ANNUAL REPORT

2013

BANCO DE ESPAÑA
Eurosistema

This English translation of the June 2013 *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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FOREWORD BY THE GOVERNOR

Luis M. Linde

The Spanish economy is immersed in a phase of recovery which began in mid-2013 and which has marked the end of a long and deep-seated recession. Economic activity progressively gained in momentum during 2013, taking the form of positive growth figures as from the third quarter. The latest data indicate this trajectory has strengthened in 2014 to date. The change has also been discernible in the labour market. There, the long phase of job destruction gave way to modest net job creation in the final stretch of 2013, which has continued into 2014, meaning that the critical job creation threshold has been breached. Despite this gradual improvement, the unemployment rate ended the year at a still unacceptably high level.

As the analysis in the *Annual Report* shows, the change in course in the Spanish economy has come about as a result of a combination of external and domestic factors.

Among the external factors, the rise in global activity and trade in the second half of 2013 and the return by the euro area to a path of economic growth shaped an environment conducive to exports, lower uncertainty and restored confidence. These impulses were strengthened by the headway made in the construction of the European Banking Union, which has contributed to easing tensions on the area's financial markets. Acting along these same lines has been the progress in fiscal consolidation and structural reform in the euro area countries subject to the greatest pressures. Naturally, there is still work to do and the challenges ahead remain significant, as was manifest in the annual review by the European Commission of the area's main macroeconomic imbalances.

The monetary policy of the ECB has contributed most significantly to shaping a more favourable environment. The strongly expansionary stance adopted since the onset of the crisis has helped ease the serious financial tensions and has improved financing conditions, although significant fragmentation and heterogeneity persist and are hampering the transmission of monetary impulses to all regions and industries. In any event, the ECB's actions are providing the vital leeway needed so that fiscal consolidation and the structural reforms may yield their full benefits and thus smooth the way for our economy and that of the rest of the area to resume growth and job creation.

Notwithstanding, the Spanish economy could not have entered a phase of recovery had it not progressed, as it has done, in the correction of imbalances and in the design and implementation of the reform programme. The year 2013 saw significant advances in fiscal consolidation, in gains in competitiveness and in the restructuring of the banking system. The result has been the normalisation of the external funding flows the Spanish economy needs for sustained growth.

As regards public finances, the deficit fell in 2013 to 6.6% of GDP, despite the cyclical weakness and the increase in interest payments; the adjustment was, therefore, the outcome of a considerable structural effort. But the task ahead remains significant and is burdened by Spain's high public debt/GDP ratio.

Turning to competitiveness, the ongoing moderation in labour costs and prices allowed further gains during the year. The adjustment of goods and services prices relative to the rest of the world is exerting a very favourable effect on our foreign trade. The year ended

with our first current-account surplus in the euro era, although the still-high external debt is a reminder of the need to persevere with and build on our efforts to date.

There was decisive progress in the restructuring, recapitalisation and clean-up of our banking system. The financial assistance programme agreed with the European authorities in 2012 for the recapitalisation of part of the system ultimately amounted to €41 billion and was successfully concluded in January 2014. Other strictly private-sector actions should be included in the overall recapitalisation drive, including most notably the burden-sharing exercises involving hybrid capital and subordinated debt instruments. Micro-prudential regulation and supervision frameworks were also overhauled, both to allay the risk of future crises and to better protect taxpayers from their adverse effects. Significant challenges remain, but the system is now more favourably placed to be able to properly finance the economic recovery.

There was also progress in 2013 in the necessary deleveraging of the private sector. This year, Chapter 2 of the *Annual Report* — the special-focus chapter — analyses this subject in depth. Deleveraging still rests on the contraction of aggregate credit, but signs of improvement are beginning to be discernible. Thus, since mid-2013, credit to non-financial corporations has continued to shrink, but at progressively lower rates. And this turnaround has also begun to be seen in the case of households since early 2014. The more disaggregated analyses show that this behaviour is proving compatible with a change in the mix of credit flows towards those companies that are better placed to channel available funds to growth- and employment-boosting investments.

Despite the progress in the restructuring of the Spanish economy, entrenching the recovery will face formidable challenges as a result of the far-reaching effects of the crisis. Unemployment and the debt of the resident sectors are of a major scale and their absorption will take considerable time. Economic policy must push through further improvements in competitiveness and reallocate resources to sectors with higher growth potential, while paving the way for public- and private-sector deleveraging. And this in an environment in which the low euro area-wide inflation rate and the appreciation of the euro make for added difficulty in proceeding with the adjustments still to be made.

The headroom for implementing expansionary domestic policies is limited. Monetary policy is already deploying considerable impulses at the European level, so the challenge is to boost their transmission to Spanish households and firms. Fiscal conduct should be governed by the priority need for further headway in consolidation and in lowering public debt. Achieving this, in line with European commitments, is pivotal to maintaining investor confidence and ensuring the external financing of the economy. The medium-term targets set on the road towards budgetary stability must help anchor agents' expectations on public finances and provide for the implementation of the measures needed. Likewise, the composition of the fiscal adjustment should seek to soften the short-term contractionary effect on activity and improve growth potential. The tax reform the Government plans to unveil in the second half of this year should seek to redress the problems beleaguering taxation in Spain, namely low revenue-raising capacity and a bias towards indirect taxation and social security contributions, since this is more harmful for competitiveness and employment. We can count, in any event, on the benefits for the sustainability of public finances stemming from the pensions reform.

The *Annual Report* highlights the important role structural reforms have to play in seeing through the remaining adjustments, minimising their costs and restoring the economy's

growth capacity. The reform-induced increase in the cyclical sensitivity of prices is prompting a correction of the competitive lag built up during the last expansionary cycle, while greater labour market flexibility has been conducive to wage moderation which, in turn, is supporting job creation. A change can also be seen in the role played by past inflation in determining costs and incomes. This is an important change as regards adaptation to EMU membership requirements. It has been boosted by various initiatives and will be reinforced by the new legislation on the deindexation of the economy. It is essential that the reforms in product markets (the respective laws on entrepreneurs, single market guarantee and insolvency, among others), designed to increase competition and improve efficiency, are implemented speedily and ambitiously.

Perseverance with this economic policy approach will help set an increasingly firm path of recovery in place, paving the way for essential reduction in the high level of unemployment, which is the most burdensome legacy of the crisis and the main economic and social problem our country faces.

1 Introduction

In the second half of 2013 there was an incipient recovery in the Spanish economy underpinned by both external and domestic factors

As from the second half of 2013, a scenario of incipient recovery progressively firmed in the Spanish economy, continuing into the opening months of 2014. Quarter-on-quarter GDP growth rates turned positive, though moderate, and modest job creation ensued. Both external and domestic factors came into play here. The economic policy decisions adopted by the euro area governments, progress in euro area governance and the ECB's expansionary monetary policy have contributed to relaxing financial tensions, although they still remain high, and to sustaining the fragile recovery in the European economy. In turn, internally, significant headway has been made in restructuring the banking system and in correcting, to varying degrees, fiscal and competitiveness-based imbalances, among others. Joint action on these fronts has led to an easing of the adverse financing conditions and a pick-up in the confidence of both international investors and domestic households and firms, which have enabled the Spanish economy to overcome the extreme tensions of 2012 and exit the second recession of the crisis.

But considerable challenges remain, meaning that the firming of the recovery requires perseverance with the measures that have prompted the turnaround

The characteristics and depth of the crisis pose numerous challenges in terms of entrenching the recovery and setting a new sustained growth path. Uncertainty and risks are still high, and GDP and employment levels remain far below those reached prior to the crisis. To meet these challenges satisfactorily, there must be further economic policy measures at the European level aimed at bolstering still-weak growth and further progress with the roadmap for attaining a genuine Economic and Monetary Union, and most particularly a banking union. At the same time, in terms of domestic economic policy, momentum in correcting imbalances and in pushing through the reform agenda must be maintained. The complex situation of the Spanish economy, according to the analysis contained in this report, highlights the importance of furthering structural measures that anchor the capacity for growth in the long run, enhance competitiveness and help achieve the budgetary stability targets needed to restore the sustainability of public finances. Only thus may domestic and external confidence be durably restored and headway made in progressively reducing the high levels of debt weighing down on agents' spending decisions, a matter to which Chapter 2 of this Report is dedicated.

2 The external boost to the recovery of the Spanish economy

Global economic activity rose in the second half of 2013 and of tensions shifted towards the emerging economies

Following a lacklustre first half of the year, global economic activity rose in the second half of 2013. As a result the year ended with an increase in global GDP of 3% and international trade on a rising trend. The recovery was essentially underpinned by the performance of the advanced economies, most particularly the United States, since the block comprising the emerging and developing economies saw some loss of momentum (see Chart 1.1). The changes in monetary policy implemented by the Federal Reserve in response to the behaviour of the US economy and the course of some of the imbalances that have built up in the emerging economies are prompting an increase in uncertainty and in the risks linked to the future performance of these latter countries.

Inflation rates are, in general, moderate

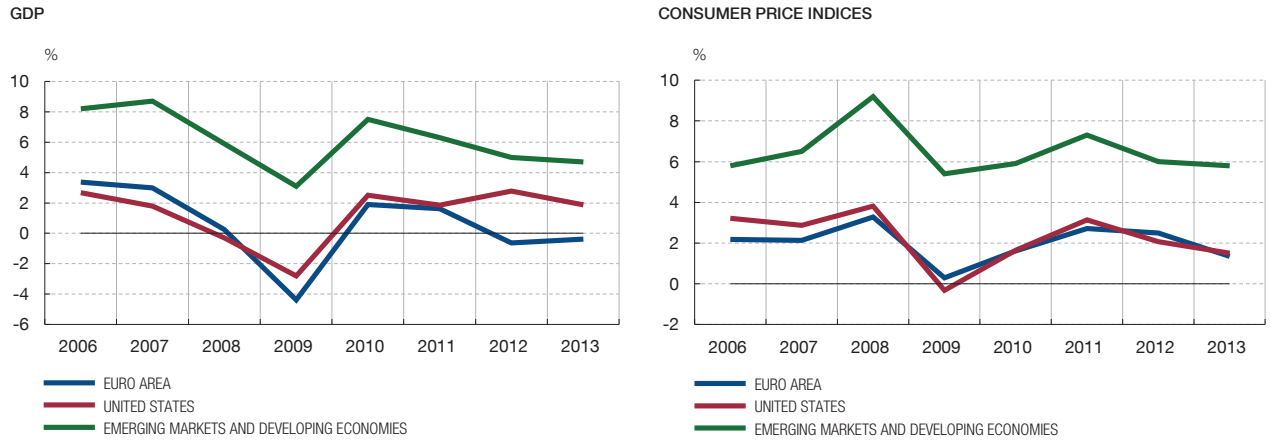
Inflation rates have broadly remained moderate, especially in the advanced economies, where activity continues to be below potential and monetary policies have adopted a strongly expansionary stance.

These same trends have run into early 2014

The economic indicators that have emerged to date in 2014 and forecasts by analysts and international organisations generally point to the main trends observed in the final stretch

GDP AND INFLATION
Rate of change

CHART 1.1



SOURCE: IMF (WEO April 2014).

of last year continuing: a progressive recovery in the global economy, a greater re-balancing of the respective contributions of the advanced and of the emerging and developing economies, a shift in the main focus of uncertainty and of risks from the former to the latter, and the absence of inflationary risks.

Euro area GDP posted positive growth rates from Q2, boosted by a more favourable external environment…

The euro area also participated in the recovery in global activity and, from 2013 Q2, posted positive quarter-on-quarter growth rates. On the whole, however, the year saw a 0.4 pp fall-off in output. The greater buoyancy of international trade boosted external demand, while the progressive shift in focus in respect of tensions towards the emerging economies provided some relief to European financial markets, which had a favourable bearing on the area's internal demand.

… by the economic policy decisions adopted by the Member States' governments, both domestically…

But the growing dynamism of the euro area was also underpinned by the economic policy decisions adopted domestically. On one hand, on the domestic stage, Member State governments continue to push through fiscal consolidation and structural reform, in accordance with the recommendations drawn up by the European Commission under the European Semester. The financial support programmes (for Greece, Ireland, Portugal and Cyprus) saw significant progress made, especially in the cases of Ireland, whose programme concluded in December, and Portugal, where it did so in May. The partial programme of financial assistance for the recapitalisation of the Spanish banking system also concluded in early 2014. Together, this has given an additional boost to domestic and external confidence in the soundness of the European project.

… and as part of the governance of the area as a whole, …

As regards the governance of the area, the European Commission revised in summer 2013 the various Member States' budget deficit objectives in order to align them to a greater extent to the economies' cyclical positions and thus promote fiscal consolidation paths that are not an obstacle to growth.

Significant headway has also been made throughout 2013 and in 2014 to date in the ongoing creation of the Single Supervisory Mechanism (SSM). Its design is practically complete and it will commence operating fully late in 2014. This centralisation of banking supervision enables the authorities to sidestep the problem of economic governance posed by the coexistence – in an economy as heavily banked as the euro area – of a single

monetary policy and currency in a setting of free capital movements, on one hand, and a micro-prudential supervision policy that is still fragmented at the level of the Member States, on the other.

Progress has also been made regarding the Single Resolution Mechanism (SRM), the other key element of the banking union project. In this case, however, aspects of great importance have still to be specified, including most notably the design of financial backstops. Banking union marks a milestone on the road to a genuine economic and monetary union, and getting its final design right will determine whether the links between banking and sovereign risk, which continue to pose a major obstacle to overcoming financial market fragmentation in the area and, consequently, to anchoring economic recovery, can be conclusively broken.

… and by the ECB's expansionary monetary policy, in a setting in which inflation stands below and some way off its reference level of 2%

Greater economic buoyancy in the euro area also has the strongly accommodating monetary policy applied by the ECB since the onset of the crisis to thank. This course of action was deepened in 2013. On the conventional front, two new cuts in official interest rates were made, placing the rate on the main refinancing operations at an all-time low of 0.25%, and the rate on the deposit facility at 0%. Regarding unconventional measures, in addition to retaining abundant long-term liquidity provision, an active policy of forward guidance was pursued from the summer. Most specifically, the ECB's Governing Council has conveyed to the public its expectations that interest rates will hold at or below their current level over a prolonged period.

Monetary policy decisions have been taken in a complex setting in which inflation, after standing at 2% in January 2013, moved on a clearly declining trajectory over the year to settle below 1% both in the final stretch of the year and in early 2014. In conjunction with the forecasts by the ECB and by other analysts, these data shape a scenario in which the growth of prices might fall some distance below the threshold of 2% over a relatively prolonged period. Admittedly, long-term inflation expectations remain anchored at levels compatible with the price stability objective set, against a background of ample slack in the euro area economy; but the persistence of low inflation rates over a lengthy period of time increases the risk that expectations may be unanchored, posing a threat to the sustainability of the recovery and an added obstacle to the necessary absorption of the internal imbalances affecting the euro area (see Box 1.1). Accordingly, the ECB continues to maintain a high degree of monetary accommodation and has reiterated its readiness to take further measures, conventional and unconventional alike, if necessary.

In June, after the cut-off date for this Annual Report, the ECB adopted an extensive package of measures. These included fresh cuts to its key interest rates; targeted long-term refinancing operations geared to promoting credit; the extension of fixed rate full allotment tender procedures at least until December 2016; the suspension of the fine-tuning operation sterilising the purchases under the Securities Market Programme, and the intensification of the preparatory work relating to outright purchases in the asset-backed securities market.

Financial conditions in the euro area have clearly improved, although it is not yet possible to talk about normality

The main indicators show an evident lowering of the degree of tension of the area's financial conditions in the area. Risk premia, volatilities and credit ratings have generally improved significantly during 2013 and in 2014 to date (see Chart 1.2). Resilience in the face of political or geo-strategic shocks has also been greater than in previous phases. However, restoring normality is proving slow, is far from complete

Inflation slowed markedly in 2013 both in Spain and in the euro area as a whole, with the respective year-on-year changes in the HICP in December standing at 0.3% and 0.8%. This trajectory has continued in 2014 to date. Projections by private analysts, official agencies and those implicit in financial market prices assume inflation will hold at very low levels for a prolonged period (see accompanying table 1). Specifically, for the euro area as a whole, the projections available point to a very slow return to rates close to 2% and to a negative Spain/euro area differential. However, longer-term inflation expectations remain anchored at levels slightly below the 2% reference (see Panel 1).

The recent downward course of inflation is due to the disappearance of certain temporary factors, linked to fiscal consolidation, and to the trend of energy prices and the exchange rate, although factors of a more permanent nature are also in play. The latter include most notably the moderation of unit labour costs and significant excess slack. The influence of these factors has been greater in Spain than in the euro area as a whole, owing to the adjustment under way here to regain the competitiveness lost during the expansionary phase.

Against this background of very low inflation, analysis of the scenarios in which price declines and, ultimately, deflationary processes – with across-the-board and sustained falls in prices – might arise has become important. In this respect, the diffusion indicators show that price declines are not overly widespread either in Spain or the euro area (see Panel 2)[1], though they have increased in 2013, albeit without yet reaching the highs observed in late 2009 and early 2010. Unlike that period, however, the recent slowdown in prices is proving especially significant in the case of services prices which, as they are particularly labour-intensive, have been more affected by wage moderation and productivity gains.

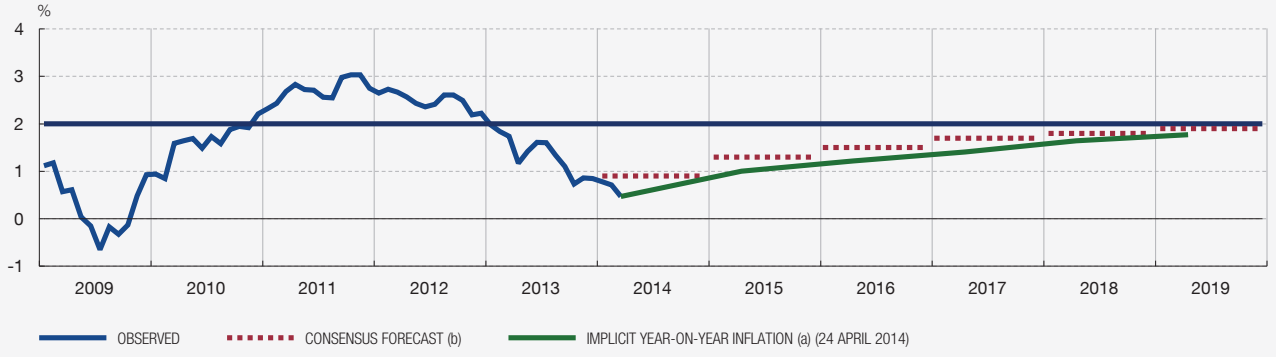
In any event, when evaluating scenarios of sustained price declines a distinction must be drawn between the consequences for the euro area as a whole and for Spain. A fall in a euro area member country's prices might reflect the adjustment of relative prices needed to correct some of its imbalances. In that respect,

1 These indicators measure the proportion of expenditure-weighted and seasonally adjusted HICP items that show month-on-month declines.

1 INFLATION FORECASTS

Spain	2014	2015	2016
Consensus Forecast (April 2014)	0.3	1.0	1.5
European Commission (February 2014)	0.3	0.9	—
IMF (April 2014)	0.3	0.8	0.9
Euro Area			
ECB (March 2014)	1.0	1.3	1.5
Consensus Forecast (April 2014)	0.9	1.3	1.5
European Commission (February 2014)	1.0	1.3	—
IMF (April 2014)	0.9	1.2	1.3
Inflation swap contracts (24 April 2014)	1.0	1.2	1.4

1 LONG-TERM INFLATION EXPECTATIONS



SOURCES: Eurostat.

a Obtained from inflation swap contracts.
b Consensus Forecast forecasts from the third year onwards are only updated in April and October each year.

shocks originating in positive developments on the supply side entail benign price declines, as they are accompanied by higher levels of output and employment. Notable among these are those linked to structural reforms that improve the economy's productivity or heighten competition in product and factor markets.[2] Conversely, contractionary demand-side shocks may be more harmful, bringing together declines in prices and output which, if they feed back into one another, may prompt a deflationary spiral.

A generalised and persistent situation of price declines may dampen activity through various channels. Firstly, expectations of sustained low inflation exerts upward pressure on the expected real interest rate, which leads to private spending being deferred. Moreover, if – as is currently the case – nominal interest rates are close to zero, the capacity of conventional monetary policy to correct this effect is very limited. Secondly, as debt contacts are specified in nominal terms, falls in prices increase the real-terms cost of servicing such debt. That is particularly significant in countries such as Spain, where the volume of household and corporate debt is still high. Lastly, and more generally, very low inflation across the euro area hampers an individual country achieving gains in competitiveness relative to the area as a whole.

In any event, a very moderate inflation scenario may trigger particularly adverse effects if it unanchors long-term inflation expectations, thereby reducing the effectiveness of monetary policy and increasing real interest rates. Nonetheless, at present European households do not seem to expect either that consumer prices will fall (see Panel 3) or that long-term inflation expectations will be far off 2%.

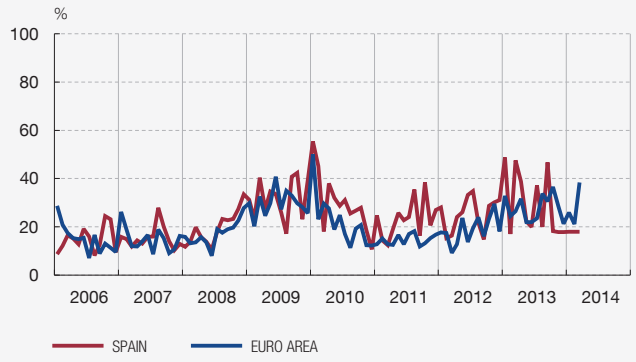
2 See J. Andrés, Ó. Arce and C. Thomas (2014), *Structural reforms in a debt overhang,* Documento de Trabajo del Banco de España (forthcoming), and Box 1.2 in this Chapter.

The Banco de España dynamic stochastic general equilibrium model BEMOD, estimated for Spain and the rest of the euro area, provides for the analysis of the probability of different price scenarios materialising in relation to Eurosystem predictions. In particular, an assessment can be made of the probability with which moderate inflation (lower than 1% on average in 2014) or price falls of some intensity (a rate of change below -1%) might be observed.[3] The estimations show that scenarios of inflation below 1% are highly likely, especially in Spain, while the scenarios of price declines of over 1% are fairly unlikely. In addition, to assess the extent to which a slightly higher level of inflation across the euro area may smooth the competitive adjustment needed in Spain, an alternative exercise has been conducted. In it, as the result of a more expansionary monetary policy, inflation in the euro area increases by 50 bp in 2014 and 2015, drawing closer to the 2% target in late 2015. Under this new scenario, there is an appreciably lower probability that Spanish inflation will be below -1%.

In short, the evidence available would indicate that inflation is going to remain at very low levels over a prolonged period, but that the probability of a costly deflation process arising at present is limited. In any event, the adjustment still required in terms of competitiveness in some economies in the area, such as Spain's, would be assisted if the euro area inflation rate were to converge towards its long-term target at a somewhat brisker rate pace than is currently anticipated.

3 In interpreting the results it should be borne in mind that the simulations performed incorporate the zero lower bound constraint whereby nominal interest rates cannot be negative, although they do not consider the possibility of implementing non-conventional monetary policy measures. In addition, the exercises presented hereafter do not take into account the debt deflation channel, meaning that the total cost of the generalised and sustained declines in prices might be being underestimated. Lastly, bootstrapping techniques are used to take into account the dependence of the structural shocks.

2 DIFFUSION INDICATORS. PERCENTAGE OF EXPENDITURE (a)



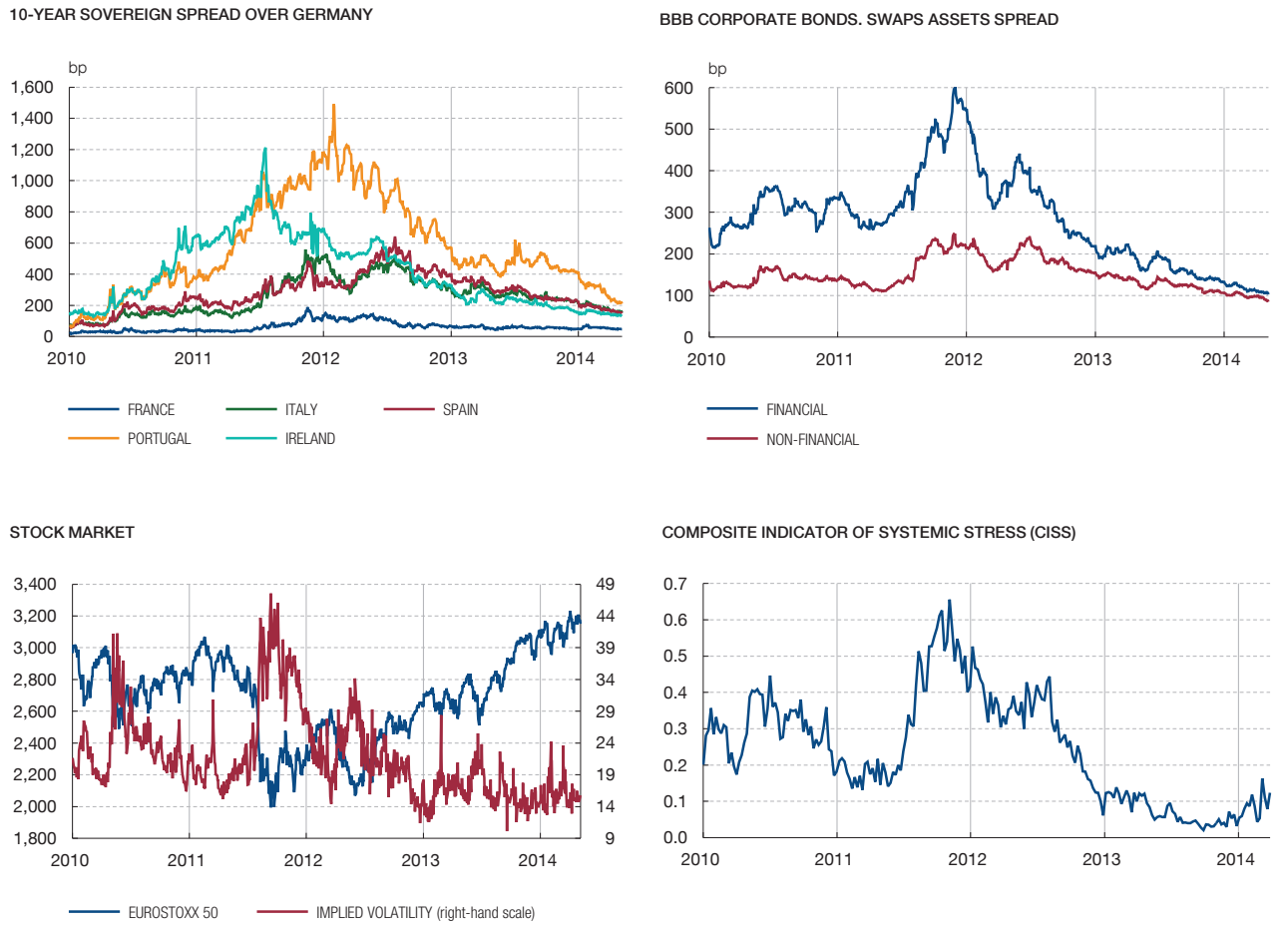
3 PRICE DECLINE EXPECTATIONS IN THE NEXT TWELVE MONTHS
European Commission surveys

SOURCES: Banco de España and European Commission.

a Calculated with seasonally adjusted series.

EURO AREA FINANCIAL CONDITIONS

CHART 1.2



SOURCES: ECB, JP Morgan and ESRB.

and remains exposed to the risk of further shocks. Adverse developments in credit, and in particular lending extended to firms, affects not only the economies most severely punished by the crisis but also the euro area as a whole, further hampering the process of economic recovery. Moreover, the persisting differences in financing costs across the various Member States still reflect a degree of financial market fragmentation that is not compatible with the normal functioning of a monetary union and which prevents expansionary monetary impulses effectively reaching the areas where they are most needed.

3 Adjustment and recovery in the Spanish economy

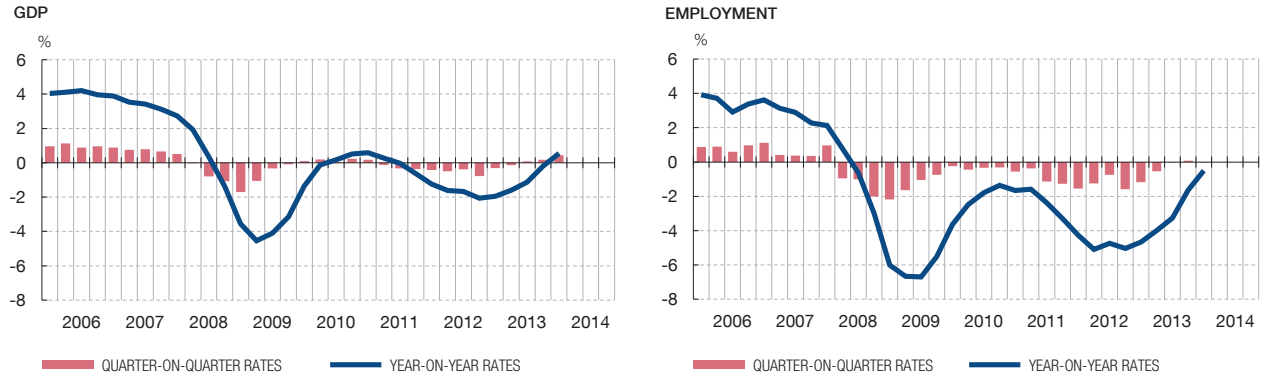
The improvement in the external environment and the abatement of financial instability were conducive to the recovery in the Spanish economy in the second half of 2013

The Spanish economy embarked on a gradual recovery in 2013 and, in Q3, it exited the recession that had begun two years earlier, posting modest increases in GDP (see Chart 1.3). This change in trajectory, which has continued into the opening months of 2014, was helped also by the easing in financial tensions and by a gradual improvement in perceptions about the labour market situation, which contributed to lessening uncertainty and increasing confidence. Adding to this was the greater gradualism in the budgetary adjustment policy, following the European Council's July decision to put back two years the date for placing the budget deficit below 3% of GDP. That entailed a relaxing of the deficit target by 2 pp mid-year, from 4.5% of GDP to 6.5% of GDP.

Despite moving on an improving course over the year, GDP fell by 1.2% in 2013, partly as a result of the carry-over effect arising from the marked decline in activity in late 2012.

SPAIN: GDP AND EMPLOYMENT

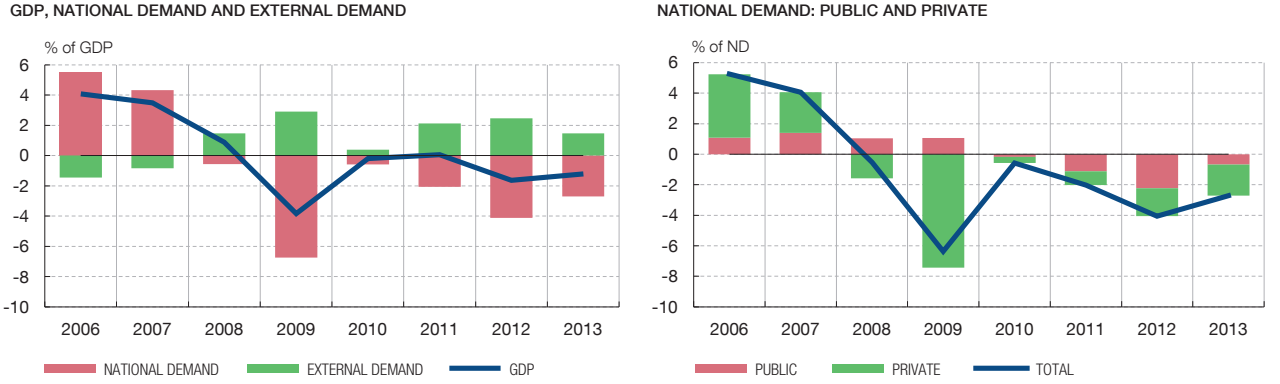
CHART 1.3



SOURCES: INE and Banco de España.

GDP AND NATIONAL DEMAND. CONTRIBUTIONS TO GROWTH

CHART 1.4



SOURCES: INE and Banco de España.

From the expenditure standpoint, national demand fell by 2.7% while the external sector made a positive contribution of 1.5 pp, thereby mitigating, for the sixth consecutive year, the impact of the contraction in domestic spending on activity (see Chart 1.4).

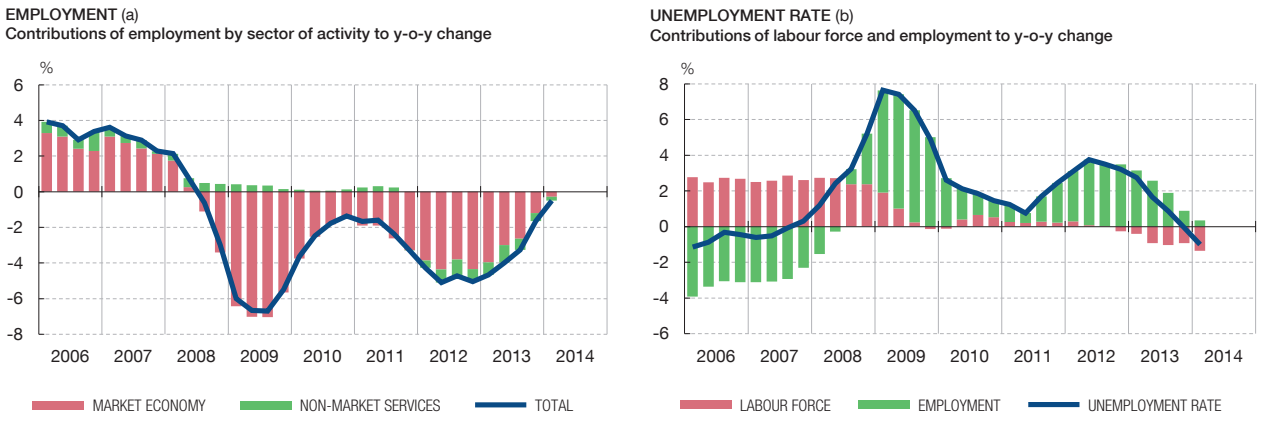
The rebalancing of external and national demand was underpinned by the recovery in investment in equipment and in household consumption

The pace of the contraction in national demand also lessened over the course of the year. Among the private components of domestic spending, investment in equipment began to pick up earlier, right at the start of the year, followed by household consumption as from Q2. In turn, residential investment posted negative figures throughout the year, albeit at an increasingly diminished pace, which took its rate of annual decline to 8%, and its percentage expressed in terms of GDP to 4.4%, 65% down on its 2006 peak. Finally, the negative contribution of the public components of expenditure (government consumption and public investment) to activity lessened against the background of the easing in fiscal requirements mid-year.

The improvement in business investment was confined to the capital goods component, which increased by a moderate 2.2%, assisted by the greater momentum of exports, the reduction in uncertainty, the incipient alleviation of adverse financing conditions and, lastly, the further restructuring of non-financial corporations' financial positions, whose net lending capacity rose to 4.3% of GDP in 2013. The internal resources generated by the surplus in saving relative to investment are helping correct the excessive debt that prevailed in recent years.

