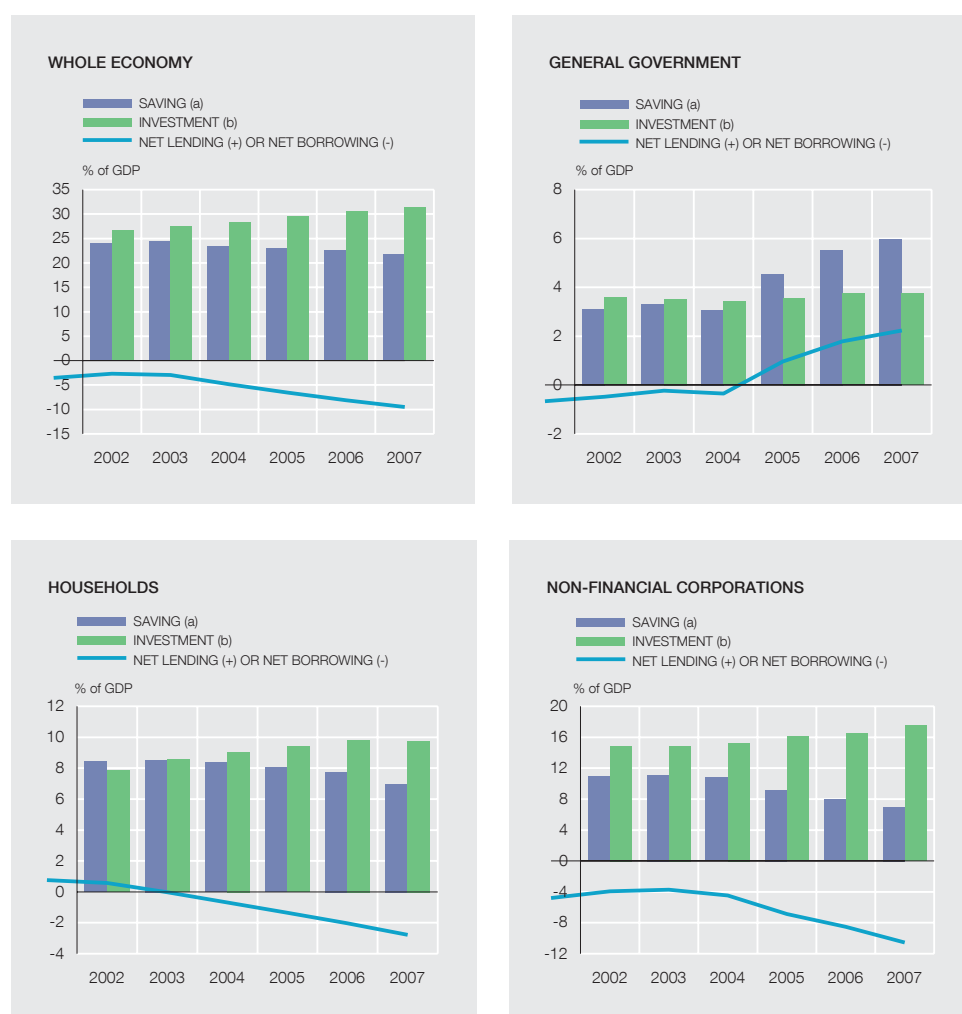
SOURCES: INE, Customs Department and Banco de España.

The income deficit accounted for most of the increase in net borrowing.

Against a background of generalised interest rate rises and the growing external debt of the Spanish economy (which led to a debit balance of its international investment position of close to 70% of GDP at the close of 2007), the investment income deficit as a proportion of GDP widened by 0.9 pp to 2.8%. From the standpoint of the balance of payments, which allows a more disaggregated analysis of this caption, the increase in the income deficit was particularly discernible in portfolio investment and, more specifically, in medium and long-term bonds, which continued to be the main source of financing of the Spanish economy, despite the change experienced in the wake of the financial turmoil unleashed in the summer. The surplus on foreign direct investment income declined significantly in 2007 as a result of the fall-off of dividend receipts and of the increase in expenditure under this heading.

The deficit on current transfers was corrected slightly, but was not able to offset the reduction in the surplus on capital transactions.

There was a deficit on net current transfers in 2007 of 0.6% of GDP, 0.1 pp less than in 2006, with the growth rate of receipts considerably outpacing that of expenditure. On the expenditure side, that relating to general government under the heading of development aid continued to increase, a trend that might hold in the coming years in the light of the growth targets set for these types of funds. Net expenditure relating to migrants' remittances – which already amounts to 0.8% of GDP, according to balance of payments data – also increased, albeit at a more moderate rate than in 2006. The weight in GDP of the surplus on capital transactions once again fell by 0.2 pp to 0.5%. Under overall current and capital transfers, the surplus with



SOURCES: INE and Banco de España

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

the EU improved slightly, interrupting the declining path of recent years. This increase was the outcome of the decline in current payments to the EU, which offset the slight reduction of receipts as a percentage of GDP, reflecting the slight fall in capital transfers.

The increase in the nation's net borrowing reflected the behaviour of non-financial corporations, in a setting of dynamic business investment, and of households.

The increase in the Spanish economy in net borrowing in 2007 was due not only to the increase in investment (of 0.7 pp to 31.4% of GDP), but also to the decline in national saving (of 0.6 pp to 21.9% of GDP) (see Chart 5.15). The increase in investment was centred essentially on non-financial corporations (and, specifically, on capital goods), which is a favourable feature as that entails a rise in the economy's endowment of productive capital. Household and general government investment held practically stable as a percentage of GDP. As to saving, the fall observed in 2007 was the result of the declines of 1.4 pp of GDP in the case of non-financial corporations and of 0.8 pp in that of households, which entails a steepening of the declining path seen in recent years in both sectors. Conversely, public saving continued to increase. Consequently, the increase in the nation's net borrowing in 2007 was due to the widening of the debit balance of non-financial corporations (by 2.1 pp to 10.6% of GDP) and of households, which increased by 0.8 pp to 2.8% of GDP. The 0.4 pp improvement in the budget balance to 2.2% of GDP only partly offset the effect of private-sector saving and investment decisions on the nation's net borrowing.

1 Introduction

In 2007, financing conditions for the private sector continued to tighten, especially after the episode of financial turmoil...

Financial developments in the Spanish economy in the first half of 2007 showed continuity of the main trends observed the previous year. Thus, the increase in Eurosystem and money market interest rates was passed through to the cost of financing for the private sector, while the gradual slowdown in house prices that commenced in 2004 continued. Against this background, household debt continued to decelerate while that of corporations began to show the first signs of moderation. Although credit institutions continued to cover the gap between the growth of lending and of deposits by means of issuance of long-term fixed-income in the first half of the year, this pattern of behaviour changed considerably after the summer.

In fact, financial developments in the second half were driven by the turmoil that arose from the rise in the US sub-prime mortgage default rate. This episode resulted in a general repricing of risk and significant tensions in international interbank and fixed-income markets, which led to a rise in credit spreads, that was more pronounced in the case of debt issued by the financial sector and, in particular, in that of securitisation instruments and structured products.

This episode entailed a tightening of financing conditions for the private sector, through two channels. First, the rise in the interest rates on interbank transactions and the rise in corporate debt credit risk premia resulted in further increases in the cost of financial resources for households and corporations. Second, according to the results of the Bank Lending Survey, credit institutions applied more restrictive credit conditions, basically as a consequence of the reassessment of risk, amid a deterioration in the global economic outlook. The greater difficulty obtaining funds on the wholesale markets appears, by contrast, to have had a limited impact on the supply of credit.

the decline in the growth rate of household and corporate debt steepening somewhat.

Hence, the slowdown in non-financial private sector debt intensified in the second half, its growth rate standing at end-2007 at around 13% in the case of households and 17% in that of corporations (some 7 pp and 11 pp less than a year earlier, respectively), against a background in which the pattern of gradual slowdown in real estate prices continued (4.8% year-on-year growth in December 2007, as against 9.1% in the same period of 2006), as it has also in the first few months of 2008. The reduction in the rate of growth of credit granted by resident financial institutions to corporations was especially pronounced in the case of funds for construction and real estate services which, even so, ended the year with year-on-year rises of more than 14% and 24%, respectively. These developments were, however, compatible with a mild acceleration in the funds channelled to industry and other services (with growth rates which increased, respectively, from 14% and 21% in 2006, to almost 19% and 23% last year), in line with the buoyancy of the productive investment undertaken by these sectors.

The rate of growth of the private sector debt ratio moderated and household wealth stabilised.

The reduced dynamism of the financing raised by the private sector led to more moderate increases than in previous years in its debt ratios. However, the associated debt burden rose to a greater extent, owing to the increase in the average cost of liabilities, which contributed to slowing the growth of household and corporate net income.

Meanwhile, household net wealth hardly changed in real terms, as a result of a moderate increase in the real estate component, stemming from the rise in house prices, which offset the slight decline in the value of net financial assets.

Banks' financial position remained sound and the direct effect of the turmoil was very limited...

Spanish credit institutions faced the turmoil from a sound financial position, as reflected in the low doubtful assets ratios (both from an international and historical perspective), high levels of profitability, comfortable solvency and high coverage of doubtful loans, in the latter case with the provisions accumulated during the good years. This position was affected comparatively less than in other countries by the instability, since their exposure to US sub-prime mortgages was very limited, they had no financing commitments to structured vehicles which invest in these assets and their short-term refinancing requirements were relatively small.

although this episode has made it more difficult to finance the gap between lending and deposits.

However, the turmoil has entailed a tightening of the financing conditions of financial institutions in the international wholesale markets, especially in the long-term debt ones, which are precisely those they have used most in recent years. In these circumstances, shorter-term instruments have gained weight in the liabilities of these intermediaries, such as commercial paper, the cost of which was less affected by the shocks, and interbank loans, including operations with the Eurosystem. These developments obviously entail an increase in refinancing risk, although the relative size of these short-term sources is still at moderate levels (around 13% of liabilities as at end-2007, approximately 2 pp higher than in the previous year).

The lower recourse to financing through long-term securities had a bearing on financial flows with the rest of the world. Thus, during the second half, the private financial sector played a less active role in the channelling of capital inflows into Spain. In parallel, and also partly linked to the turmoil, the net acquisition of external assets by corporations and institutional investors fell. However, this was not sufficient to fully offset the decline in the external funds obtained by financial institutions, so that part of the funds necessary to finance the current account deficit was covered by means of a decline in the Banco de España's credit position vis-à-vis non-residents, especially in Q3 and also, albeit to a lesser extent, in Q4.

On aggregate, the financial position of the private sector is solid, although the financial strains may affect economic dynamism.

The strength of credit institutions' financial position, their limited exposure to assets affected by the turmoil and the financial structure of their liabilities, which are concentrated in the longer term, has so far limited the impact of this shock on the cost and availability of financing for the private sector. However, given the Spanish economy's large external fund requirements, the duration of this episode and the uncertainty regarding when it will end involve a risk that domestic credit conditions may become more restrictive.

Meanwhile, the rate of growth of household and corporate debt moderated in 2007, so that this variable began to move towards a more sustainable path. At the same time, house price developments continued to be consistent with a scenario of gradual approximation of real estate values to their long-term equilibrium level. Thus, the aggregate financial position of households and corporations currently shows no signs of fragility. However, the composition of these sectors is not homogenous and this overall sound position is not incompatible with the existence of certain groups of agents with a relatively higher level of vulnerability. The pattern of the slowdown that the economy has embarked upon will probably tend to increase the degree of financial pressure, especially on those segments with higher debt and greater activity in the sectors most affected by the slowdown in GDP. In any event, the financial system's safety margins afford it significant resilience against the possibility that the risks of greater financial pressure will materialise.

2 Financial flows in the Spanish economy

2.1 HOUSEHOLDS

In 2007 household net borrowing stood at 1.6% of GDP, a similar level to the previous year. This was compatible with a decline in the sector's gross asset and liability flows, which stood at 7.1% and 8.7% of GDP, respectively (see Chart 6.1).

FINANCIAL TRANSACTIONS OF THE NON-FINANCIAL PRIVATE SECTOR (Contributions of components)

CHART 6.1



SOURCE: Banco de España.

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

b. Excluding investment funds.

c. These are largely made up of commercial loans.

Household net borrowing remained unchanged, while there was a reduction in flows of liabilities and...

Thus, the year-on-year rate of change of household financing stood at around 13%, as against almost 20% the previous year. This was consistent with the behaviour of the fundamental determinants of this variable: as explained in Box 6.1, the reduced buoyancy of lending to households was linked to the tightening of financing conditions, and the deceleration in the price of real estate and the sector's spending. The slowdown was observed both in funds for house purchase (the year-on-year growth rate of which ended the year at close to 13%, having been at rates of around 20% since 2000) and in funds for consumption and other purposes, which at end-2007 posted growth of 11%, approximately 6 pp lower than in December 2006.

assets, accompanied by a reallocation among instruments.

The increase in asset holdings was accompanied, especially from Q3, by a shift towards products less exposed to the financial market volatility and, in particular, those with higher yields, a shift that was, moreover, favoured by the increase in the yields offered by credit institutions, against a background of strains on the wholesale markets and growing competition to obtain

Following a prolonged period of marked buoyancy, lending to households started to show the first signs of easing in 2006. These signs have intensified slightly in the past year. Nevertheless, the rate of growth has remained relatively high, standing at around 13% in year-on-year terms in December. The breakdown into components shows that both house purchase financing and consumer and other lending contributed to this trend (see Chart 1). Thus the growth of funds raised for real estate purchases fell by 6 pp to 13% in 2007, after having stood at around 25% barely two years earlier. The rate of change of consumer and other credit, which had moved up somewhat in the previous year, fell back by a similar amount and ended with growth of 11% (see Chart 2).

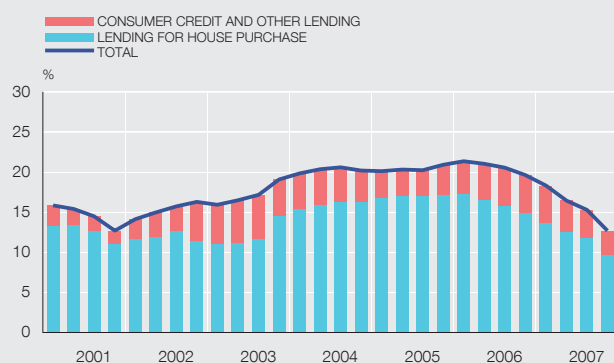
The decline since 2006 in the rate of expansion of lending to households has been broadly consistent with the recent behaviour of its main determinants. As can be seen in Chart 3, household wealth, which is a key variable in explaining the behaviour of household debt due to the role that real estate plays as loan collateral, has undergone a sharp slowdown, more marked in 2007, as a result of the deceleration in house prices. At the same time, the less vigorous consumption and residential investment, along with the rising cost of bank loans since end-2005, has dampened the growth of household liabilities.

Through the use of an estimated equation of household credit in real terms,¹ the observed changes in Spanish household liabilities, both in the period of expansion in the first half of the decade and in the current stage of gradual deceleration, can be explained by the behaviour of their fundamental determinants. Thus the marked buoyancy of lending to households in the period 2001-2005 was driven by the increase in their wealth, by the strength of consumption and residential investment and by the easy credit conditions. By contrast, in the last two years, and particularly in 2007, the contribution of these factors to the sector's liabilities has moderated notably, even turning negative in the case of the interest rate.

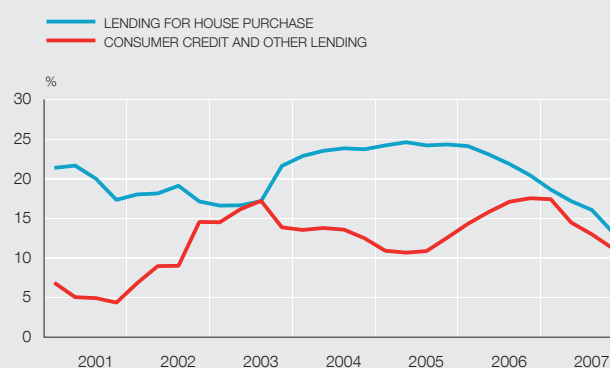
Lastly, in 2007 Q4 household credit grew slightly below the expected rate, based on the determinants included in the estimated equation, after various periods of somewhat faster than expected growth (see Chart 4). This discrepancy may be related to the tighter terms and conditions of loans to households following the financial turbulence last summer, as suggested by the responses to the latest bank lending surveys. In any event, the slight difference between the observed growth of household borrowing and that explained by the model suggests that this factor has so far been of limited significance.

1. For more details, see Nieto (2007), *The determinants of household credit in Spain*, Documentos de Trabajo, nº 0716, Banco de España.

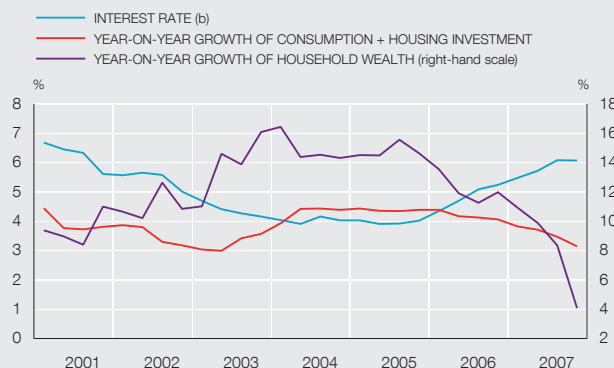
1 YEAR-ON-YEAR GROWTH OF CREDIT TO HOUSEHOLDS. CONTRIBUTION BY COMPONENTS



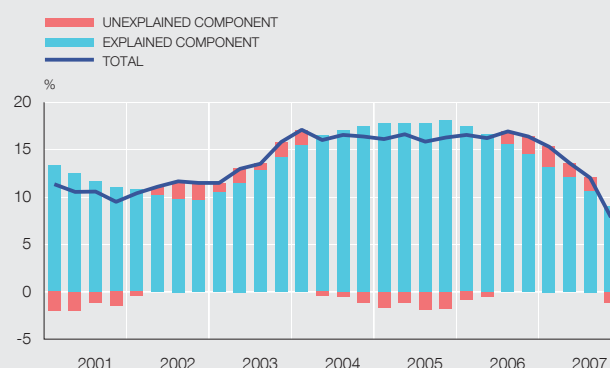
2 YEAR-ON-YEAR GROWTH OF CREDIT TO HOUSEHOLDS BY END-USE



3 CHANGES IN POSSIBLE DETERMINANTS OF CREDIT (a)



4 CONTRIBUTIONS TO THE YEAR-ON-YEAR GROWTH OF HOUSEHOLD CREDIT IN REAL TERMS



SOURCES: INE and Banco de España.

a. All variables except interest rates are expressed in real terms.

b. Calculated as a weighted average of rates on new lending to households for house purchase and for consumption and other purposes.

funds (see Box 6.2). In this way, time deposits grew at a year-on-year rate of more than 25%, while other deposits and shares in investment funds grew at negative rates and insurance and pension funds displayed less buoyancy than in 2006.

2.2 NON-FINANCIAL CORPORATIONS

Corporations' net borrowing continued to increase...

Non-financial corporations' need for funds again increased notably, partly driven by the continued buoyancy of gross capital formation and by a certain contraction in saving. Thus, the debit balance of the sector's net financial transactions increased to around 12% of GDP, almost 3 pp above the previous year's level.

This was accompanied by a decline of more than 9 pp of GDP in corporations' financial investment, which stood at 14% of GDP (see Chart 6.1). This slowdown in the acquisition of assets was apparent mainly in the reduced buoyancy of purchases of shares and other equity, especially in non-resident companies. In consequence, the financing gap, an indicator that approximates the funds needed to cover the difference between the sector's gross saving and gross capital formation plus foreign investment of a permanent nature, barely grew, representing 17% of GDP (as against 16.4% the previous year).

although their debt began to decelerate, especially in the case of construction and real estate companies.

Corporations' liability flows also fell, to 25% of GDP (down 6 pp from a year earlier). This reduction affected all the items that make up debt financing bearing explicit interest, among which the lending of resident credit institutions continued to be of particular importance. Thus, overall, the sector's debt decelerated significantly, although it continued to grow at a high rate (around 17%, as against 28% the previous year). This trend is basically explained by the slowdown in lending to construction and real estate companies, whose bank borrowing grew by 14% and 24%, respectively (as against 33% and 50% in 2006), since in the rest of these sectors there was even a certain acceleration, in line with the buoyancy of private productive investment. By contrast, equity financing was more vigorous, representing 5% of GDP, double the level in 2006.

2.3 GENERAL GOVERNMENT

Net lending by general government again increased

General government continued to expand its net lending, to 2.2% of GDP, up 0.4 pp from 2006 (see Chart 6.2). This improvement was a consequence of the increase in the central government surplus, since the Social Security financial surplus fell somewhat last year and the regional and local government deficit grew slightly. The breakdown by instrument shows that the bulk of public sector saving took the form of an increase in the volume of deposits net of lending. Meanwhile, in 2007, there was a reduction in the outstanding balance of long-term securities held by other sectors and an increase in that of short-term securities, although in both cases by small amounts.

2.4 INVESTMENT AND FOREIGN FINANCING OF THE SPANISH ECONOMY

Net borrowing increased...

As a consequence of the increase in funds required, in net terms, by the non-financial private sector (basically, by companies), which was not offset by the improvement in the credit balances of general government and financial institutions, the Spanish economy's net borrowing increased again, so that the debit balance of its net transactions reached 9.5% of GDP (see Chart 6.3).

and, in the wake of the turmoil, there were significant changes in cross-border financial flows.

In the year as a whole, the nation's net borrowing continued to be mediated mostly through financial institutions (excluding institutional investors). However, as a result of the turmoil, capital inflows channelled through this sector declined significantly. At the same time, there was a contraction in the rate of accumulation of net assets vis-à-vis non-residents by companies and institutional investors, this latter development being partly linked to net redemptions of investment fund shares, and a decline in the liabilities of general government held by non-residents, in line with the reduction in the outstanding balance of such instruments. As a result of all these changes, part of the resources necessary to finance the current account deficit was covered by means of a reduction in the external credit position of the Banco de España (see Chart 6.3).

2007 saw some significant changes in the composition of households' financial assets. Particularly noteworthy was the increase in time deposits, which posted a growth rate exceeding 25% and accounted for more than half of net flows (see Chart 1). Also up, albeit less so, were net purchases of fixed-income securities and of shares. By contrast, net investments in the form of sight deposits and investment funds were negative and flows into insurance and pension funds lost momentum.

Various factors may help to explain this change in the composition of household financial assets, in which time deposits have gained weight at the expense of sight deposits and investment funds. These developments, which first became apparent in late 2006, stemmed from the changes in tax regulations introduced by Law 35/2006 on personal income tax¹. This law made the tax burden equal on all the different forms of income from savings and as a result investment

funds ceased to enjoy some of their advantages relative to other instruments.

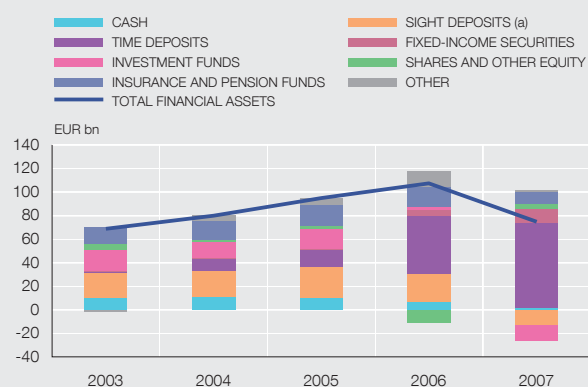
In this setting, the emergence of the financial turbulence last summer was one of the main factors behind the changes in the composition of household financial assets. This turmoil notably raised the volatility of market prices, particularly those of shares, and may have induced a shift from equity-linked instruments to less risky assets such as deposits. Evidence of this is that the largest net redemptions took place in investment funds other than those investing in euro-denominated fixed income (see Chart 2).

In addition, the difficulty in raising funds in the wholesale markets that has accompanied the financial turmoil prompted credit institutions to adopt a more active policy towards attracting deposits, particularly time deposits, which offer a higher return. It was precisely the second half of 2007 that saw the largest increase in flows towards these instruments (see Chart 3).

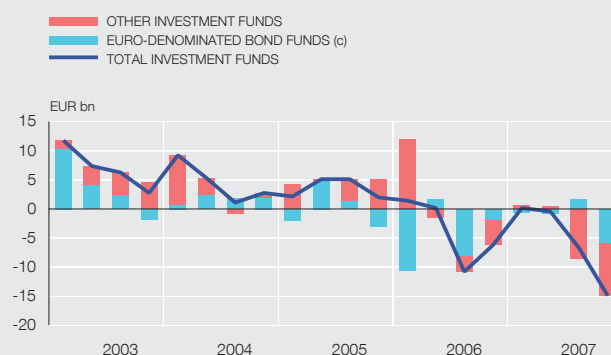
Finally, the widening of the difference in returns between time deposits, which have tracked financial market behaviour more closely, and

1. See Víctor García Vaquero and Luis Ángel Maza, *El tratamiento de los instrumentos financieros en el nuevo IRPF* (The treatment of financial instruments under the new personal income tax), Boletín Económico, January 2007.

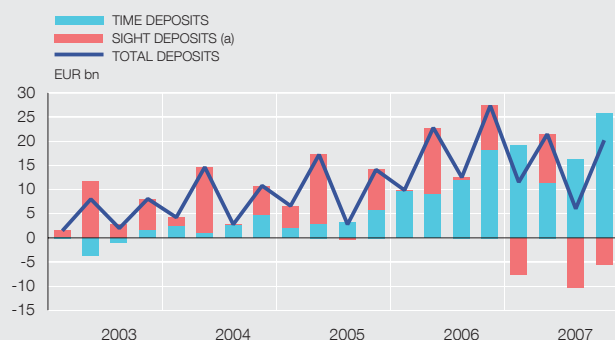
1 FINANCIAL ASSETS. FLOWS



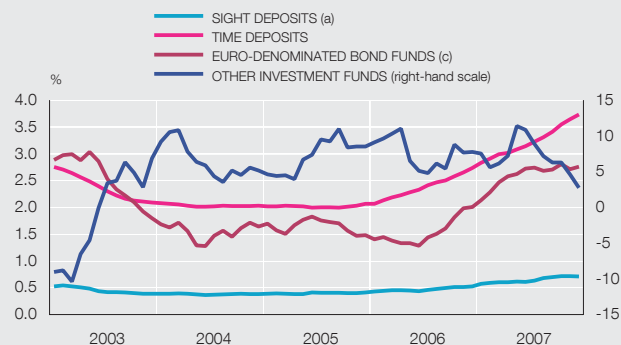
2 NET INVESTMENT IN INVESTMENT FUNDS (b)



3 NET INVESTMENT IN DEPOSITS



4 RETURN ON SOME FINANCIAL ASSETS



SOURCE: Banco de España.

a. Including savings deposits.

b. Net subscriptions to total investment funds, irrespective of the investing agent.

c. Including money market funds.

sight deposits, which are more resistant to interest rate rises, has increased the opportunity cost of holding deposits that earn lower interest (see Chart 4).

These developments have significant implications. On one hand, the decrease in the weight of equity-linked instruments relative to deposits makes for less variability in asset values, albeit naturally at the expense of lower expected long-term returns. On the other, the shift

from sight deposits to time deposits is accompanied by increased remuneration, with some loss of liquidity. From the standpoint of credit institutions, the amount of investment fund sales channelled to deposits has allowed them to raise funds at a time when these are hard to obtain by other means. However, apart from this possible transfer of funds, the continued dynamism of deposits in the medium-term is constrained by the limited existing margin for increasing household saving.

Relative to GDP, the volume of capital inflows fell by almost 4 pp from 2006, with significant changes in their composition from the summer. The growth of liabilities vis-à-vis non-residents channelled through securities other than shares issued by financial institutions moderated significantly, amounting to around 9% of GDP in 2007 as a whole, almost 11 pp less than in 2006, in step with the reduced buoyancy of long-term fixed-income placements owing to the tightening of financing conditions in the international debt markets (see Table 6.1). By contrast, the resources raised by these institutions in the interbank market increased significantly, representing almost 7% of GDP, 6 pp more than in the preceding year, so that the net flow of external funds from this market turned positive. Holdings of shares and other equity in non-financial corporations by non-residents also increased notably, this being consistent with the rise in foreign direct investment in Spain, which stood at around 4% of GDP (1.5 pp more than in 2006), a development largely explained by a single company take-over.

