ANNUAL REPORT

2011

BANCO DE ESPAÑA
Eurosistema

This English translation of the June 2011 *Informe Anual* of the Banco de España comprises Chapters 1 and 2, the boxes published in the remaining chapters of the Spanish edition and the Annual Accounts of the Banco de España. Readers interested in other chapters are referred to the Spanish edition available at **http://www.bde.es.**

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1 OVERVIEW

1 Introduction

The Spanish economy is undergoing difficult economic circumstances as a result of the prolongation and worsening of the euro area sovereign debt crisis, and the renewed dip into recession before the weak recovery was able to take root. In the very short run, the outlook remains conditional upon the need to correct the imbalances outstanding and to redress the weaknesses that have emerged during the crisis, which will require seeing adjustments through and will limit growth possibilities. However, pursuing an ambitious agenda of restructuring and reform will help restore the macroeconomic equilibria and competitiveness needed to resume a sound growth path in the medium term. It will also prevent the economy from being trapped in a low-growth scenario over a protracted period of time.

The quicker that the adjustments are completed and that the weaknesses which have placed the economy in a position of vulnerability are addressed, the sooner the foundations for sound growth will be restored and the greater the protection afforded against the shocks and accidents that may arise in the still-unstable euro area scenario. This is because while the unfolding of the sovereign debt crisis will remain a significant external constraint, the country's responsiveness and the appropriate reaction by its agents will more than ever determine how the difficult juncture at which the economy stands can be overcome.

To outline the essential features of this situation and the economic policy challenges posed by it, this chapter commences with an analysis of the euro area sovereign debt crisis. It subsequently delves into the key factors characterising the difficult circumstances of the Spanish economy, with particular attention to the imbalances and institutional inefficiencies bearing down on recovery. Finally, it highlights the major role that economic policy has to play. Chapter 2 in this Report is dedicated singularly to competitiveness. This is a cornerstone of the Spanish economy's adjustment within the Monetary Union, all the more so given that it is vital that all institutional sectors should reduce their level of debt and that the economy as a whole should lessen its dependence on external saving.

2 The systemic scope of the sovereign debt crisis

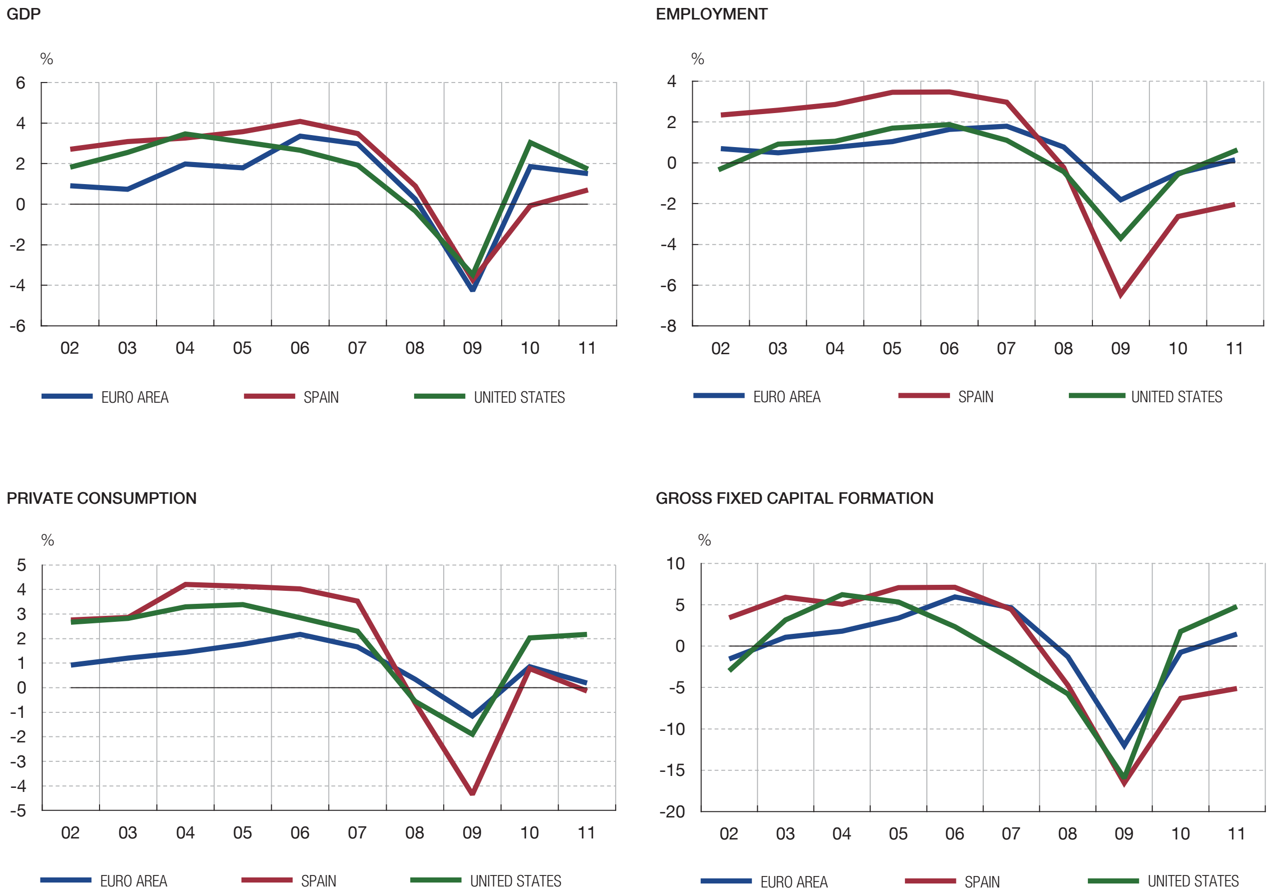
In 2011 the recovery in world growth initiated a year earlier was interrupted

The recovery in the world economy that began in 2010 did not see continuity last year (see Chart 1.1). The growth rate of global output fell back 1.4 pp (from 5.3% to 3.9%), and the decline was more marked in the advanced economies. Euro area GDP advanced at a sluggish rate, similar to that of the previous year (1.4% against 1.9% in 2010) and the result of behaviour that differed not only across its Member States, but also over time. While relatively expansionary in the first six months, the dynamism of growth was diminished in the second half of the year. This slowdown in global activity has progressively steadied over the first half of 2012 and, as this Report goes to press, most economic indicators point to some stabilisation which, on most forecasts, would translate into a further – though limited – easing in the expansion of both the most advanced and the emerging economies over the year as a whole.

Initially, emergence from the global crisis was interrupted owing to a series of shocks, such as the tsunami in Japan and its effects on the Fukushima nuclear power plant, and the outbreaks of political instability in the Arab countries. These bore down on financial markets and on international trade. Later, however, the focal point of tensions tended to shift towards the exacerbation and extension of the euro area sovereign debt crisis, ultimately

GDP, PRIVATE CONSUMPTION, EMPLOYMENT AND GROSS FIXED CAPITAL FORMATION
Rate of change

CHART 1.1



SOURCES: Eurostat and national statistics.

acting during 2011, but also in 2012 to date, as a key conditioning factor of the economic performance of the euro area in general, and of Spain in particular.

The euro area sovereign debt crisis became systemic and was one of the main factors responsible for the interruption of world growth

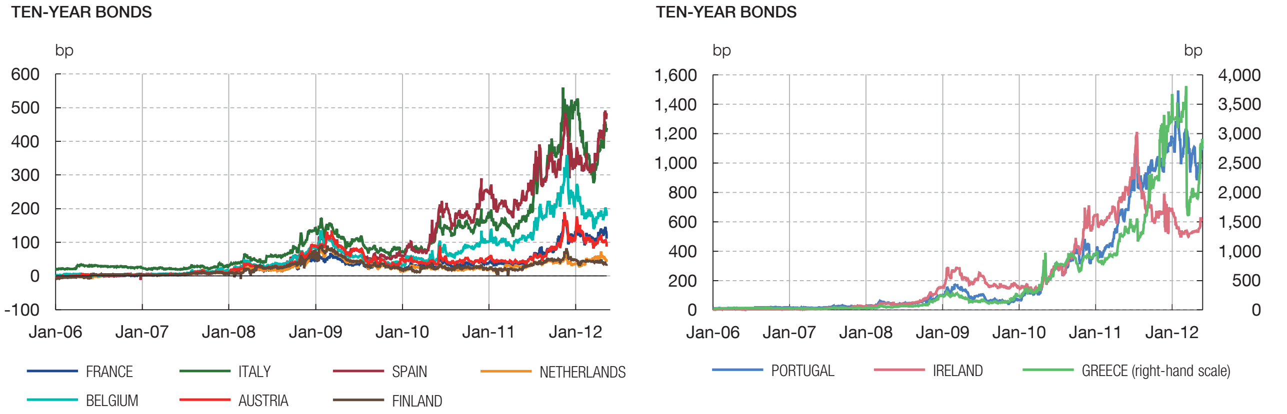
The tensions on euro area government debt markets had continued until summer last year, concentrated in a relatively limited group of countries (see Chart 1.2). Thereafter, however, they began to spread to a greater number of Member States, primarily affecting those showing more vulnerable economic fundamentals and, later, even those in sounder positions. As a result, the European debt crisis ultimately took on a systemic dimension. The causes leading to this key qualitative change are numerous and complex; but, in any event, the shortcomings in the area's institutional arrangements for governance and decision-making in the face of the crisis have had a notable influence.

The distortions in the economic policies of a limited group of countries triggered the tensions

At the source and immediate onset of the tensions on the euro-denominated government debt markets, a central role was played by a group of member countries' policies, the pursuit of which revealed an insufficient understanding of the scope and economic consequences of belonging to a monetary union. Following policies that were hardly consistent with stability in the Monetary Union had given rise to a build-up of various imbalances, which placed the economies concerned in a position of vulnerability to potential shocks such as those which, unfortunately, began to materialise in the second half of the past decade.

EURO AREA: SOVEREIGN SPREADS OVER GERMANY

CHART 1.2



SOURCE: ECB.

Practically from the very start of Monetary Union and despite the Treaty's provisions, some governments failed to exert sufficient control over public finances, which resulted in deficits and debt that were hardly compatible with the demands of a common monetary policy. Fragilities emerged in other equally important areas, as seen in the high levels of private debt accumulated, the weakening of financial systems and continuing rigidities in price and wage-formation mechanisms which, in the short term, constrain economies' ability to absorb adverse shocks and, over a longer horizon, reduce their growth potential. Recent events have highlighted the close links between sovereign risks, banking risks and economic vulnerability, and how, once any of these three components is activated, feedback loops are set in train that exacerbate and deepen tensions (see Box 1.1).

The effects of these distortions were amplified as a result first, of a relatively complacent and benign view of the imbalances generated, and one strongly anchored in the euro's success during its first 10 years; and further, of excessive confidence in the strength of a series of adjustment mechanisms which, it was assumed, would be activated were these imbalances to breach specific safety thresholds. Unfortunately, neither the competitiveness channel, which should have induced price and cost containment in those economies that were accumulating growing external misalignments, nor the market discipline channel, which should have penalised the financing of these imbalances with higher risk premia, functioned as expected. The former channel was deactivated by the persistent lack of flexibility of the price and wage-formation mechanisms, if not directly by the prevalence of dysfunctional factor and product markets. And the latter was cancelled out by the widespread underestimation of the risks not only on European financial markets but also internationally.

The weaknesses in European governance and the ups and downs of the process followed to correct them explain, nonetheless, how the crisis took on a systemic dimension as from the summer

All these factors, while central, do not explain why, as from summer 2011, the tensions also spread to Member States whose policies and economic fundamentals had not deviated significantly from stability. To understand the systemic dimension of the crisis, other factors closely linked to a series of weaknesses in European governance and to the process followed by the European authorities to overcome them must be incorporated into the analysis. Indeed, the process fell far short of the diligence and effectiveness that the seriousness of the circumstances required, as shown by the management of the grave problems assailing the Greek economy.

The destabilising potential of fiscal imbalances within a monetary union was explicitly acknowledged by the founders of EMU. The Maastricht Treaty envisaged a formal budgetary

The strong interrelation between financial crises and sovereign debt crises is an empirical regularity extensively documented in the literature. From a broad historical perspective, systemic banking crises have tended to be followed by public debt crises, so that the former "help to predict" (in the statistical sense of the term) the latter[1]. The mechanism through which this link takes place is well known: financial crises tend to turn into severe economic crises leading to pronounced falls in budgetary revenues and increases in public sector spending and debt, which may ultimately put in doubt the sustainability of public finances. If, moreover, governments have to give direct financial support to their banking systems, the problems are aggravated.

However, episodes in which banking crises and sovereign debt crises have developed (and fuelled each other) in parallel have not been rare either. In fact, the relationship between them tends to be bidirectional, with another causal nexus, existing alongside the one described above, operating in the opposite direction through various channels. First, the fall in government bond prices directly affects[2] the value of the debt holdings on the institutions' balance sheets. In addition, the contractionary fiscal policies deployed in response to possible problems of public finance sustainability typically involve a lower level of economic activity in the short term, which may lead to an increase in doubtful loans. For their part, the deterioration in the quality of bank assets and the associated worsening of the earnings outlook result in a tightening of financing conditions, which may involve the loss of access to the markets in the most extreme cases in which bank solvency is called into question. The power of this transmission channel is also amplified by the special role played by public debt in the financing of banks, being used as collateral and, especially, in repo transactions between private institutions or with the central bank. A sharp deterioration in the quality of sovereign assets raises the haircuts applied in the valuation of the collateral, and ultimately the asset may even lose its eligible asset status. Finally, a particularly powerful channel of transmission of sovereign risk to bank risk is the fact that the credit rating of the sovereign frequently places a limit on that of the domestic banks and, therefore, on their cost of financing. This is because the solvency of the public sector ultimately determines its capacity to provide support to institutions in difficulty and, therefore, the value of the implicit (sometimes also explicit) public guarantees which support banks and supplement their stand-alone ratings. Naturally, most of these effects tend to be less powerful in more disintermediated systems, in which the bulk of financial flows are channelled by the markets and not by the banks.

Panel 1 illustrates how the tensions deriving from the 2007 global financial crisis were transmitted to the euro area sovereign debt markets, resulting in a progressive widening of the interest rate differentials (which had previously remained very compressed since the creation of the euro area in 1999). However, it was not until spring 2008 that significant differentiation between countries began to take place. The crisis in the euro area acquired its own dynamic between end-2008 and the start of 2009, following the Lehman bankruptcy and the nationalisation of Anglo Irish Bank in Ireland, but especially with the outbreak of the crisis in Greece in late 2009 and early 2010. According to studies published by the International Monetary Fund[3], it was precisely at that time that the financial, sovereign debt and growth crises showed stronger feedback and became more intertwined. The correlation between sovereign credit risk and credit risk in the banking sector in the euro area has been clearly evident since the summer of last year (see Panel 2).

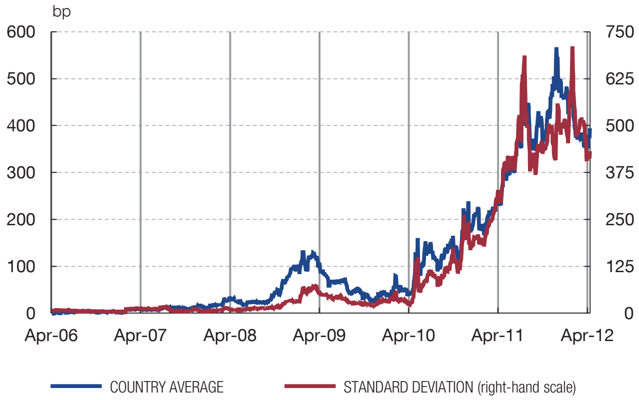
The interaction between sovereign and bank risk is not specific to the euro area, although some characteristics of the monetary union intensify this link. In fact, in the case of the euro area, the banking sector plays a predominant role in the channelling of credit to the economy, so that bank tensions have greater repercussions on economic activity. Also, the exposure of euro area banks to public debt is relatively high (see Panel 3) and shows a domestic bias that is most acute in those countries that have experienced the strongest tensions in the debt markets, with the exception of Ireland (see Panel 4). Despite this, the greater financial and real integration of the euro area means that the transmission of risks in the euro area is not limited to domestic banks, but extends beyond their borders through bank cross-country exposures. These circumstances, along with the governance problems of the area, revealed by the crisis, are conducive, in the absence of effective firebreaks, to contagion, with the problems developed in some countries eventually spreading to other countries that have fiscal weaknesses or greater dependence on external saving, thus enabling the crisis to become systemic. Finally, the weaknesses and fragmentation in the EU financial crisis management and resolution mechanisms have had a further destabilising effect and have contributed to a certain renationalisation of some market segments (see Box 4.2). The absence of a common crisis management and resolution authority offering sufficient protection to the States against liquidity crises not based on fundamentals means that the available fiscal support (potentially very costly, given the size of the domestic banking systems) has a strictly national dimension, which amplifies the possible vicious circles between public finance vulnerabilities and the banking sector.

1 C.M. Reinhart and K. Rogoff (2011), "From Financial Crash to Debt Crisis", American Economic Review, 101, pp. 1676-1706.

2 However, the reflection of the depreciation of the government bonds on institutions' income statements may be limited by the accounting method employed. Thus, bonds in held-to-maturity portfolios are not available for sale and are valued using an expected loss approach. Therefore, the banks recognise capital losses only if, as occurred in the case of Greek public debt, there is a possibility of restructuring or default by the borrower.

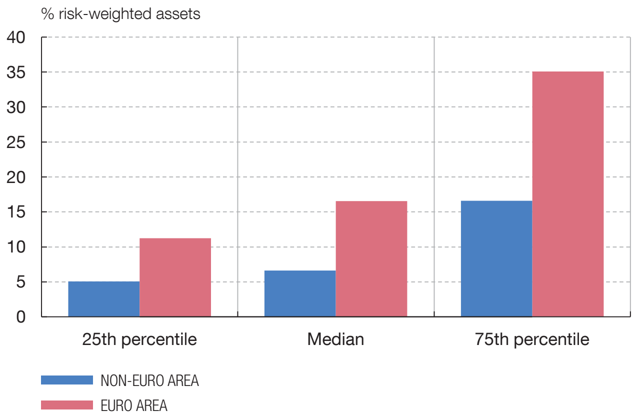
3 A. Mody and D. Sandri (2011), The Eurozone Crisis: How Banks and Sovereigns Came to be Joined at the Hip, IMF Working Paper WP/11/269.

1 FIVE-YEAR SOVEREIGN SPREADS OVER THE BUND

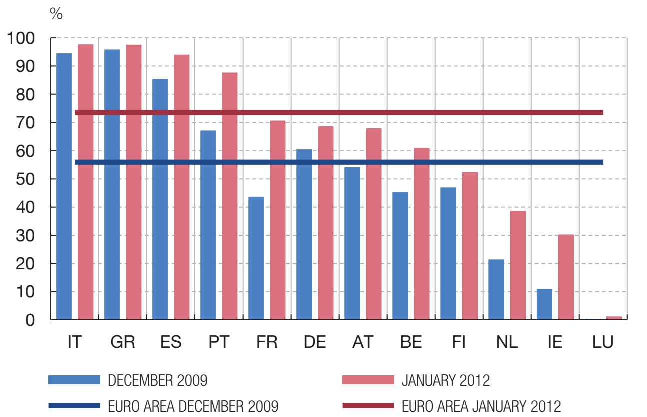


2 RISK PREMIUM IN THE EURO AREA (AVERAGE CDS EXCLUDING GREECE)

3 SOVEREIGN EXPOSURE OF EUROPEAN BANKS (a)



4 DOMESTIC BIAS IN BANK PUBLIC DEBT PORTFOLIOS (b)



INDEX OF CORRELATION BETWEEN BANK AND SOVEREIGN RISK PREMIUMS (CDS) (c)

	Euro area countries (d)				United Kingdom	United States
	All	Under assistance	AAA	Other		
2009-2012 (April)	87	88	85	88	52	47
Second half of 2011	85	65	95	92	93	30

SOURCES: European Banking Authority, ECB, Datastream and SNL.

a Net direct exposure to European sovereigns of the banks participating in the European Banking Authority's recapitalisation exercise (51 euro area and 14 non-euro area banks).
b In the aggregate bank balance sheet, domestic general government debt as a proportion of total euro area general government debt.
c The bank index is the average of the individual bank CDS.
d Includes AAA countries (Germany, France, Netherlands and Austria), countries under assistance (Greece, Ireland and Portugal) and the other countries (Italy, Spain and Belgium). For the groups of countries they are calculated as the simple average of the individual correlations.

discipline surveillance procedure, the Stability and Growth Pact, with ceilings for budget deficits and public debt. Yet the necessary mechanisms were not set in place so that these provisions of the treaty might be properly applied in practice, meaning that the Pact's effectiveness was ultimately very limited. Conditions were even more lax regarding other economic policies, subject to less strict oversight procedures in terms of their theoretical definition and even lighter oversight in respect of their practical application. Coordination of these policies was structured around the so-called Broad Economic Policy Guidelines (BEPGs), by means of which economic policy priorities were set. But oversight of each Member State's degree of adherence to these priorities was based on mere information exchange and on peer pressure mechanisms, which proved relatively ineffective for pushing through far-reaching reforms. Finally, the irreversibility of monetary union and the success reaped in its early years shaped a setting not conducive to reflection on potential crises and on the need to have mechanisms at hand to manage and overcome them. The institutional arrangements underpinning EMU lacked such an instrument, a shortcoming that prevented a flexible response at a sufficiently early stage of the tensions, which would probably have enabled such tensions to be confined and resolved more readily.

Exiting this stressed scenario requires a three-pronged action plan…

Under these conditions, action on several fronts was necessary to lessen the pressure. In the domestic policy realm, resolute action was needed by the economic authorities both to correct the vulnerabilities that had built up and, essentially, to make the required changes to definitively align internal working arrangements to those proper to a monetary union. In terms of European governance, the challenge was to shore up the foundations in which the main cracks had been detected and to set in place effective mechanisms for crisis-management and the provision of financial assistance. Finally, regarding monetary policy, it fell to the ECB to contribute to easing financial tensions through an effective liquidity supply and management policy without detracting from its capacity to react swiftly to any risk to price stability, which is its main objective and a necessary condition for growth, job creation and financial stability in the area.

Throughout 2011 and in 2012 to date, progress in these three areas has been uneven and not without difficulties. The headway made has occasionally been in response to conflicting interests, and the ups and downs experienced evidence the absence of a well-defined plan backed by a high degree of consensus. Notwithstanding, it should be acknowledged that significant steps have been taken, though there is still a considerable way to go.

… namely a re-gearing of domestic economic policies to align them to the area's stability requirements…

Regarding domestic economic policies, there has been significant headway in a good number of the countries subject to greater tensions. Broadly, however, mention may be made of the implementation of ambitious fiscal adjustment programmes, progress in the recapitalisation and restructuring of banking systems, and structural reforms in the labour market and in services markets which, at a differing pace and degree of intensity, have been applied by these Member States' governments, in some cases under the terms of conditionality proper to the financial assistance programmes set in train. But experience has also shown the difficulties of defining with any precision the optimal pattern of bringing public finances back onto a sustainable path against the background of a strong economic downturn and the risk that, in this setting, governments may succumb to reform fatigue before they have finished overhauling structures in their respective economies. The long and eventful road that finally led to Greek public debt restructuring and the approval of this country's second financial aid programme vividly illustrates the difficulties of these processes and the costs of not overcoming them quickly and effectively. And far from being confined to the economies directly involved, such difficulties and costs have – against a backdrop of high systemic uncertainty – tended to spread to other countries, especially those in a situation of greater vulnerability.

… a deep-seated reform of euro area governance …

Turning to European governance, last year's *Annual Report* anticipated the incipient progress made in the first half of last year in the field of fiscal policy. Of particular note is the strengthening of the Stability Pact, resulting specifically, among other factors, in greater emphasis being placed on prevention instruments, greater attention to debt ceilings and a higher degree of automaticity in the procedures for evaluating non-compliance and for setting heavier penalties under the corrective arm of the Pact. Later, along the same lines, a second package of measures was implemented aimed at reinforcing the framework within which domestic budgetary policies are monitored, and there is a new Treaty on Stability, Coordination and Governance to promote explicit recognition of the commitment to budgetary stability at higher levels of national legislation.

Along with progress in the fiscal realm, a new framework has been designed for the prevention and correction of domestic (non-fiscal) and external macroeconomic imbalances, known as the Excessive Imbalance Procedure. This new framework is underpinned by an early-warning mechanism based on a broad set of indicators which, when complemented by timely economic analysis, should help to detect sufficiently in advance those situations of vulnerability that may jeopardise euro area stability and to set in place the measures needed to correct them.

Another significant innovation regarding governance in the area is the so-called "European Semester", which sets a new timetable for the discussion in European fora of all matters pertaining to excessive deficit and imbalance procedures and to the national reform plans which should give expression to the commitments entered into by governments under the Euro Plus Pact and the Europe 2020 Strategy. The Euro Plus Pact is an inter-governmental agreement entered into by the euro area States and other EU members aimed at reinforcing the commitment to pursue policies geared to growth and to improving competitiveness. The Europe 2020 Strategy succeeds the former Lisbon agenda and is an action and structural reform programme oriented to creating employment, raising productivity and increasing social cohesion. The Semester begins with the presentation by the European Commission of its *Annual Report on Growth*, where the economic policy priorities that European countries must tackle are set. In late November last year, the European Commission brought forward the presentation of the Report for the current year.

Since then, significant consensus has been forged in the euro area around the idea that the progress in fiscal consolidation should now be accompanied by a collective effort, tailored in each country to the particularities in place, to boost growth and employment. The details of what has become known as the "Growth Compact" for the euro, which would complement the previously established "Fiscal Compact", are still under discussion in various fora. But the political backing the G8 and EU leaders have given to this initiative at their recent meetings in May in Chicago and Brussels, respectively, is significant.

Taking a longer view, the crisis is also highlighting the need for all these moves to be complemented by the design of a more ambitious agenda. There may then be progress towards a stronger and deeper economic union among the Member States, in which the degree of integration and transfer of monetary policy sovereignty attained may progressively pervade other economic policy areas.

… with particular attention to the design of a mechanism for crisis management and for providing financial support…

Significant headway has also been made in designing a permanent crisis-management mechanism, although it is here that the need for greater ambition, consensus and resolve by Governments is most clearly discernible. The bilateral loan arrangements underpinning the first financial aid programme for Greece paved the way for the European Financial Stability Facility (EFSF). Temporarily, the EFSF was intended to bridge the gap in European governance caused by the absence of a formal mechanism for crisis management and the provision of financial support to Member States facing difficulties. Later, and now on a permanent basis, the European Stability Mechanism (ESM) was set up, and is scheduled to finally come on stream in July.

Evidently, designing a formal mechanism of this nature is a complex task. Strength and flexibility must be combined to maximise its capacity for success. And, at the same time, there must be no weakening of the incentives either for the ambitious fiscal consolidation and structural reform programmes currently required to lay the foundations for sustained medium-term growth, or for the continuing pursuit in years ahead of the orderly and consistent policies needed so as not to jeopardise stability in the area and the future of the common project. Yet the establishment of both the EFSF and the ESM has proven too slow and subject to excessive frictions, given the scale the crisis has reached at some points and the speed with which it has spread. Debate as to their size and the range of instruments with which they were equipped has, while necessary, taken longer than was desirable and has seen too much disagreement. Investors have perceived the difficulties of advancing in this area and, in the absence of consensus, have reacted showing greater mistrust.

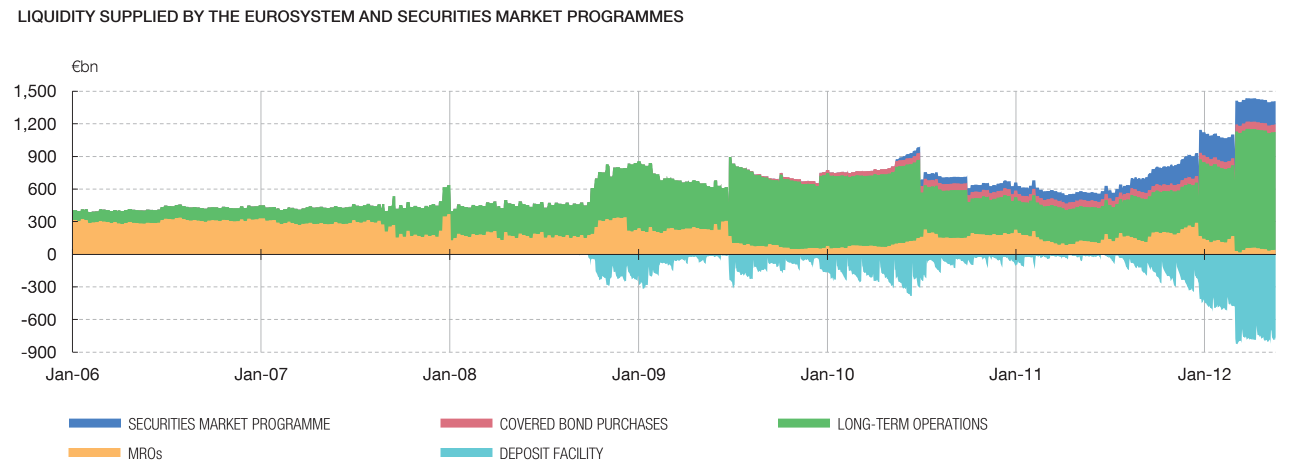
… and, in the shorter term, the contribution of the ECB in its natural sphere of influence

In these conditions, the ECB and its monetary policy decisions have ultimately become the mainstay of stability in the area, providing relief and effective safety valves at times of greatest pressure. The ECB Council faced, in fact, a very complex situation throughout the year, particularly from the summer, when there was a significant turnaround in events. The path of recovery was interrupted and tensions re-emerged forcefully on debt markets, with certain key parts of the transmission mechanism deteriorating substantially. The ECB Governing Council reacted by adopting a series of measures aimed at confirming the expansionary stance of monetary policy, at restoring the functioning of the transmission mechanism and at short-circuiting the feedback loop between risks from the banking system, with great difficulties gaining access to funding, and the sovereign risk market; at that time, the feedback was seriously threatening the stability of the area.

As a result, during 2011 Q4 official interest rates were cut on two occasions, placing them at 1% for the main refinancing operations. The rates on the deposit and marginal lending facilities were set at 0.25% and 1.75%, respectively. In addition, significant unconventional measures were approved. The ECB resumed its Securities Market Programme from 5 August and instituted a second Covered Bank Bond Purchase Programme (including related Spanish instruments) in October. Furthermore, it reinforced its dollar liquidity providing mechanisms and cut the reserve requirement to 1% (down from 2%). In turn, in August and again in October, it extended the fixed-rate tender procedure with full allotment in all its operations (until necessary and, at least, until mid-2012), and it substantially lengthened the term of its liquidity loans to cover a very long period, of three years, in two special operations (the first in December 2011, and the second in February 2012) with which it injected a gross amount of over €1 trillion (see Chart 1.3). So as to prevent any shortfall in collateral from weakening the effectiveness of these three-year LTROs, it also decided to temporarily extend the list of assets eligible as collateral.

LIQUIDITY SUPPLIED BY THE EUROSYSTEM AND SECURITIES MARKET PROGRAMMES

CHART 1.3



SOURCE: ECB.

Progress on these fronts, while uneven, has exerted a stabilising effect whose entrenchment will depend essentially on future actions by national Governments

The combined action on the triple front of national economic policies, European governance reform and monetary policy, along with the approval of the second financial aid programme for Greece after completing the restructuring of Greek public debt held by private creditors, allowed an easing of pressure compared with the critical point reached in the final stretch of 2011. In particular, the ECB's two three-year liquidity operations were decisive in checking an acceleration in tensions that threatened to become a deep-rooted problem and which, against a background of investor hypersensitivity, might ultimately have prompted a financial accident of immeasurable systemic consequences, heightening sovereign risks in the process. By blocking off this potential transmission channel of the difficulties prevailing, valuable time was gained for governments to continue progressing on the other two fronts and for the measures previously adopted to begin to bear their initial fruits. Broadly, the main financial stress indicators have since tended to move on a declining trend, though they have held at excessively high levels. Also, spikes in tension have continued, as has been the case in May, and these, in combination with the high levels of indicators, evidence the need for further headway. In this process, it seems clear that it is now for Governments, responsible both for national economic policies and for the sound working of European governance, to show greater leadership.

3 The double-dip recession in the Spanish economy

The heightening of the sovereign debt crisis interrupted the fragile recovery in the Spanish economy, plunging it once more into a bout of recession

The heightening of the sovereign debt crisis and its interaction with the situation of the financial system acutely affected the Spanish economy, worsening its financing conditions and denting agents' confidence. This broad outlook has been exacerbated by the slowdown in activity in the euro area. And all at a time when job destruction and the unemployment rate were continuing to rise, when the imbalances built up during the upturn remained difficult to absorb and when the need to redress the serious deterioration in public finances during the crisis was becoming imperative.

Against this backdrop, the muted recovery in the Spanish economy in the first half of 2011 weakened as from the summer. Indeed, it was reversed in the final quarter, with GDP declining at a quarter-on-quarter rate of 0.3%, placing the annual average growth rate at 0.7%. This pattern of decline continued into the opening months of 2012 and has seen a new recession ensue.

The adjustment turned once more on domestic demand, which fell sharply, while net external demand once again mitigated this effect

The double-dip has added complications to the adjustment initiated three years earlier. The adjustment has in any event continued, turning on domestic demand. This latter variable fell by 1.7% last year, with a negative contribution of the public and private components of expenditure. The economy's spending capacity has been much restricted by the adverse financial conditions, affected by the tension arising from the sovereign debt crisis and by the ongoing restructuring of the financial system described in Box 1.2. A further contributing factor has been the deterioration in labour prospects and the diminished value of wealth, which have fuelled an increase in uncertainty, a downturn in confidence and, in sum, a curtailing of the propensity to spend. Net external demand once again acted as a counterweight and, for the fourth year running, has mitigated the fall-off in domestic demand, contributing 2.5 pp to output growth, up on the previous year. In 2011, the increase in net external demand was the result of export buoyancy, on one hand, and the sluggishness of imports from the rest of the world, on the other, which were impacted to a greater extent than in 2010 by the weakness of final demand. In the opening months of 2012, national demand once again fell, while net external demand was positive once more.

And on the supply side all the productive sectors lost steam, while job destruction stepped up from the summer

On the supply side, all productive sectors showed diminishing momentum over the year. In the construction sector, where declines in value added were sharper, as has been the case since the crisis began, the decline in activity was centred above all on the non-residential construction segment, owing to the effect of the budgetary austerity plans on civil engineering works. Industrial activity scarcely picked up, despite the sound performance of exports in the face of the adverse trend of national demand. Lastly, the services sectors, which had shown greater resilience to the initial onslaught of the crisis, gradually lost momentum during 2011. This also reflected the extreme weakness of certain domestic expenditure components, in particular household consumption. Employment showed no signs of picking up in 2011; indeed, the path of job destruction even intensified after the summer, running into the opening months of 2012.

There are no recent precedents of a double-dip recession, which poses serious questions as to the capacity to respond…

There are no recent precedents of a double-dip recession in Spain, which poses significant questions about the Spanish economy's capacity to respond. This severe episode has arisen as a result of the interaction of the effects of the deterioration in the sovereign debt crisis with the vulnerabilities generated by the difficulty of pushing through internal adjustments and the inefficient workings of the economy, which are a drag on the recovery and an obstacle to a new path of sustained growth being restored.

… which will depend on the completion of the real estate adjustment, the recovery in competitiveness and employment, the correction of the external deficit, the deleveraging of the private sector and the restructuring of public finances

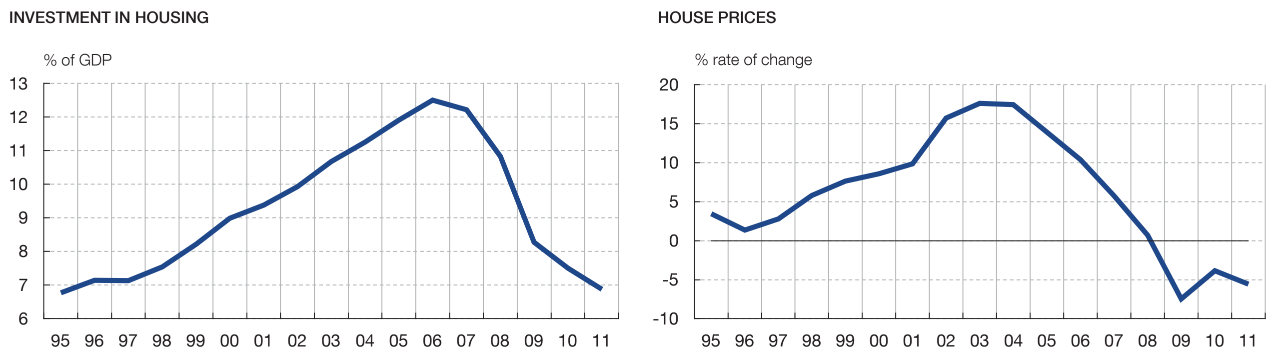
Indeed, the double-dip recession has come about while the real estate adjustment is still ongoing, job destruction has not halted, the private sector is immersed in a complex process of restoring competitiveness and of financial deleveraging, and the banking sector is undergoing a clean-up, recapitalisation and restructuring process. And, at the same time, it is proving difficult to make headway with a severe fiscal consolidation under the demanding conditions of a scenario marked by the absence of growth. These factors bearing on the double dip are likewise conditioning an exit from this complex situation. An in-depth analysis of each of these factors will form the main thread of this section.

The adjustment of the real estate sector continued in 2011, albeit with a diminishing contractionary impact, while activity in the non-residential construction segment plummeted…

The construction sector remains subject to a severe adjustment process. The collapse in the real estate sector is contributing to lengthening the recessionary trends, albeit with a diminishing impact as the adjustment of the sector advances. The sluggishness of the real estate market continued in 2011 against the background of tighter financing conditions and weak income and wealth prospects. The slackness was felt both in supply, where the number of housing starts continued to fall, and in demand, where new house sales showed no signs of picking up. As a result, the stock of unsold housing scarcely fell, to

INVESTMENT IN HOUSING AND HOUSE PRICES

CHART 1.4



SOURCES: INE and Ministerio de Fomento.

the contrary of what was expected at the start of the year. The decline in house prices stepped up in 2011, with the trend running into the opening months of 2012. Accordingly, the accumulated decline in prices from their peak, in 2008 Q1, stands at 22% in nominal terms (27% in real terms), on a greater scale than that recorded in previous real estate cycles. Since the crisis began, the weight of investment in housing in GDP has fallen to less than 7% in 2011 (see Chart 1.4).

…and will continue in 2012 in a recessionary economic environment marked by strict financial conditions

The bulk of the direct and indirect effects on activity triggered by the real estate collapse came about in the early stages of the economic and financial crisis. But some effects continued to emerge in 2011, amplified by the contractionary influence exerted by the non-residential construction segment. Value added and employment across the construction industry as a whole contracted once more, due above all to the fall-off in investment in civil engineering works under the budgetary consolidation plans.

With a view to the immediate future, in an economic environment of low growth and continuing strict financial conditions, the following may be foreseen: residential demand will remain weak, there will be further declines in house prices and the absorption of the stock of unsold housing will proceed slowly, which will delay the recovery in residential investment. In turn, fiscal consolidation will exert an additional restrictive influence on the non-residential construction segment.

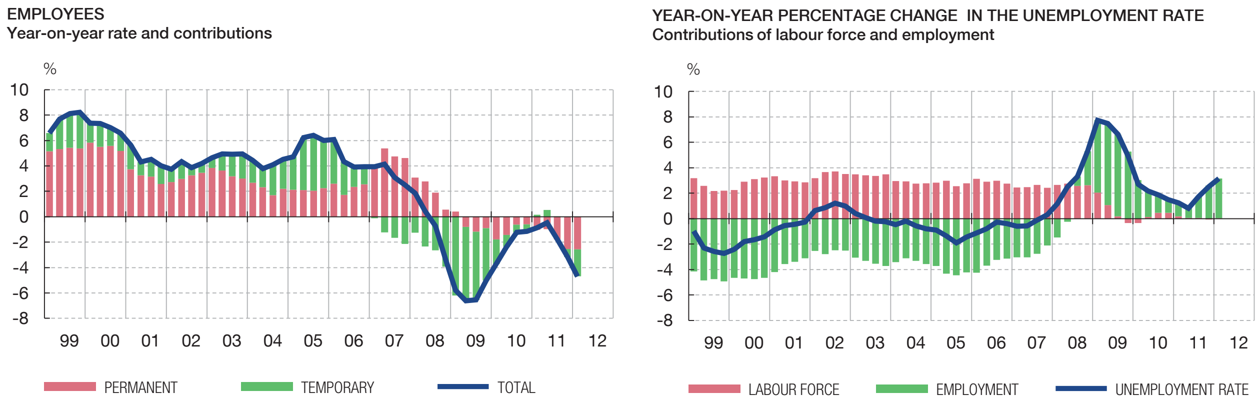
Job destruction intensified from the summer, exacerbating the depth of the crisis…

The shortcomings in the functioning of the labour market have fuelled continuing job destruction and have exacerbated the depth of the crisis. The decline in employment began in early 2008 and has run into the opening months of 2012. To date, more than 2.5 million jobs have been lost, around 13% of the jobs existing at the start of 2008.

In 2011, job destruction intensified from the summer, replicating the double dip in output (see Chart 1.5). Admittedly, part of this additional deterioration in the labour market was attributable to steeper job losses in construction. But the obstacles the other productive sectors face in generating employment and the difficulties in reallocating productive factors across sectors should not be underestimated, indicative as they are of the failures in the functioning of the labour market and of product markets during the crisis. On the labour supply side, there was an increase in the number of foreigners exiting the labour market in 2011. This was offset, however, by further increases in the female participation rate, whereby the labour force stabilised at the levels of the previous year. Unemployment rose substantially in 2011 and in 2012 to date, with the end-year figure showing more than

EMPLOYMENT AND UNEMPLOYMENT (a)

CHART 1.5



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, and the change in the definition of unemployment in 2001.

5 million unemployed. The unemployment rate climbed to 24.4% of the labour force in the opening months of 2012. Of these, approximately half were long-term unemployed.

… which is largely due to the delay in the adjustment of labour costs…

Beyond the forceful knock-on effects on employment caused by the downsizing of the construction sector, the intensity of the effects of the crisis on employment can also be attributed to the delay in the adjustment of labour costs. Despite the severity of job destruction, economy-wide compensation per employee increased by 10% from 2008, although unit labour costs (ULCs) fell by 1% owing to the high productivity gains arising as a result of the decline in employment.

… which, in their market component, rose once more in 2011 owing to the preponderant role of inflation in wage bargaining

Until 2010 there was no turnaround in wage dynamics, a fact which may be largely linked to the cut in public-sector wages and, to a lesser extent, to the demonstration effect it had on the private sector. Nonetheless, market-economy wages rose anew in 2011, after stabilising the previous year. This was due to the impact of two of the features of the collective bargaining system that add most inertia: the preponderant role of inflation in determining wage increases, amplified by the effect of the indexation clauses, and the high proportion of industry-wide multi-year agreements, which hampers their adaptation to the specific circumstances of individual companies. In any event, in 2011 and in 2012 to date ULCs fell back further, assisted by productivity gains, which provided for an improvement in the relative position vis-à-vis the euro area countries (see Chart 1.6).

Achieving lasting improvements in competitiveness will require greater adjustments in costs and prices and genuine gains in productivity

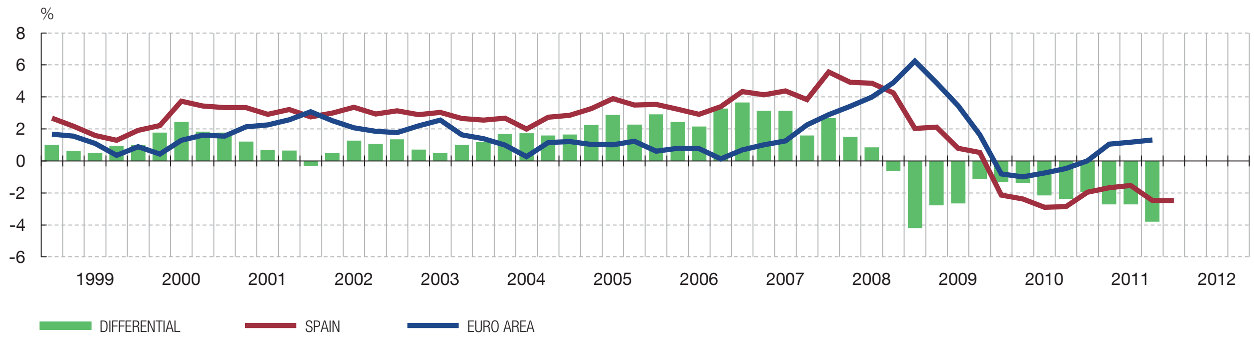
Inflation has been impacted by the weakness of activity in recent years, with increases in the core inflation rate lower than those in the euro area, except on specific occasions since 2009 (see Chart 1.7). In 2011, inflation eased significantly in the closing months of the year once the base effects stemming from the VAT rise in July 2010 and those relating to the increase in tobacco and energy prices in the final stretch of 2010 were stripped out. As a result, the inflation differential became favourable to the Spanish economy once more, a trend that has continued into the opening months of 2012 and which is helping correct the positive differentials that built up during the upturn.

However here, too, price adjustment has been clearly insufficient to restore the competitiveness lost since Spain joined the euro area and to offset, through a greater export impulse, the recessionary trend of domestic demand. Indeed, the real effective

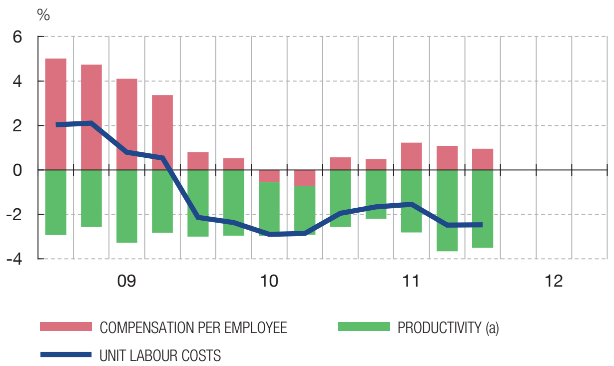
LABOUR COSTS

CHART 1.6

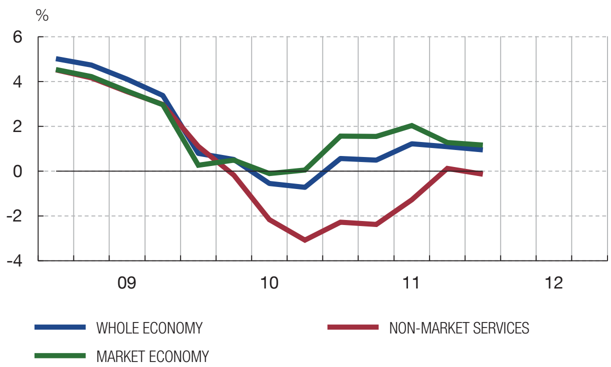
SPANISH AND EURO AREA UNIT LABOUR COSTS
Year-on-year rate



UNIT LABOUR COSTS
Year-on-year rate



COMPENSATION PER EMPLOYEE
Year-on-year rate



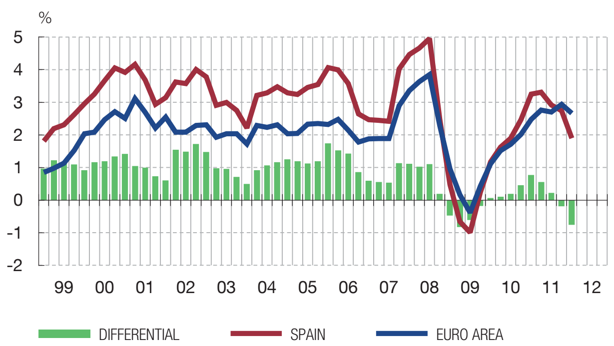
SOURCES: Eurostat and Banco de España.

a Year-on-year rate with sign changed.