EMPLOYMENT AND UNEMPLOYMENT

CHART 1.5



SOURCES: INE and Banco de España.

a Quarterly National Accounts full-time equivalents.
b The EPA (Spanish Labour Force Survey) series follow 2005 methodology and are updated with the 2011 census.

Household consumption picked up in the second half of 2013, although for the year on average it posted a fall of 2.5% following two years of declines, having worsened to a particularly acute extent in the final stretch of 2012. The recovery in consumption over the course of the year came about against the background of the slowing decline in disposable income, which was more marked in real terms owing to the moderate inflation in 2013, and the more favourable trend of households' financial wealth. The pronounced declining trajectory of the saving rate from 2009 was interrupted, and it posted a level similar to that of the previous year (10.4% of disposable income) and similar, too, to its historical average.

Net external demand contributed once again to lessening the contractionary impact of domestic demand on output, although it moved on a declining trajectory

The positive contribution of net external demand to GDP amounted to 1.5 pp. This was the result of buoyant exports, as imports stabilised owing to the improvement in final demand after having declined heavily in 2012. Export growth was driven both by goods sales to the rest of the world, which expanded more than their target markets did, and by exports of tourist services, in an exceptional year for the sector in which tourist revenues were at an all-time high. Gains in competitiveness played a very significant role in both developments, as is discussed below.

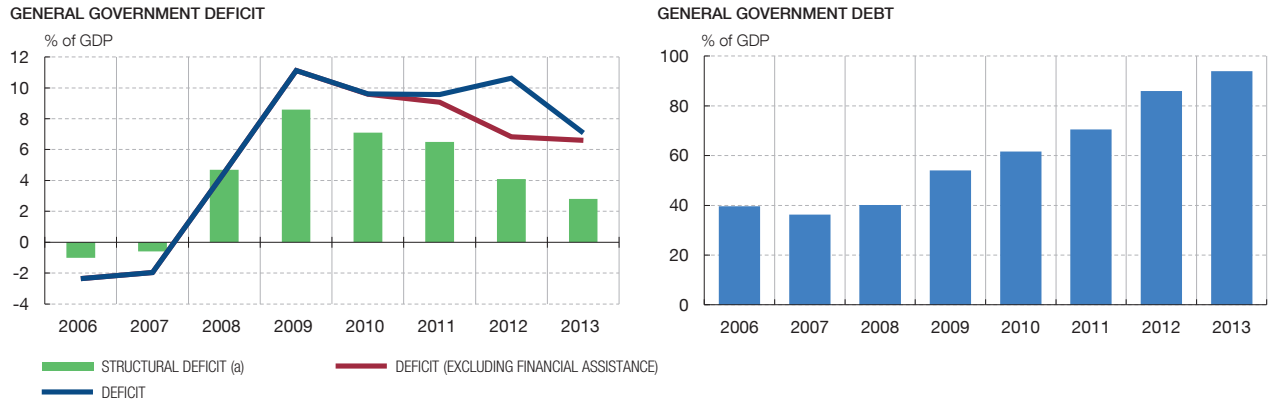
That said, the contribution of the external sector was smaller than that of the two previous years, and it moved on a declining trajectory as exports progressively slowed, following the weakening of the emerging economies, and as imports from the rest of the world rose, in step with the pick-up in the components of final demand with a greater import content (exports and investment in equipment).

The sequence of the recovery in the different components of expenditure – first exports, next business investment and lastly household consumption – provides a good starting point for anchoring the recovery. However, entrenching the recovery requires certain conditions be met so that household and business spending may grow in a sustained manner, and in the current circumstances that depends essentially on the dynamism of employment.

The rate of decline in employment lessened during the year, until turning marginally positive in the final months, for the first time since 2008 Q2...

The rate of decline in employment eased in 2013 to 3.4% (4.8% the previous year), this rate being much influenced in any event by the adverse behaviour of employment in the final stretch of 2012. Indeed, the pace of job destruction gradually eased as the year unfolded, to the point of showing marginal job creation in the closing months of the year, for the first time since 2008 Q2. This progressive improvement was fairly generalised

GENERAL GOVERNMENT DEFICIT AND DEBT CHART 1.6



SOURCES: IGAE and European Commission (AMECO).

a European Commission estimate (AMECO, spring 2014).

across the sectors of activity, although it was more marked in certain market services, and has continued in 2014 to date.

... and the unemployment rate began to turn down as from Q1, ending the year at 25.7%. The level of unemployment, its composition and its persistence indicate that a far-reaching adjustment must be made

The unemployment rate moved on to a declining trajectory in Q1, from a level of 26.9% of the labour force (a figure encompassing somewhat more than 6 million unemployed) to 25.9% in the opening months of 2014. These developments in unemployment were assisted by the contraction of the labour supply, which fell by 1.1% (after stabilising the previous year) owing to the decline in the working-age population and to a slight reduction in the participation rate, for the first time since the start of the crisis. The decline in the labour force was more acute among foreign nationals (-5.5%), although it also affected nationals for the first time (–0.6 %) (see Chart 1.5).

However, at the close of the year, the composition of unemployment in terms of age and skills groups had scarcely altered, meaning that the highest unemployment rates were among the less-skilled youths. In turn, the slight rise in unemployment exit flows in the second half of 2013 was concentrated among those unemployed for less than a year, whereby the incidence of long-term unemployment moved on a rising trajectory throughout the year, reaching a rate of 61.6% in Q1 this year. The level of unemployment, its composition and its persistence are indicative of the considerable scale of the problem to be resolved.

For the recovery to firm requires that the correction of the imbalances still in place be completed

The scenario of recovery that has finally taken shape over the past year, after overcoming the sharp double-dip recession, is closely linked to progress in the correction of the imbalances that place the Spanish economy in a position of extreme vulnerability to the international crisis and, particularly, to the euro area sovereign debt crisis. From this starting point, the sustainability of demand and the firming of the recovery depend on job creation gaining in strength and on completing the adjustments still pending in respect of the remaining imbalances.

3.1 FISCAL CONSOLIDATION

The intensity of the budgetary adjustment eased mid-year following the European authorities' decision to tailor deficit targets more to cyclical circumstances

Fiscal consolidation continued in 2013, with an initial overall general government deficit target of 4.5% of GDP, entailing a reduction of 2.3 pp on that of the previous year (6.8% of GDP, once the assistance to financial institutions is stripped out). Mid-year, however, the European Council agreed to better tailor deficit targets to the weakness of the cyclical position, providing for greater gradualism in implementing the policy of budgetary adjustment. In Spain, this decision meant a relaxing of the deficit target for 2013, which was set at 6.5% of GDP. For the 2014-2016 period, the new targets were set at 5.8%, 4.2% and 2.8% of GDP, respectively.

The updated Stability Programme submitted by the Government to the European Commission on 30 April confirmed these targets, though it considered a somewhat more ambitious reduction in the general government deficit in 2014, setting it at 5.5% of GDP.

Acting as a reference point for budgetary conduct were the commitments to reporting and monitoring emanating from the current framework of fiscal rules

The year 2013 was the first full one in which the mechanisms of the Law on Budgetary Stability and Financial Sustainability for the monitoring of the budget outturn, and those geared to ensuring compliance with the targets set for all tiers of government, began to be applied. Furthermore, an extension was made in 2013 to the payments to suppliers plan, which ended in February 2014, and which injected somewhat over €43 billion from mid-2012. Lastly, the close of the year saw the completion of the framework of national fiscal rules, with the creation of the Independent Authority for Fiscal Responsibility.

The general government deficit shrank to 6.6% in a complex macroeconomic setting, marked by cyclical weakness and by the rise in interest payments

In step with these conditioning factors, the fiscal adjustment drive continued in 2013 through a reduction in the primary structural balance of the order of 1.6% of GDP, which was less intense than in previous years (3 pp in 2012). Reducing the deficit was once again hampered by cyclical weakness and by the growing weight of interest payments (which climbed to 3.4% of GDP), as a result of which net general government borrowing shrank to 6.6% of GDP (a figure net of the assistance to financial institutions), 0.1 pp higher than the target set in July (see Chart 1.6).

In terms of sub-sectors, the reduction in the budget deficit reflected the adjustment by the regional and local governments (by 0.3 and 0.2 pp of GDP, to balances totalling -1.5% and 0.4% of GDP, respectively), with a higher surplus in the latter case than that programmed when the targets were set. In turn, the aggregate central government and Social Security System target deficit was exceeded by 0.3 pp of GDP, standing at the close of the year at 5.5% of GDP. As regards components, the slight reduction in net general government borrowing came about chiefly as a result of the increase in indirect tax revenue following the hike in VAT the previous year and the introduction of other, environment-related taxes, although their impact was less than initially foreseen. By contrast, no headway was made in reducing public spending since the increase in interest payments and in welfare benefits could not be offset by the adjustment of certain government consumption and capital expenditure items. In turn, the public debt ratio rose significantly, from 85.9% of GDP in 2012 to 93.9% last year.

3.2 RECOVERY IN COMPETITIVENESS

There was fresh momentum to the recovery in competitiveness in 2013 as a result of the easing in labour costs and in prices

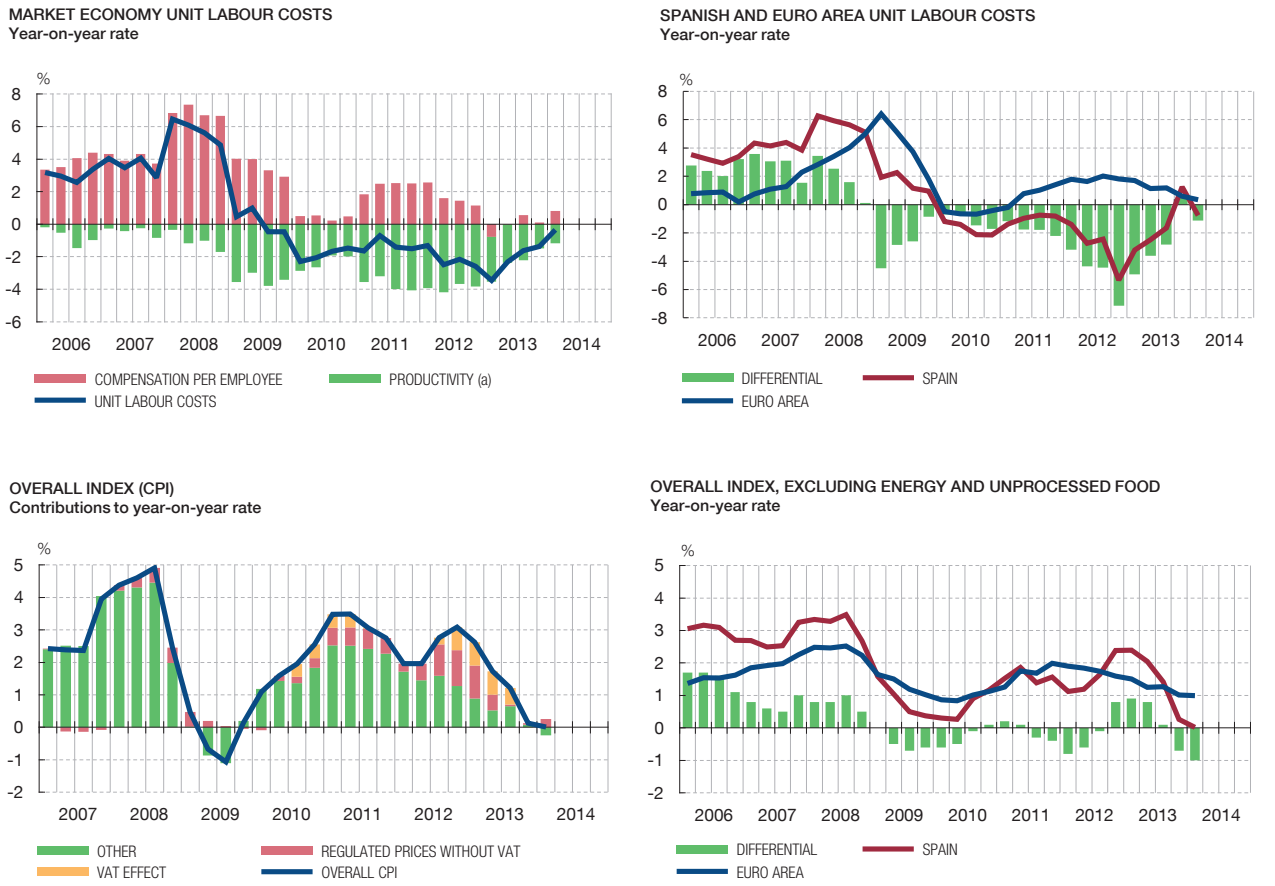
Market economy unit labour costs (ULCs) declined by 2.2% in annual average terms, the result of the stabilisation of compensation per employee in the market economy and an increase in productivity lower than that of the previous year (see Chart 1.7). The decline in economy-wide ULCs was somewhat lower (-1.6%) owing to the base effect that prompted the fall in public-sector wages in December 2012. Overall, these developments entailed the closing of the gap that opened up between the respective Spanish and euro area rates of change of labour costs during the expansionary phase, which had resulted in heavy losses in competitiveness. Unlike in the early years of the crisis, in 2013, as had occurred the previous year, the correction of ULCs turned more on the adjustment of labour costs than on productivity gains, since the latter gradually fell away in step with the diminishing pace of job destruction.

Labour costs reflected the pattern of greater wage moderation, derived in part from the increase in domestic flexibility provided by the new labour market framework

In 2013, labour costs intensified the path of wage moderation that had progressively become discernible in 2012, possibly reflecting the greater sensitivity over the setting of wages to the specific situation of firms in response to the broader possibilities for internal flexibility generated by the entry into force of the labour reform. Under collective bargaining, fewer wage settlements and a reduction in the number of agreements including indexation clauses and in their amount were observed, while wage drift (the difference between wage increases in collective agreements, adjusted where appropriate for indexation clauses,

LABOUR COSTS AND INFLATION

CHART 1.7



SOURCE: Eurostat and Banco de España.

a Year-on-year rates with sign changed.

and the rate of change of compensation per employee) turned negative once more. This latter variable may be viewed as an indirect indicator of the effect of other aspects of the labour reform, in which exact information is not available (cases in point may be the effective use of the possibilities of opt-outs or the amendment of working conditions). As a result, average real wages fell slightly.

And inflation held at a very low level, as the effects of the rises in administered prices and in indirect taxes in 2012 were progressively stripped out

The inflation rate fell markedly during the year, as the base effects of the rise in certain administered prices and the hike in VAT in September 2012 were progressively removed. Stripping out these effects, a situation of practical stagnation in the overall level of prices prevailed throughout the year, and has continued in 2014 to date.

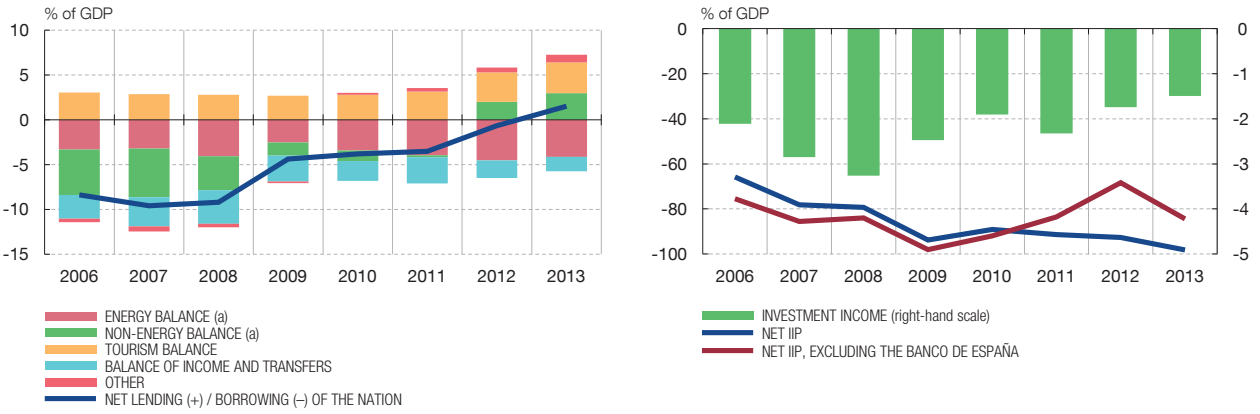
There has been an increase in the sensitivity of cost- and price-setting to the cyclical position...

This change in price dynamics reflects an increase in the sensitivity of price-setting to cyclical conditions and is particularly significant in the case of services, where the slowdown in prices is proving more pronounced, after having been the central point of inflationary tensions in the past. This appears to confirm a greater alignment of sale prices to costs borne and to the specific conditions of the business cycle.

... and the recovery in business margins has continued

The high degree of financial tension in recent years would appear to have bolstered the pick-up in margins at this phase of the cycle by inducing certain companies to alleviate the effects arising from tight credit standards by generating funds within the business

NET LENDING (+)/BORROWING (–) OF THE ECONOMY AND INTERNATIONAL INVESTMENT POSITION CHART 1.8



SOURCES: INE, Customs and Banco de España.

a The energy and non-energy balance are a Banco de España estimate drawing on Customs data.

The widening of margins would have been assisted by the prevalence of an insufficient degree of competition in certain sectors. In any event, the generation of funds within businesses should be conducive to the incipient investor cycle gaining momentum.

Overall, the prices differential has turned favourable for the Spanish economy

Overall, in recent years there has been a noticeable reduction in the Spain-euro area inflation differential, which has narrowed from 1 pp on average in the 1998-2007 period to 0.2 pp in the downturn. The narrowing of this gap has been of a similar intensity in terms of core inflation. Since September last year, Spanish inflation has stood systematically below that of the euro area (with an average differential of -0.6 pp), ensuring the continuity of the adjustment of relative prices even under the difficult conditions created by low European inflation (see Box 1.1).

The ongoing internal devaluation is exerting a very favourable effect on the Spanish economy's terms of trade

The recovery in competitiveness had a positive impact on foreign trade, whereby in 2013 a current account surplus was posted for the first time since 1997 (0.8% of GDP compared with a deficit of -1.2% of GDP in 2012). This result was in response to an improvement in virtually all the current account components, although most notably so, as has been the case since 2007, in the non-energy trade balance, which marks a most significant advance in the necessary process of external rebalancing (see Chart 1.8). That said, the high dependence on imported energy continues to exert an adverse influence on the external balance. In terms of difficulties, mention should also be made of the persistent deficit on the income balance, linked to the high level of the International Investment Position (IIP). To attain lasting external equilibrium it is thus necessary for the surplus on the trade in non-energy goods and in services to offset the deficits on the imported energy and income balances.

3.3 THE RESTRUCTURING AND CLEAN-UP OF THE BANKING SYSTEM

The crisis severely impacted a sector that was oversized and highly exposed to real estate activity…

Chapter 2 of this Report analyses in detail the implications of the increase in the Spanish economy's debt prior to the crisis, which in a heavily banked system such as Spain's took the form of an expansion in credit institutions' balance sheets and likewise translated into a high concentration of risks in productive activities linked to the real estate market. Both factors (balance sheet expansion and risk concentration) placed banks in a position of vulnerability to adverse macroeconomic shocks, and in particular to those that might affect the real estate market to a greater extent. The incidence of the crisis on the banking system's financial and wealth position was very mixed from bank to bank.

… making it necessary to set in train a restructuring, recapitalisation and clean-up of the banking system and a reform of its regulatory and supervisory frameworks

To face up to the effects of the crisis, a far-reaching reform of the banking system was undertaken. The reform has progressively adjusted to ensuing events and has been structured around four major courses of action: the restructuring of the system, its recapitalisation, the clean-up of balance sheets and the reform of the regulatory and supervisory frameworks.

Some of these measures required the release of a sizeable volume of public funds at a time at which financial tensions and the subsequent degree of market fragmentation meant they could not be obtained at reasonable prices on the markets; accordingly, the Span ish Government formally requested financial assistance in the summer of 2012, which was granted through a sectoral European programme for the recapitalisation of part of the banking system. The programme envisaged the drawdown of a maximum amount of €100 billion, although only €41 billion were used, and it was formalised with the signing of a Memorandum of Understanding (MoU) that detailed the main measures that have shaped the reform process since.

In early 2014, the European programme for bank recapitalisation was successfully concluded, having entailed far-reaching changes for the size and financial position of the system...

The authorities' positive assessment of the fulfilment of the conditions of the MoU meant that the programme could be considered as concluded in early 2014. The culmination of this stage marks the completion of a process that has deeply transformed the Spanish banking system.

Compared with the situation in 2007, the number of credit institutions has fallen by 17%; that of their offices, by 22%; and that of employees in the sector, by 15%. These adjustments, which under the timetables envisaged for certain banks' restructuring plans will be pursued further, have been particularly centred on the savings banks, which were much affected by the crisis and saw their capacity to respond greatly limited by their particular legal status. As a result, savings banks had to transfer their financial intermediation activity to banking institutions. The net exposure of the system as a whole to the real estate sector was more than halved, further to a substantial increase in provisions required (Royal Decree-Laws 2/2012 and 18/2012 entailed an increase in provisions equivalent to approximately one-fifth of prior net exposure) and, in the case of institutions that receive public aid to recapitalise, through the transfer of claims on real estate developers and foreclosures to a new and mostly privately held institution created to this end under the framework of the MoU: Sareb.

Banks' effort in terms of recapitalisation was also significant. In 2012 a stress test was performed by an independent external consultancy to estimate the funds needed to reinforce the capital of each individual institution. 17 groups of institutions participated, representing 90% of the system's total loans, and at ten of them (with a relative weight in the market for credit of 34%) an increase in capital was required. Two groups were able to cover these requirements by their own means and the remaining eight were able to count on public aid provided by the FROB and financed through the European Stability Mechanism (ESM), under the financial support programme for bank recapitalisation. Adding these contributions to those made in prior years by the FROB and the Deposit Guarantee Fund for Credit Institutions (FGDEC by its Spanish name), the total amount of public injections in the form of capital during the crisis totalled €61 billion. Additionally, through private measures, banks raised their capital by a further €53 billion, meaning that the recapitalisation drive undertaken through public and private means amounted to over 11% of GDP. Private measures included most notably burden-sharing exercises (involving hybrid instrument and subordinated debt-holders).

… and reforms of its regulatory and supervisory framework

There has also been a major reform of banking regulation and supervision with the ultimate aim of reducing the risk of future crises and of better protecting taxpayers and the economy from their potential consequences. A new bank crisis management and resolution framework has thus been established. The resulting arrangements provide for more flexible and nimble intervention by the Banco de España, they define the competencies of the FROB and the FGDEC, and they broaden the range of tools available at all stages of the crisis. The legal framework for savings banks has also been reformed, as it was revealed by the crisis to have certain key shortcomings, and stricter capital requirements have been imposed on them, setting for 2013 and 2014 a minimum level of core capital of 9%, above the minimum threshold laid down by European capital regulations, which have adapted Basel III. The reform also includes stricter requirements for reporting on exposure to the real estate sector and on refinancing operations, so as to increase the degree of banking transparency. Finally, supervisory procedures have been reviewed and reformed, with a series of organisational changes being introduced.

Reducing the State ownership share in the system, the completion of the Banking Union and the macroeconomic outlook nonetheless pose new challenges for the sector

The ongoing exit by FROB (and by FGDEC) from the capital of the State-supported banks also progressed during 2013 and has continued in 2014 to date. These two official funds have now ceased to be stakeholders in Banco de Valencia, Banco Gallego and NCG, and 7.5% of the capital of Bankia was also sold to institutional investors – non-residents in the main – early this year. The sale of shares still in public hands is, in any event, one of the challenges that will need addressing.

Likewise, the start-up of the Banking Union in Europe and the subsequent integration of banks and of the national supervisory authority into the SSM and the SRM poses organisational challenges not only for Spanish banks – and for the Banco de España itself – but also for all Eurosystem banks. This is the case too for the comprehensive assessment to which European banks as a whole are being subjected and which includes a new stress test, which the ECB is conducting in collaboration with the European Banking Authority and with the participation of the national supervisory authorities.

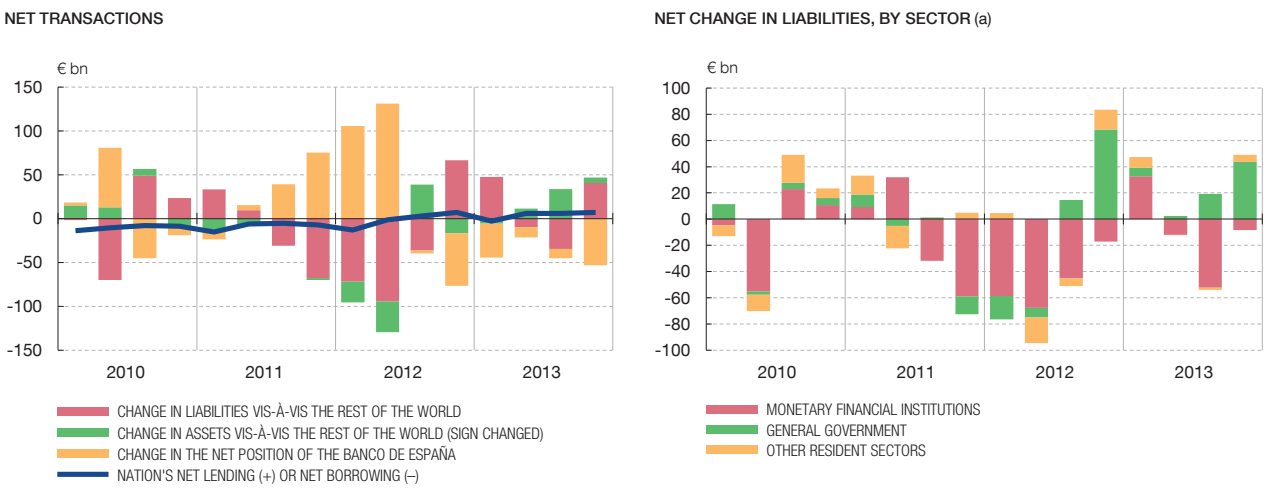
Finally, the Spanish economy's short- and medium-term growth outlook makes for a complex scenario for banks, which will be obliged to gain in efficiency and competitiveness in a setting in which progress towards the Banking Union may well be expected to heighten the degree of competition within the area. Here, too, banks will have to continue reinforcing their capital in response to the greater demands of regulators and investors.

3.4 THE PROGRESSIVE NORMALISATION OF THE FINANCING OF THE ECONOMY

The easing of tensions in the euro area and the headway on the adjustment of the Spanish economy have been conducive to improved financing conditions.

In conjunction with the easing of tensions and European markets, headway in the adjustment of the Spanish economy favourably influenced investors' confidence and translated into substantial improvements in financing conditions in Spain for credit institutions, for general government and, though comparatively to a lesser degree, for households and firms. The costs of European wholesale market funds, on which the Treasury, banks and major national corporations draw, fell. So too, though more moderately and in the final stretch of the year, did funds from bank loans. In terms of amounts, the decline in private-sector financing slowed and signs were detected of the restoring of financial flows towards companies that are in a sound position and which, therefore, are better placed to efficiently use such funds. Along these same lines, three of the main rating agencies upgraded Spanish sovereign debt in the opening months of 2014. That said, euro area financial market fragmentation has not yet been eliminated, whereby these conditions continue to be overly strict for the strongly accommodating stance of the single monetary policy and for the specific circumstances of the Spanish economy's incipient recovery.

BALANCE OF PAYMENTS FINANCIAL ACCOUNT CHART 1.9



SOURCE: Banco de España.

a Excluding the Banco de España.

External funding flows picked up, but will have to continue to do so sustainedly in order to redress the high debt position vis-à-vis the rest of the world

The pick-up in investor confidence is also visible in the Spanish economy's external funding flows (see Chart 1.9). Leaving aside the compensatory role the Banco de España balance sheet plays in this respect, the figures from the balance of payments financial account show how, following the outflow of funds totalling over €174 billion in 2012, there was a net inflow of funds of almost €88 billion in 2013. Net non-resident portfolio investment increased by almost €44 billion last year, compared with the contraction of over €55 billion observed a year earlier. However, these positive movements in terms of flows should not mask the fact that the Spanish economy's net debtor position vis-à-vis the rest of the world remains excessively high compared with peer countries and is a factor of vulnerability.

The adjustment of the International Investment Position will involve sustaining our positive trade balance with the rest of the world, as reflected by the figure recorded in 2013 for the nation's net lending (equivalent to 1.5% of GDP), the first time a positive figure has been posted since 1997. The turnaround was accompanied by a large-scale readjustment in the balances of the different institutional sectors. With the crisis, households and non-financial corporations have shown strong increases in their lending capacity, while general government borrowing needs have likewise grown substantially. From this sectoral perspective, the continuity of the adjustments under way should clearly also translate into an improved contribution of the general government sector to the economy's overall balance.

The adjustment of private-sector overindebtedness must also continue

In this respect, there was also progress in correcting private-sector overindebtedness in 2013, although the adjustment is, in comparative terms, proving somewhat slower. Chapter 2 in this Report is dedicated exclusively to the Spanish economy's debt and, in this connection, it offers a detailed analysis of how the adjustment is being made and of the main challenges it poses. As is explained, both the cyclical position of our economy and past experience suggests that credit must continue on the path of adjustment, but increasingly more moderately so, until the recovery firms and provides for a more dynamic increase in household and corporate income. Consequently, the main challenge in the short term is how to square credit containment at the aggregate level with a shift in the mix of inflows of fresh funds, with this shift enabling such flows to be allocated to those uses with a more positive impact on growth and employment. While the evidence available

MAIN INDICATORS OF THE SPANISH ECONOMY (a)

TABLE 1.1

	2008	2009	2010	2011	2012	2013
Demand and output (b)						
GDP	0.9	-3.8	-0.2	0.1	-1.6	-1.2
Private consumption	-0.6	-3.7	0.2	-1.2	-2.8	-2.1
Government consumption	5.9	3.7	1.5	-0.5	-4.8	-2.3
Gross capital formation	-4.2	-18.3	-4.2	-5.6	-6.9	-5.2
Equipment investment	-2.9	-23.9	4.3	5.3	-3.9	2.2
Construction investment	-5.8	-16.6	-9.9	-10.8	-9.7	-9.6
Housing	-9.1	-20.4	-11.4	-12.5	-8.7	-8.0
Other construction	-1.6	-12.2	-8.4	-9.2	-10.6	-10.9
Exports of goods and services	-1.0	-10.0	11.7	7.6	2.1	4.9
Imports of goods and services	-5.2	-17.2	9.3	-0.1	-5.7	0.4
Contribution of national demand to GDP growth	-0.6	-6.7	-0.6	-2.1	-4.1	-2.7
Contribution of net external demand to GDP growth	1.5	2.9	0.4	2.1	2.5	1.5
Employment, wages, costs and prices (c)						
Total employment	-0.2	-6.2	-2.3	-2.2	-4.8	-3.4
Employment rate (d)	65.4	60.8	59.7	58.8	56.5	55.6
Unemployment rate	11.3	17.9	19.9	21.4	24.8	26.1
Compensation per employee	6.9	4.2	0.4	1.3	0.2	0.7
Apparent labour productivity	1.1	2.5	2.2	2.3	3.3	2.3
Unit labour costs	5.7	1.6	-1.7	-1.0	-3.0	-1.6
GDP deflator	2.4	0.1	0.1	0.0	0.0	0.6
Consumer price index (12-month % change)	1.4	0.8	3.0	2.4	2.9	0.3
Consumer price index (annual average)	4.1	-0.3	1.8	3.2	2.4	1.4
Consumer price differential with the euro area (HICP)	0.9	-0.5	0.4	0.3	-0.1	0.2
Net lending (+) or net borrowing (-) and financial balance (e)						
Resident sectors: domestic net lending (+) or net borrowing (-)	-9.2	-4.4	-3.8	-3.5	-0.6	1.5
General government	-4.5	-11.1	-9.6	-9.6	-10.6	-7.1
General government (excluding aid to financial institutions)	-4.5	-11.1	-9.6	-9.1	-6.8	-6.6
Households and NPISHs	1.2	6.3	4.2	3.7	2.4	2.5
Companies	-5.9	0.4	1.6	2.3	7.5	6.1
Financial institutions	1.8	1.3	0.9	1.9	6.4	1.8
Non-financial corporations	-7.7	-0.9	0.7	0.3	1.1	4.3
Net international investment position	-79.3	-93.8	-89.1	-91.4	-92.7	-98.2
General government gross debt	40.2	54.0	61.7	70.5	86.0	93.9
Monetary and financial indicators (f)						
ECB minimum bid rate on MROs	3.9	1.2	1.0	1.3	0.9	0.5
Ten-year government bond yield	4.4	4.0	4.2	5.4	5.8	4.6
Synthetic bank lending rate	6.2	3.8	3.3	4.1	4.1	4.1
Madrid Stock Exchange General Index (Dec 1985 = 100)	1,278.3	1,042.4	1,076.5	971.8	767.5	879.8
Dollar/euro exchange rate	1.5	1.4	1.3	1.4	1.3	1.3
Nominal effective exchange rate vis-à-vis developed countries (g)	103.3	103.5	101.9	101.8	100.4	101.7
Real effective exchange rate vis-à-vis developed countries (h)	119.0	116.2	113.0	110.6	103.8	102.1
Real effective exchange rate vis-à-vis the euro area (h)	114.9	111.8	110.4	108.4	103.1	99.9
Households: total financing	4.4	-0.3	0.2	-2.4	-3.8	-5.1
Non-financial corporations: total financing	8.2	-1.4	0.7	-1.9	-6.1	-5.1

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 Annual average levels for the Madrid Stock Exchange General Index, interest rates and exchange rates, and rates of change for finanancial assets and liabilities.
g 1999 Q1 = 100.
h 1999 Q1 = 100. Measured with unit labour costs.

suggests this shift is already taking place, it would be worth considering potential means of speeding up and deepening the process.

4 The legacy of the crisis and the role of Spanish economic policy

The economy has emerged from the double-dip recession and is moving into economic growth territory. The gradual improvement in activity has been accompanied by the correction of the main imbalances built up during the previous upturn. However, anchoring the recovery faces major challenges related to the depth of the effects of the crisis. The level of unemployment and the debt of the resident sectors are possibly the most significant challenges, not only because of their scale but also because their absorption will foreseeably require considerable time. Against this backdrop, the pick-up in domestic demand will come about at a more moderate pace than in previous episodes of recovery.

The firming of the recovery also faces significant challenges related to the aftermath of the crisis

The weighty legacy of the crisis will continue to bear down significantly on economic policy action, which must square the deleveraging of the public and private sectors (with the inevitable restrictiveness this entails) with the ongoing adjustment of relative costs and prices needed to further improve competitiveness and push through the reallocation of resources to sectors with higher growth potential in the new economic conditions. Achieving progress in both areas faces the added difficulty posed by the macroeconomic scenario that will prevail on the more immediate horizon, given the forecasts for the continuation of a prolonged period of low inflation and moderate productivity gains.

The leeway for applying expansionary macroeconomic policies is very limited

The adjustments pending and the constraints high debt imposes mean that the leeway for applying expansionary macroeconomic policies is very limited. The stance of the single monetary policy is already exceptionally accommodating and the room to adopt further measures at the euro area level is limited. Of most relevance to the Spanish economy, however, despite the measures adopted, is the fragmentation persisting on euro area financial markets and preventing the proper transmission of monetary impulses to the economies, such as Spain's, hardest hit by the crisis. Resolute action addressing the causes behind this fragmentation, beyond the strictly monetary realm, will contribute to the normalisation of financial conditions that recovery in the Spanish economy requires.