Capital outflows also declined, to a volume equivalent to 13% of GDP, 5 pp less than in the preceding year. Credit institutions' investments were mainly in the form of shares and other equity and interbank loans. By contrast, institutional investors unwound positions, in net terms, in the rest of the world, both in fixed-income and equities. At the same time, purchases of shares and other equity by non-financial corporations declined relative to 2006, as a result of a substantial reduction in their portfolio acquisitions, since Spain's direct investment abroad increased slightly, in terms of GDP, to stand at more than 8%.

The debit balance of the international investment position increased again

As consequence of the transactions mentioned in this section and of the change in the prices of financial instruments and in the exchange rate there was an increase in the debit balance of the Spanish economy vis-à-vis the rest of the world, to around 70% of GDP, about 11 pp more than at end 2006. This was a result of the increase in the value of the external debt of the private sector (basically financial institutions) and of a reduction in the net credit position of the Banco de España, which were not offset by the reduction in the liabilities accumulated by general government vis-à-vis non-residents.

3 Spanish financial markets

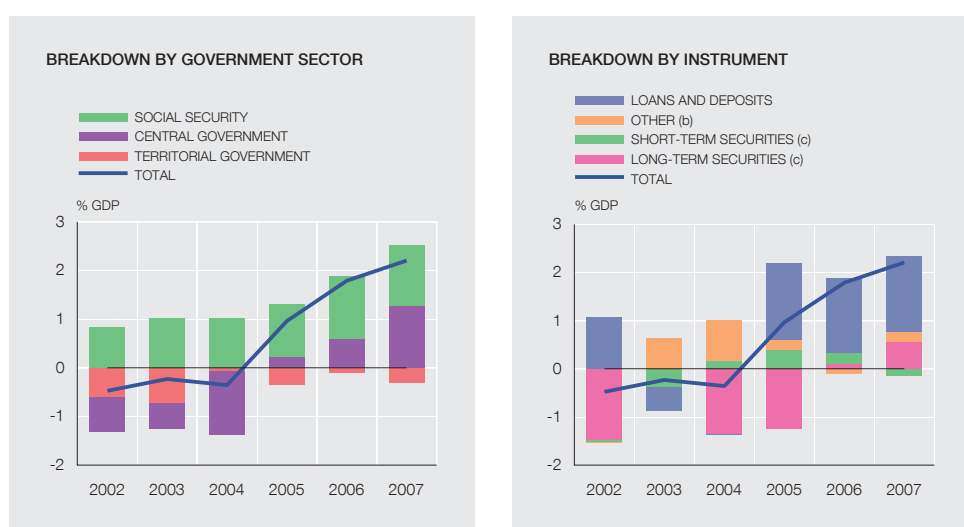
3.1 PRIMARY MARKETS

Net securities issuance grew, albeit less than in 2006, owing to the stagnation in the fixed-income market...

The net issuance of marketable securities by resident sectors totalled €265 billion in 2007, implying a year-on-year growth rate of 15%, as against 26% in 2006 (see Table 6.2). After several years of high growth rates, the net supply of fixed-income securities in 2007 as a whole held at around the same levels as in the previous year, basically as a result of the lower recourse by credit institutions (one of the main issuers) to these markets, against a background of tightening financing conditions owing to the financial turmoil, which was especially intense in the case of longer-term instruments.

GENERAL GOVERNMENT NET FINANCIAL TRANSACTIONS (a)
(Contributions of components)

CHART 6.2



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. Includes only liabilities-side transactions.

As seen in Table 6.2, placements made directly by credit institutions declined by 22% in the year as a whole, basically as a result of the fall in long-term transactions. By contrast, the net issuance of commercial paper was notably buoyant. Also notable was the rise in operations carried out by the foreign subsidiaries of these intermediaries (also linked to a large extent to short-term instruments), whose net issuance was positive following three years during which it was negative.

In the second half credit institutions continued to make intensive use of securitisation, although a notable proportion of the securities issued were kept in their portfolios in order to facilitate fund raising in future, in an environment of greater uncertainty over their future liquidity needs. Thus, the net issuance of securitisation SPEs remained highly buoyant, totalling more than €106 billion, with year-on-year growth of more than 50%.

Meanwhile, the net financing raised by non-financial corporations through the issuance of fixed-income securities, carried out directly or through resident or non-resident subsidiaries, barely exceeded €7 billion in 2007, as compared with €11 billion the preceding year. This decline was the result of the lower net issuance of securities by domestic subsidiaries, since the funds obtained in the other two ways were higher than in 2006.

Net issuance by general government continued to decline, in line with the sector's smaller financing requirements, with negative values recorded for the second consecutive year. By sub-sector, as in 2006, the outstanding balance of State securities fell (by €4.7 billion), while that of regional and local securities increased again, although by a smaller amount than in the preceding year (€0.3 billion).

since equity issues increased significantly.

Equity issues were notably buoyant, although the resources raised through this channel remained small in comparison with those obtained on the fixed-income markets. By sector, capital increases by non-financial corporations were notably strong, reaching a net amount of

NET FINANCIAL TRANSACTIONS (a) (Contributions of components)

CHART 6.3



SOURCE: Banco de España.

- a. A negative (positive) sign indicates that the rest of the world grants (receives) financing to (from) the counterpart sector.
b. Insurance companies and collective investment institutions.

€31 billion, six times their volume in 2006. Public offerings remained at similar levels to the preceding year.

3.2 SECONDARY MARKET ACTIVITY

Secondary market activity was notably buoyant

There was a notable increase in activity on the secondary markets, although developments were very uneven across the various segments (see Table 6.3). As in 2006, the most dynamic segments were those linked to equities, both in spot transactions (stock exchange) and in derivatives transactions (MEFF). Thus, trading value on stock exchanges exceeded €1,600 billion, with year-on-year growth of more than 44%. The strength of the primary market, the momentum of takeover bids (17 transactions were completed during the year, with a total value of €47 billion) and the rise in volatility may have contributed to this result. Meanwhile, derivatives trading grew by more than 55% and was concentrated, for another year, in Ibex-35 contracts, although stock options and stock futures also expanded at high rates.

FINANCIAL TRANSACTIONS OF THE NATION
Cumulative four-quarter data

TABLE 6.1

% GDP	2004	2005	2006	2007
NET FINANCIAL TRANSACTIONS	-4.8	-6.5	-8.1	-9.5
FINANCIAL TRANSACTIONS (ASSETS)	13.3	18.7	17.9	12.9
Gold and SDRs	0.0	0.0	0.0	0.0
Cash and deposits	3.2	2.2	5.5	2.2
Of which:				
<i>Interbank (a)</i>	0.7	3.1	3.4	4.2
Securities other than shares	1.8	8.8	-1.2	1.6
Of which:				
<i>Credit institutions</i>	1.0	6.6	-2.1	1.8
<i>Institutional investors</i>	0.3	2.3	0.6	-0.1
Shares and other equity	6.8	5.1	10.2	7.6
Of which:				
<i>Non-financial corporations</i>	3.8	3.9	7.7	5.3
<i>Institutional investors</i>	0.8	0.9	1.2	-1.0
Loans	0.8	1.1	1.8	0.8
FINANCIAL TRANSACTIONS (LIABILITIES)	18.2	25.2	26.0	22.4
Deposits	1.7	5.6	0.3	7.3
Of which:				
<i>Interbank (a)</i>	5.0	7.2	0.6	6.7
Securities other than shares	12.4	15.8	21.7	7.9
Of which:				
<i>General government</i>	2.7	0.2	1.3	-1.5
<i>Credit institutions</i>	4.6	6.3	8.0	3.5
<i>Other non-monetary financial institutions</i>	5.1	9.3	12.4	5.9
Shares and other equity	2.7	0.9	-0.1	4.3
Of which:				
<i>Non-financial corporations</i>	1.7	1.0	-0.5	4.5
Loans	1.3	2.3	3.6	2.5
Other, net (b)	-0.6	-0.9	-1.0	-0.3
MEMORANDUM ITEMS				
Spanish direct investment abroad	5.8	3.7	8.1	8.3
Foreign direct investment in Spain	2.4	2.2	2.2	3.7

SOURCE: Banco de España.

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

b. Includes, along with other items, the asset-side caption showing insurance technical reserves and the net flow of trade credit.

Trading value on the AIAF market easily exceeded €1 trillion, with year-on-year growth of close to 24%, and appreciable increases in all instruments, especially long-term securities.

On the government debt market, by contrast, trading value grew at very low rates, as a result of a year-on-year increase of more than 9% in spot transactions, which offset the fall in forward transactions and in repos and sell and buy-back transactions, although the latter continued to account for most of the activity.

3.3 SECONDARY MARKET

PRICES

Share prices rose moderately, although volatility increased after the summer.

During the year as a whole, stock markets recorded moderate gains, especially in comparison with the two previous years. The IBEX 35 rose by 7.3%, a similar gain to that in the Euro Stoxx 50 for the euro area (6.8%) and greater than that in the S&P 500 (3.5%). Most of this gain was generated during the first half of the year. Price volatility increased substantially from the summer, owing to the financial strains. However, the Ibex 35, like the other main international indices, displayed notable resilience during this period, so that, following the July and August falls, it recovered during the subsequent months, and closed the year at similar levels to those at the end of the first half (see Chart 6.4).

EUR bn				
	2004	2005	2006	2007
NET ISSUANCE BY RESIDENTS	146.6	184.4	231.6	265.6
FIXED INCOME	129.0	180.2	223.9	219.6
Central government	6.7	3.9	-4.8	-4.7
Territorial government	1.5	2.8	2.1	0.4
Monetary financial institutions	61.4	78.0	97.2	76.1
Other financial intermediaries	59.6	95.6	128.5	145.8
Of which:				
<i>Financial vehicle corporations</i>	43.5	53.6	69.7	106.7
<i>Subsidiaries of monetary financial institutions</i>	15.9	39.4	39.7	32.2
<i>Subsidiaries of non-financial corporations</i>	0.0	2.6	16.1	3.7
Non-financial corporations	-0.1	-0.1	1.0	2.0
EQUITIES	17.6	4.2	7.8	46.0
Monetary financial institutions	15.8	1.3	3.0	12.0
Other financial intermediaries	0.5	0.0	0.1	3.5
Non-financial corporations	1.3	3.0	4.6	30.5
PUBLIC OFFERINGS	2.6	0.2	2.5	2.1
MEMORANDUM ITEMS				
Net issuance by foreign subsidiaries	-30.2	-20.6	-8.5	9.5
Financial institutions	-26.6	-15.5	-2.6	8.2
Non-financial corporations	-3.6	-5.2	-6.0	1.3

SOURCE: Banco de España.

The performance by sector, in 2007 as a whole, was highly varied. The largest rises were in telecommunications (34%) and oil and energy (13%), while the worst performing indices were those for banks (-4%), consumer services (-8%) and, especially, real estate (-40%), although the latter ended the year at above its level at the beginning of 2006.

In early 2008 there was a sharper adjustment in domestic and international stock exchange indices, against a background in which the prolongation of the financial instability eventually had a negative effect on the global economic outlook. Thus, by the end of April, the Ibex 35 had accumulated a loss of approximately 9%.

Government debt yields increased in the first half and fell in the second...

In the first half of the year, yields on government debt markets displayed an upward trend at all maturities, in line with the actual and projected course of key Eurosystem interest rates and with the favourable macroeconomic outlook. Thus, the interest rate on 10-year bonds, which stood at 4% in December 2006, reached a high of 4.7% in July. As a result of the financial instability, government debt began to act as a safe haven. This, along with the deterioration in the international economic outlook, contributed to the fall in interest rates, which caused the 10-year benchmark to end the year at 4.4%. During this period, the yield on German debt fell to a greater extent than that on the other securities issued by euro area governments, so that the spread over the German bond widened slightly, that of the Spanish benchmark reaching 10 bp at end-2007. These movements have continued during 2008 to date. At the beginning of May, this indicator stood at around 25 bp.

while credit risk premia soared.

Finally, the CDS spreads of financial and non-financial corporations, which were at historical lows in the first half of 2007, increased very sharply as a result of the turmoil, which triggered an intense process of risk reassessment at the international level (see Chart 6.4).

EUR bn	2004	2005	2006	2007
Public-debt book-entry market (a)	22,834	22,220	22,615	22,664
Spot	2,137	2,338	2,903	3,177
Repos and sell/buy-back agreements	20,584	19,572	19,385	19,193
Forward	113	310	327	294
AIAF fixed-income market	567	872	900	1,116
Commercial paper	286	404	482	557
Covered bonds and asset-backed securities	217	372	325	390
Other	63	96	94	168
Stock exchange: fixed-income	83	93	93	90
Stock exchange: equities	644	854	1,156	1,670
MEFF derivatives markets	394	584	934	1,451
Ibex 35	371	544	883	1,384
Stock options	12	17	23	27
Stock futures	10	23	28	41

SOURCES: BME, Federation of European Stock Exchanges and Banco de España.

a. Only includes transactions in State securities.

This development, which was also seen in private fixed-income markets, counteracted the decline in long-term government debt yields in the second half of the year and led to a slight increase in the cost of financing for firms issuing this type of securities. These movements intensified during the first few months of 2008.

4 Spanish financial intermediaries

4.1 CREDIT INSTITUTIONS

The balance sheet again grew significantly and, following the summer, there was a change in the way the assets were financed.

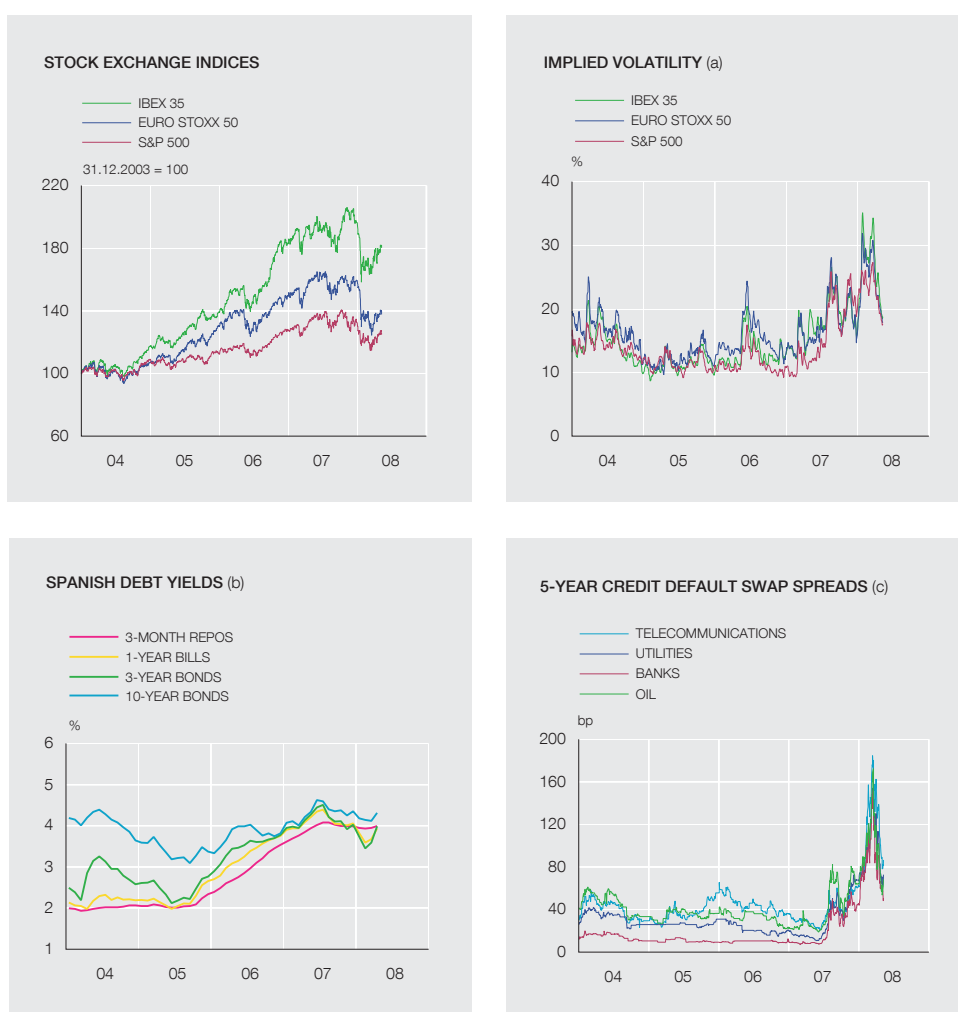
The rise in the cost of financing was passed through to lending rates...

In 2007, the balance sheet of Spanish credit institutions expanded again significantly, with year-on-year growth of 15% (see Table 6.4), despite the notable decline in the rate of growth of lending (from 24% in December 2006 to 15% at the end of 2007). The debt securities portfolio grew moderately, as compared with the decline in 2006.

On the liabilities side, customer deposits again grew at a lower rate than lending, although the gap between them, measured in terms of flows, diminished as the year elapsed. The outbreak of tensions in international debt markets in the second half of 2007 almost completely paralysed some of the markets that Spanish institutions have tapped heavily in recent years to finance themselves, leading them to seek alternative sources, such as note issuance and inter-bank financing¹ (see left-hand panel of Chart 6.5). The greater resort to short-term instruments obviously means that institutions will have to refinance themselves more frequently.

Recourse to these alternative sources of short-term funds avoided a larger rise in institutions' cost of financing, against a background of sharply rising premiums, especially at the medium and long maturities. Thus, during the year the average cost of liabilities increased by around 85 bp, more than the increase in official Eurosystem interest rates (50 bp), but less than the increase in the yield on 3-month interbank deposits (113 bp). This increase was passed through to lending, with rates charged rising by around 80-100 bp. Unchanged margins and growth in volume led, at the consolidated level, to a rise in net interest income of 19% (up 4 pp from 2006).

1. Which includes funds obtained through regular Eurosystem refinancing operations.



SOURCES: Sociedad de Bolsas, Bloomberg, Credit Trade, Datastream and Banco de España.

- a. Five-day moving average.
b. Monthly averages.
c. Asset-weighted average spreads.

giving rise to a further large increase in profits...

since neither the rise in the doubtful assets ratio nor even the turmoil had significant effects on the results.

Credit institutions are in a favourable position to confront future risks.

Thus, although other ordinary and extraordinary revenues generally grew by less than in 2006, total net profit also increased by 19% (30% at the individual level), enabling a return on equity of close to 20% to be earned for the second year running.

Unlike in other countries, Spanish institutions had virtually no exposure to products related to the US mortgage market and no financing commitments to structured vehicles that invest in such assets, which helped to sustain their results and their financial position. Write-downs and provisions, at the consolidated level, grew by 26%, basically driven by the 45% increase in the volume of doubtful assets in 2007. Thus, the ratio of doubtful assets to lending increased, as it has continued to do in 2008 to date, although it is still low (see right-hand panel of Chart 6.5), both in historical terms and in comparison with other European economies. In addition, the coverage of doubtful assets by provisions remained high (see Table 6.4).

Credit institutions are facing, therefore, a scenario of slowing economic activity, tightening financing conditions on international markets and greater uncertainty. However, they are currently in a position characterised by high levels of profitability, solvency, provisions and asset quality, which gives them valuable leeway to confront the risks inherent in this scenario.

CREDIT INSTITUTIONS
BALANCE SHEET AND INCOME STATEMENT

TABLE 6.4

	CONSOLIDATED			INDIVIDUAL		
	Dec-06	Dec-07	Y-o-y rate (%)	Dec-06	Dec-07	Y-o-y rate (%)
MAIN BALANCE SHEET ITEMS (% of TA)						
Total assets (EUR bn)	2,912.1	3,342.5	14.8	2,478.4	2,893.2	16.7
Loans and advances	67.0	67.3	15.3	64.3	64.3	16.7
<i>Of which: to resident private sector in Spain</i>				59.5	59.5	16.6
Debt securities	11.2	10.6	9.0	9.4	9.2	13.9
Other equity instrumentss	4.5	4.8	22.3	6.1	6.3	20.0
Other assets	17.3	17.3	14.6	20.1	20.2	17.3
Liabilities						
Banco de España and other central banks	1.5	2.8	112.1	1.2	2.9	171.7
Interbank deposits	15.6	14.5	6.7	19.1	17.7	8.4
Deposits from other creditors	47.8	47.1	13.2	52.2	50.7	13.4
<i>Of which: households and non-fin.corps. res. in Spain</i>				30.0	28.1	9.4
Debt securities	19.1	19.8	19.5	12.3	13.2	25.3
Other liabilities	11.5	12.2	21.8	10.4	12.4	38.5
Equity	6.0	6.3	19.6	6.0	6.0	17.2
INCOME STATEMENT (% of ATA)						
(+) Interest income	4.30	5.03	36.0	4.02	4.86	42.1
(-) Interest expenses	2.59	3.28	47.1	2.34	3.16	59.2
Net interest income	1.71	1.75	19.1	1.68	1.69	18.3
(+) Net commissions	0.77	0.73	10.3	0.56	0.53	11.1
(+) Profits on financial operations and investees	0.52	0.53	18.6	0.20	0.29	70.4
Gross income	3.00	3.01	16.8	2.44	2.51	20.8
(-) Operating expenses	1.40	1.33	10.4	1.14	1.08	10.6
Net income	1.60	1.68	22.3	1.30	1.43	29.8
(-) Write-downs and provisions	0.48	0.52	25.8	0.42	0.42	16.5
(+) Other income	0.25	0.15	-31.1	0.21	0.12	-35.5
(-) Taxes	0.34	0.26	-11.1	0.22	0.17	-10.5
After-tax profit	1.03	1.05	18.5	0.87	0.97	30.2
Group net profit	0.98	1.01	19.3			
RATIOS (%)						
Net interbank position/TA (a)	-8.6	-9.8		-7.4	-8.6	
Solvency	11.3	10.7				
Doubtful assets/TA	0.6	0.7		0.5	0.6	
Coverage of doubtful assets	220.5	182.8		262.9	209.3	
Foreign operations/TA	21.8	21.1				
Efficiency (OE/GI)(b)	47.6	44.8		48.3	44.1	
ROE	19.8	19.8		15.7	17.7	

SOURCE: Banco de España.

a. Includes liabilities to central banks.

b. Ratio of operating expenses to gross income.

4.2 INSTITUTIONAL INVESTORS

Net redemptions in collective investment institutions.

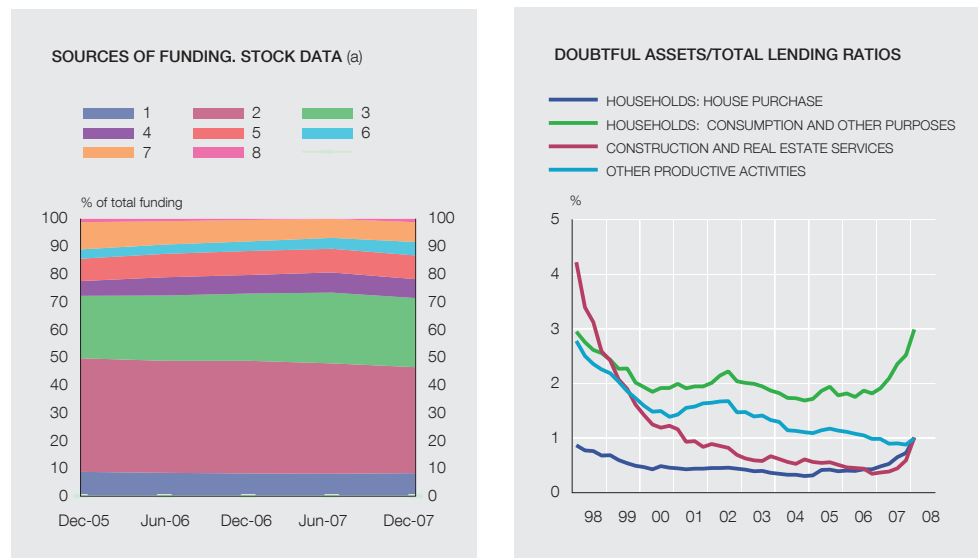
Even so, new instruments emerged.

Amid strong competition to capture domestic savings and high volatility on the financial markets, collective investment companies and funds recorded net redemptions of around €20 billion and assets under management declined slightly (see Chart 6.6 and Box 6.2). Insurance corporations and pension funds, in line with the usually greater stability of their inflows and outflows, captured funds in net terms in 2007, albeit a lower amount than in the previous year.

Despite this, the development of new products continued, with the creation of the first hedge funds. As at end-2007, these had an outstanding balance of €1,500 million and

FUNDING SOURCES AND DOUBTFUL ASSETS (Credit institutions. Individual data)

CHART 6.5



SOURCE: Banco de España.

- a. Legend:
- 1 Own funds.
 - 2 Deposits by non-financial residents.
 - 3 Other receivables (including securitisation).
 - 4 Mortgage-backed securities.
 - 5 Other debt securities.
 - 6 Short-term securities.
 - 7 Net interbank funding.
 - 8 Net financing from the Banco de España.

5,000 shareholders, corresponding to 21 hedge funds and 31 funds of hedge funds. In September 2007, somewhat more than one third of these assets corresponded to investments of Spanish insurance corporations. Also, in the area of insurance individual systematic savings plans (PIAS) began to be marketed as an alternative system of saving for retirement. However, their importance is still limited and, as at year end, they represented somewhat less than 3% of the premiums and 0.4% of the mathematical provisions of life assurance (€546 million).

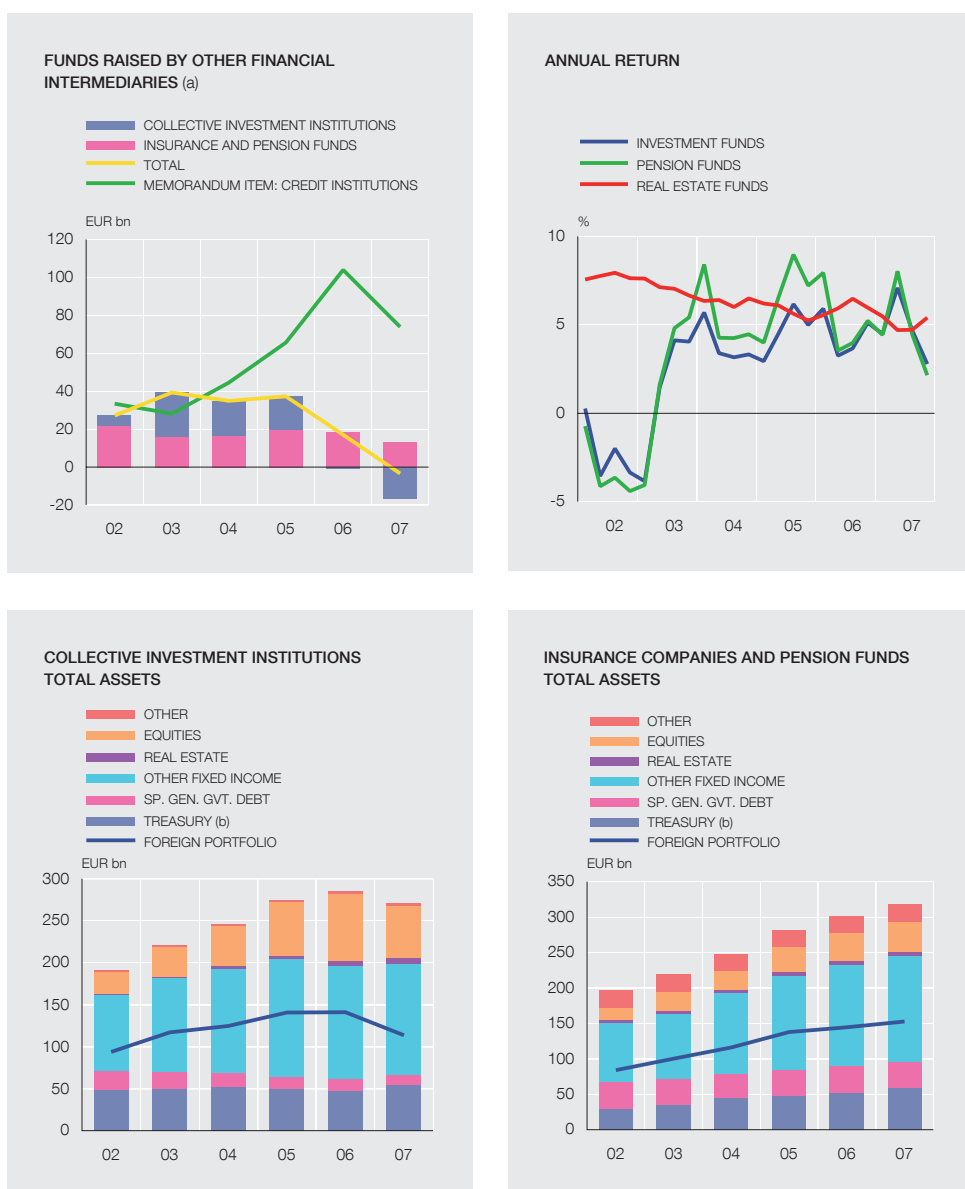
Meanwhile, in 2007 as a whole, there was an increase in the volume invested and in the funds raised by private equity, of 44% and 32%, respectively. Although activity in Q4 was still significant, a certain decline during the current year cannot be ruled out, as a consequence of the greater difficulty in financing new acquisitions, especially in the case of large-scale operations.