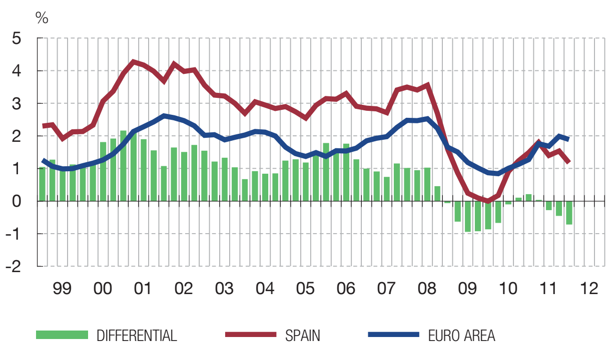
SPAIN/EURO AREA INFLATION DIFERENTIAL

CHART 1.7

OVERALL INDEX
Year-on-year rate



OVERALL INDEX ECLUDING ENERGY
Year-on-year rate



SOURCES: Eurostat and Banco de España.

exchange rate against the euro area countries has appreciated moderately if the calculation is made in terms of consumer prices. That is in contrast to the gain in competitiveness brought about by exchange rate adjustments in previous recessions, when the exchange rate was available as an economic policy instrument. The adjustment in the real exchange rate has been greater in terms of ULCs (it has depreciated by somewhat over 5%), although this has come about mainly through the gains in productivity induced by severe job destruction. True, this process may have prompted gains in efficiency in sectors and companies that had become excessively big or had not adapted to growing competitive demands, in a setting of financial laxity and strongly dynamic spending. But a significant portion of the apparent productivity gains solely reflects the intensity of the contraction in employment, and is not in response to genuine improvements in productive efficiency, which are what are important for achieving lasting increases in competitiveness. These developments highlight the slow, costly and imperfect functioning of the competitiveness channel, which is pivotal for making adjustments within a monetary union when, as is the case, the economy is in a situation of over-indebtedness.

The current account deficit has fallen significantly, but there are two stumbling blocks that will influence its pattern of adjustment in the future

Since 2007, the external deficit has been substantially corrected, declining from 10% of GDP in 2007 to 3.4% of GDP in 2011. Underpinning this reduction has been the increase in exports and the marked weakness of imports evident in the contraction in domestic demand, while the adjustment of the real effective exchange rate has been moderate. The correction of the external deficit has come up against two factors which will continue to influence its pattern of adjustment over the most immediate horizon. First, the sizeable deficit on the energy balance, which reflects the great dependence of the productive structure and of domestic spending on energy imports, and whose negative impact on the current account increases in situations of sustained energy price rises. And further, the scale of the component of net investment income payments, which has subtracted resources for an amount equivalent to 2.6% of GDP in 2011 (see Chart 1.8) and which is closely linked to the level attained by the International Investment Position (IIP), a more detailed analysis of which is given in Box 6.2 of this Report.

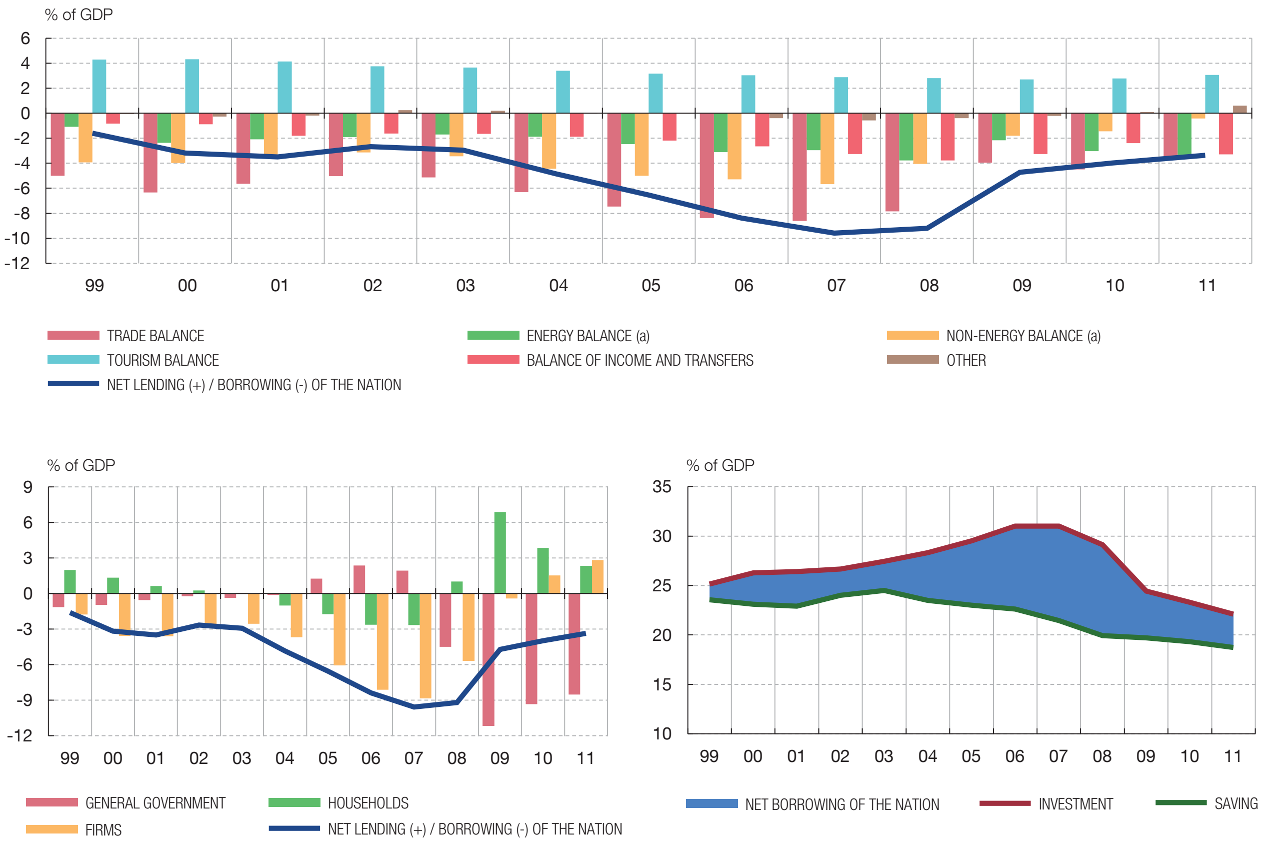
The foreseeable persistence of both developments is a drag on attempts to permanently reduce external borrowing needs, and highlights the importance of reforms that may contribute to mitigating this through the promotion of gains in competitiveness that are conducive to swifter adjustments in the real exchange rate. Only thus may a lasting decline in borrowing needs and a reversal of the rising course of the IIP be attained, once the diminishing effect of the foreseeable weakness of domestic spending on the deficit has been exhausted. The external borrowing requirement has become a major factor of vulnerability of the Spanish economy in the face of the crisis. The erosion of confidence in the euro and the clogging up of wholesale funding markets have created more pressing problems for those countries with a greater dependence on external saving.

The reduction in debt is proceeding slowly, in line with the usual pattern in situations of real estate and financial crisis

The high level of foreign debt ensuing from the strong dynamism of domestic expenditure that was largely financed by external saving can be related to the excessive laxity of financing conditions prevailing during the upturn in the Spanish economy. These conditions fuelled a high build-up of debt by households and firms, and led to the excessive size of our banking system, leaving bank balance sheets skewed towards real estate-related risks. The need to correct these imbalances hampers recovery in the economy; it narrows the headroom available for increasing investment and consumption through resort to external borrowing, and it means expansion possibilities depend closely on the funds that can be internally generated to finance expenditure.

NET BORROWING OF THE ECONOMY

CHART 1.8



SOURCES: INE, Customs and Banco de España.

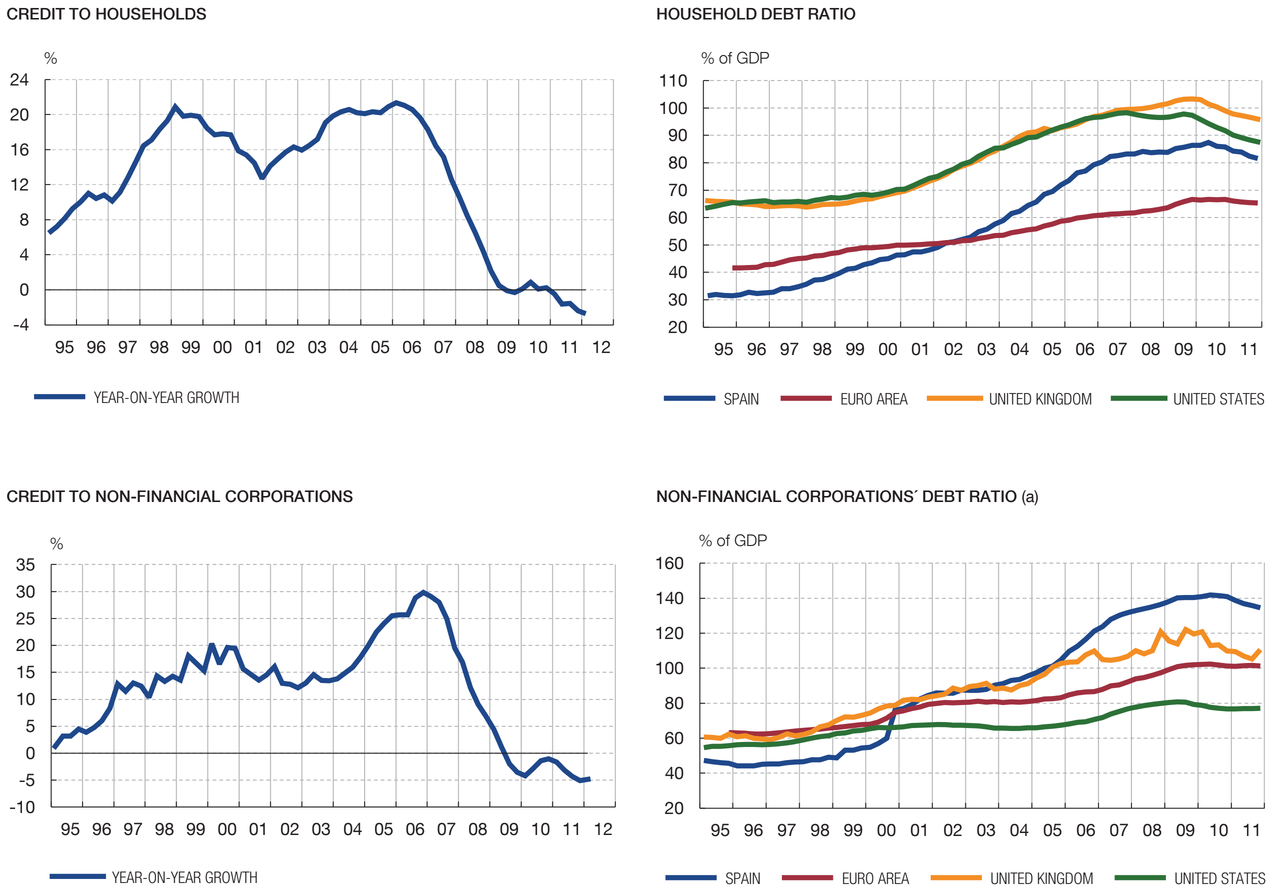
a The energy and non-energy balances are an estimate of the Banco de España drawing on Customs data.

Recourse to credit has been particularly constrained as a result of the European sovereign debt crisis and its adverse repercussions on financing conditions in the Spanish economy. Given their role as a benchmark, high sovereign risk premia have translated into an across-the-board tightening of Spanish financial intermediaries' accessibility to funds, which in turn is feeding progressively through to households and firms. This pass-through appears to have been both through higher lending costs and through quantitative restrictions, although banks have been able to exploit, until very recently, the cushion provided by the greater resort to deposits (which expanded continuously until mid-2011) and to short-term financing in the repo markets. The safety valves of quantitative restrictions, however, have been offering increasingly limited room for manoeuvre. In any event, market frictions and failures have emerged that have singularly affected the accessibility to loans of certain sectors particularly exposed, for conjunctural or structural reasons, to the crisis, as is the case with SMEs.

Experience shows that, in real estate and financial crises, lowering the debt of households and firms is usually a slow process necessarily involving a relatively lengthy initial phase of credit containment. In the current episode, moreover, the restrictions persisting on international wholesale funding markets make it difficult for the deleveraging of the financial system to turn essentially on increasing capital without affecting in some way the extension of loans. The deleveraging pattern followed by the Spanish private sector has so far been in line with this past path. In 2011, credit to the non-financial private sector contracted at a

FINANCING OF HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS

CHART 1.9



SOURCES: INE, ECB, Federal Reserve, UK Office for National Statistics and Banco de España.

a Debt of non-financial corporations includes intercompany loans.

rate of around 4%, although significant sectoral differences were observed in the behaviour of this variable (see Chart 1.9). In the case of households the related rate was close to -2.5% (the rate of contraction was brisker in the first half of the year), while credit extended to non-financial corporations ran at a rate of around 4%, which has held relatively stable since. The concentration of household liabilities in mortgage loans with notably extended maturities helps explain their slower pace of adjustment.Among corporations, the contraction was more marked in those sectors of activity such as construction and real estate development in which the prior accumulation of debt was greater and in which the level of activity was on too great a scale. The adjustment needed is, however, less in the case of large corporations that have used a significant portion of the funds they have raised to extend and diversify their business internationally and whose profitability depends to a lesser extent on the Spanish economy's position in the cycle.

The necessary restructuring of public finances is exerting contractionary effects in the short run and will condition the exit from the crisis

The implementation of budgetary consolidation plans is one of the fundamental conditioning factors of the exit route from the recession. The fiscal adjustment plan approved in 2010 and endorsed in the 2011 State Budget affected, above all, public spending (public-sector wages and employment and public investment), although it also entailed the elimination of certain tax deductions in force during the recession, along with some tax increases. The aim of the plan was, in principle, consistent with the imperative need to redress the medium-term trajectory of public finances. But short-term contractionary effects would have to be generated, due both to the direct effect of general government conduct on activity (government consumption and public investment) and to the indirect effect on household disposable income as, for the second year running, households saw how the public component of net transfers was diminishing.

However, the fiscal outturn was not as envisaged and the budgetary deviation was sizeable. Analysis of the factors underlying this slippage and of the difficulties in bringing public finances onto the path of adjustment established in the Stability Programme is part and parcel of the challenges facing economic policy in exiting the crisis; accordingly, this analysis is tackled in depth in the following section.

4 Policies for overcoming the crisis

The Spanish economy continues to display factors of vulnerability despite the progress in correcting its imbalances

Over the past three years, the Spanish economy has made progress in correcting some of the macroeconomic imbalances built up, though it has done so unevenly and to an insufficient degree, as highlighted in the previous section. Notwithstanding, it continues to display factors of vulnerability that are the outcome of the interaction between protracted economic weakness and certain features of the institutional framework that have tended to amplify the impact of the shocks.

Overcoming the crisis and the necessary protection of the Spanish economy against potential external shocks require an economic policy with a firm medium-term orientation. Such a policy should allow the correction of the macroeconomic imbalances still in place to be completed, along with the in-depth restructuring of all sectors (firms, households, general government and financial institutions) and the reform of the institutional dysfunctions that have become patently evident in numerous areas of the economy, even though the specific measures needed may exert a contractionary effect in the short term. On the basis of the diagnosis made, a stance of this type requires the economic policy agenda to be structured, as has been the case, around the following three pillars: the restructuring of credit institutions, the culmination of an ambitious fiscal consolidation process and progress in structural reforms, including most notably – given its high priority – that of the labour market.

The clean-up, recapitalisation and restructuring of the financial system is vital for restoring confidence and normalising the financing of the economy

In a setting such as the present, any sign of weakness in the financial system runs the sizeable risk of unleashing tensions on the debt market and setting in train perverse mechanisms with feedback loops. To prevent these risks materialising, it is necessary to restore investors' full confidence in the Spanish financial system. On the soundness of the system hinges the efficient financing of the economy, too, allowing the necessary deleveraging of the economy to be compatible with the availability of credit for solvent projects.

The clean-up, recapitalisation and restructuring of the Spanish banking system began in 2009. Since then, the objectives have gradually adjusted to the worsening economic and market conditions, which have amplified the scale of the problems and lessened the leeway available to resolve them. Box 1.2 describes in greater detail the measures adopted during 2011 and in 2012 to date, which have progressively adapted the financial reform process to the requirements of changing circumstances. One particular bout of tension arose in May this year, in connection with the conversion into ordinary shares of the funds previously extended by the FROB to Spain's fourth biggest lender. The changes made have essentially been aimed at strengthening banks' balance sheets through the dual means of capital and provisions, tailoring the size of the sector to the new economic scenario and resolving the governance and ownership problems that were weighing down part of the system.

In the short run, however, this broad approach to the clean-up, recapitalisation and restructuring of the system will certainly have to continue being complemented by one-off

PROGRESS IN THE CLEAN-UP, RECAPITALISATION AND RESTRUCTURING OF THE SPANISH BANKING SYSTEM

BOX 1.2

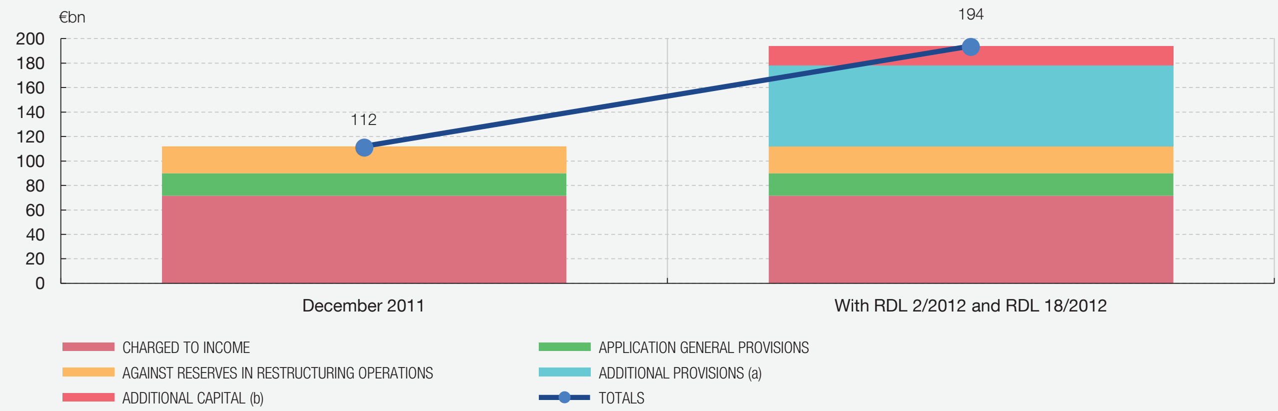
Throughout 2011 and in the opening months of 2012, the ongoing clean-up, recapitalisation and restructuring of the Spanish banking system continued. The basic parameters of this process have had to adjust to the requirements of a new economic and financial scenario that has worsened both in Spain and in the rest of the euro area.

On 18 February 2011 the Government approved Royal Decree-Law (RDL) 2/2011. This legislation raised the minimum required level of capital for banks with a view to reinforcing the soundness of the financial system and contributing to restoring investors' confidence, which had been dented following the outbreak of financial tensions further to the Irish crisis in autumn 2010. Specifically, a new solvency ratio was introduced, which had to be met maintaining core capital[1] of at least 8% of risk-weighted assets, rising to 10% for those institutions in which the relative weight of funding from wholesale markets exceeded 20% and which had not placed at least 20% of their capital with third-party investors. The functioning of the Fund for the Orderly Restructuring of the Banking Sector (FROB by its Spanish acronym) was reformed so that, under specific conditions[2], it could provide the necessary capital for institutions that could not obtain it on the market. The regulation set a timetable for compliance whose deadline was 30 September. The final outcome of its application may be summarised in the following figures: 13 out of a total of 114 registered institutions needed to raise their capital by a total amount of €13.39 billion, 9 of them did so resorting to private investors for a total of €5.84 billion, 3 required the assistance of the FROB for an

1 The definition here is stricter than the previous one for Tier 1 capital, as it eliminates certain items such as preference shares (except those convertible to 2014) and non-voting shares, and includes eligible instruments subscribed by the FROB.

2 Obligation to sell the securities within five years, the need to submit a recapitalisation plan to the Banco de España, a seat for the FROB on the board of directors and, if a savings bank or IPS is involved, the obligation to transfer all financial business to a commercial bank using the mechanisms envisaged under RDL 11/2010.

WRITE-DOWNS MADE SINCE JANUARY 2008 AND ESTIMATION OF THOSE REQUIRED UNDER RDL 2/2012 AND RDL 18/2012



SUMMARY OF INTEGRATION, CAPITALISATION AND INTERVENTION OPERATIONS TO CLEAN UP BANKING SECTOR BALANCE SHEETS (MAY 2012) (c)

	Integration phase		Recapitalisation phase		Restructuring of non-viable institutions		Total
	No. Processes	Assistance €bn	No. Processes	Assistance €bn	No. Processes	Assistance €bn	Assistance €bn
FROB	7	9.29 (d)	2	4.18 (e)	2	0.39 (f)	13.87
DGF (g)					2	6.20	6.20
TOTAL	**7**	**9.29**	**2**	**4.18**	**4**	**6.59**	**20.07**

SOURCE: Banco de España.

a This figure is based on the provisional estimate that the Ministry of Economic Affairs and Competitiveness has made of the requirements under RDL 18/2012.
b These would not be provisions, but greater capital requirements.
c Not including the additional capital requirements arising from the clean-up plan submitted by BFA-Bankia at the end of May 2012.
d Implemented through preference shares convertible into shares subscribed for by the FROB. Not including the Unnim operation, with a value of €380 million, since these securities, which had been converted into ordinary shares in the recapitalisation process, have been transferred after their sale to BBVA. Includes €4.47 billion corresponding to BFA-Bankia which are going to be converted into shares.
e Not including the €568 million corresponding to the purchase of Unnim shares by the FROB, since they have been transferred following their sale to BBVA.
f Estimated cost of the asset protection scheme of the Cajasur operation.
g Ordinary shares acquired by the DGF in the CAM operation and assumption of losses in the sale of Unnim. The possible cost of the asset protection schemes in these operations is not included.

amount of €4.75 billion[3] and 1 institution was intervened and subsequently sold by auction, with the Deposit Guarantee Fund providing €5.25 billion of the capital needed.[4] In addition, virtually all the financial activity of savings banks was transferred to commercial banks.

One of the first effects of this regulation on Spanish banks' solvency could be seen in the second stress test exercise conducted by the European Banking Authority (EBA), whose results were published on July 2011. As a result of the test, Spanish banks did not require further capital increases, despite the fact that the criteria applied were more demanding than those in 2010 and that, once again, the degree of coverage attained in Spain, namely 93% of total assets, was far higher than the 50% minimum required by the EBA.

However, the worsening of the sovereign debt crisis during the summer of 2011, which took on a systemic nature, led the Community authorities to adopt a recapitalisation plan for major banks, which affected five Spanish institutions. Specifically, an extraordinary capital buffer of a temporary nature – until market confidence problems are resolved – was established, linked to the estimated losses on the sovereign debt portfolio in accordance with market prices. Also, likewise temporarily, the Tier 1[5] ratio was raised to 9%. The calculation of the new requirements, which was made on the basis of data as at September 2011, reflected additional needs for Spanish banks of €26.17 billion, to be covered by June this year. Moreover, the three previously existing funds were unified in a single Deposit Guarantee Fund for Credit Institutions, further reinforcing this vehicle's capacity to shore up the solvency and sound functioning of banks.

Despite all these measures, the worsening economic situation in Spain and the difficulties in completing the ongoing review of European governance contributed to the problems of confidence in the Spanish financial system remaining in place, and its major difficulties in gaining access to wholesale funding continued. A by no means insignificant portion of these difficulties continued to be linked to the sector's high exposure to real estate development-related assets and to doubts over their valuation, especially in those cases, such as loans linked to land or to developments in progress, where, owing to their lesser liquidity, it was more complicated to obtain a market price. In an attempt to eliminate this source of uncertainty, the Government approved in February and May 2012 RDL 2/2012 and RDL 18/2012, respectively. This legislation sets in place an accelerated and transparent process for the clean-up of potential losses associated with real estate assets. RDL 2/2012 includes, moreover, various other measures: incentives for consolidation operations; the improved governance of institutions resulting from integration processes; the simplification of organisational and operational structures; the regulation of the distribution of the surplus of savings banks that pursue their activity indirectly, and limits on the remuneration of the directors and managers of institutions that have received aid from the FROB. For its part, RDL 18/2012 stipulates the obligation to take the foreclosed assets or those received in payment of debts linked to the real estate sector to a public limited company, other than the institution, for their management and sale. Also in May, the government entrusted the Ministry of Economic Affairs and Competitiveness with drawing up two external and independent valuation reports on the extent of the clean-up of bank balance sheets.

Against this background, the Ministry and the Banco de España agreed on 21 May to hire Roland Berger and Oliver Wyman as independent appraisers to value, within the space of a month, the Spanish banking system's balance sheets. In a second stage, audit firms, which had not yet been selected at the time of this Report going to press, will perform field work on the quality of the procedures for recognising and provisioning for loan losses. This stage will take longer.

The new measures on write-downs establish an increase in specific and general provisions[6] and, in the case of problem assets relating to land and developments in progress[7], they require a capital buffer that covers the potential losses on such assets. In this way, levels of coverage for the total real estate development-related asset portfolio would be attained for 45% of their total amount[8], which would be for 53% in the case of problem real estate assets and, within the latter, for 80% in the case of land and for 65% in the case of developments in progress. The accompanying panel gives a breakdown of the initial estimates of additional write-downs and of the increase in capital that the application of these rules would entail, namely some €82 billion[9], notably increasing the volume of those made between 2008 and end-2011 (€112 billion).

The February RDL gave institutions until 31 March to submit their plans to comply with the new requirements. On 17 April, following revision of the plans presented by the institutions, the Banco de España deemed that most of them had made this first additional clean-up and recapitalisation drive or that they were in a position

3 Subsequently, the Unnim operation required an additional increase in capital of €380 million through the conversion into shares of the preference shares held by the FROB as a result of the previous integration phase.

4 The FROB subsequently took control over another institution.

5 Basic capital comprising ordinary shares and reserves, although it includes other capital instruments arising from public aid.

6 In specific provisions the percentages set out in CBE 4/2004 are increased and certain items are added, and in general provisions additional provisioning for a total of 30% of the outstanding balance of standard real estate exposures is introduced.

7 This would affect both assets already foreclosed and loans backed by these assets, and would require covering with capital the difference between the provisions already set aside on these items and the required coverage of 80% and 65% of their value.

8 The result of the sum of the outstanding balance of loans extended and the balance-sheet initial book value of assets foreclosed in payment of debt.

9 This figure is based on the provisional estimate by the Ministry of Economic Affairs and Competitiveness of the requirements arising from RDL 18/2012.

to do so without major difficulties. At other institutions, envisaged compliance would be a closer-run matter, although with reasonable prospects of being achieved. In these latter cases, the Banco de España required additional measures on top of those initially proposed, along with contingency measures to withstand possible deviations. At the same time, it stated that it would monitor much more closely compliance with the plans. Further, of the total number of institutions, 27 (12 of them credit cooperatives) reported that they might take part in merger and acquisition operations which, if they materialised, would involve a slightly longer time margin in which to comply with the new requirements. Although envisaged under the rules, no institution then applied for intervention by the FROB. In early May, the country's fourth-biggest financial institution applied for the conversion of preference shares previously subscribed by the FROB into ordinary shares. As a result, the FROB will hold a very significant percentage of its capital. Subsequently, this same institution agreed to asked the FROB to subscribe an additional capital increase for an amount of €19 billion, as part of a new clean-up plan.

In accordance with the May RDL, institutions have until 11 June to submit new plans to comply with the additional provisioning requirements. Those that so need it, in the opinion of the institution or the Banco de España itself, may avail themselves of financial support from the FROB, either in the form of ordinary shares or securities convertible into shares, on an arm's length basis.

In parallel with these measures, the restructuring of the Spanish banking sector has moved ahead in 2011 and in 2012 to date. The mergers initiated in 2010 have been completed, other new mergers are under way and the change in the savings-bank legal organisational model has been implemented, leading to virtually all the institutions concerned transferring their financial activity to a commercial bank (around 99% of the sub-sector's risk-weighted assets). Taking stock, it can be seen that, as at March 2012, the 45 savings banks previously existing had been transformed into 11 banking institutions.[10] This sub-sector concentrated all the aid received which, as can be seen in the adjoining table, amounted to €9.29 billion in the integration phase. With €4.18 billion used for recapitalisation and €6.59 billion for operations involving non-viable institutions[11], the result is a total volume of aid of €20.07 billion (€13.87 billion provided by the FROB and €6.2 billion by the DGF).[12]

These developments have been accompanied, at the merged institutions, by an average reduction of around 11% in staffing and 13% in the number of offices, in the period from December 2008 to December 2011. Further, at all savings banks management teams have been renewed, both voluntarily and by force, with the entry of public or private investors.

10 Including the integration of Caja3 into Ibercaja and that of CEISS into Unicaja.

11 These figures show the result of the integration of Unnim into BBVA, which entailed the return to the FROB of all the funds provided via the instruments acquired in the integration and recapitalisation phases, €380 million and €568 million, which accounted for 100% of the capital. Unnim's assets and liabilities were then transferred to the BBVA for €1, with the DGF assuming the estimated losses on this operation (€953 million).

12 These figures do not include the additional capital requirements arising from the clean-up plan submitted by BFA-Bankia at the end of May 2012.

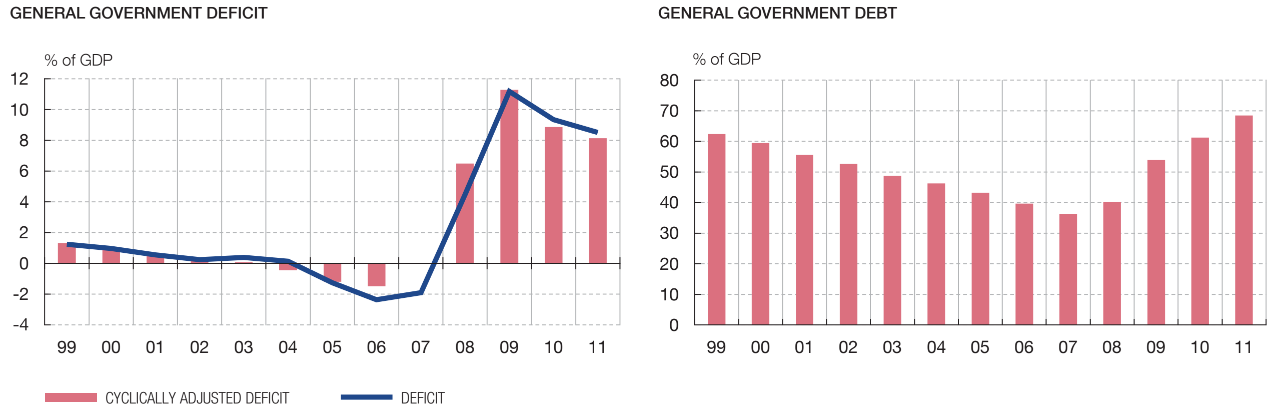
policies supporting specific modes of lending. These should help correct the market shortcomings whose effects tend to be more acute at times of great stress like the present and that may restrict the access to credit of solvent agents whose creditworthiness, nonetheless, is particularly difficult to evaluate. Special mention here should be given to the support to SMEs, channelled essentially through the ICO (Official Credit Institute). In any event, it should not be forgotten that neither the ICO nor, generally, this type of one-off policy can replace the role of a sound financial system in efficiently allocating financial resources in an economy.

In 2011, the actual deficit figures substantially exceeded the initial projection…

In the budgetary area, the measures adopted in 2010 and 2011 sought first to ensure compliance with the objectives laid down in the Stability Programme, and further, to reinforce the fiscal framework and improve the sustainability of public finances.

As to the first of these objectives, budgetary measures focused on implementing the adjustment plan designed in May 2010 and subsequently completed by the 2011 State Budget. This plan had been defined on the basis of a scenario of some recovery in activity, which would subsequently be revealed to be excessively benign, and aimed to reduce the budget deficit from 9.2% of GDP in 2010 to 6% of GDP in 2011, entailing a reduction in

GENERAL GOVERNMENT DEFICIT AND DEBT CHART 1.10



SOURCES: IGAE and Banco de España.

the structural deficit of 3.1 pp (from 7.8% to 4.7%)[1] (see Chart 1.10). This ambitious plan resided chiefly on public spending cuts and encompassed all tiers of government. Nonetheless, there was uncertainty over its actually being met owing both to the inertia of certain expenditure items and to the behaviour of local and regional government, whose budgetary effort had scarcely been discernible in the 2010 figures.

From the summer, a risk of slippage in the programmed overall general government target began to be perceptible. It was therefore necessary in August 2011 to adopt additional fiscal consolidation measures, with an estimated fiscal impact of 0.5 pp of GDP. Nonetheless, the cyclical downturn in the closing months of the year bore down even more on tax revenue and social security contributions, preventing attainment of the deficit target for that year.

Indeed, 2011 saw a substantial overrun in terms of the actual as opposed to the projected general government deficit, which stood at 8.9% of GDP. That marked a 2.9 pp deviation from the target set in the Stability Programme. All levels of government had a higher-than-forecast deficit, but the biggest deviation was in the regional governments. Here, it amounted to 2.0 pp, which has affected the credibility of the budgetary projections and has increased the scale of the budgetary consolidation effort still needed.

… confirming the difficulty of achieving effective adjustments in adverse cyclical situations…

These outturns allow some lessons to be drawn on severe fiscal consolidation processes in adverse cyclical situations and in a setting of fiscal decentralisation such as that prevailing in Spain. The cyclical weakness has weighed on tax revenue. The composition of economic activity in 2011 may have influenced this result as it was very biased towards exports, whose impact on tax revenue is lower. But the deviations indicate that the forecasts of revenue were generally high, even for the macroeconomic scenario projected. Notable under revenue was the decline in indirect taxes, in particular excise duties and transfer tax and stamp tax, linked to real estate activity. In contrast, public spending contracted on a scale similar to that established in the Stability Programme owing to the fact that less public investment than was budgeted for offset the upward deviations under the interest payments heading.

1 This objective was in line with a deficit-correction trajectory which, according to the Excessive Deficit Procedure to which Spanish public finances were subject, should place the budget deficit in 2013 at 3% of GDP and which required a 1.5 pp reduction in the structural balance over the 2010-2013 period.

MAIN INDICATORS OF THE SPANISH ECONOMY (a)

TABLE 1.1

	2006	2007	2008	2009	2010	2011
DEMAND AND OUTPUT (b)						
GDP	4.1	3.5	0.9	-3.7	-0.1	0.7
Private consumption	4.0	3.5	-0.6	-4.3	0.8	-0.1
Government consumption	4.6	5.6	5.9	3.7	0.2	-2.2
Gross capital formation	8.0	4.2	-4.2	-16.5	-6.1	-5.2
Equipment investment	8.2	10.2	-2.9	-22.3	5.1	1.4
Construction investment	6.7	2.4	-5.8	-15.4	-10.1	-8.1
Housing	6.6	1.4	-9.1	-22.1	-9.9	-4.9
Other construction	6.8	3.6	-1.6	-7.6	-10.4	-11.2
Exports of goods and services	6.7	6.7	-1.0	-10.4	13.5	9.0
Imports of goods and services	10.2	8.0	-5.2	-17.2	8.9	-0.1
EMPLOYMENT, WAGES, COSTS AND PRICES (c)						
Total employment	3.5	3.0	-0.2	-6.5	-2.6	-2.0
Employment rate (d)	65.7	66.6	65.3	60.6	59.4	58.5
Unemployment rate	8.5	8.3	11.3	18.0	20.1	21.6
Compensation per employee	3.9	4.7	6.1	4.3	0.0	0.8
Unit labour costs	3.3	4.2	4.9	1.4	-2.6	-1.9
GDP deflator	4.1	3.3	2.4	0.1	0.4	1.4
Consumer price index (12-month % change)	2.7	4.2	1.4	0.8	3.0	2.4
Consumer price index (annual average)	3.5	2.8	4.1	-0.3	1.8	3.2
Consumer price differential with the euro area (HICP)	1.4	0.7	0.9	-0.5	0.4	0.3
SAVING, INVESTMENT AND FINANCIAL BALANCE (e)						
Resident sectors: saving (f)	22.6	21.4	19.9	19.7	19.3	18.7
General government (f)	6.0	6.0	-0.3	-6.6	-5.4	-5.8
Resident sectors: investment	31.0	31.0	29.1	24.4	23.3	22.1
General government	3.6	4.1	4.2	4.6	3.9	2.7
Resident sectors: domestic net lending (+) or net borrowing (–)	-8.4	-9.6	-9.2	-4.7	-4.0	-3.4
General government	2.4	1.9	-4.5	-11.2	-9.3	-8.5
General government gross debt	39.7	36.3	40.2	53.9	61.2	68.5
MONETARY AND FINANCIAL INIDICATORS (g)						
ECB minimum bid rate on MROs	2.8	3.9	3.9	1.2	1.0	1.3
Ten-year government bond yield	3.8	4.3	4.4	4.0	4.2	5.4
Synthetic bank lending rate	4.6	5.7	6.2	3.8	3.3	4.1
Madrid Stock Exchange General Index (Dec 1985 = 100)	1,324.0	1,631.8	1,278.3	1,042.4	1,076.5	971.8
Dollar/euro exchange rate	1.3	1.4	1.5	1.4	1.3	1.4
Nominal effective exchange rate vis-à-vis developed countries (h)	100.8	101.9	103.3	103.4	101.9	101.7
Real effective exchange rate vis-à-vis developed countries (i)	111.8	115.8	119.1	116.2	112.3	108.8
Real effective exchange rate vis-à-vis the euro area (i)	110.3	113.6	115.0	111.7	109.4	106.3
Cash and cash equivalents	11.3	-3.2	-3.3	8.5	-0.2	-1.6
Liquid assets (j)	8.4	8.3	9.7	0.8	3.2	0.1
Households: total financing	19.6	12.5	4.4	-0.3	0.2	-2.4
Non-financial corporations: total financing	28.0	17.7	8.2	-1.4	0.6	-1.8

SOURCES: INE, IGAE, AMECO and Banco de España.

a Spanish National Accounts data, base year 2008.
b Volume indices. Rate of change.
c Rate of change, except the unemployment rate, which is a level.
d Employment rate (16-64).
e Levels as a percentage of GDP.
f Includes net capital transfers received.
g Annual average levels for the Madrid Stock Exchange General Index, interest rates and exchange rates, and rates of change for financial assets and liabilities.
h 1999 Q1 = 100.
i 1999 Q1 = 100. Measured with unit labour costs.
j Includes cash equivalents, other bank liabilities and money market funds.

… and the presence of significant failings in the institutional design for budgetary monitoring, early-warning and control mechanisms, especially in respect of the regional governments

The budgetary deviation in 2011 has revealed the presence of significant failings in the institutional design available for the budgetary monitoring, early-warning and control mechanisms, more markedly so in the case of regional and local government. Despite having budgetary stability legislation that set ceilings on the deficit for all levels of government and a procedure for the correction of imbalances, the monitoring and control mechanisms, along with those intended to ensure compliance with the targets set, proved clearly insufficient.

The shortcomings in the availability of information on the regional and local government outturn prevented the detection in time of budgetary deviations and led to a delay in the rule-enforcement mechanisms being activated. Accordingly, the regular publication of the regional and local government outturn is vital, with the same periodicity, degree of detail, lag and accessibility as for central government. Also, the information in the budget should furnish data on both central and regional government in National Accounts terms, which is the relevant definition for the fiscal rules in place, making explicit all the necessary information so as to evaluate the appropriateness of revenue projections to the macroeconomic scenario. Furthermore, the mechanisms enforcing correction of the budget deficits proved insufficient. On one hand, the information in the plans for their correction was not always public and its format prevented comparison with the initial budgets. On the other, the conditionality of the authorisations to incur debt was not automatically applicable, which detracted from their usefulness.

Progress in fiscal consolidation hinges crucially on reinforcing the budgetary framework. The reform of the Constitution and the Organic Law on Budgetary Stability and Financial Sustainability are two key steps in this connection

In order to correct the shortcomings, to reinforce the budgetary framework and to improve the sustainability of public finances in the medium term, significant initiatives have been set in train. In September 2011 a reform of the Constitution was approved to incorporate the deficit and debt ceilings set at the European level.[2] This was subsequently implemented in the Organic Law on Budgetary Stability and Financial Sustainability, the provisions of which are fully in keeping with the European governance reforms.

Along with a firm commitment to budgetary stability, this legislation includes stricter reporting requirements and new coercive mechanisms to ensure compliance with the fiscal targets for all levels of government. The possibility of establishing sanctions is included, the automatic adjustment of regional government spending is obligatory in specific cases of non-compliance, and provision is also made for the imposition of adjustment measures by central government that local and regional government must observe. The rigorous and immediate application of the legislation, particularly concerning the monitoring and control mechanisms, and those intended to enforce compliance with the targets set by all tiers of government, is decisive for ensuring adherence to the fiscal consolidation path.

The "non-bailout" clause envisaged in the aforementioned law is crucial for preventing the cost of inappropriate fiscal behaviour by one level of government from passing through to the others and so that the capital markets may exert disciplining effects. At the same time, regional and local government are allowed to request extraordinary liquidity-support measures of central government. In that case, they are required to submit a plan that ensures the attainment of fiscal targets, and the outlay in tranches of the financial aid will be conditional upon compliance with such targets. In this respect, in the opening months of the year the Government set in train various financial-support mechanisms for regional and local government so as to facilitate the refinancing of their previous debts or the

2 Previously, in July, a rule on the growth of public spending for central government and for large municipalities had been introduced. Under this rule, the rate of increase of public spending could not annually exceed the economy's medium-term nominal growth rate; its application to regional government was subject to approval by the Fiscal and Financial Policy Council.

payment of trade creditors. The financing mechanisms agreed upon require the definition and fulfilment of adjustment plans whose duration will span the debt repayment period. To prevent these mechanisms from diluting the incentives for regional and local government to strictly meet their budgetary targets, it is essential to apply rigorous conditionality to the provision of the funds. The economic and financial plans approved by the Fiscal and Financial Policy Council to re-balance regional government finances on 17 May entail spending-reduction and revenue-increasing measures which, in principle, are consistent with compliance with the conditionality requirements.

Lastly, mention should be made of the approval in July 2011 of the Law on Social Security Reform, in light of its importance for the sustainability of public finances. This legislation progressively raises the retirement age, extends the number of years taken into account for calculating the final pension and includes a factor of sustainability that will provide for the adaptation, from 2026, of the parameters of the system to future demographic developments.

On 30 March the Government approved the State Budget for 2012, setting the deficit programmed for this year at 3.5% of GDP, a figure compatible with the overall general government deficit of 5.3%, approved some weeks earlier. The projected decline in the State deficit is based chiefly on spending cuts – affecting goods and services purchases, public investment and capital transfers – and draws essentially on the increase in direct taxation (personal income tax and corporation tax).

For the reasons outlined earlier, over the rest of the year it will be necessary to ensure highly rigorous budget implementation and swift application of the mechanisms that allow any emergence of slippage to be detected sufficiently in advance, so as to offset this with additional measures. If this were the case, further adjustments to current expenditure would have to be made, given that the leeway for measures affecting capital spending has narrowed enormously. Also, new tax measures would have to be introduced, preferably relating to indirect taxation, with less of a distorting effect on growth and resource allocation.

The updating of the Stability Programme for the 2011-2015 period, which the Government approved on 27 April, confirmed the path of adjustment to 2013, when the deficit is projected to stand at 3% of GDP and the public debt ratio at 82.3% of GDP. It also set deficit targets for 2014 and 2015 of 2.2% and 1.1%, respectively, which would see a reduction in the public debt ratio to 80.8% in the latter year. Almost 75% of the adjustment envisaged for the 2011-2015 period would be made in the first two years of the Programme. It would essentially be structural in nature and 80% of it would focus on spending cuts.

Without a pick-up in employment and in activity, progress in fiscal consolidation will be more costly…

Of all the factors responsible for the limited progress made in correcting the budget deficit in 2011, the extreme weakness of the labour market and the absence of growth stand to the fore. Without a pick-up in employment, it will be more costly to further fiscal consolidation. This is because the increases in revenue will be limited and because the adjustment in primary expenditure will be hampered by the need to earmark a substantial portion of this item to the payment of unemployment benefits. Such a scenario might further be exacerbated by ongoing financial deleveraging and lead to increases in bad debts, with the subsequent adverse impact on the quality of bank balance sheets. Ultimately, this would have highly adverse consequences for potential growth, whose possibilities would be checked by the foreseeable loss of demographic dynamism.

… making it a priority to boost structural reforms, a cornerstone of which is labour market reform

It is thus a pressing matter to boost structural reforms enhancing the supply side of the economy. The cornerstone of this strategy involves making the labour market work efficiently, so as to generate employment, provide suitable incentives to smooth the reallocation of resources across sectors and alter the market's pattern of adjustment in the face of adverse shocks.

The Spanish labour market had been one of the main handicaps of our institutional framework. Traditionally structured around a dual hiring system – with dismissal costs that were high for permanent contracts and low for temporary ones – and collective bargaining arrangements in which an intermediate level of bargaining was predominant, thereby encouraging highly uniform wage increases bearing little relation to the specific situation of companies and adding rigidity to non-wage conditions in such a way as to stymie productivity, the labour market has amplified the effects of the crisis. Economic policy measures to tackle this problem were launched in June 2010. These included a reform of hiring mechanisms that did not alter the existing types of contract and the introduction of means to boost companies' internal flexibility, without changing the collective bargaining system, a change that would be postponed until July 2011. In both cases the measures were partial and did not alter the key features of the labour framework.