Fiscal action, in turn, is constrained by the pressing need to ensure the sustainability of public finances as a key ingredient of the deleveraging of the economy. That is an unavoidable condition for sustaining confidence and external funding flows.

Fiscal policy must keep as its primary objective the reduction of the deficit and the stabilisation and subsequent reduction in public debt

The revision of the budgetary adjustment path in the summer of 2013 eased budgetary restrictiveness in the short run but shifted a significant portion of the fiscal drive needed to restore budgetary stability to the 2015-2016 period. According to estimates from the latest Updated Stability Programme, the fiscal drive that would be required to fulfil the target path set, proxied by the change in the primary structural balance, would be around 2.5 pp, which would be on top of the effort already made. This figure illustrates the fact that the achievement of the budgetary targets cannot hinge solely on an improvement in the cyclical situation. According to the same estimates, only strict fulfilment of the programmed objectives would enable the rising trajectory of the public debt/GDP ratio to be halted from 2015, after having reached a ratio of 101.7% of GDP.

In this highly complex setting, economic policy must maintain the reduction of the budget deficit by the amount mentioned as its priority objective. The design of a well-defined

medium-term fiscal consolidation programme might contribute to anchoring expectations and to easing the way for the implementation of the measures needed to bring the budget deficit trajectory back towards more comfortable levels.

The composition of the fiscal adjustment can play a key role in improving growth potential through a more efficient fiscal system and expenditure structure

The fiscal consolidation process should also be accompanied by the definition of a public spending and revenue structure more conducive to economic growth. In the case of public spending, an adjustment has been under way since 2012, involving certain healthcare and education spending-related measures, followed by the entry into force of the local government reform, the Law on Public Sector Rationalisation and other government reform measures. Seeing these reforms through is essential for ensuring a more efficient contribution by the public sector to economic activity, laying the foundations for achieving a more lasting adjustment in public spending and placing public finances in a better position to ensure their sustainability in the medium and long run. The depth and consistency of this process would benefit from being accompanied by an assessment and comprehensive review of overall general government public spending, in line with the recommendations of the European Council.

There was further progress in 2013 towards the medium-term sustainability of pensions following the definition in December of the so-called sustainability factor, which had already been envisaged in the 2011 reform, and the introduction of the pension revaluation index. The sustainability factor, whose entry into force is envisaged for 2019, will enable life expectancy to be incorporated into the determination of initial pensions. In turn, the revaluation index replaced the automatic updating of this public spending component on the basis of past inflation with the new procedure that takes into account Social Security finances and which sets floors and ceilings for the revaluation amount (0.25% in the first instance, as was the case for 2014, and the CPI plus 0.5% in the second instance). The budgeting of pensions spending for 2014 (entailing a 0.25% revaluation) has already been made following this criterion.

As regards public revenue, the government has announced the approval of a tax reform in the second half of this year with a view to its being operational in early 2015, in compliance with the commitments entered into at the European level. The aim of the reform is to redress the problems afflicting taxation in Spain, which came particularly to light during the crisis. First among the aspects to be reviewed is the existence of legal rates on the main taxes that are similar to or higher than the average for other European countries but which have less revenue-raising capacity, a fact that may be attributed to the wide range of tax benefits in place and, probably, to high tax evasion. And, secondly, a tax structure skewed towards indirect taxation and social security contributions, which is more harmful for employment and competitiveness. Importantly, the tax changes introduced must, in addition to improving the efficiency of the tax system, be fully compatible with and conducive to budgetary consolidation.

Prior to adopting the reform, the Government entrusted a Committee of Experts with producing a report, which was released in March 2014. The report sets out avenues of reform which, overall, would tend to improve the efficiency of the tax system. Specifically, their proposal resides on the need to increase the weight of indirect taxation, which would allow reductions on an equivalent scale to be made in social security contributions and in the direct taxes raised on households and firms. It further proposes eliminating tax rebates, reductions and exemptions, greater neutrality among real and financial saving instruments, and the reduction of the relative tax incentives favouring debt that are currently in place.

The highly decentralised general government structure poses specific challenges that must be addressed

One of the prominent features of Spanish general government is the high degree of decentralisation. As a result, and as manifest over recent years, regional government conduct is crucial both for the success of the fiscal consolidation process and for the definition of a more efficient public revenue and expenditure structure. This is why the ongoing rationalisation of public spending requires the active collaboration of this tier of government. At the same time, the design of a public revenue framework commensurate with their spending responsibilities is crucial. In this respect, the reform of territorial government funding arrangements considered for the second half of 2014 must improve the link between expenditure management and the resources available to regional governments to finance such spending.

Structural reforms have an essential role to play in speeding through the adjustment and raising long-term growth capacity

Given the limited leeway available to demand-side policies, reforming the factor and product markets is the primary area in which economic policy can act to see through the adjustments, minimise their costs (see Box 1.2) and thus contribute effectively to restoring the economy's productive potential. The scope of these reforms is directly related to long- and, indeed, short-term growth capacity, since they can be influential in removing the obstacles hampering entrepreneurial initiative, productivity gains, the reallocation of resources across sectors and employment generation. All these aspects are, moreover, essential for increasing the economy's resilience in the face of potential shocks in a global context marked by persistent and numerous factors of uncertainty.

Far-reaching reforms have been undertaken on different fronts in recent years, and their effects are already discernible, particularly in respect of internal devaluation

The reforms adopted have made for appreciable headway in the area of internal devaluation. The heightened cyclical sensitivity of prices is providing for a correction of the competitive lag that built up over the past expansionary cycle, while the greater flexibility of the labour market has been conducive to wage moderation. There has also been a change in the role played by past inflation in determining costs and incomes. This is a change of significance in adapting to the requirements of euro area membership, which has been boosted by several initiatives.

Firstly, because of the latest agreement on collective bargaining entered into by the social agents in 2012, which recommended a new framework for defining wage indexation clauses geared to softening the impact on wages of increases in the inflation rate brought on by transitory shocks, such as that prompted by a temporary rise in fuel prices. Other measures have sought to reduce the degree of indexation in other markets; a case in point is the reform of the Law on Urban Rentals, which eliminates the mandatory indexation of rental contracts to the CPI. To this same end, the entry into force in the coming months of the Law on Deindexation, which will be applicable to contracts entered into in the public sector domain (and for certain public revenue items), will build on this change of behaviour. It will do so to the greatest effect if it also passes through to the private sector, where the application of the provisions of the law is not mandatory but provides the necessary instruments should this option be chosen. The upshot should be that price-setting falls into line with its supply- and demand-side fundamentals, allowing an improvement in the determinants of competitiveness and preventing the re-emergence of some of the imbalances that compounded the crisis in Spain.

The effects in terms of job creation are more incipient

In terms of employment, the effect of the labour market reform began to be perceived initially in an easing of job destruction flows in 2012, despite the still-weak economic environment. Adding to this was an initial rise in job creation flows in the closing months of 2013 (which has continued to date this year), centred mainly on the services sectors and chiefly in temporary and part-time employment. Precisely in an attempt to influence labour market duality, incentives were established in 2013 to create jobs among groups

In the current setting, there is scant headroom to boost aggregate demand by means of conventional monetary policy (interest rate cuts) and fiscal policy (countercyclical balances) instruments. Accordingly, one of the main economic policy options for reinvigorating activity is the application of structural reforms that make product and factor markets more efficient and competitive.

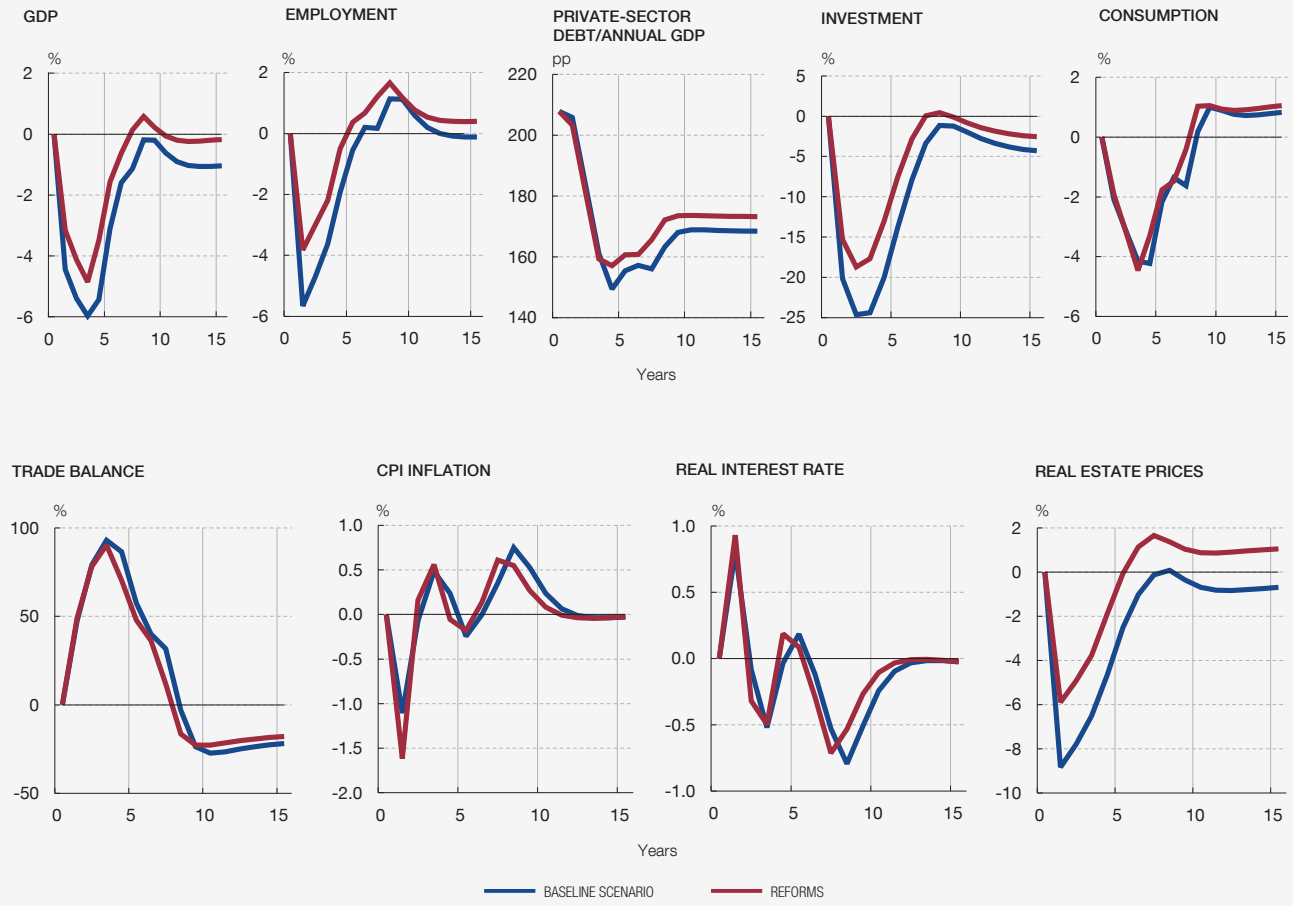
In the long run, there are few doubts over the positive effects of these reforms: insofar as a market becomes more competitive, the volume of activity grows, prices fall and the opportunities for improving economic agents' welfare increase. Through the expectations of the latter, who discount a greater future spending capacity, a portion of the durable benefits of the reforms normally materialise in the short run (the *expectations channel*). However, the moderation in prices typically prompted by structural reforms may give rise to increases in real interest rates and, therefore, to declines in household and corporate spending in the short run (the *interest rate channel*). Moreover, given debt whose nominal amount is predetermined, a moderation in prices prompts a higher real value of debt (the "Fisher effect" or the *debt deflation channel*[1]), with the subsequent restrictive effect on debtor agents' budgets.

The relative intensity of the foregoing channels – expectations, on one hand, and the interest rate and debt deflation, on the other – determines the sign of the short-term impact of the structural reforms. Some recent research has emphasised the fact that the lack of headroom to make nominal interest rate cuts may be pivotal in inclining the balance in favour of contractionary channels.[2] This type of analysis would appear to point to the

1 See I. Fisher (1933), "The debt-deflation theory of great depressions», *Econometrica* vol. 1, pp. 337-357.

2 See, for example, G. Eggertsson, A. Ferrero and A. Raffo (2014), "Can structural reforms help Europe?", *Journal of Monetary Economics*, vol. 61, pp. 2-22.

1 EFFECT OF STRUCTURAL REFORMS IN A DELEVERAGING PROCESS (a)



SOURCE: Banco de España.

a All variables expressed as deviations from their initial state, except private-sector debt/GDP, which is in percentage points.

advisability of postponing the reforms until their contractionary effects may be countered by expansionary macroeconomic policies.[3]

Nonetheless, most of the macroeconomic models used in the foregoing research are designed to analyse the fluctuations proper to a traditional economic cycle, rather than those arising from a deep-seated macrofinancial crisis such as the present one. In a recent paper, Andrés, Arce and Thomas (2014)[4] develop a specially designed model to analyse the effect of structural reforms on an environment similar to that currently characterising the Spanish economy, namely one of slow leverage, owing to the presence of a high volume of long-dated debt, and of restricted access to financing. Further, the model considers that the domestic economy is part of a monetary union that has no leeway to lower interest rates. Businesses and a portion of households take on debt using the value of their real estate assets as collateral; however, when the value of their assets falls below a specific threshold, the extension of fresh credit is interrupted and, in that case, debtors restrict themselves to repaying their outstanding debt according to the maturities stipulated in their debt contracts.

The starting point is a *baseline scenario* that includes a persistent tightening of loan access conditions for households and firms, and that entails, in particular, a reduction in the loan-to-value ratios of the new loans granted to these agents. The blue lines in Panel 1 show the response of the economy to this financial shock (the magnitudes of the simulations are merely illustrative of the qualitative behaviour of the model and should not be interpreted as realistic quantitative approximations). The slump in real estate prices and, therefore, in the value of the collateral means the flow of new credit shrinks sharply, which gives rise to a long and slow process of private deleveraging. The need for households and firms to generate saving to repay their debts and clean up their balance sheets leads them to reduce consumption and investment levels. In parallel, the trade balance improves thanks to the gains in competitiveness to which the disinflationary effect of the shock and the subsequent contraction in domestic demand gives rise. Yet this improvement does not suffice to prevent a prolonged decline in GDP. When the value of the assets of the households and firms applying for funds reaches the minimum threshold for satisfying loan access conditions, the flow of fresh credit re-starts. Thereafter, a virtuous circle takes hold, with a vigorous pick-up in asset prices, in credit and in agents' spending capacity. As a result, consumption and investment, and GDP too, begin to recover.

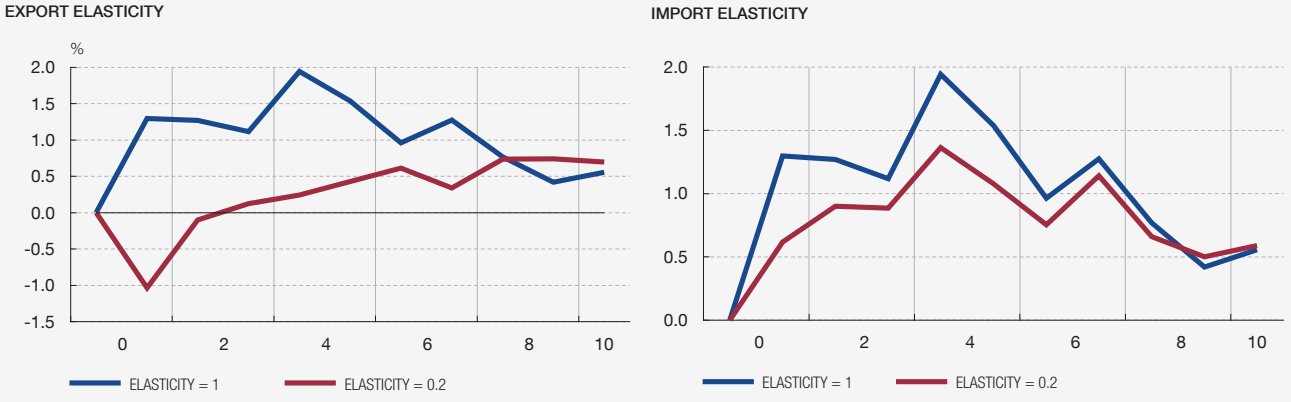
The unbroken red lines in Panel 1 show the responses of the main variables when *structural reforms* are adopted that involve increases in the degree of competition in the product and labour markets. These reforms induce a lasting reduction in business mark-ups and give rise to more moderate wages.[5] In the long run, these measures have a clearly positive effect on GDP and employment; but they also relieve the adverse effects of deleveraging in the short and medium term. This is chiefly due to

3 Some theoretical developments pointing along these lines can be found in the following papers: G. Eggertsson, G. (2012), "Was the New Deal contractionary?", *American Economic Review*, vol. 102, pp. 524-555; G. Eggertsson, and P. Krugman (2012), "Debt, deleveraging, and the liquidity trap: a Fisher-Minsky-Koo approach", *Quarterly Journal of Economics*, vol. 127, pp. 1469-1513; and J. Galí, and T. Monacelli (2014), "Understanding the gains from wage flexibility: The exchange rate connection", CEPR discussion paper 9806.

4 See J. Andrés, Ó. Arce and C. Thomas (2014), "Structural reforms in a debt overhang", Documento de Trabajo del Banco de España (forthcoming).

5 Specifically, there is a reduction in price mark-ups (i.e. the difference between production prices and marginal production costs) and wage mark-ups (that between wages paid to workers and their reserve wages).

2 ROLE OF THE EXTERNAL SECTOR IN THE TRANSMISSION OF THE EFFECTS OF THE REFORMS (a)



SOURCE: Banco de España.

a The panels show the differential effect of the structural reforms on GDP, i.e. the difference between the two lines in the top-left hand graphic in Panel 1, for different values of the elasticities of exports and imports to relative prices.

the better performance of investment. Specifically, anticipation of the beneficial effects of the reforms in the long run means that, in the short run already, households and firms increase their investment demand relative to the baseline scenario. This greater demand entails a lesser decline in real estate asset prices. That contributes to curtailing the severity of the decline in debtors' financial worth and, therefore, helps them regain earlier the minimum threshold at which new credit may be granted. Combining with this positive effect on firms' financial capacity is a contraction in these agents' consumption which, in the context of this model, may be assimilated to smaller dividend payouts (and, therefore, a greater accumulation of retained earnings).

In this way, the reforms *bring forward* the end of the deleveraging process and, therefore, of the recession, thus reinforcing the *expectations channel.* At the same time, since the flow of new credit slows substantially during the deleveraging phase, private spending decisions at the aggregate level are relatively insensitive to the increase in the real interest rate induced by the deflationary effect of the reforms. This leads to a loss of intensity in the *interest rate channel*. The combination of both effects – the reinforcement of the expectations channel and the weakening of the interest rate channel – results in a net positive effect of the reforms on activity and employment in the short run already, which prevails over the negative Fisher effect arising from a path of lower prices. In this respect, the presence of a high proportion of long-term debt – which is an essential factor in the current crisis, especially in the case of household mortgage debt – operates by substantially cushioning the short-term contractionary effect of the debt deflation channel.

One significant channel for the transmission of the effects of the reforms is that of foreign trade. As can be seen in Panel 1, the reforms do not bring about a significant effect on the trade balance in the short term. This apparent lack of effect encompasses two opposing forces: although the reforms bring about an additional lowering of the prices of domestic products, they also prompt an improvement in domestic demand. This behaviour of the external balance depends largely on the sensitivity of trade flows to the relative prices of domestic and foreign goods. The left-hand graphic of Panel 2 shows the differential effect of the reforms on GDP[6] for two different calibrations of the elasticity of exports to relative prices: unit elasticity (the baseline value[7]), and a very low elasticity of 0.2. In this latter case, the effects of the reforms in the short run turn negative, owing to the insufficient positive contribution of exports. In the case of imports (right-hand graphic), reducing their price-elasticity also reduces the positive effect of the reforms, though not to the extent of changing the sign of this effect. This example illustrates, therefore, that a key condition if the reforms are to have beneficial effects in the short term is that the resulting gain in competitiveness should pass through with sufficient intensity to trade flows.

6 The differential effect of the reforms on GD Pis equivalent to the vertical distance between the two lines in the upper left-hand graphic of Panel 1.

7 The calibration of the unit elasticity of exports is based on estimates for Spain by C. García, E. Gordo, J. Martínez-Martín and P. Tello (2009), "*Una actualización de las funciones de exportación e importación de la economía española",* Documentos Ocasionales, no. 0905, Banco de España.

with the highest unemployment rates (such as unskilled youths). Also, measures were taken to boost permanent hires, through the introduction of greater flexibility in part-time hiring arrangements or through the reduction, early this year, in the social security contributions payable in connection with new permanent jobs. This programme of incentives might provide a boost to permanent contracts this year; however, on the evidence available on the impact of this type of rebate, the effects on net employment are estimated to be more uncertain.

Looking ahead to the coming quarters, it is expected that, as a result of the greater flexibility provided by the new labour market framework, employment will grow at rates which, while moderate, are high in relation to the increase in output, which will necessarily entail a declining path of productivity. Nonetheless, even under this relatively favourable job creation scenario, the unemployment rate will fall slowly, and the risks that its structural component will increase remain present (see Box 1.3). To prevent such risks materialising, there will be a need to ensure the continuity of gains in competitiveness and of the recovery in employment. Here, it will be necessary to monitor developments in collective bargaining arrangements and, especially, progress in wage flexibility, most particularly for smaller firms, along with the degree of decentralisation of such arrangements. To reduce the

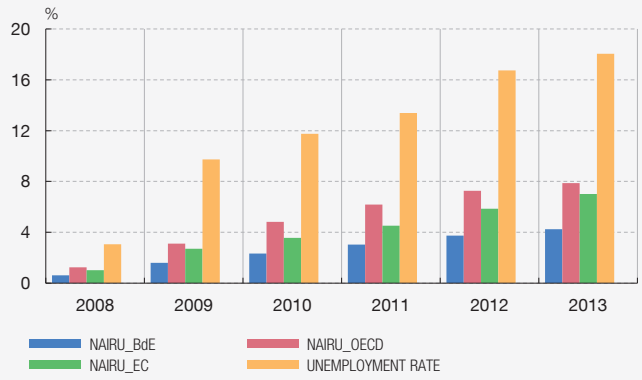
The unemployment rate in the Spanish economy peaked in 2013 Q1 (at 26.9% of the labour force), marking an increase of close to 20 pp on the low recorded in 2007 Q3. Since then, unemployment has moved on a progressively declining path, dipping to 25.9% in 2014 Q1. The latest macroeconomic projections of the Banco de España, released in March, point to the continuation of this trajectory over the remainder of 2014 and in 2015 in a setting in which the gradual recovery in activity is forecast to pass through intensely to job creation, assisted by ongoing wage moderation and its extension over the projection horizon. Notwithstanding, the unemployment rate in the Spanish economy is expected to hold at very high levels in comparative terms.

There are different reasons why an initially cyclical increase in unemployment may become persistent, generating an increase in the structural component of unemployment through what is usually known as a hysteresis effect that hampers subsequent reductions in the unemployment rate, even in an economic upturn. Such hysteresis can be caused by various factors. Thus, enduring unemployment status over a prolonged period may ultimately exert permanent effects on the human capital of the unemployed, on their intensity of job search and on firms' perception of their skills or background. These effects may be more significant in a context of sectoral reallocation of employment in which the skills demanded by firms differ from what the unemployed have to offer.

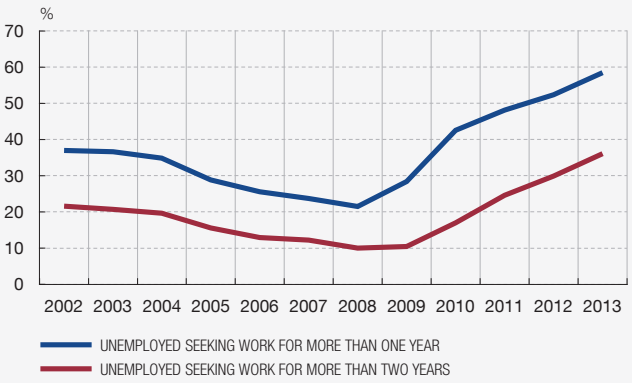
One way of analysing the degree of persistence of unemployment consists of estimating the structural rate of joblessness, a concept that can be interpreted as the unemployment rate of the economy in the medium term, once the impact of cyclical factors is stripped

THE IMPACT OF THE CRISIS ON THE STRUCTURAL COMPONENT OF UNEMPLOYMENT

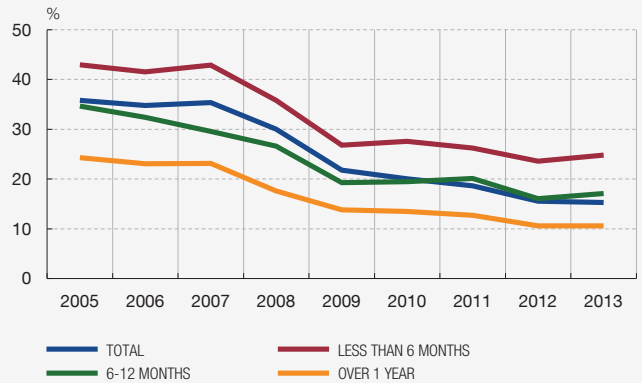
1 CUMULATIVE INCREASE IN THE UNEMPLOYMENT RATE AND IN THE ESTIMATED NAIRU



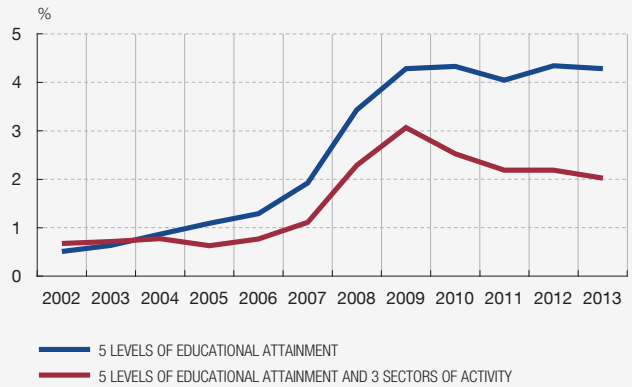
2 INCIDENCE OF LONG-TERM UNEMPLOYMENT (a)



3 UNEMPLOYMENT EXIT RATES IN RESPECT OF TIME SEEKING WORK (b)



4 SKILLS MISMATCH INDEX (c)



SOURCES: EPA (INE) microdata and Banco de España.

a Percentage of total unemployed.
b Percentage of unemployed who find work in the following quarter.
c Mismatch between the distribution by educational attainment level (primary studies or less, first-phase secondary studies, higher secondary studies, vocational training and university studies) of the employed and the unemployed. Having regard to the sectoral dimension, three major sectors of activity are used (manufacturing, construction and services) and both the unemployed seeking their first job and the long-term unemployed, on whom no information on the sector of activity is available, are excluded.

out. This structural component is, however, non-observable and estimating it is subject to high uncertainty as there are different methodological approaches that provide different results. Presented below are the results of the application of a methodology that involves estimating the disaggregation between the structural and cyclical components of unemployment using the Phillips curve approach.[1] Specifically, a relationship is assumed between wage growth and deviations of unemployment from its structural component, i.e. the cyclical component of unemployment. Hence, if unemployment is below (above) its equilibrium or structural level, higher (lower) wage growth will tend to be observed, meaning that the structural unemployment rate, which under this approach is usually called the NAIRU, could be interpreted as that level of the rate that were compatible with stable inflation.

The top left-hand hand graphic of Panel 1 shows the cumulative increase in the NAIRU since 2008 following the above-mentioned methodology. The high uncertainty constantly surrounding these estimates usually advises analysing medium-term trends rather than the discrete levels estimated.[2] The results show that the Spanish economy's structural unemployment rate would have increased by around 4 pp since the onset of the crisis.[3] the estimates available for Spain by the OECD and the EC tend to offer a somewhat higher increase, with the NAIRU showing a more procyclical profile.

This result would reflect the impact of hysteresis effects on the NAIRU. Thus, the average duration of unemployment episodes has risen from around 2.8 quarters to over 6.5 quarters in 2013, raising to 60.7% the proportion of the unemployed experiencing this status for more than a year. There has also been a most substantial increase in the percentage of those unemployed for a very long period, of over two years, to 38.9% of total unemployed (see the top right-hand graphic of Panel 1). This phenomenon is concentrated, moreover, in certain groups, such as employees over 50 years of age or the more unskilled unemployed, for which this percentage stood at around 50% at end-2013.

Unemployment exit rates, which have fallen appreciably for all unemployment durations, have begun to rise slightly in 2013, at least for the unemployed with less duration in this situation (see the bottom left-hand graphic of Panel 1). Foreseeably, the incipient recovery will help entrench this improvement which, nonetheless, will probably be slower among the group with longer durations.[4] This diminished cyclicality of exits from unemployment once a large amount of time has been accumulated experiencing this status might limit the aggregate recovery of the unemployment exit rate in the face of a cyclical upturn.

Unemployment persistence might also be related to the increase in the skills mismatch between labour supply and demand observed since the start of the crisis. In this connection, the bottom right-hand graphic of Panel 1 shows the changes in a skills mismatch index that seeks to measure the discrepancy between the breakdown by level of educational attainment of the employed and unemployed populations.[5] In principle, it is expected that the bigger this mismatch is, the more difficult it will prove to reabsorb unemployment. The clear increase in the level of skills mismatch is observed during the crisis, caused by the concentration of job destruction among the lesser-skilled. If the sectoral dimension is taken into account, the pattern is similar and highlights how the acute job destruction in the construction industry, especially at the start of the crisis, prompted a considerable increase in the relative weight of the low-skilled unemployed. These results indicate that a reduction in unemployment will require the adaptation of unemployed workers' skills to job requirements.

In short, although a significant portion of the increase in unemployment since the start of the crisis is closely associated with the cyclical downturn, it cannot be ruled out that there has in parallel been an increase in the structural component of unemployment, which might hamper any reduction in unemployment in the near future. These difficulties appear to be particularly marked for specific groups, among whom very high unemployment durations are observed. The overall design of active and passive policies of support for the unemployed should focus on increasing the employability of these groups, analysing the links with the various social protection mechanisms and facilitating wage flexibility.

1 See J. Gali (2011), "The Return of the Wage Phillips Curve", Journal of European Economic Association, June, 9 (3), pp. 436-461.

2 See, for example, Estrada, Hernando and López Salido (2000), *Measuring the NAIRU in the Spanish Economy,* Documentos de Trabajo, no. 0009, Banco de España; or ECB (2012), *Euro Area Labour Markets and the Crisis,* Occasional Paper no. 138.

3 This increase is also similar to that estimated by Doménech (2013), "Potential Growth and Structural Unemployment in Spain, EMU and the US", BBVA Research, mimeo, using an alternative methodology drawing on Okun's Law.

4 In particular, an analysis of the likelihood of exiting unemployment conducted for the 2005-2013 period, drawing on microdata on EPA flows, shows that this likelihood increases by 2.1 pp given a 1% improvement in GDP for the short-term unemployed, while for the longer-term unemployed the impact of an improvement in activity is only 1.3 pp.

5 In particular, the distribution of the employed and unemployed population is used following five levels of educational attainment drawn from Spanish Labour Force Survey data. For further details see M. Izquierdo, S. Puente and P. Font (2013), "Evolución del desajuste educativo entre la oferta y la demanda de trabajo en España", *Boletín Económico*, June, Banco de España.

unemployment rate to a level comparable with that in other European countries will require an overhaul of active employment policies. Recent measures in this area have focused on moving forward, in coordination with the regional governments, by means of a new system of active policies that reinforces the link between the funds received and the effectiveness of the programmes undertaken in each region. Still under preparation is the strategy for the application of the so-called youth guarantee, which will offer training opportunities or job-search support to unemployed youths. Both initiatives will be pursued during the current year, as envisaged in the National Reforms Programme (NRP) submitted by the Government to the European Commission on 30 April.

Product market reforms must be pushed through, providing for heightened competition and gains in efficiency

If internal devaluation is to be successful, the reduction in labour costs must be accompanied by the containment of margins and efficiency gains in productive processes. In this respect, margins at the aggregate level during the crisis have been influenced, at least in part, by the effects arising from very tight financial conditions, as earlier indicated. Yet this behaviour also reveals the presence of barriers to competition in some industries that are hampering competitive devaluation and increasing the attendant costs; accordingly, it is vital to further reforms that increase competition in the product markets and boost the comparative quality of the goods and services produced.

Some of the reforms adopted in the past year are along these lines, and include most notably the respective Laws on Entrepreneurs, Market Unity Guarantee and Insolvency (the latter is addressed in greater detail in Chapter 2). The Law on Entrepreneurs launched a series of fiscal measures to facilitate small firms' economic activities, including most notably the simplification and reduction of tax obligations. In turn, the aim of the market unity guarantee legislation is to eliminate potential inefficiencies arising as a result of different regional legislations for product marketing or services provision. In this same connection, various initiatives have been pursued to reduce the duration of legal procedures and thus cut into the high business costs stemming from the high number of lawsuits brought in Spain.

Significant headway has thus been made in product market reform, but in some cases the effective implementation of these reforms faces major difficulties. In particular, the effectiveness of the precepts laid down in the market unity guarantee legislation will hinge critically on the degree of cooperation among the different tiers of government. Nor is implementation of the reform of the electricity industry and, more generally, of an energy policy geared to reducing Spain's high dependence on imported energy proving free from difficulty. Lagging further behind in terms of implementation is the draft bill on professional services and associations, which proposes establishing a general regime of freedom of access and practice throughout Spanish territory in respect of services. The delays in the implementation process for this bill have so far prevented its final approval.

Improvements in efficiency are also crucial for shoring up gains in competitiveness and, in particular, for increasing the economy's growth potential in the medium term. Their role is all the more important in a setting in which the demographic projections available augur population declines that pose major challenges for long-term growth and the sustainability of public finances in the medium and long run.

The above-mentioned liberalisation of product and services markets is a key ingredient of any strategy to raise productivity. Such measures should be accompanied by measures aimed at improving the economy's human and productive capital. In this connection, the Organic Law for Improving Educational Quality amends various aspects of how the

Spanish educational system is organised, though the challenges the economy faces mean this measure must be complemented with far-reaching reforms in university education and vocational training. The aforementioned NRP develops this latter aspect.

In sum, fiscal consolidation and the deepening of the reform agenda are the fundamental economic policy instruments for building on the exit from the crisis and helping entrench incipient growth and job creation. Indeed, these are the only sound bases for tackling the necessary deleveraging of the economy and the lingering uncertainty in the international and European spheres.

2 THE INDEBTEDNESS OF THE SPANISH ECONOMY: CHARACTERISTICS, CORRECTION AND CHALLENGES

1 Introduction

Private-sector debt in Spain reached high levels before the onset of the crisis...

During the expansion prior to the crisis, against an international background marked by low interest rates, optimistic expectations about economic growth and underpriced risks, the debt levels of households and non-financial corporations in the advanced economies increased markedly. In Spain this phenomenon became notably acute and debt ratios higher than those observed in peer countries were recorded (see Chart 2.1). EMU membership prompted an upward revision of expected incomes and set in place very loose financing conditions, the expansionary impulses of which on lending were not sufficiently countered by other economic policies. With the onset of the crisis, whose recessionary effects were sharper in Spain than in other countries owing – among other causes – to burgeoning private debt, the value of household and corporate wealth and future income expectations were revised downwards. Under these conditions, lowering the debt ratios of the non-financial private sector became a necessity. While these ratios have fallen from their mid-2010 peaks, they are still higher than in the past and exceed those of other developed economies.