Some portfolio restructuring.

In any event, these alternative assets continued to represent a small part of the overall portfolio of domestic institutional investors, which experienced few changes in 2007. Of some note was the moderate increase in more liquid positions (towards the end of the year), and the loss of weight of external assets in favour of the private fixed-income securities of Spanish issuers, especially those with short maturities, in line with the more buoyant issuance of such instruments.

Slight decline in average yields and stagnation of insurance corporations' profits.

Although the exposure of Spanish institutional investors to products linked to the US mortgage market was very small, their profitability reflected the smaller increase in share prices than in 2006 and the rise in public and private debt yields, over the year as a whole, but remained



SOURCES: Asociación Española de Capital-Riesgo, Comisión Nacional del Mercado de Valores and Banco de España.

a. Shares and other equity in CII and reserves of insurance companies and pension funds. In the case of credit institutions, deposits and repos of households and non-financial corporations.
b. Includes cash, deposits and repos.

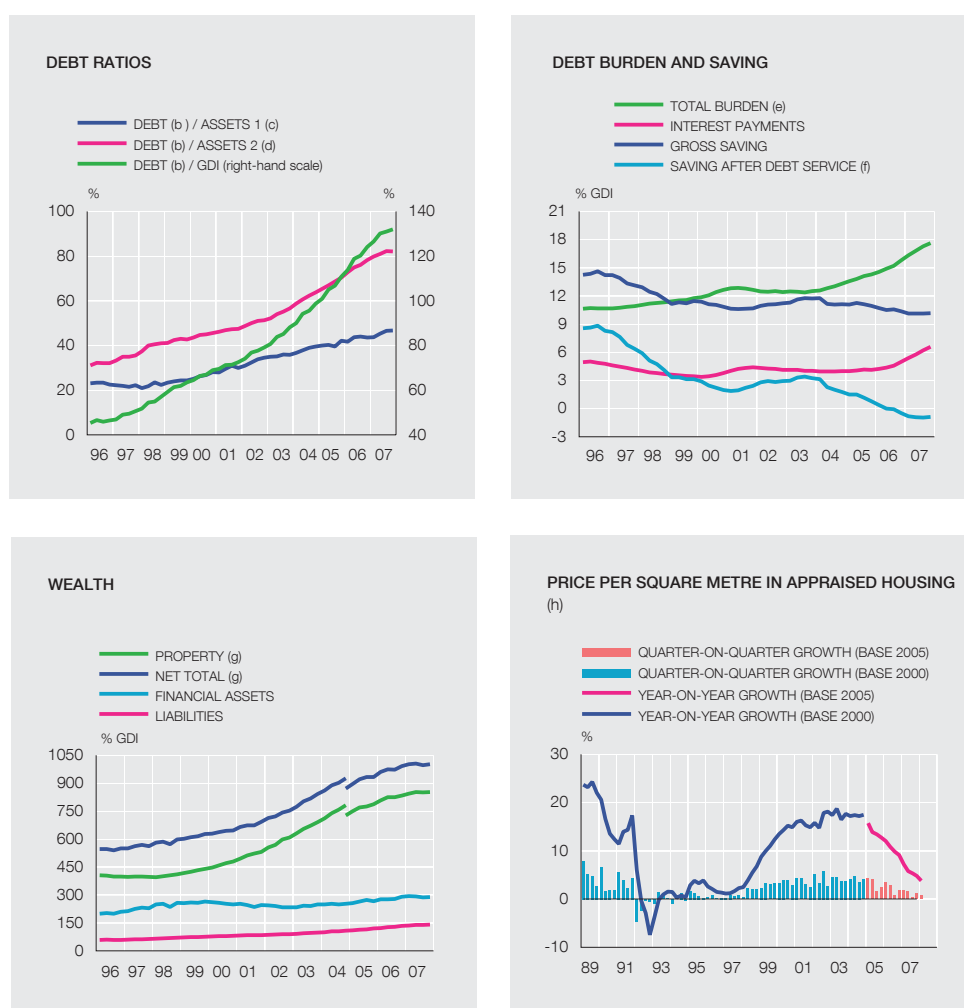
positive. On average, securities funds recorded a return of 2.8%, pension funds 2.2% and real-estate funds somewhat more (5.4%) (see Chart 6.6).

According to the initial estimates available, the profits of insurance corporations were stagnant in 2007, as a consequence of the poor performance of the technical life account. However, significant losses of value were not recorded on investments in this sector either and both the return on equity and solvency of the institutions remained high (around 20% in the first case and above 250% in the second).

5 The financial position of the non-financial private sector

5.1 HOUSEHOLDS

As already mentioned, the financing received by households in 2007 was less buoyant than in previous years, although its rate of growth again exceeded that of the sector's income. As a result household debt relative to gross disposable income (GDI) increased further, to ex-



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

- a. From 1999, the sectoral National Accounts data correspond to the CNE base 2000. For prior periods, an estimate consistent with this base is used.
- b. Includes bank credit and derecognised securitised credit.
- c. Assets 1 = Total financial assets less "other".
- d. Assets 2 = Assets 1 less shares less shares in FIM.
- e. Estimated interest payments plus debt repayments.
- f. Gross saving less estimated debt repayments.
- g. 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.
- h. New statistic from 2005.

Household indebtedness increased again, but by less than in previous years.

The debt burden increased and the doubtful loans ratio rose, although the latter remains low.

ceed 130%, an increase of around 8 pp, the lowest for the last five years (see Chart 6.7). In terms of GDP, the liabilities of these agents increased from 80% at end-2006 to 84% at end-2007.

The debt burden borne by households also continued to increase, reaching nearly 18% of their GDI. This increase was basically associated with the behaviour of interest payments, which were pushed upwards by the higher cost of debt. The portion linked to the repayment of principal did not change significantly, which, taken together with the stability shown by the gross saving of the sector, meant that households' ability to save after debt servicing barely changed, remaining slightly negative. Against this background, the doubtful loans ratio of households increased moderately in 2007, so the level reached continued to be low (around 1%).

The net wealth of the sector did not change significantly.

Following a prolonged period of sustained growth, the net wealth of the sector relative to its GDI did not change appreciably. The real component showed moderate growth (associated with a rise in property prices), countered by a slight decline in the value of net financial assets. In gross terms, these latter holdings reached a volume of nearly 290% of GDI, some 2 pp below the 2006 figure, with a slight shift towards less risky instruments. Specifically, the largest increase was in time deposits which, as pointed out above, absorbed a substantial part of the investment flows of households, and, as a result, their relative weight in the financial portfolio rose by around 3 pp to 17%. By contrast, the proportion accounted for by cash and sight deposits fell by somewhat more than 1.5 pp to 19%, while that of investment funds also declined, albeit more moderately (by around 1 pp to 10%).

The aggregate financial position of households is sound, although there are some segments which are more vulnerable.

At end-2007 the financial position of the sector as a whole continued not to show signs of vulnerability, being underpinned most notably by the comfortable levels of its net wealth. This aggregate situation is not, however, incompatible with the existence of population segments in less favourable conditions than the average. The most recent microeconomic data from the 2005 Spanish Survey of Household Finances show, for example, that while in that year the average indebted household devoted 17% of its gross income to interest payments and principal repayments on the loans received, this proportion exceeded 40% for about 6% of households, compared with 3% of households in 2002 according to the 2002 survey.²

5.2 NON-FINANCIAL CORPORATIONS

Debt and debt-burden ratios continued to increase...

Own funds continued to be the main liabilities-side item of non-financial corporations, although their weight within the balance sheet diminished for the third year running. Thus it was borrowing which, despite the drop in its growth rate, showed the most expansionary behaviour and again made for an increase in the ratio between the sector's debt and the sum of gross operating profit and financial revenue, this time to 580%, somewhat more than 50 pp above the level in 2006. The increase was, however, less than in the previous two years (see Chart 6.8).

The greater indebtedness, along with the increase in the cost of these funds, led to a further rise in the debt burden of non-financial corporations by 7 pp to more than 24%, the highest level in recent years.

and financial costs absorbed a larger part of profits.

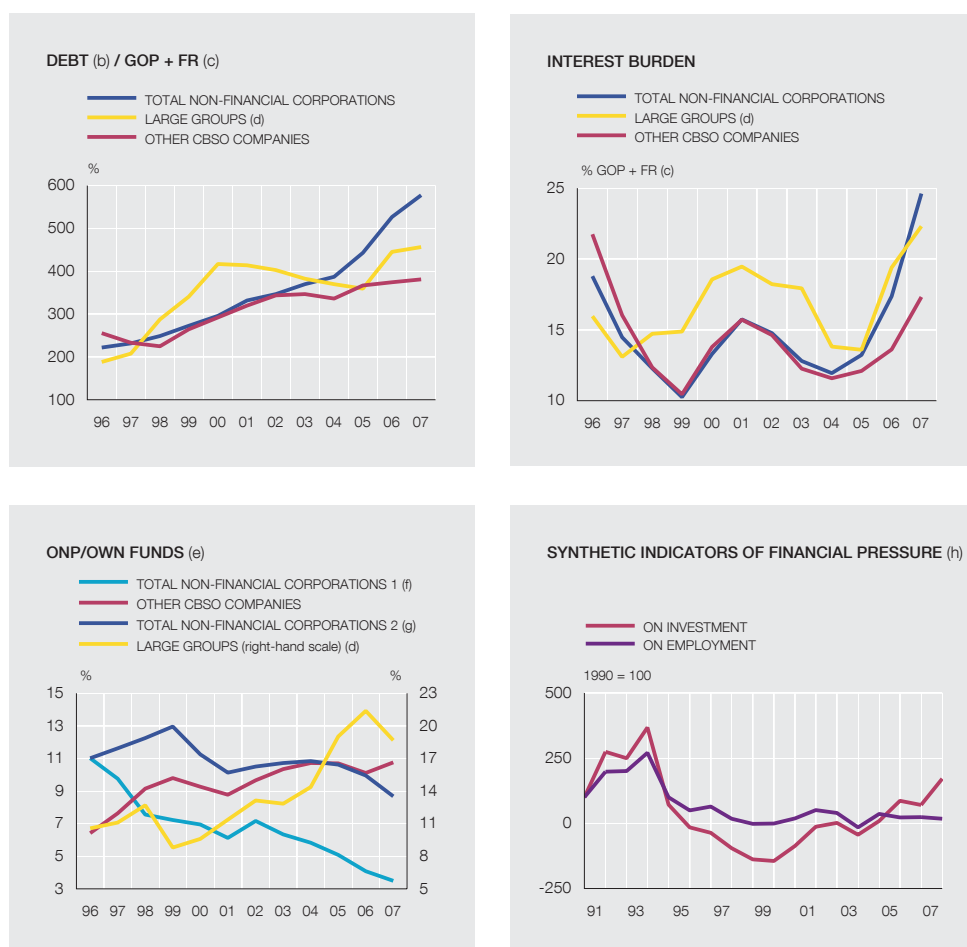
The increase in debt service payments contributed to slower growth of corporate profit after financial costs. Thus, although the sector's gross operating profit grew briskly (at above 7%), the net interest paid by firms rose by 24%, resulting in a slight fall in return on equity.

Moderate rise in the indicator of financial pressure on investment...

For the corporations contributing to the Central Balance Sheet Data Office Quarterly Survey (CBQ), which are predominantly larger firms, the debt and debt-burden ratios increased by less than at aggregate sector level. Also apparent was a decline in the return on equity, although it remained high. Sectoral analysis shows that the largest fall in return was in the energy sector, which is consistent with the contraction of margins seen in many firms in this sector, whereas, by contrast, returns rose notably in industry, in line with the expansionary trend in the activity of this sector. Also, in the second half of 2007, in consonance with the expectations of lower economic growth, the average short-term rate of expansion of unlisted non-financial corporations' profits predicted by analysts declined, although remaining at positive levels.

The overall performance of profitability, debt and debt burden led to a moderate rise, concentrated in the second half of the year, in the indicator of financial pressure on investment, which held somewhat above its historical average. By contrast, that for employment was unchanged (see Chart 6.8).

2. For more information, see "Survey of Household Finances (EFF) 2005: methods, results and changes between 2002 and 2005", Economic Bulletin, January 2008.



SOURCES: INE and 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). From 1999, the income of the sector corresponds to the CNE base 2000. Previously, an estimate consistent with this base is used.

b. Interest-bearing borrowed funds.

c. Gross operating profit plus financial revenue.

d. 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.

e. For total non-financial corporations, ordinary net profit (ONP) = gross operating surplus + interest and dividends received - interest paid - fixed capital consumption.

f. Own funds valued at market prices.

g. Own funds calculated on the basis of the 1996 figure and cumulative flows since.

h. Indicators estimated on the basis of CBSO annual and quarterly survey data. A value of more (less) than 100 indicates higher (lower) financial pressure than in the base year.

although the aggregate financial situation of firms continues to be sound, albeit concealing a high degree of heterogeneity.

Despite the higher financial pressure, the sector's aggregate financial position continues to be robust, as reflected, for example, in its doubtful loans ratios, which remain low (0.7%), and in the absence of significant changes in the credit ratings of the Spanish firms which issue securities. However, as in the case of households, this overall situation is not incompatible with the existence of certain groups in a less favourable situation than that of the average firm. In this line, the most recent information from the Central Balance Sheet Data Office Annual Survey, which relates to 2006, evidences the high dispersion of some financial indicators. Hence, for example, for 25% of the sample corporations, the proportion of earnings used for interest payments is triple the corresponding ratio for the median company.

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 2007. Some of these aspects 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, Central Credit Register, Research Activities, Oversight of Payment Systems and Public Debt Market).

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

The European Union (EU), which was enlarged again with the accession of Bulgaria and Romania, took a further step in developing its general institutional framework with the signing in Lisbon on 13 December of a new Reform Treaty, which amends the Treaty on European Union and the Treaty establishing the European Community, the latter becoming the Treaty on the Functioning of the European Union. The Lisbon Treaty, which abandons the constitutional aspects of the previous project, drawn up in 2004, aims to establish a more effective institutional framework in the context of a 27 member union and to boost democratic legitimacy. The ambition proclaimed by the European Council is that the whole ratification process should be concluded before the elections to the European Parliament in June 2009.

Cyprus and Malta adopted the euro on 1 January 2008

At the request of the Cypriot and Maltese authorities, the European Central bank (ECB) examined whether these Member States, which did not form part of the euro area, fulfilled the conditions necessary to adopt the euro in a convergence report published on 16 May. On the basis of the convergence reports from the ECB and from the Commission, and upon a proposal of the Commission, the Council decided on 10 July to abrogate the derogations of Cyprus and Malta, allowing them to adopt the euro on 1 January 2008.

As in previous years, in 2007 the Banco de España's activity as a Eurosystem member was intense. The Governor participated in the meetings of the Governing Council and of the General Council of the ECB at which, among others, decisions on monetary policy were taken as explained in detail in Chapters 1 and 4 of this Annual Report.

An extensive group of professionals from the Banco de España participated in the various committees, working groups and other Eurosystem bodies to prepare for the taking of decisions by the governing bodies of the ECB and to draft various reports.

In particular, the Bank participated actively in the Eurosystem forecasting exercises and in the drafting of the report on public finances, and also in the structural issues report, dealing on this occasion with corporate finance in the euro area. The latter report was presented to the European Parliament for the first time in 2007.

The Bank also participated in the Banking Supervision Committee (BSC) of the European System of Central Banks (ESCB), working on the preparation of the biannual Financial Stability Review, and on the publication of the annual reports on EU banking sector stability and EU banking structures. The Bank also collaborated on the drafting of the first annual report on financial integration in Europe. This committee also continued to work on preparations for identifying and analysing possible crises. In addition, in 2007 the BSC published a report on the leveraged buy-out activity of large banks in the EU.

TARGET 2 went live in
November

As in previous years, the TARGET payment system, one of the largest in the world, contributed to euro money market integration, playing an important role in the implementation of the single monetary policy. On 19 November, TARGET2, the new generation of the system, began to function satisfactorily. On the basis of a single technical platform and a single price structure, TARGET2 offers a wide range of basic services to participants and a uniform set of functions to those systems that use it for settlement. TARGET2 has been available to the Spanish banking community since 18 February 2008 (see Section 6.2).

The Eurosystem has co-operated closely with the European Commission in working to achieve a single euro payments area (SEPA) and has encouraged the European banking sector and other parties involved to create the conditions that have made its introduction possible from January 2008 and that should enable it to be fully developed by end-2010.

The ECB continued to advance financial integration in the euro area and published the first issue of a new annual publication entitled *Financial Integration in Europe*. The purpose of this regular report is to contribute to European financial integration and also to increase public awareness of the role played by the Eurosystem in the achievement of this EU objective. The report contains the latest version of the financial integration indicators that are published biannually on the ECB website.

In co-operation with the national central banks, the ECB has continued to develop, compile and disseminate a wide range of statistics useful for monetary policy implementation in the euro area and for the various missions of the European System of Central Banks. Also, in June, it published for the first time, in conjunction with Eurostat, integrated quarterly European (financial and non-financial) accounts with data from 1999. In addition, in July, the ECB adopted the Regulation (EC) No 958/2007 concerning statistics on the assets and liabilities of investment funds (ECB/2007/8), which will enable more reliable statistics on these financial intermediaries to be available from 2009.

The Banco de España
produced and distributed 843.7
million banknotes in 2007

The Banco de España was responsible for the production and distribution of 843.7 million banknotes in 2007, under the joint, decentralised system for banknote production agreed in the Eurosystem. In relation to the Framework for banknote recycling by professional cash handlers, credit institutions continued in 2007 to sign up to the general clauses applicable to the Banco de España ordinary cash service, which were published in the official State Gazette (BOE) at end-2006, and the related technical applications for cash, which develop these clauses, were drawn up. In addition, the Bank participated actively in the tests of the framework for the approval of banknote recycling machinery. The Banco de España also collaborated with the Eurosystem in the measurement of the quality of banknotes in circulation.

Also notable were the activity of the Bank in the performance of various tests to select the security elements to be included in the second series of euro banknotes and its designation to form part of the group of six central banks that will be responsible for custody of the Eurosystem strategic stock. During 2007, the Bank had numerous meetings with credit institutions and cash-in-transit companies to inform them of Eurosystem policy and the cash services provided by member central banks.

3 International activities

Intensification of the Bank's international presence and projection, in both quantitative and qualitative terms, has been one of the Bank's strategic objectives in recent years, and 2007 was no exception. Activity in the sphere of the Eurosystem has already been referred to in Section 2, so this section focuses on other fora in which the Bank participates actively, and on

bilateral relations, technical co-operation with other central banks, supervisory agencies and bank regulators, and seminars and conferences organised.

3.1 INTERNATIONAL RELATIONS

In the European Union, the Banco de España participated actively, as part of the Spanish delegation, in diverse Community working groups and committees. Notable here were the Economic and Financial Committee (EFC), which prepares the meetings of the Council of Economy and Finance Ministers (ECOFIN), and the Economic Policy Committee (EPC). Discussions in the EFC in 2007 focused on three main topics: regular review of the economic situation; financial stability and European financial architecture (inter alia, crisis prevention and resolution mechanisms, the convergence of supervisory practices and review of the so-called "Lamfalussy process"), and the definition of the European position in relation to reform of the International Monetary Fund (IMF). Also within the EFC, the Bank took part in ad hoc working groups on specific subjects, such as the group of experts on financial transparency. The EPC working agenda placed particular emphasis on the analysis of two subjects that were priorities in the combined programme of the German, Portuguese and Slovenian presidencies: the quality of public finances and the modernisation of public administrations.

As in previous years, a large part of the international activity of the Banco de España revolved around the Basel Bank for International Settlements (BIS), the main nexus of co-operation between the world's central banks. In addition to regularly attending meetings of Governors and the Annual General Meeting of the BIS, the Bank played an active role in the Committee on the Global Economy, the Committee on the Global Financial System and the Markets Committee, as well as in the complex structure of working groups arising from such committees.

The Bank participated actively in the work of the CEBS

As regards banking regulation and supervision at the global level, implementation of the rules on Pillar 1 of the new Capital Accord is very advanced and Committees have shifted their attention towards Pillar 2 and the definition of capital. The Bank has participated actively in the work of the committees that report to European institutions, in particular, the Committee of European Banking Supervisors (CEBS), the Interim Working Committee on Financial Conglomerates (which reports to the CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIPOS). In 2007, the activity of the CEBS was focused on three main areas:

- 1 The contribution to the review of the Lamfalussy arrangements.
- 2 Technical advice to the Commission on such complex subjects as the definition of regulatory capital, the regime for large exposures and liquidity risk supervision.
- 3 Supervisory practice co-operation and convergence. As regards the former, the CEBS has completed the implementation of the recommendations of the Financial Services Committee to improve the functioning of the Lamfalussy arrangements. Also, the CEBS has drawn up concrete proposals to improve its ability to achieve real convergence of supervisory practices and co-operation between supervisors within the European Union.

The Basel Committee on Banking Supervision (BCBS) has continued its work in relation to the implementation of Basel II and the monitoring of the impact of these regulations on capital requirements and their possible procyclicality. Other subjects addressed in the Committee have been the use of fair value in financial statements, credit risk in the trading book, liquidity, regulatory capital and economic capital models. The work of the International Contact Group

(set up to foster dialogue with supervisors not included in the BCBS) on risk-based supervision should also be mentioned.

Apart from working extensively on the degree of implementation of the principles for the supervision of financial conglomerates, the Joint Forum, which brings together banking, securities and insurance supervisors, is also completing an analysis of practices for assessing the suitability of retail customers and the reputational risks that may arise, and a study of firm-wide management of risk concentrations. It has also begun to update the work it carried out in 2004 and 2005 on credit risk transfers, focusing on the activity carried out through structured derivatives.

The Bank has given special attention to the review of the IMF's medium-term strategy

As regards relations with the International Monetary Fund (IMF) and the subjects it raises for debate, the Bank prepared the briefing notes for the Spanish representatives in the institution on the main matters discussed by the Executive Board. During 2007, the Bank has taken particular interest in the review of the institution's medium-term strategy, making the following proposals to date: (i) enhancement of its supervisory tasks; (ii) strengthening the Fund's role in emerging economies; (iii) greater effectiveness in its assistance to lower income countries; (iv) review of member country quotas, and (v) review of the system for financing the institution. The Bank also participated in the discussion of the Article IV reports on the United States, Japan, the United Kingdom, Germany, France, Italy, Spain, part of Latin America, new members and some of the EU accession countries. Finally, opinions and comments were contributed in relation to the main reports published by the Fund, the Report on World Economic Outlook and the Report on Global Financial Stability.

Remaining on the subject of the IMF, the Bank also prepared extensive reports for the meetings of the International Monetary and Financial Committee in the spring and in the autumn, on the occasion of the Annual Meeting. These meetings reviewed the global economic outlook and also aspects of the institution's policy and governance, which require orientation from its members at the highest level. Similarly notable was the Bank's role in the EFC Subcommittee on IMF-related issues, which discusses European positions at the Fund and questions relating to international financial architecture.

With regard to the Centre for Latin American Monetary Studies (CEMLA), which serves as the main forum for co-ordination of Latin American central banks, the Bank participates actively in the meetings of governors, of the Alternates Committee and of the Audit Committee. Matters of particular importance for CEMLA were addressed in 2007, including most notably the amendment of its statutes, the preparation of an organisational manual and the review of administrative regulations. Also, the Bank collaborated actively in the training meetings and activities sponsored by the Centre and played a leading role in some of its initiatives, such as those relating to remittances, financial information and the implementation of International Financial Reporting Standards (IFRSs) in central bank accounting.

Collaboration with the Association of Supervisors of Banks of the Americas was stepped up

In 2007, the Bank's collaboration with the Association of Supervisors of Banks of the Americas (ASBA), to which all the entities in charge of banking supervision in the American continent belong, was stepped up. The Bank, as an associate member since October 2006, participates in the Association's governing bodies, management bodies, training plans and working groups. In 2007 various seminars on matters of common interest were organised and the Bank took part in the working group on good consolidated supervision practices.

The Bank increased its collaboration with the main multilateral development banks (the World Bank, the Asian Development Bank (ADB) and the Inter-American Development Bank) and, at

a bilateral level, with other central banks and bank supervisors, through meetings at the highest level and in the technical sphere. The list of central banks and supervisors with whom bilateral meetings were held in 2007 includes Chile, China, Colombia, Korea, Ecuador, France, Japan, Mexico and Vietnam. Likewise, visits were hosted from the ECB, the Palestine Monetary Authority and a government delegation from the United Arab Emirates.

Also, in conjunction with the Ministry of Economy and Finance, the Bank participated very actively in meetings of the Paris Club and in OECD and EU working groups on export credit.

The Bank played a leading role in the promotion and start-up of the International Operational Risk Working Group, whose main objective is to act as a benchmark for knowledge and experience of operational risk management in central banks and to promote advanced management of such risks. The group has been set up and functions under the shared presidency of the Banco de España and of the Federal Reserve Bank of Philadelphia, with a permanent secretariat provided by the Bank.

International technical co-operation increased by 55%

An element that makes a decisive contribution to the external projection of the Bank is the provision of technical co-operation, with the transfer of working methods and knowledge entailed. In recent years such co-operation has been developed significantly and in 2007 was 55% up from the preceding year.

Noteworthy was the work performed in Latin America, where the Bank is on the way to becoming the benchmark for many central banks and bank supervisors. Co-operation there has a twofold logic, since the supply of training by the Bank itself, through the organisation of seminars and courses, facilitated by the common language and culture, is stimulating the demand for technical co-operation, which rises year by year. In other geographical areas, such as the Mediterranean countries, countries that have recently joined the EU and countries that are candidates for EU entry, the Banco de España has integrated its efforts with other central banks and supervisory agencies, to participate in projects co-ordinated within the Eurosystem and financed by European Union funds. Especially noteworthy in 2007 was the Bank's collaboration with the Central Bank of Bosnia and Herzegovina, a multifaceted project undertaken by eight Eurosystem central banks, for which the Bank provided the resident programme co-ordinator in Sarajevo.

Also notable was the Bank's constant collaboration with different bodies to provide technical assistance in the international sphere, especially with CEMLA, ASBA, the Central American Monetary Council, the IMF, the World Bank and the BIS Financial Stability Institute. Likewise, collaboration with agencies responsible for securities markets, both in Spain and in Latin America, is being stepped up.

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

During 2007, the Banco de España continued its efforts to become an international benchmark in the organisation of meetings and events designed to share and disseminate knowledge and experience in the most topical subjects in the institution's areas of competence. With this purpose, it has worked in collaboration with international agencies, such as the IMF and the World Bank, and it has intensified bilateral relations with other central banks of the G7 countries, Latin America, Asia and the ESCB. This type of activity undoubtedly contributes to establishing the Bank's external prestige and to disseminating its central-banking and financial-supervision know-how.