The labour reform approved in March improves key aspects of labour market workings and is conducive to job creation…

In January this year the social partners entered into an agreement with recommendations of wage moderation for the 2012-2014 period and amendments to the definition of and activation procedures for wage indexation clauses, the application of which would reduce the nominal inertia of wages. Further, in March, the Parliament ratified a new labour market reform[3], with a more comprehensive scope than that of those implemented to date. Changes to collective bargaining have been made to increase decentralisation in the bargaining process and to bolster companies' internal flexibility. Contract-termination mechanisms have also been substantially changed and a new permanent contract has been created for SMEs, which entails a series of tax incentives.[4]

The amendments to the reform improve key aspects in the functioning of the labour market in Spain. The overall effects will be conducive to job creation and job stability. However, given the marked weakness of activity lying immediately ahead, if the reform's internal flexibility measures to adapt working conditions to the specific needs of each company are not extensively harnessed, there might still be some further adjustment to the level of employment. The reform should also contribute to containing the growth of labour costs and thus boosting the competitiveness of Spanish companies. To do this, though, conditions would have to be reinforced so that business margins do not absorb and curtail the gains arising from cost moderation (see Box 1.3). In any event, the reform should ideally be completed with more ambitious active policy measures that include an exhaustive assessment of the programmes under way, closer links with passive policies and alternatives to hiring incentives which, so far, have proven relatively ineffective in terms of aggregate employment creation.

… although to achieve these effects, fresh momentum must be given to the liberalisation of markets for goods and services…

To fully reap the benefits of the labour reform, fresh momentum must be given to the liberalisation of product markets, promoting competition in the most sheltered sectors. Competition-fostering policies are the main instrument for disciplining the formation of margins and for increasing the sensitivity of price formation to demand conditions. Both issues are key to the proper functioning of the competitiveness channel, which is so important for exiting the crisis, as is analysed in the following chapter. Moreover, events in recent years

3 Royal Decree-Law 3/2012 on urgent labour market reform measures.
4 A description of the reform can be found in "La evolución del empleo y del paro en 2011, según la EPA", *Boletín Económico,* February 2012, Banco de España.

Exiting the current double-dip recession in the Spanish economy will necessarily involve restoring competitiveness at levels which allow, by means of a forceful export impulse, a recovery in activity and employment. In this respect the labour market reform in March this year, along with the new collective bargaining framework agreement (CBFA), may induce wage moderation that contributes effectively to achieving these objectives.

Under the new CBFA, the social partners agreed new wage guidelines for the 2012-2014 period, which include the recommendation that wage increases should not exceed 0.5% in 2012 and 0.6% in 2013, and should stand between 0.6% and 1.5% in 2014.[1] Substantial changes in the design of wage indexation clauses are also recommended, which may reduce nominal wage inertia and help entrench moderate behaviour in this variable.[2] In light of the experience of the previous CBFA, there is a risk that the agreed recommendations will not be strictly adhered to[3]; accordingly, there should be insistence as to the need for the social partners to effectively pass these recommendations through to the collective agreements currently under negotiation.

Turning to reforms, in March this year a new labour market reform was approved.[4] Among other aspects, it contains a set of measures aimed at enabling companies more readily to adapt themselves to changes in the economic situation through means other than labour shedding, such as changes to working hours and to wages. The measures include most notably: i) priority in respect of application to firm-level agreements as opposed to industry-, region- and nationwide agreements in a broad list of matters (wages, working hours, distribution of work time, adaptation to professional status arrangements, etc.); ii) extension of the areas in which employers can substantially change working conditions or decide not to apply conditions agreed in a collective agreement at a higher-than-firm level; iii) a maximum ceiling

1 Based on GDP growth in 2013, whereby the wage increase will not exceed 0.6% if GDP grows below 1%, 1% if GDP grows between 1% and 2%, and 1.5% if GDP grows above 2%.

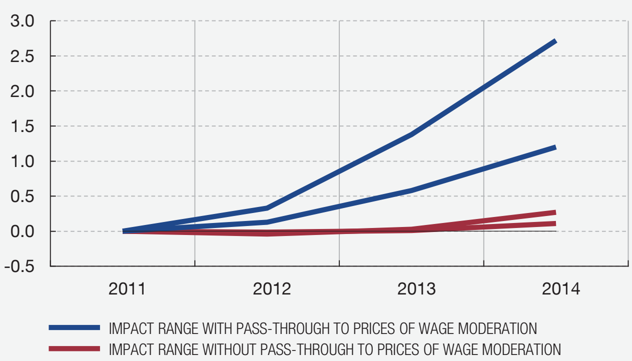
2 Specifically, it is recommended they should be activated once inflation exceeds 2% at the end of the year, instead of the increase effectively agreed upon in each collective agreement, and that indexed payments are not built into wages. Moreover, if Spanish inflation exceeds that of the euro area, the latter figure will be used to calculate the excess. Additionally, in the event of significant rises in oil prices (over 10%), the benchmark inflation indicator will exclude the heating and vehicle fuel items. In this way the moderating impact of the CBFA is reinforced, preventing potential transitory increases in inflation from feeding through to wages.

3 The previous CBFA recommended a wage increase of below 1% for 2010, a figure to which there was no adherence even in newly signed agreements, in which a 1.2% wage increase was agreed (rising to 1.7% on taking the wage indexation clauses into account). Furthermore, only 55% of the newly signed agreements settled on wage increases below 1% that year. Nor was there a high degree of compliance in respect of wage indexation clauses, where it was recommended that they should be of a multi-year nature, which was not generally passed through to collective bargaining agreements.

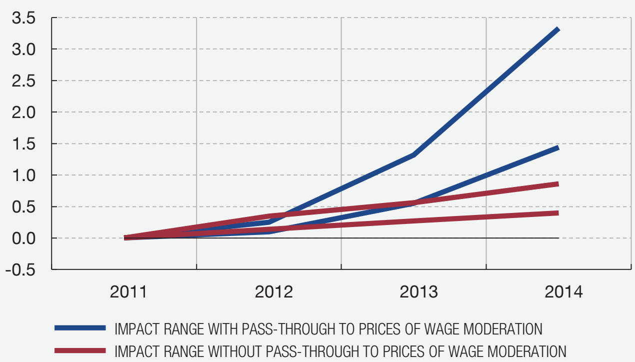
4 Royal Decree-Law 3/2012, approved on 10 February, ratified on 8 March as a draft bill, and currently under passage through Parliament, where amendments may be made.

1 RESULTS OF THE WAGE MODERATION SIMULATION EXERCISE USING THE MTBE

1.1 GDP (a)



1.2 EMPLOYMENT (a)



SOURCES: INE and Banco de España.

a Accumulated level differences in percentage points.

of two years on the applicability of collective agreements following the explanation of their term of validity (known as "ultra-activity"), and iv) simplification of the procedures for lay-off schemes involving shorter working days and contract suspension. The labour reform has also considerably reduced dismissal costs for permanent employees, making the related procedures more flexible.

Overall, these measures will foreseeably be conducive to increased decentralisation of collective bargaining and to greater wage flexibility tailored to firms' specific conditions. That will help redress the scant wage differentiation between firms and industries induced by the bargaining structure in force to date. In turn, the changes will also result in the greater adaptability of working conditions to potential changes in the economic situation. On the whole, the interaction of the reform and internal flexibility measures with the new CBFA should contribute to containing labour costs and to boosting competitiveness.

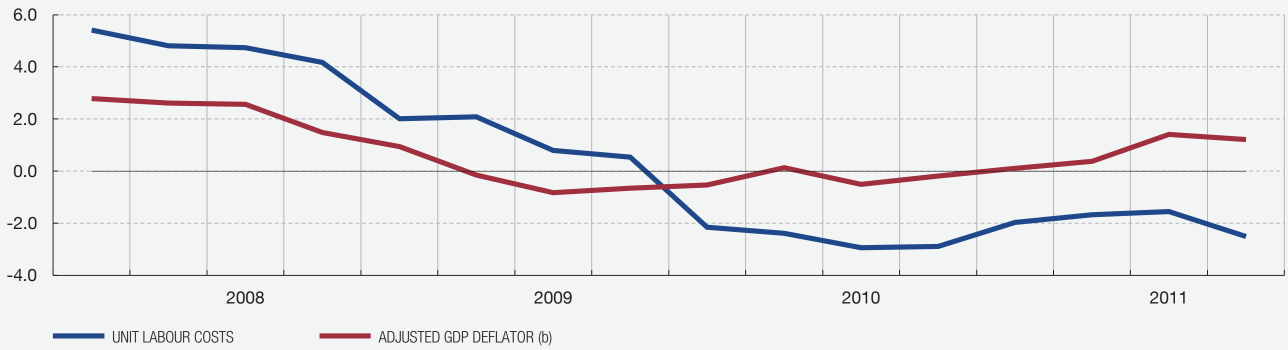
In order to assess the impact of wage moderation on GDP and employment, simulation exercises have been conducted with the Quarterly Macroeconomic Model of the Banco de España (MTBE) where we calibrate the effects of greater moderation arising from the estimated impact of the CBFA and the labour reform on growth and employment. Strict compliance with the wage guidelines set by the new CBFA for the 2012-2014 period might give rise to a scenario of lower wage growth, of 0.6 pp in 2012 and 1 pp in 2013 and 2014, compared with a benchmark scenario under which the Agreement had not been reached.[5] Added to this effect is a very tentative estimate of the additional impact that might arise from the recent labour market reform, chiefly as a consequence of an increase in the number of firm-level and working-day-reduction agreements, and of greater use of wage opt-outs. As a result, it is assumed that the overall impact of the CBFA and of the labour reform might lower wage growth in respect of the benchmark scenario in a range of between 0.6 pp and 1 pp in 2012 and between 1 pp and 2 pp in 2013 and 2014.

The MTBE simulations show that the simulated wage moderation scenario would have a positive effect on GDP and employment growth, although the scale of this hinges crucially on the extent to which lower labour costs pass through to final prices. If wage moderation is accompanied by an adjustment of a similar scale in prices (blue lines in panel 1), the resulting gains in competitiveness would prompt an increase in the demand for Spanish products that would activate other expansionary processes. At the same time, the purchasing power of wage income would be maintained and, consequently, that would give rise to a higher level of private consumption and investment. Overall, the cumulative increases in employment and in GDP to 2014 would be in a range of between 1 pp and 3.5 pp and between 1 pp and 2.5 pp, respectively, significantly contributing to

5 The inertia in wage rates added by multi-year agreements entered into in previous years is what explains the difference in the impact between 2012 and the two following years.

2 GDP DEFLATOR AND ULCs

GDP DEFLATOR AND UNIT LABOUR COSTS (a)



SOURCES: INE and Banco de España.

a Year-on-year percentage change.
b GDP deflator adjusted for tax increase.

reducing the unemployment rate. In contrast, under an extreme scenario, in which the moderation of wage costs to not pass through to prices because margins widen by the same amount (red lines in panel 1), the simulations denote a much smaller impact both on GDP and on employment, since this more inflationary behaviour would deprive the economy of the expansionary effects of price moderation on exports and private consumption.

In this respect, the recent behaviour of inflation and of unit labour costs (see panel 2) indicates there is room for the containment in ULCs to pass through to prices with greater intensity than that observed to date, which would enable the potential expansionary effects of a wage moderation scenario to be maximised. This result highlights the importance of complementing the recent labour reform with a product-market liberalisation drive that promotes competition in the most sheltered sectors and enhances the feed-through of cost moderation to prices. Indeed, on the evidence available for other countries[6], the simultaneous application of both types of reforms reinforces the beneficial effects of labour reforms (by promoting employment generation to a greater extent) and mitigates their costs (by helping maintain the purchasing power of wages).

6 Having examined four European experiences of far-reaching labour market reform in the past 20 years (in the United Kingdom, the Netherlands, Ireland and Denmark) that were successful in terms of reducing unemployment, Annett concludes that the gains in employment were greater thanks to the fact that the reforms were complemented by product-market liberalising processes [A. Annett (2007), Lessons from Successful Labor Market Reformers in Europe, IMF Policy Discussion Paper 07/1].

have highlighted the need for all sectors and activities to adapt effectively to the environment of flexibility that Monetary Union participation requires. In this connection, reforms promoting genuine gains in efficiency and productivity are vital, with a view to strengthening the sources of medium and long-term growth.

... by means of regulatory changes in a wide number of sectors and activities…

Numerous measures affecting a wide number of sectors and activities need to be taken. Many are squarely on the list of economic policy measures the Government wishes to deploy in the coming months, as envisaged in the National Reforms Programme (NRP) approved on 27 April. The housing sector has undergone a drastic adjustment in recent years, but this has not been accompanied by fundamental changes in some of the factors that contributed to the previous boom. The tax treatment of house purchases following the reintroduction of tax relief continues to be very favourable to owner-occupiers. Also, until very recently, rental regulations, which maintain very strict obligatory periods that discourage supply, had not been amended. Some of these aspects, particularly the term of rentals, are under reconsideration in the recently approved draft bill of measures to invigorate the house rental market. As is also indicated in the NRP, measures to boost competition in transport, retail trade and professional services, and to remove obstacles to business start-ups, will have appreciable effects on cost and price formation and on productivity.

The proper functioning of competition-monitoring agencies and of those entrusted with regulating the network industries is vital for further progress in the much-needed process of liberalisation. The ongoing reform of these agencies should primarily be to strengthen their independence, their accountability channels and their technical capacity, ensuring that sectoral experts can deliver decisions that counter the pressures that still emerge in some of the industries more sheltered from competition. Changes of an organisational nature and in the distribution of functions should not, under any circumstances, detract from the attainment of these objectives.

Among the network industries, the energy sector merits particular attention, as is also envisaged in the NRP. The process of liberalisation is still far from completion and there is broad scope to step up competition in all sectors. To redress these problems, resolute progress on vertical deintegration would be necessary, with the segregation of ownership between network activities and production and marketing activities, where it would have to be ensured that the market structure were sufficiently competitive. In the hydrocarbons industry there is room to increase competition in the distribution segment.

Under energy activities, the electricity industry has its own particular set of problems. These must be urgently resolved taking a medium and long-term view so as to redress certain imbalances built up in recent years arising from economic regulation in various segments, while enabling competitiveness to combine with safety as regards supply and the protection of the environment.

Finally, greater transparency in energy price formation, and in particular the remuneration of regulated activities, is essential to improve the functioning of the market. Unquestionably, the Law on Transparency, Access to Public Information and Good Governance, which is applied to all industries in which the general government sector intervenes, may contribute – along with the better functioning of regulatory agencies – to this objective.

... training in new technologies, the fostering of innovation and improvements in human capital

To boost productivity gains, moves must be made to overcome the problems of education in Spain, which displays low levels of quality on international standards. It would further be advisable to foment the use of the new information and communications technologies (in the educational system, and in the continuous training of employees and the unemployed) and to offer incentives for small firms to incorporate new technologies. To improve the quality of technological capital, efforts should focus on nurturing innovation in the private sector, which requires assessing the support tools in place and strengthening the connection between basic research and companies.

1 Introduction

Competitiveness is a primary objective of the euro area…

Over the course of the crisis, improving competitiveness has become a primary economic policy goal for a good number of euro area countries. The principal reason for this is that the scenarios of a recovery in growth have as their centrepiece a boost in external demand, especially in those economies where over-indebtedness constrains the responsiveness of domestic demand. But beyond this relatively general pattern of recovery, the importance of competitiveness in a monetary union is considerably amplified by the fact that only changes in the relative prices of tradeable goods between member states can bring about the real exchange rate realignments needed to redress the current account imbalances between them. And adding to this is the need to resolve the excessive external debt problems some of these economies have incurred, the correction of which requires redressing the current account balance. Unsurprisingly, then, the analysis of competitiveness has become a priority in the new strengthened framework of macroeconomic surveillance and supervision of European and international institutions.

… that is crucial for the ongoing adjustment of the Spanish economy

The arguments set out above are particularly pertinent in the current situation facing the Spanish economy. As explained in Chapter 1, the difficulty is to restore the momentum of economic activity while furthering the correction of excessive debt under very strong constraints on macroeconomic demand-side policies, derived from the high budget deficits run and the widespread climate of mistrust owing to the sovereign debt crisis. The deleveraging of the private sector and the restoring of sustainability to public finances limit the role domestic demand can play as a driver of economic growth in the short term, thereby shifting the centre of gravity of recovery towards external demand. Monetary policy has maintained low interest rates and exceptional liquidity-providing conditions, which have diminished the intensity of the external financing constraint. But the Spanish economy still has high financing needs, since despite the strong contraction economic activity has undergone, the balance of payments deficit on current account stood at 3.5% of GDP in 2011, while there were sizeable financing flows abroad, which were only offset by a substantial increase in the external liabilities of the Banco de España. A recovery in competitiveness therefore has a key role to play both in external demand standing in for the lack of support from domestic demand to activity and also to boost growth from the supply side.

The analysis of competitiveness calls for numerous facets to be taken into account…

The concept of competitiveness is used with different meanings and there is no single indisputable measurement of it. The usual practice is to associate competitiveness with the real exchange rate, i.e. with the price of tradeable goods and services produced domestically vis-à-vis those of the rest of the world. Under the assumption of perfect competition, prices are chiefly determined by unit labour costs (ULCs), whereby the analysis of competitiveness is often conducted on the basis of an international comparison of ULCs. However, the perfect competition model is not very suitable for characterising many international markets, in which differentiated varieties of products competing on price and quality are traded, and which, therefore, are closer to a situation of monopolistic competition.

Occasionally, the concept of competitiveness is confined to an external component, associating it with the behaviour of national companies on international markets, and obviating the degree of penetration of foreign companies in the domestic market. And this when, as regards the capacity to generate economic activity and employment, both components are significant. Accordingly, indicators of competitiveness based on changes in a country's share of exports in the world total or import penetration in the domestic market also offer useful information for the analysis of competitiveness, which does not always point in the same direction as developments in relative prices, for several reasons. One is the extensive sectoral and corporate heterogeneity existing in relation to the capacity to export and compete on international and domestic markets, meaning that the aggregate changes in shares may, occasionally, respond to composition effects arising from changes in the sectoral distribution of employment or of output. Another is the fact that relative world demand for goods of a specific country may change not only on the basis of their relative price, but also due to changes in their quality or other factors that may affect consumer preferences. For companies to gain market share frequently depends – more than on relative prices – on other aspects relating to the technical specifications of their products, to their ability to gain access to appropriate distribution channels and, in short, to their innovative capacity and the human capital of their workforce.

Consequently, other more comprehensive approaches to the concept of competitiveness are also widely used. These tend to present competitiveness as a synonym of productivity. As a result, when it comes to approximating a country's competitive potential it would, apart from production costs, be necessary to bear in mind other factors that influence companies' innovative capacity and ability to compete in areas other than relative prices, such as the composition of human capital, the efficiency of their infrastructure, the regulatory framework in which they operate and their degree of integration into global production chains.

.. which also have to be considered in the design of economic policy measures to boost gains in competitiveness

As what is involved is a multi-faceted concept, it is therefore appropriate to address the analysis of competitiveness, and the policies needed to promote it, from different approaches. This should be done combining the habitual macroeconomic indicators of relative prices and costs with attention to export shares and, also, domestic market import penetration, and also with microeconomic information allowing corporate heterogeneity in this respect and its consequences to be analysed. Only with an approach of this nature would it be possible to make an accurate diagnosis and a complete analysis of its determinants, and to design the economic policy measures that provide for improving it and which, therefore, reduce the costs of possible macroeconomic adjustments within the monetary union to achieve higher growth.

This chapter offers some bases for the analysis of the Spanish economy's competitiveness taking into account this broader approach to the concept. Firstly, emphasis is placed on the importance of gains in competitiveness for the recovery of the Spanish economy, in circumstances such as the present marked by strong constraints for domestic demand-boosting policies and in which a series of imbalances between the member countries of a monetary union needs to be corrected (section 2). The macroeconomic indicators habitually used for the analysis of competitiveness are then discussed (section 3) and, set against recent developments in the Spanish economy, its determinants are identified and analysed (section 4). The corporate heterogeneity existing in relation to productivity, costs and exports is then documented (section 5), and the macro- and microeconomic policies that can contribute to boosting competitiveness are reviewed (section 6).

2 The role of competitiveness in the adjustment of the Spanish economy

Gains in competitiveness are vital for overcoming the crisis

Drawing on the habitual indicators used, the Spanish economy underwent a considerable loss of competitiveness during the 1996-2007 period. Low interest rates and excessive optimism about growth expectations and asset prices (chiefly real estate prices) prompted a substantial boost in domestic demand which, given the limited responsiveness of supply, translated into persistently higher growth in prices and costs than that in the euro area as a whole, and than that of the core countries with the most dynamic exports in particular. In turn, the unfortunate behaviour of relative costs and prices was accompanied by very low productivity growth, as a result, inter alia, of supply-side rigidities, insufficient headway in the liberalisation of goods and services markets, and, above all, the continuing and notable inefficiencies in labour market workings. As a consequence, the deterioration in competitiveness and the increase in debt led to a sizeable widening of the external deficit and to a substantial build-up of net debt vis-à-vis the rest of the world.

The serious downturn in the worldwide financial situation and the bleaker growth expectations associated with the global economic crisis exposed the presence of a worrying external imbalance in the Spanish economy. To correct it, a substantial improvement in competitiveness was now unavoidable, and would have to be articulated simultaneously with the necessary reduction in the high levels of debt of the Spanish economy's various institutional sectors.

At the same time, improvements in the functioning of the euro area should be able to prevent the build-up of mismatches in competitiveness…

When asymmetric economic shocks occur in a monetary union, that gives rise to inflation differentials which the common monetary policy cannot correct. If these inflation differentials are persistent, they may generate deviations from equilibrium in member countries' real exchange rates , the correction of which requires changes in relative prices between domestically produced goods and services and those produced in the rest of the area. If price and cost-formation mechanisms are sufficiently flexible, the nominal adjustments needed take place at greater speed, thereby avoiding the need to correct the imbalances through activity and employment, with the subsequent rise in unemployment. The flexibility of the markets for goods, services and factors is therefore essential for bringing about appropriate adaptation to the functioning proper to a monetary union.

The experience of the first 10 years of EMU has clearly shown that the importance of this flexibility and the consequences of its absence were underestimated when the euro area governance mechanisms were designed. It was known then that persistently higher inflation rates led to excessively low real interest rates which, in the absence of sufficiently flexible supply, refuelled expansions in demand, which were the source of the inflationary tensions.[1] There was confidence, however, that a positive inflation differential and the subsequent appreciation of the real exchange rate would lead to a reduction in external demand enabling the behaviour of domestic demand to be offset. But this channel has proven clearly insufficient as an adjustment mechanism and, as a result, external imbalances have built up, the correction of which is finally coming about through changes in output and employment more than through a nominal adjustment.[2]

… which has led to the introduction of new surveillance procedures within the European governance rules

Acknowledgement that the accumulation of external and internal macroeconomic imbalances has exacted a very high cost during the current crisis has led to the introduction of far-reaching changes in European governance arrangements. More specifically, the new framework envisages a macroeconomic surveillance procedure that complements the fiscal block already in place (which is also reinforced in his new framework) and which attempts to prevent the occurrence of macroeconomic imbalances not of a fiscal nature and to ensure the rapid adoption of corrective measures should such imbalances occur. This

1 With regard to the European Monetary System, Sir Alan Walters put forward the idea that this divergence in real interest rates usually occurred under fixed exchange rates; accordingly, the term "Walters critique" was coined to refer to this source of divergence in a monetary union.

2 See O. Blanchard and P.A. Muet (1993), "Competitiveness through disinflation: an assessment of the French macroeconomic strategy", *Economic Policy,* vol. 8, no. 16, April, pp.11-56. The propensity of the euro area to a series of episodes of these characteristics is known as the theory of "rotating slumps".

"early warning mechanism" is fed by a scoreboard of 10 indicators selected on the basis of four principles: i) they should be centred on the most significant dimensions of the macroeconomic maladjustments and of the losses in competitiveness; ii) they should provide clear signals of the potential for accumulation of imbalances and losses in competitiveness at an initial stage of their occurrence; iii) they should act as an instrument of communication, and iv) they should be constructed using statistical criteria that provide for frequent availability and international comparisons.[3] The indicators on which this *Macroeconomic Imbalance Procedure* is based, and the indicator values on the basis of which a maladjustment may be considered to exist, are detailed in Table 2.1. In the last surveillance exercise conducted with indicators related to 2010, Spain exceeded these thresholds in three of the five indicators that refer to external imbalances and to competitiveness: current account balance (-6.5% of GDP on average in the period 2008-2010), net external debtor position (89.5% of GDP) and changes in export shares (a cumulative figure of -11.6% in the period 2006-2010).

The adjustment in competitiveness must combine nominal adjustments in costs, margins and prices with productivity gains…

In a monetary union there is no possibility of an exchange rate devaluation against the other countries in the area. Under these conditions, internal devaluation, i.e. the adjustment of costs and prices together with productivity gains arising from a better management of work and a more efficient allocation of productive resources, is the alternative available for restoring competitiveness. The misalignment of the relative prices of domestic goods and services can only be corrected if there is sufficient flexibility in price and wage-formation; it thus depends crucially on the effectiveness of structural measures on the functioning of the relevant markets. If, moreover, the recovery in competitiveness must run in parallel with a correction of the excess private debt that weighs on the possibilities of a recovery in domestic demand, it is vital that the nominal adjustment should be accompanied by a lasting increase in the growth rate of productivity that lays the foundations for sustained growth in the medium and long term. This all illustrates the importance of supply-side and structural reform policies to kick-start competitiveness so it may be the chief factor in overcoming the crisis.

In principle, fiscal policy could contribute to the adjustment of relative costs and prices through a change in the composition of tax revenue that helped make exports cheaper. This is what the so-called "fiscal devaluation" consists of, combining a reduction in social security contributions with an increase in the VAT rate. However, the impact of such a measure would be limited, both over time and in terms of its potential scope; the measure could not act as a substitute for the necessary flexibility in cost and price-formation and, above all, it may prove counter-productive if the public sector faces imperative re-balancing needs and is weighed down by significant implicit liabilities as a result of the potential effects of population ageing on the Social Security financial balance.

In any event, for the nominal adjustment to take place, labour market regulations must not hamper the resort to changes in wages and employment conditions as response mechanisms to the decline in demand. Also needed will be a competition-promoting policy that prevents cost adjustments being absorbed by a widening of business margins (see Box 1.3). Productivity growth also needs well-regulated factor and product markets that allow for an efficient allocation of resources and that promote improvements in employee professional skills and investment in productive capital.

3 See European Commission (2012), "Scoreboard for the surveillance of macroeconomic imbalances", *European Economy,* Occasional Papers, 92, February.

INDICATORS OF THE EUROPEAN COMMISSION'S MACROECONOMIC IMBALANCE PROCEDURE — TABLE 2.1

	Data source	Indicative threshold	Threshold calculation period	Additional indicators
EXTERNAL IMBALANCES AND COMPETITIVENESS				
Three-year moving average of the current account balance (% of GDP)	Balance of Payments statistics, Eurostat	+6/-4%	1970-2007	Credit balance or net debit balance vis-à-vis the rest of the world of the sum of current and capital account balances (% of GDP)
Net international investment position (% of GDP)	Balance of Payments statistics, Eurostat	-35% lower quartile	First year available (mid-1990s-2007)	Net external debt (% of GDP)
Three-year change in the real effective exchange rate, based on the HICP relative to 35 industrialised countries (%) (a)	DG ECFIN indicator from the database on competitiveness in prices and costs	+/-5% euro area +/-11% non-euro area lower and upper quartiles of the euro area +/- standard deviation of the euro area	1995-2007	Real effective exchange rate with respect to the rest of the euro area
Five-year change in the value-based export market share (%)	Balance of Payments statistics, Eurostat	-6% lower quartile	1995-2007	Export share based on volume of goods; labour productivity; trend TFP growth
Three-year change in nominal unit labour costs (%) (b)	Eurostat	+9% euro area +12% non-euro area upper quartile euro area 3 pp	1995-2007	Nominal ULCs (changes 1, 5 and 10 years); effective ULCs relative to the rest of the euro area; other measures of productivity
INTERNAL IMBALANCES				
Year-on-year change in deflated house prices (%) (c)	Eurostat's harmonised house price index, completed with ECB, OECD and BIS data	+6% upper quartile		Real house prices (changes over 3 years); nominal house prices (changes over 1-3 years); residential construction
Flow of credit to the private sector (% of GDP) (d) (e)	Eurostat for annual data and quarterly sectoral accounts (QSA), and ECB for quarterly data	+15% upper quartile	1995-2007	Indicator of change in the non-consolidated financial sector's financial liabilities; debt-to-equity ratio
Private-sector debt (% of GDP) (d) (e)	Eurostat for annual data and quarterly sectoral accounts (QSA), and ECB for quarterly data	+160% upper quartile	1994-2007	Private-sector debt based on consolidated data
Public debt (% of GDP) (f)	Eurostat (Treaty definition-excessive deficit protocol)	+60%		
Three-year moving average of the unemployment rate	Eurostat	+10%	1994-2007	

SOURCE: European Commission.

a The HICP is considered for EU trade partners, and for non-EU partners the deflator is based on a CPI similar to the HICP in respect of methodology.
b The ULCs index is defined as the ratio of nominal compensation per employee to real GDP per person employed.
c Relates to changes in house prices in relation to Eurostat's consumption deflator.
d The private sector is defined as non-financial corporations, households and non-profit institutions serving households.
e This is the sum of loans, securities other than shares and non-consolidated liabilities
f The sustainability of public finances is not assessed in the context of the macroeconomic imbalance procedure, as this matter is already addressed in the Stability and Growth Pact. However, this indicator is included in the procedure because public-sector debt contributes to the country's total debt and, therefore, to the country's overall vulnerability.

SIMULATIONS WITH BEMOD (a) TABLE 2.2

Cumulative level differences

Scenarios	GDP			Employment			Contribution of net exports to GDP			Nation's lending (+)/ net borrowing (-) (% of GDP)		
	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Nominal adjustment (b)	0.4	0.7	0.5	0.6	0.7	0.4	0.0	0.0	0.1	0.0	-0.1	0.0
Reduction in ULCs (c)	0.5	0.7	0.5	-0.5	0.2	0.2	0.2	0.2	0.2	0.0	0.0	0.0
Euro devaluation (d)	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Increase in the export base (e)	0.5	0.6	0.4	0.5	0.5	0.3	0.1	0.2	0.2	0.2	0.3	0.3
Improvement in productivity (f)	1.3	2.2	2.0	0.6	1.5	1.3	0.2	0.3	0.4	-0.1	-0.2	-0.1

SOURCE: Banco de España.

a The price elasticity of exports has been calibrated at two.
b Calibrated so that ULCs fall 1% on average in the first year. The first-order autoregressive coefficient has been set at 0.25.
c Only in the tradeable sector. Calibrated so that ULCs fall 1% on average in the first year. The first-order autoregressive coefficient has been set at 0.8.
d 1% depreciation in the first quarter.
e Increase in the weight of Spanish exports in the consumption basket of the rest of the euro area. Calibrated so that Spanish exports increase by 1% in the first year.
f Sum of three very persistent but not permanent shocks (the first-order autoregressive coefficient is 0.9); improvement in productivity, reduction in wages and reduction in margins. With the last two shocks, wages do not grow in real terms and prices fall as much as ULCs do.

… whose effects on GDP and employment may be substantial, even in the short term

Gains in competitiveness increase GDP and employment through different mechanisms, depending on what the sources of the gains are. In the case of a wage adjustment that reduces the production costs of domestic goods with constant profit margins, the mechanism works through the export impulse induced by the decline in their relative prices. The scale of the increase in exports will depend, however, on the resilience of international demand, whose strength in the current recessionary environment is low, and on the price-elasticity of the goods. But this price-competitiveness transmission channel is not the only one, nor perhaps the most important one. If, as is to be expected, the greater adaptability of wages results in greater stability in employment, that will also translate into improved expectations of future income, which will contribute to boosting domestic demand. This latter variable, in turn, will be met in a greater proportion by the output of domestic companies with lower relative prices.

If the gains in competitiveness arise from an increase in productivity, with this originating either in technological progress or in a better allocation of resources leading to greater specialisation in the production of tradeable goods, the effect on activity and employment will depend, in the short run, on the degree of inertia of wages and prices and on the degree of real rigidity of wages, i.e. on their reaction to changes in prices and in demand, in the medium and long term. If, as is to be expected in a situation of high unemployment and slack demand, the moderation of wages and profit margins continues, the increase in the relative demand for domestic products induced by the reduction in prices or by improvements in quality would lead to a more marked increase in GDP and in employment than in the previous case. This will be so because Spanish companies' gains in market share will be the result of a broader set of factors than the mere lowering of relative prices, and because the improved expectations of future income would also be greater. Nonetheless, it should be borne in mind that productivity gains may require more time, meaning that the improvement in competitiveness by these means will only be operational over a medium-term horizon.

The results of the simulations performed with the Banco de España general equilibrium model of the Spanish economy (BEMOD), which incorporates all these transmission channels, confirm that the improvement in competitiveness may have a significant impact on activity and employment in the short and medium term (see Table 2.2). Thus, for instance, a 1% reduction in ULCs, prompted by a reduction in wages of the same order, would boost

GDP growth and employment by around 0.6 pp on average over a three-year horizon, while an increase in the weight of Spanish exports in the consumption basket of the rest of the euro area ensuing from a 1% increase in exports would do so by 0.5 pp on average over the same horizon. This effect would be even greater if the reduction in ULCs were caused by an increase in productivity in the tradeable goods sector that did not feed through either to nominal wages or to margins. In any event, given the low price-elasticity of the current account balance, in order to obtain a positive significant effect on the economy's financing capacity, it would be necessary to generate an increase in the export base, this being broadly understood to include both the number of companies that export and the diversification of export products and markets.

3 Approaches to analysing competitiveness

The relative price and cost indicators showed a relative rise in the cost of domestically produced goods, which only began to reverse as from 2010…

The standard analysis of competitiveness is usually based on an international comparison of aggregate price and cost indicators, which show the ratio at which goods and services of one country can be traded for those of other countries.[4] These indicators can be readily calculated and are available with a high frequency for most countries, which makes them particularly attractive for monitoring conjunctural developments and for the diagnosis of elements that are key to the discussion of macroeconomic imbalances, chiefly the balance of payments deficit on current account. Thereafter, other factors can be incorporated into the analysis that are not so susceptible to measurement in short periods of time. The recent changes in these indicators for Spain shows that, as from 2010, the rise in the costs of domestic products recorded since the mid-1990s has begun to be corrected slightly. As to ULCs, the correction has been swifter and, across the whole of the economy at end-2011, they were only 1.7% higher than 1999 Q1 in relative terms vis-à-vis the group of reference countries, although in the manufacturing sector they were still 12.3% above the levels at that date (see Chart 2.1).

… which is consistent with the deficits recorded on the current account balance

The current account balance began to worsen in 1997 and its deficit climbed to 9.4% of GDP in 2007-2008. This deterioration was essentially due to the behaviour of the trade balance and, under this heading and at an initial stage, to the non-energy goods component, although since 2007 the deficit has been corrected to the extent of disappearing in 2011, while the energy goods trade balance worsened from 2005 and has since held at around 4% of GDP (with the exception of 2009). The surplus on the balance of services stood in 2011 at around 3% of GDP, 1 pp higher than the deficit on the incomes balance (see Chart 2.2). Competitiveness in the services sector is of growing importance for the economy as a whole, as reflected by the improvements recently recorded in the balance of commercial exchanges in this sector.[5]

Thus, during the crisis there has been a rapid reduction in this deficit, to 3.5% in 2011, following a pattern of adjustment similar to that seen in other countries. International evidence[6] shows that, since 2008, external deficits have fallen more in those countries that had previously posted higher deficits relative to their growth potential. It is also confirmed that what lies behind this reduction is the decline in these countries' domestic demand, rather than the depreciation of their real exchange rate. This is what has happened in Spain. And it indicates that the correction to date in the external imbalance has a significant cyclical component,

4 Of relevance as regards the measurement of the real exchange rate is the selection of countries with which the comparison is made and the relative weight of each of them, along with the heterogeneity of exported products, depending on whether services exports are included or not. See T. Bayoumi, H. Faruqee and J. Lee (2005), *A Fair Exchange? Theory and Practice of Calculating Equilibrium Exchange Rates,* IMF Working Papers 05/229, and H.Z. Bennett and Z. Zarnic (2008), *International Competitiveness of the Mediterranean Quartet: a Heterogeneous-Product Approach,* IMF Working Papers 08/240.

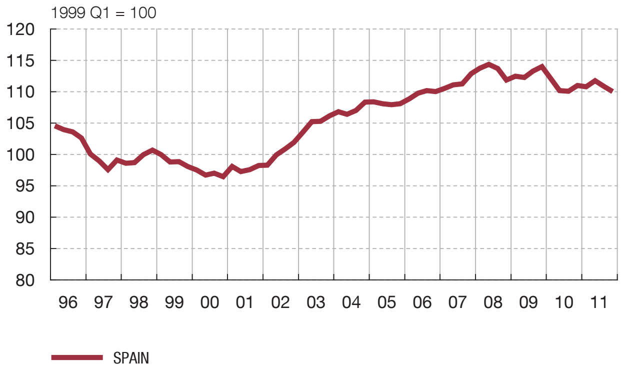
5 Unfortunately, the shortage of available information prevents an in-depth treatment of this matter; accordingly, it is not addressed explicitly in this chapter.

6 See P.R. Lane and G.M. Milesi-Ferretti (2011), *External Adjustment and the Global Crisis,* NBER, working paper 17352.

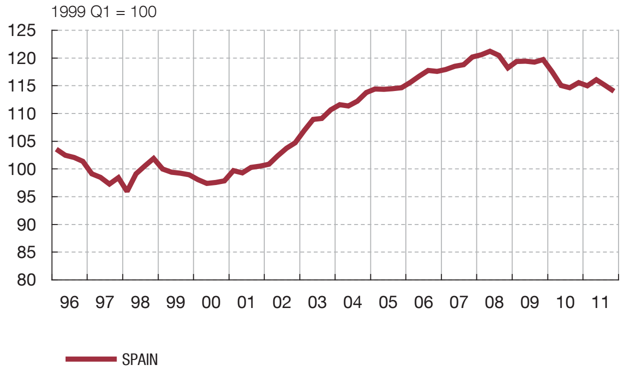
COMPETITIVENESS INDICES (a)

CHART 2.1

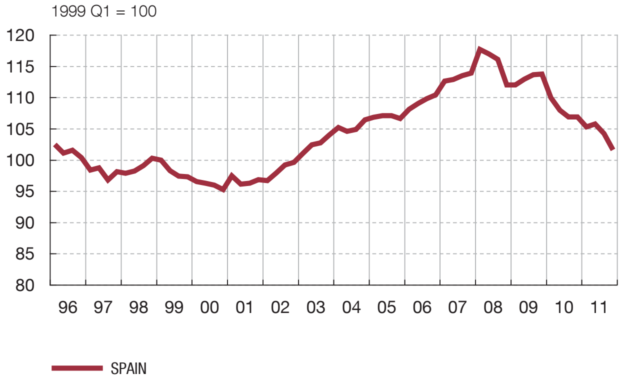
CALCULATED WITH CONSUMER PRICES



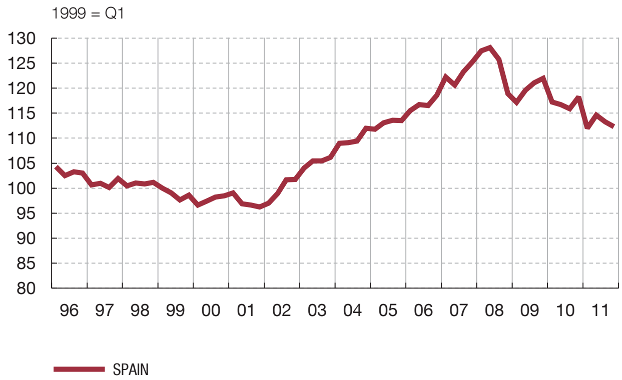
CALCULATED WITH GDP DEFLATOR



CALCULATED WITH ULCs



CALCULATED WITH MANUFACTURING ULCs



SOURCE: ECB.

a Competitiveness is measured vis-à-vis the other euro countries and vis-à-vis a broad group of 20 countries: Australia, Canada, China, Denmark, Hong Kong, Japan, Norway, Singapore, South Korea, Sweden, Switzerland, United Kingdom, United States, Czech Republic, Hungary, Latvia, Lithuania, Poland, Bulgaria and Romania. Increases (decreases) in the index denote losses (gains) in competitiveness.

meaning that the correction should still be considered as insufficient. Indeed, the estimates available of the structural component of the current account deficit in Spain show that the correction since 2009, when the deficit peaked, has so far been modest (see Chart 2.2).

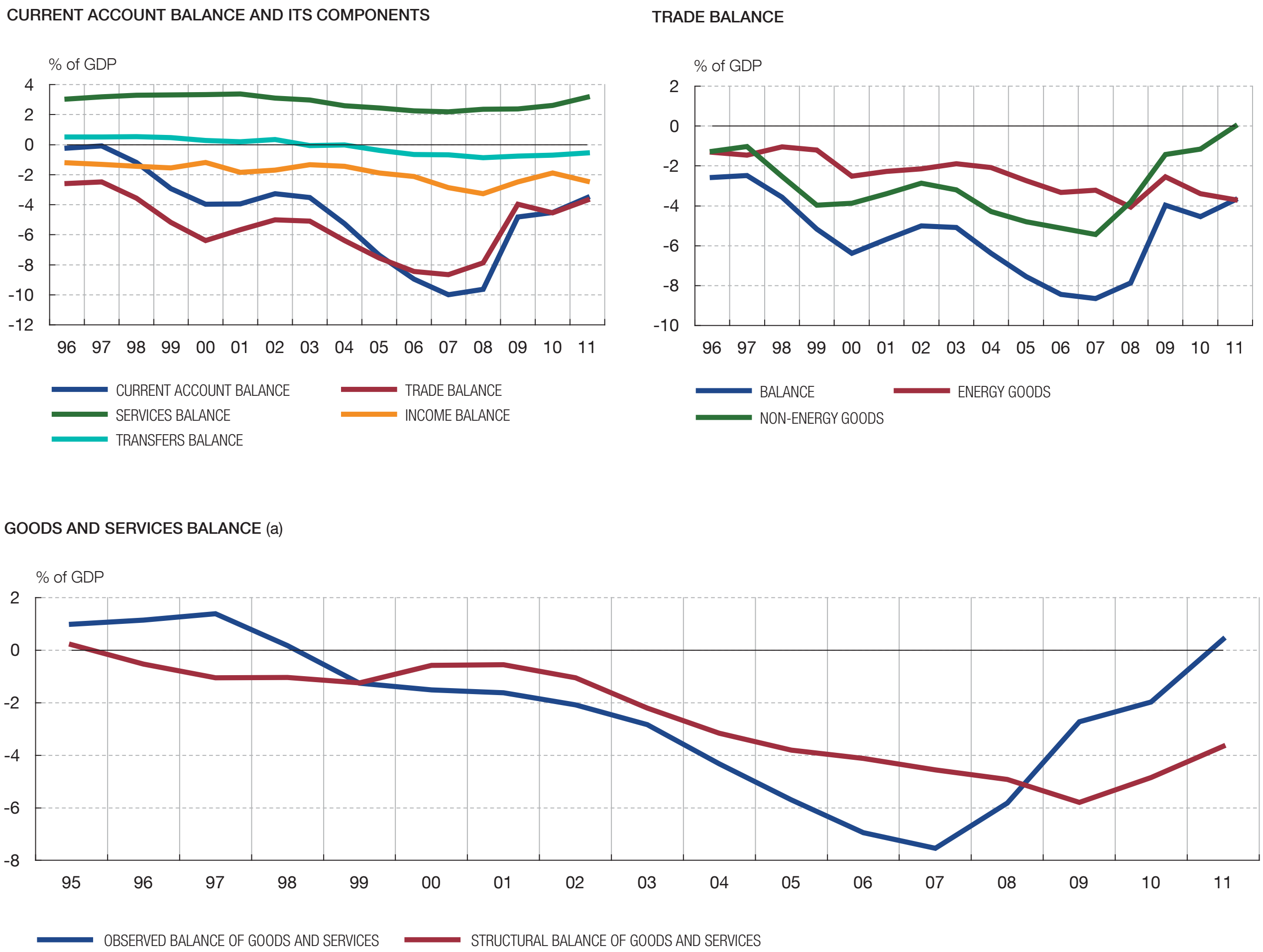
Spanish export shares in the world total have held relatively constant, although their composition evidences certain vulnerabilities…

During this period the exports/GDP ratio has moved on a rising trend, although it slowed during 2011 Q4 as a result of the decline in demand across the EU. The weight of imports in domestic demand has also grown significantly. As a result, the two ratios habitually used to measure trade openness have, in recent years, attained similar values to those of France, Italy and the United Kingdom, although they are still below those of Germany. The greater presence of Spanish companies in international markets has allowed them to uphold their share in world trade, both in real and nominal terms, despite the emergence on these markets of China and other emerging economies. But the level is lower than that of other EU countries, such as Germany, France, Italy and the United Kingdom, even after adjusting for the different size of these economies (see Chart 2.3).

The sectoral specialisation of Spanish exports shows, firstly, the high share of low-technology products, meaning exports are particularly sensitive to pressures from low-cost competitors; and, secondly, an excessive dependence on the automobile sector, which accounts for around 20% of total exports. Geographical composition also reveals vulnerabilities, as

CURRENT ACCOUNT BALANCE

CHART 2.2



SOURCES: INE, Customs Department and Banco de España.

a Real data 2008.

exports are highly concentrated in European markets and their presence is limited in emerging markets, which have greater growth potential.

…while import penetration on the domestic market continued increasing until very recently

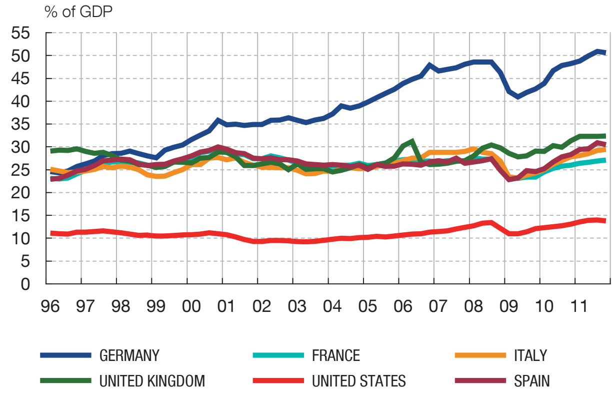
Any analysis of competitiveness would be incomplete without also envisaging Spanish companies' capacity to withstand competition from foreign companies in the domestic market, especially following the progressive internationalisation of the emerging economies, whose products have gained growing market shares in the industrialised countries over the past decade (especially in consumer goods, given their lower prices, and non-energy intermediate goods, given the international fragmentation of productive processes). In Spain, the increase in the degree of import penetration in final demand was, until halfway through the past decade, sharper than in the main euro area economies, although it has eased recently owing to the economic crisis.