... while public-sector debt rose swiftly during the crisis

At the start of the crisis, public debt was nevertheless low, from both an historical and international standpoint; but during the crisis, budget deficits and general government debt rose swiftly. At end-2013, the public debt/GDP ratio stood at 93.9%, far exceeding the 60% benchmark set under the Maastricht Treaty and slightly above the average euro area level (see Chart 2.1).

As a result of high private and public debt, the economy as a whole shows a swollen external debt

The increase in public and private debt, which has not been accompanied by a comparable rise in the financial assets of these sectors, has translated into a towering figure for the nation's net debt vis-à-vis the rest of the world: 98% of GDP at end-2013, a figure substantially higher than that of other advanced economies (see Chart 2.1). This high dependence on external saving is a considerable factor of vulnerability, as highlighted during the collapse in the financing of the balance of payments in summer 2012.

The resort to debt allows expenditure time profiles to be attained that are not constrained by the distribution over time of revenue...

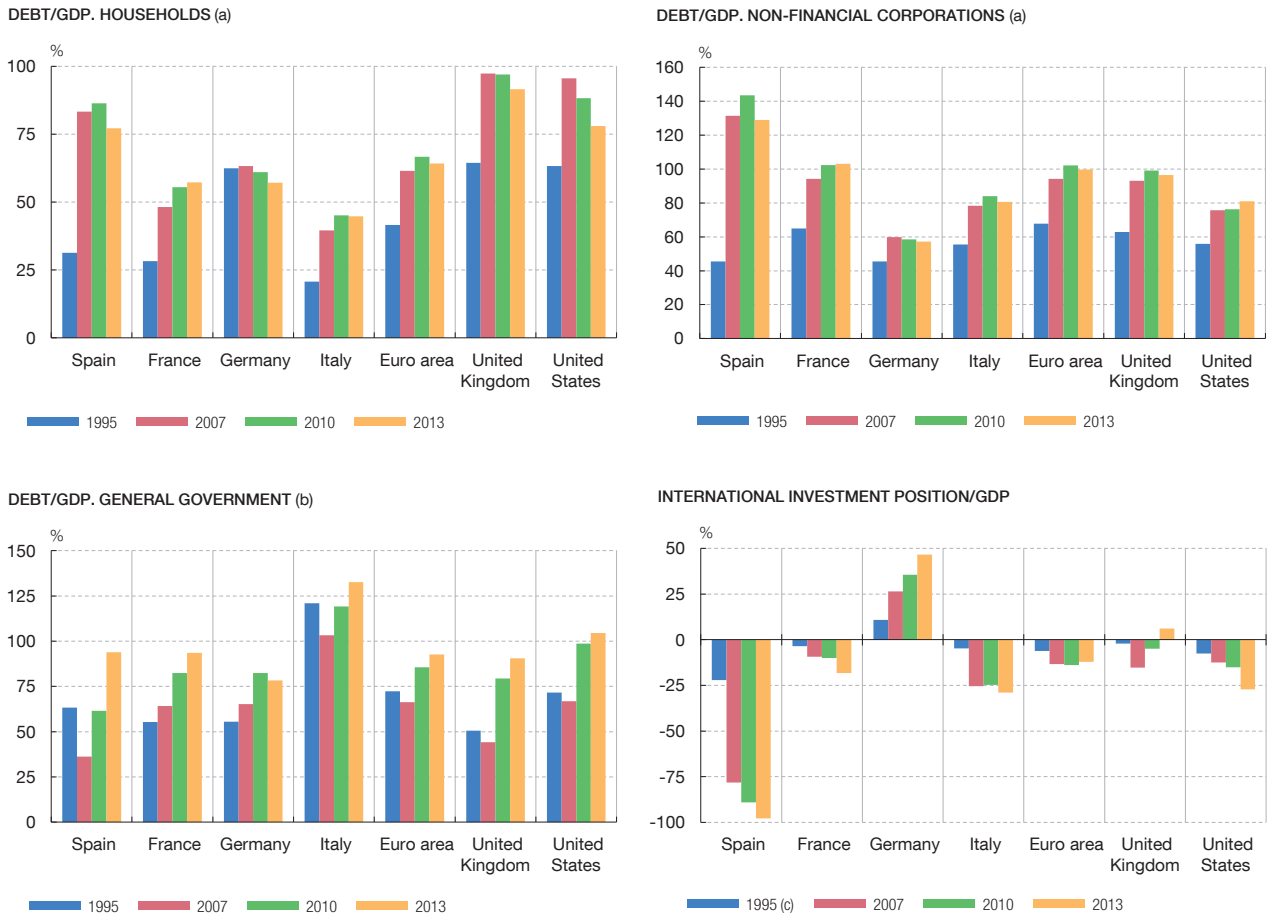
Debt, along with saving, is the instrument economic agents use to optimise their expenditure time profiles without being constrained by the distribution of their income over time. Thus, for example, in the initial stages of their life cycle, households usually incur higher expenses relative to their income than in later stages, meaning that debt levels are relatively higher among younger households. Likewise, companies resort in the short term to external funds to finance investment projects that generate earnings in the medium and long term, and general government uses debt so that the profile of public spending is less volatile over the course of the business cycle than that of revenue, which is highly sensitive to economic fluctuations.

... but high debt levels increase borrowers' financial vulnerability, amplify the economic effects of adverse shocks and bear down on economic recovery after a crisis

Given that debt enables borrowers either to attain the expenditure time profile they wish or to undertake profitable investment projects, the resort to debt helps increase social well-being. At the same time, however, debt increases their vulnerability to unforeseen shocks that constrain current or expected revenue, reduce wealth and worsen financing conditions. The readjustment of consumption and investment plans prompted by these adverse changes will tend to be greater the higher the accumulated debt. In turn, the perception by lenders that borrowers' level of debt may be excessive raises the cost of new loans and diminishes loan availability, which likewise restricts the possibilities of expanding expenditure. In a situation such as that prevailing at present in the Spanish economy, this

DEBT RATIOS AND INTERNATIONAL INVESTMENT POSITION

CHART 2.1



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

a Debt includes loans and fixed-income securities.
b For EU countries according to the Excessive Deficit Procedure.
c For Italy, the figure is for 1997; for the United States and the euro area, for 1999.

restriction weighs down significantly on growth and its correction is unavoidable if a path of recovery is to firm.

To analyse debt in a sector, its particularities and the heterogeneity of the agents comprising it must be taken into account...

Diagnosing situations of excess debt for a specific sector, whether public or private, is no easy task, since its optimum level depends on future paths of financing costs and revenues, which are highly uncertain and complex to estimate. Moreover, the conditions of indebted agents within each sector are usually considerably mixed. That means the analysis cannot confine itself solely to aggregate data and to historical and international comparisons of such figures, but that it must also delve into the informational wealth of microeconomic data. As a result, the estimates available in the economic literature on the thresholds beyond which leverage causes negative effects on economic growth[1] must be viewed with due caution. Indeed, a specific level of debt of, for instance, non-financial corporations as a whole may have very different consequences for growth depending on what its distribution is.

1 On the existence of debt thresholds beyond which economic growth declines, see C. Reinhart and K. Rogoff (2010), "Growth in a Time of Debt", *American Economic Review,* 100 (2), pp. 573-578; S. Cechetti, M. S. Mohanty and F. Zampolli (2011), *The real effects of debt,* Bis working paper 352; and U. Panizza and A. F. Presbitero (2013), "Public Debt and Economic Growth in Advanced Economies: A Survey", *Swiss Journal of Economics and Statistics* (SJES), Swiss Society of Economics and Statistics (SSES), vol. 149 (II), pp. 175-204.

A relatively standard way of identifying possible situations of excess debt is through debt sustainability analysis where, essentially, the conditions needed for liabilities to stabilise in relation to borrowers' ability to pay are characterised. This approach is of some use in the case of the public sector, but its application to households and non-financial corporations is more complex, since these sectors are made up of a much higher number of heterogeneous agents.

... as must interrelatedness with the other sectors in the economy

Nor can an analysis of the debt of each of the economy's institutional sectors ignore the fact that the position of each sector can affect the rest through different transmission channels that operate both through quantities (e.g. a reduction in consumption and in investment to amortise private debts may adversely impact economic activity and, therefore, general government revenue and expenditure) and through costs (e.g. through the pass-through of the sovereign risk premium to the credit premia paid by the private sector). Accordingly, the view offered by an itemised analysis of the sectors should be complemented by a broader overview of the nation's aggregate debt.

This chapter analyses the Spanish economy's debt, assesses the progress in its correction and discusses the challenges it poses

From this perspective, this chapter primarily characterises households' and non-financial corporations' debt and assesses progress in its adjustment. It then analyses how the financial position of these sectors has, along with financial-sector and general government measures, shaped aggregate debt in the Spanish economy. Finally, it discusses the challenges posed in squaring the necessary reduction of private and public debt with the ongoing adjustment and the restoring of sustained growth in the medium term for the Spanish economy.[2]

2 Private-sector debt in the Spanish economy

2.1 HOUSEHOLD DEBT

Household debt grew at a very sharp pace before the crisis

From 1995 to 2007, credit raised by Spanish households increased at an annual average rate of 17%, compared with an average increase in nominal GDP of 7.5% (see Chart 2.2). This strong growth in their debt is due to a combination of several factors. First, the comfortable financing conditions – prompted by the context of financial innovation and lax credit standards at the international level, by the convergence of Spanish and euro area interest rates, and by the continuation of an expansionary monetary policy – provided for access to credit at a lower cost. In parallel, greater macroeconomic stability and the favourable growth expectations associated with EMU entry led lenders and borrowers to underestimate the risks of debt. Lastly, the high demand for housing, fuelled by demographic and institutional factors as well as the two foregoing elements, led to a real estate boom which increased the expected value of real assets and which, in turn, facilitated indebtedness since the assets in question acted as collateral for the loans received.

The effects of these three factors were, moreover, mutually reinforcing: the increase in lending boosted spending, which in turn raised economic growth and asset prices, stimulating high demand for credit and ready access to it via the rise in the value of the assets that could be used as collateral.

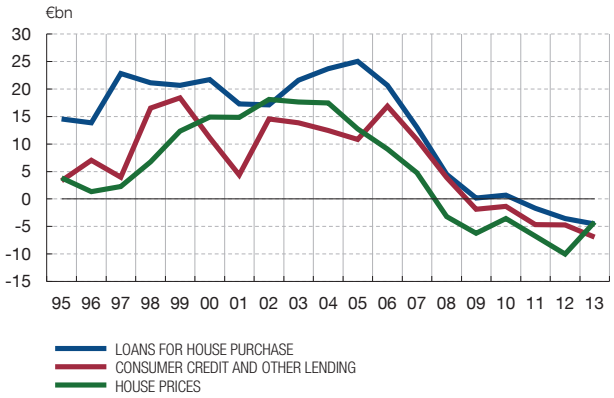
Most debt was assigned to purchasing real estate assets

This interaction between the demand for credit and asset prices was particularly intense in the real estate market.[3] Most household debt was thus assigned to house purchases, meaning that the weight of this type of lending rose from 56% of the sector's liabilities in

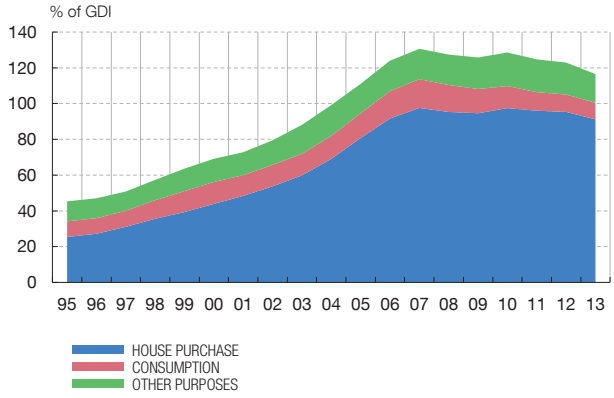
2 The role of fiscal policy in the growth of public debt during the crisis and the analysis of its sustainability were addressed in Chapter 2 of the 2010 *Annual Report*.

3 For an empirical analysis of the relationship between house prices and real estate lending in Spain, see R. Gimeno and C. Martínez Carrascal (2010), "The relationship between house prices and loans for house purchase. The Spanish case", *Journal of Banking and Finance,* 34, pp. 1849-1855.

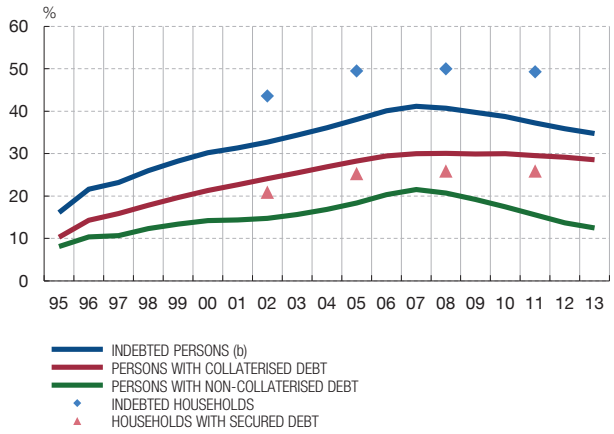
HOUSEHOLD CREDIT (a) AND HOUSE PRICES
(Year-on-year growth)



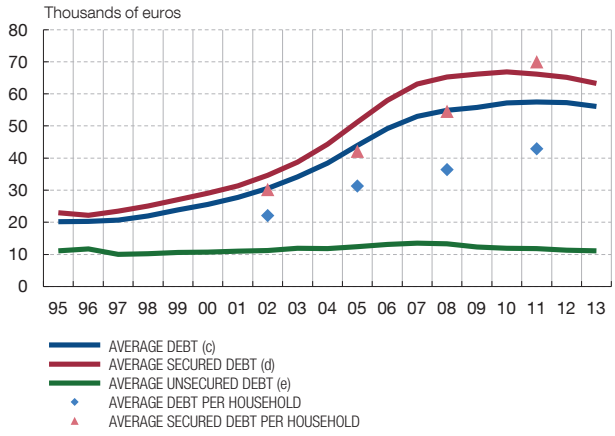
HOUSEHOLD DEBT. BREAKDOWN BY PURPOSE



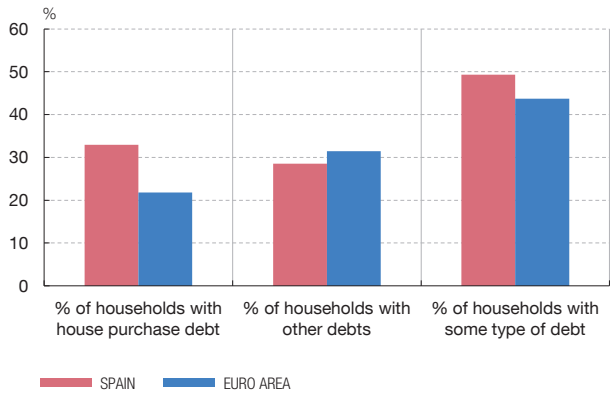
PROPORTION OF INDEBTED AGENTS



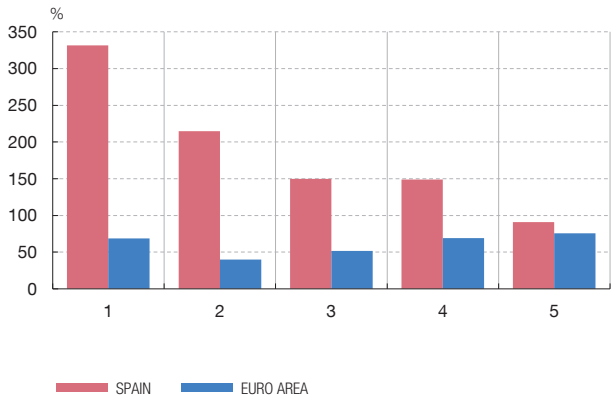
DEBT AMOUNT



PERCENTAGE OF HOUSEHOLDS WITH OUTSTANDING DEBT. BREAKDOWN BY PURPOSE (f). 2011



MEDIAN DEBT/INCOME RATIO. BREAKDOWN BY INCOME QUINTILE (f). 2011



SOURCES: Banco de España and Eurosystem Household Finance and Consumption Survey.

a Includes securitised credits and loans transferred to Sareb.
b As a proportion of total persons aged over 16.
c Average debt of persons with outstanding loans.
d Average secured debt of persons with this type of loan.
e Average unsecured debt of persons with this type of loan.
f For Spain, the data refer to 2011. For the euro area, the reference year is 2010 for most countries.

1995 to 75% in 2007. Consumer credit and other lending increased at a slower pace, but also expanded notably (posting annual average growth of 11%).

The debt/income ratio stands above the average level for the euro area and the United States

As a result of these developments, household debt as a percentage of GDP, which stood in 1995 at 31% (a low level compared with other advanced countries), climbed to 83% in 2007. This figure exceeded the average for the euro area, though not that observed in the United States and the United Kingdom (see Chart 2.1). In terms of gross disposable income (GDI), the increase was likewise notable, rising from 45% to 131%. Debt relative to GDI peaked in 2008 but, in terms of GDP, it continued increasing during the initial years of the crisis owing to the negative trend of output, peaking in 2010. Both ratios have since tended to fall slowly, while remaining above the average figure for the euro area, and the debt/GDI ratio has reached a level higher than that of the United States.

The increase in debt was the outcome both of a higher proportion of households with loans and of an increase in debt per indebted household

According to Central Credit Register (CCR) figures, the increase in household debt during the expansion prior to the crisis reflects both the rise in the proportion of households in debt (up from 15% in 1995 to 40% in 2007) and the increase in the average debt borne by each household (which rose, in nominal terms, from €20,000 to €52,000 over this same period). The Spanish Survey of Household Finances (EFF by its Spanish acronym) – which provides much more detailed information on the socio-economic characteristics of indebted households but which is only available every three years, from 2002 – corroborates this. According to this source, the percentage of households with some form of debt increased from 43.6% in 2002 to 50% in 2008, while the median of this debt, in constant 2011 terms, rose from €28,000 to €38,700 over the same period. The latest edition of the EFF, which refers to the end-2011 situation, evidences the slight decline in the proportion of indebted households, while median debt shows an additional increase of 11% which, nonetheless, is fully determined by the behaviour of debt tied to house purchase.[4]

There is high heterogeneity across the debt ratios of the different population groups ...

As might be expected, the EFF also shows that the proportion of indebted households grows commensurately with level of income (22% in the first quintile of the distribution and 65% in the last) and declines in step with the age of the household head (higher than 70% in the age bracket below 44). The median debt/income ratio is higher in the lower-income segments (around 330% for the first quintile of the distribution) and for households whose head is younger (around 300% for the under-35 segment).[5]

... but they are higher in Spain than in the euro area for most of the debtor segments

Compared with the euro area, the proportion of indebted households was, at the end of the current decade, somewhat higher in Spain owing to the greater weight of lending for house purchases in our country.[6] The greater incidence of mortgage loans in Spain also explains why the debt/income ratio of the representative indebted household is higher, given that the amounts of the loans for property purchases are usually higher and that the loan-to-value ratio for these assets is, nevertheless, less than in the euro area (although this difference has narrowed recently as a result of the decline in house prices in Spain).

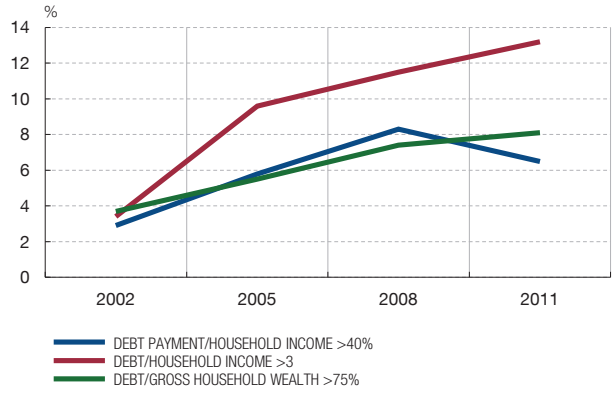
4 In the remaining components there was, in fact, a contraction. See "Survey of Household Finances (EFF) 2011: methods, results and changes since 2008", *Economic Bulletin,* January 2014, Banco de España. The figures for median debt are expressed in 2011 euro.

5 These data refer to 2011.

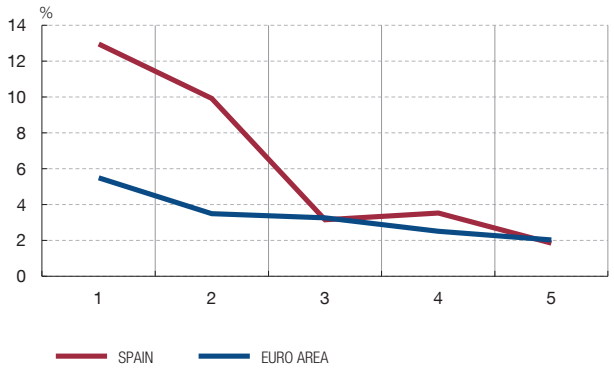
6 The euro area data are based on the Eurosystem household finance and consumption survey, which contains similar information to that of the EFF for 15 euro area countries, and whose first edition referred to the start of the current decade. For further details on the comparison with the euro area, see M. A. Marchetti and C. Martínez Carrascal (2013), "Un análisis del endeudamiento de las familias a partir de la encuesta del Eurosistema sobre la situación financiera y el consumo de los hogares de 2010", *Boletín Económico,* December, Banco de España.

HOUSEHOLDS FACING HIGH FINANCIAL PRESSURE CHART 2.3

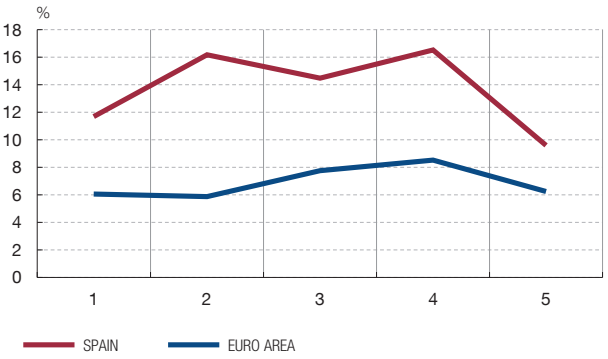
PROPORTION OF HOUSEHOLDS WITH HIGH FINANCIAL PRESSURE INDICATORS



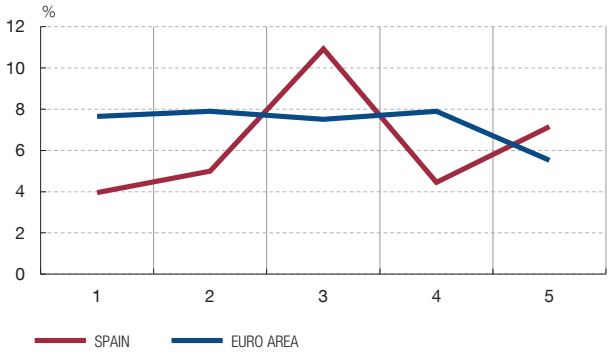
PROPORTION OF HOUSEHOLDS WITH DEBT PAYMENTS EXCEEDING 40% OF THEIR INCOME. BREAKDOWN BY INCOME QUINTILE (a). 2011



PROPORTION OF HOUSEHOLDS WITH DEBT/INCOME RATIO > 3. BREAKDOWN BY INCOME QUINTILE (a). 2011



PROPORTION OF HOUSEHOLDS WITH DEBT/GROSS HOUSEHOLD WEALTH RATIO > 75%. BREAKDOWN BY INCOME QUINTILE (a). 2011



SOURCES: Spanish Survey of Household Finances and Eurosystem Household Finance and Consumption Survey.

a For Spain, the data are for 2011. For the euro area, the reference year is 2010 for most countries.

The household segment subject to most financial pressure in the short term also accounts for a higher percentage in Spain than in the euro area, although this figure has recently fallen somewhat

The segment of households subject to most financial pressure in the short term, understood as those whose debt burden associated with debt payments exceeds 40% of their income, is also higher in Spain (6.5%) than in the euro area (3.4%). This percentage grew uninterruptedly from 2002 to 2008 (see Chart 2.3), but fell in 2011 (the latest available wave of the EFF) thanks to the lowering of interest rates during the crisis. By population group, lower-income, lower-wealth households with outstanding debts and those whose household head is young are those that most frequently face higher financial pressure.

The indicators generally used to approximate the proportion of households subject to greater financial pressure more into the medium term (a debt/income ratio above 3 and a debt/wealth ratio over 75%) evidence a continuation of the growing path prior to the crisis. In the first place, the percentage (13.2%) is also higher than that observed in the euro area, while in the second instance (8.1%) it is similar. As occurs with the short-term indicator, the percentage of indebted households facing greater financial pressure in the medium term is higher among lower-income, lower-wealth households and in those in which the household head is young.

The high level of household debt has intensified the

Over the past five years there has been a positive relationship in the advanced economies between the increase in household debt in the run-up to the crisis and the intensity of the

contraction in consumption during the crisis

crisis, through the effect exerted by debt on the reduction in consumption (durable goods in particular).[7] This effect can operate through three channels. First, through a wealth effect, which leads consumption to vary in the face of changes in household net wealth. Debt enables a higher volume of assets to be acquired and, therefore, raises household exposure to declines in the value of such assets, as was the case during the crisis. Moreover, debt levels exert a greater constraint on access to credit, which raises the proportion of households subject to liquidity restrictions and, therefore, with less spending capacity. Finally, greater uncertainty prompts an increase in precautionary saving, which reduces consumption. This increase in uncertainty is probably greater for households that are more indebted and, therefore, more exposed to the shocks that usually accompany a crisis.[8]

There is empirical evidence in Spain on how important these channels were in the unfolding of the crisis. Studies conducted drawing on the EFF reveal, first, that the wealth effect is relatively small in our economy: given a decline in (net real estate) wealth of €100, consumption falls by only €1 (€0.4 in the case of durable goods).[9] However, according to the same source, the percentage of households reporting saving for "emergency reasons", which may be considered as an indicator of the trend of precautionary saving, increased from 11.6% in 2005 to 19.1% in 2011, and the increase was substantially greater (12.5 pp) in the quintile of the most indebted households (see Table 2.1).

As regards the role of liquidity constraints, the percentage of households applying for a bank loan fell from 27.1% in 2005 to 17.7% in 2011. The decline was greater among households with some type of debt (by almost 20 pp) than among those with none; and, among the former it was higher for those in the upper quintile of the distribution of the debt/income ratio (in this latter case the reduction was almost 30 pp) (see Table 2.2). Partly, this shows that households in that quintile were also those that reported having increased to a greater extent their propensity for emergency saving (and, by saving more, they would cease to resort to credit). Nonetheless, the proportion of households that did not apply for a loan because they thought it would not be granted also increased more in this quintile, suggesting that their debt restricted their capacity to gain access to new credit.

2.2 NON-FINANCIAL CORPORATIONS' DEBT

Non-financial corporations' debt reached very high levels...

During the expansionary phase prior to the crisis, non-financial corporations' debt also increased at a very high rate (15% in annual average terms, from 1995 to 2007). As in the case of households, this expansion in debt was driven by very loose financing conditions and by optimistic expectations about the return on investments. The phenomenon was particularly intense in certain sectors of activity, particularly those linked to the real estate

7 It has been estimated with international data that, for each 10 pp increase in household debt prior to the crisis, consumption fell by 2.6 pp [see IMF (2012), "Dealing with Household Debt", chapter 3, *World Economic Outlook,* Spring]. In the United States, most of the decline in GDP during the 2007-2009 recession was due to the reduction in household consumption (durable goods in particular), which was much sharper in those areas in which households were more indebted [see A. Mian and A. Sufi (2010), "Household Leverage and the Recession of 2007 to 2009", *IMF Economic Review,* 58 (1), pp. 74-117, and Th. Philippon and V. Midrigan (2011), *Household Leverage and the Recession,* NBER working paper 16965].

8 See K. Dynan (2012), *Is a Household Debt Overhang Holding Back Consumption?,* Brookings Papers on Economic Activity, Spring, pp. 299-362; T. Jappelli and L. Pistaferri (2013), *Fiscal Policy and MPC Heterogeneity,* CEPR Discussion Paper 9333; and Á. Estrada, D. Garrote, E. Valdeolivas and J. Vallés (2014), *Household Debt and Uncertainty: Private Consumption after the Great Recession,* Documento de Trabajo del Banco de España, forthcoming.

9 See O. Bover (2005), *Wealth effects on consumption: Microeconometric estimates from the Spanish Survey of Household Finances*, Documentos de Trabajo, no. 0522, Banco de España, and C. Barceló and E. Villanueva (2010), *The response of household wealth to the risk of losing the job: evidence from differences in firing costs,* Documentos de Trabajo, no. 1002, Banco de España. The estimates of the wealth effect in relation to spending on durable consumption are taken from a panel survey of Spanish municipalities for which spending on cars from 2007 to 2012 is related to the changes in real estate wealth recorded in these municipalities [see D. López-Rodríguez and F. Elías (2014), *Mortgage Lending Cycles with Heterogeneous Credit Quality: Evidence from the Spanish Housing Boom and Bust,* Documento de Trabajo del Banco de España, forthcoming].

EMERGENCY SAVINGS (a) **TABLE 2.1**

% of total households

		2005	2008	2011
Total households		11.6	16.4	19.1
Occupancy status of main residence	Ownership, without mortgage	13.2	16.7	19.8
	Ownership, with mortgage	11.6	17.5	17.4
	Other	8.1	13.8	19.3
Real estate wealth	Below 25th percentile	10.0	12.5	18.8
	Between 25th and 50th percentile	10.3	14.4	17.1
	Between 50th and 75th percentile	11.4	16.9	18.6
	Between 75th and 90th percentile	14.7	22.6	23.8
	Between 90th and 100th percentile	18.1	21.8	19.7
Debt/income (indebted households)	Below 20th percentile	11.1	21.1	17.5
	Between 20th and 40th percentile	11.1	14.2	16.5
	Between 40th and 60th percentile	10.5	15.8	15.9
	Between 60th and 80th percentile	9.9	15.9	16.0
	Between 80th and 100th percentile	9.7	13.1	22.2

SOURCES: Spanish Survey of Household Finances (EFF), Banco de España (EFF2005, EFF2008, EFF2011).

a Percentage of households affirming emergency savings.

LOAN APPLICATIONS AND LOANS REJECTED OR GRANTED FOR A LOWER AMOUNT IN THE PAST TWO YEARS **TABLE 2.2**

		2005		2008		2011	
		Application	Applications rejected as a % of applications made	Application	Applications rejected as a % of applications made	Application	Applications rejected as a % of applications made
Total households		27.1	12.0	22.9	12.4	17.7	23.2
Occupancy status of main residence	Ownership, without mortgage	19.6	11.5	16.2	7.4	12.2	17.6
	Ownership, with mortgage	43.4	10.2	36.6	14.6	26.8	21.4
	Other	26.5	17.0	24.3	18.2	21.8	37.3
Real estate wealth	Below 25th percentile	23.1	18.2	19.8	18.1	18.4	37.1
	Between 25th and 50th percentile	29.5	11.0	24.6	12.8	18.4	23.5
	Between 50th and 75th percentile	27.5	12.7	22.0	13.8	15.8	22.8
	Between 75th and 90th percentile	25.5	8.0	25.3	5.1	18.5	7.6
	Between 90th and 100th percentile	31.4	3.6	25.4	7.3	17.5	11.3
Debt/income (indebted households)	Below 20th percentile	48.0	11.0	38.8	10.2	30.1	23.4
	Between 20th and 40th percentile	53.6	10.2	41.9	9.1	38.1	17.5
	Between 40th and 60th percentile	45.7	8.3	43.8	3.4	31.5	18.4
	Between 60th and 80th percentile	54.8	7.0	41.0	7.2	35.1	16.8
	Between 80th and 100th percentile	66.6	15.0	59.5	19.8	36.9	24.2

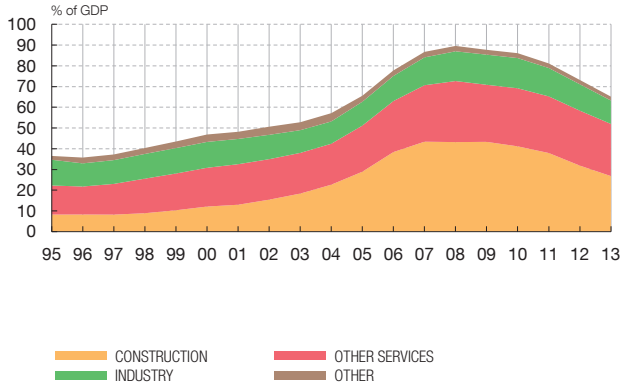
SOURCES: Spanish Survey of Household Finances (EFF), Banco de España (EFF2005, EFF2008, EFF2011).

sector, where around 55% of the increase in bank lending to companies was concentrated (see Chart 2.4). The heavy fall in property sales that accompanied the crisis, along with the decline in property prices, meant growing difficulties for a significant portion of these companies in meeting meet their payment obligations. Other firms, however, used borrowings to finance international expansion processes which, in general, have

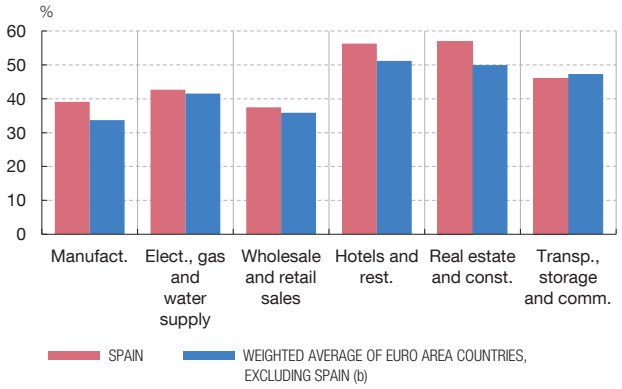
NON-FINANCIAL CORPORATIONS' DEBT

CHART 2.4

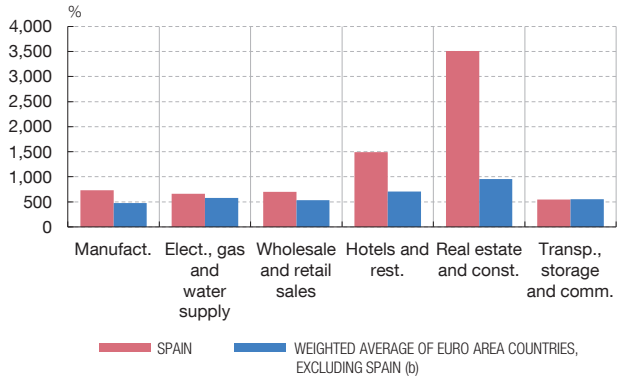
RESIDENT CREDIT INSTITUTIONS' LENDING TO NON-FINANCIAL CORPORATIONS. BREAKDOWN BY PURPOSE OF EXPENDITURE (a)



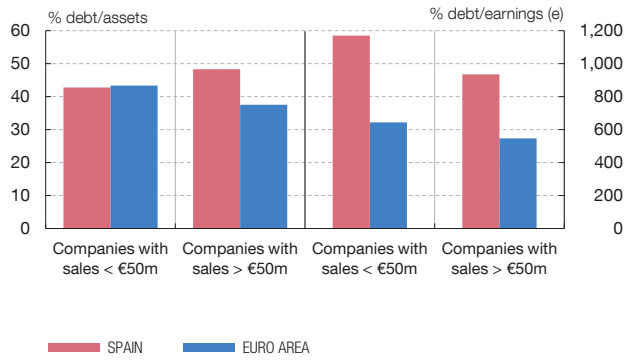
NFCs: DEBT/TOTAL ASSETS. BREAKDOWN BY SECTOR. 2012



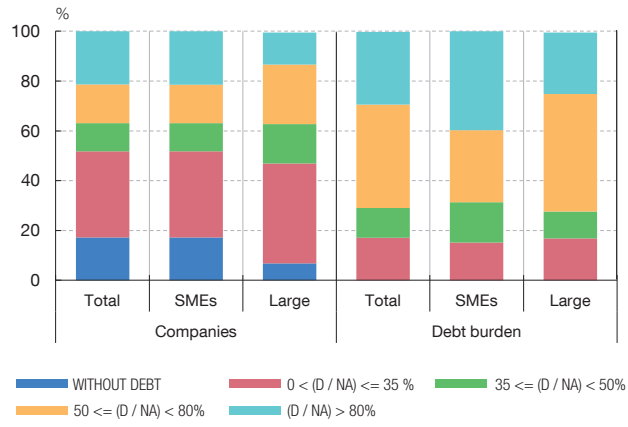
NFCs: DEBT/GROSS OPERATING PROFIT. BREAKDOWN BY SECTOR. 2012



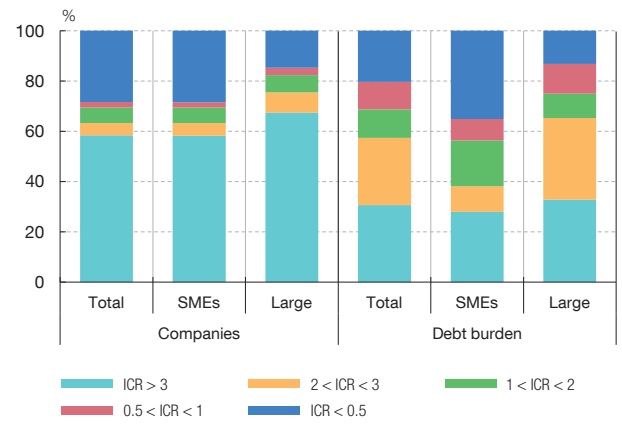
DEBT RELATIVE TO ASSETS AND INCOME. BREAKDOWN BY SIZE. SPAIN (c) AND EURO AREA (d). 2012



COMPANIES BY DEBT/NET ASSETS RATIO (D / NA) SEGMENT. 2012



COMPANIES BY INTEREST COVERAGE RATIO (ICR) SEGMENT. 2012 (f)



SOURCES: Banco de España and Bank for the Account of Companies Harmonised.

a Includes securitised credits and loans transferred to Sareb.
b GDP-weighted average of the ratios in Germany, France, Italy, Portugal, Belgium and the Czech Republic. For Germany and the Czech Republic, the ratio is for 2011, as the 2012 figure is not available. For Germany, unlike the other countries, liabilities include debt with group and associated companies.
c Weighted average based on the sectoral distribution of the gross value added in the euro area of the sectoral ratios.
d GDP-weighted average and value added in the euro area of the sectoral ratios in Germany, France, Italy, Portugal, Belgium and the Czech Republic. For Germany, unlike the other countries, liabilities include debt with group and associated companies.
e Gross operating profit.
f ICR defined as (gross operating profit + financial revenue)/financial expenditure. Companies without financial expenditure are included in the group with ICR > 3.

contributed to the greater geographical diversification of their revenue, helping soften the impact of the decline in domestic business.