The fourth Euro-Mediterranean seminar was held in Valencia in April

Notable in this area was the organisation, in conjunction with the ECB, of the fourth Euro-Mediterranean Seminar, which took place in Valencia in April. This event brought together governors and senior officials from the central banks of the Eurosystem and of the Mediterra-

nean countries. The work programme was divided into three main areas: economic and financial developments in the Mediterranean countries; fiscal policy in the macroeconomic framework of the region; and the recent developments and prospects for Euro-Mediterranean trade.

The Banco de España and the Central Bank of China organised the China-Spain Financial Forum, which was held in October in Madrid. This event enjoyed the participation of authorities from the public and private sectors, and leading academics. The main objective was to discuss recent developments in the world economy, with a special focus on China, Spain and Europe. More specifically, the subjects addressed included developments in the financial and real-estate sectors, international experience of financial system reform and China's integration into the world economy.

Also in Madrid, the inaugural meeting of the Latin American Emerging Markets Forum was organised in close collaboration with the Iberoamerica General Secretariat in June. A broad group of senior representatives of economy and finance ministries, treasuries, central banks, international organisations, the private sector and academic world participated and the working agenda included subjects such as the economic and political outlook for Latin America, financial market development, energy policy integration and co-ordination and trade links with other emerging markets.

In November, the XII Meeting of the Central Bank Researchers' Network of the American Continent, sponsored by the Centre for Latin American Monetary Studies (CEMLA), was held at the Banco de España's headquarters. A total of 44 research papers were presented at the meeting, produced by central banks associated with CEMLA: the majority of the Latin American central banks, the Federal Reserve, the Bank of Canada, the Latin American Reserve Fund (LARF) and the Banco de España itself.

In June, the Bank and the Ministry of Economy and Finance hosted an extraordinary meeting of the European Union's EFC Subcommittee on IMF-related issues. The meeting was preceded by a presentation on the outlook for the Asian region by an IMF representative invited to participate in order to outline the IMF's views on the strategic review it is currently undertaking.

Finally, the choice of the Banco de España as the forum for presentation of important reports prepared by various international bodies should be noted. In particular: the Asian Development Outlook 2007 by the ADB; the World Bank report *Informality: Exit and Exclusion*; and the Transition Report of the European Bank for Reconstruction and Development.

4 Economic analysis and research

In 2007 various departments of the Banco de España carried out analysis and research on the Spanish economy and its international environment, in order to give advice to the Bank's governing bodies in relation to the performance of their functions.

In line with output in recent years, 41 Working Papers and 6 Occasional Papers were published in 2007. The number of papers published by Banco de España staff in academic journals and specialised books was 53, 28 of which were in anonymously refereed journals, 23 of these being international in scope.¹

1. The Banco de España's *Research Memorandum, 2007*, available at www.bde.es, contains further details of these publications. This publication also describes in greater detail the other research activities carried out by the Banco de España during the year.

4.1 PRIORITY AREAS OF ANALYSIS

The research agenda of the Banco de España revolves around five major areas: i) Macroeconomic modelling and forecasting, ii) Monetary policy and its transmission mechanisms, iii) Financial stability, iv) International economy and v) Spanish economy.

Progress was made in updating macroeconomic forecasting models

As regards macroeconomic modelling and forecasting, progress was made in estimating a dynamic, stochastic general equilibrium model (BEMOD) of the Spanish economy and on updating the Banco de España's quarterly model for short and medium-term forecasting. Also real-time forecasting models were developed for economic activity in the euro area and in Spain.

The lines of research on monetary policy and its transmission mechanisms focused on analysis of the consequences of financial frictions for monetary policy transmission and the implications of price and wage rigidities and of the sources of oil price shocks for optimal monetary policy design.

Research in the area of financial stability and banking analysis was orientated in several directions. The impact of monetary policy on the credit risk assumed by institutions was addressed, research into the relationship between competition and financial stability extended and the role played by banks in the evolution of firms' financial situation analysed. Also, progress was made in measuring the productivity of Spanish banks and in analysing the determinants of the bank service production process.

Research on the international economy reflects Spain's growing exposure to and influence in the global economy. The research agenda has been tilting towards monetary and financial themes of global relevance, but attention is still given to the economic and financial aspects of the emerging economies (in particular, Latin America) that have characterised the analysis in recent years, and that have been reflected in studies of remittances and the financial structures and flows of these countries. In addition, other areas of increasing importance were studied, such as certain Asian economies (China, India) and the Mediterranean countries. Also the analysis of global financial and commercial integration was extended, as were various aspects of the international financial architecture, and the consequences of demographic developments on international capital flows.

Finally, as regards lines of research on the Spanish economy, a broad set of subjects relating to its structural characteristics were considered, such as the consequences of demographic changes, productivity developments, the functioning of its markets (in particular, the housing and labour markets), business financing and the financial situation of households.²

4.2 RELATIONS WITH ACADEMIA

The connections between the Banco de España and academia and the economic analysis and research units at other central banks and international institutions were maintained through the four traditional channels. First, the analysis and research produced by the Banco de España was presented and discussed at domestic and international seminars, congresses and academic conferences and published through the profession's usual channels. Second, the Banco de España organises a number of regular seminars, in which members of the domestic and international academic community participate, including a weekly economic research seminar. It also organises, sometimes in collaboration with other bodies, domestic and international conferences. In 2007, the Banco de España organised, on its own or in conjunction with other institutions, various international conferences (see Section 3). Third, the Banco de España contributes to the research networks within the Eurosystem for the analysis of the euro

2. In relation to the financial situation of Spanish households, the preliminary results of the Survey of Household Finances were published. See "Survey of Household Finances (EFF) 2005: methods, results and changes between 2002 and 2005", *Economic Bulletin*, January 2008, Banco de España.

	31.12.2006	31.12.2007
CREDIT INSTITUTIONS	353	358
Banks	73	70
Saving banks	47	46
Credit co-operatives	83	85
Branches of foreign credit institutions	70	80
Specialised credit institutions	79	76
Official credit institutions	1	1
OTHER	141	141
Mutual guarantee and reguarantee companies	25	25
Currency-exchange and money-transfer bureaux	59	59
Appraisal companies	57	57
TOTAL	494	499

area economy, such as the Wage Dynamics Network in 2007 and, in Latin America, within CEMLA. Finally, there are regular visitor and external adviser programmes which promote projects that may be considered strategic in different areas of analysis and research.

4.3 DISSEMINATION AND COMMUNICATION

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 conducted or under way.³ Together with these publications, the review *Estabilidad Financiera*, launched in 2001, continued to serve as a channel of communication and discussion between the Banco de España and the Spanish financial sector on prudential regulation and supervision issues, including also the dissemination of research findings in these areas. Finally, during 2007 the preparatory work was carried out to equip the Bank's website with a section, called the Economic Research Portal, which since February 2008 gives access to information on the research activities carried out at the Banco de España and communication with its research staff.

5 Banking supervision and regulation

5.1 SUPERVISORY ACTIVITY

As at 31 December 2007, a total of 499 diverse entities were subject to Banco de España supervision, 358 of which were credit institutions (see Table 7.1). In addition, by reason of its status as supervisor on a consolidated basis, the Bank supervises foreign credit institutions whose parent is a Spanish credit institution.

The Bank continued to prepare for the changes made by the new Capital Accord

In 2007, the Banco de España continued to prepare to adapt to the regulatory changes made by the new Capital Accord, commonly known as Basel II, which was introduced into Community law by Directive 2006/48/EC. As a result, sizeable human and technical resources were assigned to the process of supervisory pre-validation of the advanced internal models for measuring Pillar 1 risks, and special attention was given to the necessary collaboration with host country authorities in the case of international groups with a Spanish parent, and with home country authorities in the case of Spanish subsidiaries of European banking groups.

The ongoing supervision process applied by the Banco de España to the institutions in Table 7.1 consists of a system for the permanent monitoring and analysis of their situation, which is backed up by an intensive programme of on-site inspections. In 2007, as a result of the turmoil on international financial markets, which began in August, special monitoring and actions were

3. English translations of these summaries are sometimes published in the quarterly *Economic Bulletin*.

	COMPLETED AS AT 31.12.2006	IN PROGRESS AS AT 31.12.2006	COMPLETED AS AT 31.12.2007	IN PROGRESS AS AT 31.12.2007
CREDIT INSTITUTIONS	69	80	125	43
Banks	36	37	63	11
Saving banks	11	21	17	18
Credit co-operatives	10	12	18	4
Branches of EU credit institutions	1	2	6	1
Specialised credit institutions	11	8	21	9
OTHER	12	16	22	12
Mutual guarantee and reguarantee companies	3	5	9	4
Currency-exchange and money-transfer bureaux	7	5	5	1
Appraisal companies	2	6	8	7
TOTAL	81	96	147	55

carried out to assess the situation of Spanish banks in these new circumstances. A total of 202 inspection visits were made in 2007, of which 55 were under way as at 31 December, according to the breakdown in Table 7.2.

Under the scheduled arrangements for supervisory activities, inspection visits may be either of an overall scope or confined to specific aspects.

The bank sent 115 letters to supervised institutions containing 581 observations

As a result of the supervisory activity undertaken in 2007, 115 recommendation and requirement letters were sent to credit institutions and other entities supervised by the Banco de España, these being either the institutions ultimately addressed or the parents of consolidated groups, in accordance with the breakdown in Table 7 .3.

The letters sent to supervised institutions contained a total of 581 observations on various aspects relating to the matters set out in Table 7.4. Thus, 158 more observations were made than in 2006, basically due to the increase in those relating to credit risk and internal control.

Credit risk was the main subject of the recommendations

As usual, credit risk, in its various forms, was the main subject of the recommendations, accounting for 164, or 28% of the total. Notable here were the continuing reprimands made by the Bank regarding the quality of the controls established in credit risk procedures. Through these letters, the bank conveyed its reflections to institutions on the risks of mortgage portfolios.

The second most notable group, accounting for 120 recommendations, referred to the internal control of institutions, which generally encompasses the need for proper management of overall risk and improved internal control procedures. All these matters are aspects of continuous interest as far as the Banco de España's supervision is concerned, which ties in with the international concern for internal control, risk management systems and the governance of institutions shown by the latest European directives; inter alia, Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions, and Directive 2004/39/EC on markets in financial instruments, both of which are incorporated into Spanish law by means of Law 36/2007 and Law 47/2007. The strict oversight of compliance with solvency rules gave rise to 41 requirements and recommendations.

In 2007, it was not necessary to take any precautionary measures in relation to the supervised institutions.

REQUIREMENT AND RECOMMENDATION LETTERS TO SUPERVISED INSTITUTIONS

TABLE 7.3

	2006	2007
CREDIT INSTITUTIONS	80	97
Banks	24	31
Savings banks	14	17
Credit co-operatives	20	22
Branches of EU credit institutions	4	7
Branches of foreign credit institutions	5	4
Specialised credit institutions	13	16
OTHER	17	18
Mutual guarantee and reguarantee companies	4	4
Currency-exchange and money-transfer bureaux	8	7
Appraisal companies	5	7

SUBJECT MATTER OF LETTERS SENT TO SUPERVISED INSTITUTIONS

TABLE 7.4

	2006	2007
CREDIT RISK	145	231
Accounting for credit risk, borrower weakness and increased coverage requirements	96	164
Quality of credit risk controls (granting and monitoring procedures, etc.)	49	67
INTERNAL MANAGEMENT AND CONTROL	102	147
Internal management and control in general	84	120
Capital market activities	18	27
CAPITAL AND SOLVENCY	30	41
Solvency ratio	30	41
OTHER RULES	146	162
Failure to comply with rules on transparency and customer relations	31	35
Deficiencies in information reported to the CCR	22	30
Other	13	14
Requirements for authorisation of non-credit institutions	80	83

5.2 IMPOSING OF SANCTIONS

In 2007, 8 cases were opened against supervised institutions and 27 against their managers or directors

As regards sanctioning proceedings initiated in 2007, 8 cases were opened against supervised institutions and, in conjunction with these, 27 cases against the directors or managers of those institutions. Specifically, these proceedings were initiated against 2 appraisal companies and 6 currency-exchange and money-transfer bureaux. Also in 2007 the stay of proceedings against a bank and 16 of its directors, as a result of a criminal proceeding on the same facts, was lifted and the proceedings resumed. Also 2 cases were conducted for failure to comply with the ECB's minimum reserve requirements.

The above data are similar to those of past years, both as regards the numbers of proceedings and the types of supervised institutions.

14 cases against institutions and 46 against directors and managers were resolved

In 2007, a total of 14 cases against supervised institutions were resolved and 46 cases against members of their boards of directors and management bodies. These resolutions involved the imposition of: 12 sanctions on institutions and 27 on directors for the commission of very seri-

ous infringements; 24 sanctions on institutions and 91 on directors for the commission of serious infringements; and 7 sanctions on institutions for minor infringements, there being no provision in Spanish law for sanctions to be imposed on directors for the commission of minor infringements.

These cases were brought against supervised institutions of various types. Thus, sanctions were imposed on one bank, a branch of a Community credit institution, a specialised credit institution, two appraisal companies, five currency-exchange and money-transfer bureaux, and two institutions that engaged in currency exchange activities without being authorised to do so.

The sanctioning activity of the Banco de España also covers those individuals or legal entities which, without having obtained the required authorisation and having been registered in the corresponding registers, pursue activities reserved to credit or other types of institutions which by law require some type of authorisation or approval. Two proceedings of this type were resolved in 2007 against companies which engaged in foreign currency purchase operations without the compulsory authorisation, sanctions being imposed in both cases.

Also proceedings were brought to withdraw the authorisation of a currency-exchange bureau, on account of its having relinquished such authorisation. Strictly speaking such cases do not involve exercise of the Banco de España's sanctioning power, but they do represent a form of control over supervised institutions, insofar as they enable entities which, for the reasons established by law, are liable to have their authorisation withdrawn, to be prevented from forming part of the system.

5.3 REGULATORY CHANGES

The national transposition of some very significant Community provisions was commenced

As regards the organisational and disciplinary rules to which credit institutions and other financial intermediaries subject to Banco de España supervision are subject, in 2007 a set of far-reaching Community provisions began to be transposed into domestic law. These will undoubtedly have a great impact both on what we might call "the internal dimension of financial activity", i.e. the organisation, financing and solvency of institutions, and on the external facet of such activity, i.e. customer relations. It should not be inferred from this, however, that the changes made are going to involve a radical transformation of the Spanish financial sector or its practices. Rather, these changes will be the tool to consolidate and preserve the level of development and efficiency of which this sector has boasted to date.

Notable among the main regulatory changes of a national scope bearing on the internal side of financial activity are:

- *Law 36/2007 of 16 November 2007 amending Law 13/1985 of 25 May 1985 on investment ratios, own funds and reporting requirements of financial intermediaries and other financial system rules.* This Law, which partially transposes Directives 2006/48/EC and 2006/49/EC of the European Parliament and of the Council, incorporates the so-called Basel II Accord into the national legal framework with the aim, inter alia, of ensuring an appropriate level of solvency and a level playing field for credit institutions, making the regulatory capital required more sensitive to the risks of their activities and encouraging better risk management.
- *Law 41/2007 of 7 December 2007 amending Law 2/1981 of 25 March 1981 on mortgage market regulation and other mortgage and financial system rules, on the regulation of reverse mortgages and dependency insurance, and establishing a specific tax regulation.* This law reforms certain aspects of the Spanish mort-

gage market in order to make it more secure and competitive (with a particular impact on the activities and supervision of appraisal companies), but its main purpose is the introduction of better techniques into the instruments for financing mortgage activity. In addition, it regulates various aspects of contractual and pre-contractual relations between credit institutions and their customers as well as so-called “reverse mortgages”.

Notable among the regulatory changes that have had a significant bearing on the external facet of financial activity are:

- *Law 47/2007 of 19 December 2007 amending Law 24/1988 of 28 July 1988 on the securities market.* Apart from making important changes to the legal framework for investment services companies and in that for official secondary securities markets and multilateral trading system, this Law regulates the provision of investment services and, in particular, the relations between those who provide them (credit institutions being quantitatively the most important group) and their customers, with the intention of providing the latter with an effective framework for their protection.
- *Law 22/2007 of 11 July on the distance marketing of consumer financial services.* This Law, with the same objective of protecting consumers, establishes rigorous rules regarding the information that the latter must receive prior to entering into the contract, regulates the right of withdrawal and introduces other protection procedures and guarantees.

Along with these main changes, certain regulatory developments which, even though they have a narrower sphere of influence, insofar as they are only applicable to listed companies or issuers of securities, have a significant impact both on such companies and on the markets in which their securities are traded. Among these rules notable is Law 6/2007 of 12 April 2007 reforming Law 24/1988 on the securities market, for the amendment of the regime governing initial public offerings and the transparency of issuers; as well the Royal Decrees 1066/2007 of 27 July 2007 and 1362/2007 of 19 October 2007 which implement it.

As regards the changes in 2007 in the regulatory framework of Community scope, and for the purposes that concern us in this section, a special significance should be attributed to the following directives:

- *Directive 2007/44/EC of the European Parliament and of the Council of 5 September 2007* which, within the prudential supervision framework for financial institutions, has made certain changes to the procedural rules and evaluation criteria applicable to acquisitions and increases in holdings in the financial sector.
- *Directive 2007/64 of the European Parliament and of the Council of 13 November 2007*, which establishes a legal framework for the provision of payment services and market access for the providers of such services, for the purpose of contributing to the creation of a single payment services market linked to the SEPA and to promote its proper working, without forgetting, once again, the protection of consumers.

5.4 FINANCIAL AND PRUDENTIAL INFORMATION

5.4.1 Analysis of the impact (cost-benefit) of financial regulation

In 2006, the Banco de España published, for the first time, an impact study for the new capital regulations. This was a first step in an area which is becoming increasingly established as part of best international practice in financial regulation.

As part of its efforts to “improve regulation”, the Banco de España decided to do more in this area, to increase transparency and improve decision-making in the financial regulation field.

A Division has been set up with responsibility for analysing the impact of regulatory activity

Thus, in 2007 an organisational reform was undertaken within the Financial Stability Department of the Directorate General Banking Regulation. Two areas of analysis were created: one responsible for monitoring financial stability (the Financial Stability Analysis Division) and the other, *inter alia*, for analysing the impact of regulatory activity (the Banking Analysis and Regulatory Policy Division).

This will bring about systematisation of the analysis of market failures and cost and benefit considerations during policy preparation, from the initial design stages. Specifically, formalising this analysis will entail justifying and discussing the economic rationale for regulatory intervention and comparing the costs and benefits of different feasible regulatory policy proposals.

5.4.2 Preliminary consultative process on the future solvency circular

This exceptional and informal preliminary public information procedure on the content of the future solvency circular to replace Circular 5/93, which is currently in force, was continued during much of 2007, having been initiated in late 2006. This aim of this procedure, undertaken in anticipation of conclusion of the transposition of *Directives 2006/48/EC and 2006/49/EC of the European Parliament and of the Council* (mentioned in Section 5.3 above), was to facilitate implementation of the new regulation and thereby enable institutions to speed up their preparations.

The preliminary consultative process on the solvency circular was concluded in September

This consultative process, conceived of as an open or dynamic procedure, continued with inclusion on the Banco de España’s website on the Internet, the medium for this consultative process, of new content as it became available, until all the planned chapters had been posted. At that point, 30 September 2007 was fixed as the deadline for receiving comments on the text under consultation.

During this period numerous comments were received from associations representing credit institutions, as well as from some of the institutions themselves and other interested parties. All of these were analysed scrupulously and have contributed notably to the preparation of what will be the final step of the process of transposition into Spanish law of the directives mentioned above.

5.4.3 XBRL activity

The public financial statements of institutions have been published on Internet through XBRL

In 2007 the objective was achieved of publication on Internet by the associations of credit institutions of the public financial statements of their members using XBRL (eXtensible Business Reporting Language).

Also, the work continued to develop the Spanish extension of the COREP (COmmon REPorting) taxonomy, developed by the CEBS. This must be used for the new returns with information on the calculation of the solvency ratio that credit institutions will have to send to the Banco de España as a consequence of the adaptation of Spanish law to *Directive 2006/49/EC on capital adequacy*. The taxonomy shall be used for the first time to receive in XBRL the information for December 2007 that must be sent in February 2008 by institutions that have requested approval of internal ratings based (IRB) models.

Meanwhile, the study and definition of a new computing platform, to be used in the process of reception, validation and monitoring of financial information, was commenced. The new tool will enable the current data-processing applications, which go back to 1983, to be replaced by others incorporating new functionalities that will permit control of the quality of financial information, as well as its use, to be simplified. With the new tool, it is planned that all financial information will be received in XBRL.

5.5 CENTRAL CREDIT REGISTER

Using data from its Central Credit Register (CCR), the Banco de España compiles individualised 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 also by the Banco de España, in conjunction with the accounting statements of credit institutions, maintaining the confidentiality of the individual data, as a source for work connected with its supervisory and statistical functions.

The number of registered exposures grew by 8.4% and their amount by 13.2%

During 2007, growth in the information compiled and distributed by the CCR continued as in recent years, although at a more moderate rate, in line with the reporting institutions' lending. As at 31 December 2007, 33.5 million exposures were registered in the CCR (8.4% more than in the same month of the previous year). The total amount of these exposures was €3.6 trillion (up 13.2%), and the total number of different borrowers was 17.6 million (up 4.8%). As regards its work of providing to institutions the data necessary for the performance of their activity, the CCR sent them in 2007 a total of 291.2 million reports on their customers' exposures and 6.8 million reports on the exposures of potential customers. The latter are expressly requested by the institutions to assess the credit quality of possible customers.

117,000 requests for reports by borrowers were attended to

However, the largest increase in the CCR's activity was in the information service provided to the reported borrowers themselves. Thus, more than 117,000 requests for reports by borrowers were attended to (29.4% more than in the previous year) and 394 claims were processed in relation to the data reported by institutions, an increase of 18.7% over the previous year.

As regards the exchange of information with other European central credit registers (Germany, Austria, Belgium, France, Italy and Portugal), the international working group to which the CCR belongs was very active in 2007. The work related mainly to the study and analysis of various initiatives aiming to achieve an improvement, not only in the quantity and quality of the data exchanged, but also in their timeliness, to make them more useful both to the Banco de España in its supervisory capacity and to the reporting institutions, which receive quarterly information on the debt of their legal person customers registered in the other six credit registers. In relation to the volumes of information exchanged, on September 2007 data, the CCR received information on the exposures of 3,417 Spanish legal persons (up 16.42%) recorded in the six other central credit registers, the total amount of which was €222,470 million (up 20.55%). Also, the CCR sent to European registers information on 1,742 legal persons with the nationality of the countries to which the data were sent, with exposures amounting to €71,358 million (up 27.34% and 10.65%, respectively, from the previous year's data).

6 Operational functions

6.1 MANAGEMENT OF THE BANCO DE ESPAÑA'S ASSETS

In the euro area, the implementation of monetary policy is carried out 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 perform the liquidity providing/absorbing operations, as well as dealing with aspects relating to the provision of collateral, with the credit institutions within their purview.

Spain's liquidity requirements fell by 7.2%, but financing from the Eurosystem increased

While liquidity requirements in the euro area as a whole grew on average by 4.3% in 2007, in Spain they fell by 7.2%. The provision of funds to Spanish institutions through Eurosystem monetary policy operations increased by 5%, from €23,916 million in 2006 to €25,943 million in 2007. By contrast, the funds obtained from institutions situated in other euro area countries declined by 19.7%, to €18,835 million. Both changes were especially intense in the final quarter, when the conditions of less liquidity and greater sensitivity to credit risk in money markets caused institutions to prefer to resort to a greater extent to financing from Eurosystem central banks.

These lower liquidity requirements, which indicate a reduction in the Spanish banking system's structural liquidity deficit, are explained by the fact that, in the context of a process of gradual strengthening of the Banco de España's balance sheet, its purchases of financial assets have been larger than the increases recorded (on the liabilities side of its balance sheet) in banknotes (which grew notably more moderately than in previous years) and in the reserves held by credit institutions.

The above-mentioned process of strengthening of the Bank's financial position included reductions in the non-interest bearing asset headings, specifically gold and special loans to the public sector. First, within the terms of the Central Bank Gold Agreement, the Banco de España sold 4.3 million troy ounces of fine gold (135.1 tonnes) in 2007. Second, various changes were agreed with the Treasury and the Social Security System in relation to their debts to the Banco de España under the *special loans* granted before 1994, on which no interest is paid. The repayment schedule for the loan to the Treasury was changed, so that the final repayment will now take place in 2015 (nine years earlier there initially stipulated), if the Treasury does not exercise its option to make early payments, an option that was not previously available and which has been exercised in 2007. For its part, the Social Security System repaid in May 2007 the total amount of its loan from the Banco de España, which was due to mature in 2019.

These changes in the special loans have revealed hidden losses, arising from the difference between the nominal value of the loans and their market value, which have been covered by making the necessary provisions. The losses on the special loans were of the same magnitude as the gains realised on the gold sales. Both the proceeds from the sale of gold and the receipts from early payment of the special loans were reinvested in euro-denominated fixed-income securities.

The Bank continued to increase its portfolio of euro-denominated fixed-income bonds

In addition, and with the same objective of achieving a more profitable balance-sheet composition, in 2007 the Banco de España again increased its portfolio of euro-denominated fixed-income bonds, the average amount of which reached €69,618 million. For their part, holdings of foreign currency denominated assets stood on average at €8,199 million, a slightly higher level than in 2006.

As at 31 December 2007, manageable assets in euro, foreign currency and gold totalled €88,848 million.

During 2007 the Banco de España managed a portion of the ECB's foreign reserves. On average, it managed a portfolio of \$4,600 million.

6.1.1 Summary of gold sales in recent years

From 2005 to 2007, within the terms of the Central Bank Gold Agreement, referred to above, the Banco de España decided to sell part of its gold reserves in order to obtain a regular return on the assets required to replace them and to strengthen the financial structure of its balance sheet.

At end-2004, the Banco de España possessed 523.4 tonnes of gold, which had cost €1,581 million and which had a market value of €5,411 million.

In 2005 and 2006 the Banco de España sold 106.6 tonnes of gold, for €1,407 million and realised gains of €1,085 million. In 2007, the Banco de España sold another 135.1 tonnes, for a market consideration of €2,156 million, with gains of €1,748 million. In all, the sales in these periods totalled 241.8 tonnes, which represent 46% of the Banco de España's total holdings at end-2004.

The amount obtained from gold sales (€3,563 million in total) was reinvested in fixed-income securities. The yield on these investments has formed part of the core earnings of the Banco de España and has been paid to the Treasury.

All the gains realised upon the sale of gold (€2,833 million in total) have been used to strengthen the Banco de España's financial position. Specifically, €1,085 million arising from gains on gold sales, along with another €910 million of extraordinary profit arising from the peseta banknotes not exchanged for euro, were used to increase the Bank's capital and reserves, from €5 million to €2,000 million. The other €1,748 million have been used to offset the hidden losses in relation to the special loans granted to the Treasury and to the Social Security System before 1994 which pay no interest.

6.2 MANAGEMENT OF PAYMENT SYSTEMS

TARGET2 came on stream on 19 November with a first group of countries

As regards the Spanish large-value payment system, the Banco de España Settlement Service (SLBE), which the Banco de España is responsible for managing, continued in 2007 to operate smoothly, without any significant changes in its design or operation, recording growth in both the number of transactions and in the amounts processed. Thus, the SLBE in 2007 processed more than 12 million transactions, with a value of more than €96 trillion. These figures were 12% and 17% higher, respectively, than in 2006.

Meanwhile, at the European level, TARGET2, the new generation of the TARGET payment system, came on stream on 19 November with the first group of countries incorporated, in accordance with the staggered migration plan designed for the purpose. The migration of the Spanish banking community took place satisfactorily. In accordance with this plan, on 18 February. Thus, the SLBE has been transformed into TARGET2-Banco de España, the Spanish component of the new TARGET2 system.