Goods and services imports also show a high sensitivity to the Spanish economy's cyclical position (the income elasticity of imports is around 2, against 1.5 in Germany, France and Italy), which is essentially due to the high dependence on high-value-added and imported-technology goods and services, as the principal means of incorporating the latest technological advances, and on intermediate energy inputs. The Spanish economy's input-output tables illustrate the high import content (in final products and in inputs) of investment in equipment and of goods exports, followed by private consumption and investment in construction.

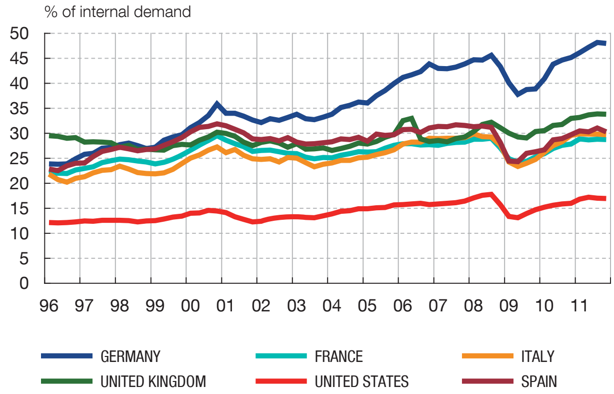
TRADE OPENNESS BY COUNTRY

CHART 2.3

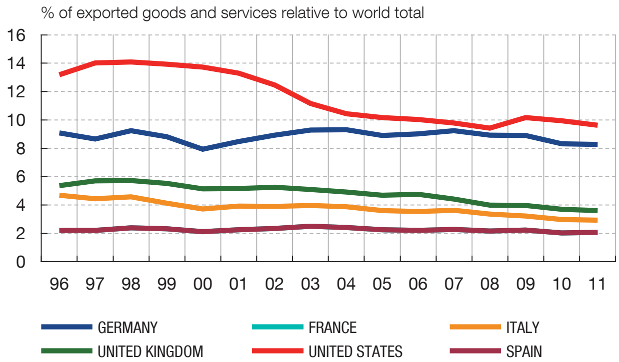
EXPORTS OF GOODS AND SERVICES (a)



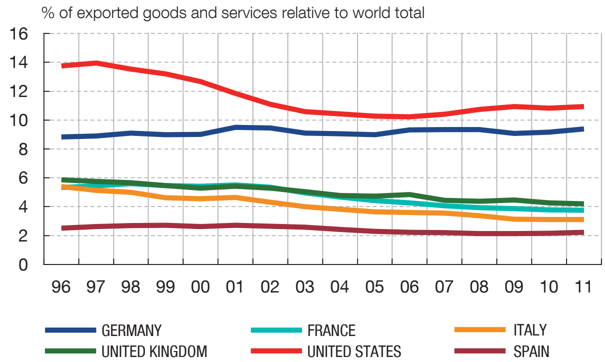
IMPORTS OF GOODS AND SERVICES (a)



NOMINAL EXPORT SHARES (b)



REAL EXPORT SHARES (b)



SOURCES: Eurostat and IMF.

a Seasonally adjusted quarterly data.
b Annual data.

Of particular significance is the weight of imported inputs, which is considerably higher than in the core euro area economies, even if the influence of the energy branches is excluded. Behind this feature lies the greater propensity to import of the high and medium-high technological-content industrial sectors in Spain, and not only the presence of differences in productive structure, or the fact that the Spanish economy is of smaller size, which might warrant a greater degree of external openness. As a consequence, the knock-on effect of the increases in final demand on the other domestic productive sectors is relatively low.[7]

Finally, the international competitiveness rankings place Spain in a low position relative to other euro area countries

Other, broader approaches to competitiveness seek to encompass the main determinants of a country's capacity to provide its citizens with high levels of welfare. From this rather general vantage point, competitiveness depends on the effectiveness with which a country uses its available resources. And here, a broad set of institutional factors relating to the overall working of the economic system and, ultimately, to the economy's productivity will exert an influence. Specifically, competitiveness indices combining a high number of indicators, obtained both from objective data and from subjective evaluations of the aforementioned institutional factors, are usually used. One of the most frequently used indices here is that constructed by the *World Economic Forum*, which in its latest report for 2011-

7 See A. Cabrero and M. Tiana (2012), "The import content of the industrial sectors in Spain", *Economic Bulletin,* April, Banco de España.

2012 ranked Spain in 36th position. This was the result of a favourable evaluation of Spain's infrastructures, offset by a less positive assessment of institutional quality and a very negative view of the efficiency of its labour market.

4 The behaviour of the Spanish economy's competitiveness

A correction of relative prices and costs began in 2010

In 2010 a slight correction of the costs and prices of domestic goods and services relative to those of the rest of the world began. This was due to the lower growth of ULCs which, across the economy, posted an annual average rate of 3.3% during the 2002-2007 period and of 0.4% in the past four years, while the growth of the profit margin, obtained as the difference between the growth rate of the value added deflator and of ULCs was, respectively, 1.1% and 1.5% (see Chart 2.4). The growth of ULCs from 2002 to 2007 was essentially due to higher growth in wages than in the productivity of small and medium-sized enterprises (SMEs) and in that of a broad segment of firms with intermediate productivity growth. Meantime, the companies that posted higher productivity growth held their ULCs approximately constant. This led to significantly different company-by-company wage and productivity growth distributions than those in Germany, France and Italy (see Table 2.3 and Chart 2.5).

The easing in price growth from 2010 has come about as a result of different patterns of behaviour across the main sectors of the economy, with higher increases in value added deflators in the energy and industrial sectors than in the rest, and with lower increases in ULCs in the construction and industrial sectors, where even negative growth rates were posted. However, the lower aggregate growth of ULCs stems not so much from the easing in labour costs as from rising productivity growth, arising from severe job destruction. This has translated into an increase in average productivity, not so much due to greater productive efficiency on the part of surviving companies as to the disappearance of lower-productivity companies.

Nor do other determinants of competitiveness indicate that significant gains have come about through other channels

Apart from relative prices and costs, competitiveness depends on other factors related to the quality of products such as technological advantages, efficiency of production processes and distribution networks, post-sales service, etc. These determine whether consumers' evaluation of the products of a specific country or company is more or less positive. As a result, an increase in the prices of domestic goods may not necessarily entail a deterioration in competitiveness if, at the same time, there has been an increase in the quality of such products. There have been proposals for quality-adjusted price indices, but the information needed to construct them is not always available. Empirical research on this matter uses information – highly detailed by product – from price indices and from the attendant trade balance to deduce the relative position of each country as far as the quality of its exports is concerned. The intuition behind this type of exercise is that, given equal export prices, those countries whose products are of greater equality should also enjoy a bigger trade surplus on those products. The results obtained for Spain indicate that the quality of their export products ranks in an intermediate position among the 43 countries with the biggest export volumes and that such quality is estimated to have declined in relative terms during the 1989-2003 period[8], while in recent years no major changes in the quality of Spanish exports have been detected, such quality being estimated to stand below that of the exports of the major euro area countries.[9]

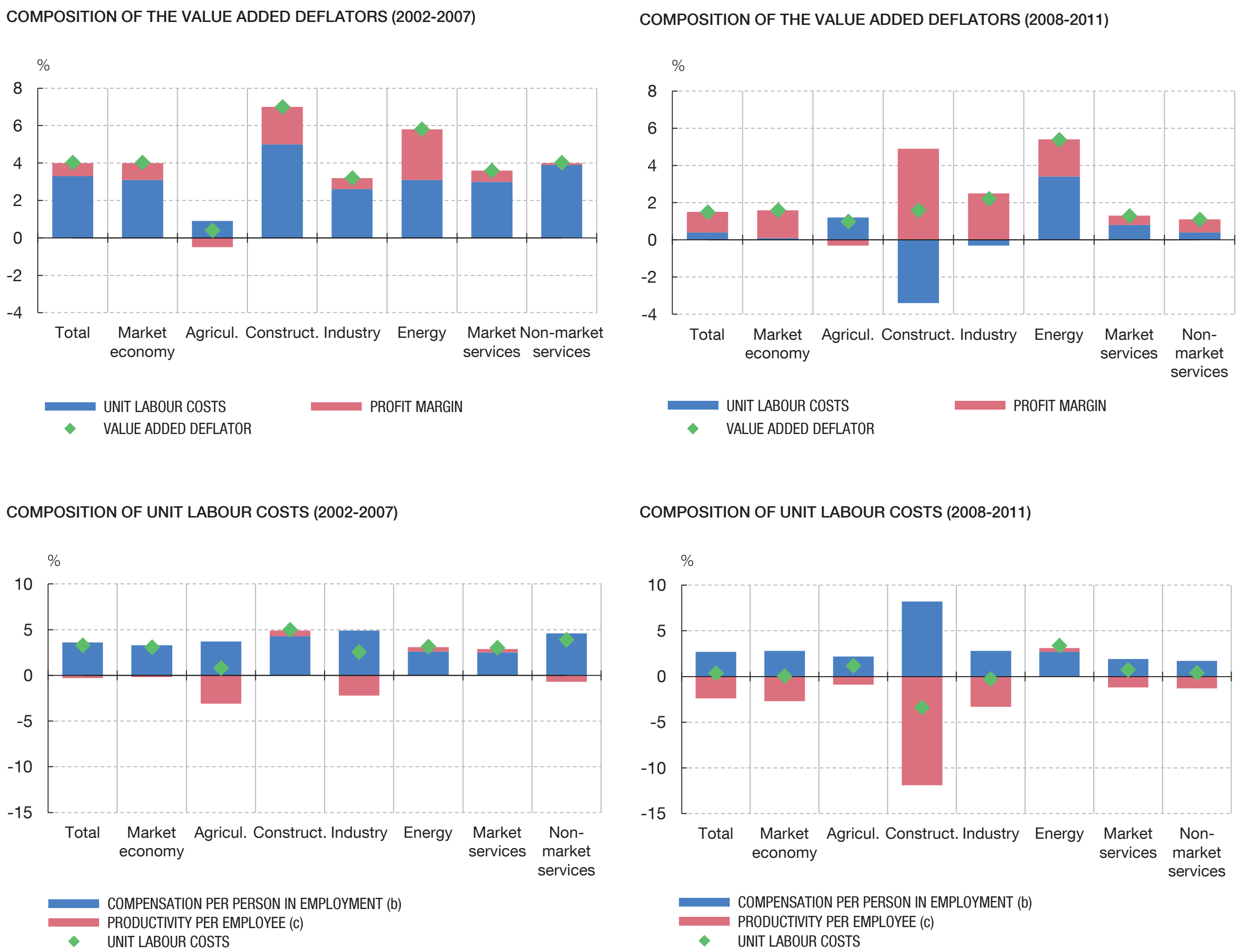
Given the empirical problems of constructing quality-adjusted price indicators, it is more usual to complement the information offered by international comparisons of prices and costs with information on the factors of the country in question and the efficiency of its productive system. All other things being equal, improvements in these indicators would

8 See J.C. Hallak and P.K. Schott (2011), "Estimating Cross-Country Differences in Product Quality", *The Quarterly Journal of Economics,* 126, pp. 417-474.

9 See E. Gordo and P. Tello (2011), "Diversificación, precios y calidad de las exportaciones españolas: una comparación a nivel europeo", *Cuadernos Económicos de ICE,* 82, pp.31-62.

SECTORAL ANALYSIS OF THE VALUE ADDED DEFLATOR AND OF UNIT LABOUR COSTS (a)

CHART 2.4



SOURCES: INE and Banco de España.

a Percentage changes, yearly average.
b Proxied by compensation per employee.
c Refers to the average change in productivity with reverse sign.

be indicative of gains in quality. Under this approach, the indicators most used are total factor productivity (TFP), the stock of technological capital, labour skills, investment in R&D and the production of patents. None of these variables shows significant improvements in Spain's case. Changes in TFP relative to the euro area as a whole show a slight rise in the most recent stage which, however, is not sufficient to recoup on the continuous decline recorded during the 1996-2007 period. The diminishing trend in relative human capital does not appear to have halted, while progress in R&D and in the accumulation of technological capital to 2007 has not continued in recent years (see Chart 2.6).

The efficient reallocation of resources across sectors and among companies within each sector is also a significant factor for gaining competitiveness…

A country's productivity and, therefore, its export capacity depend not only on average productive efficiency across the economy as a whole, but also on how productive resources are allocated across sectors and among companies within the same sector.[10] For example, if as a result of specific distortions in the factor markets (for capital and labour) there are certain activities of companies that can access these resources under more

10 Regarding the productivity differences between companies and their dynamics in terms of business demographics, see P. López-García, S. Puente and Á.L. Gómez (2007), "Dinámica de la productividad en el ámbito empresarial en España", *Boletín Económico,* July-August, Banco de España.

AVERAGE ANNUAL GROWTH OF WAGES AND PRODUCTIVITY BY FIRM SIZE 2002-2007

TABLE 2.3

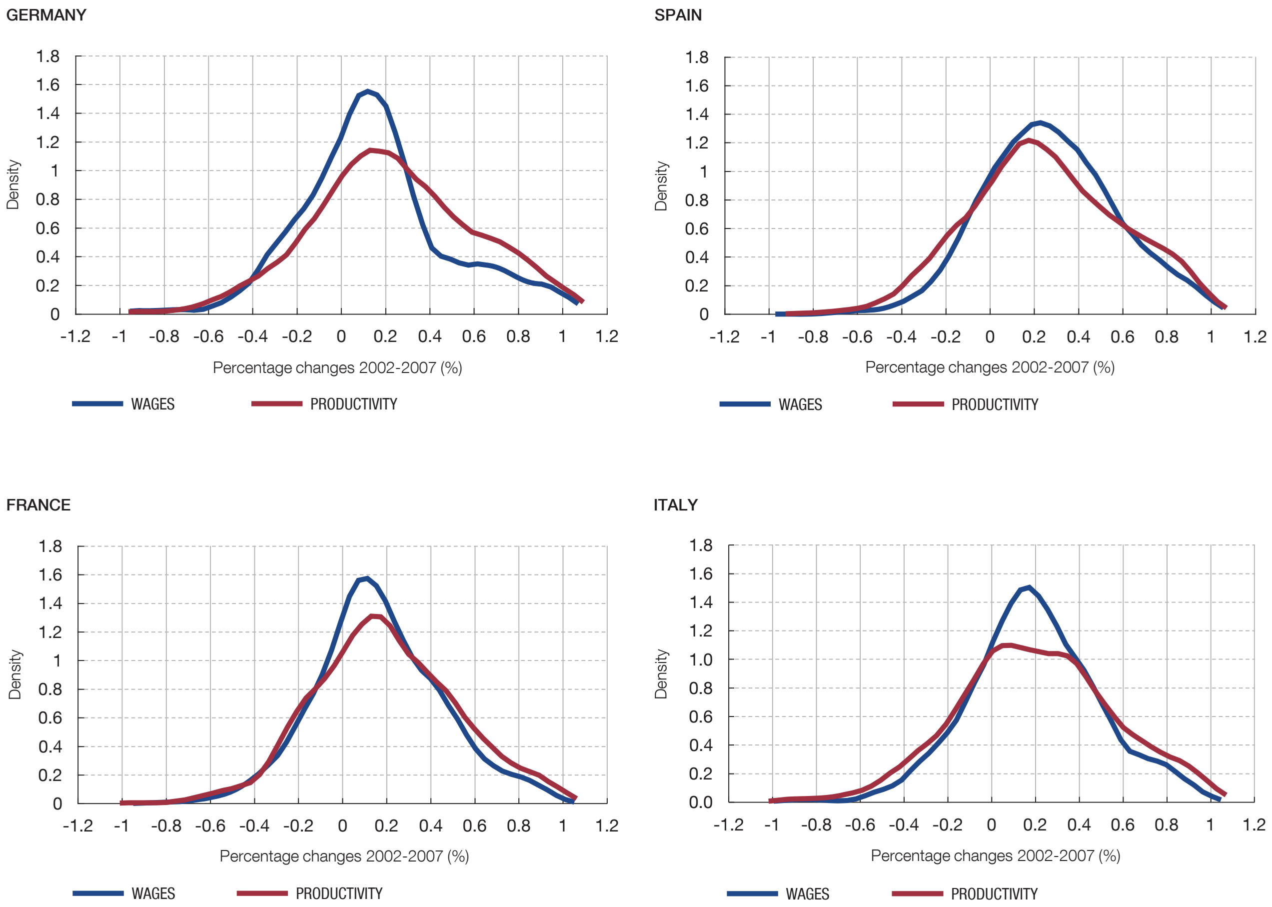
Changes in nominal wages and productivity, annual rate (average for the period, %)

	France		Germany		Italy		Spain	
	Wages	Productivity	Wages	Productivity	Wages	Productivity	Wages	Productivity
TOTAL	**3.3**	**3.8**	**2.4**	**4.0**	**3.8**	**3.9**	**5.3**	**4.9**
1 to 50 employees	3.4	3.8	4.5	4.9	3.8	3.8	5.4	4.8
51 to 250 employees	3.9	3.1	0.0	2.4	4.3	4.6	5.1	5.6
Over 250 employees	2.3	3.5	2.8	4.7	4.7	5.7	4.0	5.3

SOURCE: Banco de España.

INTERNATIONAL COMPARISON OF DENSITIES OF CHANGES IN PRODUCTIVITY AND WAGES (a)

CHART 2.5



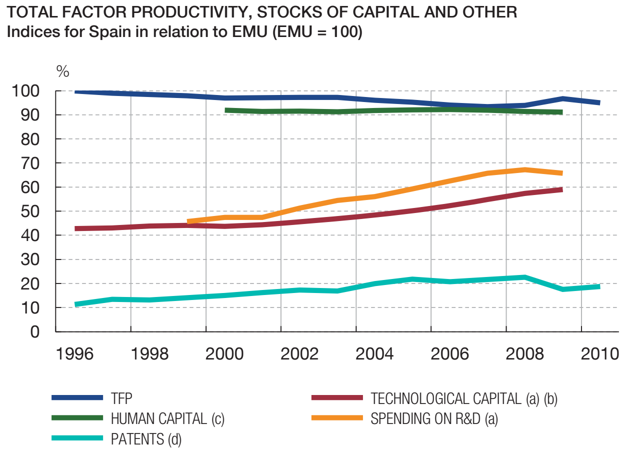
SOURCE: EFIGE.

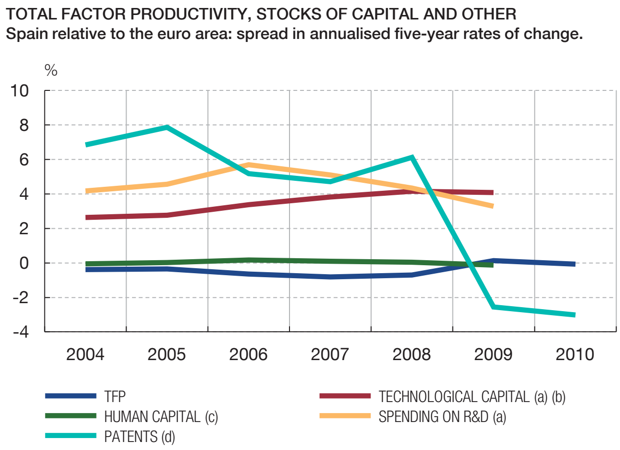
a Distributions proxied by estimating the kernel density of each variable by means of the Epanechnikov function.

favourable conditions, it will be these sectors and companies that attain most weight within the economy, even if their productivity is lower. And since there are institutions and economic policy measures that can generate such distortions, improving productivity does not only require technological advances to be incorporated, employee skills to be enhanced and the stock of productive capital to be increased (actions which, moreover, take time to come about); it is also vital to promote the efficient allocation of resources by means of the elimination of these distortions. Empirical results show that the gains in productivity achievable through an efficient allocation of resources can be quite sizeable,

STRUCTURAL INDICATORS OF THE SPANISH ECONOMY

CHART 2.6





SOURCES: Eurostat, Ameco and Banco de España.

a In relation to GDP.
b Calculated on the basis of accumulation in R&D spending according to the perpetual inventory methodology.
c This is the stock of human capital adjusted for quality using the PISA report results.
d Resident patent applications per million inhabitants.

amounting to up to around 50% in the manufacturing industry of emerging countries.[11] In Spain's case, the inefficient allocation of resources between 2002 and 2007 might have caused losses in competitiveness, measured in terms of relative ULCs, of around 10% relative to Germany.[12] Similar calculations suggest that, if labour shares in output with similar distributions across sectors and by firm size to those of Germany were attained in Spanish manufacturing industry, productivity might increase significantly. This result responds fundamentally to a relative insufficiency in capital in small Spanish firms and, above all, to a lesser elasticity of output with respect to labour in large corporations.

… especially if the volume of exports is determined by a small group of firms, which is that of the firms with the highest productivity

The latest developments pay increasing attention to analysing the characteristics of exporting firms and to their role in changes in aggregate competitiveness and in a country's trade transactions (see Box 2.1). There is abundant empirical evidence supporting the idea that changes in the aggregate competitiveness indicators depend closely on corporate composition, and in particular on the behaviour of the sub-group of high-productivity firms. Exporting firms are usually a small and non-random percentage of firms belonging to a single sector. And they generally coincide with larger-sized firms, they have higher levels of productivity and they are more innovative. The evidence in these papers also tends to find that the direction of causality appears to run fundamentally from productivity to export propensity, and not so much vice versa.[13]

The results of this new branch of literature point to two significant consequences. Firstly, aggregate indicators may provide an incomplete view of the situation, meaning it is essential to identify the characteristics of each country's business base that influence the propensity to export (extensive margin) and the proportion of output that is exported (intensive margin). Secondly, confirmation that productivity generates export capacity reinforces

11 See C.T. Hsieh and P.J.Klenow (2009), "Misallocation and Manufacturing TFP in China and India", *The Quarterly Journal of Economics,* CXXIV, 4, November, pp. 1403-1448.

12 See A. Crespo, G. Pérez-Quirós and R. Segura (2011), "Indicadores de competitividad: la importancia de la asignación eficiente de los recursos", *Boletín Económico,* December, Banco de España.

13 See A.B. Bernard, J.B. Jensen, S.J. Redding and P.K. Schott (2011), *The Empirics of Firm Heterogeneity and International Trade,* CEP Discussion Papers, 1084, and P. Antrás, R. Segura-Cayuela and D. Rodríguez-Rodríguez (2010), *Firms in international trade, with an application to Spain,* mimeo.

The use of indices of relative prices and costs between countries to analyse competitiveness is warranted by the observation that there is a trade-off between the relative price of a good and the market share of the country or firm that produces it. However, for this relationship to exist for exports as a whole, certain conditions relating to the determinants of international trade, the type of technology and market structure must be met. Specifically, for this result to hold, international trade must be generated by technological comparative advantages or by the relative abundance of factors of production, and firms must produce – under constant returns to scale – homogeneous goods that are sold on perfectly competitive markets.[1]

Subsequent advances have relaxed some of these assumptions and analysed their consequences for measuring competitiveness. First, models were developed with imperfect competition, increasing returns to scale and product differentiation, ingredients that gave sense to the notion of the firm, that enabled an industry and its size to be well defined, and that provided grounds for two similar countries to trade with one another.[2] In this new theoretical framework, the aggregation of microeconomic relationships requires that the different elasticities of each product be taken into account and that profit margins be assumed to be constant for the relationship between relative costs and demand to continue to exist. For these reasons information at the aggregate level is usually supplemented with information at the sectoral level. In any case, this new approach leads to two significant predictions. First, in relation to a country's propensity to export, only "corner solutions" exist, i.e. either all firms export, or none of them do. Second, trade liberalisation would have a similar effect on all firms. However, in recent years the availability of more and better databases has enabled us to appreciate that, even within a sector, the level of firm heterogeneity is very high, principally as regards size and productivity, that only a percentage of firms export and that this minority is very different from the rest, since it is made up of firms that are much larger and more productive, even before they begin to export.

These empirical observations have led to the development of the "new" theory of international trade, which stresses the importance of firm heterogeneity, basically in terms of the size and productivity of firms, and of the presence of fixed exporting costs.[3] These two ingredients are the basis for a selection effect in exports, whereby only the most productive firms export, and for an explanation of how trade liberalisation, through the reallocation of resources towards the most efficient firms in a sector and the forced exit of the least productive, leads to productivity gains. Moreover, recent studies show that for certain firm size distributions – regularly observed in most sectors and countries – the changes in a country's exports are explained mainly by the behaviour of the exports of the largest firms.[4] Thus, if the productivity or costs of these firms behave differently to those of the rest of their sector, the aggregate price and cost indices do not adequately capture the change in the competitive position of a country. In addition, sectoral aggregation in the presence of increasing returns to scale and differentiated goods gives rise to difficulties, insofar as, among other things, the sector's competitive position is not adequately represented by the sector average.[5]

As evidence of the importance of firm heterogeneity to an understanding of aggregate relationships, other studies show that persistent deviations in purchasing power parity (PPP) can be generated through the entry and exit of firms with different levels of productivity from those of the established firms,[6] and that when profit margins vary across firms and over the business cycle – as confirmed by the data – the patterns described above can be explained.[7] Specifically, the size of a country, its competitive structure, the existence of geographical barriers and trade integration are determinants of profit margins, so that there is a non-linear relationship between costs and prices. In this situation, for example, liberalisation of international trade would not necessarily eliminate the difference in profit margins across countries. In consequence, the aggregation of costs and prices to construct the relevant competitiveness indicators proves complicated.

1 See R. Dornbusch, S. Fischer and P.A. Samuelson (1979), "Comparative Advantage, Trade, and Payments in a Ricardian Model with a Continuum of Goods", *American Economic Review,* vol. 67 (5), pp. 823-839.

2 See P. Krugman (1979), "Increasing returns, monopolistic competition, and international trade", *Journal of International Economics,* vol. 9 (4), pp. 469-479, November.

3 See M.J. Melitz (2003), "The Impact of Trade on Intra-Industry Reallocations and Aggregate Industry Productivity", Econometrica, vol. 71 (6), pp. 1695-1725, November.

4 See J. di Giovanni and A. Levchenko (2009), *International Trade and Aggregate Fluctuations in Granular Economies,* working paper 585, Research Seminar in International Economics, University of Michigan.

5 See C. Altomonte, G. Barba Navaretti, F. di Mauro and G. Ottaviano (2011), *Assessing competitiveness: how firm-level data can help,* Bruegel policy contribution 2011/16.

6 See F. Ghironi and M. J. Melitz (2005), "International Trade and Macroeconomic dynamics with Heterogeneous Firms", *The Quarterly Journal of Economics,* vol. 120 (3), pp. 865-915, August.

7 See M. J. Melitz and G. I. P. Ottaviano (2008, "Market Size, Trade, and Productivity", *Review of Economic Studies,* vol. 75 (1), pp. 295-316.

the need to prioritise measures to boost productivity and to reallocate resources when designing competitiveness-boosting policies.

5 Competitiveness from a microeconomic corporate perspective

The internationalisation of Spanish companies has intensified in recent decades…

The number of goods-exporting firms totalled 122,987 in 2011, 40% up on the start of the past decade, and was around 35,000 in the case of non-tourist services-exporting firms in 2007, 50% higher than at the start of the decade.[14] Other means of participation in international markets, such as the externalisation of certain phases of the productive process, either through agreements with third companies located abroad, or through maintaining control in the same company, or of production in its entirety [horizontal foreign direct investment (FDI)], have also increased significantly, with around 17,000 resident companies undertaking FDI operations during the 2003-2011 period. These activities affect trade flows, exports and imports, in several ways. For instance, locating initial or intermediate phases of the productive process abroad generally entails an increase both in exports and in imports. However, when the entire productive process is located abroad and another country is used as a direct export platform, exports diminish.

… although this has not been a widespread phenomenon, and Spanish export firms continue to account for a minority share of the total

In Spain, export firms account for a minority share of the total: from 2001 to 2011, 12% of Spanish firms exported goods and, as regards exports of non-tourist services, the proportion was 9%. In other countries the percentage of exporting firms is also low, although the proportion of Spanish manufacturing companies that export continues to be lower than that of other countries with a similar level of development.[15] There is also a high degree of concentration of the export total in a small number of firms: in 2011, 1% of goods exporters with a higher volume of exports made around 67% of all exports, while the percentage relating to 10% of the firms that most export is 93%.

Exporting firms are bigger and more productive than non-exporters, and a higher proportion of them belong to multinational groups and have access to more sources of financing…

Spanish exporting firms are generally larger, they have a higher-than-average level of productivity, their labour force is more skilled and they evidence greater technological intensity (see Table 2.4), which also occurs in other countries. The detailed information available on the internationalisation activities of a representative group of European manufacturing firms[16] shows that productivity and export propensity increase with the size of the firm, and there is a very wide gap between small firms (10-19 employees) and larger corporations (over 249 employees).[17] It can also be seen that firms of a similar size in different countries have similar productivity levels and that their probabilities of exporting and their exporting intensities are not very different.

In light of these observations, and given that in the larger Spanish corporations wage growth has more closely followed productivity gains than in small-sized companies,

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14 According to figures from the Spanish Customs and Excise Duties Department of the Tax Revenue Service and from the Banco de España Balance of Payments, respectively. The terms "other services" and "non-tourist services" are used interchangeably. In any event, tourism is always understood to be excluded, along with financial services, insurance and government services.

15 The percentage of manufacturing firms with more than 10 employees that exported in 2008 accounted for 61.1% of the total firms in Spain, according to the EFIGE database, compared with 64.4% for Germany, 57.9% for France and 77.2% for Italy. See G. Barba-Navaretti, M. Bugameli, F. Schivardi, C. Altamonte, D. Horgos and D. Maggioni (2011), *The global operations of European firms. The second EFIGE policy report,* Bruegel Blueprint series.

16 This information is from the project "European Firms in a Global Economy: Internal Policies for External Competitiveness", the description of which is available in www.efige.org.

17 There are, however, significant aggregate cross-country differences in size and in productivity per employee. Thus, for instance, in 2008 the average size of Spanish firms in the sample was 49 employees, compared with 77 employees in the case of Germany, 79 in France and 42 in Italy. As regards employee productivity, the standardised figures were 102 in Spain, 156 in Germany, 114 in France and 153 in Italy. See G. Barba-Navaretti, M. Bugameli, F. Schivardi, C. Altomonte, D. Horgos and D. Maggioni (2011), *The global operations of European firms. The second EFIGE policy report,* Bruegel Blueprint series.

CHARACTERISTICS OF SPANISH EXPORTING AS OPPOSED TO NON-EXPORTING FIRMS (a)
Median for the period 2001-2011

TABLE 2.4

		Size (b)	Labour skills (c)	Temporary employment ratio (d)	Physical capital per employee ratio (e)	Innovative intensity (f)	Debt ratio (g)	Market listing (h)	Foreign capital stake (i)	Outward FDI (j)	Productivity (GVA/ employment) (k)
Total	Exporters (l)	12.0	16.3	7.8	15.0	2.7	30.2	0.2	3.0	1.9	50.4
	Non-exporters	2.0	12.1	3.5	9.2	1.4	29.8	0.0	0.6	0.3	36.6
Goods	Exporters (m)	14.0	15.6	8.3	17.3	2.8	30.0	0.2	2.8	1.9	50.8
	Non-exporters	2.0	13.4	3.5	9.2	1.4	29.9	0.0	0.7	0.4	37.4
Non-tourist services	Exporters (n)	10.0	20.6	6.2	10.2	2.9	31.6	0.3	4.5	3.0	56.9
	Non-exporters	2.0	12.2	4.0	9.5	2.3	29.7	0.0	0.7	0.4	39.3
Total number of firms in the sample		1,140,788	5,474	887,454	884,882	983	22,335	248	35,272	16,509	21,099

	% of total	Degree of concentration of exports		
		TOP 1%	TOP 5%	TOP 10%
Goods and/or non-tourist services exporting firms (l)	16.7	64.3	83.4	90.4
Goods exporting firms (m)	12.0	67.4	86.5	92.9
Non-tourist services exporting firms (n)	8.6	74.5	91.3	95.9

SOURCES: Banco de España, drawing on Balance of Payments, Central Balance Sheet Data Office and Mercantile Register statistics.

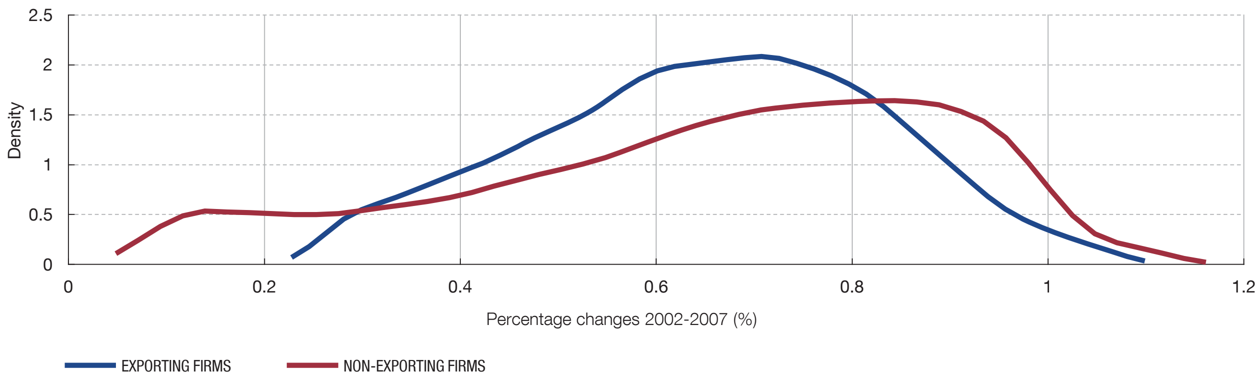
a The database comprises 6,085,857 observations relating to 1,243,550 firms.
b Proxied by the number of employees.
c Calculated as the percentage accounted for by directors, company managers, professionals, specialists and similar relative to total employees.
d Calculated as the percentage accounted for by non-permanent employment relative to total employment. Firms with total employment equal to zero have been excluded.
e Calculated as the ratio of tangible fixed assets to the number of employees.
f Calculated as the percentage accounted for by spending on R&D relative to gross value added.
g Calculated as the percentage accounted for by interest-bearing borrowed funds relative to remunerated liabilities at current prices.
h Calculated as the percentage of market-listed firms. The sample average is given.
i Calculated as the percentage of firms with a foreign capital stake. The sample average is given.
j Calculated as the percentage of firms engaging in outward FDI during the period 2003-2011. The sample average is given.
k Calculated as the ratio of gross value added to the number of employees
l Goods and/or non-tourist services exporting firms.
m Firms exporting goods, or goods and non-tourist services.
n Firms exporting non-tourist services, or non-tourist services and goods.

Spanish exporting firms have lower ULCs than their non-exporting counterparts (see Chart 2.7). Consequently, these firms appear to have a greater capacity to accommodate an adverse competitiveness shock, such as a reduction in the prices of foreign competitive firms. This suggests that an intermediate step in the goal to extend the Spanish economy's exporting capacity will be to raise the average size of companies, which may be restricted by certain factors relating to labour regulations and competition policy.

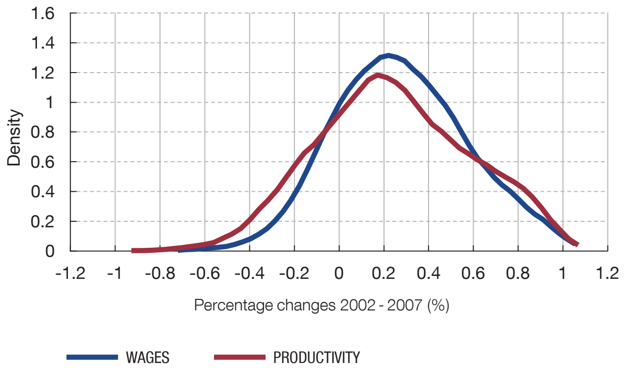
Exporting firms also have access to more diversified sources of financing (for instance they are listed, they engage to a greater extent in FDI and there are foreign stakes in their capital). The advantages these firms have are linked, among other things, to the presence of economies of scale in production, organisational and institutional advantages, and a better knowledge of foreign markets. Finally, the quality of productive factors and the absence of financial constraints, by means of access to capital markets and a limited level of debt, also tend to raise the propensity to export, albeit generally to a lesser extent than the previous characteristics. The fact that variables such as the firm's degree of internationalisation, FDI abroad and foreign capital holdings in the firm's ownership structure influence substantially

DISTRIBUTIONS OF ULCs, PRODUCTIVITY AND NOMINAL WAGES BY TYPE OF FIRM (a) CHART 2.7

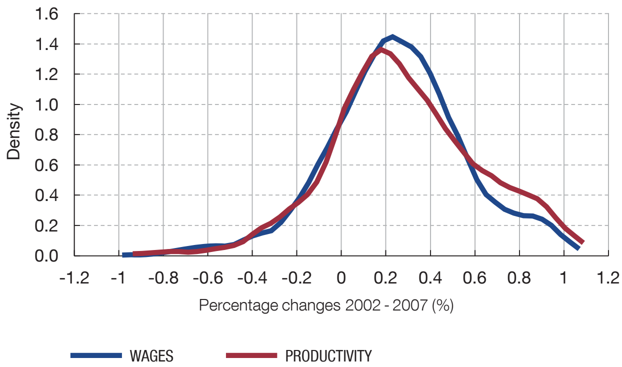
DISTRIBUTION OF NOMINAL ULCs (b)



DISTRIBUTION OF PRODUCTIVITY AND WAGES IN SMALL FIRMS (c)



DISTRIBUTION OF PRODUCTIVITY AND WAGES IN LARGE FIRMS (d)



SOURCE: Banco de España, drawing on Balance of Payments, Central Balance Sheet Data Office and Mercantile Registries statistic

a These distributions have been proxied estimating the kernel density of each variable by means of the Epanechnikov function, after removing the firms situated below the 5th percentile and above the 95th percentile.
b ULCs are defined as the ratio of compensation per employee to productivity per employee (defined as GVA divided by the number of employees) in nominal terms.
c Refers to firms with 50 or fewer employees.
d Refers to firms with over 50 employees.

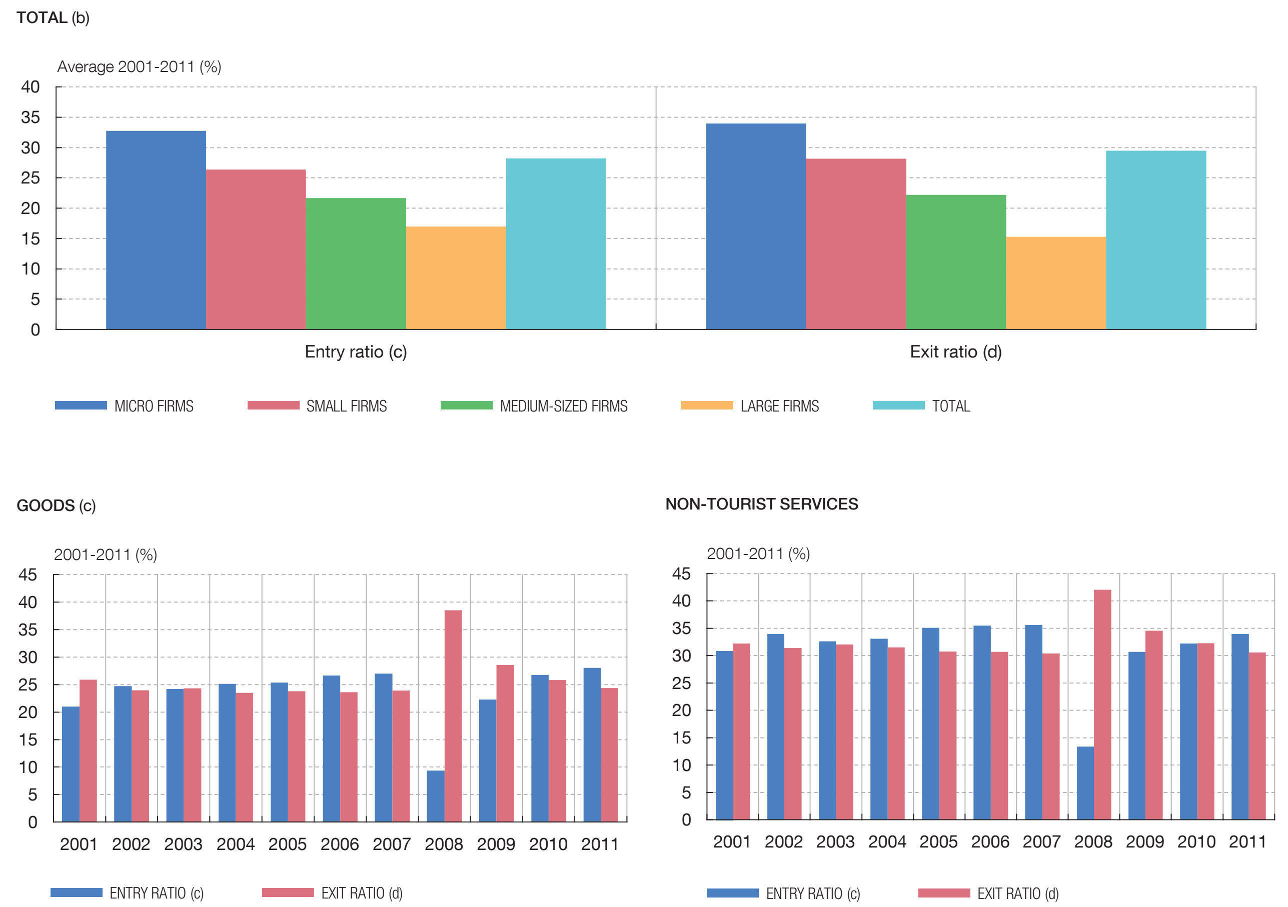
the likelihood of exporting indicates that there is some complementarity between exporting activity, FDI and outsourcing.[18]

As regards the patterns of geographical diversification, exporting firms generally sell to a small number of markets, concentrated in the developed economies, especially in the case of non-tourist services exports. Here, larger corporations that are more efficient and inclined to engage in innovative activities, have access to more diversified sources of financing and are multinationals, are those that most diversify their exports and direct them towards emerging and more dynamic markets. Size, FDI abroad and prior experience in other countries are also associated with a greater probability of exporting to developing as opposed to developed countries.

Accordingly, the Spanish exporting companies most affected by the collapse of world trade in 2008-2009 were the least productive ones, those that made no FDI abroad and those that had less access to alternative sources of financing and a higher level of debt.

18 See C. Martín, A. Rodríguez-Caloca and P. Tello (2009), "Determinantes principales de la decisión de exportar de las empresas españolas", *Boletín Económico,* December, Banco de España.

ENTRY-EXIT DYNAMICS IN THE EXPORT ACTIVITY OF SPANISH COMPANIES (a) CHART 2.8



SOURCE: Banco de España, drawing on Balance of Payments, Central Balance Sheet Data Office and Mercantile Registries statistics.

a In 2008 the declaration simplification threshold per transaction-country was raised to €50,000 (from €12,500), affecting the comparability with the period 2001-2007.
b The size of the firm is proxied on the basis of the number of employees. In this way micro firms are those with fewer than 10 employees, small firms have between 10 and 49 employees, medium-sized and large firms are respectively classified as those with between 50 and 249 employees and with 250 employees or more. The information for 2009 was taken for 2010 and 2011. Firms on which no information relative to size is available have been excluded.
c Calculated as the ratio (between exporters) of New firms_n to (New firms_n + Existing firms_{n-1}).
d Calculated as the ratio (between exporters) of Exiting firms_n to (Exiting firms_n + Existing firms_{n-1}).
e Calculated for the total sample size.

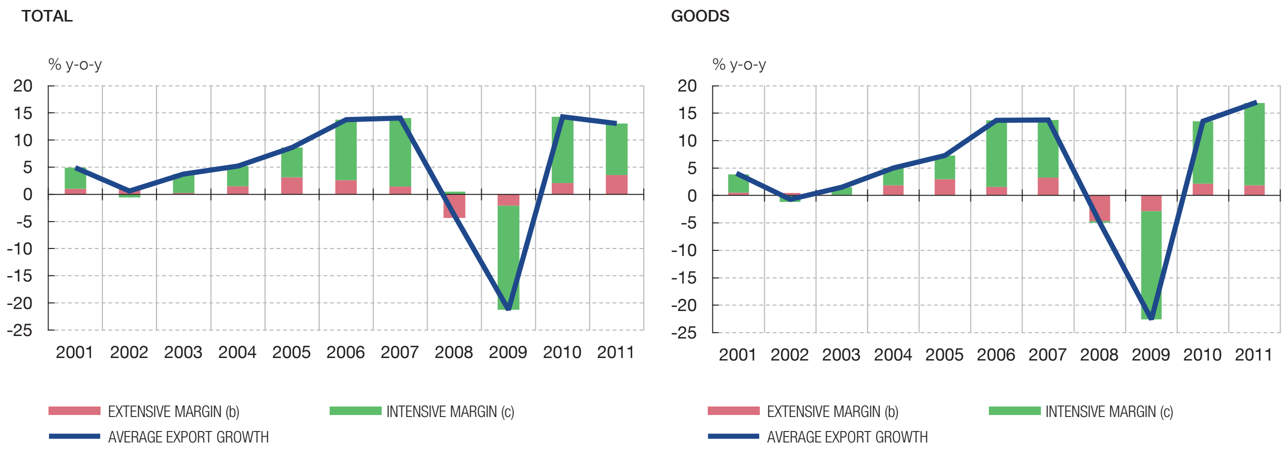
… and a significant portion of those that export do not always do so sustainedly over time

One factor that contributes to explaining the high degree of concentration of exports in a limited number of companies is that those that initiate their exporting activity show a low degree of permanence in international markets. Around 41% of the companies that began to export goods in 2001 continued to do so in 2002, and only 12% did so five years later. These rates of permanence, relating only to exporters of non-tourist services, are, respectively, 36% after one year and 7.5% after five years (see Chart 2.8). The smaller firms are those that show the highest rates of entry and exit, generally conditioning the net change in the number of exporting firms. As a result, the expansion of Spanish exports during the period 2001-2011, in terms both of goods and of non-tourist services, was underpinned to a greater extent by the intensive margin than the extensive margin (see Chart 2.9), and exports to emerging economies are lower than might be expected, according to the traditional gravity models that take geographical distance into account.[19] Over time, firms that manage to stabilise their presence in international markets export a higher proportion of

19 See C. Martín (2011), "Un análisis del destino geográfico de las exportaciones españolas de bienes a través de una ecuación de gravedad", *Boletín Económico,* July-August, Banco de España.

COMPONENTS OF THE GROWTH OF GOODS AND NON-TOURIST SERVICES EXPORTS (a)

CHART 2.9



SOURCE: Banco de España, drawing on Balance of Payments statistics.

a In 2008 the declaration simplification threshold per transaction-country was raised to €50,000 (from €12,500), affecting comparability with the period 2001-2007.
b The extensive margin is defined as the contribution to the increase (decrease) in exported value derived from an increase (fall) in the number of countries to which a firm exports, or "firm-country of destination" trade relations.
c The intensive margin is defined as the contribution to the increase (decrease) in exported value derived from an increase (fall) in the amount exported by each firm to each country.

their sales (intensive margin) and direct their products at a higher number of markets (extensive margin).