The corporate debt/GDP ratio, which stood below that of other developed countries in the mid-1990s (at around 45%), climbed to 132% in 2007 (117% if intercompany loans are excluded), far higher than the figures observed on average for the euro area (94%), the United Kingdom (93%) and the United States (76%) (see Chart 2.1).[10] The inertia of financing flows and the unfavourable course of GDP meant that this ratio continued rising, up to almost 145% of GDP by mid-2010. Following the correction since, it stood at end-2013 at 128% of GDP, almost 30 pp above the figure for the euro area and also higher than that of other advanced economies, such as the United Kingdom and the United States.

... which affects both SMEs and larger companies, proving more prominent in certain sectors, such as those linked to the real estate market...

Compared with the euro area average, corporate debt is higher in Spain in most sectors of activity, especially when set in relation to earnings, although the differences are more marked in sectors linked to the real estate market. This suggests that the need for debt to be corrected, while more acute in the sectors linked to the real estate market, is not confined to the latter.

The breakdown by size (proxied by the volume of sales) shows that, in relation to assets, the debt of the biggest Spanish corporations is higher than that of their euro area peers, while for smaller firms the levels are similar. In terms of income generated, the ratio is higher in Spain for both groups of companies, even after controlling for differences in sectoral distribution, and the discrepancies are more marked for smaller-sized firms which, having been more affected by the recession, saw a greater contraction in their earnings.

... although there is a significant proportion of companies with moderate debt levels

In any event, there is notable dispersion in the degree of debt within each sector of activity and for companies of different sizes. Thus, somewhat more than 15% of SMEs and almost 7% of larger companies do not have interest-bearing debt. And among the companies that do, for 42% of these the leverage ratio is lower than 35%, while for 26% it exceeds 80%. This heterogeneity is also discernible when indicators measuring the degree of financial pressure associated with debt incurred are used. For instance, while 30% of companies (whose borrowings are equivalent to 31% of corporate liabilities) obtained revenue flows in 2012 that did not suffice to cover their financial expenses, almost 60% of them (accounting for a further 31% of corporate debt) did not have to pay interest or earmarked in this connection less than one-third of their ordinary profits. Therefore, these data show that the high aggregate debt of the non-financial corporations sector is compatible with the existence of a notable proportion of firms with moderate levels of debt. For these companies, their degree of leverage does not appear to be an obstacle to obtaining borrowed funds with which to finance profitable investment projects. Along these lines, information on micro-scale credit shows that, in 2012 and 2013, around 40% of companies underwent no contraction whatsoever in their outstanding credit balance.

Companies' debt has influenced their recent activity

The evidence available since the start of the crisis reveals that the most indebted companies have seen their activity trend more adversely in terms of employment and investment (see Box 2.1). That would suggest that the sector's high debt influences macroeconomic developments and highlights the need to complete the ongoing restructuring of that part

10 To assess the degree of debt of the corporate sector, intercompany loans should preferably not be included since these are liabilities of certain companies but assets of others. However, details on these loans are not available either for the United States or for the United Kingdom. Accordingly, in this chapter the concept of liabilities used to make the international comparison includes intercompany debt.

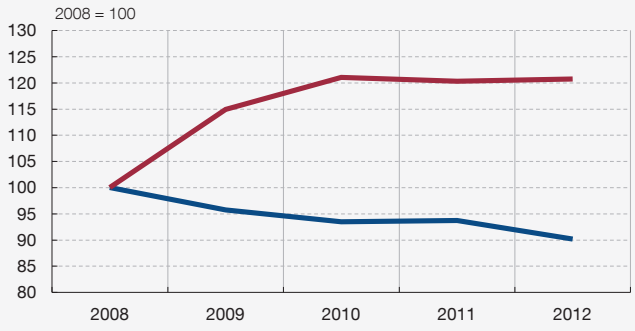
Before the crisis, the debt of non-financial corporations increased very quickly. Afterwards, it has decreased slowly and progressively against a background characterised by a macroeconomic recession in which employment and productive investment have deteriorated notably. This Box analyses to what extent the employment and tangible fixed-asset investment behaviour of non-financial corporations differs depending on their level of debt. To do this, use is made of the merged CBSO and Mercantile Register database (CBI)[1], which contains microeconomic data from a sample of around 600,000 firms per year, for the period from 2008 to 2012 (latest year available). The firms are separated into two groups according to whether at the beginning of each year their ratio of debt to net assets is above or below the average for their sector of activity.

1 This database is obtained by merging the CBA and CBB databases. The CBA database contains information on some 10,000 firms reporting annually to the Central Balance Sheet Data Office and is somewhat biased towards larger firms. The CBB database is constructed from financial statements lodged by firms in the mercantile registers and contains information on small and medium-sized enterprises.

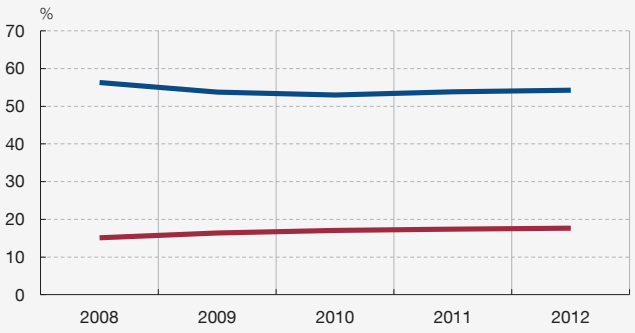
Panel 1 shows the financial debt of the two groups of companies. It can be seen that, whereas the most indebted firms progressively reduced their borrowed funds from 2008, the debt of other firms followed an upward path until 2010 and then remained steady for the following two years. A more detailed analysis by sector of activity and firm size confirms the existence of similar behaviour patterns in all sectors of activity, and in both SMEs and larger firms. As a result of this behaviour the ratio of debt to net assets of both aggregates became slightly more similar (see Panel 2). This convergence is more evident if construction is excluded, since this sector's debt ratio was pushed upward by the high losses in the period analysed, which reduced the denominator of this indicator.

Panels 3 and 4 show investment in tangible fixed assets (measured as the ratio of the flow of gross fixed capital formation to its balance a year earlier) and unemployment for each of the two groups of firms analysed (more indebted and less indebted). Both aggregates show declining investment and job destruction, but the falls are sharper for more indebted firms. This pattern is observed in all sectors of activity, in both SMEs and large firms.

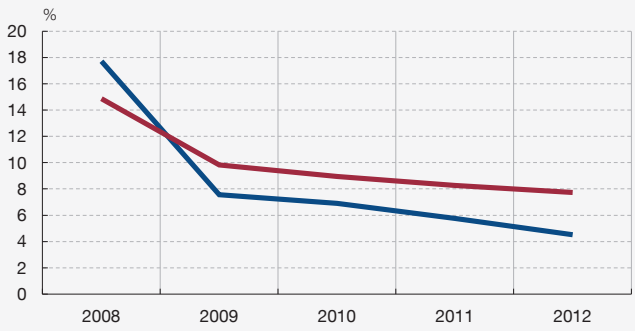
1 INTEREST-BEARING DEBT



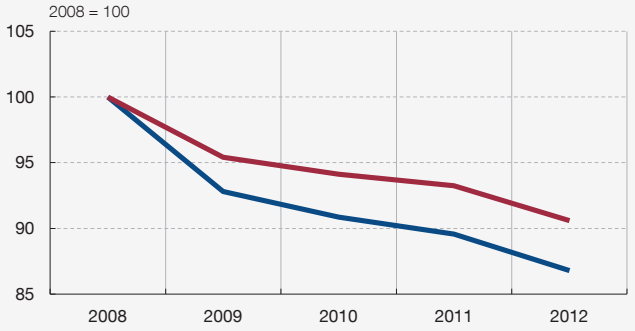
2 DEBT/NET ASSETS

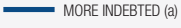


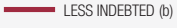
3 GFCF (c)/TANGIBLE FIXED ASSETS AT t-1



4 EMPLOYMENT







SOURCE: Banco de España.

a Firms whose debt ratio is greater than the average debt in their industry at t-1.
b Firms whose debt ratio is equal to or less than the average debt in their industry at t-1.
c Gross fixed capital formation. In CBB firms this flow is approximated by the difference between the balance-sheet amounts of tangible fixed assets less depreciation expense.

In short, the results reported in this Box indicate that the level of firms' indebtedness influenced their investment and employment decisions during the crisis. In particular, more indebted firms were comparatively more strongly affected by the crisis, since they were more vulnerable to the contraction of their income. That obliged them to adjust their balance sheet and to reduce employment and investment more sharply compared with financially sounder firms.

of the productive system subject to a greater degree of financial pressure. The experience of past economic recoveries following episodes of financial crisis further points to initial patterns of growth which, in the case of companies, tend to be underpinned to a greater extent by less credit-intensive activities and financed with alternative funds, such as self-financing or own funds. This tends to contain price adjustments insofar as the most indebted companies will face greater difficulties in adjusting their profit mark-ups.[11]

2.3 PROGRESS IN THE CORRECTION OF PRIVATE-SECTOR DEBT

Private-sector debt can be reduced through several means

The debt ratio can be reduced either through a decline in the outstanding balance of debt (the numerator of this ratio) or as a result of an increase in the funds agents have to meet this balance (the denominator). A decline in the balance of liabilities may, in turn, occur because the repayments of outstanding debt exceed the flow of new gross financing (net negative financing flow), because the loans are unpaid or because their valuation changes (write-downs and valuation effects).

Past experience reveals that debt-reduction processes following financial crises tend to be slow and rest, initially, on contractions in the outstanding balance of debt.[12] The main reason is that these processes are accompanied by weak growth in income, which restricts agents' spending and is a drag on economic recovery. Later, once the economy begins to recover, the decline in the ratio tends to be compatible with more moderate growth in debt than that of nominal GDP.

The correction of private debt in the advanced economies is occurring at different degrees of intensity and through different channels, depending on each country's situation. Where the pick-up in economic activity has come about earlier and has been greater, and where household debt restructuring has had a greater incidence (the United States), the reduction in debt has been swifter. It has also proceeded more briskly in those countries where the inflation rate has been higher (the United Kingdom).[13]

In Spain, the reduction in non-financial private-sector debt has advanced significantly, despite sluggish GDP

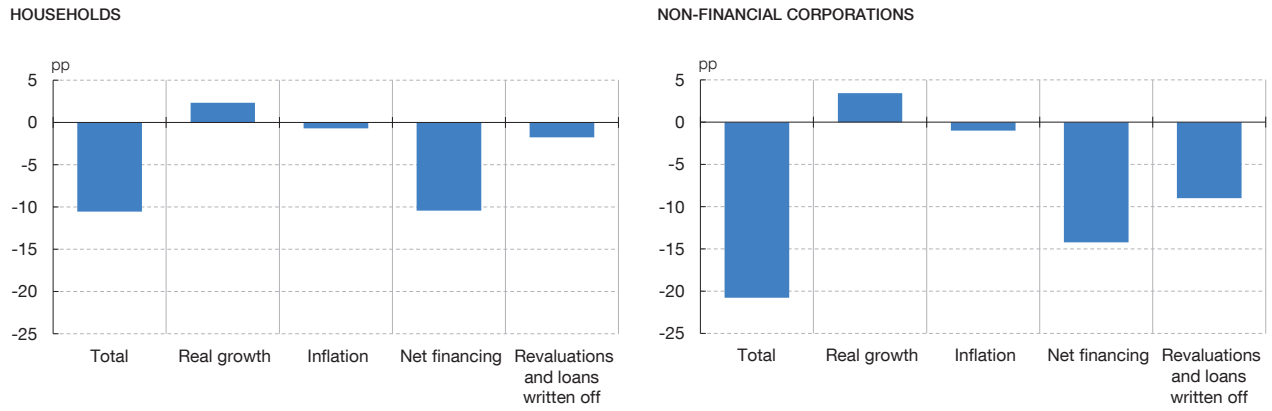
In Spain, private-sector debt/GDP ratios peaked in mid-2010. Since then there has been a cumulative reduction to end-2013 of 11 pp in the case of households, and of 21 pp (16 pp when intercompany debt is included) in that of non-financial corporations. In both, the reduction has essentially come about through negative net debt flows, i.e. through debt repayments higher than the gross flow of new financing. This factor contributed almost 11 pp of the reduction for households and 15 pp for firms (see Chart 2.5). In this latter

11 See J. M. Montero and A. Urtasun (2014), *Price-Cost Mark-ups in the Spanish Economy: a Microeconomic Perspective,* Documentos de Trabajo, no. 1407, Banco de España.

12 See, for example, O. Aspachs-Bracons, S. Jódar-Rosell and J. Gual (2011), *Perspectivas de desapalancamiento en España,* Documentos de economía «la Caixa», and McKinsey (2012), *Debt and deleveraging: uneven progress on the path to growth,* McKinsey Global Institute.

13 See D. Garrote, J. Llopis and J. Vallés (2013), *Los canales del desapalancamiento del sector privado: una comparación internacional*, Documentos Ocasionales, no. 1302, Banco de España.

CONTRIBUTIONS TO CHANGES IN THE DEBT RATIO BETWEEN 2010 Q2 AND END-2013 (a) CHART 2.5



SOURCES: Banco de España.

a Debt ratio is defined debt (excluding intercompany loans), relative to GDP.

case, the write-downs and valuation effects, including the impact of the transfer of real estate loans to Sareb, have also played a significant role (8 pp). Conversely, inflation has made a marginal contribution and real growth, which has been negative, has exerted a counter-effect (increase in the debt ratio). The reduction in overall Spanish corporate and household debt has been greater than that recorded in economies such as the United States, the United Kingdom and the Netherlands, which also faced private-sector over-indebtedness problems. However, the level of the Spanish ratio continues to stand above that of these countries.

The decline in household debt has been sharper in loans not intended for house purchase

In the household sector, the contraction in debt has been quantitatively more significant in loans not linked to house purchase, which reflects both the shorter relative term of these transactions (which makes their repayment swifter) and the lack of collateral in this type of loan, thereby raising the risk for lenders (leading supply-side conditions to be more cyclically sensitive). Indeed, in this type of financing the reduction in the outstanding balance began in 2008, before it did so in the case of real estate debt. Moreover, this reduction was the result both of the proportion of indebted households and of average loan amounts (see Chart 2.2). Conversely, in loans for house purchase the proportion of indebted households stabilised between 2006 and 2010, and fell very slowly only from 2011, while the average amount of debt has fallen somewhat more sharply since this latter date. Part of the decline in the outstanding balance of debt for property purchases is linked to the cancellation of loans associated with the hand-over of houses when borrowers are in situations of financial difficulty. Specifically, during 2012 and 2013, such transactions accounted for 1.4% of outstanding mortgages.

Companies have used different means to reduce their debt, and those that have done so most intensely are the most indebted ones

In the case of companies, the decline in debt has been fairly widespread across sectors and has affected both large corporations and, especially, SMEs; that said, the reduction is most concentrated in the most indebted companies, which are those that have greater balance-sheet restructuring requirements.[14] On the contrary, those other companies with little debt have, on average, increased their debt. Companies that have reduced their borrowings have used different means to do so, such as the use of internally generated funds, capital increases or asset (essentially financial assets and, in particular, shares and

14 See Á. Menéndez and M. Méndez (2013), "Spanish non-financial corporations' debt since the start of the crisis. A disaggregated analysis", *Economic Bulletin*, January, Banco de España.

holdings in other companies) disposals. Some of the biggest corporations have resorted especially to asset disposals.[15]

3 The nation's debt

3.1 THE ROLE OF THE BANKING SYSTEM

The banking system financed the increase in private-sector debt by raising funds on international markets...

Spain is a heavily banked economy, meaning that the bulk of financing raised by households and non-financial corporations is from the national banking system. Consequently, the counterpart of the strong growth in household and corporate debt in the years prior to the crisis was the expansion of resident credit institutions' balance sheets and activity. From 1995 to 2007 their total assets increased by 286%, the number of offices did so by 25% and employment in the industry by 12%. In 2008, the lending/GDP ratio stood at around 170%, far higher than in other developed countries (105% in the euro area, 132% in the United Kingdom and 64% in the United States). As earlier discussed, the expansion was accompanied by a progressive concentration in transactions linked to the real estate market.

Given the insufficiency of domestic saving to finance this expansion in lending, banks resorted to international debt markets. Most funds were raised through the issuance of long-term fixed-income securities, directly by the banks themselves (as in the case of covered bonds, for instance) or through special vehicles (as in the case of asset-backed bonds). As a result, non-residents' holdings of fixed-income instruments issued by domestic financial institutions climbed from 0.4% of GDP in 1995 to 62.5% of GDP in 2007, against the generalised background of the internationalisation of financial flows, and driven also by Spanish euro area entry.

... meaning that the banking system's situation was much affected by the crisis...

The excessive size of the banking system, along with the bias of its portfolios towards real estate sector-related activities, made it vulnerable to adverse macroeconomic shocks, and in particular to those linked to the real estate market. In these circumstances, the economic crisis that broke in 2008 ultimately undermined the financial and balance-sheet position of the banking system, albeit with a very mixed degree of incidence from bank to bank.

... which made it necessary to undertake a major restructuring, recapitalisation and clean-up of the banking system, along with regulatory reform

As a result, it was necessary to overhaul the banking system by means of a four-pronged reform: restructuring, recapitalisation, balance sheet clean-up and the reform of the regulatory and supervisory framework.[16] These measures are analysed in Chapter 1 of this Report, as they are one of the most significant factors behind developments in the Spanish economy during the reference period.

3.2 THE ROLE OF THE PUBLIC SECTOR

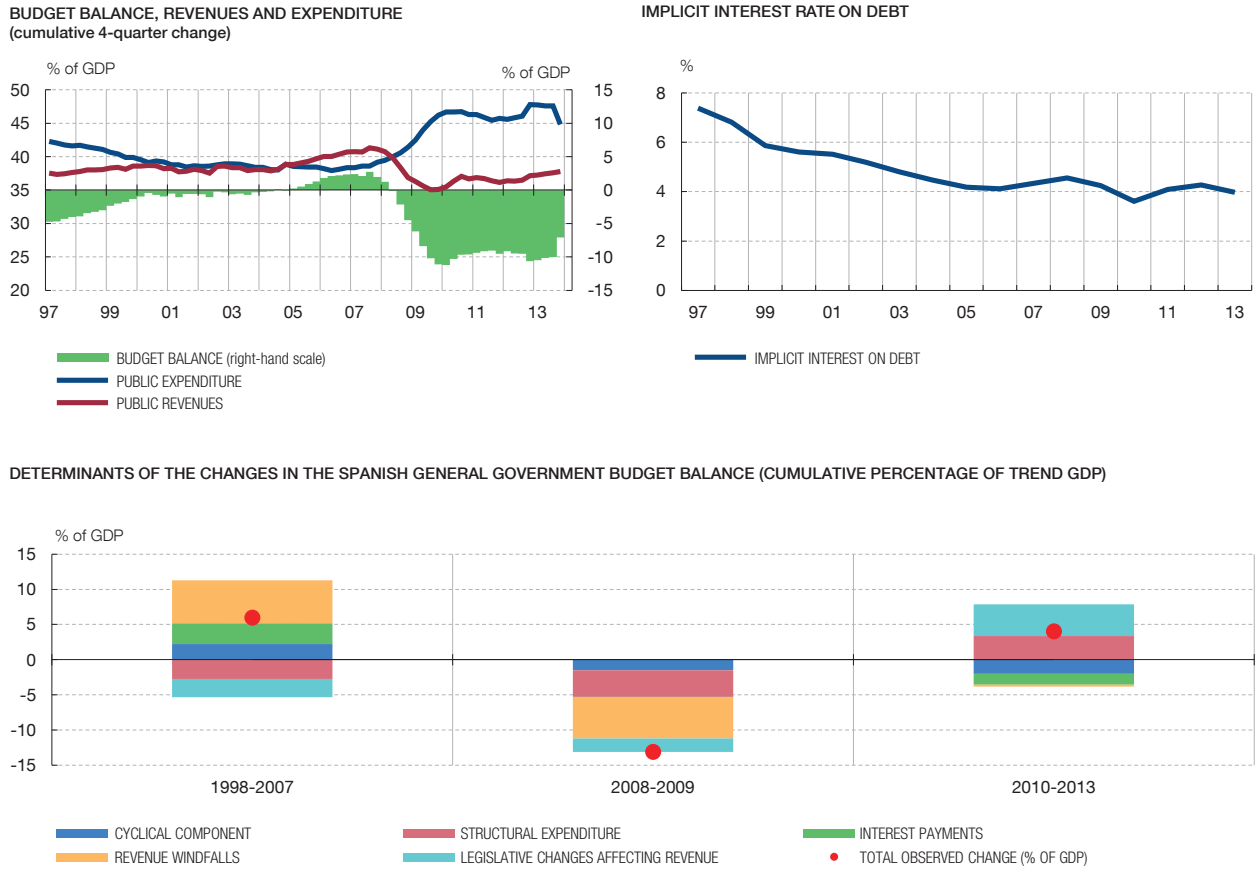
State aid for the restructuring of the banking system came on top of growing general government financing requirements

The banking system clean-up and restructuring measures required public injections of capital. The necessary resources were obtained, in part, from a specific European support programme totalling €41 billion, which was requested in July 2012 and successfully concluded in early 2014. The financing of these capital injections came on top of growing general government financial requirements in the wake of the crisis, linked essentially to the operation of the automatic stabilisers and to the expansionary discretionary measures adopted (see Chart 2.6). The assistance and stimuli to the private sector, set against the strong decline in tax receipts, translated into growing budget deficits and into a rapid increase in public debt. It was through all these measures that the link between both sectors progressively increased, in such a way that a portion of the private-sector adjustment costs ultimately passed through to the public sector.

15 For further details on the means used by large corporate groups to reduce their debt, see Box 1 in Á. Menéndez and M. Méndez (2013), "Results of non-financial corporations to 2012 Q4 and summary year-end data", *Economic Bulletin,* March, Banco de España.

16 See Chapter 3 of the *Financial Stability Report,* November 2012, Banco de España.

GENERAL GOVERNMENT BUDGET BALANCE AND DETERMINANTS CHART 2.6



SOURCE: Banco de España.

Most of the increase in public debt had to be financed through resort to the rest of the world and to the banking system itself, through which 31% and 47%, respectively, of new funds were raised. As a result, there was a rise not only in the Spanish economy's external debt but also a sizable increase in banks' exposure to the public sector.

The link between the banking system and the public sector gave rise to a risk feedback loop between both that has hampered resolution of the debt crisis

The heightened bank exposure to general government and the assumption by the latter of a most sizeable portion of the restructuring bill for certain financial institutions contributed to increasing the interrelatedness between the financial position of the banking system and that of the public sector. The combination of both situations with the worsening macroeconomic outlook shaped the three sides of a triangle of negative interactions. These were particularly acute at the height of the tension on financial markets during the European debt crisis and they ultimately highlighted the difficulty of maintaining a single currency in the presence of highly integrated financial markets if, at the same time, supervisory and banking resolution policies remained in the hands of the national authorities.[17] The weakness of expected economic growth dented banks' earnings expectations. This adversely impacted their financing costs, and the pass-through of

17 For empirical evidence on these negative interactions between the banking and public sectors, see V. V. Acharya, I. Drechsler and Ph. Schnabl (2012), "Tale of two overhangs: the nexus of financial sector and sovereign credit risks", and R. Breton, C. Pinto and P.-F. Weber (2012), "Banks, moral hazard, and public debts", in Banque de France (2012), *Public debt, monetary policy and financial stability. Financial Stability Review,* April. The European crisis, in general, and the nature of the links between the financial fragility of the banking system and of the public sector, in particular, were addressed more fully in Chapter 2 of the *Annual Report, 2012.*

these greater costs to the price of credit detracted from the possibility of higher growth. Further, it negatively affected the projections of public finances through the attendant impact on the automatic stabilisers and also as a result of the perceived greater risk of a potential public intervention in the financial system, which had been fuelled by the above-mentioned effects on bank profitability. The subsequent expected difficulties in general government being able to exert a stabilising effect fed through, in turn, to expectations of excessively weak growth.

3.3 EXTERNAL DEBT

As a result of the changes in the financial position of the different sectors and of their interrelatedness, the nation's debt increased strongly

The debt of the various domestic economic agents and their interrelatedness are reflected in the nation's overall financial position vis-à-vis the external sector. Thus, the build-up of debt by the private sector during the pre-crisis expansionary phase, which outpaced the public sector's saving capacity, translated into successive deficits on the current and capital accounts. And owing to these deficits and to the trend of the relative prices of our assets and liabilities vis-à-vis the rest of the world[18], the net external liabilities of resident agents as a whole increased substantially (as a percentage of GDP) from the mid-1990s to the onset of the global financial crisis in 2007 (see Chart 2.7). They carried on rising thereafter, albeit at a lesser pace, in a setting in which the economy continued to evidence net borrowing requirements, albeit increasingly smaller ones, until posting net lending capacity in 2013. Gross liabilities increased to a greater extent, since this growth was accompanied by the greater internationalisation of the Spanish economy, reflected in a growth of its claims on the rest of the world.

The course of liabilities was essentially determined by the behaviour of external debt, which includes only liabilities that entail payment obligations, as opposed to others, such as investment in equity instruments, which do not give rise to such commitments. Considering gross external debt (160% of GDP in December 2013) exclusively, the Spanish economy's current position is not significantly different from that of nations such as Germany, and this debt proportion is even lower than that of France and the United Kingdom. However, given that these countries have a greater volume of claims on the rest of the world, Spain's international investment position in net terms shows high figures (98% of GDP), exceeded only by Portugal, Ireland and Greece among the euro area countries and far above the 35% threshold set by the European Commission as a benchmark for identifying macroeconomic imbalances under the new EU surveillance procedure.

The risks associated with a specific position against the rest of the world depend on the magnitude involved and on the composition of liabilities

The sustainability of the external financial position depends ultimately on the ability to meet the periodic payments associated therewith, their repayment at maturity and, also, potential withdrawals of funds by foreign investors or the non-rollover of the operations which, at the time of maturing, need to be rolled over. Accordingly, what is important is not only the volume of foreign liabilities, but also their composition in terms of maturities and instruments.

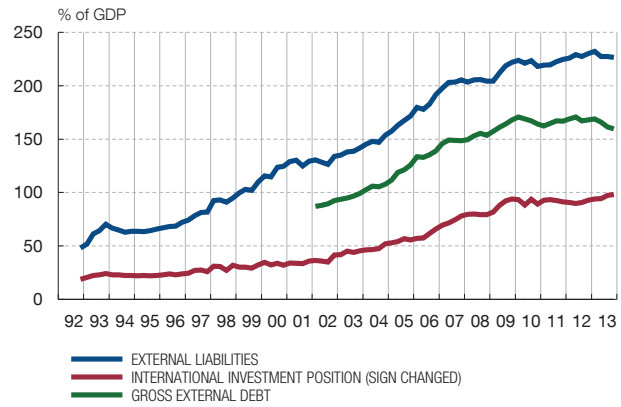
Direct investment and investment in listed shares entail, from this perspective, a lower risk given the generally more durable nature of the former and the lesser callability of the latter. Under other investment (portfolio investment and other investment), their callability varies with the maturity of the instruments. Lastly, euro area membership generates asset- and liabilities-side positions among the participating central banks (intra-system claims) that do

18 According to estimates based on information from the Spanish balance of payments and international investment position, the valuation effects (along with other adjustments) account for somewhat more than half of the increase in net external liabilities from 1995 to 2007.

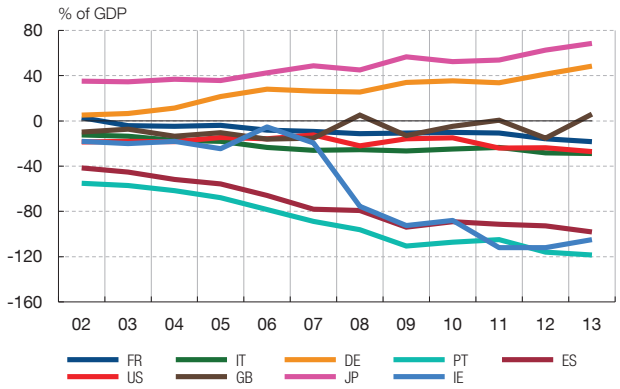
INDEBTEDNESS OF THE NATION

CHART 2.7

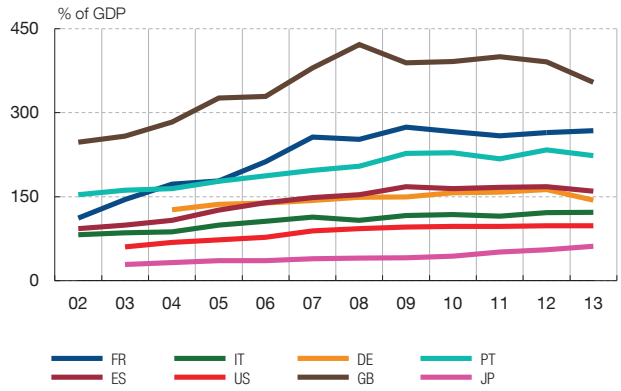
EXTERNAL LIABILITIES



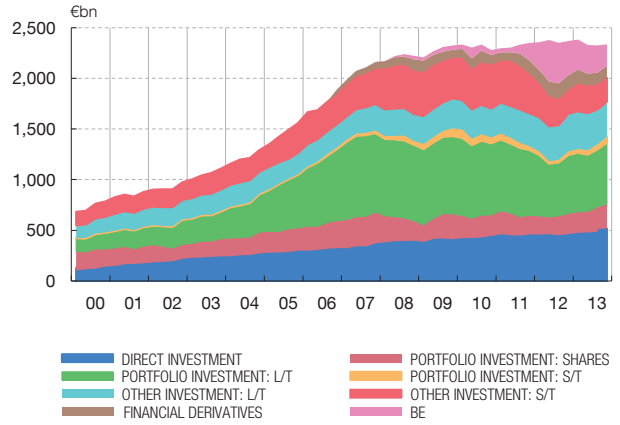
INTERNATIONAL INVESTMENT POSITION (a)



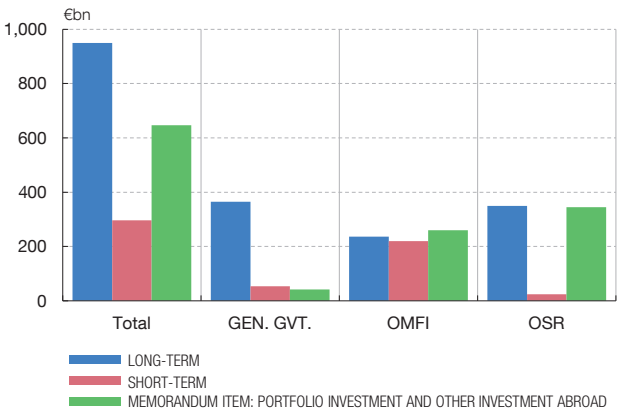
GROSS EXTERNAL DEBT (a)



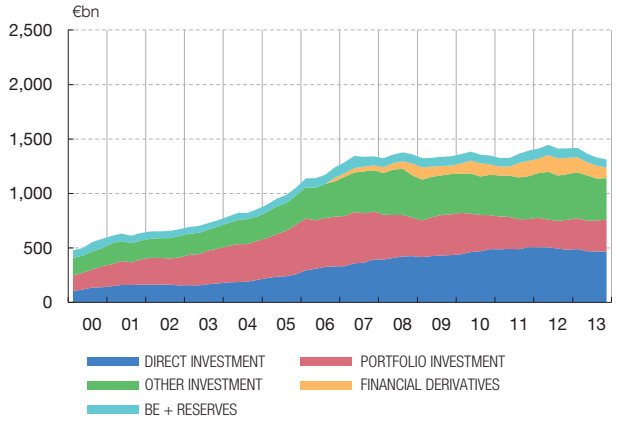
EXTERNAL LIABILITIES



PORTFOLIO INVESTMENT AND OTHER FOREIGN INVESTMENT IN SPAIN (b)
September 2013



EXTERNAL ASSETS



SOURCES: IMF, national sources and Banco de España.

a Countries are named with their ISO code (ES: Spain; DE: Germany; FR: France; IT: Italy; PT: Portugal; US: United States; GB: United Kingdom; JP: Japan; IE: Ireland).
b Excluding the Banco de España.

not have a specific maturity and which are not, therefore, callable in the strict sense. However, the level is informative since a high net debtor position in these assets corresponds to greater dependence by resident credit institutions on financing from the Eurosystem.[19]

Although the bulk of external financing corresponds to long-term portfolio investment and refinancing risks in the short term are limited...