With a single technical platform and a single price structure, TARGET2 offers a broad range of basic services to its participants and a homogeneous set of functions to those systems that use it for settlement. The Banco de España has worked hard on the co-ordination and preparation of migration to the new system, and on putting its legal framework into place.

The Eurosystem continued the preparatory work to establish a new service that would allow the harmonised settlement of securities transactions in euro in central bank money (TARGET2-Securities), and decided to undertake work on CCBM2, a new system for management of the collateral provided by its counterparties.

With regard to retail payments, the Banco de España is developing the oversight of the National Electronic Clearing System (SNCE), which is managed by Iberpay, a private company owned by the system participants themselves. In 2007, the SNCE processed 1,439 million transactions, with a total value of more than €2 trillion, involving growth rates of 6.5% and 7%, respectively, which are comparable to those of previous years.

Preparations for the Single Euro Payments Area (SEPA) completed

In 2007 various working groups were formed, with participation of the various sectors involved, and the National Migration Plan to SEPA (Single Euro Payments Area) was published. This plan covers the main aspects that must be considered to achieve an orderly transition of the Spanish community to the new SEPA environment, which came into operation in January 2008 and should reach its maximum development by end-2010.

With the design and preparation stage having been completed and migration to SEPA commenced, the first pan-European payment instruments have been available since January 2008. Henceforth, consumers, firms and other economic agents can make electronic payments in

euro to any beneficiary in the European Union, subject to the same basic conditions and with the same rights and obligations, using one single bank account and a single set of payment instruments.

The Banco de España will continue to work with all interested parties in those areas in which questions have still to be resolved, giving top priority to ensuring that the SEPA, in a competitive environment, covers the needs and expectations of users, without entailing any deterioration in the current levels of service.

6.2.1 Oversight of payment systems

In 2007, the Banco de España continued to exercise the oversight of payment systems, with the aim of contributing to their security and efficient operation. Also, to ensure that this activity is exercised with the greatest transparency, the second edition of the annual report on oversight, covering the most notable developments in national payment systems, the oversight activities carried out and their results, was published.

Apart from the regular monitoring of Spanish payment systems, the Banco de España has actively participated in the exhaustive analysis of the new TARGET2 system carried out by the Eurosystem prior to its launch. This evaluation concluded that the design of the system complies with the standards adopted by the Eurosystem for payment system oversight.

Meanwhile, with regard to the SNCE, the Banco de España published Circular 1/2007, which specifies how the powers of oversight over this system, conferred upon it by the provisions of Chapter V of Law 41/1999, shall be exercised. Also, pursuant to this Law, the Banco de España revised and approved the new SNCE regulations in 2007, the main changes including definition of the moments at which the transactions processed by the system are irrevocable and final as required by the above-mentioned law and the establishment of a system of settlement guarantees.

In 2007 the development of an adequate strategy regarding the continuity of operations within the Eurosystem continued. This involves contemplating various potential scenarios, having the appropriate tests and establishing communication procedures for crisis situations.

6.3 BANKNOTE MANAGEMENT

The Banco de España, as an integral part of the Eurosystem, is responsible for producing, putting into circulation and withdrawing euro banknotes, so that it controls the quality of banknotes in circulation and takes all the necessary measures to avoid or reduce their counterfeiting. During 2007 it was responsible for the production of 843.7 million euro banknotes, with the denominations of 5, 20 and 50 euro, some of which were distributed to other Eurosystem central banks.

The upward trend in the distribution and withdrawal of banknotes continued

During the year, the Bank delivered 2,300 million banknotes to credit institutions and withdrew from circulation more than 2,500 million banknotes. In both cases, the upward trend that has been seen since the introduction of the euro continued. In fact, these are record figures for the activity of the Bank, which is participating more and more intensely in the banknote circulation circuit and helping to improve the cleanliness and condition of the banknotes. It should be noted here that, overall, and especially in the case of the 10 and 20 euro denominations, the fact that the number of banknotes withdrawn exceeds the number put into circulation means that the phenomenon of “negative circulation” is occurring. The weight of tourism in Spain is one factor, among others, of singular importance in this respect.

The number of banknotes counted at the Bank and selected, authenticated and checked before being returned to circulation, exceeded 2,536 million banknotes, an increase of 11.2%

with respect to the previous year, so that record figures have also been achieved in this area. Naturally, not all of them are returned to circulation. According to the rules established by the European Central Bank, the Banco de España destroys the banknotes that are considered unfit for circulation. The process is carried out mechanically and in a decentralised fashion by the Bank's branch network.

The European recycling framework seeks to prevent the distribution of counterfeit banknotes by ATMs

In connection with the foregoing, the Bank worked hard during 2007 on the steps necessary for the application in Spain of the European framework for the recycling of euro banknotes by professional cash handlers, which helps to harmonise the systems for the checking and care of cash by banks in Europe, standardising the levels of quality throughout the euro area. The new system involves more obligations for banks and seeks, inter alia, to offer the public an absolute guarantee that an ATM will never put a counterfeit banknote into circulation. Aspects relating to specialised machinery and technology played an important role in this area, with the Bank collaborating closely with the Eurosystem in the tests to measure the quality of banknotes in circulation. This collaboration extended to the performance of various tests to select the new security features to be included in the second series of euro banknotes. Notably, the Banco de España was designated to form part of the group of six central banks that will be responsible for custody of the Eurosystem's strategic banknote reserve.

As regards coins, the Banco de España acts as the Treasury's agent, withdrawing from and putting into circulation the coins issued by the Spanish state. In 2007, more than 1,374 million coins were put into circulation, while 222 million were withdrawn from circulation.

7 Statistics

7.1 THE STATISTICAL FUNCTION OF THE BANCO DE ESPAÑA

The statistical function of the Banco de España is established in its *Law of Autonomy* and in the National Statistics Plan (PEN).³ The *Law of Autonomy* provides that the Banco de España shall compile and publish statistics relating to its functions and assist the ECB in the compilation of the statistical information needed for the fulfilment of the ESCB's functions.⁴ Since the creation of the Economic and Monetary Union (EMU) it has been the tasks in connection with the ECB/ESCB that have been progressively increasing the demand for resources dedicated to this function.

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 and Pension Funds (DGSFP)].

The statistics compiled and disseminated under the current PEN (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). A significant part of these statistics broadly coincides with the requirements of the ESCB, being compiled using the information that all resident units are obliged to provide by law.

In addition, the Banco de España, through its Central Balance Sheet Data Office, collects, compiles and disseminates information on the balance sheet position and the results of non-financial corporations, based on questionnaires completed voluntarily by the reporting firms and on the annual accounts filed by non-financial corporations at the Mercantile Registries. All

3. The National Statistics Plan is established every four years (the current Plan is for 2005-2008) by means of a royal decree, pursuant to Law 12/1989 on the Public Statistical Function. 4. Article 7.5.f).

these statistics are published in the *Boletín Estadístico*, in monographic publications and on the Banco de España's website.

Apart from the compilation and dissemination of the statistics referred to, the Bank uses statistics produced by other national agencies and supervisors (INE, IGAE, ministries, CNMV, DGSFP, etc.) and by international organisations as a source for another area of statistical work, which it makes available to the Bank's own analysts and to the general public. These activities are completed by the active participation of Banco de España representatives in international statistical fora (within the ESCB, the European Commission through Eurostat, the European Committee of Central Balance Sheet Data Offices, the IMF, BIS, OECD, etc.), and by the maintenance of databases that make it possible to study the evolution of the variables for which data are collected.

7.2 MAIN CHANGES INTRODUCED DURING 2007

During 2007, the statistics for which the Banco de España is responsible were updated in accordance with generally accepted quality levels and the data released on pre-announced dates, in accordance with the calendar published on the Banco de España's website. Each of the updates referred to incorporates the changes and methodological improvements reported in each of the publications, the most notable of which are mentioned below.

7.2.1 Monetary and financial statistics

In 2007, in the area of the monetary and financial statistics relating to the functions referred to by the *Law of Autonomy*:

Detailed information incorporated on doubtful loans

- 1 Chapter 4 of the *Boletín Estadístico*, containing statistics on credit institutions based on their supervisory returns, was completed in accordance with the provisions of *CBE 4/2004*, which adapted the accounting statements of credit institutions to the IFRSs. Detailed information was included on doubtful loans broken down by instrument and sector and, when granted to other resident sectors, by purpose. Information was also included on credit institutions' non-performing loans.
- 2 Work was carried out on the second phase of the implementation of the Centralised Securities Data Base (CSDB), which will, inter alia, offer security-by-security information on the key characteristics of all securities issued by the various institutional groupings of the euro area countries and on securities they hold, even if they have been issued by non-residents of the euro area.

The second edition of the Survey of Household Finances presented in December

- 3 As part of the process of harmonisation of euro area statistics, a new ECB Regulation on investment funds was approved and the Guideline on monetary, financial institutions and markets statistics was adapted. These provisions will enable harmonised statistics to be compiled for this important group of financial intermediaries. Finally, with regard to the statistics included in the PEN, in 2007 the results of the Survey of Household Finances (EFF) as at end-2005 were published, including a study of the changes since the last survey in 2002.

7.2.2 Balance of payments and international investment position statistics

The main changes made during 2007 are as follows:

- 1 Progress was made in revising the information system currently used to compile the balance of payments, to adapt it to the changes that will affect it during 2008: the raising of the reporting threshold for cross-border transactions to €50,000 from 1 January, the entry into operation of TARGET2 and of other systems for interconnecting euro area settlement systems, and the launch of the single euro payments area (SEPA).

The work carried out will enable the dissemination of monthly balance of payments data to be brought forward

- 2 Efforts were stepped up to reduce the lag with which monthly balance of payments data are disseminated and revised, enabling a new calendar to be drawn up. With effect from the publication of the January 2008 data in April, monthly balance of payments data will be disseminated 15 days earlier and revisions will be quarterly instead of annually. This new calendar will allow the degree of consistency between the balance of payments and international investment position data and the financial accounts data and the national accounts data to be increased.
- 3 The work to incorporate into the balance of payments and the international investment position the direct investment data drawn from the investment register kept by the Directorate General for Trade and Investment of the Ministry of Industry, Trade and Tourism. This work, which yielded its first fruits in 2006, should be completed in 2008.

7.2.3 Balance sheet position and results of non-financial corporations according to the Central Balance Sheet Data Office

In 2007, the Central Balance Sheet Data Office collaborated with the Spanish Accounting and Audit Institute (ICAC) on compilation of the standard formats to be used for filing accounts for 2008 (the first year to which the general chart of accounts approved in 2007 will apply), as well as on the preparation of its development taxonomy, based on the XBRL language.

At the same time, the Central Balance Sheet Data Office led the initiative to create the ERICA database of consolidated accounts of European groups, which uses the IFRSs, and improved the conditions for the use of the “European Sectoral References Database”.

For the first time the annual database included data for more than 9,000 reporting corporations

Also, as in previous years, the number of firms included in the various databases of the Central Balance Sheet Data Office increased, so that in 2007 the annual database included, for the first time, data on more than 9,000 directly reporting firms. Meanwhile, collaboration with the Spanish Mercantile Registries, pursuant to an agreement with the Spanish Registrars’ Association, allowed data to be included on more than 500,000 firms. These two databases are complemented by the closer view afforded by the quarterly database, with data on more than 800 reporting firms.

Finally, in 2007, work began to adapt the databases and statistics of the Central Balance Sheet Data Office to the new classification of economic activities due to enter into force in 2009 (CNAE 2009). Also, the quantitative evaluation of the Kyoto Protocol was revised, once information on its impact on firms’ balance sheets and income statements for two years had become available.

7.3 OTHER WORK RELATING TO THE COLLECTION, MANAGEMENT AND DISSEMINATION OF STATISTICAL INFORMATION

In 2007, work was undertaken to improve the infrastructure for collecting, exchanging and accessing the Banco de España’s statistical information. Part of this work has already been implicitly or explicitly referred to above. This section covers the work with a special interest, as follows:

- 1 The new system for exchanging ESCB information came into operation. This has been used, since December 2007, for the transmission of statistical information between the ECB and the national central banks.
- 2 A new IT application has been developed to facilitate the access and management of the database for the sectorisation of the Spanish economy, which the Banco de España has made available to users on its website.

- 3 The first electronic form to collect information on cross-border transactions directly from firms and individuals has been installed on the Banco de España's website. Others will be added until all the current hard-copy forms are covered.
- 4 Work has been commenced to enable the statistical information of the Banco de España to be accessed on internet using high-speed search systems.

8 Complaints Service

Significant growth in the numbers of cases and enquiries

The Complaints Service continued its work of attending to the users of products and services offered by financial institutions subject to Banco de España supervision. There was notable growth, during the year, in the number of cases brought, without the traditional decline in activity in the July-August holiday period, while use of the system for resolving telephone and e-mail enquiries, available to the public since 2006, continued to follow an upward trend.

With regard to internal operations, the work to launch a new computer application for the management of complaints was concluded. This application enables the public and institutions to communicate by e-mail, and will significantly speed up and simplify the procedure. The Banco de España, along with a growing number of public institutions, is thus participating in the e-government project.

The Complaints Service used its annual and quarterly reports to step up its efforts to provide information to financial institutions and customers on the matters that give rise to most complaints and queries, and on the criteria it uses. Also, it revised and updated the principles of good banking practice that should inform the activities of institutions and their customers. The 2006 annual report includes, for the first time, a highly detailed analysis of the behaviour of individuals and financial institutions in the various regions of Spain.

Meetings and seminars were organised and attended in Spain to debate the most topical issues addressed by the Complaints Service. Notable were the discussion forum held at the Banco de España to consider "internet bank fraud" and the conference organised jointly with the Madrid Notaries' Association on the "Protection of the Consumer in Banking Contracts", at which various issues relating to good contractual practice were addressed.

Notable in the field of co-operation with other bodies and institutions was the publication of an information brochure on how to make a financial services claim, the result of collaboration between the Banco de España, the National Securities Market Commission, the Directorate General for Insurance and Pension Funds and the National Consumer Affairs Institute.

The external profile of the Complaints Service was raised and it participated very actively in international meetings held to discuss issues relating to the protection of financial consumers. Notable at the European level was its participation in the Steering Committee, promoting the spread of the FIN-NET network, for settling cross-border financial disputes out of court in the European Union, of which Spain is a founder member. At the international level, the Service participated in INFO'07, an international conference of financial services ombudsmen, held last September in London, and in the international seminar on the protection of the rights of financial services customers and users held in La Paz in November 2007.

The work of technical co-operation was also stepped up, especially in the Latin American area. Notable was the organisation, jointly with the Bank's International Technical Cooperation Division, of the 1st course on the protection of the financial customer, held at the Banco de España's headquarters in June 2007. Representatives of consumer protection supervisors and agencies of numerous South American countries participated in this course, which it is planned to hold on an annual basis.

9 External communication

The communication policy of the Banco de España pursues a twofold objective: to explain the functions and activities of the institution and to ensure the confidence of citizens in the financial system. External communication for the Banco de España is a necessary complement to its functions under the Law of Autonomy and by reason of its membership of the ESCB.

9.1 MEDIA RELATIONS

The Banco de España's media communication strategy aims to enhance knowledge of the institution's activities among information professionals, since these are a necessary link in the mechanism for transmitting messages to the public. In 2007, the journalist training programme was continued, with sessions to explain the use of the statistics generated by the Bank and the implications of the single euro payments area (SEPA). In order to publicise the work of the various departments of the Bank, informative meetings were organised, such as those to present the results of the Central Balance Sheet Data Office surveys in November and of the second edition of the *Survey of Household Finances* in December.

Notable, in addition to these regular meetings, was the media coverage of other acts in 2007, such as the *High-Level Seminar of the Eurosystem and the Mediterranean Central Banks*, held in Valencia in March, the presentation of the ADB's Asian Development Outlook 2007 in April; the Tribute to Professor Fuentes Quintana in June and the China-Spain Financial Forum in October (see Section 3.2).

Other events that aroused media interest last year were the presentation in April of the new Bank Customer's Portal, following a significant overhaul of its appearance and content, the presentation in May of the Bernácer Prize and the presentation to the media of the winning entry in the 1st Competition for Schools "The Banco de España and economic stability" in June (see Section 9.2.1).

During 2007 there was a significant demand for media interviews. In total, Bank representatives granted twenty interviews, both domestically and internationally, on a broad range of topical issues. Some of the interviews in 2007 came within the Bank's branch network-based communication plan, the purpose of which is to acquaint local and regional media with the Banco de España's activities. Likewise, for the first time in 2007, the Annual Report of the Complaints Service was presented simultaneously in Madrid and at the Barcelona, Seville and Valencia branches. This initiative was well received by the media of these four cities, which gave wide coverage to the event.

Members of the governing bodies participated in 30 domestic and international fora

Nonetheless, as in previous years, the main channel for communicating the Bank's viewpoint regarding the economic situation and the financial system was its regular publications, such as the *Annual Report* and the *Economic Bulletin*, and the public speeches made by its management. In addition to the Governor's regular appearances before Parliament (in June, to present the *Annual Report*) and before the Parliamentary and Senate Budget Committees (in October), three other speeches were notable in 2007, one to explain the influence of monetary policy on Spanish firms and households (in April, in Parliament) and another two on the possible effects of the financial turmoil on the Spanish economy (in September, before both chambers of Parliament). Also, members of the Bank's governing bodies participated in 30 domestic and international fora in 2007.

9.2 INSTITUTIONAL COMMUNICATION PROGRAMME

9.2.1 Educational initiatives

During the first year of its life, the Virtual Classroom, an educational portal for young people designed to foster knowledge of the Banco de España and spread awareness of its mission to guarantee the stability of prices, payments and the financial system, became established as a learning tool for the educational community. This is clear from the fact that 400,000 portal pages were consulted during 2007.

314 schools participated in the 1st Competition for Schools, entitled "The Banco de España and economic stability"

In 2007, the first edition of a Competition for Schools was held, entitled "The Banco de España and economic stability". It was open to upper secondary schools and based on the content of the Virtual Classroom. The 314 entrant teams, from all over Spain, had to do an initial general test, which 39 schools passed, and then to submit an essay on "the Banco de España and economic stability". The winning team, with a prize of eight PCs, was the Torrellano Secondary School, from Torrellano-Elche (Alicante). The students in the team were also presented with certificates by the Governor, the president of the panel of judges, in a ceremony held at the Banco de España's headquarters in Madrid. The Bank has published the winning essay, distributing it to 5,000 schools, along with the details of the second edition of the competition. The latter is dedicated to the tenth anniversary of the ESCB, the Eurosystem and the ECB, and is to be held during the 2007/2008 academic year.

9.2.2 Information to the public

The Banco de España's website recorded 17 million page views

The Banco de España's commitment to providing reliable information to various target groups makes the Banco de España's website a very important channel for direct communication with the public. And so the access statistics show, with more than 17 million page views in 2007, including almost 2 million for the Bank Customer's Portal.

As part of the process of continued expansion and improvement of page content and architecture, some content was translated last year into the co-official languages of particular regions, to enable users to navigate in the Catalan, Galician, Valencian and Basque languages.

Also in 2007, the first steps were taken to completely restructure the website. During the first half of the year, the Banco de España carried out a study to identify the expectations and demands of the various target users. The result was recommendations to improve the technology, design, architecture, ease of use and accessibility of the website. The necessary actions to carry out these recommendations were initiated in Q4 and will be continued during 2008.

The Statistical Information Service responded to around 1,200 telephone and e-mail requests from the public in 2007. The most commonly requested information related to interest rates and exchange rates. Meanwhile, 3,266 consultations were dealt with through the Bank Customer's Portal on diverse aspects of the relationship between banks and their customers.

As regards informative publications and brochures, in 2007 the Banco de España designed 22 leaflets on its branches which, along with its Madrid headquarters, today make up its geographical presence. The aim of the leaflets, of which 55,000 were produced, is to inform the public of the services provided by the Bank through its branch network and to improve the knowledge of the history and functions of the Banco de España. In accordance with the Bank's policy of using the official languages of the various regions in materials addressed to the public, these leaflets were translated into the Catalan, Galician, Valencian and Basque languages.

In line with the Banco de España's wish to make itself more familiar to different social groups, 60,000 brochures and 9,600 other informative materials were distributed at conferences held by the Bank and to visitors to the Madrid headquarters and the branch network, including professionals, students and others.

9.3 CO-OPERATION WITH THE ESCB

In 2007, the Banco de España carried out communication activities as a member of the ESCB. In addition to helping to define and implement the Eurosystem's communication strategy through its participation in the External Communications Committee and to publishing ECB press releases and communications on its website, the Communication Department carried out various initiatives within the Eurosystem communication plan, notably including activities

designed to perform the Eurosystem's mission, and preparation of the Banco de España's commemorative programme to celebrate in 2008 the 10th anniversary of the ESCB, the Eurosystem and the ECB and in 2009 the 10th anniversary of the introduction of the euro.

10 Internal organisation and administration

10.1 HUMAN RESOURCES AND ORGANISATION

Total number of staff
unchanged at 2,720

As at 31 December 2007, the Banco de España employed a total of 2,720 staff, the same as a year earlier as the number of new staff matched the number of departures. Last year, the Executive Commission approved the "Banco de España staff" and its distribution by area, as the starting point towards a target level, which has been set at 2,722 employees. The proportion of females increased, both overall and among management posts, where they reached 35%.

In order to contribute to greater mobility and transparency and to facilitate the search for the best professionals, a management-post pre-selection protocol was launched. This protocol establishes four possible channels for filling these discretionary positions, the preferred channel being internal appointment with publication of the vacancy, 29 posts having been filled by this means.

A special drive to promote internal mobility led to a total of 182 movements, involving 7% of the permanent staff.

In 2007, the Bank increased the number of students on work-experience contracts from the Colegio Universitario de Estudios Financieros (CUNEF), the Universidad Complutense de Madrid and the Centro de Estudios Monetarios y Financieros (CEMFI). In addition, a new Co-operation Agreement was signed with the Universidad Autónoma de Madrid.

Moving on to training, the activities performed in 2006 were continued and new courses were commenced, to boost both knowledge (of credit derivatives, financial instrument valuation, international accounting standards, use of the library and computer applications through e-learning) and skills (presentations and written communication in English). In addition, as a Eurosystem training activity, the Banco de España launched a course for training trainers, and also opened new skills training activities to participants from other Eurosystem central banks. At the same time, in October English training began to be given to branch employees and management-tool training in the context of organisation management, which was first given to Department Directors in 2004, was given lastly to Division Heads.

The average assessment of the training activities by participants was 8.6 out of 10. The number of employees trained rose by 6% from the previous year, to reach a total of 1,540.

The 2007 collective labour agreement represented a step forward in the reconciliation of work and family life

The 2007 collective labour agreement was characterised by progress in the reconciliation of work and family life, with new measures that notably include provision for a pilot telework programme. This agreement also involved an important step forward in the implementation of a plan to achieve effective equality between women and men, as well as increased working-hour flexibility and social improvements.

At the same time, employees were given access through the Intranet to new human resource management functions.

10.2 ADMINISTRATION AND PROPERTIES

During 2007, the ambitious programme to renovate facilities and update buildings, both at the Bank's central headquarters and at the branches and recreation centres, continued.

At the Cibeles complex the third and final phase of restoration of the zinc roofing of the old building was commenced, involving complete renovation using the same materials and the

original design. Inside the buildings of this complex the renovation and updating of security installations was being completed, and the work to improve fire-prevention installations was finished, with the incorporation of elements to separate areas in the event of fire or smoke and a megaphone system to enable evacuation drills to be performed.

Also, the conditions for reorganising and rationalising the maintenance of the facilities of the buildings of this complex were completed during 2007, so that next year a comprehensive maintenance contract will come into effect. This will replace 20 different contracts with a cost saving of around 13% per annum, and will also improve management efficiency.

A programme was drawn up for the renewal of branch network facilities

In 2007, the evaluation of the state of the general facilities at all the branches was concluded, enabling a programme to be drawn up for their modernisation, which will be implemented over the coming years, and the conditions to be established for efficient rationalisation of the maintenance contracts. Also, the renewal and updating of security installations was completed.

Access to the Bank's buildings was improved, under a specific programme for the elimination of impediments to access by the disabled, with the installation of elements eliminating barriers at the Alcalá, 522 building and at 12 of the 22 branches. It is planned to complete this programme during 2008 at the rest of the branches where it is technically viable.

10.3 CORPORATE DOCUMENT MANAGEMENT

The Banco de España, as part of the initiatives of documentary policy and electronic management, has a model for corporate document management which provides appropriate solutions to its current and future document processing needs. In 2007 this model was consolidated, revised and improved. More than 1,200 employees use the computer application GDC (corporate document manager), and 41,000 documents were incorporated in 2007.

Against this background, *Law 11/2007 on electronic access to public services* came into force on 24 June 2007. This law recognises the right of citizens to use electronic media to deal with public authorities in the course of administrative procedures, and also to obtain information, make consultations and declarations, file applications, give consent, file requests, make payments, perform transactions and object to administrative decisions and acts. Given the large documentary component of the Bank's administrative processes, this new law has an important impact on the conception of the document management system in the Banco de España. For this reason, implementation of an important project to extend corporate document management and to adapt working processes to comply with the requirements of Law 11/2007 has been initiated, in order to design and put into operation a plan of action to enable the requirements and deadlines of this Law to be met.

10.4 INFORMATION SYSTEMS AND PROCESSES

There was a high level of activity in this area in 2007, owing to the number of projects under way (102), the criticality of some of them (such as those related to TARGET2 entry) and the technological conversion of the applications of the central computer systems. To avoid the risk of technological obsolescence, the latter were switched from the Natural programming language and Adabas database to the Cobol programming language and DB2 database.

Also notable was the work performed to enable the Banco de España to join the SEPA (single euro payments area); the new system for declaring foreign accounts by internet, which incorporates for the first time the use of digital certificates (1,200 certificates have been issued for foreign institutions and 2,000 personal electronic certificates for Banco de España employees); and the start up of the new Central Balance Sheet Data Office operating system, of the integrated supervisory activity management system (SIGAS) and of the new Complaints Service complaint management system.

The Bank's central computers were updated, with the installation of equipment incorporating new technology and with a greater processing capacity, and a new configuration named SYSPLEX was developed and put into operation. This enabled the cost of renting programmes to be reduced significantly and gave the Bank a platform with new high-availability facilities, improving its disaster response capacity.

Under the equipment renewal plan, 1,085 pieces of equipment were replaced, including computers, monitors and printers, 789 of which were given to employees and 300 to non-profit institutions. The performance of the Bank's user help desk continued to improve; 42,237 calls and 30,094 incidents were handled.

With regard to business continuity, the draft Internal Circular on Business Continuity was finalised, which establishes the procedures for the resumption of activity, should an unforeseen event prevent work as normal, and the 2007 Test Plan was implemented, with the checking of the resumption of 79 processes on 20 test days. Also, the first Eurosystem Business Continuity conference was organised at the Banco de España.

10.5 CONTROL, BUDGET AND ACCOUNTING

A new Risk Management Committee set up to direct overall risk management

As part of the process of improving its corporate governance mechanisms, the Banco de España established the new conceptual framework to govern its internal control system. This framework sets the targets to be met, the basic principles and general guidelines on which its activities should be based, its organisational structure and the related assignment of functions. All of this culminated in the setting up of a new risk Management Committee to supervise the system and oversee overall risk management.

At the same time, and within the general framework mentioned, implementation of the operational risk management system was extended to six departments of the central services. Its introduction into all areas of the Bank is planned to be completed in 2008.

In the international arena, the International Working Group on Operational Risk, co-chaired by the Banco de España and the Federal Reserve Bank of Philadelphia, in which 35 central banks and/or regulatory/supervisory bodies from all over the world now participate, was strengthened. In the European arena the Bank participated very actively in the work commenced in the ECB to establish the general policy and principles that should govern operational risk management in the Eurosystem. Finally, the Banco de España has taken part in various events to train professionals from Latin American central banks in operational risk management.

In order to improve the procurement procedures for goods, supplies and services, a new Centralised Procurement Service was set up for all contracts exceeding a certain quantitative limit. At the same time, the Bank's budgetary rules were changed to adapt them to the new situation.