Raising the Spanish economy's export potential will therefore involve broadening the base of companies that export in a stable fashion. Identifying the characteristics that enable a firm to successfully tackle penetration and permanence in foreign markets is thus of great interest in gearing other economic policy measures to complement those needed to promote the gains in competitiveness that the economy needs to restore a robust and sustained growth rate (see Box 2.2).

6 Policies to promote competitiveness

Competitiveness-promoting measures should be aimed essentially at providing nominal flexibility, increasing productivity and improving resource allocation…

The efficient functioning of the markets for goods and services and for factors is essential for providing nominal flexibility in the economy. This comes about through the adaptation of prices and wages, an increase in productivity and the reallocation of resources needed to expand the tradeable goods sector and to sustain higher growth in the medium and long term under the demanding stability requirements stemming from euro area membership. The institutional rigidities preventing such adaptability foment higher unemployment and its persistence when adverse shocks occur, they restrict productivity gains and hamper the reallocation of resources towards more efficient uses, which translates into losses in well-being. Headway in the agenda of structural reforms outlined in Chapter 1 of this report is thus key to boosting the competitiveness of the Spanish economy.

... which means ensuring that the facilities provided by the recent labour market reform for the internal flexibility of companies and for the decentralisation of collective bargaining are fully operational…

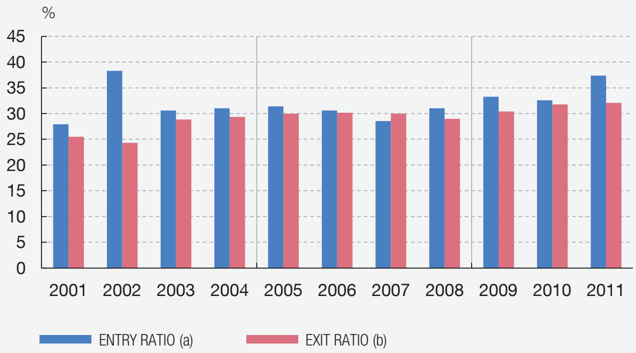
The sound functioning of the labour market is pivotal to improving competitiveness. The recent labour market reform approved by Royal Decree-Law 3/2012 of 10 February 2012 contains certain far-reaching measures. On one hand, these provide for the adjustment of wages and, on the other, they offer firms more extensive instruments to manage the organisation of their labour force, without the limitations imposed by employment contracts or collective bargaining agreements of a sectoral, regional or national scope under economic conditions which may differ greatly from those currently prevailing in different places.

As regards wage flexibility, giving prevalence to firm-level collective bargaining agreements over those at a higher level, the possibility of alleging two consecutive quarters of declines in sales to

According to customs data, around 37% of the firms that exported goods in the 2003-2011 period were stable or regular exporting companies, defined as those that sell their products abroad over four consecutive years. These companies accounted for around 90% of total exports in this period, while the firms that export temporarily or occasionally only represented, on average, 10% of exports. The average number of countries to which stable exporting firms sold goods and services stood at around five countries per year, compared with an average of three countries in the case of all firms[1], with the former having a greater presence in developing countries. Consequently, a firm's

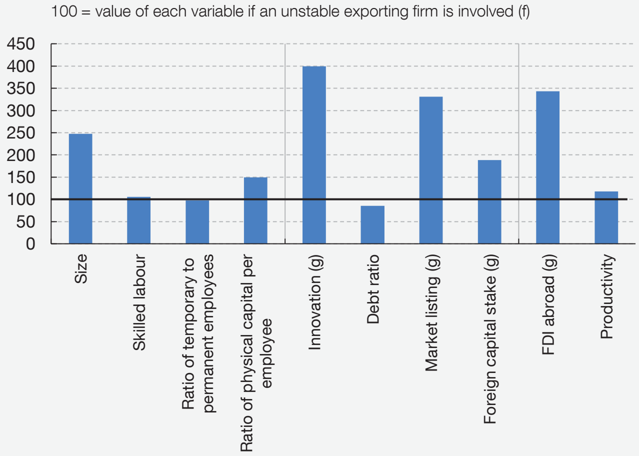
1 According to the database combining information from Balance of Payments, Central Balance Sheet Data Report and Mercantile Registries statistics *(BP-CB-RM).* The information made available by the Customs and Excise Duties Department of the Tax Revenue Service confirms the existence of a positive relationship between a firm's entrenchment in respect of exports and the number of markets to which it directs its

1 ENTR-EXIT DYNAMICS OF GOODS EXPORTING FIRMSY

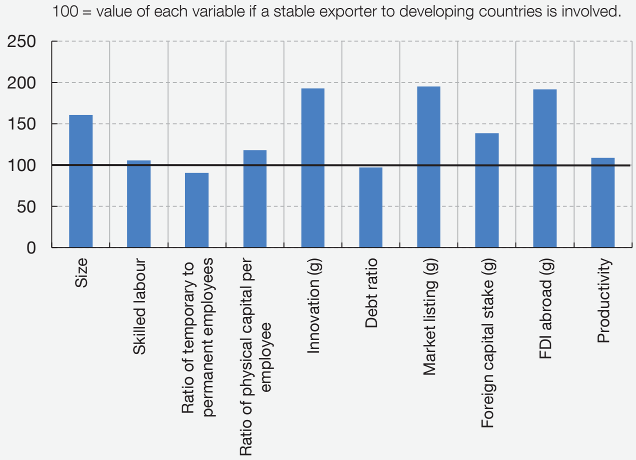


2 ENTRY-EXIT DYNAMICS OF STABLE GOODS EXPORTING FIRMS

3 CHARACTERISTICS OF STABLE AS OPPOSED TO UNSTABLE GOODS/SERVICES EXPORTING FIRMS (e)



4 CHARACTERISTICS OF STABLE GOODS/SERVICES EXPORTING FIRMS IN DEVELOPING AS OPPOSED TO DEVELOPED COUNTRIES (e)



SOURCES: ICEX, based on Customs data, and Banco de España, drawing on Balance of Payments, Central Balance Sheet Data Office and Mercantile Registries statistics.

a Calculated as the New firms n to (New firms n + Existing firms n-1) ratio (among exporters). New firms are considered to be those that have exported in the reference year, but not in any of the four previous years.
b Calculated as the Exiting firms n to (Exiting firms n + Existing firms n-1) ratio (among exporters). Exiting firms are considered to be those that have not exported in the reference year, but have done so in the previous year.
c Calculated as the New firms n to (New firms n + Existing firms n-1) ratio (among exporters). New firms are considered to be those that have exported in the reference year and in the three previous consecutive years, but not in the fourth year.
d Calculated as the Exiting firms n to (Exiting firms n + Existing firms n-1) ratio (among exporters). Exiting firms are considered to be those that have not exported in the reference year, but have done so in the four previous consecutive years.
e Median of the period 2003-2011. Exports of financial services, insurance and government services are not included.
f In the case of the size of stable exporters, for example, this should be interpreted as approximately three times that of unstable exporters.
g For these variables the statistic depicted is the monthly average.

export volume increases over time, meaning that if new trade relations are to contribute significantly to a country's export growth, they must last.[2]

Given that the greater export persistence is, the bigger the amount exported and the larger the number of recipient countries will be, increasing Spain's share in world trade in a significant and stable fashion involves cementing trade relations, once these are initiated. In principle, the high entry costs, some of them sunk, that firms incur when beginning to export would point to greater permanence in foreign markets. Accordingly, the combination of high entry and exit rates in export activity (see panels 1 and 2) might reflect some lack of prior planning (e.g. product selection/country on which the sale is targeted) or other factors that are structural (such as, for instance, the higher relative weight of SMEs), institutional (wage-setting processes, difficulties in diversifying sources of financing or in making and/or receiving FDI) or related to the endowment and quality of productive factors (skilled labour or spending on R&D). It is, therefore, important to identify those characteristics present in stable as opposed to unstable exporting firms. A probit model estimated for the period 2001-2007[3] indicates that, generally, the factors that increase the likelihood of a firm exporting in a stable fashion are size, experience in the internal market, access to financing on capital markets, FDI abroad, foreign capital stakes in its ownership structure, R&D spending and experience as an exporter in other markets.

Indeed, firms that export in a regular fashion tend to be bigger, have higher levels of apparent labour productivity, a bigger stock of physical capital per employee and to spend more frequently on R&D (see panel 3). They also evidence lower levels of debt, although they have access to alternative sources of financing. Stable exporters tend to engage in more FDI operations abroad and the presence of foreign capital in their productive structure is also bigger, in line with their greater degree of internationalisation. If a comparison is made between the characteristics that determine a firm's export status and those respectively shown by Spanish firms exporting in a stable fashion to developed countries and developing countries (see panel 4), it is likewise confirmed that firms exporting to emerging countries are also the biggest, the most productive, those that have a skilled labour force, those that engage in R&D activities and, generally, those that show a greater degree of internationalisation. All these characteristics allow firms to incur higher entry costs in respect of distant markets. At the same time, their entry costs may be lower, since the fact of belonging to a multinational group, through FDI[4], contributes to reducing the information asymmetries of and the uncertainty entailed by initiating sales on distant markets.

The results obtained suggest that policy measures geared to improving firms' productivity and efficiency will contribute to raising the proportion of those that export in a stable fashion and, at the same time, to furthering the geographical diversification of exports and to raising their share in international trade.

products (Observatorio de la Internacionalización, December 2010). J.J. Lucio et al. (2006),"Permanencia de las empresas en la exportación: una mirada a las características de su actividad exterior", ICE, *Tribuna de Economía,* no. 640, find that during the period 1998-2003, stable firms export on average to four countries more than occasional exporters.

2 The findings by J. A. Máñez, F. Requena-Silvente, M. E. Rochina-Barrachina and J. A. Sanchis-Llopis (2011) in "El papel de los márgenes extensivo e intensivo en el crecimiento de las manufacturas españolas por sectores tecnológicos", *Cuadernos Económicos de ICE,* 82, show, first, that the duration of trade relations – defined as the export of a specific product to a specific country – in Spain is half that in Germany, and this difference widens with the technological content of the goods traded; and further, that the limited time of survival of Spanish exports restricted their growth in the period 1991-2005.

3 See C. Martín, A. Rodríguez-Caloca and P. Tello (2009), "Determinantes principales de la decisión de exportar de las empresas españolas", *Boletín Económico,* December, Banco de España.

4 D. Córcoles, C. Díaz Mora and R. Gandoy (2012), "La participación en redes internacionales de producción: un factor de estabilidad para las exportaciones españolas", *Economistas,* 130, find that the biggest rates of survival of Spanish exports are in destinations where the degree of integration in production networks is greater.

initiate an opt-out from a higher-level agreement and the extension of the areas in which the employer can decide not to apply the working conditions agreed in collective bargaining agreements, along with the limitation to two years of the period over which such agreements can be extended, all serve the purpose of achieving a better match of wages to firms' economic conditions. As a result, job destruction is contained when such conditions worsen, unlike what has occurred since the onset of the crisis. As to managing how work is organised, the possibilities of altering individual and collective working conditions are extended; what was a prerequisite under the previous legislation, namely prior legal or administrative authorisation, has been eliminated.

However, for a better allocation of resources across sectors and firms in the same sector, more ambitious measures are needed in respect of active labour market policies. These should provide for the training, integration and guidance of unemployed workers and of employees at risk of losing their job, and should include an exhaustive assessment of current programs and closer links to unemployment protection policies. It should also be pointed out that overcoming excessive labour turnover and its adverse effects on productivity and resource allocation hinges excessively on the promotion of permanent hiring through rebates, which have proven relatively ineffective in the past, both in reducing the proportion of temporary to permanent employees and in increasing aggregate employment.

… and deepening policies to safeguard and promote competition…

Given the significance of resource reallocation in restoring productivity and, consequently, competitiveness, it is of vital importance to lower the barriers to competition, and in particular those impeding access to specific sectors, and to eliminate the administrative obstacles to business start-ups. The measures envisaged in the Sustainable Economy Law in relation to the involvement of local and regional governments in the procedure for obtaining licences to engage in economic activities should be implemented so that, while preserving the unity of the internal market, they provide for a substantial reduction in the cost and time incurred in setting up a new business. Along with this, it is very important to strengthen the supervisory agency's powers by restricting government intervention to the minimum needed, both at the central and regional government levels.

Given the significance of the size of firms as a determinant of their export propensity, the involvement of local and regional government in regulating competition should be prevented from bringing about an unnecessary fragmentation of the national market that were to limit the growth of SMEs. Finally, competition-promoting measures that may be considered as pressing are those that affect sectors whose functioning has significant consequences for firms' costs, and in particular for those that have a more global activity. These include most notably, as indicated in Chapter 1, those concentrated in the energy, transport, retail and business services sectors. Lastly, measures that improve the efficiency of financial markets will help provide access for a greater number of firms to more diversified sources of financing, a feature that has proven essential in sustaining export activity.

… bearing in mind the recent trends in international trade…

In recent decades tariff barriers have been lowered substantially, in particular in the industrial sector of the advanced economies. But non-tariff barriers (e.g. certain rules arising from national regulations and from customs procedures) remain an obstacle to international trade.[20] International institutions have focused their measures on matters pertaining to services and to FDI; and, as regards the EU, on the coordination and simplification of national regulations in order to deepen the single market, removing obstacles to the growth of companies. The Services Directive was a major step forward here, since the improvement in the efficiency of services contributes to raising the level of efficiency of the productive system as a whole. And that, in turn, raises competitiveness and firms' export propensity.[21] A full and effective transposition of these initiatives to national legislation would be enormously conducive to a comprehensive improvement in competitiveness.

In the important area of exports to emerging markets, it is non-tariff barriers and market failings (information frictions, etc.) that most hamper the initial phases of internationalisation towards these destinations. These obstacles are more significant for SMEs and firms that are initiating their export activity, since they usually lack experienced human capital in the international area and knowledge of consumer preferences, of business opportunities and of the technical quality and requirements demanded in the new foreign markets.

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20 See European Commission (2008), *European Competitiveness Report.*

21 See J. Francois and B. Hoekman (2010). "Services Trade and Policy", *Journal of Economic Literature,* 48, September, pp. 642-692.

CLASSIFICATION OF EXPORT PROMOTION PROGRAMMES

TABLE 2.5

	Specific policies
Financing of internationalisation projects	**Export insurance** (CESCE). **Reciprocal Adjustment of Interest Agreements (CARI)** run by the ICO (Official Credit Institute). This arrangement offers support to Spanish exports of goods and services by encouraging the granting by financial institutions of long-term (two or more years) export credits at fixed interest rates (agreed rates). Every six months these rates are compared with market rates and the resulting difference, plus a management margin in favour of the financial institution, is regularised between the latter and the ICO. This is called an "adjustment" operation and may give rise to a payment by the ICO to the lending institution, or vice versa. DAF-SMEs facilities (2009), intended to finance the supply of goods and services by SMEs aimed at countries eligible for development aid funds (DAF). Creation of the Fund for the Internationalisation of the Firm (FIEM), under the DAF, allowing operations conducive to the internationalisation of the Spanish economy to be financed.
Detection of export potential and definition of the internationalisation strategy	**External Initiation and Promotion Plan (PIPE),** which comprehensively supports the various phases of the internationalisation of SMEs. This Plan, initiated in 1997, is at the State level. The ICEX, the CSC and the related regional government agencies collaborate in its application. The Plan envisages support for two years to the internationalisation of the firms selected, and comprises three phases: diagnosis of export potential, design of the strategic internationalisation plan and implementation of the plan. **Awareness seminars and conferences** [ICEX, Promomadrid, COPCA (Catalonian Trade Promotion Consortium)]. Continuous support aimed at **cementing presence abroad** (PIPE, ICEX economic and trade offices abroad, ICEX business centres abroad, COPCA).
Promotion of participation in international tenders	**Introduction to international tenders** [CSC (Supreme Council of Chambers of Commerce)]. **Tendering Plan** (ICEX).
Support to penetrating specific markets	**Comprehensive Market Development Plans (PIDM)** of the Ministry of Economic Affairs and Competitiveness. Since 2005 the Spanish government has set in train such plans targeted on Brazil, China, Russia, Mexico, the United States, India, Algeria, Morocco, Japan, Turkey, South Korea and the Gulf countries.
Search for partners in market of destination	ICEX economic and trade offices abroad and business centres abroad. Virtual portals (ICEX, COPCA). Coordination with sectoral groupings [Chambers of Commerce, the Basque SPRI (Industrial Promotion and Regeneration Company) agency, Tecniberia, Promomadrid].
Incentives for business cooperation at source	Overseas Consortia Programme (ICEX). Aimed at SMEs which obtain partial financing for three years for expenses relating to start-up and legal advice, staffing, rentals, external professional services, external promotion services, legal branding safeguards and the official certification of products before official agencies. Virtual platforms (COPCA, SPRI). Promotion of the internationalisation of clusters (SPRI, COPCA).
Human resources development and training	Foreign trade scholarships (ICEX, regional government agencies). External advisers (ICEX PIPE). Training of local staff in market of destination (ICEX PROPEX programme, COPCA, SPRI).
Export promotion through innovation	Co-operation between exporting firms and the research area (more developed in foreign countries; e.g. the British agency UKTI, the Finnish FINPRO and Innovation Norway). Financial support to innovation [CDTI (Industrial Technological Development Centre)].
Improvement of corporate image or branding	**Made in/Made by Spain Programme** of the Ministry of Economic Affairs and Competitiveness. Dissemination of the brand image of a region (e.g. Promomadrid). Virtual platforms of the ICEX, COPCA, SPRI.

SOURCE: Banco de España.

… and reassessing direct export support policies, which already have a broad set of instruments in Spain

The promotion of exports is backed in Spain by a series of private-sector institutions (e.g. CEOE, Chambers of Commerce) and agencies at different levels of government, both central (Ministry of Economy and Competitiveness, ICEX and ICO) and regional (specific export-promoting agencies). Most programmes are aimed at broadening the export base, in particular that of SMEs, although there are also measures that directly foment foreign market penetration, including most notably the support facilities for international tenders, the PIPE (Overseas Initiation and Promotion Plan), directed at SMEs, and the PIDM (Integral Market Development Plans), whose aim is to promote trade and economic relations with specific countries. Some of the export-promoting measures were strengthened in the face of the financial crisis and the collapse of world trade in late 2008. In particular, the financing instruments for internationalisation projects were boosted and made more flexible so as to alleviate the impact on trade credit of the restricted access to financing.[22]

Studies on the effectiveness of the export-promoting programmes set in train in Spain suggest they are susceptible to improvement. In particular, mention is made of aspects relating to excessive administrative costs and heterogeneous treatment depending on the firm's sector of activity, with the need for agencies to adopt a more proactive role and the advisability of boosting plans that integrate R+D+i and exports, along with the advantages of strengthening initiatives that harness the economies of scale of industrial clusters. Finally, coordination problems among the various agencies that draw up export-boosting policies have been detected.[23]

Finally, it should be stressed that there is widespread agreement that the impact of the export-promotion programmes depends significantly on whether, in parallel, other far-reaching structural reforms are adopted to improve the economy's overall productivity and competitiveness. Consequently, the export-promotion programmes can only complement, not replace, the structural reforms needed to boost productivity, the growth capacity of companies and the overall competitiveness of the economy.

22 See Box 3.2 in *Annual Report,* 2009, Banco de España.

23 To alleviate this situation, the Inter-territorial Council for Internationalisation was set up in 2006. It comprises the Ministry of Economy and Competitiveness, the competent regional government departments, the CSC (Supreme Council of Chambers of Commerce) and the CEOE (Spanish Confederation of Employers' Organisations). The Council drew up in 2011 the Integrated Plan for Strengthened Exports and Foreign Investment, in which it was agreed to integrate information and training systems for exporters, and the provision of export and internationalisation initiation programmes.

BOXES

The latest stage of the global financial and economic crisis has been particularly severe and long-lasting in the euro area, taking the form of a sovereign debt crisis (see Chapter 1 of this Report), with significant repercussions in the rest of the world. Indeed, since summer 2011 the renewed concerns over the sovereign debt of Greece and other euro area countries have seen a heightening of tensions, which have again become a determining factor in the world outlook.

The euro area represents around 20% of world GDP and a somewhat smaller percentage of world trade (about 15%, excluding intra-euro area trade). Therefore, euro area spending and relative prices can influence goods and services exports and imports to and from the rest of the world. From a financial standpoint, the importance of the euro area is even greater, because it acts as intermediary in a significant proportion of global capital flows, and European financial institutions' interconnections with the rest of the world are deep-rooted and complex. On Bank for International Settlements (BIS) data,[1] euro area banks account for between 25% and 40% of world finance, depending on the institutional sector considered.

The real transmission channels of the sovereign debt crisis to the rest of the world takes place mainly through international trade in goods and services. The greater saving of households (precautionary or to reduce leverage), the postponement of investment projects (as a result of heightened uncertainty) and ongoing fiscal consolidation reduce the aggregate demand of the euro area and thus exports from the rest of the world. This channel should be especially important in those regions with greater trading exposure to the euro area. Panel 1 shows that the United Kingdom and the eastern European countries (which, moreover, are very open economies) would be particularly vulnerable, since the euro area is the destination of more than 50% of their goods exports. In the cases of Asia (including China), Latin America and the United States, the euro area accounts for 5-10% of the trade in goods. As regards trade in services, although the euro area is a major market for the United Kingdom and for certain Latin American and African countries, the potential impact is mitigated by the fact that services exports represent a still-small percentage of GDP in comparison with goods exports. According to the IMF[2], the global impact through the trade channel is not particularly significant. Specifically, in the most exposed countries it would reduce GDP at the most by 0.2 pp per percentage point of contraction in euro area aggregate demand. The latest economic data suggest that the impact through the trade channel may have started to manifest itself in some countries. Panel 2 shows that in the second half of 2011 a more marked loss of dynamism in exports to the euro area than in exports to the rest of the world became discernable. More specifically, in the same period the euro area export growth differential vis-à-vis the rest of the world turned negative in the cases of the United States, Japan and eastern Europe, while for China and emerging Asia the already negative differential widened. In the case of Latin America, the positive differential recorded during the first six months of 2011 shrank considerably.

The trade channel may be strengthened by the gains in euro area price competitiveness if, as a result of the crisis, the euro depreciates against other currencies. According to Dieppe et al.,[3] for each percentage point that the euro depreciates, there is a 0.3 pp increase in euro area exports (i.e. imports by the rest of the world) and a 0.1 pp fall in euro area imports (i.e. exports by the rest of the world). Since late summer, the euro has depreciated to a certain extent – 8% against the dollar and 5% on a multilateral basis. The downturn in economic activity and exchange rate developments tend to be reflected in migrant workers' remittances which, while modest in the case of the euro area (totalling some €25 million per year), are an important source of income in poorer countries.

The financial transmission channels are much more complex and their scope more difficult to quantify on account of the multiple interlinkages in place. As is known, the euro area sovereign debt crisis triggered the adjustment in equity markets during the summer. Indeed, the financial stress indicators, which are a measure of US and UK market volatility, increased significantly whenever the risk premium of the euro area periphery countries rose (see Panels 3 and 4) to levels not seen since end-2009, with the onset of Greece's difficulties. Equity markets and the banking sector were the main focus of the heightened uncertainty.

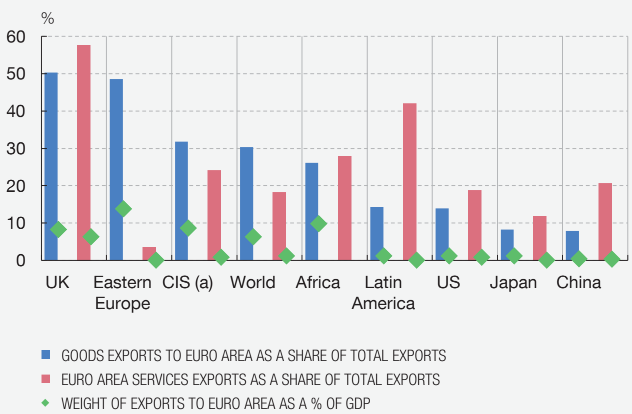
The worsening situation in the euro area may also be adversely affecting the market valuation of those companies in the rest of the world, whether they are in the financial sector or not, with strong trade or financial ties with the euro area. This exposure is most apparent in the financial sectors of countries such as the United States and the United Kingdom, whose businesses are highly exposed to the public and private sectors in the euro area. Indeed, US banks' exposure to European debt increased in 2011, owing partly to the size of their positions in credit derivatives. These derivatives, mainly credit default swaps, became more commonplace on account of the impairment of some European countries' debt. In contrast, the United Kingdom, with a lower exposure to European debt through derivatives, saw its exposure fall slightly. Other financial agents have been more active in their response to these shocks by reducing their exposure to euro area risk. One of the most prominent cases is that of US money market funds. A large portion of the assets belonging to these funds is in the form of fixed-income securities issued by credit institutions. The funds' exposure to euro area institutions had increased until mid-2010, when it accounted for almost 40% of investment holdings in financial institutions. During 2011, however, this exposure fell due to the sovereign debt crisis, to stand at 14% by year-end. Lastly, in the case of the non-financial sector, empirical evidence

1 See *World Economic Outlook* (2012), IMF, April.
2 "Euro Area Policies: Spillover Report for the 2011 Article IV Consultation and Selected Issues", IMF Country Report No. 11/185.
3 See A. Dieppe, A. González Pandella, S. Hall and A. Willman (2011), "The ECB's new multi-country model for the euro area. NMCM – with boundedly rational learning expectations", Working Paper Series, No. 1316, European Central Bank.

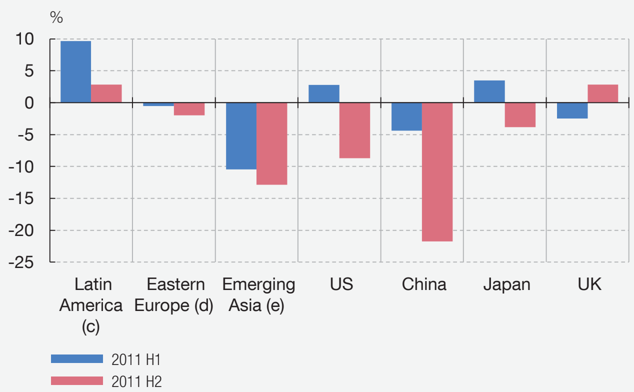
suggests that businesses with high exposure to the euro area, being recipients of euro area production or funding from its financial institutions, may have seen their market values adversely affected. Were this to persist, it could impact shareholder wealth and investment decisions.

A final, potentially significant, financial channel seems to be working in the opposite direction, namely through the withdrawal of euro area financial institutions' activity from other geographical regions, particularly eastern Europe. Here, there are three types of factor to be taken into account. First, given the difficulty in obtaining permanent external funding, major European banks may decide to strengthen their core capital through disinvestment in other regions. Thus far, there is no evidence to suggest that this has occurred on a large scale. Second, there are signs that financial institutions are embarking upon a process of specialisation on account of the new global financial scene, which could lead them to abandon certain lines of business and, consequently, investment in specific regions. However, this is not exclusive to European institutions, nor does it stem from the sovereign debt crisis. Lastly, European institutions are faced with higher costs for funding obtained on international markets, which is used to finance part of their activities in other regions. As a result, they are scaling down their activity in certain segments, such as international trade credit. On the back of this development, Asian and US competitors are taking the place of European institutions and gaining market share.

1 EURO AREA IMPORTS AND EXPORTS IN 2010

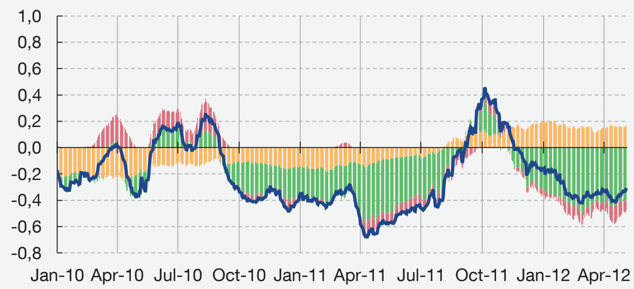


2 EURO AREA EXPORT GROWTH DIFFERENTIAL (b)



3 UNITED STATES. FINANCIAL STRESS INDICATOR (f)

4 UNITED KINGDOM. FINANCIAL STRESS INDICATOR (f)



EXCHANGE RATE SECURITIES MARKET BANKING SECTOR INDICATOR

SOURCES: Banco de España, Datastream, Eurostat and IMF.

a CIS: Commonwealth of Independent States.
b A positive value indicates that exports to the euro area increased more than those to the rest of the world.
c Argentina, Brazil, Chile, Colombia, Mexico and Peru.
d Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania.
e Korea, India, Indonesia and Thailand.
f An increase in the index denotes greater stress in the financial markets. Daily data. The indicator is made up of a simple average of three sub-indices relating to: the banking sector (1-year and 10-year government bond spreads, Treasury bill yield and 3-month repo spread, and banking stock price index); securities market (corporate bond spread, overall stock market index and implied volatility of the overall stock market index); and exchange rate (implied volatility of the real effective exchange rate).

UNCONVENTIONAL MONETARY POLICY. THE EFFECTIVENESS OF THE ASSET PURCHASE PROGRAMMES IN THE UNITED STATES AND THE UNITED KINGDOM

BOX 3.2

The exhaustion of the leeway available to traditional monetary policy instruments to act, once official interest rates reached levels close to zero, has led the central banks of the main developed economies to activate a wide range of unconventional measures, against a background of persistent economic and financial fragility. These include most notably the extraordinary liquidity and long-term refinancing operations, the large-scale asset purchase programmes and the changes in balance sheet composition (as part of quantitative easing or credit easing strategies[1]). The objectives pursued may be the re-opening of certain markets, the maintenance of financial stability, the reduction of funding costs and the expansion of nominal spending. The use by central banks of these instruments has been widespread, although the US and UK central banks have applied them with greater intensity, particularly asset purchases.

The Federal Reserve announced a credit easing strategy in November 2008, undertaking to purchase $600 billion in debt and mortgage-backed securities (MBS) held by federal agencies with a view to smoothing the functioning of these market segments. In March 2009 it raised the volume of this operation by $850 billion and it initiated, moreover, a quantitative easing strategy with the purchase of $300 billion in Treasury bonds. In a second stage, in November 2010, the quantitative easing strategy was expanded following the decision to purchase an additional $600 billion worth of Treasury bonds. Overall, asset purchases amounted to $2.35 trillion, equivalent to 15.3% of GDP. Subsequently, in September 2011, the Federal Reserve initiated a public debt portfolio reallocation strategy, known as *Operation Twist*, which involved replacing short-term securities with other, longer-dated instruments so as to lengthen the average maturity of the portfolio without increasing the size of its balance sheet. Previously, in August, it had decided to keep its MBS portfolio stable through the reinvestment of the instruments maturing in securities of the same type.

The Bank of England initiated a quantitative easing strategy through an asset purchase facility (APF) in March 2009. From that month up to February 2010, purchases centred on public debt, for an amount of £200 billion. In October 2011, a second phase was launched, which finalised on May 2012 and which has raised the total amount of purchases to £325 billion (23% of GDP).

There are numerous transmission channels for a central bank's asset purchase programme to financial and macroeconomic variables (see accompanying diagram). First, they have a direct effect on the price of the assets purchased, by exerting downward pressure on their yields. Lower yields, along with the increase in liquidity arising from the purchases, will lead investors to portfolio shifts towards other assets, such as shares or corporate bonds, whose price will also increase. Moreover, the announcement of the purchases plays a signalling role in respect of the monetary authority's objectives, which will affect interest-rate expectations over different horizons, as well as the exchange rate.[2] Furthermore, especially in the case of credit easing strategies, these operations can help prop up specific markets subjected to stress, providing them with liquidity. The increase in asset prices has a bearing, in turn, on the recovery in wealth, which, combined with the reduction in financing costs, will boost consumer spending and investment and, ultimately, GDP and employment. This will all be conducive to brighter economic prospects and enhanced business and consumer confidence, provided that the exit mechanisms from these easing strategies are credible and that inflation expectations remain anchored. Ultimately, the injection of liquidity into the economy will also induce an increase in the supply of credit, given the improvement in the economic climate.

Any assessment of the economic impact of the asset purchase programmes is a complex task, since it is difficult to isolate their effect from that of other factors. Further, to compare their effectiveness from one country to another, the relative size of the programmes must be taken into account. In the case of the United States, the Federal Reserve increased its share in the Treasury bond market by 8.9 pp to 16.6% of the stock at end-2011; likewise, it came to account for 19.1% of the outstanding balance of federal agency-backed debt and MBS. In the United Kingdom, after the end of the first round of quantitative easing, the stock of government bonds held by the central bank accounted for 22% of the total in circulation, and this percentage rose to 32% in May. Several studies offer estimates of the impact of these programmes on financial and macroeconomic variables (see accompanying table). For the case of credit easing and the first phase of quantitative easing in the United States, some results point to a downward impact on 10-year Treasury bond yields of between 30 bp and 80 bp, while in the case of federal agency bonds and MBS, the fall is estimated to be around 130 bp and 110 bp, respectively, although the impact would have been minimal in the MBS market segments not backed by federal agencies. According to other research, the purchases would also have affected the term structure of interest rates, lowering 10-year rates and increasing short-term ones.[3] Finally, it is estimated that the dollar depreciated by between 3.6% and 10.8%, depending on the counterpart currency, in the period between the two days before and the two days after the announcement of the purchases. In the case of the United Kingdom, empirical evidence suggests that the first phase of the APF significantly and immediately reduced the interest rates on public debt by around 100 bp, likewise lowering the rates on corporate bonds in general, reflecting a balance sheet restructuring effect. Further, the level of real GDP is estimated to have increased by between 1.5 pp and 2 pp, and inflation by between 0.75 pp and 1.5 pp. These figures would be equivalent to a reduction in the official interest rate of between 150 bp and 300 bp.

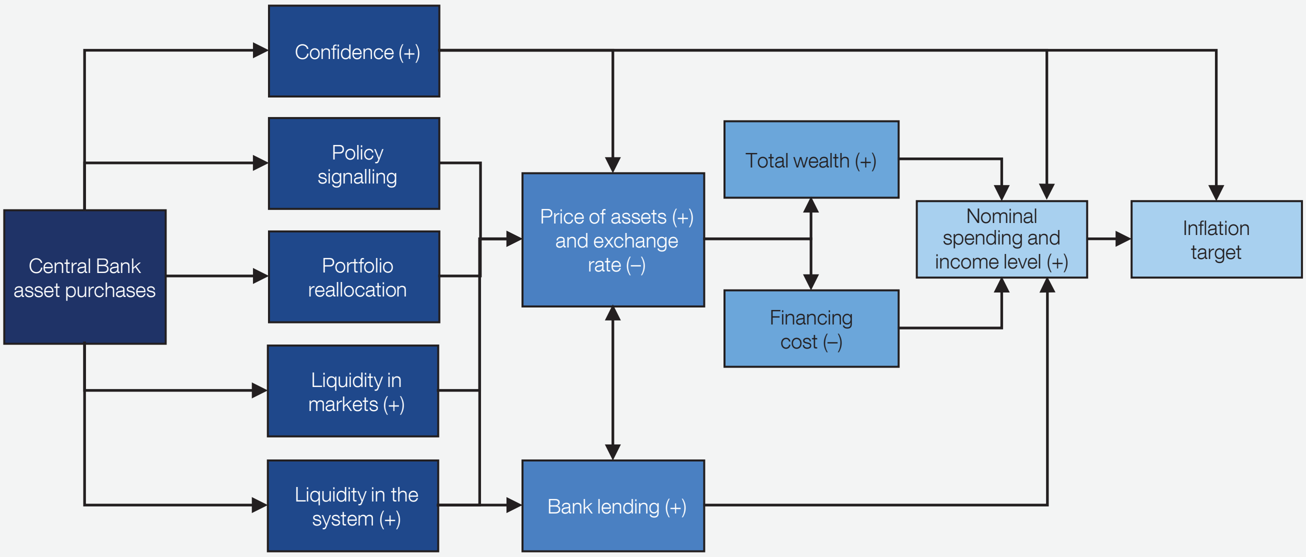
In sum, the evidence available indicates that the asset purchase programmes have been conducive to reducing financing costs

1 Quantitative easing involves increasing the size of the central bank's balance sheet through the purchase of securities financed by an expansion of bank reserves. Since the aim is to inject money into the economy to boost nominal spending, the key point of this strategy is how the balance sheet expansion is financed. Conversely, the focus of credit easing is on the composition of the central bank's balance sheet assets.

2 Insofar as investors decide to invest in foreign-currency-denominated assets, part of the effect on the exchange rate will come about through portfolio reallocation.

3 See J. Hamilton and J.C. Wu (2011), *The Effectiveness of Alternative Monetary Policy Tools in a Zero Lower Bound Environment,* Working Paper no.16,956, April, National Bureau of Economic Research.

TRANSMISSION CHANNELS OF THE ASSET PURCHASE PROGRAMMES



IMPACT OF THE ASSET PURCHASE PROGRAMMES (a)

Financial variables	United States	United Kingdom
Long-term Treasury bond yield	Decrease of between 30 bp and 100 bp (b). Sack (2009), Gagnon et al. (2011), and Neely (2011)	Decrease of 100 bp. Joyce et al. (2011a)
Yield on federal agency-backed bonds and MBS	Decrease of between 150 bp and 110 bp, respectively. Gagnon et al. (2011)	—
Corporate bond yields (investment grade)	Decrease of 70 bp. Gagnon et al. (2011)	Decrease of 70 bp. Joyce et al. (2011a)
Corporate bond yields (high yield)	—	Decrease of 150 bp. Joyce et al. (2011a)
Exchange rate	3.6% - 10.8% depreciation depending on the counterparty currency. Neely (2011)	Effective depreciation of 4%. Joyce et al. (2011a)
Macroeconomic variables		
GDP	Persistent 0.4% increase. Chen et al. (2011)	Increase from 1.5 pp to 2 pp Joyce et al. (2011b), Kapetanyos et al. (2012) and Bridges and Thomas (2012)
CPI	Very small. Chen et al. (2011)	Increase from 0.75 pp to 1.5 pp. Joyce et al. (2011b), Kapetanyos et al. (2012) and Bridges and Thomas (2012)

SOURCES: Banco de España; Bank of England; J. Bridges and R. Thomas (2012), *The impact of QE on the UK economy — some supportive monetarist arithmetic,* Bank of England Working Paper no. 442; H. Chen, V. Cúrdia and A. Ferrero (2011), "The macroeconomic effects of Large-Scale Asset Purchase Programs", *Staff Report,* no. 527, December, Federal Reserve Bank of New York; J. Gagnon, M. Raskin, J. Remache, y B. Sack (2011), "Large-Scale Asset Purchases by the Federal Reserve: Did they work?", *Economic Policy Review,* May, Federal Reserve Bank of New York; M. Joyce, A. Lasaosa, I. Stevens and M. Tong (2011a), "The financial market impact of quantitative easing in the United Kingdom", *International Journal of Central Banking,* vol. 7, no. 3, pp. 113-161; M. Joyce, A. Lasaosa, I. Stevens and M. Tong (2011b), "The United Kingdom's Quantitative Easing Policy: Design, Operation and Impact", *Quarterly Bulletin,* vol. 51, no. 3, March, Bank of England; G. Kapetanios, H. Mumtaz, I. Stevens and K. Theodoridis (2012), *Assessing the economy-wide effects of quantitative easing,* Bank of England Working Paper no. 443; C. Neely, (2011), *The Large-Scale Asset Purchases had large international effects,* Working Paper no. 2010-018C, January, Federal Reserve Bank of St. Louis, and B. Sack, (2009), "The Fed's expanded balance sheet", address at the Money Marketeers New York University, December.

a In the case of the financial variables, the impact refers to the effect on such variables around the date of the purchase announcements, unless otherwise stated. In the case of the United Kingdom, it refers to the impact of the first round of quantitative easing.
b Corresponds to the estimated impact up to March 2010.

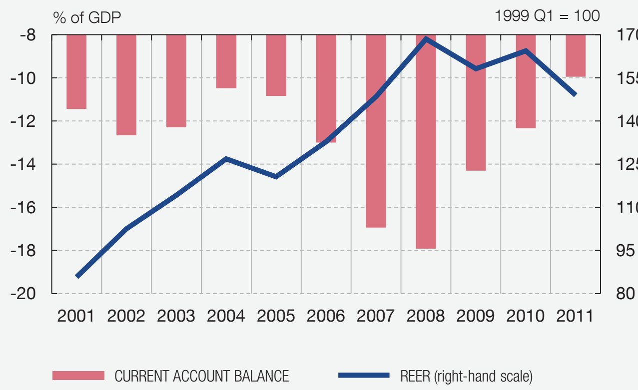
and have contributed to upholding nominal expenditure, although there are also signs that their effectiveness may be diminishing over time. Furthermore, the asset purchase programmes pose some risks that must be borne in mind. First, the flattening of the yield curve may place a brake on the necessary process of deleveraging (public and private alike), narrow bank business margins and delay the clean-up of bank balance sheets. Second, the expectation that central banks will intervene persistently in the system may exacerbate moral hazard and encourage excessive risk-taking; further, a dominant role of central banks might ultimately replace, in part, the financial intermediation function of the private sector. Costs may also emerge in terms of diminished monetary policy credibility, especially in a setting of fragile public finances. Last, the very exit strategy poses challenges, especially if the withdrawal of the extraordinary stimuli has to be done quickly. Accordingly, the central bank's communication policy must be transparent, clearly signalling the objectives and the implementation of the exit strategy.[4]

In any event, even with these caveats, there is extensive consensus concerning the decisive contribution of this set of extraordinary monetary measures to preserving financial stability; by making it easier for the banking system to obtain financing, the measures alleviate banks' liquidity problems and allow the necessary deleveraging of the banking system to unfold in a scenario of diminished tensions.

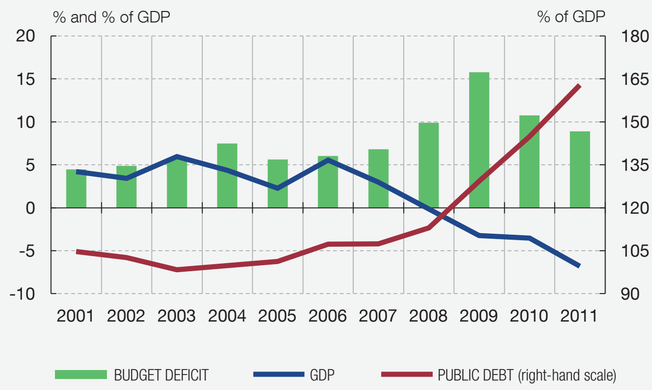
4 See Hervé Hannoun (2012), "Monetary policy in the crisis: testing the limits of monetary policy", address before the 47th SEACEN Governors' Conference, Seoul, 13-14 February; and Masaaki Shirakawa (2012), presentation at the conference "Central Banking: Before, During, and After the Crisis", organised by the Federal Reserve Board and the *International Journal of Central Banking*.

In recent years Greece has been the main source of instability in the euro area, acting as the catalyst of a crisis of confidence in the European project. The Greek economy is probably the most patent example of the costs which, sooner or later, arise owing to an inadequate adjustment to the demands that membership of an economic and monetary union imposes. Its experience also illustrates the weakness of European supervisory arrangements and the difficulties involved in designing an efficient mechanism for crisis management, and for providing financial support to ailing Member States.

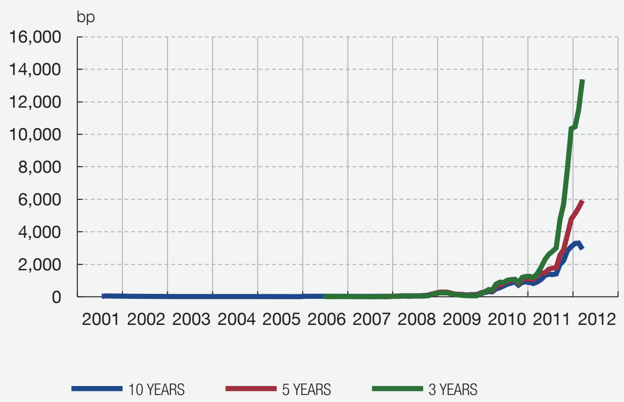
1 CURRENT ACCOUNT BALANCE AND EXCHANGE RATE (a)



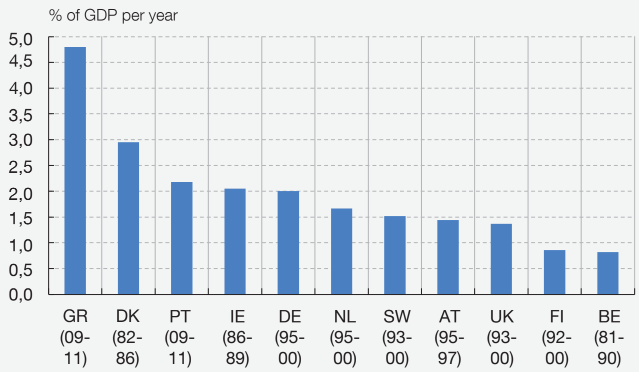
2 GDP, BUDGET DEFICIT AND PUBLIC DEBT



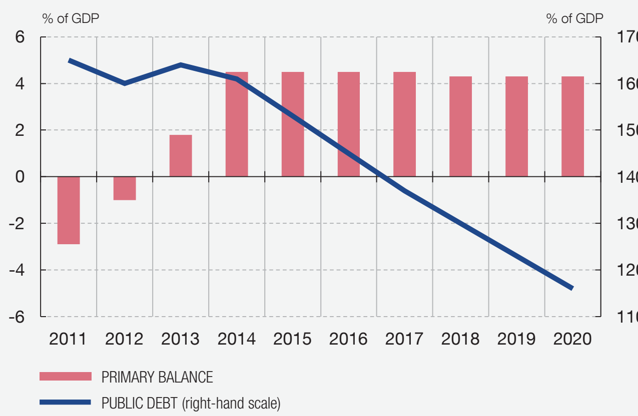
3 SOVEREIGN BOND SPREADS OVER GERMANY



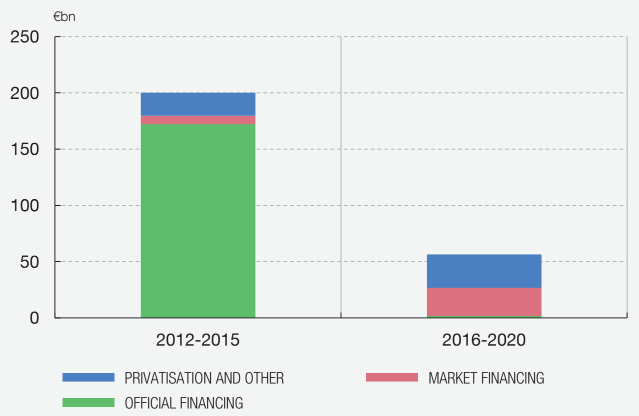
4 COMPARISON OF THE FASTEST FISCAL CONSOLIDATIONS (b)



5 PROJECTED BUDGET DEFICIT AND PUBLIC DEBT (assistance programme)



6 FINANCING NEEDS AND SOURCES (Troika estimates)



SOURCES: Banco de España, ECB and AMECO.

a Real effective exchange rate with unit labour costs.
b Reduction in the structural deficit in annual average terms during the consolidation period.