The bulk of foreign liabilities corresponds to non-residents' portfolio investments in long-term instruments (issued mainly by financial institutions). Close to 80% of short-term investments, which entail higher refinancing risks, correspond to Spanish credit institutions' liabilities. In turn, a sizeable portion of the latter are interbank loans, of which one-third are collateralised. Furthermore, 58% of those that are not collateralised correspond to foreign banks. Both factors significantly reduce the risks of their potential non-rollover. Taking available interbank claims on the external sector also into account, the net non-collateralised debtor position of domestic banks was practically zero at end-2013.

In the remaining sectors, claimable foreign liabilities are essentially long-term instruments. Moreover, as indicated for credit institutions, these sectors also have claims on the foreign sector which, though they have fallen in recent years, and even bearing in mind the fact that the private agents holding these assets do not exactly match the borrowers, they still provide for something of a buffer to withstand possible fund withdrawals.

... maintaining such a high net debtor position is a major factor of vulnerability

Although refinancing risks are contained, maintaining a high net debtor position vis-à-vis the external sector is a factor of vulnerability for the Spanish economy, due both to the draining off of resources entailed by the payments associated with this debt and, above all, to the exposure to potential bouts of instability.

4 The reduction of debt: conditioning factors and challenges

The economy's high level of debt conditions growth and is a major factor of vulnerability, meaning its reduction is unavoidable

The swollen debt of Spanish households, firms and general government sectors conditions their capacity to undertake new spending and hiring decisions. At the same time, the aggregation of this debt translates into a high debtor position of the whole of the economy vis-à-vis the rest of the world, which makes it vulnerable to potential shocks that alter the normal functioning of international financial markets or that affect foreign investors' confidence in our economy. Accordingly, reducing these debt ratios to more comfortable levels is a vital condition for setting in place a stable growth path.

The adjustment has begun, but it is gradual and must be completed under demanding conditions

The redressing of private-sector debt began some time back, but the singular macroeconomic conditions prevailing restrict the speed of its progress. First, the momentum behind economic growth that is needed to reduce the weight of the debt rests largely on the continuous attainments of gains in competitiveness, which requires maintaining price restraint that ensures the favourable behaviour of the inflation differentials in relation to the euro area average. The low levels of inflation in the euro area at present and the projections on its future behaviour show that the easing in debt ratios that an increase in the level of prices may provide will continue to be fairly limited. Also, the foreseeable path of recovery of the economy suggests moderate real growth rates, whose contribution to reducing the debt ratios will likewise be modest.

High public debt makes continuing fiscal consolidation vital

Despite the progress achieved in fiscal consolidation, the decline in public debt has not yet begun. On the forecasts available, the fiscal adjustment still needed to stabilise the public debt/GDP ratio remains considerable. In particular, according to the latest Stability Programme update, keeping the public debt/GDP ratio below the 100% threshold in 2017

19 See the note "Banco de España claims on the Eurosystem in the Balance of Payments" (http://www.bde.es/webbde/en/estadis/bpagos).

would require a cumulative 6.4 pp reduction, in terms of GDP, in the primary deficit. It should be borne in mind that the fiscal consolidation that enabled public debt to stabilise at 70% of GDP in the first half of the 1990s involved a reduction in the primary deficit for the period as a whole of 3.6 pp.[20]

These considerations underscore the significance of fiscal consolidation for firstly stabilising and subsequently reducing the public debt ratio. That would lessen the vulnerability of our economy to potential adverse shocks, while contributing to reducing the cost of financing for the other sectors in the economy, providing for a reduction in private debt.

Under these conditions, structural reform policies are the most evident option available to square the need to correct the economy's debt with economic growth...

Under these conditions, supply-side policies are the best option for squaring the adjustment of private and public debt with sustained economic growth. The habitual objection to these types of reforms in recessions is that they may, in the short run, cause reductions in agents' incomes that translate into an increase in private debt ratios and in their associated burdens. However, if there are constraints on the capacity to incur debt, as is the case at present, structural reforms that improve the workings of the product and labour markets may – practically immediately – stimulate employment and aggregate demand, raising by extension economic agents' incomes (see Box 1.2). Moreover, the positive effects of these reforms on productivity result in gains in competitiveness which, along with those prompted by the adjustment of labour costs, contribute to stimulating economic growth and to reducing external debt.

... accompanied by mechanisms that help provide for the survival of viable companies with financial problems ...

Given the non-contingent nature of traditional debt agreements, the cost they entail for debtors does not adjust to changes in their financial position or adverse shocks that affect their revenue flows. Nonetheless, it is in the interest of creditors to avoid debtor insolvency when such adverse shocks arise. Thus, under certain conditions, agreements that smooth debt service through the orderly amendment – in clearly defined cases – of certain contractual terms may be favourable to both parties. The challenge consists of legally designing procedures that avert the problems of moral hazard and do not jeopardise the solvency of creditors, as the latter are also vulnerable to default in a financial crisis situation.[21]

The legal framework for insolvency proceedings was regulated in Spain in 2003, but it has since been the subject of intense reform, including most recently Royal Decree-Law 4/2014. This process has essentially been aimed at setting in place more flexible and orderly mechanisms that facilitate the survival of companies that are under pressure in the short run but are viable in the medium and long term (see Box 2.2).

In the case of households, the types of loans involved – mortgage loans in the main, with a single lender – mean that the mechanisms for the private restructuring of the debt are less complex. In December 2013 (the latest available figure), refinancing and restructuring operations affected 10% of house mortgage loans. Additionally, shorter-dated financial pressure problems are more limited since they affect a smaller proportion of borrowers compared with what occurs with non-financial corporations and because, on the latest EFF data, there has been a decline in this proportion in recent years (see the upper left-hand panel of Chart 2.3), largely linked to the fall in interest rates prompted by a very expansionary monetary policy.

20 See P. Hernández de Cos and J. F. Jimeno (2013), *Fiscal policy and external imbalances in a debt crisis: the Spanish case,* Documentos Ocasionales, no. 1303, Banco de España.

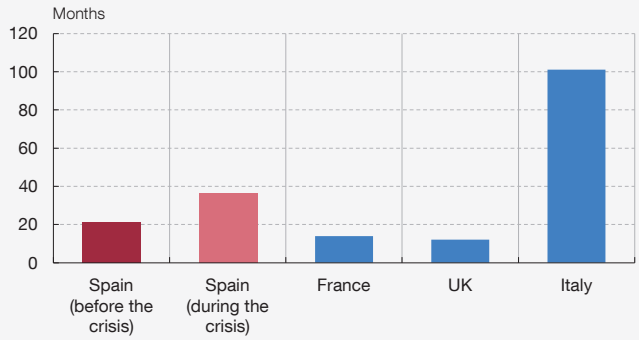
21 See A. Mian, A. Sufi and F. Trebbi (2012), *Resolving Debt Overhang: Political Constraints in the Aftermath of Financial Crisis,* NBER working paper 17831.

Corporate insolvency proceedings are a legal proceeding which aims to address the situation of a borrower's insolvency either through an agreement (accord) between the creditors and the debtor firm or through the winding-up of the latter. In the first case, a reduction in the nominal value of the debt is agreed (partial acquittance) and/or in the schedule of payments (payment period). In the second case, the creditors are paid by selling the company's assets in accordance with the legally stipulated order of priority of creditors. These proceedings exist in all developed countries and most emerging economies. In Spain, they are currently governed by the Insolvency Law,[1] which was approved in 2003 and came into force on 1 September 2004. The economic crisis underlined some of the shortfalls in the Law and, consequently, it has been subject to four major reforms through Royal Decree-Law 3/2009[2], Law 38/2011[3], the Entrepreneurs' Law[4] and Royal Decree-Law 4/2014[5].

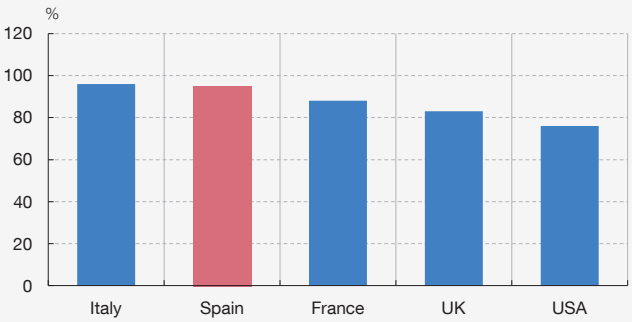
The main function of insolvency proceedings is to overcome problems of coordination and asymmetric information which make it difficult to renegotiate debt privately and for debts to be recovered individually and may lead to suboptimal results for lenders and borrowers. Coordination problems arise where there is a high number of creditors with diverging interests, whereas the asymmetric information problems are particularly important in the case of small creditors, with little information and a short commercial relationship with the debtor, and in the case of small borrowers. Individual recoveries of the debts of a firm whose

1 This proceeding may also be used by individuals without a business activity (consumers), although this box focuses on firms.
2 Royal Decree-Law 3/2009 of 27 March 2009 on urgent tax, financial and insolvency measures in the face of economic developments.
3 Law 38/2011 of 10 October 2011 reforming Insolvency Law 22/2003 of 9 July 2003.
4 Law 14/2013 of 27 September 2013 to support entrepreneurs and their internationalisation.
5 Royal Decree-Law 4/2014 of 7 March 2014, adopting urgent measures on corporate debt refinancing and restructuring.

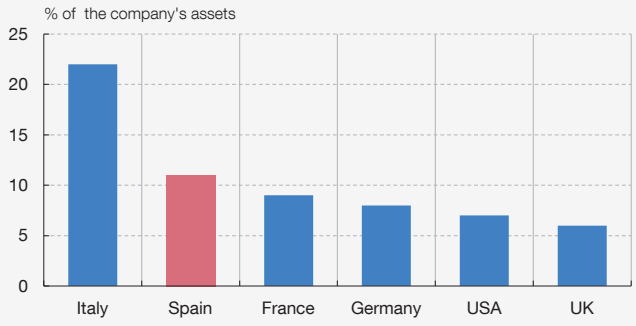
1 DURATION OF INSOLVENCY PROCEEDINGS (a)



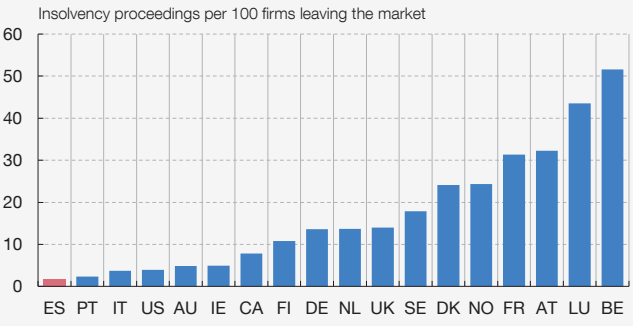
2 PERCENTAGE OF FIRMS SUBJECT TO INSOLVENCY PROCEEDINGS THAT ARE WOUND UP (b)



3 DIRECT COSTS OF INSOLVENCY PROCEEDINGS (c)



4 BUSINESS INSOLVENCY RATES (d)



a Data for Spain are for 2007 (before the crisis) and 2012 (during the crisis), data for France and Italy are for 2007 and data for the United Kingdom are for 2006. Sources: Consejo General del Poder Judicial (2012 and subsequent years), "La Justicia Dato a Dato. Año 2012", Estadística Judicial; Ministère de la Justice (2010), "Annuarie statistique de la Justice", Édition 2009-2010 and S. Frisby (2006), "Report on Insolvency Outcomes, The Insolvency Service Report, U.K." Istat.
b The data for Spain, the United Kingdom and the United States are for 2004-2012, the data for Italy are for 2004-2007 and the data for France are for 2004-2008. Sources: M. Celentani, M. García-Posada and F. Gómez (2010), "The Spanish Business Bankruptcy Puzzle and the Crisis", Working Paper 2010-2011, FEDEA; Consejo General del Poder Judicial and E. van Hemmen (2013 and subsequent years), "Estadística concursal. Anuario 2012", Colegio de Registradores de la Propiedad y Mercantiles de España, Madrid; The Insolvency Service, United States Courts. The data on insolvencies in the United Kingdom also include the sale of the whole business to third parties and, consequently, they overestimate the percentage of companies which are dismantled.
c Year 2013. Source: Doing Business (World Bank).
d Year 2010. Sources: Eurostat, OECD, national sources and Euler Hermes (2011); "Economic Outlook 2011", No. 4, Business Insolvency Worldwide, Evreux.

assets do not cover its liabilities usually result in a creditors' race for the available funds. This may lead to the dismantling of a firm which is solvent but has liquidity problems and to losses for all creditors.

Insolvency proceedings in Spain attempt to overcome these problems through several arrangements. Generally, the beginning of the insolvency proceedings halts all enforcement proceedings against the firm. Additionally, a list is drawn up of all the company's assets and the claims against it, so that all creditors have the same information about the company's net worth position. Finally, for a creditors' agreement to be approved the favourable vote of ordinary creditors representing at least 50% of the firm's liabilities, which are not collateralised, is required.

However, in practice, several factors have prevented insolvency proceedings in Spain from carrying out their function satisfactorily. First, they last a very long time compared with similar proceedings in other developed countries, except for Italy, and their duration has increased significantly since the beginning of the crisis (see Panel 1). Second, a very high proportion of firms which are subject to insolvency proceedings (95%) are ultimately wound up. Since it is unlikely that practically all the firms entering insolvency proceedings are non-viable, the system would seem to be incapable of restructuring the debt of solvent companies with liquidity problems. As for other developed countries, only Italy has a similar percentage, whereas the figures for France, the United Kingdom and the United States are substantially lower (see Panel 2). Finally, as shown by Panel 3, insolvency proceedings in Spain have high direct costs which consume a large share of the firm's assets. These costs are higher than in the United Kingdom, the United States, Germany and France, and only lower than those in Italy. These factors contribute to insolvency proceedings being used much less in Spain by firms under financial pressure than in most developed countries as shown by the insolvency rates (the number of companies commencing insolvency proceedings divided by those leaving the market), shown in Panel 4.

The need to have rapid and flexible proceedings in place is particularly important in the case of large and medium-sized firms where coordination problems can reduce the success of private negotiations owing to the large number of creditors involved. By contrast, private restructurings are more likely to work at small companies in view of the small number of lenders (35% of Spanish SMEs with bank debt use only one bank and 60% use one or two banks)[6].

The reforms of the Insolvency Law implemented recently by the Entrepreneurs' Law and Royal Decree-Law 4/2014, develop the alternatives to insolvency proceedings. The former creates a specific procedure – the out-of-court agreement for payment – for the self-employed and small businesses, which habitually used insolvency proceedings least due to their high fixed costs. The latter introduces changes into how pre-insolvency refinancing works to make it more appealing and effective so that firms can restructure their debt more flexibly without having to apply for insolvency proceedings.

More specifically, Royal Decree-Law 4/2014 simplifies the proceedings required for undertaking such operations and for halting individual debt enforcement proceedings while negotiations take place. It extends the list of conditions of these agreements which can be imposed on dissident creditors. Thus, in addition to partial acquittances, provision is also made for the possibility of reductions in the payment period, the conversion of debt into equity, and the transfer in payment of debt of the assets or claims of the company in difficulties. The mere capitalisation of debt by creditors does not make them persons specially related to the insolvent legal person. Consequently, they avoid the detrimental treatment (subordination of their loans) generally received by the claims of shareholders or partners of a firm subject to insolvency proceedings. The Royal Decree-Law also stipulates that temporarily during a period of two years from the entry into force of the law, any fresh financing (previously 50%) which has been extended in the framework of a refinancing agreement will be considered preferential credit, thus giving it a higher priority in the ranking of claims. Insofar as the agreements reached respond to a feasible plan permitting the continuity of the firm, the liabilities arising from the negotiations will, logically, have a lower risk of default. In the particular case of bank creditors, restructured debts, providing that they comply with the strict criteria established, would be classified as standard exposure, as was clarified by the Banco de España's communication to banks in March 2014. This would reduce the need to record provisions for them and would thus increase the capacity of banks to meet new solvent demand for lending.

6 Source: Central Credit Register, May 2013.

... and measures aimed at correcting frictions in the credit market that hamper the channeling of new flows to their most efficient uses

So that the reduction in debt should not hamper economic growth, it is also important that the containment of lending at the aggregate scale – which is vital for reducing debt ratios – should be compatible with the availability of financing for more solvent agents with profitable investment projects.

The evidence available suggests that, in the case of corporations, this type of reallocation of credit among companies might already be taking place. Hence, over the past two years, despite the aggregate contraction in corporate debt, around 40% of Spanish firms with debt have increased or maintained the outstanding balance of their bank borrowings. These companies are characterised by having a sounder financial position than those whose debt has contracted (higher profitability and a lower degree of debt and interest burden) and by showing more dynamic activity (high growth in sales and in employment).

To boost this pattern of healthy credit reallocation among companies, it is important to smooth the frictions bearing down on credit supply. These frictions arise, in part, from the financial fragmentation in Europe that is preventing monetary impulses from being passed through in full to all the euro area countries. In this respect, the successful conclusion of banking union in Europe is pivotal to achieving greater financial market integration in the area. Another strand of the frictions, however, relates to the asymmetric information problems that hamper SMEs' access to financing. The public assistance schemes for this type of company and the measures aimed at improving the quality of credit information are examples of measures that can contribute to mitigating these problems.[22]

The speed of the adjustments will influence the pace and scope of the recovery

Past experience shows that recovery following episodes of crisis with a strong financial component tends to be slow. In the current setting, part of this slowness is due to the difficulties involved in correcting financial imbalances when real and nominal growth in the economy is low.

Despite these difficulties, adjustments in the financial positions of the various institutional sectors of the Spanish economy are not only unavoidable; indeed, the speed at which they ultimately come about will influence the pace and scope of the economic recovery under way. If corporations, households and general government maintain an excessive level of debt, investment and consumption will not prove dynamic enough to recoup the losses in output and employment caused by the crisis and to place the economy on a stable growth path.

22 See J. Ayuso (2013), "An analysis of the situation of lending in Spain", *Economic Bulletin,* October, Banco de España.

BOXES

Inflation slowed markedly in 2013 both in Spain and in the euro area as a whole, with the respective year-on-year changes in the HICP in December standing at 0.3% and 0.8%. This trajectory has continued in 2014 to date. Projections by private analysts, official agencies and those implicit in financial market prices assume inflation will hold at very low levels for a prolonged period (see accompanying table 1). Specifically, for the euro area as a whole, the projections available point to a very slow return to rates close to 2% and to a negative Spain/euro area differential. However, longer-term inflation expectations remain anchored at levels slightly below the 2% reference (see Panel 1).

The recent downward course of inflation is due to the disappearance of certain temporary factors, linked to fiscal consolidation, and to the trend of energy prices and the exchange rate, although factors of a more permanent nature are also in play. The latter include most notably the moderation of unit labour costs and significant excess slack. The influence of these factors has been greater in Spain than in the euro area as a whole, owing to the adjustment under way here to regain the competitiveness lost during the expansionary phase.

Against this background of very low inflation, analysis of the scenarios in which price declines and, ultimately, deflationary processes – with across-the-board and sustained falls in prices – might arise has become important. In this respect, the diffusion indicators show that price declines are not overly widespread either in Spain or the euro area (see Panel 2)[1], though they have increased in 2013, albeit without yet reaching the highs observed in late 2009 and early 2010. Unlike that period, however, the recent slowdown in prices is proving especially significant in the case of services prices which, as they are particularly labour-intensive, have been more affected by wage moderation and productivity gains.

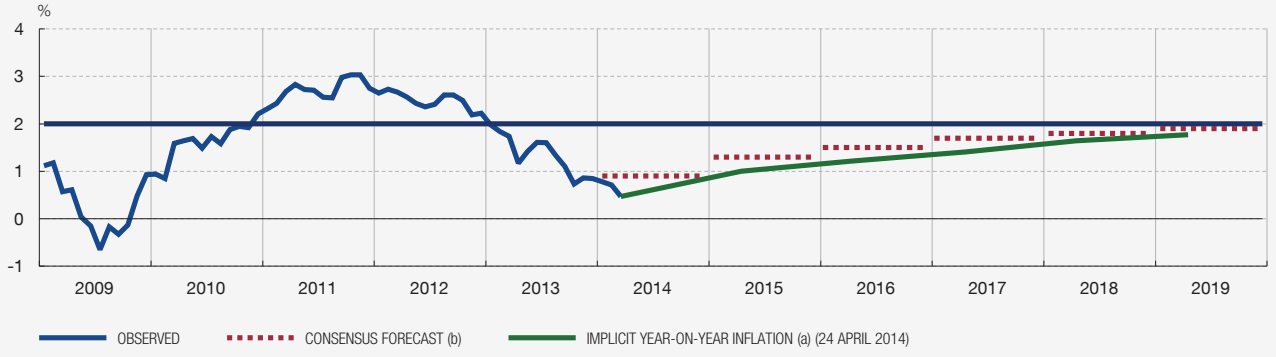
In any event, when evaluating scenarios of sustained price declines a distinction must be drawn between the consequences for the euro area as a whole and for Spain. A fall in a euro area member country's prices might reflect the adjustment of relative prices needed to correct some of its imbalances. In that respect,

1 These indicators measure the proportion of expenditure-weighted and seasonally adjusted HICP items that show month-on-month declines.

1 INFLATION FORECASTS

Spain	2014	2015	2016
Consensus Forecast (April 2014)	0.3	1.0	1.5
European Commission (February 2014)	0.3	0.9	—
IMF (April 2014)	0.3	0.8	0.9
Euro Area			
ECB (March 2014)	1.0	1.3	1.5
Consensus Forecast (April 2014)	0.9	1.3	1.5
European Commission (February 2014)	1.0	1.3	—
IMF (April 2014)	0.9	1.2	1.3
Inflation swap contracts (24 April 2014)	1.0	1.2	1.4

1 LONG-TERM INFLATION EXPECTATIONS



SOURCES: Eurostat.

a Obtained from inflation swap contracts.
b Consensus Forecast forecasts from the third year onwards are only updated in April and October each year.

shocks originating in positive developments on the supply side entail benign price declines, as they are accompanied by higher levels of output and employment. Notable among these are those linked to structural reforms that improve the economy's productivity or heighten competition in product and factor markets.[2] Conversely, contractionary demand-side shocks may be more harmful, bringing together declines in prices and output which, if they feed back into one another, may prompt a deflationary spiral.

A generalised and persistent situation of price declines may dampen activity through various channels. Firstly, expectations of sustained low inflation exerts upward pressure on the expected real interest rate, which leads to private spending being deferred. Moreover, if – as is currently the case – nominal interest rates are close to zero, the capacity of conventional monetary policy to correct this effect is very limited. Secondly, as debt contacts are specified in nominal terms, falls in prices increase the real-terms cost of servicing such debt. That is particularly significant in countries such as Spain, where the volume of household and corporate debt is still high. Lastly, and more generally, very low inflation across the euro area hampers an individual country achieving gains in competitiveness relative to the area as a whole.

In any event, a very moderate inflation scenario may trigger particularly adverse effects if it unanchors long-term inflation expectations, thereby reducing the effectiveness of monetary policy and increasing real interest rates. Nonetheless, at present European households do not seem to expect either that consumer prices will fall (see Panel 3) or that long-term inflation expectations will be far off 2%.

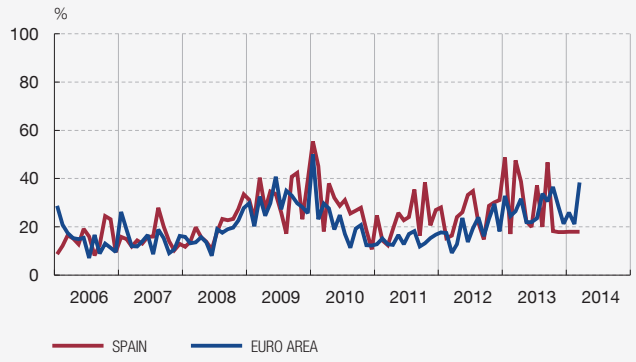
The Banco de España dynamic stochastic general equilibrium model BEMOD, estimated for Spain and the rest of the euro area, provides for the analysis of the probability of different price scenarios materialising in relation to Eurosystem predictions. In particular, an assessment can be made of the probability with which moderate inflation (lower than 1% on average in 2014) or price falls of some intensity (a rate of change below -1%) might be observed.[3] The estimations show that scenarios of inflation below 1% are highly likely, especially in Spain, while the scenarios of price declines of over 1% are fairly unlikely. In addition, to assess the extent to which a slightly higher level of inflation across the euro area may smooth the competitive adjustment needed in Spain, an alternative exercise has been conducted. In it, as the result of a more expansionary monetary policy, inflation in the euro area increases by 50 bp in 2014 and 2015, drawing closer to the 2% target in late 2015. Under this new scenario, there is an appreciably lower probability that Spanish inflation will be below -1%.

In short, the evidence available would indicate that inflation is going to remain at very low levels over a prolonged period, but that the probability of a costly deflation process arising at present is limited. In any event, the adjustment still required in terms of competitiveness in some economies in the area, such as Spain's, would be assisted if the euro area inflation rate were to converge towards its long-term target at a somewhat brisker rate pace than is currently anticipated.

2 See J. Andrés, Ó. Arce and C. Thomas (2014), *Structural reforms in a debt overhang,* Documento de Trabajo del Banco de España (forthcoming), and Box 1.2 in this Chapter.

3 In interpreting the results it should be borne in mind that the simulations performed incorporate the zero lower bound constraint whereby nominal interest rates cannot be negative, although they do not consider the possibility of implementing non-conventional monetary policy measures. In addition, the exercises presented hereafter do not take into account the debt deflation channel, meaning that the total cost of the generalised and sustained declines in prices might be being underestimated. Lastly, bootstrapping techniques are used to take into account the dependence of the structural shocks.

2 DIFFUSION INDICATORS. PERCENTAGE OF EXPENDITURE (a)



3 PRICE DECLINE EXPECTATIONS IN THE NEXT TWELVE MONTHS
European Commission surveys

SOURCES: Banco de España and European Commission.

a Calculated with seasonally adjusted series.

In the current setting, there is scant headroom to boost aggregate demand by means of conventional monetary policy (interest rate cuts) and fiscal policy (countercyclical balances) instruments. Accordingly, one of the main economic policy options for reinvigorating activity is the application of structural reforms that make product and factor markets more efficient and competitive.

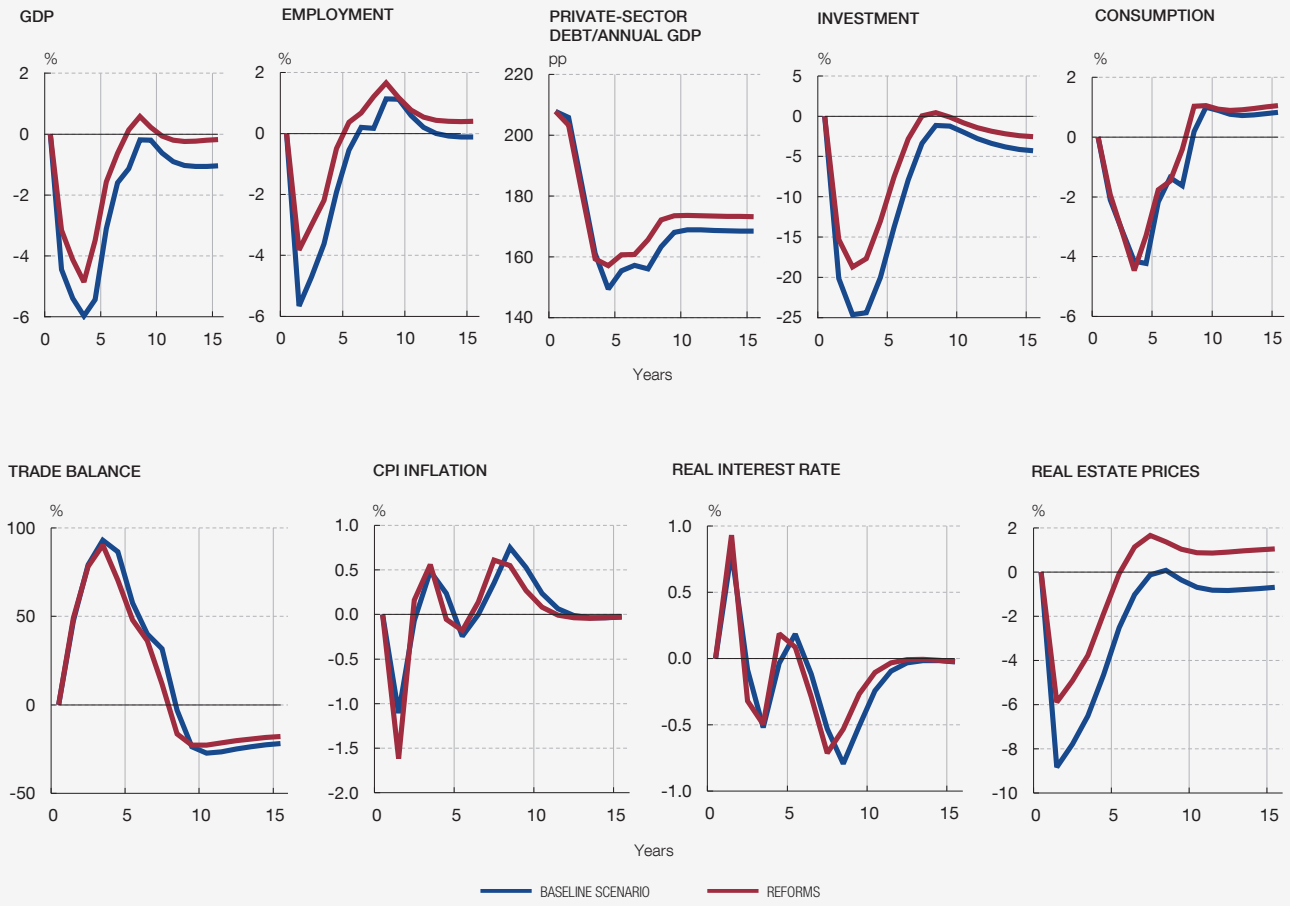
In the long run, there are few doubts over the positive effects of these reforms: insofar as a market becomes more competitive, the volume of activity grows, prices fall and the opportunities for improving economic agents' welfare increase. Through the expectations of the latter, who discount a greater future spending capacity, a portion of the durable benefits of the reforms normally materialise in the short run (the *expectations channel*). However, the moderation in prices typically prompted by structural reforms may give rise to increases in real interest rates and, therefore, to declines in household and corporate spending in the short run (the *interest rate channel*). Moreover, given debt whose nominal amount is predetermined, a moderation in prices prompts a higher real value of debt (the "Fisher effect" or the *debt deflation channel*[1]), with the subsequent restrictive effect on debtor agents' budgets.

The relative intensity of the foregoing channels – expectations, on one hand, and the interest rate and debt deflation, on the other – determines the sign of the short-term impact of the structural reforms. Some recent research has emphasised the fact that the lack of headroom to make nominal interest rate cuts may be pivotal in inclining the balance in favour of contractionary channels.[2] This type of analysis would appear to point to the

1 See I. Fisher (1933), "The debt-deflation theory of great depressions», *Econometrica* vol. 1, pp. 337-357.

2 See, for example, G. Eggertsson, A. Ferrero and A. Raffo (2014), "Can structural reforms help Europe?", *Journal of Monetary Economics*, vol. 61, pp. 2-22.

1 EFFECT OF STRUCTURAL REFORMS IN A DELEVERAGING PROCESS (a)



SOURCE: Banco de España.

a All variables expressed as deviations from their initial state, except private-sector debt/GDP, which is in percentage points.

advisability of postponing the reforms until their contractionary effects may be countered by expansionary macroeconomic policies.[3]

Nonetheless, most of the macroeconomic models used in the foregoing research are designed to analyse the fluctuations proper to a traditional economic cycle, rather than those arising from a deep-seated macrofinancial crisis such as the present one. In a recent paper, Andrés, Arce and Thomas (2014)[4] develop a specially designed model to analyse the effect of structural reforms on an environment similar to that currently characterising the Spanish economy, namely one of slow leverage, owing to the presence of a high volume of long-dated debt, and of restricted access to financing. Further, the model considers that the domestic economy is part of a monetary union that has no leeway to lower interest rates. Businesses and a portion of households take on debt using the value of their real estate assets as collateral; however, when the value of their assets falls below a specific threshold, the extension of fresh credit is interrupted and, in that case, debtors restrict themselves to repaying their outstanding debt according to the maturities stipulated in their debt contracts.

The starting point is a *baseline scenario* that includes a persistent tightening of loan access conditions for households and firms, and that entails, in particular, a reduction in the loan-to-value ratios of the new loans granted to these agents. The blue lines in Panel 1 show the response of the economy to this financial shock (the magnitudes of the simulations are merely illustrative of the qualitative behaviour of the model and should not be interpreted as realistic quantitative approximations). The slump in real estate prices and, therefore, in the value of the collateral means the flow of new credit shrinks sharply, which gives rise to a long and slow process of private deleveraging. The need for households and firms to generate saving to repay their debts and clean up their balance sheets leads them to reduce consumption and investment levels. In parallel, the trade balance improves thanks to the gains in competitiveness to which the disinflationary effect of the shock and the subsequent contraction in domestic demand gives rise. Yet this improvement does not suffice to prevent a prolonged decline in GDP. When the value of the assets of the households and firms applying for funds reaches the minimum threshold for satisfying loan access conditions, the flow of fresh credit re-starts. Thereafter, a virtuous circle takes hold, with a vigorous pick-up in asset prices, in credit and in agents' spending capacity. As a result, consumption and investment, and GDP too, begin to recover.

The unbroken red lines in Panel 1 show the responses of the main variables when *structural reforms* are adopted that involve increases in the degree of competition in the product and labour markets. These reforms induce a lasting reduction in business mark-ups and give rise to more moderate wages.[5] In the long run, these measures have a clearly positive effect on GDP and employment; but they also relieve the adverse effects of deleveraging in the short and medium term. This is chiefly due to

3 Some theoretical developments pointing along these lines can be found in the following papers: G. Eggertsson, G. (2012), "Was the New Deal contractionary?", *American Economic Review*, vol. 102, pp. 524-555; G. Eggertsson, and P. Krugman (2012), "Debt, deleveraging, and the liquidity trap: a Fisher-Minsky-Koo approach", *Quarterly Journal of Economics*, vol. 127, pp. 1469-1513; and J. Galí, and T. Monacelli (2014), "Understanding the gains from wage flexibility: The exchange rate connection", CEPR discussion paper 9806.

4 See J. Andrés, Ó. Arce and C. Thomas (2014), "Structural reforms in a debt overhang", Documento de Trabajo del Banco de España (forthcoming).

5 Specifically, there is a reduction in price mark-ups (i.e. the difference between production prices and marginal production costs) and wage mark-ups (that between wages paid to workers and their reserve wages).