The Banco de España participated in the definition of a new monetary income system, to redistribute the income arising from monetary policy among the Eurosystem central banks, which will replace the current system from 2008, and in the definition of the procedures to distribute among the central banks the profits arising from unreturned issued euro banknotes.

10.6 INTERNAL AUDIT

According to the Statute approved by the *Internal Circular 4/2007 of 20 July 2007*, the aim of internal auditing is to evaluate the efficacy, sufficiency and suitability of all the systems and procedures established for the management and control of risks.

The internal audit function is performed by the Internal Audit Department, which reports directly to the Governor. In addition, the Internal Audit Department must afford the Audit Committee of the Governing Council all such assistance as it may request and provide it with any information it may need.

The Internal Audit Department and its audit staff shall adhere to the principles of objectivity, impartiality, confidentiality and absence of conflict of interests, and act in keeping with the principles, standards and procedures laid down in the *Internal Audit Manual* approved by Ordinance 7/2007 of 15 February 2007.

The Internal Audit Department'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 2007, the main audits performed by the Internal Audit Department related to the following: the annual accounts of the Banco de España; the report envisaged in *Law 44/2002 on financial system reform measures*; the security of automated information systems; the counting of the strategic reserves deposited by the ECB; the processing of euro banknotes (classification and destruction); the consolidated financial statements of the Eurosystem; monetary policy operations; Extranet and ESCB documentation distribution projects; local implementation of the SWIFT services used for TARGET and CCBM; and ordinary inspection of the Alicante, Barcelona, A Coruña, Málaga, Melilla, Tenerife, Toledo and Valladolid branches. Also, it monitored the recommendations of the specific audits of the Banco de España carried out between 2004 and 2006 and of those common to the ESCB.

ANNUAL ACCOUNTS OF THE BANCO DE ESPAÑA
2007

1 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). Pursuant to the provisions of that article, the accounts have been prepared in accordance with the accounting guidelines and instructions of the European Central Bank (ECB)¹ established under Article 26.4 of the Statute of the European System of Central Banks (ESCB)/ECB relating to standardisation of Eurosystem accounting principles and practices, and, whenever they are not applicable, in accordance with internal accounting policies. These internal policies follow generally accepted accounting principles, adapted to the special characteristics of the operations and functions of a central bank.

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 the Bank's Governing Council. 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 2006 are presented solely for comparison with 2007. 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 2007. Section 2 includes the balance sheet and profit and loss account at 31.12.2007; Section 3 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 4, 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. Guideline of the European Central Bank of 10 November 2006 on the legal framework for accounting and financial reporting in the ESCB (ECB/2006/16), as amended.

2 Balance sheet and profit and loss account

BALANCE SHEET OF THE BANCO DE ESPAÑA AS AT 31 DECEMBER 2007

EUR m

	NOTE NUMBER	2007	2006
ASSETS			
1 Gold and gold receivables	1	5,144.72	6,467.38
2 Claims on non-euro area residents denominated in foreign currency		3,749.43	3,855.62
2.1 Receivables from the IFM	2	589.64	674.33
2.2 Balances with banks and security investments, external loans and other external assets	3	3,159.78	3,181.29
3 Claims on euro area residents denominated in foreign currency	4	2,579.16	1,176.98
4 Claims on non-euro area residents denominated in euro		594.29	912.78
4.1 Balances with banks, securities investments and loans	5	594.29	912.78
4.2 Claims arising from the credit facility under ERM II		—	—
5 Lending to euro area credit institutions related to monetary policy operations denominated in euro	6	71,373.51	21,865.81
5.1 Main refinancing operations		57,247.89	18,695.60
5.2 Longer-term refinancing operations		14,123.44	3,169.93
5.3 Fine-tuning reverse operations		—	—
5.4 Structural reverse operations		—	—
5.5 Marginal lending facility		—	—
5.6 Credits related to margin calls		2.18	0.29
6 Other claims on euro area credit institutions denominated in euro	7	1.91	1.98
7 Securities of euro area residents denominated in euro	8	29,341.38	29,396.07
8 General government debt denominated in euro	9	5,832.38	7,416.32
9 Intra-Eurosystem claims	10	4,786.88	29,834.73
9.1 Participating interest in ECB		437.71	432.70
9.2 Claims equivalent to the transfer of foreign reserves		4,349.18	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)		—	25,075.06
10 Items in course of settlement		0.85	2.71
11 Other assets		51,824.13	36,880.40
11.1 Tangible and intangible fixed assets	11	229.93	210.72
11.2 Other financial assets	12	48,535.13	34,090.77
11.3 Off-balance sheet instruments revaluation differences	13	103.38	201.33
11.4 Accruals and prepaid expenses	14	1,795.09	1,511.27
11.5 Sundry	15	1,160.59	866.31
TOTAL ASSETS		175,228.63	137,810.78

	NOTE NUMBER	2007	2006
LIABILITIES			
1 Banknotes in circulation	16	67,612.95	62,864.84
2 Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	17	52,320.79	20,558.76
2.1 Current accounts (covering the minimum reserve system)		38,327.45	20,558.13
2.2 Deposit facility		215.00	—
2.3 Fixed-term deposits		13,775.00	—
2.4 Fine-tuning reverse operations		—	—
2.5 Deposits related to margin calls		3.34	0.64
3 Other liabilities to euro area credit institutions denominated in euro		—	—
4 Debt certificates issued		—	—
5 Liabilities to other euro area residents denominated in euro		20,355.60	17,503.08
5.1 General government	18	18,030.35	15,057.47
5.2 Other liabilities	19	2,325.25	2,445.62
6 Liabilities to non-euro area residents denominated in euro	20	157.98	126.59
7 Liabilities to euro area residents denominated in foreign currency		1.24	2.07
8 Liabilities to non-euro area residents denominated in foreign currency		117.03	154.14
8.1 Deposits, balances and other liabilities	21	117.03	154.14
8.2 Liabilities arising from the credit facility under ERM II		—	—
9 Counterpart of special drawing rights allocated by the IMF	22	320.92	341.12
10 Intra-Eurosystem liabilities	23	21,141.50	24,113.87
10.1 Net liabilities related to the allocation of euro banknotes within the Eurosystem		17,903.61	24,113.87
10.2 Other liabilities within the Eurosystem (net)		3,237.89	—
11 Items in course of settlement	24	209.75	205.57
12 Other liabilities		608.99	548.05
12.1 Off-balance-sheet instruments revaluation differences	25	—	—
12.2 Accruals and income collected in advance	26	293.32	238.25
12.3 Sundry	27	315.67	309.80
13 Provisions	28	4,005.81	2,651.57
14 Revaluation accounts	29	4,371.09	5,293.55
15 Capital and reserves		2,000.00	1,500.00
15.1 Capital	30	1,000.00	1,000.00
15.2 Reserves	31	1,000.00	500.00
16 Profit for the year	32	2,004.98	1,947.57
TOTAL LIABILITIES		175,228.63	137,810.78

	NOTE NUMBER	2007	2006
1 Interest income	1	5,060.38	3,493.02
2 Interest expense	2	2,177.94	1,442.89
3 Net interest income (1 – 2)		2,882.43	2,050.13
4 Realised gains/losses arising from financial operations	3	1,745.19	453.04
5 Write-downs on financial assets and positions	4	529.44	239.54
6 Transfer to/from provisions for foreign exchange rate and price risks	5	1,688.56	-1.36
7 Net result of financial operations, write-downs and risk provisions (4 – 5 – 6)		-472.81	214.86
8 Fees and commissions income		19.09	15.43
9 Fees and commissions expense		7.27	6.25
10 Net income from fees and commissions (8 – 9)	6	11.82	9.17
11 Income from equity shares and participating interests	7	9.68	20.22
12 Net result of pooling of monetary income	8	37.25	21.23
13 Other income and losses	9	-22.95	81.73
14 TOTAL NET INCOME (3 + 7 + 10 + 11 + 12 + 13)		2,445.42	2,397.34
15 Staff costs	10	211.14	204.63
16 Administrative expenses	11	113.94	111.18
17 Depreciation of tangible and intangible fixed assets	12	20.12	33.97
18 Banknote production services	13	70.95	89.48
19 Other expenses		2.35	2.26
20 TOTAL OPERATING EXPENSES (15 + 16 + 17 + 18 + 19)		418.49	441.52
21 Transfers and additions to other funds and provisions	14	21.95	8.26
22 PROFIT FOR THE YEAR (14 – 20 – 21)	15	2,004.98	1,947.57

Countersigned by
The Governor,



MIGUEL FERNÁNDEZ ORDÓÑEZ

The Comptroller,



ANTONIO ROSAS

3 Notes on the accounts

3.1 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. Futures shall be valued daily at market price and significant participating interests at underlying book value.

Transactions in assets and liabilities are generally recorded on the settlement date. However, since 2 November 2006 the Banco de España has applied the so-called economic approach², and, within it, the alternative method. Under this method, forward transactions in foreign currencies and in gold are booked at the spot settlement date (usually the trade date plus two days), unless a period-end falls between the trade date and the spot settlement date, in which case they have to be recognised at the trade date.

The specific valuation criteria applied to the various assets and liabilities were the following:

Gold

Gold is recorded at acquisition cost³, which is determined by the cash amount paid in the transaction including any related expense.

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.

2. Defined in the Guideline of the European Central Bank of 10 November 2006 on the legal framework for accounting and financial reporting in the ESCB (ECB/2006/16), as amended. 3. As at 31/12/1998 its acquisition cost was adjusted to the market price then prevailing and the unrealised gains were credited to revaluation accounts. These gains are subsequently credited to profit and loss when the asset is sold or, alternatively, they are used to offset unrealised losses.

Foreign currencies

Spot purchases or sales of foreign currencies are recorded at the settlement date, affecting the foreign currency position from that date. In application of the economic approach, gains and losses on the spot sale of foreign currencies are similarly considered to be realised from the settlement date. Meanwhile, foreign exchange forward purchase and sale transactions shall be recognised in off-balance-sheet accounts at the spot date of the transaction, affecting the foreign currency position as at that date. The gain or loss on the transaction shall also be considered to be realised on that date.

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 trade date. Transactions in a foreign currency that do not modify the overall position therein have no effect on the book value of such position.

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

In application of the aforementioned economic approach, accrued interest denominated in foreign currency is recorded on a daily basis using the mid-market rate on each day. If the rate on the relevant day is not available, the latest mid-market rate available shall be applied. Accrued interest receivable or payable denominated in foreign currency shall form part of the foreign currency position.

Foreign currencies are revalued monthly to market price. This revaluation is performed without netting unrealised gains against unrealised losses on the various currencies. Unrealised gains and losses (except for unrealised losses at year-end) are reflected in adjustment accounts and credited or debited, respectively, to revaluation accounts and expense accounts. Both revaluation and expense accounts are reversed at the end of the following month.

Unrealised losses existing at the end of the year are taken to the profit and loss account for the year, in which case they affect the average cost of the currency in question. Such losses are considered irreversible in subsequent revaluations.

Foreign banknotes

The criteria applied are the same as those indicated in the preceding section for foreign currencies.

Special drawing rights (SDRs)

SDRs and the net position in the International Monetary Fund (IMF) are valued at the year-end SDR market exchange rate by the same methods used for other currencies.

Securities

Since 15 June 2006, the Banco de España holds two separate securities portfolios: a trading portfolio and a held-to-maturity portfolio.

In both cases, the securities are recorded at acquisition cost (subject to loss of value due to impairment of the issuer, in the case of the held-to-maturity portfolio), which is determined by the cash amount paid, less any accrued gross coupon.

The cost of securities sold or redeemed is determined by the average book price of the security in question. The securities in the held-to-maturity portfolio may not be sold except in exceptional circumstances and with the authorisation of the Executive Commission.

Trading portfolio securities are revalued monthly to market price. This revaluation is carried out without any netting of unrealised gains and losses on different security codes. Unrealised gains and losses (with the exception of unrealised losses at year-end) are reflected in adjustment accounts and credited or debited, respectively, to revaluation and expense accounts. Both revaluation and expense accounts are reversed in subsequent revaluations. Unrealised losses existing at the end of the year are taken to the profit and loss account. Their amount is credited directly to the securities account, and the average book price – and therefore the internal rate of return – of the security code concerned is modified. Such losses are considered irreversible, not being reversed at the end of the following month.

Securities within the held-to-maturity portfolio are not subject to any periodic valuation.

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. These accruals are recorded daily.

The above references to acquisition cost and market prices shall, in relation to securities denominated in foreign currency, be understood to refer to the currency concerned, these amounts being translated into euro, as stipulated in the “Foreign currencies” section.

Repurchase agreements involving securities

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

Repurchase agreements involving securities are recorded on the liabilities side of the balance sheet as an inward deposit collateralised by securities, the balancing entry of which is the cash received. Securities sold under this type of agreement remain on the Bank's balance sheet and are treated as if they had remained part of the portfolio from which they were sold. Repurchase agreements involving securities denominated in foreign currencies have no effect on the average cost of the currency position.

In direct loans of securities, repurchase and reverse repurchase agreements conducted simultaneously are accounted for separately, each being recorded according to the valuation rules set forth in the preceding two paragraphs.

Automated security loans (contracts empowering a depository of securities to lend them to a third party in overnight transactions, subject to certain contractual limitations) are not recorded in the balance sheet. The only item accounted for is the income, which is recorded in the profit and loss account. Transactions outstanding at year-end are recorded off-balance-sheet.

Doubtful debtors

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

Loans to financial institutions and balances with EU central banks

These are valued at their nominal amount.

Special loans to the State

Special loans granted to the State that are referred to in transitional provision seven of Law 21/1993 on the State budget for 1994 are valued at their nominal amount (see Note 28 to the balance sheet and Note 5 to the profit and loss account).

Shares and participating interests Shares and participating interests in national and/or international institutions, including the participating interest in the European Central Bank (ECB), are valued at cost. The participating interest in Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros S.A. is valued at its underlying book value.

Tangible and intangible fixed assets Fixed assets are generally valued initially at cost, defined as the amount of the monetary disbursements made or committed to, including any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the intended manner, such as transport, installation, professional fees for legal services, non-refundable taxes and the fair value of other consideration given.

Trade discounts and those for defects in assets received are recorded as a reduction in the cost of the related assets. Cash discounts and those for late delivery are recorded in the profit and loss account under other income or, where appropriate, as a reduction in expenses, and do not affect the acquisition cost of the asset purchased.

Fixed assets are deemed not to include those assets which, although meeting the conditions to be classed as such (i.e. they are non-financial assets owned by the Bank that are intended be used for a period exceeding 12 months and contribute directly or indirectly to fulfilling its objectives and/or to the probable generation of income in the future and, in addition, their cost can be reliably assessed), do not generally exceed the amount of €600 (€6,000 in the case of buildings, structures and plant in buildings), although there may be exceptions.

Only extensions, replacements, rehabilitations and improvements that exceed €6,000 are capitalised, provided also that the elements replaced can be removed from the balance sheet.

Computer applications developed specifically for the Banco de España the cost of which does not exceed €300,000 are recorded directly as expenses and are not eligible for subsequent capitalisation.

After initial recognition, fixed assets are valued at acquisition cost less accumulated depreciation or amortisation and any impairment losses.

The acquisition cost of a fixed asset, net of its residual value, is depreciated or amortised systematically during its useful life on a monthly basis from the month following that in which it was recognised in the accounts. Generally, all depreciable/amortisable fixed assets are estimated to have a residual value of zero unless there is a deep, liquid market for assets similar to the one whose residual value may be received. Land, the art collection and fixed assets under construction are not depreciated.

The depreciation/amortisation rates and estimated useful lives applied to the various fixed assets in 2007 were as follows:

	Depreciation /Amortisation Rate (%)	Useful life (years)
Buildings and structures	2	50
Renovation work	4	25
Plant in buildings (a)	10	10
Security-related plant in buildings	20	5
Furniture and fittings	10	10
Office machines other than computer equipment. For the handling of banknotes and coins	10	10
Office machines other than computer equipment. Other office machines	20	5
Computer equipment	25	4
Transport equipment. Cars and motor bikes	25	4
Transport equipment. Trucks and buses	10	10
Libraries	10	10
Other tangible fixed assets	20	5
Computer applications	20	5
Industrial property	—	Number of years of exclusive use

a. Except security-related plant in buildings, which will have a useful life of five years (20%).

An asset is impaired when its book value exceeds the recoverable value. In this case, and only if the amounts are significant, an impairment loss is recognised by simultaneously reducing the item's book value and modifying its depreciable/amortisable base.

Banknotes in circulation

The ECB and the national central banks (NCBs), which together comprise the Eurosystem, have issued euro banknotes since 1 January 2002⁴. The total value of euro banknotes in circulation is recorded by allocating to each Eurosystem NCB, on the last working day of each month, an amount based on the banknote allocation key⁵.

The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation, whereas the remaining 92% has been allocated to the NCBs and divided amongst them 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 interest⁶, are disclosed under the sub-item "Intra-Eurosystem: Net claims/liabilities related to the allocation of euro banknotes within the Eurosystem" (see "Intra-Eurosystem balances" in this section 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 the relative income positions of the NCBs that initially formed part of the Eurosystem as compared with previous years. The adjustments are effected by taking into account the differences between the average value of banknotes in circulation of each NCB in the period between July 1999 and June 2001 and the

4. 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, as amended. 5. The banknote allocation key is that which results from applying 92% to the Eurosystem subscribed capital key (the other 8% is attributed to the ECB). 6. 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 to 2007, inclusive (ECB/2001/16), OJ L 337, 20.12.2001, as amended.

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. However, the entry of Slovenia in the Eurosystem on 1 January 2007 entails a new adjustment of this type, which will affect the period 2007-2012. Subsequently, the entry of Malta and Cyprus in the Eurosystem on 1 January 2008 also brought a fresh adjustment of this type, which will affect the period 2008-2013.

The interest income and expense on these balances is cleared through the accounts of the ECB and is disclosed under "Net interest income" in the profit and loss account.

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 annually⁷. This Decision stipulates however that the ECB's Governing Council may decide before the end of the financial year to transfer part or all of this income to an ECB 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.

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 TARGET⁸ 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.

In the case of TARGET operations, the resulting balance is included as an asset or liability, as appropriate, under the sub-item "Other claims/liabilities within the Eurosystem (net)". Intra-ESCB balances arising from the allocation of euro banknotes within the Eurosystem are included, depending on their net amount, as an asset or liability under "Net claim/liability related to the allocation of euro banknotes within the Eurosystem" (see "Banknotes in circulation" in this section on accounting policies).

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.

⁷. Decision ECB/2002/9 of 21 November 2002, which previously regulated this matter, stipulated that the distribution of this income to national central banks was to be quarterly. ⁸. Trans-European Automated Real-time Gross settlement Express Transfer system.

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

Premiums or discounts on purchased securities are calculated and shown as reductions of or additions to 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. Contributions made by the Banco de España on behalf of the employees who, having joined the Bank after 1/2/1986, are eligible to and do participate in the Scheme, are established at 7.5% of the so-called "regulating salary", consisting of the salary items determined in the Scheme Rules. The amounts contributed by the Bank are recognised as a current expense in the year to which they relate.

Off-balance sheet positions⁹

Foreign exchange forward currency positions, which comprise 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.

As a general rule, 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. Specifically, in application of the economic approach, the gains and losses on positions in interest rate futures are considered to be realised at the time when they are settled net each day. In the case of futures denominated in foreign currency, such settlements shall affect the foreign currency position on the day on which they take place.

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.

Other matters

In view of the nature of the Banco de España, it is considered that the publication of a statement of cash flows would not provide any significant additional information to the users of the financial statements.

3.2 Notes on the balance sheet

1 GOLD AND GOLD RECEIVABLES

The Banco de España's gold holdings amount to €5,144.72 million, consisting of 9,054 million troy ounces¹⁰ of fine gold valued at €568.24 per ounce. The value of these holdings is €1,322.66 million less than in 2006, as a result of the sales during the year (4.345 million troy ounces) under the gold agreement between central banks of 8 March 2004, partially offset by the rise in the market price (at 2006 year-end, the price per ounce was €482.69).

2 CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY.— RECEIVABLES FROM THE IMF

This sub-item has three components:

- a The position in the International Monetary Fund (IMF) in the reserve tranche. This is the euro equivalent of the SDRs relating to the foreign currencies assigned to the IMF due to Spain's initial quota and successive increases in it and due to the

⁹ 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. ¹⁰ One troy ounce is equal to 31.1035 grams.

net financing granted to the IMF. Spain's IMF quota was not changed in 2007 and remained at SDR 3,048.90 million.

- b Special drawing rights (allocations). These represent the euro equivalent of the successive allocations of this currency by the IMF. The changes in allocations are mainly due to loan agreement transactions with third countries and to interest receipts or payments resulting from positions vis-à-vis the IMF.
- c Other claims on the IMF. These reflect the amount that the Banco de España has provided to the IMF as a contribution to the Poverty Reduction and Growth Facility. This fund is used to finance low-interest loans to the poorest countries. The Banco de España has undertaken to contribute a maximum of SDR 425 million to this fund.

The breakdown in 2006 and 2007 is as follows:

EUR m				
	Type of asset	2007	2006	Change
	Reserve tranche position	217.00	302.75	-85.75
	Special drawing rights (allocation)	250.74	254.20	-3.46
	Other claims on the IMF	121.91	117.38	4.52
	TOTAL	589.64	674.33	-84.69

The overall amount of claims on the IMF decreased by €84.69 million with respect to the balance at end-2006. The decrease, basically in the reserve tranche position account, arose from net repayments to the Banco de España by the IMF of loans to third countries (Turkey, Romania, Sri Lanka, Ukraine and Bosnia-Herzegovina) which have fulfilled their obligations. Of this amount, €47.57 million related to the net decrease in amounts denominated in foreign currencies and the remaining €37.11 million to the change in market foreign exchange rates between the two years.

SDRs are valued at the year-end market rate, calculated by the ECB for all the Eurosystem national central banks, of €1 = SDR 0.931099. SDRs are defined in terms of a basket of currencies. Its value is determined as the weighted sum of the exchange rates of the four major currencies: the US dollar, the euro, the yen and the pound sterling. The interest rate, which is updated weekly, remained between 3.38% and 4.38% during the year.

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 deposits, debt security investments in the trading portfolio and other claims on non-euro area residents denominated in foreign currency. Their total amount as at 31.12.2007 was €3,159.78 million, with the following breakdown:

EUR m				
	Type of asset	2007	2006	Change
	Deposits	492.29	873.17	-380.88
	Security investments (a)	2,667.19	2,306.77	360.41
	Other	0.31	1.35	-1.04
	TOTAL	3,159.78	3,181.29	-21.51

a. As at 31 December 2007, repurchase agreements were constituted over part of the USD-denominated securities portfolio with a market value of USD 1,986.41 million, under automated security lending contracts with the depositories of these securities.

As at 31 December 2007, 99.78% of these assets 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 1.4721).

The decrease in the balance of this sub-item (€21.51 million) was due to the net effect of the factors listed in the following table:

EUR m		
	Reason for change	Amount
	Net purchase/sale	-33.65
	Adjustment to market exchange rates as at 31 December	-20.50
	Adjustment to market prices as at 31 December	37.84
	Accrued interest receivable	-5.01
	Other	-0.20
	TOTAL	-21.51

The main reason for the decrease in this sub-item was the decline in the balance held in US dollar-denominated fixed-term deposits, partly offset by the increase in trading portfolio securities.

4 CLAIMS ON EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY

This balance sheet item may include current accounts, balances with banks and security investments. As at 31.12.2007, deposits at monetary financial institutions amounting to €747.23 million were held. The year-end balance also includes a claim arising from reverse operations with Eurosystem counterparties amounting to €1,831.87 million in connection with the US dollar Term Auction Facility. Under this program USD 20 billion were provided by the Federal Reserve to the ECB by means of a temporary reciprocal currency arrangement (swap line) with the aim of offering short-term US dollar funding to Eurosystem counterparties. The ECB simultaneously entered into back-to-back swap transactions with NCBs that have adopted the euro, which used the resulting funds to conduct liquidity-providing operations with the Eurosystem counterparties. These back-to-back swap transactions resulted in non-remunerated inter-Eurosystem balances between the ECB and the NCBs reported under "Other claims within the Eurosystem (net)".

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 and trading portfolio securities denominated in euro. Of the total of this sub-item (€594.29 million), substantially all (€593.73 million) relates to fixed-income securities issued in euro by international agencies (European Investment Bank and Bank for International Settlements), which nevertheless decreased by €318.45 million with respect to the balance as at 31.12.2006, as shown in the following table:

EUR m				
	Type of asset	2007	2006	Change
	Balances with banks	0.56	0.60	-0.04
	Security Investments	593.73	912.18	-318.45
	Loans	0.00	0.00	0.00
	TOTAL	594.29	912.78	-318.49

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 by type of transaction is as follows:

EUR m			
Type of operation	2007	2006	Change
Main financing operations	57,247.89	18,695.60	38,552.29
Longer-term refinancing operations	14,123.44	3,169.93	10,953.51
Fine-tuning reverse operations	—	—	—
Structural reverse operations	—	—	—
Marginal lending facility	—	—	—
Credits related to margin calls	2.18	0.29	1.90
TOTAL	71,373.51	21,865.81	49,507.69

In the second half of the year, against a background of money market tensions in the euro area, the ECB conducted liquidity-providing operations of various maturities to meet the additional liquidity demands and hold very short-term interest rates near to the minimum bid rate on main refinancing operations.

The balance of this item as at 31 December 2007 exceeds that of 2006 by 226.42%. However, the average daily balance of the financing granted during the year only increased by 8.47% (€25,943.00 million in 2007, against €23,916.45 million in 2006).

70.41% of the annual average balance of daily financing was extended through “Main refinancing operations” and another 29.46% was granted under “Longer-term refinancing operations”. Only 0.12% was financed through other instruments.

a. Main refinancing operations

These operations play a pivotal role in achieving 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 €57,247.89 million as at 31.12.2007. This was €38,552.29 million more than at 31.12.2006 for the aforementioned reasons and meant a significant decrease in the external financing requested by these institutions, as reflected in the intra-Eurosystem position arising from TARGET transactions (see Note 23).

b. Longer-term refinancing operations

These operations aim to provide counterparties with additional longer-term refinancing. They account for a limited part of the overall 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 €14,123.44 million as at 31.12.2007, showing an increase of €10,953.51 million with respect to the previous year.

This increase, which took place in the second half of the year, is a consequence of the measures taken in the Eurosystem to normalise the functioning of the euro money market, along the lines mentioned above. These measures were effected partly through transactions of this type, which provide supplementary liquidity.

c. Fine-tuning reverse operations	<p>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.</p> <p>Their balance at end-2007 was zero, as it was at the previous year-end, although seven fine-tuning reverse operations took place in the Eurosystem during the year. Financing was obtained by Spanish credit institutions in six of them.</p>
d. Structural reverse operations	<p>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.</p> <p>The end-2007 balance was zero, as it was at the previous year-end. No structural reverse operations took place during the year.</p>
e. Marginal lending facility	<p>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.</p> <p>The end-2007 balance was zero, as it was at the previous year-end. Very few of these transactions were carried out during the year.</p>
f. Credits related to margin calls	<p>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).</p> <p>In the national central banks that make margin calls by debiting or crediting the accounts of credit institutions, as is the case for the Banco de España, these debits or credits are the balancing entries of the asset-side or liability-side accounts reflecting the changes in these margins. These balance sheet accounts are remunerated at the interest rate applied in main refinancing operations</p> <p>As at 31.12.2007 this sub-item had a balance of €2.18 million, up €1.90 million with respect to the previous year.</p>
7 OTHER CLAIMS ON EURO AREA CREDIT INSTITUTIONS DENOMINATED IN EURO	<p>This item includes claims on credit institutions unrelated to monetary policy operations. Its balance of €1.91 million as at 31.12.2007, which includes the amount of the correspondent accounts in euro with euro area credit institutions, is €0.06 million lower than in 2006.</p>
8 SECURITIES OF EURO AREA RESIDENTS DENOMINATED IN EURO	<p>This item includes that part of the Bank's trading portfolio which consists of euro-denominated fixed-income securities issued by euro area residents, as follows:</p>

EUR m

Type of security	2007	2006	Change
DOMESTIC	5,910.94	7,353.26	-1,442.31
Issued by general government	4,908.76	6,240.97	-1,332.21
Issued by financial institutions	1,002.18	1,112.29	-110.11
NON-DOMESTIC	23,430.43	22,042.81	1,387.62
Issued by general government	21,594.48	19,500.30	2,094.18
Issued by financial institutions	1,835.96	2,542.51	-706.56
TOTAL	29,341.38	29,396.07	-54.69

The balance of this item as at 31.12.2007 was €29,341.38 million¹¹, of which 79.9% relate to non-domestic securities and the remainder (20.1%) to domestic securities. Of the former, 92.2% were issued by general government and 7.8% by financial institutions.