Like other countries, after joining EMU in 2001 Greece saw its domestic demand expand notably. This was readily financed by the inflow of foreign capital at low interest rates, lured by favourable growth expectations. But the pressure of demand far exceeded the responsiveness of an economy which did very little to correct its structural rigidities, thereby prompting a continuous erosion in competitiveness, low productivity growth and wage growth above the euro area average. In 2008, the real exchange rate appreciated relative to its equilibrium value by between 20% and 30% on IMF estimates; the current account deficit exceeded 10% of GDP, and foreign indebtedness climbed to comparatively very high levels (see Panel 1).

Strong imbalances also built up in the general government sector (see Panel 2). The continuous growth of spending, the generosity of pension and healthcare systems, the inefficiencies of tax collection and tax evasion meant that the budget deficit and public debt persistently exceeded the reference values set in the Stability and Growth Pact. Problems concerning the reliability of the fiscal statistics further complicated the situation. In 2004 the European Commission had initiated an excessive deficit procedure against Greece and had drawn attention to the scant quality of its fiscal statistics. But it was decided to close this procedure in 2007, it being considered that Greece had adopted the necessary measures to attain a deficit of below 3% of GDP in 2006 and 2007. Nor did the global financial markets, where a climate of widespread under-pricing of risk prevailed, react to this accumulation of vulnerabilities. Indeed, in the months leading up to the crisis, the Greek sovereign debt spread over the German Bund stood at 10-40 basis points (see Panel 3), far below that observed in the years prior to membership.

The situation took a radical turn in late 2009, when the recently elected government revised the deficit estimates for that year upwards from 6.7% of GDP to 12.7% (with the figure later exceeding 15%). In the context of international financial crisis in which this came about, the revision was the trigger for a sudden re-evaluation of risk in the Greek economy, which hampered its access to the capital markets, and mired it in a liquidity crisis that precipitated the request for financial assistance. Given the lack of instruments in the framework of euro area governance enabling aid to be channelled to this country, the euro area countries decided, following a process not free from difficulties, to extend bilateral loans totalling €80 billion, to which €30 billion granted by the IMF were added, making up a total amount of almost 50% of Greek GDP. This initial loan was conditional upon compliance with an ambitious fiscal adjustment and structural reform programme, and stipulated interest rates and non-concessional terms which, ultimately, proved excessively burdensome and had to be revised.

The adjustment programme began satisfactorily. From 2009 to 2011, Greece saw through one of the swiftest and sharpest of fiscal consolidations in recent economic history as it cut its structural fiscal deficit by almost 10 pp of GDP (see Panel 4). But, on the reforms front, implementation fell short owing to the lack of administrative capacity and political will, which contributes to explaining why inflation and the current deficit remained at high levels, despite the prolonged recession. The programme, conceived as a stop-gap so that Greece could carry out the necessary change and restructuring and restore growth, underestimated the economy's dysfunctionalities. Nor did it anticipate the heightening of tensions and the limited scope of the economic recovery at the euro area level. The Greek economy, in short, became immersed in an increasingly deeper recessionary spiral, which made it difficult to meet its fiscal targets and restore market confidence. The crisis took on a social and political dimension which ultimately triggered the fall of the government and the formation of a coalition government.

Doubts grew in the opening months of 2011 over the possibility of Greece being able to return to the markets to raise funding within the envisaged timeframe, and the need to increase the financial assistance was considered. Discussions on this second programme took place against the backdrop of significant political tensions. These ultimately fed through to the markets, given certain countries' insistence on the need to share the costs of the aid with the private sector (PSI). At first, at the summit meeting on 21 July, there was agreement on a "soft" restructuring mechanism based on voluntary private sector participation so as not to compound the difficulties of the Greek banking system and of other European banks. But it soon became apparent that, in order to restore the sustainability of Greek debt, restructuring on a greater scale was needed. In March 2012, a 53.5% haircut was applied to the nominal value of the bonds, tantamount to 78% in terms of current discounted prices, and which was extensive to 95% of Greek debt in private hands.

After the restructuring the second official aid programme was approved, for €130 billion, on top of the first programme, and the consolidation and reform strategy was revised. So as not to make the economic recession more acute, the new programme delays part of the fiscal adjustment outstanding to 2013-2014, and it has entailed a boost to labour market and services reform, which will now be assisted by a technical group of international experts. A sizeable portion of the funds (€50 billion) will be earmarked for the recapitalisation of financial institutions. As a result, Greece is expected to restore positive growth rates as from 2013, and its public debt should fall below 120% of GDP in 2020.

Even so, factors of risk remain. To be able to cut debt to below 120%, Greece will have to persist with what is practically unprecedented fiscal austerity[1], running primary surpluses of over 4% to 2020 and beyond (see Panel 5), and an extensive privatisation programme. The restructuring of Greek public debt has involved one of the biggest haircuts applied in recent years, and the empirical evidence available suggests that the bigger this haircut is, the longer it will take private investors' confidence to be re-

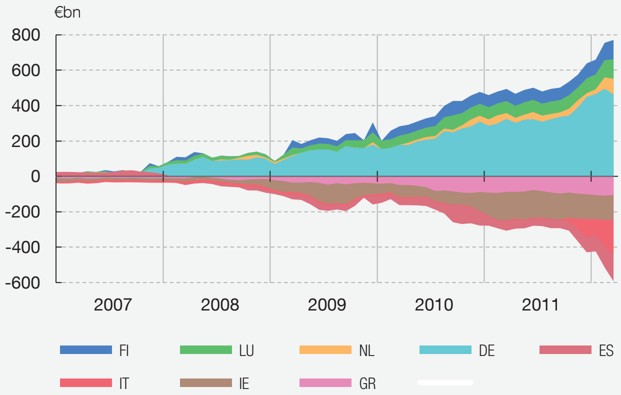
1 *Fiscal consolidations: lessons from past experiences,* OECD Economic Outlook, 2007.

stored.[2] This might be compounded by the fact that a large portion of the debt will be in the hands of official creditors, who may be received as preferential creditors in respect of any new Greek bond. Finally, the difficulties in forming a stable government following the elections on 6 May cast doubt over the degree of commitment to the programme that the government resulting from the election scheduled for June may have. All told, after a period of several years in which the economy has been shackled by uncertainty over fundamental issues affecting the country, including the possibility of a disorderly default or in relation to continuing euro area membership, the rigorous implementation of the new programme by the Greek government should contribute to dispelling uncertainty and offer an opportunity for Greece to make a radical change, enabling it to improve competitiveness, restore growth and ensure the sustainability of its public finances. If this opportunity is seized, investor confidence may be restored more swiftly.

2 J. Cruces and C. Trebesch (2011), *Sovereign default: the price of haircuts,* CESIFO working paper 3604.

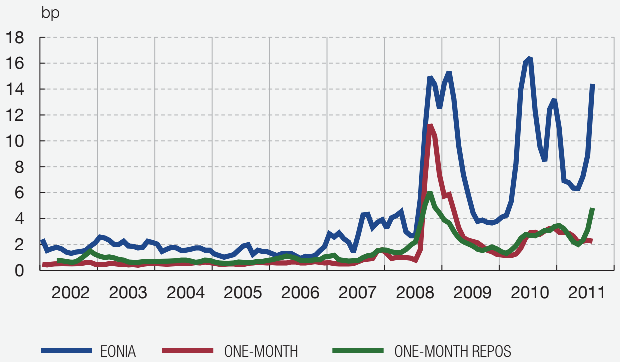
The benefits arising from financial integration are well-known: to smooth the proper channelling of funds from economic agents and countries with saving surpluses towards those posting deficits; and to allow risks to be shared and diversified more efficiently. From the outset, the Monetary Union has played a key role as a catalyst in this integration process in the euro area. Throughout

1 TARGET2 BALANCES OF NCBs IN THE EUROSYSTEM

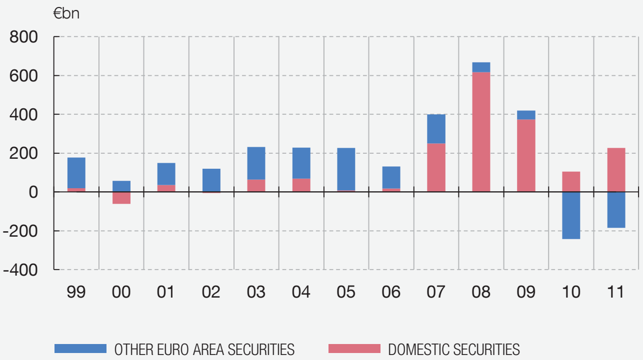


2 PERCENTAGE OF LOANS GRANTED BY CREDIT INSTITUTIONS TO NATIONAL SECTORS RELATIVE TO THE EURO AREA TOTAL

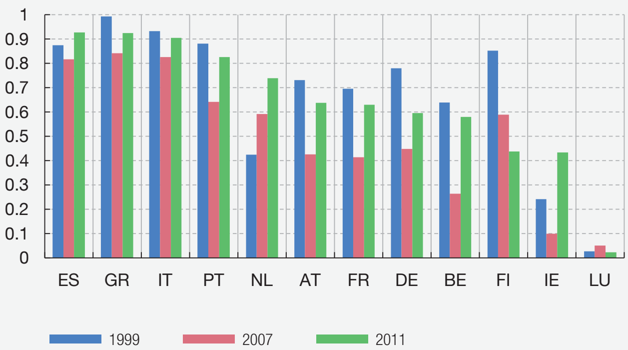
3 STANDARD DEVIATION BY COUNTRY OF INTERBANK INTEREST RATES (61-day moving average)



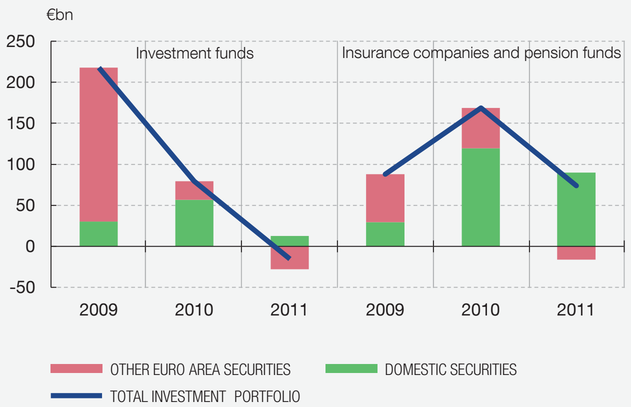
4 NET FLOWS OF FIXED-INCOME SECURITIES HELD BY CREDIT INSTITUTIONS



5 INDICATOR OF HOME BIAS IN CREDIT INSTITUTIONS' FIXED-INCOME PORTFOLIOS (a)



6 NET FLOWS OF SECURITIES IN INSTITUTIONAL INVESTORS' PORTFOLIOS



SOURCES: ECB and NCBs.

a The indicator of home bias in credit institutions' fixed-income portfolios has been calculated as 1 minus the ratio of the proportion of other euro area countries' securities in monetary financial institutions' fixed-income portfolios and the relative size of the other euro area countries' fixed-income issues to the euro area total. Values for the indicator close to 1 evidence a high presence of domestic securities in credit institutions' portfolios (high home bias), and values close to zero denote sizeable holdings of non-domestic securities (low home bias).

this period, headway in this field has given rise to an increase in cross-border financial flows within the area, and in the volumes of foreign assets and liabilities accumulated by euro area countries.

However, the crisis that began in 2007 has interrupted the trajectory of European financial integration in a setting in which, at the international level, ongoing globalisation has also been severely affected. The mid-2011 heightening of tensions on the sovereign debt markets has slowed cross-border financial activity among euro area countries and has given rise to the segmentation and, indeed, renationalisation of certain markets. One of the consequences of this interruption in private cross-border payment and revenue flows within the euro area has been the need for the Eurosystem to act as an intermediary, a role previously performed by the interbank market. The reflection of this has been a sizeable build-up in NCB debit and credit balances with the ECB in TARGET2 (see Panel 1). This return by investors to domestic financial markets has highlighted some of the weaknesses of the EU's financial and institutional architecture.

One usual measure of financial integration is the so-called "home bias", which translates into the presence, in investor portfolios, of a higher relative volume of domestic as opposed to foreign assets than would be suggested by international portfolio diversification models. French and Poterba (1991), in *Investor Diversification and International Equity Markets,* document this phenomenon. Nonetheless, during the 1990s and the opening years of the current millennium, there had been a reduction in home bias both in bank balance sheets and in the balance sheet of OECD countries' institutional sectors, most especially euro area countries.

The financial crisis has brought to a halt and, indeed, reversed this dynamic of the past two decades, and the first signs of an increase in the relative weight of domestic assets were already evident in 2007. One of the markets where this development has been most patent is the interbank market. After a long period of decline, the proportion of financing negotiated with domestic credit institutions increased in just one year from 65% to a figure above 70% in 2008, a rise which strengthened further in the second half of 2011, following the stepping up of sovereign tensions, to close to 75% in early 2012 (see Panel 2). These distortions were also mirrored in interbank market interest rates, affecting the first link of the monetary policy transmission chain (see Panel 3). But, even in the case of bank loans, the mild declining profile seen since the onset of the euro in the proportion of domestic activity – despite the fact that the retail nature of this segment means that these transactions are in the main between lenders and borrowers resident in the same country – came to a halt in 2007 (see Panel 2).

Banks' fixed-income securities portfolios evidenced similar behaviour in this period. After a sizeable increase in debt purchases from issuers with the same nationality in the years 2007 to 2009, the worsening of tensions on sovereign public debt markets caused credit institutions also to begin offloading foreign securities (see Panel 4). Country by country, the increase in home bias in credit institutions' fixed-income portfolios has been across the board since 2007 and, in fact, in some of them – namely the Netherlands, Spain and Ireland – the preference for domestic bonds has even attained levels higher than those recorded prior to the introduction of the euro (see Panel 5). Home bias is higher in the Mediterranean countries, which has reinforced the interaction between sovereign risk and banking risk (see Box 1.1). However, the increase in the presence of domestic bonds has been more pronounced in the countries less affected by sovereign tensions, which may reflect the greater credit risk perceived in bonds issued by other States as a consequence of the sovereign debt crisis.

Although the information available is more limited, this same development is seen in institutional investors' portfolios. Thus, in 2011 the presence of euro area cross-border assets has diminished both in investment funds and in insurance and pension funds. While the flows of both have been significantly reduced in 2011, the breakdown of between domestic and other euro area assets shows a sizeable disinvestment in non-domestic securities (see Panel 6).

Finally, it should be stressed that some weaknesses in the euro area's institutional framework have tended to amplify the effects of the crisis on the area's financial stability and its cross-border financial activity. The imperfect harmonisation at the European level of banking regulation and supervision, and the virtual absence of a macroprudential dimension to both hampered the detection of vulnerabilities before the crisis and, once the crisis was in train, posed an obstacle to efficient crisis management, contributing to the fragmentation and indeed the re-nationalisation of certain market segments. In response to these weaknesses, the EU has launched a series of reforms aimed at improving coordination in financial regulation and supervision both at the macro- and microprudential levels. It has also promoted measures geared to strengthening banks' resilience, improving infrastructures and advancing harmonisation at the European level. Nonetheless, it is vital that euro area countries should make headway in resolving the limitations that the existing and eminently national frameworks for financial crisis-management and resolution evidence in the context of monetary union.

Since 2008 Spain's economy has been mired in a severe downturn, which has prompted a significant rise in the number of business closures. Based on available business demography data for Spain[1], it is estimated that during the period 2008-10[2], in net terms (start-ups minus closures) some 65,000 businesses, on average, closed each year. This contrasts with an average annual net increase of almost 120,000 businesses over the period 2002-07[3]. Admittedly, business start-ups and closures are part and parcel of the developments in any economic system, in which progress is made by reallocating resources from inefficient firms to more competitive projects. But this virtuous cycle can become distorted if viable business initiatives ultimately succumb to external factors. That would adversely affect physical and human capital and, therefore, the economy's medium and long-term growth potential.

The about-turn in new business creation is the consequence of both the fall in the number of new projects and, more particularly, the rise in the rate of business closures. Thus, while the number of business closures averaged 270,000 per year during the period 2002-07, in 2008-10 this figure rose to 391,000. An analysis of the distribution of business closures by size and sector of activity (see accompanying table) reveals a notable increase in the number of closures of businesses with between 1 and 9 employees. As for sectors of the economy, during the crisis all of them have recorded business closure rates higher than in previous years, with a marked increase in the construction sector, where 16% of pre-existing businesses have closed, and the hotel and restaurant sector, where the number of closures has risen to 14%. However, a comparison with other EU countries (Germany, France, Italy, Portugal and the United Kingdom), using Eurostat data available only to 2009, shows that the increase in business closures in Spain during the economic crisis has been similar to that observed in other economies (see Panel 1).

With available business demography data, it is also possible to analyse the impact of business closures on employment developments. Based on Eurostat figures, Spain was the European economy where the number of persons employed across all active businesses most declined during the crisis. In 2009 numbers fell by around 6%, compared with 2.1% in Italy, 2.6% in Germany and 3.6% in Portugal, while the United Kingdom recorded a slight increase of 0.3%. In the case of the Spanish economy, the negative contribution of business closures to job destruction was very significant, at around 4 pp, and accounted for just over 60% of the fall in overall employment. This contribution, exceeded only by the negative contribution of business closures in Portugal, was much larger than that in the rest of Europe's economies.

For a better understanding of this phenomenon, the main determinants of business closures are analysed below using data drawn

1 The reference statistic for Spain for the business census analysis is the information provided by INE via the Central Business Directory (DIRCE), which draws mainly on fiscal information. International comparisons are based on data made available by Eurostat, following an internal data editing process which makes registration and de-registration data supplied by individual countries comparable.
2 Last year for which data is available.
3 This figure includes both the self-employed and mercantile companies.

SPAIN: BUSINESS CLOSURES. DISTRIBUTION BY SECTOR (a)

	Total		Without employees		1-9 employees		10 or more employees	
SECTOR	2002-2007	2008-2010	2002-2007	2008-2010	2002-2007	2008-2010	2002-2007	2008-2010
TOTAL	**8.8**	**11.7**	**11.3**	**13.5**	**6.6**	**10.5**	**2.6**	**2.7**
Manufacturing	7.5	9.1	12.8	14.6	6.2	7.8	2.1	1.9
Mining/extraction/quarrying	5.5	6.1	11.0	11.4	4.8	6.2	1.5	0.4
Energy and recycling	3.1	5.2	3.7	5.4	2.8	5.8	2.5	1.5
Construction	9.9	16.4	13.0	17.6	7.9	16.5	3.9	5.3
Distribution and sale of vehicles	9.3	10.7	12.5	13.9	6.4	8.1	1.7	1.5
Real estate services	6.4	11.8	8.1	9.9	4.4	15.1	1.8	3.5
Transport	6.7	8.5	7.8	9.7	5.2	7.5	1.6	1.5
Hotels and restaurants	12.8	14.1	16.5	17.7	10.4	12.2	4.3	3.1
Post and telecommunications	10.7	12.7	14.0	16.8	9.4	9.2	3.5	1.8
Financial services	8.8	10.5	11.0	12.7	4.3	6.2	2.1	2.0
Other market services	7.7	10.5	9.3	11.0	5.1	10.1	2.7	2.3
Non-market services	7.8	10.4	10.5	12.4	5.3	9.2	2.4	2.7

SOURCE: DIRCE (NACE-93 until 2007; NACE Rev. 2 since 2008).

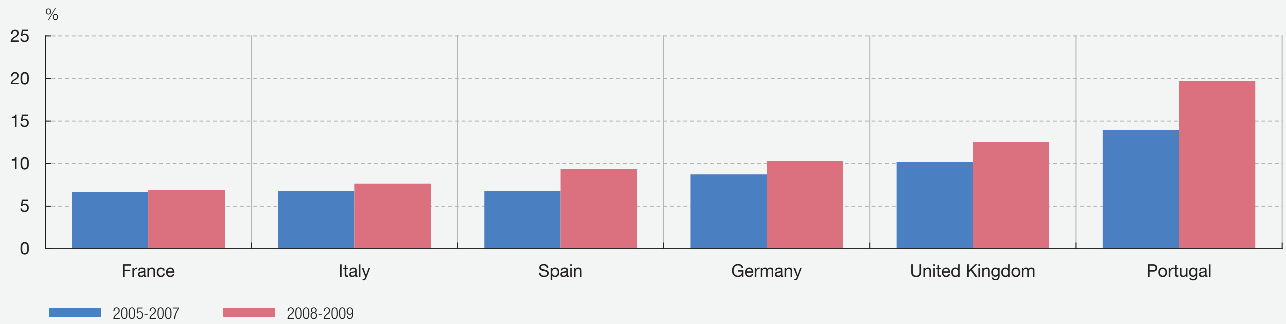
a Percentage of total companies from previous year. Average for the period.

from the Banco de España's Central Balance Sheet Data Office-Mercantile Registers[4] and statistical information on business closures provided by the DIRCE (the latter relating solely to companies[5]). Furthermore, a multivariate probit model is estimated, in which the dependent variable is a dummy which takes a value of 1 if the business exits the market between 2008 and 2010 and a value of 0 if it does not. Two sets of potential explanatory variables are identified. First, specific "structural" business characteristics, such as company size, age, export activity and recourse to temporary employment, are computed and their value taken as constant and equal to the value in the pre-crisis period (2006-07). The second set of variables, which are more cyclical in nature and whose values can therefore change during the crisis period[6], includes the ratio of indebtedness[7], the financial burden[8], change in profit for the year, a proxy for the degree of company wage flexibility/rigidity[9] and, lastly, the average customer payment cycle, a variable which aims to capture the influence of late or non-payment of invoices on the probability of business closure[10].

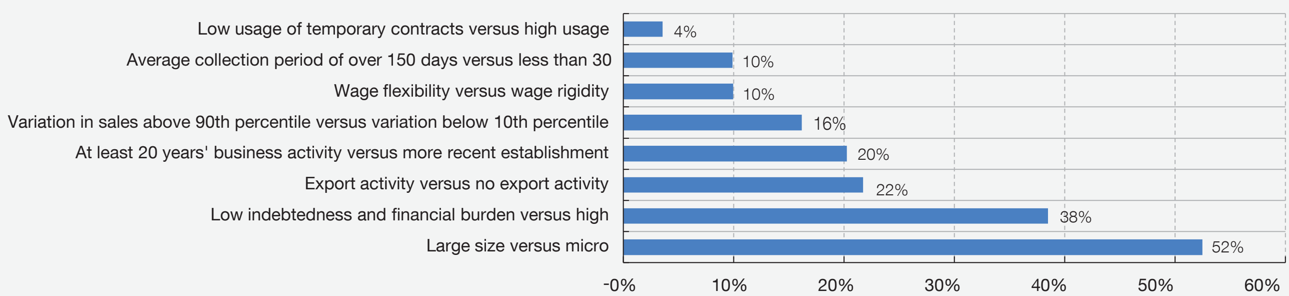
The results reveal that one of the major determinants of business closure is size (see Panel 2). More specifically, a business that had fewer than 10 employees when the crisis started has a 50% higher probability of closure than an identical, but larger[11], business. Nevertheless, the importance of this factor diminishes with age (micro-businesses with over 20 years of activity in

4 Only firms incorporated as mercantile companies are required to file their accounts with the mercantile registers. No information is therefore available for sole proprietorships.
5 A sample was taken of businesses active in the period 2006-07 and for which information was available on variables traditionally considered to be relevant in the empirical literature. Data editing left over 140,000 companies, with around 210,000 observations for the analysis.
6 Although these variables lag by one period (or two) to avoid problems of endogeneity wherever possible, it being assumed therefore that they are pre-determined once the business ceases to exist.
7 Defined as the interest-bearing borrowing of a business relative to its net assets.
8 Percentage of financial costs relative to the sum of gross operating profit and financial revenue.
9 Defined as the difference between the variation in a company's wages relative to the sector average.
10 Also included are control variables for the sector of activity, region and year of observation.
11 Closure probabilities are compared for businesses operating in the same sector, region and year, assuming that the value of the remaining variables is equal to the average across the distribution.

1 BUSINESS CLOSURE RATES (a)



2 SIGNIFICANCE OF THE DETERMINANTS OF THE PROBABILITY OF BUSINESS CLOSURES DURING THE CRISIS (b)



SOURCES: Eurostat and Banco de España.

a Closures as % of total business.
b Comparison of businesses operating in same sector, region, year and value of rest of variables.

2007 have a 20% lower probability of closure than a business facing the crisis after one year of activity), export activity (a 22% lower probability of closure) and proportion of temporary staff (4% lower in the case of businesses with a temporary employment ratio in the tenth percentile of distribution vis-à-vis businesses with a ratio in the 90th percentile. The analysis also shows the importance of financial position: a business with a ratio of indebtedness and a financial burden below the tenth percentile has almost 40% less risk of closure than a business at the opposite end of the distribution. Additionally, the late or non-payment of invoices has also been identified as one of the main determinants of business closures in Spain in recent times. Thus, a small business with an average customer collection period exceeding 150 days will have a 10% higher probability of closure than a business of the same characteristics but with a collection period of less than 30 days. Moreover, the impact of the delay in customer payment diminishes significantly as the size of the business increases[12].

In conclusion, based on the business demography statistic, the impact of business closures during the current economic crisis in Spain has increased in terms of the destruction of the productive base and job losses. Business closures have been especially pronounced in construction sector-related activities, as well as among sole proprietorships and micro-businesses. Furthermore, an analysis of individual data on business closures identifies specific variables which increase the probability of closure, such as small size, low export capacity, wage rigidity, high level of indebtedness and long customer collection period.

12 The combined effect of size and late or non-payment of invoices is considerable due to the extent of the interplay between both variables. Thus, a small business with a payment cycle of more than 150 days is around 80% more likely to close than a large business with the same customer payment cycle.

According to estimates for different countries, the ratio between changes in the rates of unemployment and GDP, widely referred to as the "Okun coefficient", usually averages around -0.3, i.e a 1 pp fall in GDP tends to cause a 0.3 pp increase in unemployment. Notwithstanding, in Spain, between 2008 Q2 and end-2011, unemployment rose by 3 pp for each percentage point of cumulative decline in GDP – the largest relative increase in unemployment observed in advanced economies[1].

The top panel of the accompanying chart below shows changes in the unemployment rate and GDP growth during both the current and early-1990s crises, the starting point being the final quarter of the expansive cycle prior to both recessions. As can be seen, the latest recession has had a significant effect on the unemployment rate, although the crisis is proving to be both deeper and longer than the previous recession. The behaviour over time of Okun's coefficient can be analysed by estimating the ratio of the unemployment rate (u) to GDP growth as follows:

$$\Delta u_t = \alpha - \beta_i \Delta GDP_{t-1} + \varepsilon_t$$

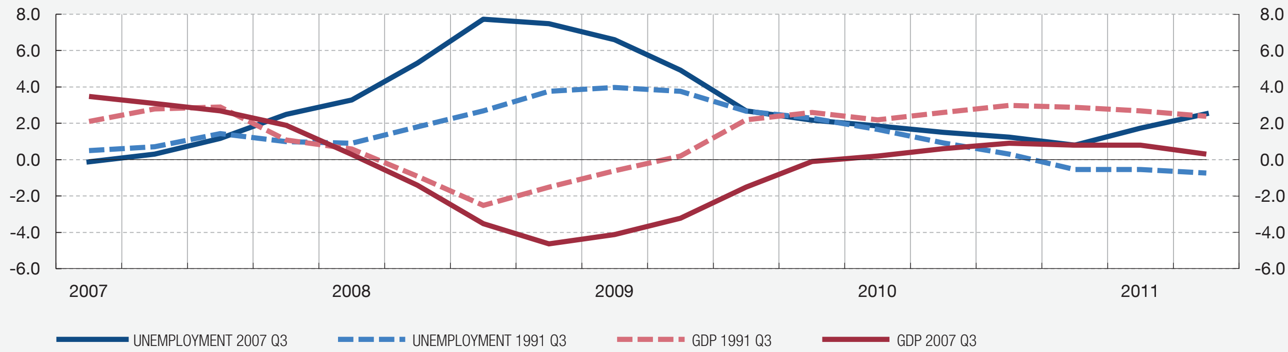
The bottom left panel of the chart shows the outcome of the estimation using a recursive procedure which estimates an average value for parameter β for every period. The recession in the early 1990s saw an initial increase in the absolute value of this coefficient. Its pace in fact intensified in the subsequent period of expansion, in which strong job creation brought about a significant reduction in the high level of unemployment. As for the more recent period, since 2008 the elasticity of unemployment to changes in GDP has also been greater.

A time-variable Okun coefficient can also be estimated using a linear model, assuming a random walk, or a model allowing the

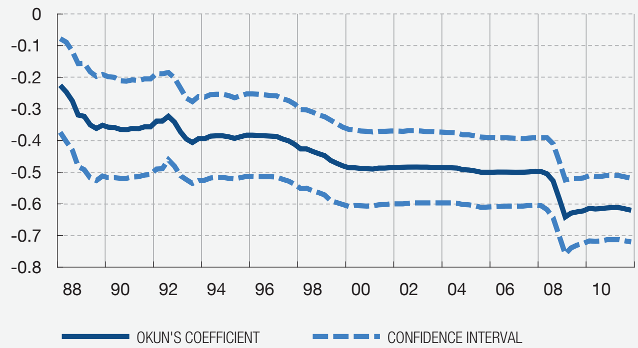
1 For recent country estimates of this coefficient in a number of countries, see *World Economic Outlook* (2010), IMF, April.

UNEMPLOYMENT RATE AND GDP GROWTH IN THE SPANISH ECONOMY

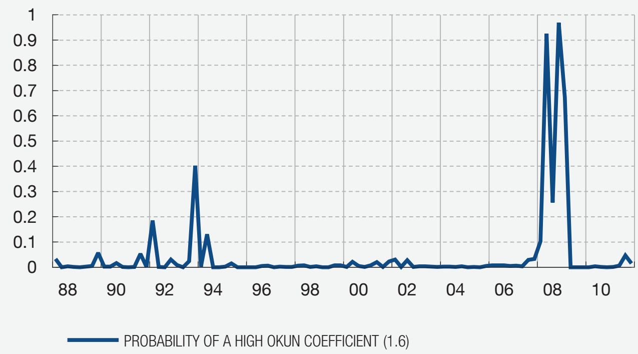
UNEMPLOYMENT RATE AND GDP GROWTH DURING THE LAST TWO RECESSIONS



RECURSIVE ESTIMATION OF OKUN'S LAW



ESTIMATE OF A MARKOV PROCESS WITH TWO POSSIBLE OKUN COEFFICIENTS



SOURCES: INE and Banco de España.

existence of two possible states, which follow a Markov process, each with a different value for Okun's coefficient. The outcomes obtained using the two approaches tend to point to relative stability in Okun's coefficient for the Spanish economy until the start of the current crisis. Thus, in the first case, the estimates indicate a sharp increase in the coefficient from 2008 Q4 to 2009 Q1. In the second case, the two-state model gives Okun coefficients of -0.6 and -1.6, with a very high probability of entering the high-elasticity state after 2008 Q4 (see bottom right panel of the chart).

The determinants of the value of Okun's coefficient can be identified by breaking down the change in the unemployment rate using the following approximation:

$$\Delta u \approx -\Delta \ln Y + \Delta \ln(Y/H) + \Delta \ln(H/N) + \Delta \ln(LF)$$

which simply approximates changes in the unemployment rate (u) taking the sum of the GDP growth rate (Y), with a negative value, and the growth rates of productivity per hour (Y/H), average working hours per employee (H/N) and labour force (LF).

Since 2008, the four addends have contributed to the rise in unemployment (see accompanying table). More specifically, the sharp increase in Okun's coefficient in the recent crisis can be linked to two main factors: the increase in the labour force, which has not been adversely affected by the worsening labour market conditions, and the surge in productivity, partly associated with large-scale shedding of construction sector jobs. Available data suggest that the buoyancy of productivity is not the result of a reallocation of jobs to more productive sectors, but rather of strong productivity gains in each of them, coupled with the pace of the job destruction observed[2]. Moreover, contrary to what has happened in other European countries, not only have working hours per employee not fallen during the crisis in an attempt to soften the impact on employment, they have actually increased slightly.

In short, one of the main characteristics of Spain's labour market is excessive employment volatility and, consequently, as shown above, a high elasticity of unemployment to economic activity. This high elasticity is related, inter alia, to the labour market's institutional framework, which hinders adjustments in wages, hours and other working conditions and, instead, encourages job destruction, mainly of those employed on temporary contracts. Additionally, different empirical results tend to show an increase in Okun's coefficient in the recent crisis to even higher levels from an international perspective, which seems to be related to the severe adjustment in construction sector jobs and the increase in the labour force. Nevertheless, the recent labour market reform is expected to allow working conditions to adapt better to businesses' individual financial situations and, in future, to foster a more balanced adjustment between wages and jobs in the face of adverse shocks.

2 Aggregate productivity growth can be broken down into a first component which captures sectoral weighted productivity growth, a second component which captures the impact of sectoral job reallocation to sectors with different levels of productivity, and a third residual component which captures crossover effects. Calculations for the most recent period suggest the first component accounts for the sharp growth in productivity.

BREAKDOWN OF UNEMPLOYMENT RATE GROWTH

	GDP	Productivity	Hours per employee	Labour force	Unemployment rate (EPA)
1981-1984	-1.1	4.4	-1.6	0.3	1.7
1985-1991	-3.9	2.2	-0.7	1.7	-0.5
1992-1993	0.0	2.6	-0.4	0.6	2.4
1994-2000	-3.9	0.5	-0.2	2.1	-1.2
2001-2007	-3.4	0.6	-0.6	3.0	-0.3
2008	-0.9	0.8	0.3	3.3	3.1
2009	3.7	2.7	0.4	0.9	6.7
2010	0.1	2.3	0.3	-0.1	2.1
2011	-0.7	1.9	0.7	0.0	1.4
2008-2011	0.6	1.9	0.4	1.0	3.3

SOURCE: Quarterly National Accounts and EPA (INE).

THE PRIVATE-SECTOR DELEVERAGING PROCESS IN SPAIN. COMPARISON WITH OTHER COUNTRIES AND LESSONS FROM HISTORICAL EVIDENCE

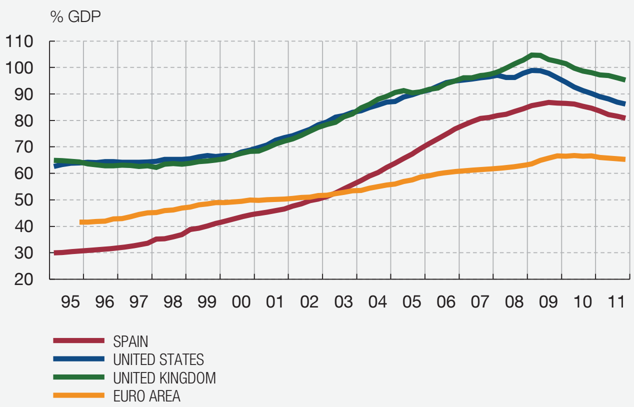
BOX 6.1

The indebtedness of Spanish households and non-financial corporations grew at a very fast pace during the latest upturn (between 1995 and 2007), reaching high levels in relation to GDP both from a historical perspective and in comparison with other advanced economies[1] (see Panels 1 and 2). Although a large part of the increase in these indicators is in response to structural changes in the Spanish economy in that period (belonging to an area of greater macroeconomic stability and a permanent reduction in interest rates), the levels reached were excessive and it is necessary for them to be steered towards more moderate values.

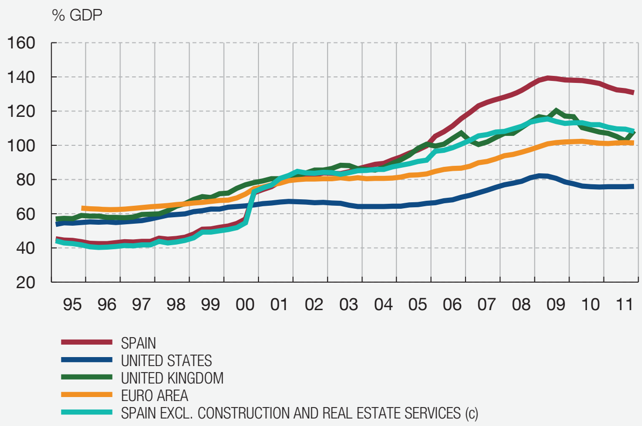
1 In this box the debt ratios are calculated as the quotient between debt and GDP of the quarter in annualised terms and are seasonally adjusted. This approach, which is not usually used, provides a more accurate date for the peak in the series.

The deleveraging process has already begun, albeit not at an even pace to date. Following the outbreak of the crisis, debt ratios continued to climb due to the inertia of the financing flows and the sharp contraction of GDP (the denominator of the ratio). Subsequently, they tended to stabilise and from the second half of 2009, they moved on a downward path. From the peak reached in September 2009 (87% of GDP) until the end of 2011, the household debt ratio has declined by 5.9 pp (see Panel 3). This contraction was the result of the combined effect of a series of factors: 1.9 pp are accounted for by the fact that the volume of new loans has been lower than repayments of outstanding debt (the net flow of operations was negative); 1.9 pp are attributable to inflation (which reduces the real value of previously incurred debts); 0.7 pp are due to real GDP growth (the denominator of the ratio), and a further 1.3 pp, to loan write-offs (loans which have been removed from lenders' assets since they are deemed difficult to collect). As for

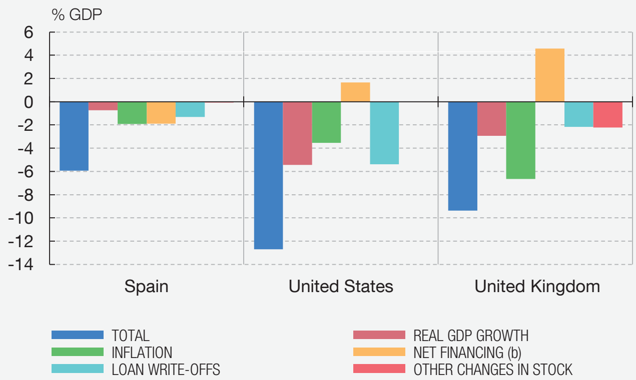
1 HOUSEHOLD DEBT RATIO (a)



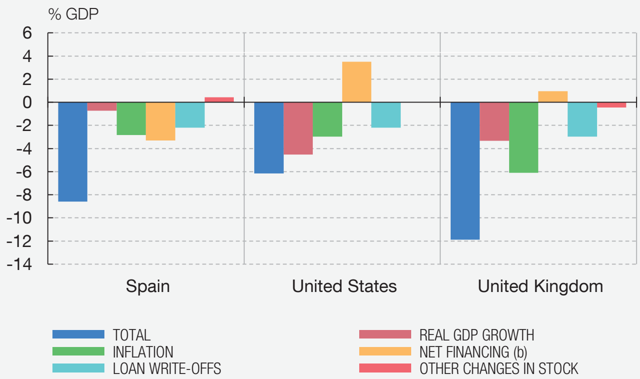
2 NON-FINANCIAL CORPORATIONS' DEBT RATIO (a)



3 CHANGE IN DEBT RATIO FROM PEAK. HOUSEHOLDS (a)



4 CHANGE IN DEBT RATIO FROM PEAK. NON-FINANCIAL CORPORATIONS (a)



SOURCES: ECB, Federal Reserve, Office for National Statistics and Banco de España.

a The debt ratio is obtained as the quotient between debt and GDP of the quarter in annualised terms, and is seasonally adjusted.
b In the case of the United States, it is calculated as the variation in the stock minus loan write-offs.
c Calculated as the quotient between the debt of non-financial corporations, excluding credit for construction and real estate services, and national GDP excluding the gross value added of these branches of activity.

corporations (see Panel 4), the indicator fell to a greater extent (8.6 pp) from the high recorded in the second half of 2009 (139% of GDP). The breakdown by factor shows that, as in the case of households, all the components contributed to the decline in the indicator (except for the heading "other changes in stock"), especially net financing flows and inflation.

In the United States and the United Kingdom, economies in which private debt had also reached high levels, a deleveraging process has also been observed recently which, however, shows some differences compared with that of Spain. In the United States, to date the adjustment has been sharper for households, whose debt ratio also increased substantially during the latest upswing, to a higher level than that in Spain (99% of GDP in 2009 Q1). Thus, in less than three years this sector's debt ratio has fallen back by 13 pp. The two factors which have contributed most to these developments have been the rise in defaults on consumer loans and those for house purchase, and the recovery of activity, especially in 2010 (see Panel 3). Similarly, the notable reduction in net flows of new loans has also contributed to the process, although the accumulated net flow of lending to this sector remained positive, unlike in Spain. The indebtedness of non-financial corporations, which had expanded more moderately during the phase of economic dynamism, to represent 82% of GDP in 2009 Q1 (clearly lower than the value recorded in Spain), experienced a slightly more moderate correction (of around 6 pp), and the ratio had stabilised during 2011, since the recovery of the flows of new operations had been more or less offset by nominal GDP growth (see Panel 4).

In the United Kingdom, where indebtedness had reached very high levels as a percentage of GDP in the two sectors (105% for households in 2009 Q1 and 120% for corporations in September 2009), the adjustment has been sharper to date than in Spain (see Panels 3 and 4), both in the case of households (9 pp) and in the case of non-financial corporations (12 pp). The greater intensity of the deleveraging process is essentially explained by high inflation, which remained persistently above the central bank's target, and the higher real growth of the British economy. Also noteworthy, as in the case of the United States, and unlike Spain, the deleveraging of the private sector is not underpinned by a contraction of financing.

The comparison of the deleveraging process in Spain with that in the United States and the United Kingdom shows that in Spain it is a slower process which turns to a greater degree on a drop in financial flows due, on one hand, to the lower growth of Spanish GDP and, on the other, especially in relation to the UK, to lower inflation. In the case of US households, the high volume of defaults has also played an important role, a phenomenon which may be associated with the poorer quality of the mortgages extended during the years prior to the crisis and to institutional factors which tend to favour an increase in loan write-offs in adverse situations. Logically, households reducing their indebtedness in this way has a negative impact on the profitability of the banking system.

Developments to date in Spain, in any event, are largely in step with the historical patterns of previous deleveraging processes, which show that the latter are relatively protracted (lasting around six years on average) especially if they are accompanied by real estate and banking crises.[2] In the case of a banking crisis, during the early years there is usually an adjustment based to a large degree on negative net financing flows, due to the economy flatlining – a normal characteristic of this initial stage. If the degree of pressure to which Spanish banks have been subject since the beginning of the crisis, as a result of over-expansion and excessive real estate exposure built up during the upswing in the cycle, and commitments in terms of price stability arising from Spain's euro area membership are taken into account, it is difficult to think of an alternative path for the behaviour seen in the debts of the non-financial private sector. The duration of the process of credit contraction will hinge crucially on the economy's capacity to resume growth which does not pivot on recourse to borrowing. As explained in detail in this *Annual Report*, this scenario involves greater momentum of exports which will have to be based on a swift recovery of the competitiveness lost during the previous upturn.

2 See, for example, McKinsey Global Institute (2010), "Debt and deleveraging: The global credit bubble and its economic consequences", and O. Aspachs-Bracons, S. Jódar-Rosell and J. Gual (2011), "Perspectivas de desapalancamiento en España", Documentos de Economía "La Caixa".

The internationalisation of financial flows and, more generally, the recent globalisation of finance broaden the options for diversifying portfolios and financing sources. From this standpoint, a large external debt, particularly if accompanied by a similarly high balance of foreign assets, does not constitute a problem. However, an accumulation of liabilities to the rest of the world raises the exposure to refinancing risk in the international markets. And this, in the current climate of financial strain in the euro area and of distrust towards certain euro area countries, including Spain, is an important factor of vulnerability. In Spain's case, moreover, the amount of claims on non-residents is well below the sum of debts to them. To reduce this element of risk, Spain will have to significantly adjust the balance of its cross-border flows by means of gains in competitiveness, with related benefits in the net international investment position that will only be seen in the medium term.

Against this background, it is pertinent to analyse in detail the short-term refinancing risks to which the Spanish economy is ex-

EXTERNAL DEBT OF THE SPANISH ECONOMY (a)
Balances at December 2011

€bn

	Securities			Deposits (incl. interbank)			Commercial loans and trade credit	Total
	Total	Maturity (b)		Total	Maturity (c)		Total	Total
		2012	Subsequent years		2012	Subsequent years		
General government	247.6	53.7	193.9				34.7	282.3
Central government	213.2	50.4	162.8				4.9	218.1
Regional government	27.4	3.2	24.1				26.5	53.8
Local government	1.0	0.1	1.0				3.4	4.4
FROB and FADE	6.0	0.0	3.8				0.0	6.0
MFIs (excl. Banco de España)	223.0	45.2	177.7	493.5	354.5	139.0		716.4
Of which:								
Covered bonds	*122.6*	*6.7*	*115.9*					*122.6*
Other resident sectors	237.5	28.1	209.4				363.5	601.0
Insurance and pension funds	0.0	0.0	0.0				7.1	7.1
Financial vehicle corporations	112.9	5.6	107.3				0.4	113.3
Financial auxiliaries	0.0	0.0	0.0				0.2	0.2
Other financial intermediaries (d) (e)	114.2	21.7	92.5				1.8	116.0
Of which:								
MFI subsidiaries	*65.3*	*20.5*	*44.8*					*65.3*
Non-financial corporations (e)	9.7	0.8	8.9				173.4	183.1
Intercompany loans (direct investment)							178.4	178.4
Individuals and NPIs	0.8	0.0	0.8				2.3	3.0
TOTAL SECTORS	**708.1**	**127.0**	**581.1**	**493.5**	**354.5**	**139.0**	**398.2**	**1,599.8**

SOURCE: Banco de España.

a Unconsolidated individual data, excluding the Banco de España.
b The difference between the total and the sum of the two specified tranches is due to issues whose maturity could not be de determined. In no case is this difference significant.
c The separation of MFIs' deposits by residual maturity is based on information from return T9, in which loans and deposits are broken down by residual maturity, It should be kept in mind that return T9 refers to total business and, in the case of MFIs, does not separate residents from non-residents,
d Basically subsidiaries of MFIs and of large non-financial corporations.
e Excluding inter-company loans constituting direct investment.

posed. Assessing them requires a knowledge of the total volume of debt to the rest of the world, which at end-2011 amounted to €1,600 bn excluding the Banco de España (149% of GDP),[1] and of the nature of this debt. In this respect, the accompanying table breaks down this debt by instrument, sector and, where possible, maturity. Thus, for example, it can be seen that, of the €708 bn of external debt in the form of securities, less than one-fifth (€127 bn) matures in 2012. It is true that non-residents can sell on the market the securities maturing after 2012, but this does not represent an immediate reduction of the funds available to Spanish issuers, although it may cause a fall in price and, consequently, a higher subsequent issuance cost.