2 ROLE OF THE EXTERNAL SECTOR IN THE TRANSMISSION OF THE EFFECTS OF THE REFORMS (a)

SOURCE: Banco de España.

a The panels show the differential effect of the structural reforms on GDP, i.e. the difference between the two lines in the top-left hand graphic in Panel 1, for different values of the elasticities of exports and imports to relative prices.

the better performance of investment. Specifically, anticipation of the beneficial effects of the reforms in the long run means that, in the short run already, households and firms increase their investment demand relative to the baseline scenario. This greater demand entails a lesser decline in real estate asset prices. That contributes to curtailing the severity of the decline in debtors' financial worth and, therefore, helps them regain earlier the minimum threshold at which new credit may be granted. Combining with this positive effect on firms' financial capacity is a contraction in these agents' consumption which, in the context of this model, may be assimilated to smaller dividend payouts (and, therefore, a greater accumulation of retained earnings).

In this way, the reforms *bring forward* the end of the deleveraging process and, therefore, of the recession, thus reinforcing the *expectations channel.* At the same time, since the flow of new credit slows substantially during the deleveraging phase, private spending decisions at the aggregate level are relatively insensitive to the increase in the real interest rate induced by the deflationary effect of the reforms. This leads to a loss of intensity in the *interest rate channel*. The combination of both effects – the reinforcement of the expectations channel and the weakening of the interest rate channel – results in a net positive effect of the reforms on activity and employment in the short run already, which prevails over the negative Fisher effect arising from a path of lower prices. In this respect, the presence of a high proportion of long-term debt – which is an essential factor in the current crisis, especially in the case of household mortgage debt – operates by substantially cushioning the short-term contractionary effect of the debt deflation channel.

One significant channel for the transmission of the effects of the reforms is that of foreign trade. As can be seen in Panel 1, the reforms do not bring about a significant effect on the trade balance in the short term. This apparent lack of effect encompasses two opposing forces: although the reforms bring about an additional lowering of the prices of domestic products, they also prompt an improvement in domestic demand. This behaviour of the external balance depends largely on the sensitivity of trade flows to the relative prices of domestic and foreign goods. The left-hand graphic of Panel 2 shows the differential effect of the reforms on GDP[6] for two different calibrations of the elasticity of exports to relative prices: unit elasticity (the baseline value[7]), and a very low elasticity of 0.2. In this latter case, the effects of the reforms in the short run turn negative, owing to the insufficient positive contribution of exports. In the case of imports (right-hand graphic), reducing their price-elasticity also reduces the positive effect of the reforms, though not to the extent of changing the sign of this effect. This example illustrates, therefore, that a key condition if the reforms are to have beneficial effects in the short term is that the resulting gain in competitiveness should pass through with sufficient intensity to trade flows.

6 The differential effect of the reforms on GD Pis equivalent to the vertical distance between the two lines in the upper left-hand graphic of Panel 1.

7 The calibration of the unit elasticity of exports is based on estimates for Spain by C. García, E. Gordo, J. Martínez-Martín and P. Tello (2009), "*Una actualización de las funciones de exportación e importación de la economía española",* Documentos Ocasionales, no. 0905, Banco de España.

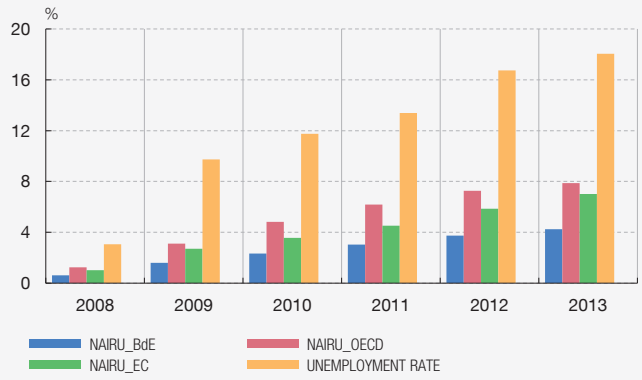
The unemployment rate in the Spanish economy peaked in 2013 Q1 (at 26.9% of the labour force), marking an increase of close to 20 pp on the low recorded in 2007 Q3. Since then, unemployment has moved on a progressively declining path, dipping to 25.9% in 2014 Q1. The latest macroeconomic projections of the Banco de España, released in March, point to the continuation of this trajectory over the remainder of 2014 and in 2015 in a setting in which the gradual recovery in activity is forecast to pass through intensely to job creation, assisted by ongoing wage moderation and its extension over the projection horizon. Notwithstanding, the unemployment rate in the Spanish economy is expected to hold at very high levels in comparative terms.

There are different reasons why an initially cyclical increase in unemployment may become persistent, generating an increase in the structural component of unemployment through what is usually known as a hysteresis effect that hampers subsequent reductions in the unemployment rate, even in an economic upturn. Such hysteresis can be caused by various factors. Thus, enduring unemployment status over a prolonged period may ultimately exert permanent effects on the human capital of the unemployed, on their intensity of job search and on firms' perception of their skills or background. These effects may be more significant in a context of sectoral reallocation of employment in which the skills demanded by firms differ from what the unemployed have to offer.

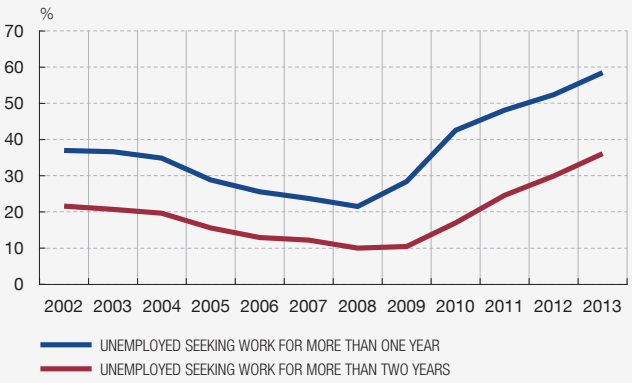
One way of analysing the degree of persistence of unemployment consists of estimating the structural rate of joblessness, a concept that can be interpreted as the unemployment rate of the economy in the medium term, once the impact of cyclical factors is stripped

THE IMPACT OF THE CRISIS ON THE STRUCTURAL COMPONENT OF UNEMPLOYMENT

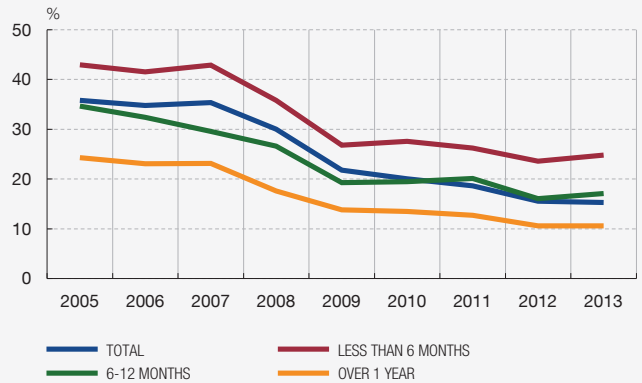
1 CUMULATIVE INCREASE IN THE UNEMPLOYMENT RATE AND IN THE ESTIMATED NAIRU



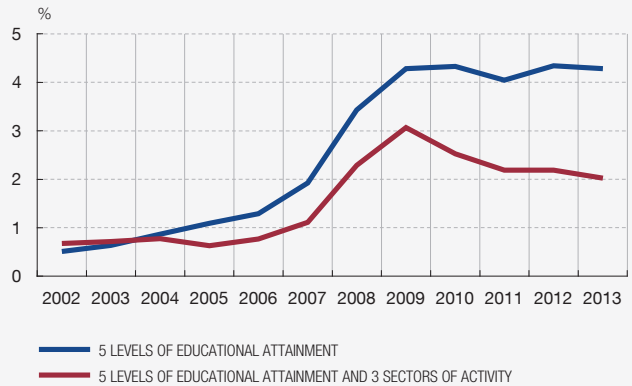
2 INCIDENCE OF LONG-TERM UNEMPLOYMENT (a)



3 UNEMPLOYMENT EXIT RATES IN RESPECT OF TIME SEEKING WORK (b)



4 SKILLS MISMATCH INDEX (c)



SOURCES: EPA (INE) microdata and Banco de España.

a Percentage of total unemployed.
b Percentage of unemployed who find work in the following quarter.
c Mismatch between the distribution by educational attainment level (primary studies or less, first-phase secondary studies, higher secondary studies, vocational training and university studies) of the employed and the unemployed. Having regard to the sectoral dimension, three major sectors of activity are used (manufacturing, construction and services) and both the unemployed seeking their first job and the long-term unemployed, on whom no information on the sector of activity is available, are excluded.

out. This structural component is, however, non-observable and estimating it is subject to high uncertainty as there are different methodological approaches that provide different results. Presented below are the results of the application of a methodology that involves estimating the disaggregation between the structural and cyclical components of unemployment using the Phillips curve approach.[1] Specifically, a relationship is assumed between wage growth and deviations of unemployment from its structural component, i.e. the cyclical component of unemployment. Hence, if unemployment is below (above) its equilibrium or structural level, higher (lower) wage growth will tend to be observed, meaning that the structural unemployment rate, which under this approach is usually called the NAIRU, could be interpreted as that level of the rate that were compatible with stable inflation.

The top left-hand hand graphic of Panel 1 shows the cumulative increase in the NAIRU since 2008 following the above-mentioned methodology. The high uncertainty constantly surrounding these estimates usually advises analysing medium-term trends rather than the discrete levels estimated.[2] The results show that the Spanish economy's structural unemployment rate would have increased by around 4 pp since the onset of the crisis.[3] the estimates available for Spain by the OECD and the EC tend to offer a somewhat higher increase, with the NAIRU showing a more procyclical profile.

This result would reflect the impact of hysteresis effects on the NAIRU. Thus, the average duration of unemployment episodes has risen from around 2.8 quarters to over 6.5 quarters in 2013, raising to 60.7% the proportion of the unemployed experiencing this status for more than a year. There has also been a most substantial increase in the percentage of those unemployed for a very long period, of over two years, to 38.9% of total unemployed (see the top right-hand graphic of Panel 1). This phenomenon is concentrated, moreover, in certain groups, such as employees over 50 years of age or the more unskilled unemployed, for which this percentage stood at around 50% at end-2013.

Unemployment exit rates, which have fallen appreciably for all unemployment durations, have begun to rise slightly in 2013, at least for the unemployed with less duration in this situation (see the bottom left-hand graphic of Panel 1). Foreseeably, the incipient recovery will help entrench this improvement which, nonetheless, will probably be slower among the group with longer durations.[4] This diminished cyclicality of exits from unemployment once a large amount of time has been accumulated experiencing this status might limit the aggregate recovery of the unemployment exit rate in the face of a cyclical upturn.

Unemployment persistence might also be related to the increase in the skills mismatch between labour supply and demand observed since the start of the crisis. In this connection, the bottom right-hand graphic of Panel 1 shows the changes in a skills mismatch index that seeks to measure the discrepancy between the breakdown by level of educational attainment of the employed and unemployed populations.[5] In principle, it is expected that the bigger this mismatch is, the more difficult it will prove to reabsorb unemployment. The clear increase in the level of skills mismatch is observed during the crisis, caused by the concentration of job destruction among the lesser-skilled. If the sectoral dimension is taken into account, the pattern is similar and highlights how the acute job destruction in the construction industry, especially at the start of the crisis, prompted a considerable increase in the relative weight of the low-skilled unemployed. These results indicate that a reduction in unemployment will require the adaptation of unemployed workers' skills to job requirements.

In short, although a significant portion of the increase in unemployment since the start of the crisis is closely associated with the cyclical downturn, it cannot be ruled out that there has in parallel been an increase in the structural component of unemployment, which might hamper any reduction in unemployment in the near future. These difficulties appear to be particularly marked for specific groups, among whom very high unemployment durations are observed. The overall design of active and passive policies of support for the unemployed should focus on increasing the employability of these groups, analysing the links with the various social protection mechanisms and facilitating wage flexibility.

1 See J. Gali (2011), "The Return of the Wage Phillips Curve", Journal of European Economic Association, June, 9 (3), pp. 436-461.

2 See, for example, Estrada, Hernando and López Salido (2000), *Measuring the NAIRU in the Spanish Economy,* Documentos de Trabajo, no. 0009, Banco de España; or ECB (2012), *Euro Area Labour Markets and the Crisis,* Occasional Paper no. 138.

3 This increase is also similar to that estimated by Doménech (2013), "Potential Growth and Structural Unemployment in Spain, EMU and the US", BBVA Research, mimeo, using an alternative methodology drawing on Okun's Law.

4 In particular, an analysis of the likelihood of exiting unemployment conducted for the 2005-2013 period, drawing on microdata on EPA flows, shows that this likelihood increases by 2.1 pp given a 1% improvement in GDP for the short-term unemployed, while for the longer-term unemployed the impact of an improvement in activity is only 1.3 pp.

5 In particular, the distribution of the employed and unemployed population is used following five levels of educational attainment drawn from Spanish Labour Force Survey data. For further details see M. Izquierdo, S. Puente and P. Font (2013), "Evolución del desajuste educativo entre la oferta y la demanda de trabajo en España", *Boletín Económico*, June, Banco de España.

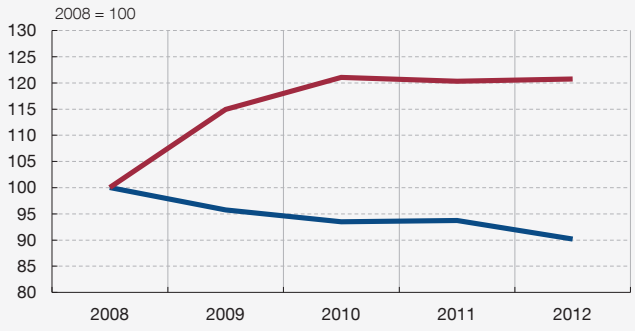
Before the crisis, the debt of non-financial corporations increased very quickly. Afterwards, it has decreased slowly and progressively against a background characterised by a macroeconomic recession in which employment and productive investment have deteriorated notably. This Box analyses to what extent the employment and tangible fixed-asset investment behaviour of non-financial corporations differs depending on their level of debt. To do this, use if made of the merged CBSO and Mercantile Register database (CBI)[1], which contains microeconomic data from a sample of around 600,000 firms per year, for the period from 2008 to 2012 (latest year available). The firms are separated into two groups according to whether at the beginning of each year their ratio of debt to net assets is above or below the average for their industry.

1 This database is obtained by merging the CBA and CBB databases. The CBA database contains information on some 10,000 firms reporting annually to the Central Balance Sheet Data Office and is somewhat biased towards larger firms. The CBB database is constructed from financial statements lodged by firms in the mercantile registers and contains information on small and medium-sized enterprises.

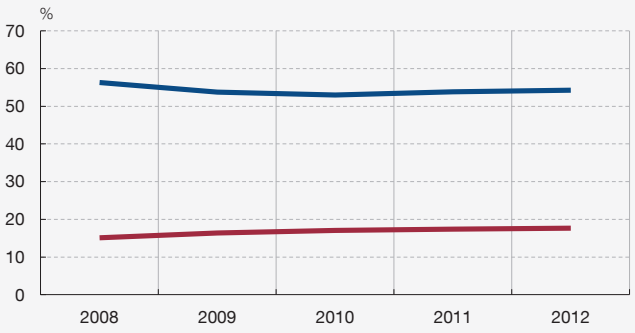
Chart 1 shows the financial debt of the two groups of companies. It can be seen that, whereas the most indebted firms progressively reduced their borrowed funds from 2008, the debt of other firms followed an upward path until 2010 and then remained steady for the following two years. A more detailed analysis by industry and firm size confirms the existence of similar behaviour patterns in all industries, and in both SMEs and larger firms. As a result of this behaviour the ratio of debt to net assets of both aggregates became slightly more similar (see Chart 2). This convergence is more evident if construction is excluded, since this industry's debt ratio was pushed upward by the high losses in the period analysed, which reduced the denominator of this indicator.

Charts 3 and 4 show investment in tangible fixed assets (measured as the ratio of the flow of gross fixed capital formation to its balance a year earlier) and unemployment for each of the two groups of firms analysed (more indebted and less indebted). Both aggregates show declining investment and job destruction, but the falls are sharper for more indebted firms. This pattern is observed in all industries, in both SMEs and large firms.

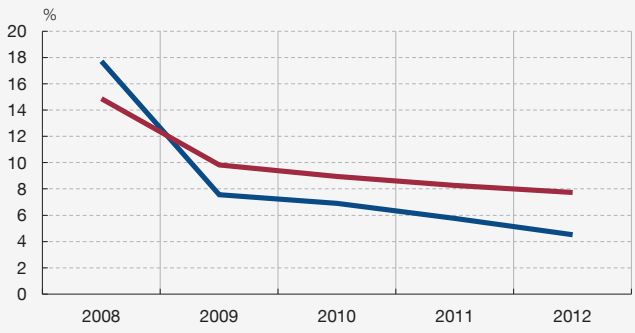
1 INTEREST-BEARING DEBT



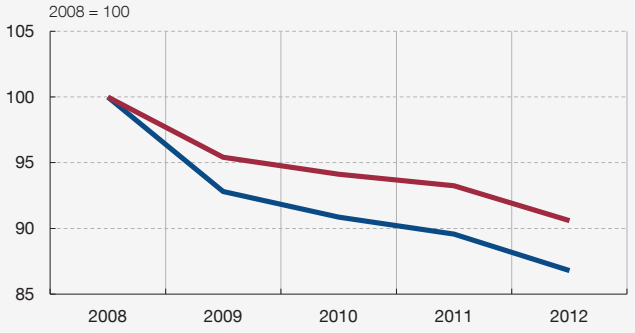
2 DEBT/NET ASSETS

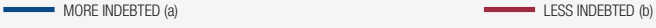


3 GFCF (c)/TANGIBLE FIXED ASSETS AT t-1



4 EMPLOYMENT





SOURCE: Banco de España.

a Firms whose debt ratio is greater than the average debt in their industry at t-1.
b Firms whose debt ratio is equal to or less than the average debt in their industry at t-1.
c Gross fixed capital formation. In CBB firms this flow is approximated by the difference between the balance-sheet amounts of tangible fixed assets less depreciation expense.

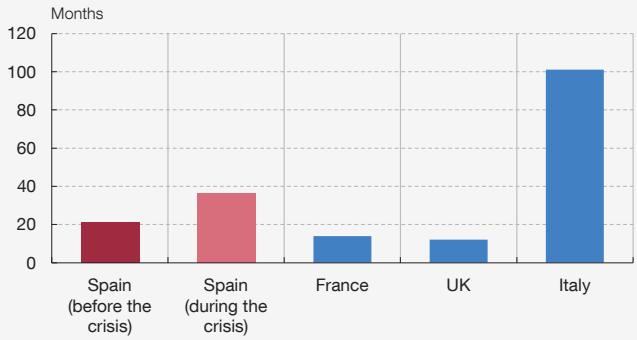
In short, the results reported in this Box indicate that the level of firms' indebtedness influenced their investment and employment decisions during the crisis. In particular, more indebted firms were comparatively more strongly affected by the crisis, since they were more vulnerable to the contraction of their income. That obliged them to adjust their balance sheet and to reduce employment and investment more sharply compared with financially sounder firms.

Corporate insolvency proceedings are a legal proceeding which aims to address the situation of a borrower's insolvency either through an agreement (accord) between the creditors and the debtor firm or through the winding-up of the latter. In the first case, a reduction in the nominal value of the debt is agreed (partial acquittance) and/or in the schedule of payments (payment period). In the second case, the creditors are paid by selling the company's assets in accordance with the legally stipulated order of priority of creditors. These proceedings exist in all developed countries and most emerging economies. In Spain, they are currently governed by the Insolvency Law,[1] which was approved in 2003 and came into force on 1 September 2004. The economic crisis underlined some of the shortfalls in the Law and, consequently, it has been subject to four major reforms through Royal Decree-Law 3/2009,[2] Law 38/2011,[3] the Entrepreneurs' Law[4] and Royal Decree-Law 4/2014[5].

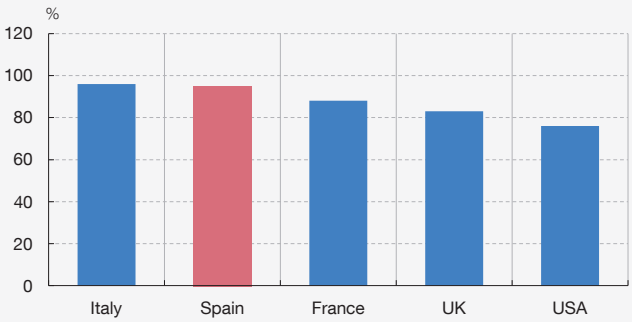
The main function of insolvency proceedings is to overcome problems of coordination and asymmetrical information which make it difficult to renegotiate debt privately and for debts to be recovered individually and may lead to suboptimal results for lenders and borrowers. Coordination problems arise where there is a high number of creditors with diverging interests, whereas the asymmetrical information problems are particularly important in the case of small creditors, with little information and a short commercial relationship with the debtor, and in the case of small borrowers. Individual recoveries of the debts of a firm whose

1 This proceeding may also be used by individuals without a business activity (consumers), although this box focuses on firms.
2 Royal Decree-Law 3/2009 of 27 March 2009 on urgent tax, financial and insolvency measures in the face of economic developments.
3 Law 38/2011 of 10 October 2011 reforming Insolvency Law 22/2003 of 9 July 2003.
4 Law 14/2013 of 27 September 2013 to support entrepreneurs and their internationalisation.
5 Royal Decree-Law 4/2014 of 7 March 2014, adopting urgent measures on corporate debt refinancing and restructuring.

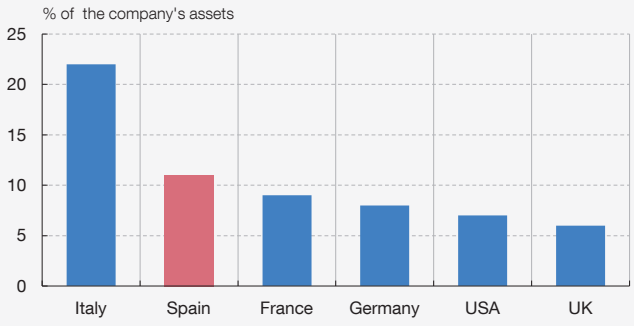
1 DURATION OF INSOLVENCY PROCEEDINGS (a)



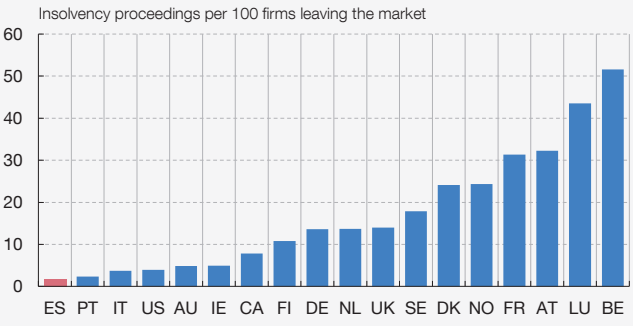
2 PERCENTAGE OF FIRMS SUBJECT TO INSOLVENCY PROCEEDINGS THAT ARE WOUND UP (b)



3 DIRECT COSTS OF INSOLVENCY PROCEEDINGS (c)



4 BUSINESS INSOLVENCY RATES (d)



a Data for Spain are for 2007 (before the crisis) and 2012 (during the crisis), data for France and Italy are for 2007 and data for the United Kingdom are for 2006. Sources: Consejo General del Poder Judicial (2012 and subsequent years), "La Justicia Dato a Dato. Año 2012", Estadística Judicial; Ministère de la Justice (2010), "Annuarie statistique de la Justice", Édition 2009-2010 and S. Frisby (2006), "Report on Insolvency Outcomes, The Insolvency Service Report, U.K." Istat.
b The data for Spain, the United Kingdom and the United States are for 2004-2012, the data for Italy are for 2004-2007 and the data for France are for 2004-2008. Sources: M. Celentani, M. García-Posada and F. Gómez (2010), "The Spanish Business Bankruptcy Puzzle and the Crisis", Working Paper 2010-2011, FEDEA; Consejo General del Poder Judicial and E. van Hemmen (2013 and subsequent years), "Estadística concursal. Anuario 2012", Colegio de Registradores de la Propiedad y Mercantiles de España, Madrid; The Insolvency Service, United States Courts. The data on insolvencies in the United Kingdom also include the sale of the whole business to third parties and, consequently, they overestimate the percentage of companies which are dismantled.
c Year 2013. Source: Doing Business (World Bank).
d Year 2010. Sources: Eurostat, OECD, national sources and Euler Hermes (2011); "Economic Outlook 2011", No. 4, Business Insolvency Worldwide, Evreux.

assets do not cover its liabilities usually result in a creditors' race for the available funds. This may lead to the dismantling of a firm which is solvent but has liquidity problems and to losses for all creditors.

Insolvency proceedings in Spain attempt to overcome these problems through several arrangements. Generally, the beginning of the insolvency proceedings halts all enforcement proceedings against the firm. Additionally, a list is drawn up of all the company's assets and the claims against it, so that all creditors have the same information about the company's net worth position. Finally, for a creditors' agreement to be approved the favourable vote of creditors representing at least 50% of the firm's liabilities, which are not collateralised, is required.

However, in practice, several factors have prevented insolvency proceedings in Spain from carrying out their function satisfactorily. First, they last a very long time compared with similar proceedings in other developed countries, except for Italy, and have increased significantly since the beginning of the crisis (see Panel 1). Second, a very high proportion of firms which are subject to insolvency proceedings (95%) are ultimately wound up. Since it is unlikely that practically all the firms entering insolvency proceedings are non-viable, the system would seem to be incapable of restructuring the debt of solvent companies with liquidity problems. As for other developed countries, only Italy has a similar percentage, whereas the figures for France, the United Kingdom and the United States are substantially lower (see Panel 2). Finally, as shown by Panel 3, insolvency proceedings in Spain have high direct costs which consume a large share of the firm's assets. These costs are higher than in the United Kingdom, the United States, Germany and France, and only lower than those in Italy. These factors contribute to insolvency proceedings being used much less in Spain by firms under financial pressure than in most developed countries as shown by the insolvency rates (the number of companies commencing insolvency proceedings divided by those leaving the market), shown in Panel 4.

The need to have rapid and flexible proceedings in place is particularly important in the case of large and medium-sized firms where coordination problems can reduce the success of private negotiations owing to the large number of creditors involved. By contrast, private restructurings are more likely to work at small companies in view of the small number of lenders (35% of Spanish SMEs with bank debt use only one bank and 60% use one or more banks)[6].

The reforms of the Insolvency Law implemented recently by the Entrepreneurs' Law and Royal Decree-Law 4/2014, develop the alternatives to insolvency proceedings. The former creates a specific procedure – the out-of-court agreement for payment – for the self-employed and small businesses, which habitually used insolvency proceedings least due to their high fixed costs. The latter introduces changes into how pre-insolvency refinancing works to make it more appealing and effective so that firms can restructure their debt more flexibly without having to apply for insolvency proceedings.

More specifically, Royal Decree-Law 4/2014 simplifies the proceedings required for undertaking such operations and for halting individual debt enforcement proceedings while negotiations take place. It extends the list of conditions of these agreements which can be imposed on dissident creditors. Thus, in addition to partial acquittances, provision is also made for the possibility of reductions in the payment period, the conversion of debt into equity and other financial instruments, and the transfer in payment of debt of the assets or claims of the company in difficulties. The mere capitalisation of debt by creditors does not make them persons specially related to the insolvent legal person. Consequently, they avoid the detrimental treatment (subordination of their loans) generally received by the claims of shareholders or partners of a firm subject to insolvency proceedings. The Royal Decree-Law also stipulates that temporarily during a period of two years from the entry into force of the law, any fresh financing (previously 50%) which has been extended in the framework of a refinancing agreement will be considered as a claim on the debtor's assets, thus giving it a higher priority in the ranking of claims. Insofar as the agreements reached respond to a feasible plan permitting the continuity of the firm, the liabilities arising from the negotiations will, logically, have a lower risk of non-payment. In the particular case of bank creditors, restructured debts, providing that they comply with the strict criteria established, would be classified as standard exposure, as was clarified by the Banco de España's communication to banks in March 2014. This would reduce the need to record provisions for them and would thus increase the capacity of banks to meet new solvent demand for lending.

6 Source: Central Credit Register, May 2013.

In recent years, the central banks of the main advanced economies have made increasingly frequent use of forward guidance, in order to steer agents' expectations, against a background of official interest rates close to the zero lower bound and doubts over the marginal effectiveness and risks of non-standard quantitative measures.[1]

Although the use of this instrument has been increasing generally among these central banks, there are significant differences in the objectives pursued in each case. The European Central Bank (ECB) has insisted that the new tool does not involve any change in its monetary policy strategy; rather, the aim is to anchor interest rate expectations more effectively and, by reducing uncertainty, to increase the effectiveness of monetary policy[2] (see main text). Meanwhile, the Federal Reserve System (the Fed) has used forward guidance to indicate its intention to provide a prolonged stimulus to the economy and, more recently, to communicate the way in which it expects to normalise its policy in future. Some academics have argued for the use of this instrument to prompt a change in the central bank's reaction function and to maintain a more expansionary monetary policy stance than would be consistent with a conventional Taylor rule, assigning greater relative weight to activity.[3]

These diverse objectives have translated into differences in the design and evolution of forward guidance measures (see Panel 1). Some central banks have decided to offer qualitative guidance with no specific time limit, indicating the maintenance of a particular monetary policy for a prolonged period (this is what the Fed did initially and what the ECB is currently doing). Other forms of forward guidance are more complex. For example, specific time periods may be set (as the Fed has done in recent years) or the guidance may be contingent, i.e. conditional upon quantitative thresholds for certain economic variables, such as the rate of unemployment (the Fed and the Bank of England), provided that this does not entail risks to price stability or financial stability. Finally, the Bank of Japan uses a special case of forward guidance that is contingent upon the achievement of an inflation target of 2%, that refers to the monetary base (which has replaced the official interest rate as the main instrument of monetary policy) and that has an open-ended time horizon.

As regards the effectiveness of forward guidance measures, the analyses carried out to date conclude that their impact has been positive, reducing the volatility of money market interest rates and the uncertainty regarding the future monetary policy stance and improving general financial conditions (see Panel 2), albeit with weaker effects at longer time horizons. These findings should be treated with some caution, however, since it is generally difficult to separate the different factors and the anticipated effects. Moreover, forward guidance measures have not always succeeded in aligning market expectations with the central bank's signalled intentions. Thus, while there seems to be evidence that the Fed's announcements indicating a specific period managed to transmit to the markets a switch towards a more accommodating monetary policy, the experience with forms of forward guidance subject to numerical thresholds has been less favourable. In the case of the Bank of England, following the announcement of its strategy in August 2013, the markets expected the first official rate rise more than a year before the central bank's own forecasts. The difficulties of designing and communicating contingent forward guidance have also been apparent in recent months in the abandonment of numerical thresholds by both the Fed and the Bank of England. This was a consequence of a much more rapid reduction in unemployment rates in these economies than was initially anticipated, without a similarly favourable evolution of the fundamentals of the economy (see Panel 3),[4] which forced the central banks concerned to reintroduce qualitative elements, indicating that official rates would be held at current levels for a more or less prolonged period.

These communication problems illustrate the significant challenges facing forward guidance measures. The main issue is how to ensure the credibility of instruments that, by their very nature, pose more severe time-inconsistency problems than other tools. Additional effort is needed, when designing these measures, to ensure that the need to recalibrate or redefine them subsequently is minimised, and also when explaining them, since their effectiveness depends on correct interpretation by the public of the monetary authority's message. A balance thus needs to be struck between transparency and clarity, since agents may be confused as much by a lack of information as by an excess of technical detail. These difficulties have been highlighted by recent experience with quantitative thresholds; they are especially severe when the measures are complicated to explain to the public or the projection of the reference variables is surrounded by a high degree of uncertainty or hinges on controversial factors.

Finally, although forward guidance measures have been useful in the context of the monetary policy response to the crisis, a relevant question for the future is whether they have a role to play in the

1 The use of forward guidance is not new. For a review of the most recent experience of forward guidance, see for example, S. López and P. del Río (2013), "El uso de la orientación de expectativas o *forward guidance* como instrumento de política monetaria", *Boletín Económico,* December, Banco de España; or A. Filardo and B. Hofmann (2014), "Forward guidance at the zero lower bound", *BIS Quarterly Review,* March.

2 See P. Praet (2013), "Forward guidance and the ECB", in W. den Haan (ed.), *Forward guidance: Perspectives from central bankers, scholars and market participants,* a voxEU.org eBook, CEPR; and B. Coeré (2013), "The usefulness of forward guidance", speech delivered at the Money Marketeers Club of New York, New York, 26 September; and ECB (2014), *Annual Report 2013.*

3 See, for example, the recommendations in P. Krugman (1998) "It's baaaack! Japan's slump and the return of the liquidity trap", *Brookings Papers on Economic Activity,* No 2; and M. Woodford (2012), "Methods of policy accommodation at the interest-rate lower bound", *Jackson Hole Economic Symposium Conference Proceedings,* Federal Reserve Bank of Kansas City, pp. 185-288.

4 An analysis of the difficulty inherent in this type of tools, in the context of the recent problems that the Federal Reserve System and the Bank of England have had, can be found in the article "The world economy faced with a change in scenario. Developments, outlook and risks", *Economic Bulletin,* March 2014, Banco de España.

process of withdrawal of monetary stimuli. In general, it might be considered that, as the economy recovers, they should play a key role in the communication of exit strategies, by steering agents' expectations. However, when the situation returns to normal, the question of whether these measures should form part of the standard set of monetary policy instruments will need to be analysed.

1 FORWARD GUIDANCE BY THE MAIN CENTRAL BANKS FOLLOWING THE FINANCIAL CRISIS

Central bank	Type of forward guidance	Date of decision	Announcement
Bank of Japan	Contingent	February 2012	"Until the 1% inflation goal is in sight"
	Contingent	April 2013	"The Bank will continue with the quantitative and qualitative monetary easing, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner, with a time horizon of about two years"
Federal Reserve System	Open-ended	December 2008	"For some time"
	Open-ended	March 2009	"For an extended period"
	Fixed period	August 2011	"At least through mid-2013"
	Fixed period	January 2012	"At least through late 2014"
	Fixed period	September 2012	"At least through mid-2015"
	Contingent	December 2012	"As long as the unemployment rate remains above 6.5%, inflation between one and two years ahead is projected to be no more than 2.5% and longer-term inflation expectations continue to be well anchored"
	Contingent, with greater qualitative assessment	December 2013	"Additional measures of labour market conditions will be considered and it likely will be appropiate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the 2% goal"
	Contingent, with qualitative assessment	March 2014	"In determining how long to maintain the current 0% - 0.25% target range for the federal funds rate, measures of labour market conditions, indicators of inflation pressures and inflation expectations and financial developments will be taken in to account"
Bank of England	Contingent	August 2013	"At least until the unemployment rate has fallen to a threshold of 7%, subject to three 'knockouts' related to inflation and financial stability"
	Contingent, with greater qualitative assessment	February 2014	"There remains scope to absorb spare capacity further before raising Bank Rate. The path of Bank Rate over the next few years will depend on economic developments, although the rise in Bank Rate is expected to be gradual and the appropriate level is likely to be materially below 5%"
European Central Bank	Open-ended	July 2013	"For an extended period of time. This expectation is based on the overall subdued outlook for inflation extending into the medium term, given the broad-based weakness in the real economy and subdued monetary dynamics"
Bank of Canada	Fixed period	April 2009	"Until the end of the second quarter of 2010, conditional on the inflation outlook"
Sveriges Riksbank	Fixed period	April 2009	"Until the beginning of 2011"

SOURCE: Federal Reserve System, ECB, Bank of England, Bank of Japan, Bank of Canada and Sveriges Riksbank.
NOTE: Conditingent: conditional upon economic variables.