Overall, these securities decreased by €54.69 million in 2007. Specifically, the portfolio of Spanish fixed-income public debt declined by €1,332.21 million and securities issued by monetary financial institutions were down by €816.66 million, while non-Spanish general government securities rose by €2,094.18 million.

Specifically, the changes were for the reasons reflected in the following table:

EUR m

Reason for change	Amount
Net sales of securities	-468.56
Net unrealised gains at year-end	6.91
Accrued implicit interest	406.96
TOTAL	-54.69

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 1993 on the State budget for 1994. Initially they were to be repaid at their nominal amount on a straight-line basis over twenty-five years by means of yearly payments as from 1999, inclusive. However, on 26 March 2007 an agreement was entered into with the State government, represented by the Director General of the Treasury and Financial Policy by delegation of the Minister of Economy and Finance, to bring forward the repayment schedule of these loans, such that they mature in full by 2015 at the latest and the Treasury can request early repayment of a part or all of them, paying the cash amount of their market value.

Under that agreement, in 2007 two instalments of the Law 3/1983 loan (that of the reporting year and the last outstanding instalment of the original repayment schedule) and the instalments of the other two loans corresponding to the reporting year were paid.

¹¹. As at 31 December 2007, repurchase agreements were constituted over part of the euro-denominated securities portfolio with a market value of €252.88 million, under automated securities lending contracts with the depositories of these securities.

The outstanding nominal balance as at 31 December 2007 of the loans granted to the State amounted to €5,832.38 million, broken down as follows:

EUR m	2007	2006	Change
Treasury. Law 3/1983 special account	1,562.01	1,757.26	-195.25
Treasury. Law 4/1990 special account	3,821.39	4,168.78	-347.40
Treasury. Credits arising from subscription for participating interests, contributions and quotas in international agencies	448.99	489.80	-40.82
TOTAL	5,832.38	6,415.85	-583.47

The change was solely due to yearly repayments on the above-mentioned loans, as set out above. The amounts are shown in the above table.

b. Social Security System

This sub-item, which had a zero balance at year-end, 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.

In 2007, in compliance with the third additional provision of Law 4/2007 of 3 April 2007, the Directorate General of the Social Security Treasury agreed with the Banco de España to settle in full the loan, the balance of which was €1,000.47 million as at 31.12.2006, and was reimbursed at the debt's present value at the time of payment (see Note 5 to the profit and loss account).

10 INTRA-EUROSISTEM CLAIMS

This item includes the amounts of the following sub-items:

EUR m	2007	2006	Change
Type of asset			
Participating interest in the ECB	437.71	432.70	5.01
Claims equivalent to the transfer of foreign reserve assets to the ECB	4,349.18	4,326.98	22.20
Net claims related to the allocation of euro banknotes within the Eurosystem	0.00	0.00	0.00
Other claims within the Eurosystem (net)	0.00	25,075.06	-25,075.06
TOTAL	4,786.88	29,834.73	-25,047.85

a. Participating interest in the ECB

As at 31 December 2007 this sub-item totalled €437.71 million. This total amount is divided into two components: participating interest in capital and participating interest in equity excluding capital. Regarding the first of these components, the capital subscribed and paid by the Banco de España amounted to €434.92 million, which is equal to a share of 7.5498% in such capital. This percentage is that corresponding to the Banco de España in accordance with the capital key established using European Commission data on the basis of Spain's population and GDP relative to those of the total ESCB countries. The second component (participating interest in ECB equity excluding capital) amounted at that date to €2.79 million, which is the amount of the cost paid due to the adjustments to the ECB capital key.

Pursuant to Article 28 of the ESCB Statute, the ESCB national central banks are the sole subscribers to the capital of the ECB. Subscriptions depend on the participating interests fixed in accordance with Article 29 of the ESCB Statute and which must be adjusted every five years or whenever new Member States join the European Union and their NCBs thus join the ESCB. On 1 January 2007 the ECB capital key was again changed for this latter reason (accession of Bulgaria and Romania to the ESCB). Based on the Council Decision of 15 July 2003 on the statistical data to be used for the determination of the key for subscription of the capital of the European Central Bank, the capital keys of the NCBs were adjusted on 1 January 2007 by means of transfers among the NCBs.

In accordance with Article 49.3 of the Statute of the ESCB, which was added to the Statute by the Treaty of Accession, the ECB's subscribed capital is automatically increased when a new member joins the EU and its NCB joins the ESCB. The increase is determined by multiplying the prevailing amount of the subscribed capital (in this case €5,565 million) by the ratio, within the expanded capital key, between the weighting of the entering NCB(s) and the weighting of those NCBs that are already members of the ESCB. Therefore, on 1 January 2007 the subscribed capital of the ECB was increased to €5,761 million. Consequently, on 1 January 2007, the share that the Banco de España held in the increased subscribed capital of the ECB – €5,761 million – decreased from 7.7758% to 7.5498% and asset item 9.1 "Participating interest in the ECB" increased from €432.70 million to €434.92 million.

Further, as a result of the aforementioned capital key changes, the relative shares of NCBs in the accumulated net profits of the ECB – equity (excluding capital) – as at 31 December 2006 also changed. This change is also included in this sub-item for the cost of the adjustments.

b. Claims equivalent to the transfer of foreign reserve assets to the ECB

These represent ECB's debt to the Banco de España arising from the transfer of foreign reserve assets to the ECB. The claims are denominated in euro at a value fixed from 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-2007 balance amounted to €4,349.18 million, an increase of €22.20 on the previous year.

The reasons for this increase is that the adjustments to the capital key and the resulting changes in the NCBs' participating interests in the subscribed capital of the ECB made it necessary to also adjust the assets that the ECB credited to the NCBs for their contributions of external reserve assets to it. Despite the decrease in the Banco de España's capital key, its asset-side balancing entry of the external reserves transferred to the ECB (asset sub-item 9.2) increased in January 2007 by €22.20 million with respect to December 2006 to the aforementioned figure of €4,349.18 million, as a result of the rise in the Banco de España's relative weight in the capital of the ECB in comparison with the other central banks participating in the euro and, consequently, in the reserves each NCB has to transfer.

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)

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.

11 TANGIBLE AND INTANGIBLE FIXED ASSETS

The balance of this sub-item amounted to €229.93 million at end-2007, of which €505.36 million related to cost and €275.43 to accumulated depreciation.

The breakdown of this sub-item into its components, together with their accumulated depreciation, is as follows:

EUR m	2007	2006	Change
TANGIBLE FIXED ASSETS	429.56	384.63	44.93
Land and unbuilt plots	5.35	4.52	0.84
Buildings, structures and renovation work	99.28	78.78	20.50
Plant in buildings	137.70	124.00	13.71
Furniture and fittings	33.24	30.76	2.48
Office machines other than computer equipment	43.10	42.87	0.23
Computer equipment	51.20	45.13	6.07
Transport equipment	9.06	8.81	0.24
Libraries	9.23	8.67	0.56
Other tangible fixed assets	3.26	3.21	0.05
Art collection	38.14	37.88	0.26
INTANGIBLE FIXED ASSETS	40.18	34.63	5.56
Computer applications	40.13	34.57	5.55
Industrial property	0.06	0.05	0.00
FIXED ASSETS IN PROGRESS	35.62	51.21	-15.59
Buildings, plant in buildings and other structures under construction	30.91	48.77	-17.86
Computer applications under development	4.31	1.74	2.57
Other fixed assets in progress	0.40	0.70	-0.30
TOTAL	505.36	470.47	34.90

EUR m	2007	2006	Change
Accumulated depreciation or amortisation			
TANGIBLE FIXED ASSETS	-247.11	-234.84	-12.26
Buildings, structures and renovation work	-28.24	-26.52	-1.71
Plant in buildings	-109.87	-106.77	-3.10
Furniture and fittings	-20.24	-18.92	-1.32
Office machines other than computer equipment	-36.30	-35.17	-1.12
Computer equipment	-37.80	-34.46	-3.34
Transport equipment	-5.28	-4.31	-0.96
Libraries	-6.59	-6.11	-0.48
Other tangible fixed assets	-2.79	-2.56	-0.22
INTANGIBLE FIXED ASSETS	-28.32	-24.90	-3.42
Computer applications	-28.27	-24.86	-3.41
Industrial property	-0.05	-0.04	-0.01
TOTAL	-275.43	-259.74	-15.68

The increase in fixed assets in 2007 basically arose from the transfer of significant items of fixed assets in progress to “Buildings, structures and renovation work” and “Plant in buildings” following construction of the remaining portion of the Bank’s headquarters in Madrid and from the new investments in security-related plant in buildings, both in central headquarters and in branches. Also noteworthy was the increase in investments in computer equipment and in certain computer applications under development.

12 OTHER FINANCIAL ASSETS

The balance of this sub-item at end-2007 (€48,535.13 million) includes the Banco de España’s held-to-maturity portfolio and other financial investments.

To ensure stable returns throughout the cycle, on 15 June 2006 the Executive Commission authorised the creation of a held-to-maturity portfolio. This portfolio, which is valued at amortised cost, enables more stable yearly profits to be achieved because it is not subject to the annual recognition of unrealised gains and losses.

The Banco de España's held-to-maturity portfolio had the following balances at the end of 2006 and 2007:

EUR m			
Held-to-maturity portfolio securities	2007	2006	Change
IN FOREIGN CURRENCIES	3,749.03	4,164.92	-415.89
Issued by non-euro area residents	3,749.03	4,164.92	-415.89
Issued by euro area residents	0.00	0.00	0.00
IN EURO	44,734.71	29,878.21	14,856.50
Issued by non-euro area residents	4,379.57	3,702.55	677.02
Issued by euro area residents	40,355.14	26,175.65	14,179.48
TOTAL	48,483.74	34,043.12	14,440.61

The change in this sub-item (€14,440.61 million) basically resulted from the increased investment in this portfolio through the addition of euro-denominated securities issued by euro area residents.

This sub-item also includes €51.39 million of other financial investments relating basically to the Banco de España's participating interests in the Bank for International Settlements and Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A. The increase of €3.75 million in these financial assets was due to the rise in the underlying book value of the shares of the latter company.

13 OFF-BALANCE-SHEET INSTRUMENTS REVALUATION DIFFERENCES

This sub-item includes the amount of the net debtor position arising from foreign-exchange forward and swap transactions valued at the exchange rates prevailing at the end of the year. When the position is a creditor one, it is recorded under the same heading in liability sub-item 12.1. Its balance of €103.38 million as at 31.12.2007 is the net value of the swap transactions outstanding at that date. This includes the outstanding swaps with the ECB under the US dollar Term Auction Facility programme with the Federal Reserve.

14 ACCRUALS AND PREPAID EXPENSES

The main components of this sub-item, the balance of which amounts to €1,795.09 million, are as follows:

EUR m	2007	2006	Change
ACCRUED INTEREST ARISING FROM SECURITIES ACQUISITIONS AND ACCRUED COUPON INTEREST RECEIVABLE	1,455.54	1,225.33	230.21
Trading portfolio	486.21	560.28	-74.07
<i>Denominated in foreign currency</i>	22.86	20.59	2.26
<i>Denominated in euro</i>	463.35	539.69	-76.34
Held-to-maturity portfolio	969.33	665.05	304.28
<i>Denominated in foreign currencies</i>	33.12	34.68	-1.56
<i>Denominated in euro</i>	936.21	630.37	305.83
OTHER ACCRUED INTEREST RECEIVABLE	323.00	270.98	52.02
On forward foreign exchange transactions	0.00	0.00	0.00
On swaps	0.00	0.00	0.00
On deposits and other assets denominated in foreign currency	28.12	70.48	-42.37
On claims equivalent to the transfer of foreign reserves to the ECB	147.34	105.00	42.35
On other intra-Eurosystem claims arising from TARGET transactions	1.19	69.57	-68.38
On loans collateralised by securities	101.69	17.25	84.43
Other	44.66	8.68	35.98
ACCRUED COMMISSIONS RECEIVABLE AND PREPAID EXPENSES	12.28	12.28	0.00
ACCRUED DIVIDENDS RECEIVABLE	4.26	2.67	1.60
TOTAL	1,795.09	1,511.27	283.82

As can be seen from the foregoing table, the most significant accounts are accrued interest arising from securities acquisitions and accrued coupon interest receivable denominated in euro arising from trading portfolios (€463.35 million) and from held-to-maturity portfolios (€936.21 million).

15 OTHER ASSETS. SUNDRY

The most significant components of this sub-item, which totals €1,160.59, are the transfer made to the Treasury on 2 November 2007 of €981.21 million, equivalent to 70% of the Bank's distributable profits earned to 30 September 2007, which was €286.14 million higher than in the previous year, and the home loans and repayable advances granted to employees of the Bank, the balance of which, at €167.05 million, was up by €9.34 million.

16 BANKNOTES IN CIRCULATION

The balance of banknotes in circulation (€67,612.95 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 (9.9925%¹² of the total issue by all the central banks) after deducting those corresponding to the ECB (8% of the total). This balance was €4,748.12 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 €52,320.79 million at end-2007, €31,762.02 million more than in the previous year. This increase basically took place in the sub-item "Current accounts (covering the minimum reserve system)" and in fixed-term deposits.

¹² After Cyprus and Malta joined the Eurosystem on 1 January 2008, the banknote allocation key is 9.9660%

The breakdown is as follows:

EUR m				
	Type of liability	2007	2006	Change
	Current accounts (covering the minimum reserve system)	38,327.45	20,558.13	17,769.32
	Deposit facility	215.00	0.00	215.00
	Fixed-term deposits	13,775.00	0.00	13,775.00
	Fine-tuning reverse operations	0.00	0.00	0.00
	Deposits related to margin calls	3.34	0.64	2.70
	TOTAL	52,320.79	20,558.76	31,762.02

The first component, 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, underwent an increase of €17,769.32 million, against a background of year-end tensions in the money markets. However, if the average balance of these accounts is analysed, the increase is significantly less: from €17,224.09 million in 2006 to €20,355.55 million in 2007.

The balance of fixed-term deposits amounted to €13,775.00 million as at 31 December 2007, having shown high levels in the last few days of the year related to the ECB's decision to conduct liquidity absorption operations to keep short-term money market interest rates at a level near the minimum bid rate on Eurosystem main refinancing operations. They are thus fine-tuning operations that take the form of deposits. Spanish institutions participated in these liquidity withdrawals in fourteen of the seventeen operations conducted by the Eurosystem in 2007. There was no balance at end-2007.

Also included in this item are the deposits placed by credit institutions in relation to deposit facilities, fine-tuning reverse operations and deposits related to margin calls. As at 31.12.2007 the institutions' balances relating to the deposit facility amounted to €215 million (no balance at end-2006), while those relating to margin calls stood at €3.34 million (€0.64 million in 2006).

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 €18,030.35 million, which breaks down as follows:

EUR m				
		2007	2006	Change
	Central government (State)	4,193.50	4,388.29	-194.79
	<i>Treasury current account</i>	<i>164.79</i>	<i>99.74</i>	
	<i>Other central government agencies and similar bodies</i>	<i>4,028.71</i>	<i>4,288.55</i>	
	Territorial government	653.36	165.22	488.15
	<i>Regional (autonomous) governments, administrative agencies and similar bodies</i>	<i>648.41</i>	<i>160.34</i>	
	<i>Local government</i>	<i>4.95</i>	<i>4.87</i>	
	Social security funds	13,183.49	10,503.96	2,679.53
	<i>Social Security System</i>	<i>11,215.36</i>	<i>9,465.53</i>	
	<i>Other</i>	<i>1,968.14</i>	<i>1,038.43</i>	
	TOTAL	18,030.35	15,057.47	2,972.88

The increase in the balance of this sub-item (€2,972.88 million) was basically due to the rise in the balances held by social security funds and, to a lesser extent, by territorial (regional and local) government agencies, while the balances of other central government agencies other than the Treasury decreased slightly.

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 public and 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-2007 was €2,325.25 million, and its decrease of €120.37 million on end-2006 was basically due to the decrease in the balances of the current accounts of State agencies (€–147.27 million).

20 LIABILITIES TO NON-EURO
AREA RESIDENTS DENOMINATED
IN EURO

This item basically includes the treasury accounts of non-Eurosystem countries, central banks and monetary authorities and of international agencies to which reserve management services are provided, and the euro accounts held by non-euro area international agencies and central banks. The balance of €157.98 million was €31.38 million higher than a year earlier, basically due to the increase in reserve management activity on behalf of third parties.

21 LIABILITIES TO NON-EURO
AREA RESIDENTS DENOMINATED
IN FOREIGN CURRENCY.—
DEPOSITS, BALANCES AND
OTHER LIABILITIES

This sub-item basically includes the foreign-currency balances of non-euro area central banks, which amounted to €33.97 million at 2007 year-end (€119.18 million less than at end-2006). It also includes collateralised inward deposits recorded in respect of reverse transactions conducted under repurchase agreements, the balance of which was €83.07 million as at year-end (zero as at 31.12.2006). Overall, the total balance of this sub-item decreased by €37.11 million.

22 COUNTERPART OF SPECIAL
DRAWING RIGHTS ALLOCATED BY
THE IMF

This item of €320.92 million shows the amount of the special drawing rights allocated to Spain by the IMF in proportion to its quota. The total amount of this item decreased by €20.20 million with respect to the previous year, due to the variation in the exchange rate.

23 INTRA-EUROSISTEM
LIABILITIES

This item, which as at 31.12.2007 had a balance of €21,141.50 million, comprises the following two sub-items:

a. Net liabilities related to the
allocation of euro banknotes
within the Eurosystem

This sub-item, the balance of which amounted to €17,903.61 million at end-2007, consists of the claims and liabilities of the Banco de España vis-à-vis the Eurosystem in relation to the allocation of euro banknotes within the Eurosystem (see “Banknotes in circulation” and “Intra-Eurosystem balances” in the section on accounting policies).

Its decrease relative to 2006 (€6,210.26 million) was due to the decrease in banknotes put into circulation by the Banco de España in 2007 (down from €86,978.71 million at 31.12.2006 to €85,516.56 million at end-2007 (–1.7%) as compared with the increase in the Eurosystem as a whole (7.7%), which gave rise to the aforementioned decrease in these accounts.

b. Other liabilities within the
Eurosystem (net)

The balance of €3,237.89 million as at 31.12.2007 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 Eu-

rosystem 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 seignorage income relating to euro banknotes issued by the ECB.

Regarding the first component, for the first time since inception of the Eurosystem, the year-end net transfers via TARGET had a credit balance (€3,275.18 million), while the correspondent accounts showed a debit balance of €0.04 million. From 30 November 2000, the balances arising from TARGET transfers vis-à-vis the Eurosystem banks, and vis-à-vis the rest of the European Union banks have been netted and replaced by a single balance vis-à-vis the ECB. The remuneration of the Banco de España’s 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 €37.25 million at end-2007.

Finally, in regard to 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, following approval of the Decision of the European Central Bank of 17 November 2005 on the distribution of the income of the European Central Bank on euro banknotes in circulation to the national central banks of the participating Member States (ECB/2005/11), the income on euro banknotes in circulation earned in each financial year is distributed by the ECB on the second working day of the following year, although the ECB Governing Council may decide before the end of the financial year not to distribute part or all of this income (see “Banknotes in circulation” in Section 3.1.2). This year the ECB Governing Council decided to retain the 2007 banknote seignorage income in order to increase the provision for foreign exchange rate, interest rate and gold price risks set up in 2005 and therefore the balance of this component at end-2007 was zero.

24 ITEMS IN COURSE OF SETTLEMENT

Included here are various items which as at 31.12.2007 were in the course of settlement: transfer instructions pending execution, transfers sent to deposit institutions but not yet reimbursed, transfers pending payment, etc.

Of the total balance of this item (€209.75 million) at year-end, €184.97 correspond to transfers ordered by credit institutions pending payment at year-end, and €23.83 million relate to transfers received on 31 December 2007 by the Sistema Nacional de Compensación Electrónica (National Electronic Clearing System) that have been settled and are pending payment.

This item increased by €4.17 million with respect to 2006 (the first of the aforementioned sub-items rose by €49.04 million and the second decreased by €44.06 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, as in 2007, it is recorded under the same heading in asset sub-item 11.3 (see Note 13 on the balance sheet).

26 LIABILITY ACCRUAL ACCOUNTS AND INCOME COLLECTED IN ADVANCE

This sub-item includes interest accrued but not yet paid, expenses accrued but not yet paid and deferred income.

As at 31.12.2007, its balance amounted to €293.32 million, the main component being interest accrued but not yet paid (€286.27 million). The increase in 2007 (€55.10 million) mainly

resulted from the higher interest incurred on intra-Eurosystem accounts relating to the adjustment of banknotes in circulation and to TARGET transactions (which had a credit balance at end-2007). Also higher than in the previous year was the interest incurred on minimum reserves.

27 OTHER LIABILITIES. SUNDRY

This includes other liabilities not classifiable above.

As at 31.12.2007 the balance of this sub-item amounted to €315.67 million and its main component was the “Banco de España employee social welfare scheme (*Mutualidad de empleados*).—Contributions payable” (€199.89 million). The most significant change relates to the decrease of €34.34 million in this debt to the employee social welfare scheme.

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	2007	2006	Change
For exchange rate and interest rate risks	2,421.95	2,421.95	0.00
For early repayment of special loans	1,393.21	0.00	1,393.21
For exchange of withdrawn peseta banknotes	61.83	89.61	-27.77
For early and regular retirement	50.31	66.28	-15.98
For death and retirement assistance	68.88	69.98	-1.10
For sundry liabilities and charges	9.65	3.75	5.90
TOTAL	4,005.81	2,651.57	1,354.25

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. Subsequently, 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 31.12.2007 amounted to €2,421.95 million, the same as in the previous year (see Note 5 on the profit and loss account).

The balance of this provision is revised annually based on the Banco de España’s valuation of its exposure to the aforementioned risks by value-at-risk methodology. This review takes into account, in addition to that valuation, a number of factors, including the estimated profit for the coming year, the envisaged behaviour of risk assets and any others deemed to be worthy of consideration under the circumstances.

2007 saw, on one hand, the publication of Law 4/2007 of 3 April 2007, the third additional provision of which stipulates that “in 2007 the Social Security Treasury shall repay to the Banco de España all the loans extended to the Social Security System in 1990 and 1991, at the present value of the outstanding debt for those loans on the payment date” and, on the other, the aforementioned agreement with the State government (see Note 9) under which the Treasury can request early repayment of a part or all of these loans, paying the cash amount of their market value instead of their nominal value. In view of these two new events, in 2007 a provision for losses on early repayment of special loans was set up to cover any losses that may arise from early repayment of these loans (included under asset sub-item 8; see Note 9). As at 31.12.2007 its balance, determined as the difference between the nominal value and the present market value of the loans, amounted to €1,393.21 million.

The main decreases were in the provision recorded for the exchange of peseta banknotes withdrawn from circulation (€27.77 million) and in the provision for payments to early and regular retirees (€15.98 million), as a result of the use of these provisions for their intended purpose.

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	2007	2006	Change	
GOLD	4,294.28	5,208.90	-914.62	
FOREIGN CURRENCY	0.02	20.35	-20.33	
SECURITIES	55.24	46.50	8.74	
Issued in foreign currency by non-euro area residents	43.61	5.77	37.84	
Issued in euro by euro area residents	11.62	40.73	-29.11	
OTHER	21.56	17.81	3.75	
TOTAL	4,371.09	5,293.55	-922.46	

The revaluation accounts decreased by €922.46 million in 2007. The main change was in gold, the unrealised gains on which were €914.62 million lower despite the increase in its market price, as a result of gold sales during the year. The unrealised gains on foreign currencies decreased by €20.33 million, basically due to the depreciation of the US dollar against the euro. Finally, the main change in the securities revaluation accounts was in foreign-currency-denominated securities, with an increase of €37.84 million, which was partly offset by the decrease in euro-denominated securities issued by euro area residents (€29.11 million), as a result of security price movements driven by interest rates (fall in the US dollar interest rate and rise in the euro interest rate).

30 CAPITAL

As at 31 December 2007 the capital of the Banco de España amounted to €1,000 million, with no change in the year. Of this amount, €1.37 million were constituted pursuant to Royal Legislative Decree 18/1962 of 7 June 1962 and €998.63 million as a capital increase carried out in 2006. This capital increase resulted from the approval by the Council of Ministers on 28 July 2006 of the proposal submitted by the Governing Council of the Banco de España in application of Law 192/1964 that a portion of the 2005 profits, which were retained as permitted by the resolution of the Council of Ministers of 29 July 2005 and by Royal Decree 1198/2005 on the regime governing the payment of Banco de España profits into the Treasury, be used to increase capital at the Bank within the limits authorised by the thirty-eighth additional provision of Law 30/2005 of 29 December on the State Budget for 2006, i.e. until the capital of the Banco de España reaches the figure of €1,000 million.

31 RESERVES

Included in this sub-item is, first, 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 (€3.17 million) and, second, the portion of 2005 and 2006 profit taken to reserves, authorised by the Council of Ministers on 28 July 2006 (€496.83 million) and 29 June 2007 (€500 million), respectively, in application of the legal provisions cited in the previous note. Accordingly, with the increase made in the reporting year, the reserves of the Banco de España amount to €1,000 million.

The net profit for 2007, after deducting the transfer to the Beneficent Social Fund (€20.25 million), amounted to €2,004.98 million, up 2.9% on 2006. Of this amount, €981.21 million was paid to the Treasury on 2 November 2007, in accordance with Royal Decree 1198/2005 of 10 October 2005.

During the year, the following amounts were also paid to the Treasury out of 2006 profits:

- a On 1.3.2007, €607.74 million, which, together with the payment in November 2006, amounted to 90% of the €1,447.57 million of distributable profit for that year.
- b On 13.8.2007, once the balance sheet and profit and loss account for the year 2006 had been approved by the Council of Ministers, €144.76 million, representing the rest of the distributable profit for 2006, were paid to the Treasury.

The details of the various components of the profit for 2007 and the reasons for the changes in them with respect to 2006 are given in Section 3.3 below on the profit and loss account.

3.3 Notes on the profit and loss account

1 INTEREST INCOME

This item includes income from interest accrued on the main assets of the Banco de España. It was made up, in 2007 and 2006, as follows:

EUR m and %					
	Interest income			Average investment in 2007	Average yield in 2007
	2007	2006	Change		
FOREIGN CURRENCY	445.55	456.48	-10.93	9,090.61	4.8
Securities	323.73	272.94	50.78	6,669.69	4.8
Deposits and other assets	121.83	183.54	-61.71	2,420.92	5.0
EURO	4,614.82	3,036.54	1,578.29	118,105.76	3.9
Securities	2,626.17	1,572.55	1,053.62	68,356.66	3.8
Monetary policy operations	1,076.76	678.06	398.71	25,943.00	4.1
Intra-Eurosystem accounts	910.00	784.18	125.83	23,806.10	3.8
Claims equivalent to the transfer of foreign reserves to the ECB	147.34	105.00	42.35	4,349.18	3.3
Other claims within the Eurosystem (net)	762.66	679.18	83.48	19,456.92	3.9
Other assets	1.89	1.75	0.14	—	—
TOTAL	5,060.38	3,493.02	1,567.36	127,196.36	3.9

Interest income increased sharply (€1,567.36 million) in 2007 with respect to 2006. Substantially all of it (€1,578.29 million) arose from euro-denominated investments, while income from foreign-currency investments decreased by €10.93 million.