Most of the other short-term debt consisted of deposits received by Spanish MFIs, amounting to €354 bn. MFIs, however, also had €149 bn of short-term deposits with non-resident institutions, so the net amount to be refinanced in 2012 by the sector as a whole decreases to €205 bn. Also, two-thirds of these transactions were collateralised interbank transactions which, although not risk-free, are less exposed to refinancing problems, particularly since Spanish institutions began to operate on a large scale in the repo market through central counterparty clearing houses. Moreover, €103 bn of the uncollateralised portion related to Spanish branches and subsidiaries of foreign banks, which are naturally funded mainly by their parents. Consequently, funding risks would be concentrated mainly in the uncollateralised net position of Spanish banks, which amounted to €20 bn at end-2011.

1 This figure is the amount of debt claims, which is lower than the total financial liabilities to the rest of the world (€2,201 bn) because a portion of these consists of equity claims (mainly foreign investment in the capital of Spanish firms).

Finally, in the case of commercial loans and trade credit from non-residents to Spanish entities (€398 bn in total), the accompanying table shows that approximately half of it related to transactions between companies of the same group, the roll-over of which can be expected to be less influenced by the current widespread climate of uncertainty.

Having said all this, an analysis of short-term refinancing risks should also take into account the possible existence of mitigating factors. In this respect it should first be noted that resident agents (excluding the Banco de España) had a balance of €258 bn of portfolio investments abroad. Thus, if difficulties were to arise in financing the Spanish economy, there would be some leeway for sectors in need of funds to raise them, partly, from those sectors that have invested their savings in foreign securities, as has commonly occurred in the last four years, over which the stock of foreign portfolio investment has decreased by 40%. Similarly, the notable rise in recourse by resident MFIs to the Eurosystem in the opening months of 2012 has provided them with a buffer to help face possible roll-over difficulties in their own or other domestic sectors over the next three years.

These alternative means of financing are not, however, unlimited and their use entails costs. External and domestic portfolios are not perfect substitutes for each other. Furthermore, this buffer can only be used temporarily, since as residents close out their external positions, it leaves progressively less leeway to keep resorting in the future to this source of funding to meet the economy's borrowing requirements. Similarly, the greater recourse to the Eurosystem is not sustainable and a significant reduction in the level of external debt through gains in competitiveness will be a lengthy process. Therefore, in the short term it is crucial to persevere with action to rebuild the confidence of foreign investors in the Spanish economy, so as to restore normal financing flows with the rest of the world.

ANNUAL ACCOUNTS OF THE BANCO DE ESPAÑA 2011

1 INTRODUCTION

The annual accounts of the Banco de España ("the Bank") as established by Article 29.1 of its internal rules, approved by a Resolution of the Governing Council of 28 March 2000 (Official State Gazette (BOE) of 6 April 2000), comprise the balance sheet, the profit and loss account and the notes on the accounts. The accounts have been prepared in accordance with the internal accounting rules and principles of the Banco de España. These rules and principles are based on the accounting framework established for national central banks (NCBs) of the European System of Central Banks (ESCB)[1] pursuant to Article 26.4 of the Statute of the ESCB on standardisation of accounting and reporting procedures relating to operations undertaken by NCBs. In the cases not regulated by Eurosystem accounting legislation, the Banco de España applies its internal policies based on 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 Economic Affairs and Competitiveness, 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.g) of the aforementioned Law, is responsible for preparing the Bank's annual accounts.

Unless otherwise indicated, the figures are expressed in millions of euro. Those relating to 2010 are presented solely for comparison with 2011. 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 2011. Section 2 includes the balance sheet and profit and loss account at 31 December 2011; Section 3 contains the notes on the accounts, with the accounting policies that have served as a framework for their preparation, the explanatory notes on the most important aspects of the balance sheet and profit and loss account, and the changes in capital, reserves, provisions and revaluation accounts; and Section 4, in compliance with Article 4.2 of the Law of Autonomy, details the contributions made to the Deposit Guarantee Fund 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, along with the estimated amount.

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.

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1 Guideline of the European Central Bank of 11 November 2010 on the legal framework for accounting and financial reporting in the ESCB (ECB/2010/20), as amended.

BALANCE SHEET OF THE BANCO DE ESPAÑA AS AT 31 DECEMBER 2011

EUR m

	Note number	2011	2010
ASSETS			
1 Gold and gold receivables	**1**	**11,017.18**	**9,555.49**
2 Claims on non-euro area residents denominated in foreign currency		**25,019.85**	**14,040.29**
2.1 Receivables from the IFM	2	5,803.75	4,782.17
2.2 Balances with banks and security investments, external loans and other external assets	3	19,216.10	9,258.12
3 Claims on euro area residents denominated in foreign currency	**4**	**4,250.73**	**0.06**
4 Claims on non-euro area residents denominated in euro		**844.31**	**907.25**
4.1 Balances with banks, securities investments and loans	5	844.31	907.25
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**	**168,196.45**	**61,550.47**
5.1 Main refinancing operations		11,422.10	20,285.31
5.2 Longer-term refinancing operations		156,677.80	39,662.77
5.3 Fine-tuning reverse operations		—	1,585.00
5.4 Structural reverse operations		—	—
5.5 Marginal lending facility		—	—
5.6 Credits related to margin calls		96.55	17.39
6 Other claims on euro area credit institutions denominated in euro		**2.74**	**2.04**
7 Securities of euro area residents denominated in euro	**7**	**106,385.64**	**87,827.96**
7.1 Securities held for monetary policy purposes		31,080.11	13,906.71
7.2 Other securities		75,305.53	73,921.24
8 General government debt denominated in euro	**8**	**3,498.51**	**4,081.98**
9 Intra-Eurosystem claims	**9**	**32,177.68**	**20,945.82**
9.1 Participating interest in ECB		940.10	801.70
9.2 Claims equivalent to the transfer of foreign reserves		4,783.65	4,783.65
9.4 Net claims related to the allocation of euro banknotes within the Eurosystem		26,453.93	15,360.48
9.5 Other claims within the Eurosystem (net)		—	—
10 Items in course of settlement		**1.29**	**1.06**
11 Other assets		**4,172.85**	**3,708.73**
11.2 Tangible and intangible fixed assets	10	268.51	254.61
11.3 Other financial assets	11	46.76	47.18
11.4 Off-balance sheet instruments revaluation differences	12	—	—
11.5 Accruals and prepaid expenses	13	2,439.70	1,891.39
11.6 Sundry	14	1,417.88	1,515.55
TOTAL ASSETS		**355,567.23**	**202,621.16**

BALANCE SHEET OF THE BANCO DE ESPAÑA AS AT 31 DECEMBER 2011 (cont'd)

EUR m

	Note number	2011	2010
LIABILITIES			
1 Banknotes in circulation	**15**	**97,024.85**	**91,917.98**
2 Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	**16**	**50,933.71**	**26,964.03**
2.1 Current accounts (covering the minimum reserve system)		14,561.25	19,950.00
2.2 Deposit facility		33,335.00	6,997.50
2.3 Fixed-term deposits		3,000.00	—
2.4 Fine-tuning reverse operations		—	—
2.5 Deposits related to margin calls		37.46	16.53
3 Other liabilities to euro area credit institutions denominated in euro		**0.02**	**0.14**
5 Liabilites to other euro area residents denominated in euro		**5,570.05**	**9,488.74**
5.1 General government	17	5,425.69	9,336.63
5.2 Other liabilities	18	144.35	152.11
6 Liabilities to non-euro area residents denominated in euro	**19**	**380.75**	**400.15**
7 Liabilities to euro area residents denominated in foreign currency		**1.08**	**0.93**
8 Liabilities to non-euro area residents denominated in foreign currency		**0.78**	**0.76**
8.1 Deposits, balances and other liabilities		0.78	0.76
8.2 Liabilities arising from the credit facility under ERM II		—	—
9 Counterpart of special drawing rights allocated by the IMF	**20**	**3,355.46**	**3,272.05**
10 Intra-Eurosystem liabilities	**21**	**174,826.42**	**50,864.34**
10.2 Liabilities related to promissory notes backing the issuance of ECB debt certificates		—	—
10.3 Net liabilities related to the allocation of euro banknotes within the Eurosystem		—	—
10.4 Other liabilities within the Eurosystem (net)		174,826.42	50,864.34
11 Items in course of settlement	**22**	**240.47**	**138.39**
12 Other liabilities		**506.24**	**300.24**
12.1 Off-balance-sheet instruments revaluation differences	23	110.92	30.43
12.2 Accruals and income collected in advance	24	161.00	80.96
12.3 Sundry	25	234.32	188.84
13 Provisions	**26**	**6,365.20**	**5,478.81**
14 Revaluation accounts	**27**	**12,012.07**	**9,274.59**
15 Capital and reserves		**1,950.00**	**1,950.00**
15.1 Capital	28	1,000.00	1,000.00
15.2 Reserves	29	950.00	950.00
16 Profit for the year	**30**	**2,400.13**	**2,570.00**
TOTAL LIABILITIES		**355,567.23**	**202,621.16**

PROFIT AND LOSS ACCOUNT OF THE BANCO DE ESPAÑA FOR THE YEAR ENDING 31 DECEMBER 2011

EUR m

		Note number	2011	2010
1	Interest income	1	5,273.93	4,450.57
2	Interest expense	2	1,341.45	1,040.39
3	**Net interest income (1 – 2)**		**3,932.49**	**3,410.18**
4	Realised gains/losses arising from financial operations	3	101.29	366.04
5	Write-downs on financial assets and positions	4	467.61	793.89
6	Transfer to/from provisions for foreign exchange rate and price risks	5	-1,081.34	-407.96
7	**Net result of financial operations, write-downs and risk provisions (4 – 5 + 6)**		**-1,447.66**	**-835.81**
8	Fees and commissions income		17.57	20.07
9	Fees and commissions expense		10.68	11.12
10	**Net income from fees and commissions (8 – 9)**	**6**	**6.89**	**8.95**
11	Income from equity shares and participating interests	7	109.64	191.04
12	Net result of pooling of monetary income	8	211.05	253.47
13	Other income and losses	9	40.23	-11.56
14	**TOTAL NET INCOME (3 + 7 + 10 + 11 + 12 + 13)**		**2,852.63**	**3,016.27**
15	Staff costs	10	230.90	228.40
16	Administrative expenses	11	116.61	117.83
17	Depreciation of tangible and intangible fixed assets	12	31.86	27.34
18	Banknote production services	13	54.71	61.71
19	Other expenses		2.89	3.27
20	**TOTAL OPERATING EXPENSES (15 + 16 + 17 + 18 + 19)**		**436.97**	**438.54**
21	Transfers and additions to other funds and provisions	14	15.53	7.73
22	**PROFIT FOR THE YEAR (14 – 20 – 21)**	**15**	**2,400.13**	**2,570.00**

Countersigned by
The Governor,

MIGUEL FERNÁNDEZ ORDÓÑEZ

The Comptroller,

JOSÉ MIGUEL GARCÍA HERNANDO

3 NOTES ON THE ACCOUNTS

3.1 Accounting policies

1 BASIC PRINCIPLES

The annual accounts of the Banco de España present fairly its net worth, financial and economic position. They have been drawn up in accordance with the following accounting principles: prudence, recognition of post-balance-sheet events, going concern, the accruals principle, consistency and comparability, no offset, matching of revenues and expenses, and materiality. These principles conform to those set out in the accounting guides and instructions of the ECB.

2 BASIS OF ACCOUNTING

The annual accounts have been prepared on a historical cost basis, modified as necessary to include market valuation of trading-book 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, except that forward transactions in foreign currencies are booked at the spot settlement date. If a period end falls between the trade date and the spot settlement date, both spot and forward transactions are 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 cost,[2] 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, gold 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.

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

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

Foreign currencies

Spot purchases or sales of foreign currencies are recorded at the settlement date, and affect the foreign currency position from that date. Gains and losses on the spot sale of

2 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 taken to profit and loss when the asset is sold or, alternatively, they are used to offset unrealised losses.

foreign currencies are similarly considered to be realised from the settlement date. Meanwhile, foreign exchange forward purchase and sale transactions are 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 is also considered to be realised on that date. If a period-end falls between the trade date and the spot settlement date, the transactions have to be recognised at the trade 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.

Accrued interest denominated in foreign currency is recorded on a daily basis, generally 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 and expense accounts.

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

The Banco de España holds three separate securities portfolios: a trading portfolio, a held-to-maturity portfolio and a monetary policy portfolio (set up in accordance with the ECB Governing Council decisions of 7 May 2009 and 4 June 2009, 9 May 2010 and 6 October 2011).

In all three cases, the securities are recorded initially at acquisition cost, 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 value of the security in question. The securities in the held-to-maturity portfolio may not be sold except in exceptional, duly authorised circumstances.

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 (except for unrealised losses at year-end) are reflected in adjustment accounts and credited or debited, respectively, to revaluation and expense accounts. 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. These unrealised losses are considered irreversible. The year-end adjustment was made using the market prices on the last day of the year.

Securities within the held-to-maturity portfolio and the monetary policy portfolio are not subject to any periodic valuation, except for recognition, where applicable, of loss of value due to asset impairment.

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 within each portfolio. These accruals are recorded daily.

The above references to acquisition cost and market prices shall, given that these securities are denominated in foreign currency, be understood to refer to the currency concerned. Accordingly, these amounts will be 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 special 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.

The ECB establishes the conditions applicable to the monetary policy operations conducted by Eurosystem central banks and the need to obtain adequate collateral for them. Also, Article 32.4 of the Statute of the ESCB and of the ECB stipulates that the Governing Council may decide that national central banks shall be indemnified, in exceptional circumstances, for specific losses arising from monetary policy operations undertaken for the ESCB. Indemnification shall be in a form deemed appropriate in the judgment of the Governing Council; these amounts may be offset against the national central banks' monetary income (see Note 26 on the balance sheet and Note 8 on the profit and loss account).

Loans to the State

In accordance with the Guideline of the European Central Bank of 11 November 2010 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2010/20), they are valued at nominal amount (see Notes 8 and 26 on the balance sheet and Note 5 on 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. Unrealised gains or losses will be calculated as the positive or negative difference, respectively, between the underlying book value of the shares and their carrying amount at the Banco de España. Gains will be debited to an adjustment account which, when added to the account representing the investment, will show the aforementioned underlying book value according to the investee's balance sheet, and will be credited to a revaluation account. Losses, which will be considered to be unrecoverable until the shares are sold, will be recorded as a direct reduction of the value of the investment, being debited to the profit and loss account.

Tangible and intangible fixed assets

Fixed assets are defined as those non-financial assets owned by the Bank that are intended to 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.

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, 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, normally for control reasons.

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 or that they are fully depreciated.

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.

Computer applications developed for the Eurosystem as a whole are recognised as fixed assets for the related acquisition cost, which is normally calculated on the basis of the Banco de España's share of the ECB capital key.

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 straight-line 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 2011 were as follows:

	Depreciation /Amortization Rate (%)	Useful life (years)
Buildings and structures	2	50
Renovation work	4	25
Plant in buildings	10	10
Security-related plant in buildings	20	5
Furniture and fittings	10	10
Office machines for the handling of banknotes and coins	10	10
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

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 NCBs, which together comprise the Eurosystem, have issued euro banknotes since 1 January 2002.[3] 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 key.[4]

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 item "Banknotes in circulation" on the liability side of their respective balance sheets.

3 Decision of the European Central Bank of 13 December 2010 on the issue of euro banknotes (ECB/2010/29).
4 The banknote allocation key is that which results from applying 92% to the Eurosystem subscribed capital key.

The difference between the value of the euro banknotes allocated to each NCB in accordance with the banknote allocation key and the value of the euro banknotes that it actually puts into circulation also gives rise to remunerated intra-Eurosystem balances. These claims or liabilities, which incur interest,[5] are disclosed under the 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 were 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 were effected by taking into account the differences between the average value of banknotes in circulation of each NCB in the specified reference period[6] and the average value of banknotes that would have been allocated to them during that period under the ECB's capital key. The adjustments were progressively reduced in annual stages until the end of 2007. However, this mechanism has also been applied in the case of new Member States adopting the euro so as to calculate the amount of compensation corresponding to each of them under the aforementioned calculation method. This adjustment is gradually reduced over a six-year period, being held unchanged during each financial year.

The interest income and expense on intra-Eurosystem balances relating to banknote allocation is cleared through the accounts of the ECB and is disclosed under "Net interest income" in the profit and loss account.

Under the ECB Decision of 25 November 2010 (ECB/2010/24) on the interim distribution to euro area NCBs of the ECB's income on euro banknotes in circulation arising from the 8% of euro banknotes assigned to it and from securities purchased under the Securities Markets Programme, this income belongs to the NCBs and will be allocated in full to them in the financial year in which it accrues. Settlement takes place in January of the following year, in the form of an interim distribution of the income. The Governing Council may decide to reduce ECB income on euro banknotes in circulation by the costs incurred by the ECB in connection with the issue and handling of banknotes. This Decision establishes that the ECB Governing Council shall decide before the end of the financial year whether all or part of the ECB's income arising from securities purchased under the Securities Markets Programme and, if necessary, all or part of the ECB's income on euro banknotes in circulation should be retained to the extent necessary to ensure that the amount of the distributed income does not exceed the ECB's net profit for that year. The ECB Governing Council may also decide to transfer all or part of this income to an ECB provision for foreign exchange rate, interest rate, credit and gold price risks. The amount distributed to NCBs is shown in the profit and loss account item "Income from equity shares and participating interests".

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 TARGET2[7] 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

5 Decision of the ECB of 25 November 2010 on the allocation of monetary income of the national central banks of Member States whose currency is the euro (ECB/2010/23).
6 The reference period taken has a duration of 24 months and it begins 30 months prior to the euro cash changeover date.
7 Trans-European Automated Real-time Gross settlement Express Transfer system.

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 TARGET2 operations, the resulting balance is included as an asset or liability, as appropriate, under the balance sheet 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.

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 for Bank employees is of the defined-contribution type. The Pension Fund of which this Scheme forms part is external and closed-end. Contributions made by the Banco de España on behalf of the employees who, having joined the Bank after 1 February 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.

Provisions

In application of the principle of prudence, the liabilities side of the balance sheet includes provisions approved by the Executive Commission of the Banco de España which are considered necessary to cover adequately, on objective criteria, the risks derived from the financial positions held and other losses of a diverse nature (see Note 26 on the balance sheet).

Off-balance-sheet positions[8]

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.

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

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. Since these futures are denominated in foreign currency, such settlements shall affect the foreign currency position on the day on which they take place.

3 CONSIDERATIONS REGARDING THE ESTIMATES MADE

These annual accounts were prepared using Bank estimates to quantify some of the assets, liabilities, income, expenses, commitments and, in particular, provisions recorded in them (see Note 26 on the balance sheet). As regards monetary policy operations, since they are conducted jointly in the Eurosystem, the estimates made by the European System of Central Banks are also taken into account [see Notes 6 and 7.a) on the balance sheet].

These estimates assume an ongoing slow economic recovery and instability in some debt markets. Although these estimates are based on the best information available at end-2011, future events may require them to be changed in the coming financial years. Any such changes would be made prospectively in accordance with current accounting rules.

4 POST-BALANCE-SHEET EVENTS

Assets, liabilities and the profit and loss account are adjusted on the basis of events taking place between the end of the accounting period and date of preparation of the annual accounts, should those events materially affect the Banco de España's year-end financial position. The events occurring after year-end which do not affect the assets and liabilities at that date do not give rise to adjustments thereto, although if they are material they are disclosed in the notes on the accounts.

3.2 Notes on the balance sheet

1 GOLD AND RECEIVABLES

The Banco de España's gold holdings amount to €11,017.18 million, consisting of 9.054 million troy ounces[9] of fine gold valued at a market price of €1,216.86 per ounce. These holdings did not change during the financial year. The value of these holdings is €1,461.69 million more than in 2010, as a result of the rise in the market price (at end-2010 the price per ounce was €1,055.42). This increase is included in the liability revaluation accounts. The cost of the gold holdings is €850.43 million.

2 CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY.— RECEIVABLES FROM THE IMF

This 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 net financing granted to the IMF. Spain's quota in the IMF was increased on 16 March 2011 from SDR 3,048.90 million to SDR 4,023.40 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 essentially 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 Trust (PRGT) and the bilateral loan agreements between the

9 One troy ounce is equal to 31.1035 grams.

IMF and Spain, these latter currently included in the NAB. For the PRGT, the Banco de España has given a commitment to contribute, through concessional lending to low-income countries, up to SDR 830 million, the amount drawn down at end-2011 being €391.88 million (SDR 330.29 million). The NAB agreements concluded to support the IMF's ability to provide balance of payments assistance to its members were expanded to SDR 6,702.18 from 1 April 2011 and the transactions carried out in 2011 totalled €829.22 million (SDR 698.76 million).

The breakdown in 2010 and 2011 is as follows:

EUR m

Type of asset	2011	2010	Change
Reserve tranche position	1,421.01	692.76	728.25
Special drawing rights (allocation)	3,161.64	3,394.22	-232.58
Other claims on the IMF	1,221.10	695.19	525.91
TOTAL	**5,803.75**	**4,782.17**	**1,021.58**

The overall amount of claims on the IMF increased by €1,021.58 million with respect to the balance at end-2010.

The increase in the reserve tranche position account (€728.25 million) is basically due to the Banco de España's net contributions to the IMF for loans to third countries (Ireland, Greece and Portugal) and to the increase in Spain's quota. Of this increase, €692.92 million related to the net increase in amounts denominated in foreign currencies and €35.32 million to the effect of the change in market foreign exchange rates between the two years.

The decrease of €232.58 million in the special drawing rights (allocation) account was due to the decline in foreign currency (€311.17 million) resulting from the rise in the IMF quota, which was paid in SDRs, and from net effect of loan disposals and repayments. The effect of the year-end market foreign exchange rates accounted for an increase of €78.60 million.

The "Other claims on the IMF" account increased by €525.91 million. This account includes the loans granted under the NAB and under the PRGT programme. The contributions under the former increased substantially due to new transactions with Greece, Ireland and the Dominican Republic (€519.77 million), while the relative weight of the latter (PRGT), decreased because, although new programmes were undertaken (PRGT 19 and 20), they were outweighed by partial repayments (net reduction of €11.58 million). The change of €525.91 million arises from the overall effect of two factors: the increase in foreign currency due to the execution of the two programmes, amounting to €495.56 million (SDR 428.24 million), and the effect of the change in foreign exchange rates between the two years, amounting to €30.36 million.

SDRs are valued at the year-end market rate, calculated by the ECB for all the Eurosystem national central banks, of €1 = SDR 0.842673. The SDR is defined in terms of a basket of currencies. Its value is determined as the weighted sum of the exchange rates of four major currencies: the US dollar, the euro, the yen and the pound sterling. The interest rate, which is updated weekly, remained at an average of 0.40%, with a high of 0.59% and a low of 0.11% 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 item includes current accounts, deposits, debt security investments in the trading and held-to-maturity portfolios and other claims on non-euro area residents denominated in foreign currency. The held-to-maturity portfolio consists of securities with fixed or determinable payments which the Banco de España intends to hold until maturity.

The total amount as at 31 December 2011 was €19,216.10 million, with the following breakdown:

EUR m

Type of asset	2011	2010	Change
Deposits	102.07	142.11	-40.04
Security investments	19,111.20	9,115.69	9,995.51
Trading portfolio	11,364.02	3,712.65	7,651.37
Held-to-maturity portfolio	7,747.17	5,403.04	2,344.13
Other	2.83	0.32	2.51
TOTAL	**19,216.10**	**9,258.12**	**9,957.98**

As at 31 December 2011, 99.97% 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 1.2939).

The increase in the balance of this item (€9,957.98 million) was due to the net effect of the factors listed in the following table:

EUR m

Reason for change	Amount
Net investment	9,402.96
Changes of market exchange rates as at 31 December	608.28
Changes of securities market prices as at 31 December	14.47
Accrued interest receivable	-67.78
Other	0.05
TOTAL	**9,957.98**

4 CLAIMS ON EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY

This balance sheet item may include current accounts, balances with banks and security investments. The balance of €4,250.73 million at 31 December 2011 includes a claim arising from reverse operations with Eurosystem counterparties amounting to €4,250.71 million in connection with the US dollar Term Auction Facility. In mid-2010 and, subsequently, in 2011, the ECB decided to continue the US dollar liquidity providing arrangements (swap line) with the Federal Reserve in response to the resurgence of tensions in US dollar denominated short-term funding on the European markets. Thus US dollars 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 dollar liquidity-providing operations with the Eurosystem counterparties in the form of repos and received euro-denominated securities from them as collateral. These back-to-back swap transactions between the ECB and the Eurosystem NCBs give rise to intra-Eurosystem balances reported under “Other claims within the Eurosystem (net) / Other liabilities within the Eurosystem (net)”.

5 CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN EURO.—BALANCES WITH BANKS, SECURITY INVESTMENTS AND LOANS

Included here is the balance of current accounts at correspondents and trading and held-to-maturity portfolio securities denominated in euro. The held-to-maturity portfolio consists of securities with fixed or determinable payments which the Banco de España intends to hold until maturity.

The breakdown is as follows:

EUR m

Type of asset	2011	2010	Change
Deposits	0.19	0.20	-0.01
Security investments	844.12	907.05	-62.93
Trading portfolio	—	—	—
Held-to-maturity portfolio	844.12	907.05	-62.93
TOTAL	**844.31**	**907.25**	**-62.94**

Of the total of this heading (€844.31 million), most (€844.12 million) relates to fixed-income securities included in the held-to-maturity portfolio, which decreased by €62.93 million with respect to the balance as at 31 December 2010. This portfolio consists of euro-denominated securities issued by international organisations (the European Investment Bank and the Bank for International Settlements) and by non-euro area States. The trading portfolio, as in 2010, had a zero balance at the end of the reporting year.

6 LENDING TO EURO AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS DENOMINATED IN EURO

This item includes the amount of the euro-denominated lending to euro area credit institutions through which monetary policy is implemented. The total amount of these loans in the Eurosystem as a whole is €863,568 million, of which €168,196.45 are included in the balance sheet of the Banco de España. Pursuant to Article 32.4 of the ESCB/ECB Statute, any counterparty risk that may materialise in monetary policy operations must be shared by all Eurosystem central banks in proportion to their share of the subscribed capital of the ECB according to the capital keys in force when this risk materialises (see the provision for counterparty risks in Eurosystem monetary policy operations, in Note 26.- Provisions).

The breakdown by type of transaction is as follows:

EUR m

Type of operation	2011	2010	Change
Main financing operations	11,422.10	20,285.31	-8,863.20
Longer-term refinancing operations	156,677.80	39,662.77	117,015.03
Fine-tuning reverse operations	—	1,585.00	-1,585.00
Structural reverse operations	—	—	—
Marginal lending facility	—	—	—
Credits related to margin calls	96.55	17.39	79.16
TOTAL	**168,196.45**	**61,550.47**	**106,645.98**

Throughout the whole of 2011, against a background of money market tensions in the euro area, the ECB continued to conduct liquidity-providing operations of various maturities to meet the additional liquidity demands of counterparties.

The balance of this item as at 31 December 2011 is 173.3 % higher than that of 2010. However, the average daily balance of the financing granted during the year decreased by 28.4% (€71,064.16 million in 2011, against €99,291.50 million in 2010).

a Main refinancing operations

They are executed through liquidity providing reverse transactions with a weekly frequency and a maturity of one week, normally by means of standard tenders. These operations play a pivotal role in achieving the aims of steering interest rate, managing market liquidity and signalling the monetary policy stance. However, in 2011, continuing the trend initiated in previous years, they were used less than longer-term refinancing operations. In this connection, it should be noted that 37.5 % of annual average financing was extended through them. In 2011 these operations were conducted at fixed rate with allotment of the total amount bid.

The balance of this item at 31 December 2011 was €11,422.10 million (€20,285.31 million at 31 December 2010) and its daily average balance during the year was €26,662.79 million (€12,270.58 million in 2010).

b Longer-term refinancing operations

These operations aim to provide counterparties with additional longer-term refinancing. In 2011 operations were conducted with maturities equal to the reserve maintenance period and with maturities of three, six, twelve and thirty-six months. These operations were conducted at fixed rate with allotment of the total amount bid.

The balance of these operations at end-2011 amounted to €156,677.80 million (93.2% of the total), having increased by €117,015.03 million with respect to the previous year. However, the average balance decreased (from €86,561.06 million in 2010 to €44,141.74 million in 2011), representing 62.1% of overall financing in the year. Most of the increase in the balance of this item took place in the closing days of the year due to the 36-month financing operation on 21 December 2011.

c Fine-tuning reverse operations

The purpose of these operations is to regulate the market liquidity situation and control interest rates, particularly to smooth the effects on interest rates caused by unexpected market fluctuations. Owing to their nature, their frequency is not standardised.

In 2011 one fine-tuning reverse operation took place in the Eurosystem. As a result of it, financing was obtained by Spanish credit institutions. Its end-2011 balance was zero.

d Structural reverse operations

These are reverse open-market transactions through standard tenders to enable the Eurosystem to adjust its structural liquidity position vis-à-vis the financial sector.

The end-2011 balance was zero, as it was at the previous year-end. No structural reverse operations took place during the year.

e Marginal lending facility

Counterparties may use the marginal lending facility to obtain overnight liquidity from national central banks at a pre-specified interest rate against eligible assets. This interest rate is penalised with respect to the intervention rate set in the weekly tenders or in main refinancing operations.

The balance at the end of 2011 was zero. As in 2010, there were few of these operations during the year.

f Credits related to margin calls

Under Eurosystem rules for monetary policy management, all operations providing liquidity to the banking system must be backed by adequate underlying assets accepted by the system as eligible for use as collateral. If, after daily valuation, the market value of the assets used as loan collateral has fallen below the lower trigger point set for each security, the counterparty must provide additional assets or cash (see Note 16 on the balance sheet). If the market value of the underlying assets, following their revaluation, exceeds the amount of the financing obtained from the national central bank plus the variation margin, the counterparty may withdraw an amount of underlying assets equal to that excess (or receive this difference as a cash payment in its account).

In the national central banks that make margin calls by debiting or crediting the accounts of credit institutions, as is the case for the Banco de España, these debits or credits are the balancing entries of the asset-side or liability-side accounts reflecting the changes in these margins. These balance sheet accounts are remunerated at the interest rate applied in main refinancing operations.

As at 31 December 2011 this item had a balance of €96.55 million, up €79.16 million with respect to the previous year.

7 SECURITIES OF EURO AREA RESIDENTS DENOMINATED IN EURO

a Securities held for monetary policy purposes

This item includes the amount of euro-denominated fixed-income securities issued by euro area residents which were acquired by the Banco de España for monetary policy purposes under covered bond purchase programmes[10] and under the securities markets programme.[11] These securities were classified as held-to-maturity (see "Securities" in Section 3.1 "Accounting policies"). The balance of this item at 31 December 2011 was €31,080.11 million and there was no objective evidence that these assets were impaired at year-end. The breakdown is as follows:

EUR m

Monetary Policy Portfolio	2011	2010	Change
Covered bond purchase programme	6,337.86	6,524.01	-186.15
Second covered bond purchase programme	266.01	_	266.01
Securities market programme	24,476.23	7,382.70	17,093.53
TOTAL	**31,080.11**	**13,906.71**	**17,173.40**

The securities purchases under the first covered bond purchase programme were completed in June 2010. The decrease in the balance of this portfolio is due to the redemption of securities and to the premiums and discounts relating thereto which were applied throughout 2011.

On 6 October 2011 the ECB Governing Council announced a second covered bond purchase programme. Under this programme, in November 2011 the European Central Bank and the Eurosystem central banks initiated the purchase of euro-denominated covered bonds issued by euro area residents in order to improve the financing conditions of credit institutions and firms and to encourage banks to maintain and increase lending to their customers. It is expected that these purchases will be completed by the end of October 2012.

Under the securities markets programme established in May 2010, the Eurosystem central banks may purchase public and private euro area debt securities in order to ensure depth and liquidity in those market segments displaying dysfunctional behaviour. The purpose of this programme is to address the poor functioning of securities markets and re-establish an appropriate monetary policy transmission mechanism. The net increase in this item in 2011 was due to the purchases made.

The total amount of the securities acquired by all Eurosystem NCBs under the aforementioned securities markets programme amounted to €194.2 billion, of which €24,476.23

10 Decision of the ECB of 2 July 2009 on the implementation of the covered bond purchase programme (ECB/2009/16) and Decision of the ECB of 3 November 2011 on the implementation of the second covered bond purchase programme (ECB/2011/17).

11 Decision of the ECB of 14 May 2010 establishing a securities markets programme (ECB/2010/5).

million were included in the balance sheet of the Banco de España. Pursuant to Article 32.4 of the ESCB/ECB Statute, any risks that materialise in the securities included in this portfolio must be shared by all Eurosystem central banks in proportion to their share of the subscribed capital of the ECB according to the capital keys in force.

Against this background, the ECB Governing Council considered the impact of the participation of the private sector in the initiative undertaken in 2011 (PSI), which proposed the restructuring of a part of the debt issued by the Hellenic Republic in order to ensure its long-term sustainability. A part of the Banco de España's holdings under the securities markets programme consists of bonds issued by the Hellenic Republic. However, taking into account that the initiative was designed as a voluntary restructuring of debt held by the private sector, no changes are expected in the future flows associated with holdings of these securities. On 31 December 2011 the ECB Governing Council considered that there was no evidence for assuming that the initiative would be unsuccessful and, accordingly, there was no need to record any impairment of these securities at year-end.

b Other securities

This item includes that part of the Bank's trading and held-to-maturity portfolios which consists of euro-denominated fixed-income securities issued by euro area residents that are not held for monetary policy purposes. The held-to-maturity portfolio consists of securities with fixed or determinable payments which the Banco de España intends to hold until maturity. The breakdown of this item is as follows:

EUR m

Security investments	2011	2010	Change
Trading portfolio	40,160.88	33,027.21	7,133.67
Held-to-maturity portfolio	35,144.65	40,894.03	-5,749.38
TOTAL	**75,305.53**	**73,921.24**	**1,384.29**

The balance of this item as at 31 December 2011 was €75,305.53 million, of which 53.3% relate to trading portfolio securities and the remainder (46.7%) to held-to-maturity securities, with no evidence of impairment at year-end.

Overall, these securities increased by €1,384.29 million in 2011. It was, however, trading securities which underwent an increase, of €7,133.67 million, whereas held-to-maturity securities decreased by €5,749.38 million.

Specifically, the changes were for the reasons reflected in the following table:

EUR m

Reason for change	Trading portfolio	Held-to maturity portfolio	Total
Net purchase/amortization of securities	7,120.21	-5,714.92	1,405.29
Unrealised gains at year-end (a)	192.42	—	192.42
Unrealised losses at year-end (a)	-463.14	—	-463.14
Accrued implicit interest	284.18	-34.46	249.72
TOTAL	**7,133.67**	**-5,749.38**	**1,384.29**

a As stated in Section 3.1 "Accounting policies", no periodic valuation is performed on the held-to-maturity portfolio.

This portfolio includes securities issued by general government and by financial institutions in the euro area. 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.

c Post-balance-sheet events

In February 2012 the Eurosystem central banks changed their holdings of Greek sovereign bonds for new securities issued by the Hellenic Republic. The recently received securities have the same financial characteristics as those given up. The new securities are not included in the list of those restructured under the private sector participation initiative.

8 GENERAL GOVERNMENT DEBT DENOMINATED IN EURO

This item includes loans which, by virtue of their respective laws of creation, were granted to the State prior to the entry into force of Law 21/1993 of 29 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, in accordance with transitional provision seven of the aforementioned law. However, on 26 March 2007 an agreement was entered into with the central government 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 all or part of them. Loans repaid early are paid by the Treasury at the cash amount of their market value at the time. A provision has been set up for losses arising from early repayment of these loans (see Note 26 on the balance sheet).

Under that agreement, in 2011 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 collected.

The outstanding nominal balance as at 31 December 2011 of the loans granted to the State amounted to €3,498.51 million, broken down as follows:

EUR m

	2011	2010	Change
Treasury. Law 3/1983 special account	781.01	976.26	-195.25
Treasury. Law 4/1990 special account	2,431.79	2,779.19	-347.40
Treasury. Credits arising from subscription for participating interests, contributions and quotas in international agencies	285.72	326.53	-40.82
TOTAL	**3,498.51**	**4,081.98**	**-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.

9 INTRA-EUROSYSTEM LIABILITIES

This heading includes the amounts of the following items:

EUR m

Type of asset	2011	2010	Change
Participating interest in the ECB	940.10	801.70	138.40
Claims equivalent to the transfer of foreign reserve assets to the ECB	4,783.65	4,783.65	—
Net claims related to the allocation of euro banknotes within the Eurosystem	26,453.93	15,360.48	11,093.45
TOTAL	**32,177.68**	**20,945.82**	**11,231.85**

a Participating interest in the ECB

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 based on each country's share in the total population and gross domestic product of the ESCB countries per data furnished by the European Commission. These subscriptions must be adjusted every five years or whenever new Member States join the European Union, i.e. when their NCBs join the ESCB. Since 1 January 2009 the Banco de España's key for subscription of ECB capital has been 8.3040%.

In 2010 the ECB decided to increase its subscribed capital by €5 billion, from €5,760,652,402.58 to €10,760,652,402.58, with effect from 29 December 2010 and the euro area national central banks agreed to pay their additional capital contributions in three equal annual instalments.[12] The first of these payments took place on 29 December 2010, the second on 28 December 2011 and the remaining instalment will be paid at the end of 2012. With this second payment, the capital disbursed by the Banco de España reached €755.16 million.

As a result of this increase, the subscribed capital and paid-up capital of the national central banks is as follows:

EUR

	Subscribed capital	Paid-up capital as at 31 December 2010	Paid-up capital as at 31 December 2011
Nationale Bank van België/Banque Nationale de Belgique	261,010,384.68	180,157,051.35	220,583,718.02
Deutsche Bundesbank	2,037,777,027.43	1,406,533,694.10	1,722,155,360.77
Eesti Pank (a)	19,261,567.80	722,308.79	16,278,234.47
Central Bank and Financial Services Authority of Ireland	119,518,566.24	82,495,232.91	101,006,899.58
Bank of Greece	211,436,059.06	145,939,392.39	178,687,725.72
Banco de España	893,564,575.51	616,764,575.51	755,164,575.51
Banque de France	1,530,293,899.48	1,056,253,899.48	1,293,273,899.48
Banca d'Italia	1,344,715,688.14	928,162,354.81	1,136,439,021.48
Central Bank of Cyprus	14,731,333.14	10,167,999.81	12,449,666.48
Banque centrale du Luxembourg	18,798,859.75	12,975,526.42	15,887,193.09
Central Bank of Malta	6,800,732.32	4,694,065.65	5,747,398.98
De Nederlandsche Bank	429,156,339.12	296,216,339.12	362,686,339.12
Oesterreichische Nationalbank	208,939,587.70	144,216,254.37	176,577,921.04
Banco de Portugal	188,354,459.65	130,007,792.98	159,181,126.31
Banka Slovenije	35,381,025.10	24,421,025.10	29,901,025.10
Národná banka Slovenska	74,614,363.76	51,501,030.43	63,057,697.10
Suomen Pankki – Finlands Bank	134,927,820.48	93,131,153.81	114,029,487.14
Subtotal for euro area NCBs	**7,529,282,289.35**	**5,184,359,697.03**	**6,363,107,289.36**
Българска народна банка (Bulgarian National Bank)	93,467,026.77	3,505,013.50	3,505,013.50
Česká národní banka	155,728,161.57	5,839,806.06	5,839,806.06
Danmarks Nationalbank	159,634,278.39	5,986,285.44	5,986,285.44
Latvijas Banka	30,527,970.87	1,144,798.91	1,144,798.91
Lietuvos bankas	45,797,336.63	1,717,400.12	1,717,400.12
Magyar Nemzeti Bank	149,099,599.69	5,591,234.99	5,591,234.99
Narodowy Bank Polski	526,776,977.72	19,754,136.66	19,754,136.66
Banca Naţională a României	265,196,278.46	9,944,860.44	9,944,860.44
Sveriges Riksbank	242,997,052.56	9,112,389.47	9,112,389.47
Bank of England	1,562,145,430.59	58,580,453.65	58,580,453.65
Subtotal for non-euro area NCBs	3,231,370,113.23	121,176,379.25	121,176,379.25
TOTAL (b)	**10,760,652,402.58**	**5,305,536,076.26**	**6,484,283,668.61**

a On 1 January 2011 the central bank of Estonia joined the Eurosystem.
b Due to rounding, the subtotals and totals may not equal the sum of the individual figures in the table.

12 Decision of the ECB of 13 December 2010 on the increase of the European Central Bank's capital (ECB/2010/26) and Decision of the ECB of 13 December 2010 on the paying-up of the increase of the European Central Bank's capital by the national central banks of Member States whose currency is the euro (ECB/2010/27).

As regards the Banco de España, the above table shows that its subscribed capital is €893.56 million, equivalent to 8.3040% of the ECB's capital stock. As at 31 December 2011, the capital disbursed by the Banco de España amounted to €755.16 million following the payment made on 28 December 2011.

This item also includes the participating interest in ECB equity. Its balance of €184.94 million at 31 December 2011, as in 2010, is the amount paid in previous years for the Banco de España's participating interest in ECB reserves due to the increase in the Banco de España's share of the ECB capital key. Accordingly, the Banco de España's share in ECB capital is €940.10 million.

b Claims equivalent to the transfer of foreign reserve assets to the ECB

These represent the ECB's debt to the Banco de España arising from the transfer of foreign reserve assets to the ECB. The claims equivalent to the transferred reserves are denominated in euro at a value fixed from the time of their transfer. They are remunerated at the marginal rate for the Eurosystem's main refinancing operations, reduced by 15% to reflect a zero return on the gold component. Their year-end balance of €4,783.65 million is unchanged from the previous year.

c Net claims related to the allocation of euro banknotes within the Eurosystem

This item, the balance of which amounted to €26,453.93 million at end-2011, 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 when there is an overall debit balance (see "Banknotes in circulation" and "Intra-Eurosystem balances" in the section on accounting policies).

The increase with respect to 2010 (€11,093.45 million) was due to the decrease in banknotes put into circulation by the Banco de España in 2011 (-7.8%) and the contrasting rise in the Eurosystem as a whole (growth of 5.8%), which resulted in the aforementioned increase in the balance of these accounts.

d Other claims within the Eurosystem (net)

In accordance with Eurosystem rules, since the accounts making up this item have a net credit balance, this information is presented on the liabilities side of the balance sheet (see Note 21 on the balance sheet).

10 OTHER ASSETS. TANGIBLE AND INTANGIBLE FIXED ASSETS

The balance of this item amounted to €268.51 million at end-2011, of which €619.86 million related to cost and €351.35 million to accumulated depreciation.

The breakdown of this item into its components, together with their accumulated depreciation, is as follows:

EUR m

	2011	2010	Change
TANGIBLE FIXED ASSETS	496.25	485.85	10.40
Land and unbuilt plots	5.35	5.35	—
Buildings, structures and renovation work	107.34	107.45	-0.12
Plant in buildings	174.99	171.72	3.27
Furniture and fittings	37.64	37.19	0.45
Office machines other than computer equipment	53.92	48.20	5.72
Computer equipment	58.97	58.59	0.38
Transport equipment	8.53	8.52	0.01
Libraries	5.42	5.59	-0.17
Other tangible fixed assets	4.99	4.31	0.68
Art collection	39.11	38.93	0.18
INTANGIBLE FIXED ASSETS	72.25	60.42	11.83
Computer applications	72.19	60.36	11.83
Industrial property	0.06	0.06	—
FIXED ASSETS IN PROGRESS	51.37	46.90	4.47
Buildings, plant in buildings and other structures	16.44	24.45	-8.01
Computer applications of Banco de España	15.21	19.24	-4.04
Computer applications of Eurosystem	19.29	—	19.29
Other fixed assets in progress	0.43	3.21	-2.78
TOTAL	**619.86**	**593.17**	**26.69**

EUR m

Accumulated depreciation or amortization	2011	2010	Change
TANGIBLE FIXED ASSETS	-299.88	-294.35	-5.53
Buildings, structures and renovation work	-36.32	-35.25	-1.07
Plant in buildings	-134.01	-130.42	-3.59
Furniture and fittings	-27.17	-25.41	-1.76
Office machines other than computer equipment	-42.53	-40.28	-2.25
Computer equipment	-45.67	-49.59	3.92
Transport equipment	-7.24	-6.84	-0.40
Libraries	-3.02	-2.89	-0.13
Other tangible fixed assets	-3.92	-3.67	-0.25
INTANGIBLE FIXED ASSETS	-51.47	-44.21	-7.26
Computer applications	-51.41	-44.15	-7.26
Industrial property	-0.06	-0.06	—
TOTAL	**-351.35**	**-338.56**	**-12.79**

The increase in fixed assets in 2011 basically arose from increased investment in development of certain computer applications, from the acquisition of banknote and coin handling machines, from electrical system upgrading and from renewal of fire alarm systems at branches. This increase was partly offset by the sale of buildings and facilities of the branches closed in 2011.

11 OTHER ASSETS. OTHER FINANCIAL ASSETS

This item includes €46.76 million of 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 decrease of €0.42 million in these financial assets was due to the lower underlying book value of this firm.

12 OTHER ASSETS. OFF-BALANCE-SHEET INSTRUMENTS REVALUATION DIFFERENCES

This 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, as in 2011, it is recorded under the same heading in liability item 12.1 (see Note 23 on the balance sheet).

13 OTHER ASSETS. ACCRUALS AND PREPAID EXPENSES

The main components of this item, the balance of which amounts to €2,439.70 million, are as follows:

EUR m

	2011	2010	Change
ACCRUED INTEREST ARISING FROM SECURITIES ACQUISITIONS AND ACCRUED COUPON INTEREST RECEIVABLE	2,197.17	1,775.91	421.26
Trading portfolio	777.61	584.13	193.48
Denominated in foreign currency	51.96	9.89	42.06
Denominated in euro	725.66	574.23	151.42
Held-to-maturity portfolio	792.22	859.56	-67.34
Denominated in foreign currency	49.68	44.68	5.00
Denominated in euro	742.54	814.88	-72.34
Held for monetary policy purposes	627.34	332.22	295.11
OTHER ACCRUED INTEREST RECEIVABLE	238.41	112.01	126.41
On claims equivalent to the transfer of foreign reserves to the ECB	51.50	41.23	10.28
On intra-Eurosystem claims arising from banknote adjustments	87.11	38.86	48.24
On monetary policy operations	95.33	27.14	68.19
On exceptional liquidity-providing operations	1.20	—	1.20
Claims on the IMF	3.21	3.75	-0.54
Other	0.06	1.03	-0.97
ACCRUED COMMISSIONS RECEIVABLE AND PREPAID EXPENSES	4.12	3.47	0.64
TOTAL	**2,439.70**	**1,891.39**	**548.31**

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 the trading portfolio (€725.66 million), from the held-to maturity portfolio (€742.54 million) and from monetary policy operations (€627.34 million). In total, this interest increased by €421.26 million with respect to 2010. Furthermore, accrued interest receivable on monetary policy operations increased significantly (by €68.19 million) due to the larger volume of outstanding transactions at year-end. There was also an increase in interest receivable on claims equivalent to the transfer of foreign reserve assets to the ECB due to the higher average rate of return. Furthermore, the increase in interest accrued on intra-Eurosystem banknote adjustment and offsetting accounts increased as a result of the larger balance to be remunerated and of the higher average rate of return.

14 OTHER ASSETS. SUNDRY

The most significant components of this item, which totals €1,417.88 million, are the transfer to the Treasury on 1 December 2011 of €1,220.03 million, equivalent to 70% of the

Bank's profits earned to 30 September 2011, adjusted in line with the projected performance of profits up to year-end (see Note 15 on the profit and loss account), which was €96.46 million lower than in the previous year, and the home loans and repayable advances granted to Bank employees, the balance of which, at €185.58 million, was down by €1.68 million from 2010.

15 BANKNOTES IN CIRCULATION

The balance of banknotes in circulation (€97,024.85 million) represents the Banco de España's share in the total euro banknotes in circulation (see "Banknotes in circulation" in Section 3.1 Accounting policies) according to the Eurosystem euro banknote allocation key (10.9185% of the total issue by all the central banks after deducting those corresponding to the Eurosystem 8% of the ECB total). This balance was €5,106.87 million higher than in the previous year because of the greater volume of euro banknotes in circulation in the Eurosystem.

16 LIABILITIES TO EURO AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS DENOMINATED IN EURO

The overall balance of the different types of deposit held by credit institutions with the Banco de España amounted to €50,933.71 million at end-2011, €23,969.67 million more than in the previous year. This higher balance was basically due to the increase in the deposit facility and fixed-term deposits, offset in part by the decrease in the balances of the "Current accounts (covering the minimum reserve system)" item.

The breakdown and the amounts in both reporting years are as follows:

EUR m

Type of liability	2011	2010	Change
Current accounts (covering the minimum reserve system)	14,561.25	19,950.00	-5,388.75
Deposit facility	33,335.00	6,997.50	26,337.50
Fixed-term deposits	3,000.00	—	3,000.00
Fine-tuning reverse operations	—	—	—
Deposits related to margin calls	37.46	16.53	20.93
TOTAL	**50,933.71**	**26,964.03**	**23,969.67**

The first component, which includes the total current accounts held by credit institutions at the Banco de España, in which they maintain the minimum reserves required for monetary policy implementation purposes, underwent a decrease of €5,388.75 million. Its average balance also decreased during the year, falling from €25,383.94 million in 2010 to €23,591.06 million in 2011.

The item "Deposit facility", which includes overnight deposits remunerated at a fixed interest rate (appreciably lower than the interest rate on main refinancing operations), increased from €6,997.50 million in 2010 to €33,335.00 million in 2011. However, the average balance decreased (€6,153.64 million in 2011 compared with €9,393.71 million in 2010).

The balance of fixed-term deposits was €3,000.00 million as at 31 December 2011. They are fine-tuning operations (liquidity withdrawals) that take the form of deposits. During 2011 the Eurosystem carried out 64 operations of this type.

The other captions in this item relate to fine tuning reverse operations and deposits related to margin calls. As at 31 December 2011, fine tuning reverse operations had a zero balance, while institutions' deposits related to margin calls amounted to €37.46 million (€16.53 million in 2010).

17 LIABILITIES TO OTHER EURO AREA RESIDENTS DENOMINATED IN EURO.– GENERAL GOVERNMENT

This item includes the deposits held by general government with the Banco de España. The outstanding balance at year-end was €5,425.69 million, which breaks down as follows:

EUR m

	2011	2010	Change
Central government (State)	2,096.91	3,633.00	-1,536.08
Treasury current account	225.04	300.01	
Other central government agencies and similar bodies	1,871.87	3,332.98	
Territorial government	153.66	355.48	-201.82
Regional (autonomous) governments, administrative agencies and similar bodies	152.70	351.16	
Local government	0.96	4.32	
Social security funds	3,175.12	5,348.15	-2,173.03
Social Security System	3,174.20	5,347.19	
Other	0.93	0.96	
TOTAL	5,425.69	9,336.63	-3,910.94

The decrease in this item (€3,910.94 million) was basically due to the smaller balances held by Social Security Funds (€2,173.03 million in comparison with 2010), by the Fund for the Orderly Restructuring of the Banking Sector (FROB) under "Other central government agencies and similar bodies" (€1,447.85 million) and, to a lesser extent, by the Treasury and territorial (regional and local) government.

18 LIABILITIES TO OTHER EURO AREA RESIDENTS DENOMINATED IN EURO.– OTHER LIABILITIES

Included here are the current accounts of financial institutions other than credit institutions, such as the Deposit Guarantee Fund, 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-2011 was €144.35 million, and its decrease of €7.76 million with respect to end-2010 was basically due to the decrease in the balances of the current accounts of State agencies.

19 LIABILITIES TO NON-EURO AREA RESIDENTS DENOMINATED IN EURO

This item includes basically the euro-denominated accounts held by international organisations, non-Eurosystem monetary authorities and central banks to which reserve management services are provided. The balance of €380.75 million was €19.40 million lower than a year earlier, due to a decrease in deposits of the central banks to which reserve management services are provided, partly offset by an increase in the deposits of international organisations and non-Eurosystem monetary authorities.

20 COUNTERPART OF SPECIAL DRAWING RIGHTS ALLOCATED BY THE IMF

This item of €3,355.46 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 increased by €83.41 million with respect to the previous year, due to the variation in the exchange rate.

21 INTRA-EUROSYSTEM LIABILITIES

This item, which as at 31 December 2011 had a balance of €174,826.42 million, comprises the following two sub-items:

a Net liabilities related to the allocation of euro banknotes within the Eurosystem

In accordance with Eurosystem rules, since the accounts making up this item have a net debit balance, this information is presented on the assets side of the balance sheet.

b Other liabilities within the Eurosystem (net)

The balance of €174,826.42 million as at 31 December 2011 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 TARGET2 by the ESCB national central banks, including the ECB, plus the balances held with Eurosystem central banks through correspondent accounts; 2) the position vis-à-vis the ECB in respect of the pooling and allocation of monetary income within the Eurosystem pending settlement; 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 seigniorage income relating to euro banknotes issued by the ECB and of the securities acquired by the ECB under the securities markets programme.

Regarding the first component, the year-end net transfers via TARGET2 had a credit balance of €174,978.70 million, while the correspondent accounts showed a debit balance of €0.13 million. The remuneration of this position is calculated daily at the marginal interest rate of Eurosystem main refinancing operations.

The second component, i.e. the position vis-à-vis the ECB in respect of the annual pooling and allocation of monetary income within the Eurosystem national central banks, had a debit balance of €74.78 million at year-end (see "Net result of pooling of monetary income" in Note 8 on the profit and loss account).

Finally, in regard to the position vis-à-vis the ECB relating to the distribution of income arising from the seigniorage of euro banknotes issued on its behalf by the NCBs and to the securities purchased under the securities markets programme, pursuant to the Decision of the European Central Bank of 25 November 2010 (ECB/2010/24), 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 Accounting Policies). In 2011 the Council resolved not to distribute the income obtained from the securities purchased under the securities markets programme and to distribute only a part of the income arising from the seigniorage of euro banknotes. Its balance as at 31.12.11 was €77.38 million (see "Income from equity shares and participating interests" in Note 7 on the profit and loss account).

22 ITEMS IN COURSE OF SETTLEMENT

Included here are various accounts which as at 31 December 2011 were in the course of settlement, such as transfer instructions pending execution and transfers sent to deposit institutions yet to be reimbursed.

The balance of this item amounted to €240.47 million at end-2011, of which €188.72 related to transfers to accounts with other institutions, with payment of those transfers yet to be made, and €50.82 million to transfers received from the TARGET2 Platform but yet to be processed.

23 OTHER LIABILITIES. OFF-BALANCE-SHEET INSTRUMENTS REVALUATION DIFFERENCES

This item includes the amount of the net creditor position arising from foreign-exchange forward and swap transactions valued at the exchange rates prevailing at the end of the year. When the position is a debtor one, it is recorded under the same heading in asset item 11.4. Its credit balance of €110.92 million as at end-2011 is the net value of the swap transactions outstanding at that date that are listed below:

			2011			2010
Operation	Position	Currency	Currency amount (million)	Market exchange rate	Equivalent (million €)	Equivalent (million €)
SWAP	DEBTOR	EUR	4,139.80	1.0000	4,139.80	2,888.29
		USD	—	1.2939	—	—
	CREDITOR	EUR	—	1.0000	—	—
		USD	5,500.00	1.2939	4,250.71	2,918.72
NET POSITION					110.92	30.43

At year-end the only unexpired euro-US dollar swaps were those entered into under the liquidity provision cooperation agreements (swap line) with the Federal Reserve.

Regarding these exceptional liquidity-providing transactions in the form of swaps, it should be noted that in January 2010 the ECB Governing Council decided, in agreement with the central banks involved, to cease these transactions in view of the lower demand and of the improvements in the functioning of the financial markets. However, in mid-2010 the ECB decided to continue the liquidity providing arrangements (swap line) with the Federal Reserve until 1 August 2011 in response to the resurgence of tensions in US dollar denominated short-term funding on the European markets. These swap lines were subsequently extended until 1 February 2013.

24 OTHER LIABILITIES. LIABILITY ACCRUAL ACCOUNTS AND INCOME COLLECTED IN ADVANCE

This item includes interest accrued but not yet paid, expenses accrued but not yet paid and income collected in advance.

As at 31 December 2011, its balance amounted to €161.00 million, the main component being interest accrued but not yet paid (€159.89 million). The increase in this item in 2011 (€85.65 million) basically resulted from the larger amount of interest incurred on intra-Eurosystem accounts relating to TARGET2 transactions (€97.37 million) This increase was partly offset by the decrease in the interest payable on the minimum reserves held by credit institutions to (€7.36 million) and that payable to remunerate the Fund for the Orderly Restructuring of the Banking Sector (FROB) accounts (€5.02 million).

25 OTHER LIABILITIES.– SUNDRY

This includes other liabilities not classifiable above.

As at 31 December 2011 the balance of this item amounted to €234.32 million (€45.48 million more than in 2010) and its main sub-items were the “Cash immobilised under EU legislation drawn from book-entry government debt. Repayments and interest” (€112.60 million), “Banco de España employee social welfare scheme (*Mutualidad de empleados*).- Contributions payable” (€20.39 million) and “Sundry accounts payable and unallocated items. Accrued operating expenses” (€23.17 million). The main variation relates to the first of the aforementioned sub-items relating to compliance with Article 215 of the Treaty on the Functioning of the European Union and Council Regulation (EU) No 204/2011 of 2 March 2011 concerning restrictive measures in view of the situation in Libya.

26 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

	2011	2010	Change
For exchange rate and interest rate risks	4,666.01	3,957.27	708.74
For early repayment of special loans	577.68	786.25	-208.56
For counterparty risks in Eurosystem's monetary policy operations	102.80	239.07	-136.27
For operational risk	24.50	22.86	1.64
For credit risk	870.96	336.20	534.76
For exchange of withdrawn peseta banknotes	36.49	50.46	-13.97
For early and regular retirement	27.98	25.85	2.13
For death and retirement assistance	58.26	59.70	-1.44
For sundry liabilities and charges	0.53	1.15	-0.62
TOTAL	**6,365.20**	**5,478.81**	**886.39**

Provision for exchange rate and interest rate risks

This is the most important provision. 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 December 2011 amounted to €4,666.01 million, which was €708.74 more than in 2010 (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 and the envisaged behaviour of risk assets and any others deemed to be worthy of consideration under the circumstances. In this respect, on 22 February 2012 the Executive Commission adjusted to market conditions the methodology used to calculate the provision for exchange rate and interest rate risks. To do so, it set, inter alia, the calculation basis and the percentages of coverage to be applied for exchange rate and interest rate risks in each portfolio.

Provision for losses arising from early repayment of special loans

The agreement in 2007 with the Spanish State government whereby the Treasury can ask to repay a portion or all of these loans early, paying a cash amount equal to their market value instead of their nominal amount, led the Banco de España to set up in that year a provision for losses due to early repayment of special loans, so as to cover the possible losses that may arise from early repayment of these loans (recorded in asset item 8; see Note 8 on the balance sheet). The balance of this provision was set at the difference between the nominal amount and the current market value of the loans. Its balance of €577.68 million as at 31 December 2011 was €208.56 million less than in the previous year.

Provision for counterparty risk in Eurosystem monetary policy operations

In accordance with the general accounting principle of prudence, the ECB Governing Council considered it appropriate in 2008 to establish a buffer totalling €5,736.00 million against counterparty risks in monetary policy operations (see these operations in Note 6 on the balance sheet). In accordance to Article 32.4 of the ESCB/ECB Statute, this buffer will be funded among all Eurosystem national central banks in proportion to their subscribed capital key shares in the ECB prevailing at the time. As a result, a provision for €621.35 million, equivalent to 10.8324 % of the total provision, was created. On 1 February 2012 the ECB Governing Council reviewed the adequacy of the amount of this provision with effect as at 30 December 2011 and decided to reduce it from €2,207 million to

€949 million. As a result, the Banco de España provision was set at €102.80 million and, accordingly, a portion of it amounting to €136.27 million was released (see Note 8 on the profit and loss account).

Provision for credit and operational risks

In 2009 the Executive Commission approved a methodology for calculating the credit risk on Banco de España investment portfolios, as a basis for setting up a provision for credit risk, as well as the percentage of coverage to be applied to the value of the risk exposure. This provision is reviewed yearly in accordance with the valuation made by the Banco de España of its risk exposure. This methodology, revised by the Executive Commission on 22 February 2012, was used in 2011 to record the aforementioned provision of €534.76 million, the balance of which reached €870.96 at the end of the year.

Also, the Executive Commission approved in 2009 a methodology for calculating operational risk. It will be used to set aside a provision for any losses arising from operational risk. Using this methodology, which was adjusted in 2011, and once the suitability of the resulting amount was duly analysed in that year, it was decided to increase it by €1.64 million to a balance of €24.50 million.

Provision for exchange of peseta banknotes withdrawn from circulation due to the introduction of the euro

This is the most important of the two provisions set aside for the exchange of peseta banknotes withdrawn from circulation. It was recorded initially in 2005 to cater for the exchange of any peseta banknotes withdrawn from circulation due to the introduction of the euro that may be tendered at the Banco de España. At the same time, the Council of Ministers decided that if the amount of banknotes tendered for exchange exceeded the amount of the provision at that time, the Banco de España would meet the excess with a charge to its reserves.

In November 2010 the balance of the provision fell to zero. Accordingly, pursuant to a resolution of the Executive Commission, an additional €50 million were provisioned (provision for a period of approximately five years), using the Banco de España reserves arising from the retention of 2005 earnings. At year-end this provisions had a balance of €34.51 million, representing a decrease of €13.81 million with respect to the previous year.

Other provisions

In the reporting year there was an increase in the provision for payments to early and regular retirees (€2.13 million), basically due to the provisioning of payments to be made in coming years for early retirements agreed by the Banco de España with its employees in July 2011 because of the closure of seven of its branches.

27 REVALUATION ACCOUNTS

This item includes the revaluations arising from unrealised gains on financial assets and liabilities valued at market prices and exchange rates at year-end. It may be broken down as follows:

EUR m

Type of account	2011	2010	Change
Gold	10,166.75	8,705.06	1,461.69
Foreign currency	1,535.85	468.33	1,067.52
Securities (trading portfolio)	292.43	83.73	208.70
Issued in foreign currency by non-euro area residents	57.07	40.79	16.27
Issued in euro by euro area residents	235.36	42.94	192.42
Other	17.04	17.47	-0.43
TOTAL	**12,012.07**	**9,274.59**	**2,737.48**

The balance of revaluation accounts at end-2011 was €12,012.07, up €2,737.48 on 2010. The main change was in gold, the unrealised gains on which were €1,461.69 million higher as a result of the increase in its market price (up from €1,055.42 per ounce at 31 December 2010 to €1,216.86 per ounce at 31 December 2011). Its balance at 31 December 2011 was €10,166.75 million.

With regard to fixed-income securities in the trading portfolio, there was an increase in unrealised gains arising basically on securities issued in euro by euro area residents (€192.42 million), as a result of security price movements driven by interest rates.

As regards the foreign exchange revaluation accounts, the unrealised gains on foreign currencies increased by €1,067.52 million, basically due to the appreciation of the US dollar and the SDR against the euro (€1,003.66 million and €64.14 million, respectively).

28 CAPITAL

As at 31 December 2011 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 Decree-Law 18/1962 of 7 June 1962 and €998.63 million as a capital increase carried out in 2006 through the retention of 2005 earnings.

29 RESERVES

As at 31 December 2011 the reserves of the Banco de España amounted to €950 million, with no change in the year. Included in this 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, respectively, on 28 July 2006 and 29 June 2007.

30 PROFIT FOR THE YEAR

The net profit for 2011, after deducting the transfer to the Beneficent Social Fund (€7.22 million), amounted to €2,400.13 million, down 6.6% on 2010. Of this amount, €1,220.03 million was paid to the Treasury on 1 December 2011, in accordance with Royal Decree 2059/2008 of 12 December 2008 (see Note 15 on the profit and loss account “Profit for the year”).

During the year, the following amounts were also paid to the Treasury out of 2010 profits:

a) On 1 March 2011, €996.51 million, which, together with the payment in December 2010, amounted to 90% of the €2,570.00 million of distributable profit for that year.

b) On 12 August 2011, once the balance sheet and profit and loss account for the year 2010 had been approved by the Council of Ministers, €257.00 million, representing the rest of the distributable profit for that year.

The details of the various components of the profit for 2011 and the reasons for the changes in them with respect to 2010 are given in Section 3.3 below on the profit and loss account.

3.3 Notes on the profit and loss account

This item includes income from interest accrued on the main assets of the Banco de España. The breakdown in 2011 and 2010 is as follows:

1 INTEREST INCOME

Interest income increased by €823.37 million in 2011 with respect to 2010. This increase was a result of a rise of €863.43 million in the return on euro-denominated investments and, to a lesser extent, of a decline in income from foreign-currency investments (€40.07 million).

EUR m

	Interest income		
	2011	2010	Change
FOREIGN CURRENCY	245.08	285.15	-40.07
Securities	207.73	266.38	-58.65
Deposits and other assets	21.29	14.49	6.80
Swap, forward and other operations	16.06	4.28	11.78
EURO	5,028.85	4,165.42	863.43
Securities	3,789.79	2,978.79	811.00
Monetary policy operations	913.88	1,006.76	-92.88
Intra-Eurosystem accounts	321.25	160.19	161.07
Claims equivalent to the transfer of foreign reserves to the ECB	51.50	41.23	10.28
Claims related to allocation of euro banknotes within the Eurosystem	269.69	118.96	150.73
Other claims within the Eurosystem (net)	0.06	—	0.05
Other assets	3.94	19.68	-15.75
TOTAL	**5,273.93**	**4,450.57**	**823.37**

Of the €245.08 million of interest on foreign-currency investments, €207.73 million arose from investments in fixed-income securities denominated in US dollars, €21.29 million from deposits and other assets, €14.68 million from swap, forward and other transactions, and €1.38 million from exceptional liquidity providing operations which generated expenses for the same amount. Interest on this dollar-denominated portfolio decreased by €58.65 million, that on deposits and other assets increased by €6.80 million, and that on swap, forward and other transactions was up by €11.78 million, of which €1.36 million related to exceptional liquidity providing operations. The average return on foreign-currency investments was 1.6% in 2011, compared with 2.2% in 2010.

Euro-denominated interest income (€5,028.85 million) arose basically from the securities portfolios (€3,789.79 million, an increase of €811.00 million), monetary policy operations (€913.88 million, down €92.88 million) and intra-Eurosystem balances (€321.25 million, up €161.07 million).

The main reason for the increase of €863.43 million in euro-denominated income with respect to the previous year was the higher average return in the reporting year (up from 2.0% in 2010 to 2.6% in 2011), partly offset by a decrease in the average balance of the aforementioned assets (down from €202,799.46 million in 2010 to €191,792.48 million in 2011).

Specifically, analysis of the average investment made discloses the significant decrease in monetary policy operations (€71,064.16 million in 2011 against €99,291.50 million in 2010), derived from the lower funding requested by Spanish financial institutions from the ECB. Furthermore, there was an increase in claims related to the allocation of euro banknotes, which rose from €11,732.79 million in 2010 to €20,942.03 million in 2011 as a result of changes in banknotes put into circulation (-7.8% in Spain, compared with 5.8% in the Eurosystem as a whole). Investment in securities increased by €8,007.35 million (9.2%), basically in the monetary policy portfolio (the securities markets programme continued, with purchases under the second covered bond acquisition programme commencing in November) and in the trading portfolio.

2 INTEREST EXPENSE

This item includes interest expenditure on the liabilities listed below, as follows:

EUR m

	Interest expense		
	2011	2010	Change
FOREIGN CURRENCY	19.43	10.02	9.41
Swap, forward and other operations	6.63	0.54	6.09
Other liabilities	12.80	9.48	3.32
EURO	1,322.01	1,030.37	291.64
Remuneration of minimum reserves	297.60	256.30	41.31
Deposit facility	35.47	23.81	11.66
Fixed-term deposits	4.41	8.64	-4.23
Changes in the value of collateral	1.19	0.43	0.75
General government deposits	70.97	122.86	-51.89
Other liabilities within the Eurosystem (net)	910.37	617.49	292.88
Other liabilities denominated in euro	2.01	0.85	1.16
TOTAL	**1,341.45**	**1,040.39**	**301.06**

Interest expenses increased by €301.06 million in 2011 as a result of rises in expenses on euro-denominated liabilities (€291.64 million) and in interest expenses on liabilities denominated in foreign currencies (€9.41 million).

Of the euro-denominated interest expenses (€1,322.01 million), €910.37 million relate to the remuneration of other intra-Eurosystem balances (TARGET2), €297.60 million to remuneration of minimum reserves, €70.97 million to remuneration of general government deposits, €35.47 million to remuneration of the deposit facility, and the remainder to fixed-term deposits and other euro-denominated liabilities.

The increase in euro-denominated expenses (€291.64 million) basically resulted from the higher average cost of remunerating the aforementioned liabilities, which rose from 0.9% in 2010 to 1.2% in the reporting year, partly offset by the lower average balance of liabilities (€108,905.29 million in 2011 against €119,475.45 million in 2010).

Regarding the net credit balance of intra-Eurosystem balances arising from TARGET2 transactions, interest expenses rose by €292.88 million due to the considerable increase in its average balance with respect to 2010 from €60,903.05 million to €70,706.62 million in 2011, and to the increase in the average cost (up from 1.0% in 2010 to 1.3% in 2011).

Interest expenses denominated in foreign currencies (€19.43 million) related mainly to allocated SDRs (€12.80 million), to forward transactions (€5.25 million) and to exceptional liquidity providing operations (€1.38 million).

3 REALISED GAINS/LOSSES ARISING FROM FINANCIAL OPERATIONS

This item includes the profits and losses arising from dealing in financial assets. In 2011 the net gains in this connection amounted to €101.29 million, arising from the following sources:

EUR m

	2011	2010	Change
FOREIGN CURRENCY	54.14	47.45	6.70
Sale of gold	—	—	—
Sale of foreign currency (exchange gains)	5.29	31.39	-26.10
Sale of securities (price losses)	52.97	14.85	38.12
Other gains/losses	-4.12	1.20	-5.32
EURO	47.15	318.59	-271.45
Sale of securities (price losses)	47.15	318.59	-271.45
TOTAL	**101.29**	**366.04**	**-264.75**

Compared with the prior year, the total amount recorded in 2011 decreased by €264.75 million due to smaller losses on the sale of euro-denominated debt securities (€271.45 million) and on the sale of foreign currencies, basically US dollars (€15.28 million) and SDRs (€9.46 million), partly offset by the higher gains on the sale of US dollar-denominated securities (€38.12 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 2011 and 2010 is as follows:

EUR m

	2011	2010	Change
FOREIGN CURRENCY	4.47	2.97	1.50
Foreign currency (exchange rate losses)	—	0.05	-0.05
Securities (price losses)	4.46	2.92	1.54
EURO	463.14	790.92	-327.78
Securities (price losses)	463.14	790.92	-327.78
TOTAL	**467.61**	**793.89**	**-326.28**

Unrealised losses in 2011 amounted to €467.61 million, most of which related to investments in euro-denominated debt securities in the trading portfolio (€463.14 million). Compared with 2010, unrealised losses decreased by €326.28 million, of which €327.78 million relate to lower losses on euro-denominated debt securities and €1.54 million to higher unrealised losses on US dollar-denominated debt securities.

5 TRANSFERS FROM/TO PROVISIONS FOR FOREIGN EXCHANGE RATE, PRICE AND CREDIT RISKS

EUR m

	2011	2010	Change
Transfers to provisions	-1,711.11	-1,109.75	-601.36
Foreign exchange rate and interest rate risk	-1,176.35	-942.46	-233.89
Credit risk	-534.76	-167.29	-367.47
Transfer from exchange rate and interest rate provision	467.61	793.89	-326.28
Transfer/reversal from provision for losses arising from early repayment of special loans	162.15	-92.10	254.26
TOTAL	**-1,081.34**	**-407.96**	**-673.39**

This includes, first, the transfer of €467.61 million from the provision for foreign exchange rate and interest rate risks to cover the losses recorded at end-2011 and, second, the transfer of €1,176.35 million to this provision to cover the estimated foreign exchange rate and price risks associated with the financial positions subject to such risks, in accordance with the Executive Commission resolution of 22 February 2012.

This item also includes the transfer to the provision for credit risk in accordance with an Executive Commission resolution, amounting to €534.76 million in 2011.

Lastly, regarding the provision for losses arising from early repayment of special loans derived from the adjustment of changes in the market value of these assets, in 2011 the provisioning expense underwent a positive change of €254.26 million with respect to 2010, due to the recovery of €162.15 million in 2011 resulting from adjustment of market value changes in these assets, as against the charge of €92.10 million in the prior 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 (TARGET2, transfers, handling of cheques, custody and administration of securities, etc.). It may be broken down as follows:

EUR m

	2011	2010	Change
1 Income from fees and commissions	17.57	20.07	-2.51
Foreign operations	0.01	0.03	-0.01
Domestic operations	17.56	20.05	-2.49
2 Expenses from fees and commissions	10.68	11.12	-0.44
Foreign operations	3.18	3.06	0.12
Domestic operations	7.50	8.06	-0.56
NET INCOME FROM FEES AND COMMISSIONS (1-2)	**6.89**	**8.95**	**-2.06**

Net fee and commission income in 2011 (€6.89 million) was €2.06 million less than in 2010. This variation relates basically to the lower fee income from securities transactions. This lower income was partially offset by the lower expense of fees and commissions paid on security transactions.

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 from ordinary operations, seigniorage income, income generated by the ECB portfolio derived from the security market programme and the dividends on other shares and participating interests.

Of the total amount of €109.64 million recorded, €77.38 million relate to the ECB dividend from banknote seigniorage income, €20.33 million to the ECB ordinary dividend, €8.80 million to dividends on the participating interest in Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, SA (BME) and €3.14 million to participating interests in international agencies (Bank for International Settlements).

In 2011 the ECB Governing Council decided not to distribute among the Eurosystem central banks a portion of the banknote seigniorage income or the income generated by its securities portfolio purchased under the security market programme, but rather to retain it to record a provision for foreign exchange rate, interest rate, credit and gold price risks.

Compared with 2010, the amount recorded in 2011 was €81.40 million lower, basically due to the smaller ordinary dividend distributed by the ECB in the reporting year out of the prior year's profit (€154.11 million), partly offset by the payment in 2011 of a portion of the ECB dividend from seigniorage income (€77.38 million were allocated to the Banco de España, versus the absence of a dividend in 2010).

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 TARGET2 transactions whenever they have a credit balance; and net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem whenever they have a credit balance. 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; monetary policy portfolio securities; intra-Eurosystem claims equivalent to the transfer of foreign reserve assets to the ECB; net intra-Eurosystem claims resulting from TARGET2 transactions, whenever they have a debit balance; net intra-Eurosystem claims related to the allocation of euro banknotes in the Eurosystem, whenever they have a debit balance; and a limited amount of each NCBs gold holdings, in proportion to its capital key. Gold is considered to generate no income and the securities acquired under the covered bond purchase programme are deemed to generate income at the interest rate on main refinancing operations. 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 most recent marginal interest rate on main refinancing operations.

The breakdown of this item in 2011 and 2010 is as follows:

EUR m

	2011	2010	Change
Monetary income pooled	-1,791.49	-1,177.53	-613.96
Monetary income allocated	1,866.27	1,235.58	630.69
Provision for counterparty risk in monetary policy operations	136.27	195.42	-59.15
TOTAL	**211.05**	**253.47**	**-42.42**

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 2011, amounting to €1,791.49 million, and that reallocated to it, amounting to €1,867.04 million, is equivalent to a net allocation of €75.55 million. From this net allocation €0.77 million should be deducted for the Banco de España's share of the losses on Eurosystem monetary policy operations (expenses for professional consultancy and audit services by independent experts). Compared with 2010, there was a positive net change of €16.73 million in these results.

Also, with regard to the provision for counterparty risk in Eurosystem monetary policy operations, on 1 February 2012 the ECB Governing Council approved the amounts relating to each NCB. Accordingly, the Banco de España reversed a portion of the provision recorded (€136.27 million out of a total of €239.07 million), resulting in a decrease of €59.15 million in profit (in 2010 €195.42 million were released).

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

	2011	2010	Change
Extraordinary profit	40.09	0.35	39.74
Employee social welfare scheme	-7.98	-13.14	5.17
Sundry	8.11	1.23	6.89
TOTAL	**40.23**	**-11.56**	**51.79**

As can be seen, this item shows a net gain of €40.23 million, which is €51.79 million more than in 2010, basically due to the gain of €33.41 million on the sale of the buildings of the branches closed in 2011, to the amounts received for the Banco de España's participation in Eurosystem projects (€7.00 million) and to the decrease in the principal of the debt to the employee social welfare scheme (Mutualidad de Empleados), which generated €5.17 million less in expenses.

10 STAFF COSTS

This item includes the headings "Wages and salaries", "Contributions to pension scheme" and "Social security contributions and employee benefits".

The breakdown of changes by component is as follows:

EUR m and %

	2011	2010	Change	(%)
Gross staff costs	232.51	230.86	1.65	0.7
Wages and salaries	170.21	174.12	-3.91	-2.2
Social Security	32.06	32.27	-0.21	-0.6
Staff welfare expenses	23.42	18.01	5.41	30.0
Contributions to Pension Scheme	6.82	6.46	0.36	5.5
Reversal of staff costs due to capitalization of computer applications	-1.61	-2.47	0.85	-34.5
TOTAL	**230.90**	**228.40**	**2.50**	**1.1**

Its balance increased from €228.40 million in 2010 to €230.90 million in 2011, a rise of €2.50 million (1.1%). The main reason for this increase was the provision for risks and expenses recorded to allow for payments to early and regular retirees resulting from the closure of branches in 2011 (€6.25 million), partly offset by the lower expense of temporary hires (€1.03 million) and by the wage reduction derived from the application from June 2010 of Royal Decree-Law 8/2010 on extraordinary measures to reduce the budget deficit.

The following table sets out the changes in permanent and temporary staff, in terms of average number of employees:

	2011	2010	Change	%
Average number of employees	2,704.8	2,733.2	-28.4	-1.0
Managerial staff	1,633.7	1,617.1	16.6	1.0
Administrative staff	879.7	917.6	-37.9	-4.1
Other	191.4	198.6	-7.2	-3.6

As at 31 December 2011, the Bank's total staff numbered 2,686 employees, 23 fewer than at the same date of the previous year. Regarding the staff composition by gender, at 31 December 2011 women accounted for 40.5% of the Bank's total workforce.

The compensation of members of the governing bodies is set by the Minister for Economic Affairs and Competitiveness in accordance with the provisions of the Law of Autonomy of the Banco de España. The Governor received a gross annual wage of €176,000, including the years-of-service and family allowances; the Deputy Governor received €199,000 in this connection. The elected members of the Governing Council receive a gross annual wage of €52,000; if they belong to the Executive Commission, the gross annual wage is €65,000.

In addition to the foregoing, the members of the governing bodies receive equal amounts of fees for attending meetings of the body to which they belong, set at €1,026 per meeting of the Governing Council and €492 per meeting of the Executive Commission.

11 ADMINISTRATIVE EXPENSES

This item includes expenses arising from the purchase of current assets and from the diverse services received during the year, as follows:

EUR m and %

	2011	2010	Change	%
Gross administrative expenses	122.29	123.44	-1.15	-0.9
Rental and maintenance	32.26	33.03	-0.77	-2.3
Material and supply	11.62	11.10	0.52	4.7
External services	61.97	62.76	-0.79	-1.3
Training, promotion and selection	3.86	4.02	-0.15	-3.8
Sundry operating expenses	12.58	12.53	0.04	0.3
Reversal of administrative expenses due to capitalisation of computer applications	-5.68	-5.61	-0.07	1.3
TOTAL	**116.61**	**117.83**	**-1.22**	**-1.0**

The above table shows that in 2011 the most significant administrative expenses were external services (€61.97 million), mainly IT services (€37.24 million) and rental and maintenance (€32.26 million), composed mainly of hardware and software rental and maintenance (€15.76 million) and property rental and maintenance (€11.36 million).

Goods and services expenses decreased in 2011 (€1.22 million). This decrease basically resulted from the decline in expenses for external services (€0.79 million) and for rental and maintenance (€0.77 million)

"External services" include €142,173.18 (including VAT) relating to the fees of the external auditors Deloitte, S.L. for the audits in 2011 of the Bank's annual accounts and of certain aspects of the Bank's management of European Central Bank reserves at the request of this institution's external auditor, the latter being the only service provided by the auditor to the Bank. In 2011 no services were received from and, consequently, no amounts were paid to, other firms related to the auditor.

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 %

	2011	2010	Change	%
Depreciation of buildings, structures and renovation work	2.58	2.33	0.25	10.9
Depreciation of plant in buildings	9.89	8.32	1.57	18.9
Depreciation of furniture and fittings	2.11	2.07	0.05	2.3
Depreciation of office machines other than computer	2.48	1.98	0.49	24.9
Depreciation of computer equipment	6.22	5.18	1.04	20.1
Depreciation of transport equipment	0.52	0.71	-0.20	-27.8
Depreciation of other tangible fixed assets	0.29	0.30	-0.02	-5.1
Depreciation of bibliografic fund	0.53	0.54	-0.01	-2.3
Amortization of computer applications	7.25	5.90	1.35	22.9
TOTAL	**31.86**	**27.34**	**4.53**	**16.6**

13 BANKNOTE PRODUCTION SERVICES

This amount (€54.71 million) corresponds to payments made by the Banco de España to purchase banknotes from the Spanish Royal Mint. The decrease with respect to the previous year (€7.00 million) was because in 2011 the volume of purchases of €50, €20 and €5 banknotes decreased, as did the unit cost of €50 and €5 banknotes, the cost of €20 banknotes remaining unchanged. Also, the pilot production of series 2 €5 banknotes took place in 2011. This gave rise to an expense of €2.99 million.

14 TRANSFERS AND ADDITIONS TO OTHER FUNDS AND PROVISIONS

The net balance of transfers and applications to other funds and provisions in 2011 amounted to €15.53 million, compared with €7.73 million in 2010. This increase (€7.81 million) derived basically from the charge to the provision for risks and expenses in respect of early retirement and other commitments to pensioners (€5.38 million) and from the updating of the provision for death and retirement assistance referred to in Article 190 of the Banco de España Conditions of Employment, which entailed a credit of €1.61 million to the profit and loss account. This item also includes transfers to and releases from the provision for operational risks, which in 2011 was used to cover losses arising from operational risk (€0.02 million). An amount of €1.66 was transferred to it to raise its balance to the agreed level of €24.50 million. The transfer to the Beneficent Social Fund amounted to €7.22 million (€25.96 million in 2010).

The Banco de España, because of the nature of its activity, is not an institution with a high environmental risk. Accordingly, in 2011 it was not considered necessary to record any provision for environmental liabilities and charges.

15 PROFIT FOR THE YEAR

Pursuant to Article 1.1.b) of Royal Decree 2059/2008 of 12 December 2008, the Banco de España must pay into the Treasury, on the first working day of March 2012, 90% of the profits earned and recorded up to 31 December of the previous year, less the amount paid on 1 December of the previous year.

On 1 December 2011 the Banco de España paid into the Treasury €1,220.03 million, equal to 70% of the profit recorded as at 30 September 2011.[13]

Once the year had ended, and taking into account that the provisional profits amounted to €2,400.13 million and that 90% of the profits was €2,160.12 million, a payment of €940.09 million was made to the Treasury on 1 March 2012.

13 Pursuant to the aforementioned Royal Decree, the payment resolution must take into consideration the foreseeable performance of profits up to the end of the year. For this reason, account was taken of a number of factors which entailed a risk of lower profit estimated at €696.35 million. Accordingly, this amount was subtracted from the Banco de España profit of €2,439.26 million as at 30 September, resulting in a profit of €1,742.90 million, 70% of which was paid into the Treasury.

The payments to the Treasury of 2011 profit are as follows:

EUR m

1 Total profit for 2011	2,400.13
2 Payments to the Treasury	2,160.12
On 1.12.2011	1,220.03
On 1.3.2012. Difference between the above amount and 90% of profit as at 31.12.2011	940.09
3 Profit payable to the Treasury	240.01
At date of approval of the 2011 accounts	240.01

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 change in provisions and the effect on the balance sheet of the appropriation of profit for the year.

EUR m

	Capital	Reserves	Revaluation accounts	Undistibuted profit	Provisions	Total
A) 2011 OPENING BALANCE	**1,000.00**	**950.00**	**9,274.59**	**1,253.51**	**5,478.81**	**17,956.91**
1 Unrecognised net gains in profit and loss			2,737.48			2,737.48
In gold			1,461.69			1,461.69
In foreign currency			1,067.52			1,067.52
In securities			208.70			208.70
Other			-0.43			-0.43
2. 2011 profit				2,400.13		2,400.13
3. Change in provisions					886.39	886.39
4. Appropriation of profit				-2,473.54		-2,473.54
Payment to the Treasury of 2010 profit				-1,253.51		-1,253.51
Payment to the Treasury of 2011 profit				-1,220.03		-1,220.03
B) CHANGES IN THE YEAR B = 1+2+3+4	—	—	**2,737.48**	**-73.41**	**886.39**	**3,550.47**
C) 2011 CLOSING BALANCE C = A + B	**1,000.00**	**950.00**	**12,012.07**	**1,180.10**	**6,365.20**	**21,507.38**

The changes reflected in this table have been explained above in the explanatory notes on the balance sheet and profit and loss account that refer to provisions (Note 26 on the balance sheet), revaluation accounts (Note 27 on the balance sheet), capital (Note 28 on the balance sheet), reserves (Note 29 on the balance sheet) and profit for the year (Note 30 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 Contribution made by the Bank to the Deposit Guarantee Fund

On 15 October 2011, Royal Decree-Law 16/2011 of 14 October 2011 creating the Credit Institution Deposit Guarantee Fund came into force and the three previously existing credit institution deposit guarantee funds were wound up. The contribution of the Banco de España to the Deposit Guarantee Fund continues to be regulated by Article 3 of Royal Decree 2606/1996 of 20 December 1996, in which references to the wound-up funds are deemed to be to the new Fund.

Royal Decree 2606/1996 established that the Deposit Guarantee Fund may only exceptionally "be supplemented by contributions from the Banco de España, the amount of which shall be fixed by Law". In 2011 the Banco de España made no contributions whatsoever to this Fund.

4.2 Loss of profit

The table below shows the loans outstanding in 2011 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	Average balance in 2011	Interest rate received (%)	Reference interest rate (%)	Estimated loss of profit
Net State debt	3,502.91	—	1.25	43.79
Housing loans and repayable advances to employees	40.69	0.12	1.25	0.46
Housing loans	6.76	0.75	1.25	0.03
Repayable advances	33.92	—	1.25	0.42
TOTAL	**3,543.60**	—	**1.25**	**44.24**

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.

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

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 2004 (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 2011 payment 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 2011 the Treasury paid to the Banco de España the amount of €537.06 million, the effective market price of the debt repaid on that date.

1 REPORT OF THE EXTERNAL AUDITORS

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Translation of a report originally issued in Spanish based on our work performed in accordance with International Standards on Auditing. In the event of a discrepancy, the Spanish- language version prevails.

To the Governor of the Banco de España

We have audited the financial statements of the Banco de España which, in accordance with Article 29.1 of its Internal Rules, comprise the balance sheet al 31 December 2011 and the related income statements and notes to the financial statements for the year then ended.

Responsibility for the financial statements

The Executive Commission of the Banco de España is responsible for organising the Bank and appointing its directors general. Under the Internal Rules of the Banco de España, the Directorate General Services is responsible for preparing the financial statements in accordance with the internal accounting rules and principles of the Banco de España, which are indicated in Note 3.1 to the accompanying notes to the financial statements 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 financial statements that are free from material misstatements due either to fraud or error; the selection and application of appropiate accounting rules; and the performance of the estimates considered to be reasonable in the circumstances (see Note 3.1.3. of the accompanying financial statements). Pursuant to Article 21. g) of Law 13/1994, of 1 June, on the Autonomy of the Banco de España, these financial statements are prepared by the Governing Council of the Banco de España.

Responsibility of the auditor

Our responsibility is to express an opinion on the financial statements taken as a whole, based on our audit work performed in accordance with International Standars 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 financial statements are free material misstatements or irregularities.

An audit entails the performance of procedures designed to obtain evidence supponting the amounts and disclosures contained in the financial statements. The procedures selected depend on the auditor's judgment, which includes the assessment of the risks of the occurrence of material misstatements or irregularities in the financial statements 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 financial statements by the entity, in order to design audit procedures that are appropiate 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 financial statements. We consider that the evidence we have obtained is sufficient and adequate to provide a basis on which to express our audit opinion.

Opinion

In our opinion, the accompanying financial statements for 2011 present fairly, in all material respects, the net worth and financial position of the Banco de España at 31 December 2011 and the results of its operations in the year then ended, in conformity with the internal accounting rules and principles of the Banco de España, which are indicated in Note 3.1. to the accompanying financial statements and are based on the accounting regulations established for the member central banks of the European System of Central Banks.

DELOITTE, S.L.

Miguel Ángel Bailón

24 May 2012

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2 REPORT OF THE BANCO DE ESPAÑA AUDIT COMMITTEE

We the undersigned, Ángel Luis López Roa, Ana María Sánchez Trujillo and Carmen Alonso Ledesma, 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 2011.

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 2011, 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 2011, 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 2011 give a true and fair view of the net worth and financial position of the Banco de España.

Madrid, 8 May 2012.

Ángel Luis López Roa | Ana María Sánchez Trujillo | Carmen Alonso Ledesma

The Banco de España publishes various types of documents providing information on its activity (economic reports, statistics, research papers, etc.). The full list of Banco de España publications can be found on its website at http://www.bde.es/webbde/Secciones/Publicaciones/Relacionados/Fic/cat_publ.pdf.

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ABBREVIATIONS

BCBS	Basel Committee on Banking Supervision
BE	Banco de España
BIS	Bank for International Settlements
BLS	Bank Lending Survey
BOE	Official State Gazette
BRICs	Brazil, Russia, India and China
CBFA	Collective Bargaining Framework Agreement
CBSO	Central Balance Sheet Data Office
CCR	Central Credit Register
CDSs	Credit default swaps
CEIPOS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CNE	Spanish National Accounts
CNMV	National Securities Market Commission
CPI	Consumer Price Index
DGF	Deposit Guarantee Fund
EBA	European Banking Authority
ECB	European Central Bank
ECOFIN	Council of the European Communities (Economic and Financial Affairs)
EDP	Excessive Deficit Procedure
EFF	Spanish Survey of Household Finances
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
EONIA	Euro overnight index average
EPA	Official Spanish Labour Force Survey
ESA 79	European System of Integrated Economic Accounts
ESA 95	European System of National and Regional Accounts
ESCB	European System of Central Banks
ESFS	European System of Financial Supervisors
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
EURIBOR	Euro interbank offered rate
EUROSTAT	Statistical Office of the European Communities
FASE	Financial Accounts of the Spanish Economy
FDI	Foreign direct investment
FROB	Fund for the Orderly Restructuring of the Banking Sector
FSB	Financial Stability Board
FSF	Financial Stability Forum
GDI	Gross disposable income
GDP	Gross domestic product
GFCF	Gross fixed capital formation
GNP	Gross national product
GVA	Gross value added
HICP	Harmonised Index of Consumer Prices
IASB	International Accounting Standards Board
ICO	Official Credit Institute
IFRSs	International Financial Reporting Standards
IGAE	National Audit Office
IIP	International Investment Position
IMF	International Monetary Fund
INE	National Statistics Institute
SPEE	National Public Employment Service
LTROs	Longer-term refinancing operations
MFIs	Monetary financial institutions
MMFs	Money market funds
MROs	Main refinancing operations
MTBDE	Banco de España quarterly macroeconomic model
NAIRU	Non-accelerating-inflation rate of unemployment
NCBs	National central banks
NFCs	Non-financial corporations
NPISHs	Non-profit institutions serving households
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of Petroleum Exporting Countries
PMI	Purchasing Managers' Index
PPP	Purchasing power parity
QNA	Quarterly National Accounts
RDL	Royal Decree-Law
SEPA	Single Euro Payments Area
SGP	Stability and Growth Pact
SMEs	Small and medium-sized enterprises
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
TFP	Total factor productivity
ULCs	Unit labour costs
VAT	Value Added Tax
WTO	World Trade Organisation
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 (Estonian kroon)
IE	Ireland	EUR (euro)
GR	Greece	EUR (euro)
ES	Spain	EUR (euro)
FR	France	EUR (euro)
IT	Italy	EUR (euro)
CY	Cyprus	EUR (euro)
LV	Latvia	LVL (Latvian lats)
LT	Lithuania	LTL (Lithuanian litas)
LU	Luxembourg	EUR (euro)
HU	Hungary	HUF (Hungarian forint)
MT	Malta	EUR (euro)
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	EUR (euro)
FI	Finland	EUR (euro)
SE	Sweden	SEK (Swedish krona)
UK	United Kingdom	GBP (Pound sterling)
JP	Japan	JPY (Japanese yen)
US	United States	USD (US dollar)

CONVENTIONS USED

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