Of the €445.55 million of interest on foreign-currency investments, €323.73 million arose from investments in fixed-income securities denominated in US dollars and €121.83 million from deposits and other assets. Interest on the aforementioned US-dollar denominated portfolio increased by €50.78 million, whereas that on deposits and other assets decreased by €61.71, mainly because of the transfer of a portion of investments from deposits to securities (in 2006 the average balance invested in securities was €5,249.86 million in 2006 and that in deposits was €3,857.75 million).

Euro-denominated interest income (€4,614.82 million) arose basically from the securities portfolios (€2,626.17 million, an increase of 1,053.62 million), monetary policy operations

(€1,076.76 million, up €398.71 million) and intra-Eurosystem balances (€910.00 million, up €125.83 million). These rises were due to the higher average investment (€103,503.66 million in 2006) and, in particular, to the return, which rose from 2.9% to 3.9%.

2 INTEREST EXPENSE

This item includes interest expenditure on the liabilities listed below, as follows:

EUR m and %	Interest expense			Average financing in 2007	Average cost in 2007
	2007	2006	Change		
FOREIGN CURRENCY	82.04	132.22	-50.18	5,053.14	1.6
Swap, forward and other transactions	62.95	112.43	-49.48	4,698.85	1.3
Other liabilities	19.09	19.79	-0.70	354.29	5.3
EURO	2,095.91	1,310.67	785.24	53,133.12	3.9
Remuneration of minimum reserves	811.55	493.73	317.83	20,355.55	3.9
Fixed-term deposits	32.26	0.34	31.93	796.37	4.0
General government deposits	497.14	315.06	182.08	13,180.98	3.8
Intra-Eurosystem liabilities-Net liabilities related to allocation of euro banknotes within the Eurosystem	724.41	499.43	224.98	18,263.39	3.9
Other liabilities within the Eurosystem (net)	22.78	0.00	22.78	536.82	4.2
Other liabilities denominated in euro	7.76	2.11	5.65	—	—
TOTAL	2,177.94	1,442.89	735.05	58,186.26	3.7

Interest expenses increased by €735.05 million in 2007, with a rise of €785.24 million in those relating to euro-denominated liabilities and a fall of €50.18 million in those relating to liabilities denominated in foreign currencies.

Interest expenses denominated in foreign currencies (€82.04 million) relate to swap, futures and other transactions (€62.95 million) and to other liabilities (€19.09 million). The decrease in expenses with respect to 2006 was due to both the lower average balance (down from €5,765.83 million in 2006 to €5,053.14 in 2007) and to the lower average cost (down from 2.3% in 2006 to 1.6% in 2007).

Of the interest expenses denominated in euro (€2,095.91 million), €811.55 million arise from the remuneration of minimum reserves, €724.41 million from the remuneration of intra-Eurosystem balances related to allocation of euro banknotes, €497.14 million from the remuneration of general government deposits and the remainder (€62.81 million) from other euro-denominated liabilities, including most notably the expense derived from fixed-term deposits (€32.26 million) and the remuneration of other intra-Eurosystem balances (€22.78 million). These increases were due, first, to the higher average cost (up from 2.8% in 2006 to 3.9% in 2007) and to the higher balance to be remunerated (up from €46,307.17 million in 2006 to €53,133.12 in 2007).

3 REALISED GAINS/LOSSES ARISING FROM FINANCIAL OPERATIONS

This item includes the profits and losses arising from dealing in financial assets. In 2007 the net gains in this connection amounted to €1,745.19 million, arising from the following sources:

EUR m	2007	2006	Change
FOREIGN CURRENCY	1,749.64	565.22	1,184.42
Sale of gold	1,748.21	500.03	1,248.18
Sale of foreign currency (exchange rate)	-2.84	87.74	-90.58
Sale of securities (price)	3.11	-22.62	25.73
Other gains/losses	1.16	0.08	1.08
EURO	-4.45	-112.18	107.73
Sale of securities (price)	-4.45	-112.18	107.73
TOTAL	1,745.19	453.04	1,292.15

As shown in the above table, substantially all the realised gains arose from the sale of gold (€1,748.21 million), offset to a slight extent by the realised losses on the sale of euro-denominated debt securities (€4.45 million).

Compared with the previous year, the total net realised gains arising from financial operations increased by €1,292.15 million, basically due to the following:

- Higher gains on the sale of gold: €1,248.18 million more than in 2006.
- Decrease in net gains on sales of foreign currencies with respect to the previous year (€90.58 million), basically as a result of the lower volume of sales.
- Smaller losses on the sale of securities compared with those of 2006 (variation of €133.46 million), basically in euro-denominated securities (€107.73 million) and, to a lesser extent, due to the net positive change in gains on sales of securities denominated in foreign currencies (€25.73 million).

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 2007 and 2006 is as follows:

EUR m	2007	2006	Change
FOREIGN CURRENCY	430.29	8.96	421.32
Foreign currency (exchange rate)	429.78	2.71	427.07
Securities (price)	0.51	6.26	-5.75
Other	0,00	0,00	0,00
EURO	99.15	230.57	-131.42
Securities (price)	99.15	230.57	-131.42
TOTAL	529.44	239.54	289.90

Unrealised losses in 2007 amounted to €529.44 million, of which 81.18% related to exchange rate depreciation (€429.78 million) – basically US dollars (413.92 million) and SDRs (15.75 million) – and 18.82% were on securities. Specifically, unrealised losses on euro-denominated securities amounted to €99.15 million, while unrealised losses on securities denominated in foreign currency amounted to €0.51 million.

Overall, the amount of unrealised losses in 2007 exceeded that in 2006 by €289.90 million, as a result of the €427.07 million increase in foreign exchange losses and the €137.17 million decrease in losses on securities.

5 TRANSFERS TO/FROM PROVISIONS FOR FOREIGN EXCHANGE RATE AND PRICE RISKS

This includes the following. First, transfers to/reversals of provisions for losses on early repayment of special loans amounting to €1,688.56 million in 2007. Of these, €1,457.89 relate to loans to the State and €230.67 million to loans to the Social Security System. The transfers relating to the former were due to an agreement, entered into on 26 March 2007, with the Spanish State government to bring forward the scheduled repayments of the special loans to it. Under this agreement, the loans all reach final maturity by 2015 at the latest and the Treasury will be able to request early repayment of part or all of these loans irrespective of the approved schedule, in which case it would have to pay the cash amount of their market value. Meanwhile, the transfer to the provision for the loan to the Social Security System (repayment of which was completed in May 2007) was a result of compliance with the third additional provision of Law 4/2007 of 3 April 2007.

Second, pursuant to the resolution adopted by the Executive Commission on 31 January 2008, in 2007 the provisions to cover the unrealised losses on financial assets and positions recorded in that year were reversed to income in the amount of €529.44 million. Also, a transfer of €529.44 million was made to this provision, leaving it at the same level as in the previous year.

6 NET INCOME FROM FEES AND COMMISSIONS

This basically includes income and expenses arising from fees and commissions for banking services and the like (transfers, handling of cheques, custody and administration of securities, settlement service for securities transactions, etc.). It may be broken down as follows:

EUR m						
	Income			Expenses		
	2007	2006	Change	2007	2006	Change
Foreign operations	0.12	0.30	-0.18	3.42	2.86	0.56
Domestic operations	18.96	15.12	3.84	3.85	3.40	0.46
TOTAL	19.09	15.43	3.66	7.27	6.25	1.02

The higher net fee income in 2007 (up 23.7%) was mainly because more fees and commissions were received on securities transactions (€3.27 million) under the correspondent central banking model (CCBM) used for managing the custody of collateral on monetary policy operations, and because more fees and commissions were received from member institutions of the Banco de España Settlement Service (€0.65 million).

7 INCOME FROM EQUITY SHARES AND PARTICIPATING INTERESTS

This item includes the participating interest of the Banco de España in the profit of the ECB and the dividends on other shares and participating interests.

Of the total amount of €9.68 million recorded, €6.93 million was dividend income from the participating interest in Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistema Financieros, SA (BME) and €2.75 million from interests in international agencies (Bank for International Settlements). In 2007 the ECB Governing Council decided to retain the banknote seignorage income in order to increase the provision for foreign exchange rate, interest rate and gold price risks set up in 2005 and, accordingly, as in the prior year, the Banco de España did not receive income from the ECB in this connection. In 2007 the Banco de España did not receive an ordinary dividend from the ECB either.

The decrease with respect to the previous year (€10.54 million) is due basically to the smaller dividend received on the participating interest in BME.

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 2007, amounting to €2,478.30 million, and that reallocated to it, amounting to €2,515.55 million, is the net result arising from the calculation of monetary income (€37.25 million). This result was €16.02 million higher than in 2006.

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	2007	2006	Change
Extraordinary profit	2.18	2.49	-0.31
Employee social welfare scheme	-25.76	-29.17	3.40
Sundry	0.63	108.41	-107.78
TOTAL	-22.95	81.73	-104.68

As can be seen, this item decreased by €104.68 million with respect to the previous year, basically due to profits on the sale in July 2006 of a portion of the shares of Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, SA, which amounted to €107.79 million.

10 STAFF COSTS

This sub-item includes the headings "Wages and salaries", "Contributions to pension scheme" and "Other staff welfare expenses". Its amount rose by €6.51 million (3.2%) from €204.63 in 2006 to €211.14 in 2007, basically as a result of the economic improvements included in the Collective Agreement for 2007, estimated at €5.25 million, and of the changes in staff size and structure, wage drift due to promotions, years of service, etc., totalling €1.26 million.

The breakdown of changes by component is as follows:

EUR m and %

	2007	2006	Change	(%)
Staff costs	211.14	204.63	6.51	3.2
Wages and salaries	154.95	149.76	5.19	3.5
Contributions to Pension Scheme	5.12	4.71	0.41	8.6
Staff welfare expenses and other	51.07	50.15	0.92	1.8

The following table sets out the changes in permanent and temporary staff, in terms of average number of employees:

	2007	2006	Change	(%)
AVERAGE NUMBER OF EMPLOYEES	2,718.6	2,720.7	-2.3	-0.1
1 Permanent staff	2,605.3	2,626.4	-21.1	-0.8
<i>Managerial staff</i>	1,447.9	1,436.8	11.0	0.8
<i>Administrative staff</i>	928.3	955.8	-27.4	-2.9
<i>Other</i>	229.1	233.8	-4.7	-2.0
2 Temporary staff	113.3	94.3	18.9	20.1
<i>Managerial staff</i>	63.1	49.3	13.8	28.0
<i>Administrative staff</i>	43.8	36.3	7.5	20.7
<i>Other</i>	6.4	8.8	-2.3	-26.7

As at 31 December 2007, the Bank's total staff numbered 2,720 employees, four fewer than at the same date of the previous year. Despite this decrease, the number of women rose by 18 to account for 36% of the Bank's staff.

11 ADMINISTRATIVE EXPENSES¹³

This item includes expenses arising from the purchase of current assets and of diverse services received during the year, as follows:

EUR m and %

	2007	2006	Change	%
Office expenses	65.42	62.66	2.76	4.4
Property expenses	19.50	20.49	-0.99	-4.8
Transport and communications	7.44	7.21	0.23	3.2
Surveillance and security	6.65	6.45	0.20	3.0
Training and grants	2.86	2.61	0.25	9.7
Sundry operating expenses	11.13	10.97	0.16	1.4
Local taxes	0.94	0.79	0.15	19.6
TOTAL	113.94	111.18	2.76	2.5

As can be seen in the above table, in 2007 the most important components were office expenses – including IT costs – and those relating to premises, which amounted to €65.42 and €19.50 million, respectively.

The increase in administrative expenses in 2007 was due primarily to the services price adjustment at rates of around 2.7% (the CPI for 2006). The table shows that the main change was

¹³. 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.

in office expenses (€2.76 million, of which €2.03 million relate to IT expenses and €0.4 million to TARGET2 platform development and operating expenses in 2007 Q4). Property expenses decreased with respect to the previous year because in 2006 major roof restoration and façade cleaning work was done on the Cibeles building in Madrid and the façade of the Seville branch was cleaned.

“Sundry operating expenses” include €127,445.43 (including VAT) relating to the fees of the external auditors Deloitte, S.L. for the audits in 2007 of the Bank’s annual accounts and of certain aspects of the Bank’s management of European Central Bank reserves. In 2007 no services were received from or amounts paid to other firms in the group.

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 and %				
	2007	2006	Change	%
Depreciation of buildings, structures and renovation work	1.67	1.61	0.06	3.8
Depreciation of plant in buildings	4.10	19.69	-15.60	-79.2
Depreciation of furniture and fittings	1.54	1.35	0.19	13.8
Depreciation of office machines other than computer equipment	1.41	1.43	-0.02	-1.2
Depreciation of computer equipment	6.18	5.93	0.25	4.2
Depreciation of transport equipment	1.05	0.94	0.11	11.9
Depreciation of libraries	0.48	0.45	0.02	5.1
Depreciation of other tangible fixed assets	0.26	0.28	-0.02	-7.2
Amortisation of intangible fixed assets	3.42	2.27	1.15	50.6
TOTAL	20.12	33.97	-13.85	-40.8

The decrease in accumulated depreciation and amortisation of fixed assets was because the change in depreciation rates and other criteria relating to the useful life of certain assets as a result of the harmonisation of Eurosystem financial and cost accounting methodology led to a significant rise in the expenses booked in 2006.

13 BANKNOTE PRODUCTION SERVICES

This amount (€70.95 million) corresponds to payments made by the Banco de España to purchase banknotes from the National Mint. The decrease with respect to the previous year (€18.54 million) was attributable to the lower volume of euro banknotes acquired by the Bank in the reporting year (€856 million in 2007, against €1,038 million in 2006) and to the decrease in unit prices.

14 TRANSFERS AND ADDITIONS TO OTHER FUNDS AND PROVISIONS

The net balance of transfers and applications to other funds and provisions in 2007 amounted to €21.95 million, compared with €8.26 million in 2006. This change (€13.69 million) was due to the following. First, the larger transfer in 2007 to the Beneficent-Social Fund (€20.25 million in 2007, against €4.36 million in 2006) for the purpose of stepping up the research and training activities planned for the coming years. Second, less provisioning was needed in 2007 for the 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 2007 it was not considered necessary to record any provision for environmental liabilities and charges.

As detailed and explained in the preceding notes, the net profit for 2007 amounted to €2,004.98 million, up 2.9% on the previous year.

In application of Royal Decree 1198/2005 of 10 October 2005, the payments to the Treasury of 2007 profit of the Banco de España are as follows:

EUR m	
1 Total profit for 2007	2,004.98
2 Payments to the Treasury	
On 2.11.2007. 70% of profit as at 30.09.2007	981.21
On 3.3.2008. Difference between the above amount and 90% of profit as at 31.12.2007	823.28
3 Profit payable to the Treasury	
At date of approval of the 2007 accounts	200.50

3.4 Changes in capital, reserves, provisions and revaluation accounts

The following table shows the changes in the reporting year, which, in addition to the accounting profit, include the net gains not recognised as income in the profit and loss account, the variation in the coverage of exchange and interest rate risks and the effect on the balance sheet of the appropriation of profit for the year.

EUR m						
	Capital	Reserves	Revaluation accounts	Undistributed profit	Provisions	Total
A) 2007 OPENING BALANCE	1,000.00	500.00	5,293.55	1,252.50	2,651.57	10,697.62
UNRECOGNISED NET GAINS IN PROFIT AND LOSS (1)	0.00	0.00	-922.46	0.00	0.00	-922.46
In gold			-914.62			-914.62
In foreign currency			-20.33			-20.33
In securities			8.74			8.74
Other			3.75			3.75
2007 PROFIT (2)				2,004.98		2,004.98
CHANGE IN PROVISIONS (3)					1,354.24	1,354.24
APPROPRIATION OF PROFIT (4)	0.00	500.00	0.00	-2,233.71	0.00	-1,733.71
Increase in capital and reserves		500.00		-500.00		0.00
Payment to the Treasury of 2006 distributable profit				-752.50		-752.50
Payment to the Treasury of 2007 profit				-981.21		-981.21
B) CHANGES IN THE YEAR. B = 1+2+3+4	0.00	500.00	-922.46	-228.73	1,354.24	703.05
C) 2007 CLOSING BALANCE. C = A + B	1,000.00	1,000.00	4,371.09	1,023.77	4,005.81	11,400.67

The changes reflected in this table have been explained above in the notes on the balance sheet and profit and loss account that refer to provisions (Note 28 on the balance sheet), revaluation accounts (Note 29 on the balance sheet), capital (Note 30 on the balance sheet), reserves (Note 31 on the balance sheet) and profit for the year (Note 32 on the balance sheet and Note 15 on the profit and loss account).

4 Specific information required by Article 4.2 of the Law of Autonomy of the Banco de España of 1 June 1994

4.1 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 aforementioned 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 2007 the Banco de España made no contributions whatsoever to these Funds.

4.2 Loss of profit

The table below shows the loans outstanding in 2007 with interest rates below the reference rates used, in order to estimate the loss of profit for the year pursuant to the provisions of Article 4.2 of Law 13/1994 of 1 June 1994 of Autonomy of the Banco de España.

EUR m and %				
Type of credit/loan	Estimated average balance in 2007	Interest rate received	Reference interest rate	Estimated loss of profit
Net State debt	4,984.71	0.00%	3.93%	195.95
Loans to the Social Security System	350.85	0.00%	3.93%	13.79
Housing loans and repayable advances to employees	162.44	1.07%	3.93%	4.65
<i>Housing loans</i>	<i>131.65</i>	<i>1.32%</i>	<i>3.93%</i>	<i>3.44</i>
<i>Repayable advances</i>	<i>30.80</i>	<i>0.00%</i>	<i>3.93%</i>	<i>1.21</i>
TOTAL	5,498.00	0.03%	3.93%	214.40

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 less 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 above table shows the loss of profit relating to these loans from the beginning of the year until they were repaid in full on 9 May 2007.

The reference rate used to estimate the loss of profit in all the loans is the daily average of the marginal interest rate on main refinancing operations conducted during the year.

4.3 Other transactions

A. WITH THE STATE

On 26 March 2007 an agreement was entered into with the State government to bring forward the repayment schedule of the loans granted to the State prior to the entry into force of Law 21/1993 of 29 December 1993 on the State Budget for 1994 (Law 3/1983 loan, Law 4/1990 loan and credits arising from subscription for participating interests, contributions and quotas in international agencies), such that they all reach final maturity by 2015 at the latest and the Treasury can request early repayment of part or all of these facilities, paying on the due date the effective market price instead of the nominal amount. Under this agreement, in 2007 pay-

ment was received of two instalments of the first of the aforementioned facilities (that for the reporting year and the last outstanding instalment of the original repayment schedule), along with the reporting year instalments of the other two facilities, the repayment date of all of them being brought forward from 31 December to 30 April. In accordance with the foregoing, on 30 April 2007 the Treasury paid to the Banco de España the amount of €518,779,866.92, the effective market price of the debt repaid on that date, equivalent to a nominal amount of €583,466,935.01.

B WITH THE GENERAL
TREASURY OF THE SOCIAL
SECURITY

The third additional provision of Law 4/2007 of 3 April 2007 stipulates that “in 2007 the Directorate General of the Social Security Treasury shall repay to the Banco de España all the loans extended to the Social Security System in 1990 and 1991, at the present value of the outstanding debt for those loans on the payment date”. The nominal amount of the outstanding debt prior to its total repayment was €1,000,474,799.54, with 13 instalments of €76,959,599.97 payable from 2007 to 2019, both inclusive. On the date of repayment in full, namely 9 May 2007, the Social Security authorities settled the aforementioned outstanding debt by paying to the Banco de España the amount of €769,803,938.88, the effective market price of the debt on that date.



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Translation of a report originally issued in Spanish based on our work performed in accordance with International Standards on Auditing and of annual accounts originally issued in Spanish and prepared in accordance with the internal accounting rules and principles of the Banco de España, which are indicated in Note 3.1 to the accompanying annual accounts and are based on the accounting regulations established for the member central banks of the European System of Central Banks. In the event of a discrepancy, the Spanish-language version prevails.

AUDITORS' REPORT ON ANNUAL ACCOUNTS

To the Governor and Governing Council of the Banco de España

We have audited the annual accounts of the Banco de España which, according to article 29.1 of its Internal Rules, comprise the balance sheet at 31 December 2007 and the related profit and loss account and notes to the accounts for the year then ended.

Responsibility for the annual accounts

The Executive Commission of the Banco de España is responsible for organising the Bank and appointing its general directors. Under the Internal Rules of the Banco de España, the Directorate General Services is responsible for preparing the annual accounts in accordance with the internal accounting rules and principles of the Banco de España, which are indicated in Note 3.1 to the accompanying annual accounts and are based on the accounting regulations established for the member central banks of the European System of Central Banks. This responsibility, which is exercised through the Control, Budget and Accounting Department, includes the supervision of operations and, therefore, the design, implementation and maintenance of the relevant internal controls required for the preparation and adequate presentation of the annual accounts that are free from material misstatement due either to fraud or error; the selection and application of appropriate accounting rules; and the performance of the estimates considered to be reasonable in the circumstances. Pursuant to Article 21.g) of Law 13/1994, of 1 June, on the Autonomy of the Banco de España, these annual accounts are prepared by the Governing Council of the Banco de España.

Responsibility of the auditor

Our responsibility is to express an opinion on the annual accounts taken as a whole based on our audit work performed in accordance with International Standards on Auditing, which require that we comply with certain ethical requirements and that we plan and perform the audit to obtain reasonable assurance that the annual accounts are free from material misstatements or irregularities.

An audit entails the performance of procedures designed to obtain evidence supporting the amounts and disclosures contained in the annual accounts. The procedures selected depend on the auditor's judgment, which includes the assessment of the risks of the occurrence of material misstatement or irregularities in the annual accounts due either to fraud or error. In assessing these risks, the auditor considers the internal control system applicable to the preparation and adequate presentation of the annual accounts by the entity, in order to design audit procedures that are appropriate in view of the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control system. An audit also includes the evaluation of the adequacy of the accounting policies used and of the reasonableness of the accounting estimates made by the entity, as well as an assessment of the overall presentation of the annual accounts. We consider that the evidence we have obtained is sufficient and adequate to provide a basis on which to express our audit opinion.

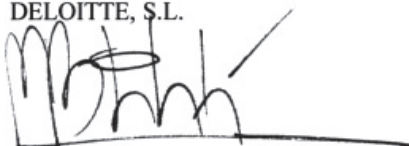
Comparative information

For comparison purposes, the accompanying annual accounts present, in addition to the 2007 figures for each item in the balance sheet and profit and loss account, the figures for 2006. Our opinion refers only to the 2007 annual accounts. On 31 May 2007, we issued our auditors' report on the 2006 annual accounts in which we expressed an unqualified opinion.

Opinion

In our opinion, the accompanying annual accounts for 2007 present fairly, in all material respects, the net worth and financial position of the Banco de España at 31 December 2007 and 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 internal accounting rules and principles of the Banco de España, which are indicated in Note 3.1 to the accompanying annual accounts and are based on the accounting regulations established for the member central banks of the European System of Central Banks.

DELOITTE, S.L.

A handwritten signature in black ink, consisting of stylized, overlapping loops and a long horizontal stroke at the end.

Miguel Angel Bailón
3 June 2008

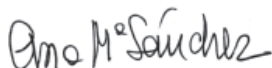
2 Report of the Audit Committee

We the undersigned, Ángel Luis López Roa, Jesús Leguina Villa and Ana María Sánchez Trujillo, are members of the Governing Council of the Banco de España and of the Audit Committee appointed by the Governing Council. In accordance with Article 29 of the Internal Rules of the Banco de España, we were given the task of reviewing the accounts of the Institution for the year 2007.

As required by the aforementioned precept, 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 2007, prepared by the Directorate General Services of the Banco de España; 2) studying the audit of the balance sheet and profit and loss account of the Banco de España for 2007, 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, Budget 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, Budget 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 2007 give a true and fair view of the net worth and financial position of the Banco de España.

Madrid, 8 May 2008.



ANA MARÍA SÁNCHEZ TRUJILLO



ÁNGEL LUIS LÓPEZ ROA



JESÚS LEGUINA VILLA

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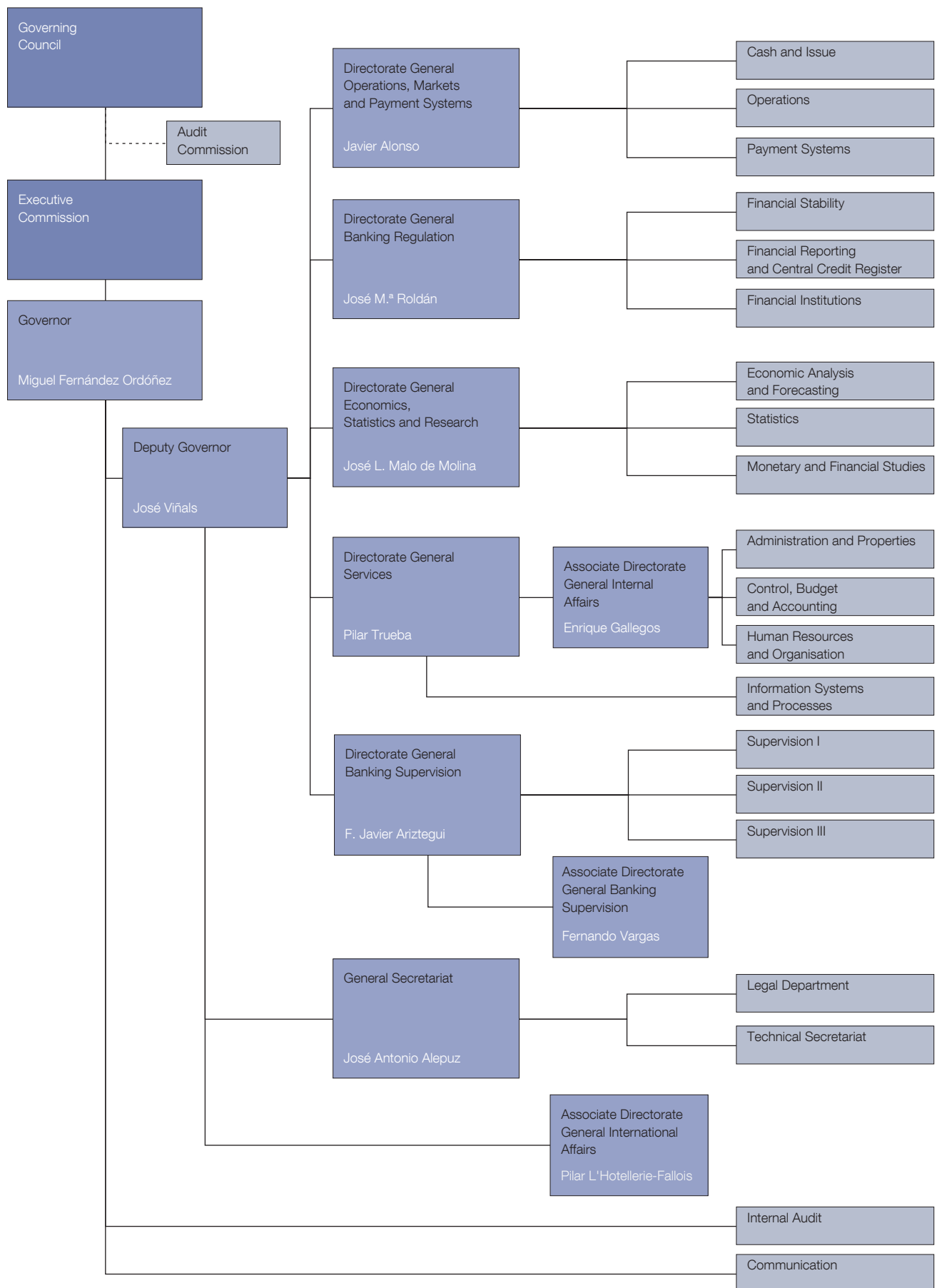
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COMPOSITION OF THE GOVERNING BODIES
OF THE BANCO DE ESPAÑA

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