2 FINANCIAL MARKET RESPONSE TO FORWARD GUIDANCE ANNOUNCEMENTS

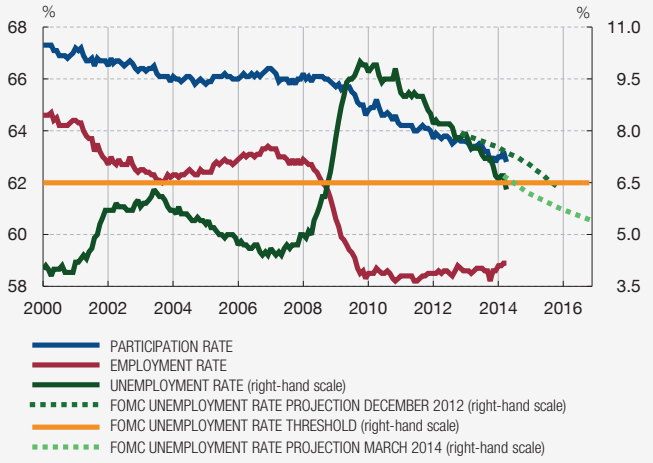
	Types of forward guidance						
	Qualitative	Calendar			Conditional on economic variables		
	European Central Bank	Federal Reserve System	Federal Reserve System	Federal Reserve System	Federal Reserve System	Bank of Japan	Bank of England
	4.7.2013	9.8.2011	25.1.2012	13.9.2012	12.12.2012	4.4.2013	7.8.2013
Treasury bond (a)							
Two-year	-6	-7	-1	-1	0	0	1
Ten-year	-3	-16	-6	-1	5	-11	0
Volatility (VIX) (a)							
VIX	0.0	-12.9	-0.6	-1.8	0.4	-0.3	0.3
Market index (b) (%)							
S&P 500	0.0	4.7	0.9	1.6	0.0	0.4	-0.4
EUROSTOXX	2.9	0.3	-0.5	-0.8	0.2	-0.7	0.1
FTSE	3.1	1.9	-0.5	0.7	0.4	-1.2	-1.4
NIKKEI	-0.3	-1.7	1.1	0.4	0.6	2.2	-4.0
MSCI - Global	0.6	2.1	0.5	0.9	0.2	-0.3	-0.6
Exchange rates (b) (c) (%)							
Dollar-euro	0.2	0.3	-0.5	0.1	0.4	-0.1	0.2
Yen-dollar	0.0	-0.6	0.1	-0.3	0.7	3.5	-1.1
Sterling-dollar	1.4	0.0	-0.3	-0.3	-0.2	-0.7	-0.9

SOURCES: Bloomberg and Datastream-Thomsom Reuters.

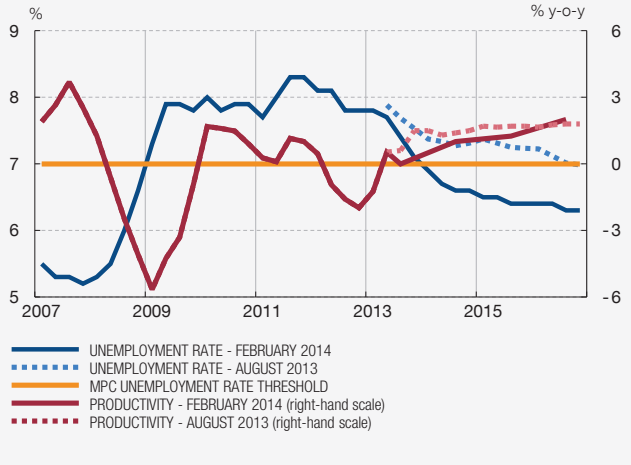
a One-day change, in basis points.
b One-day percentage change.
c Minus sign denotes depreciation of the second currency.

3 LABOUR MARKET INDICATORS AND FORWARD GUIDANCE IN THE UNITED STATES AND THE UNITED KINGDOM

UNITED STATES. PARTICIPATION, UNEMPLOYMENT AND EMPLOYMENT RATES



UNITED KINGDOM. UNEMPLOYMENT RATE AND PRODUCTIVITY (a)



SOURCES: Bureau of Labor Statistics, Federal Reserve System, Bank of England, national statistics, Bloomberg and Datastream-Thomsom Reuters.

a Data from the Bank of England's Inflation Reports published in August 2013 and February 2014.

Bank loans are the main source of private-sector financing in the euro area and, consequently, their availability is pivotal in supporting economic recovery. The markedly cyclical nature of loans is determined by the combination of demand and supply factors which operate in the same direction over the economic cycle and, consequently, are difficult to separate. For non-financial corporations this cyclical pattern has shown historically a slight lag with respect to GDP.

Even taking into account these regularities, loans have been weak since mid-2012, out of kilter with the more stable economic activity. This suggests the presence of additional factors that would seem to be restraining their growth (see Panels 1 and 2).

On the demand side, a prime candidate for explaining this behaviour is the high private-sector debt in certain countries and the need to decrease it. As shown by Panels 3 and 4, this situation is evident in the highly negative net flows of bank loans in countries where private debt rose substantially before the crisis – mainly in Ireland, Cyprus, Portugal and Spain. The debt levels are being addressed in a setting of low economic growth and moderate inflation, which means that deleveraging has to take place essentially through net negative financing flows. In the Spanish case there is empirical evidence that corroborates the negative effect of debt levels on bank loans to non-financial corporations (see, for example, Box 4.1 of this report).

On the supply side, the capital and liquidity position of banks essentially determines the strength with which the cyclical position feeds through to credit [Jiménez *et al.* (2012)][1]. Although the solvency of banks is not isolated from the economic situation, which has had a negative impact on the quality of the assets in their portfolios, the effects on lending may be intensified on this occasion by the fact that, as a result of the global financial crisis, both markets and new regulatory frameworks demand more stringent prudential standards. There is also empirical evidence which supports the importance of supply factors for credit during the last crisis both for the area as a whole [Darracq Paries *et al.* (2014)][2] and for core countries such as Germany [Blaes (2011)][3].

During the most recent period, the indirect information of the Bank Lending Survey indicates that during 2013 both demand and supply factors have been important. Within supply factors, the perception of credit risk has been the main determining factor of the restrictive bias in supply conditions, although the banks have also stated that the regulatory changes have affected credit standards and prompted an adjustment of their loan portfolios – particularly those with the highest risk – (see Panel 5).

It is also interesting to note that among the larger corporations there is some substitution of external sources of financing as a result of the expansionary monetary policy stance which seems to have passed through more strongly into the debt markets than into the cost of new loans. Since 2009 fixed-income issues have represented more than 4% of GDP in cumulative terms, compared with a fall in bank loans of almost 2% of GDP. Issuance was more vigorous in countries where firms started from a more market-oriented structure of liabilities (see Panel 6). In the economies subject to greater stress during the crisis, the problems of financial fragmentation within the area raised the funding costs of the banks themselves and, consequently, the costs of the loans that they could extend.

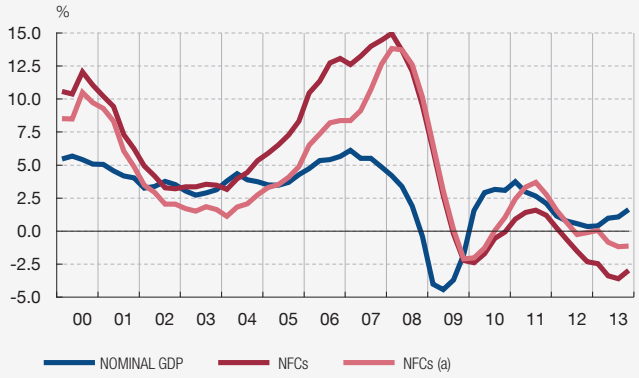
In short, the recent sluggishness of bank loans is a reason for concern insofar as it seems to respond, aside from cyclical factors, to the presence of factors restricting both demand and supply. The effect of such factors is quite mixed from country to country. In a setting in which banks are immersed in a process of adapting to the new regulatory and market standards, successfully completing this adaptation may be crucial so that credit supply does not limit investment or the economic recovery. From a different standpoint, the crisis has also underlined the risks which arise from companies limiting the diversification of their sources of financing. The risks are more pronounced for SMEs, it is particularly complex for them to gain access to markets because of restrictions due to their size and ability to produce relevant information for investors. Such risks justify the study of initiatives specifically targeted at this sector.

1 G. Jiménez, S. Ongena, J.L. Peydró and J. Saurina (2012), "Credit supply and Monetary Policy: Identifying the Bank Balance-Sheet Channel with Loan Applications", *American Economic Review,* 102 (5), pp. 2301-2326.

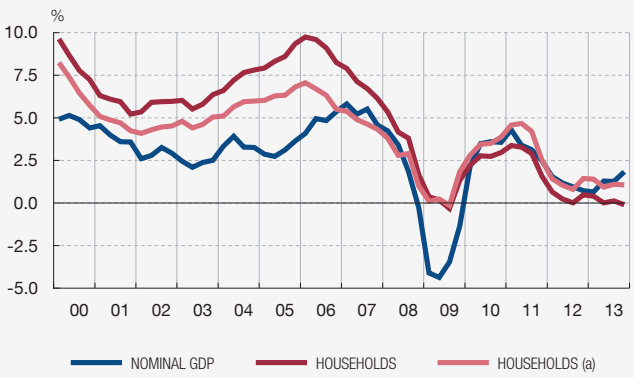
2 M. Darracq Paries, L. Maurín and D. Moccero (2014), *Financial Condition Index and Credit Supply Shocks for the Euro Area,* Working Paper No. 1644, March, European Central bank.

3 B. Blaes (2011), *Bank-related loan supply factors during the crisis: an analysis based on the German bank lending survey,* Discussion Paper, No. 31/2011, Deutsche Bundesbank.

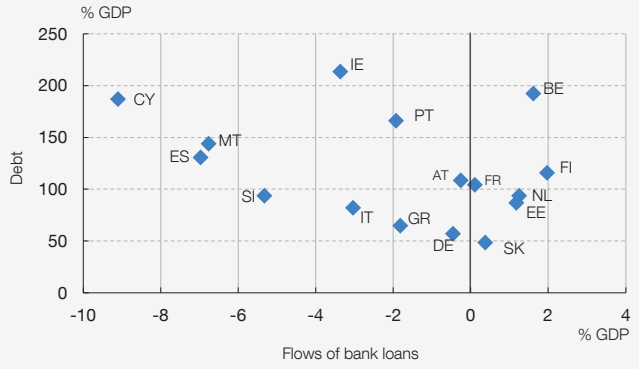
1 GDP AND BANK LOANS TO NON-FINANCIAL CORPORATIONS IN THE EURO AREA
(y-o-y growth)



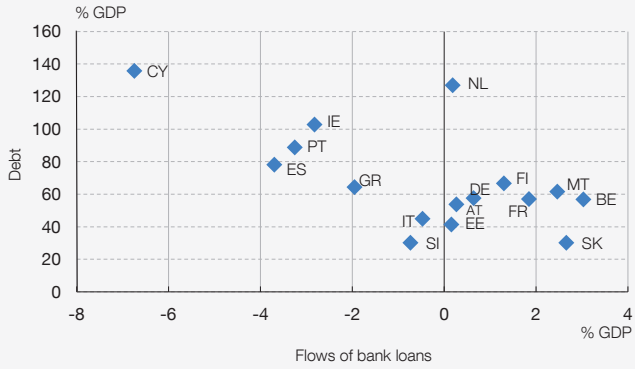
2 GDP AND BANK LOANS TO HOUSEHOLDS IN THE EURO AREA
(y-o-y growth)



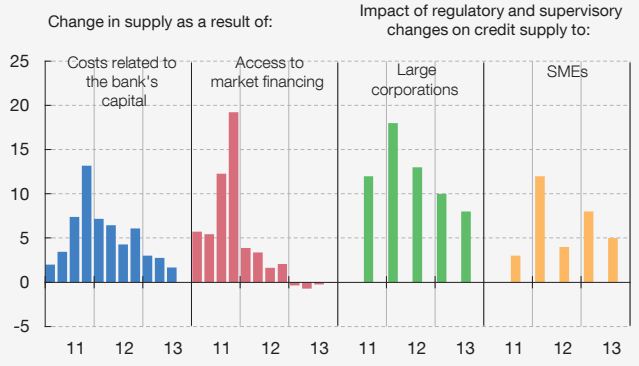
3 DEBT OF NON-FINANCIAL CORPORATIONS
2013



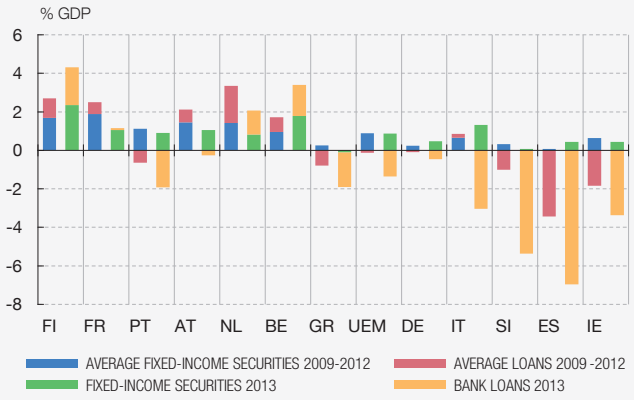
4 DEBT OF HOUSEHOLDS
2013



5 BANK LENDING SURVEY



6 BANK LOANS AND CORPORATE BOND ISSUES (b)
(Flows as % of GDP)

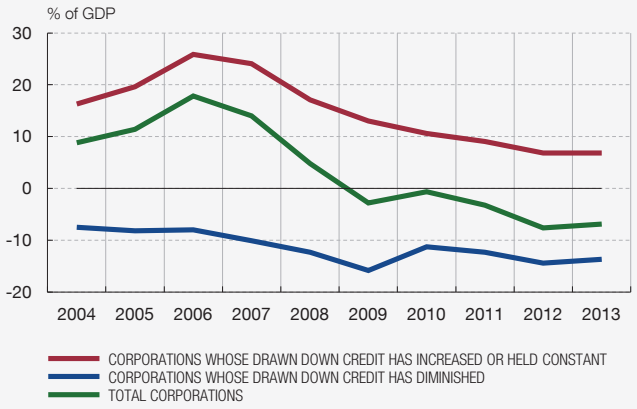


SOURCES: Eurostat, ECB and Banco de España.

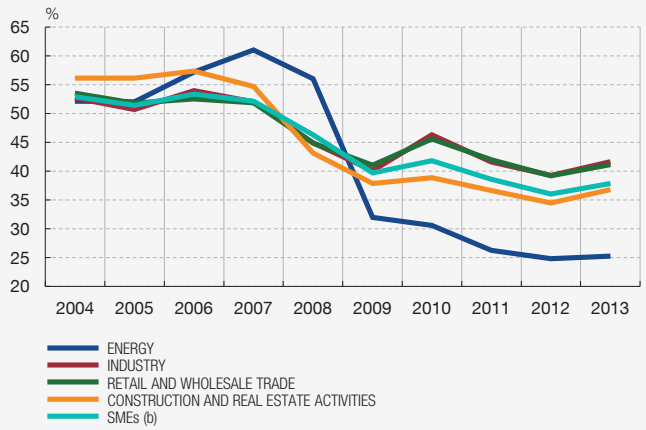
a Excluding countries with high debt that are undergoing adjustment (Spain, Portugal, Ireland and Cyprus).
b Ranked according to the weight of fixed-income securities in total debt. The importance of the financing of non-financial corporations via securities is undervalued in countries like Germany or Spain where, on occasions, financing is raised by subsidiaries abroad or by financial subsidiaries and subsequently distributed through inter-company loans.

Since its mid-2009 peak, aggregate debt in the corporate sector has progressively declined. However, this aggregate contraction encompasses very mixed individual behaviours. As can be seen in Panel 1, the decline in the aggregate outstanding balance of corporations' bank lending (which is their main source of financing, especially in the case of the smaller firms) has occurred alongside sizeable positive financing flows towards certain corporations. The increase in loans extended to the latter has

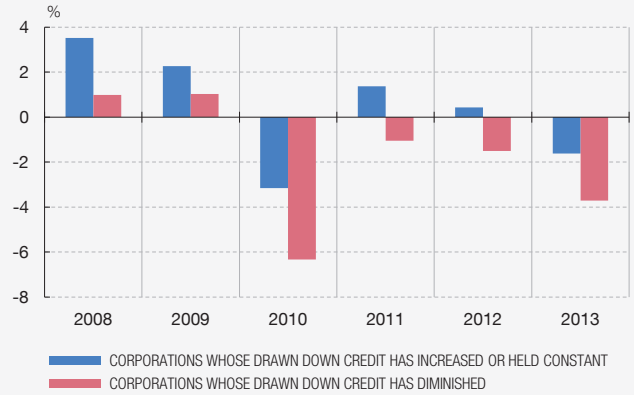
1 GROWTH IN CREDIT DRAWN DOWN: FLOW AS A PERCENTAGE OF GDP (a)



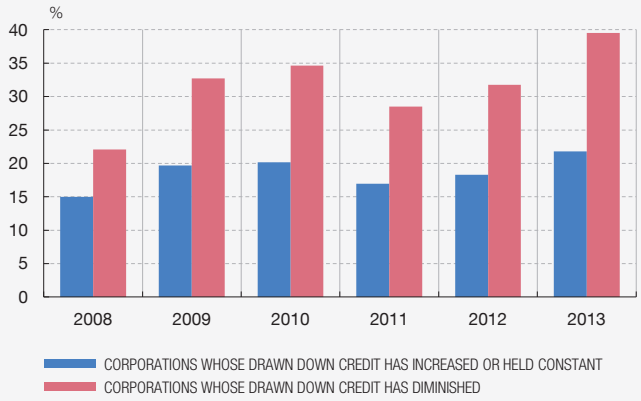
2 PERCENTAGE OF CORPORATIONS WHOSE DRAWN DOWN CREDIT HAS INCREASED OR HELD CONSTANT. BREAKDOWN BY SECTOR (a)



3 YEAR-ON-YEAR GROWTH RATE IN EMPLOYMENT AT t-1 (b) (c) (d)



4 MEDIAN OF THE DEBT BURDEN AT t-1 (b) (c) (e)



5 MARGINAL IMPACT ON THE PROBABILITY OF A CORPORATION INCREASING OR MAINTAINING ITS LEVEL OF CREDIT (f)
Sample period covered in the estimate: 2008-2013

	Coefficient	P-value
Profitability (t-1)	0.0238	0.000
Debt burden (t-1) (e)	-0.0080	0.000
Indebtedness (t-1)	-0.1529	0.000
Growth rate of employment (t-1)	0.0043	0.004
Growth rate of sectoral employment (t-1)	0.0034	0.064
Level of dependence on banks undergoing restructuring (t-1) (g)	-0.0293	0.000

SOURCE: Banco de España.

a Calculations made with information from the Central Credit Register.
b Average of the related sectoral results.
c Calculations made with cross-checked information from the Central Credit Register and the Central Balance Sheet Data Office.
d Average of the year-on-year growth rate of employment in each sector.
e Debt burden defined as financial charges/(Gross Operating Profit + Financial Revenue).
f Results obtained on estimating a linear probability model with fixed effects.
g Ratio of credit received from banks undergoing restructuring to the corporation's total volume of loans.

logically been lower than that recorded pre-crisis (in line with the more unfavourable economic setting and the stricter credit standards in force), but it has held at considerable volumes (between 6.8% and 13% of GDP over this period). As a counterpoint to this, for companies with negative credit flows, deleveraging has come about at an appreciably greater pace than what the aggregate figure suggests.

In terms of the number of firms, from 2008 to 2012 the percentage of companies recording an increase (or stability) in their bank financing fell progressively, but held constantly at significant levels for almost all the sectors of activity and for both SMEs and bigger corporations (see Panel 2).[1] This declining trend was interrupted in 2013, with the proportion of companies with a net positive or zero credit flow rising slightly (up by 1 pp to 39%). The change affected all sectors of activity and both large corporations and, especially, SMEs.[2] This was accompanied by a stabilisation of credit flows, following the declining trend in train since 2006.

Panels 3 and 4 compare the one-period-lagged[3] average values of two characteristics of significance from an economic and financial standpoint, distinguishing between companies on the basis of whether they received more bank credit or not: the debt burden (which combines information on the level of debt, interest rates paid and income generated) and employment. These panels infer that companies at which outstanding loan balances fell showed, on average, in the previous year, lower debt servicing ratios and a more lacklustre performance in terms of staffing[4].

For a more in-depth analysis of the variables that are most significant when it comes to explaining whether a company increases its level of credit or not, a simple model has been estimated in which this binary variable is related to a series of potential determinants. These include both the sector in which the company is operating and the dynamism of this productive sector as individual characteristics of the companies such as its debt, debt burden and profitability (measured as a proportion of assets), or the growth rate of its staff (which proxies the dynamism of its activity). Also included is a variable that captures the degree of dependence on banks undergoing restructuring, defined as the ratio of credit received from these banks and the total volume of the company's bank loans.

As is seen in the accompanying table, the results show that the relevant variables (i.e. those that are statistically significant) when it comes to determining whether a company increases its level of credit are its profitability, its indebtedness level and debt burden, the rate at which its staff numbers are increasing and that of the sector in which it is operating, and its dependence on banks undergoing restructuring.[5] Results are as expected: the greater dynamism of the company's activity or of the sector in which it operates translates into a higher probability of the company increasing its volume of loans. Conversely, greater financial pressure (whether that resulting from higher debt, from lower profitability or from a higher proportion of income generated being absorbed by financial expenses) lessens this probability.[6] The degree of dependence on banks subject to restructuring plans also has a contractionary influence on this probability, showing that companies linked to these banks would not have been able to fully replace the funds they ceased to receive from their habitual lenders with financing from other sounder banks.[7]

1 These proportions have been lower in the case of smaller firms, where the impact of the economic crisis has been greater, than for large corporations, where the figure stood at 46%, on average, between 2008 and 2013.

2 The smaller rise in the first case is probably linked to the replacement of financing from resident banks with other sources, such as securities issuance or foreign loans .

3 The one-period-lagged values are offered to correct the potential problems of endogeneity. In the case of employment, the average is given, and in that of the debt burden, the median.

4 Although not shown in the panels, they were also less profitable and had higher debt ratios.

5 All the variables are one-period-lagged in order to correct the potential problems of endogeneity. The ratios are all significant with a confidence level of 95%, except that associated with the growth rate of sectoral employment, which is significant with a confidence level of 90%.

6 When the non-performing loans ratio is introduced into the model, it proves significant, although its quantitative impact is very low: a 10 pp increase in this variable translates into a 0.008 pp rise in the probability that the company will increase its credit.

7 It was estimated in Box 6.1 in the 2012 *Annual Report* that, on average, dependent companies might replace around 65% of the financing they ceased to receive from these banks. Subsequent updates confirm the validity of the estimate in the case of the so-called Group 1 banks (those in which the FROB already had a stake at the time of the stress test). The contractionary impact of the restructuring plans on the growth rate of the dependent companies' financing is estimated at somewhat less than 2 pp in 2013. Given that the Group 1 banks were channelling 12% of non-financial corporations' total credit at the start of this year, the influence of these plans on the rate of decline of the overall sector's credit would be around 0.2 pp.

The economic and financial crisis has led to a substantial increase in the general government debt of the OECD countries, to levels that represent 25-year highs, well above those in the period immediately preceding 2008 (see Panel 1). This growth in debt, and the difficulty of bringing it to a halt, has placed the sustainability of public finances at the centre of the economic policy debate in Europe. In the particular case of Spain, despite the fiscal adjustment implemented since 2010, the public debt-to-GDP ratio has carried on rising, since the start of the crisis, reaching 93.9% of GDP in 2013. According to the latest government forecasts (2014-2017 Stability Programme), in a scenario of compliance with deficit commitments and moderate economic growth (average real GDP growth of 2.1% over the period 2014-2017) the public debt-to-GDP ratio will stabilise in 2015 at slightly above 100% (see Chart 1), a level without precedent in Spain's recent past, and well above the peak reached in the crisis of the 1990s, when it remained below 70% of GDP.

The international evidence available suggests that the existence of high levels of public debt for prolonged periods may have significant macroeconomic repercussions.[1] First, high levels of debt are usually associated with higher interest rates (see Panel 2) and, potentially, owing to the impact of these on investment and the crowding-out of funding for the private sector, lower medium-term GDP growth rates. However, the latest evidence suggests that it is not possible to associate these negative effects on growth with a particular threshold of public debt, which may vary from country to country, and that the dynamics of debt may be as important as the level when explaining the effects on growth.[2] Second, high public debt reduces the leeway for a counter-cyclical fiscal policy, which may be very necessary in countries that belong to a monetary union. Indeed, there is evidence associating high levels of public debt with greater volatility of economic growth, which could be a consequence of this lack of fiscal policy leeway. In addition, the sustainability of a high level of public debt, in an environment of weak or moderate growth, requires large and sustained primary surpluses, which may affect the composition of public finances and, ultimately, the potential growth of the economy if, for example, fiscal policy involves levels of taxation that are less conducive to growth or lower levels of productive spending. Finally, a high public debt ratio generates larger borrowing requirements in the short term, which increase the economy's vulnerability to adverse financial market reactions.

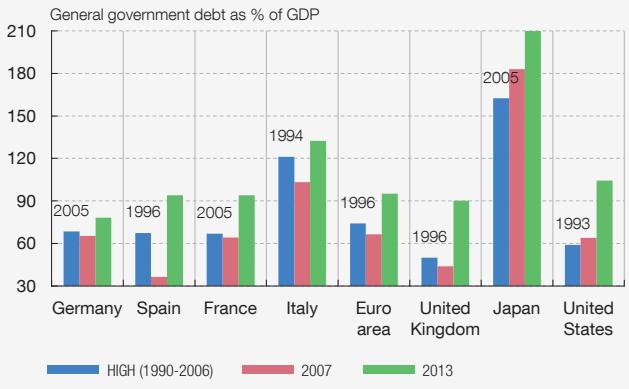
The international evidence available on episodes of reduction of high levels of debt in advanced economies since the 1980s shows that the most effective were those associated with high GDP growth rates and large and sustained primary surpluses (see Panel 3). In comparison, other determinants of the dynamics of public debt, such as inflation, the fall in interest rates and deficit/debt adjustments (reflected, for example, in aggressive privatisation processes or financial asset sales), played a secondary role. On the other hand, the slowest debt reduction processes have usually been constrained by the need for very large fiscal adjustments and

1 See, for example, S. A. Abbas, B. Akitoby, J. Andritzky, H. Berger, T. Komatsuzaki and J. Tyson (2013), "Dealing with high debt in an era of low growth", *IMF Staff Discussion Note,* SDN/13/07; C. Checherita-Westphal and P. Rother (2012), "The impact of high government debt on economic growth and its channels: An empirical investigation for the euro area", *European Economic Review,* 56, pp. 1392-1405.

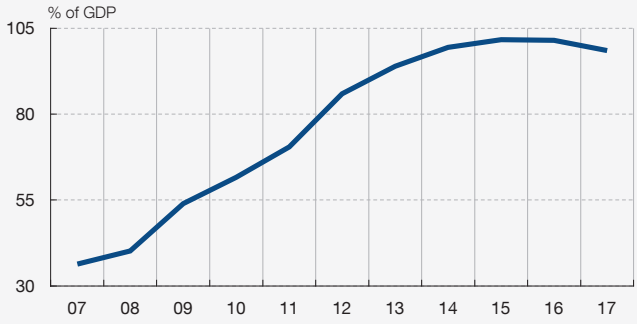
2 See A. Pescatori, D. Sandri and J. Simon (2014), "Debt and Growth: Is There a Magic Threshold?", *IMF Working Paper,* No 14/34.

1 INTERNATIONAL COMPARISON OF CURRENT SITUATION AND PUBLIC DEBT OUTLOOK IN SPAIN

INTERNATIONAL COMPARISON (a)



GENERAL GOVERNMENT DEBT IN SPAIN ACCORDING TO THE 2014-2017 STABILITY PROGRAMME (b)



SOURCES: IMF, INE and Ministerio de Hacienda y Administraciones Públicas.

a The year of the highest level of the general government debt-to-GDP ratio over the period 1990-2006 is shown for each country.
b The values for 2014-2017 are the official forecasts of the Kingdom of Spain's Stability Programme 2014-2017, submitted in April 2014.

macroeconomic environments characterised by low economic growth and high interest rates.

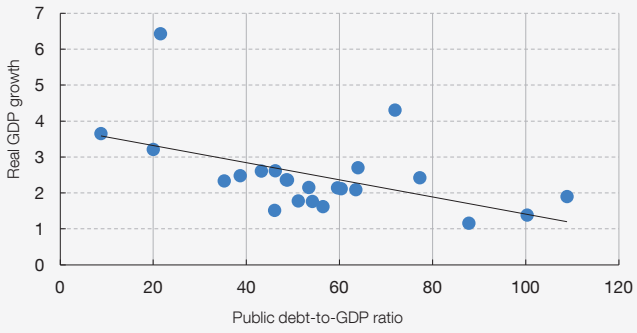
In the case of Spain, the process of public debt reduction is constrained, in the short term, by the need for private-sector deleveraging and by the process of fiscal consolidation itself and, in the medium term, by the effect of an ageing population. The medium-term outlook of moderate economic growth and inflation will make the task of reducing public debt difficult and will require significant fiscal surpluses to be achieved and sustained. The importance of these constraints can be seen from the following simulation: in a scenario with real GDP growth of 1%, inflation of 1.5% and an implied nominal interest rate of 3.5% (similar to the level observed in 2013), the primary surplus necessary to stabilise public debt at 100% of GDP would be 1% of GDP,[3] as compared with an actual primary deficit in 2013 of 3.2% of GDP.

The current macroeconomic situation is very different from that which prevailed when public debt was reduced between 1996 and 2007. Comparing the determinants of the change in the public debt-to-GDP ratio during the current fiscal consolidation process that began in 2009, when the budget deficit reached 11.1% of GDP, with

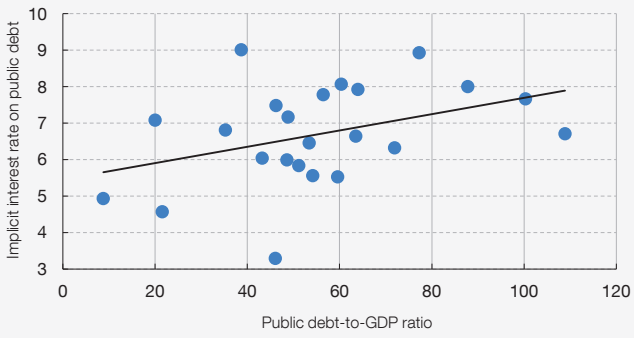
3 In the case of Spain, since the 1980s consecutive primary surpluses have only been recorded between 1987 and 1990 (on average 0.5% of GDP) and between 1997 and 2007 (on average 2.4% of GDP), in the latter case against a background of strong economic growth and easing financial conditions.

2 PUBLIC DEBT, ECONOMIC GROWTH AND INTEREST RATES (a)

PUBLIC DEBT AND GDP GROWTH
(OECD COUNTRIES: 1980-2012 AVERAGES)



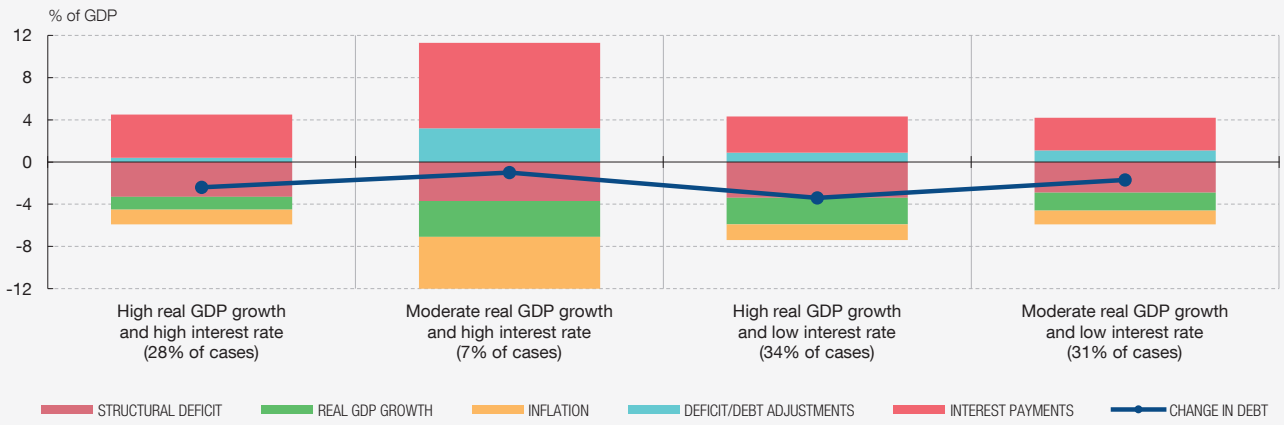
PUBLIC DEBT AND IMPLIED INTEREST RATE ON DEBT
(OECD COUNTRIES: 1980-2012 AVERAGES)



SOURCES: OECD and IMF.

a Including: Germany, Australia (1989-2012), Austria, Belgium, Canada, South Korea, Denmark, Spain, United States, Finland, France, Greece, Ireland, Iceland, Italy, Luxembourg (1990-2012), New Zealand (1986-2012), Norway, the Netherlands, Portugal, United Kingdom, Sweden and Switzerland (1990-2012).

3 INTERNATIONAL EVIDENCE ON EPISODES OF PUBLIC DEBT REDUCTION (OVER A FOUR-YEAR PERIOD) FOR A SAMPLE OF 30 COUNTRIES DURING THE PERIOD 1980-2011 (a)



SOURCE: Abbas, S. A., B. Akitoby, J. Andritzky, H. Berger, T. Komatsuzaki and J. Tyson (2013), "Dealing with high debt in an era of low growth", *IMF Staff Discussion Note,* SDN/13/07 (September).

a High (moderate) growth: real GDP growth of over 2% (between 0% and 2%) over four consecutive years (allowing a single year's exception). High (low) interest rate: rate above (below) the median for each country (sample 1980-2011).

those lying behind the last fiscal consolidation process, between 1998, when the budget deficit resulting from the 1990s crisis peaked (at 7.5% of GDP), and the end of the decade, reveals a fundamental difference. Although the reduction in the deficit over the first four years of each episode was similar – some four percentage points of GDP – during the last fiscal consolidation process this adjustment was sufficient to stabilise and slightly reduce the debt ratio, while in the current situation debt has continued to grow.

The main explanation for this significant difference is the contribution of nominal GDP growth. Between 1994 and 1997 GDP growth enabled the public debt ratio to be reduced by some 17 percentage points, while between 2010 and 2013 the negative behaviour of GDP increased the public debt ratio by some two GDP percentage points.

In short, high levels of public debt have significant adverse effects, which mean that the first priority of fiscal policy must be stabilisation, and thereafter a gradual reduction in the public debt-to-GDP ratio towards low levels. The Spanish economy's medium-term macroeconomic scenario suggests that debt reduction will require a prolonged sizeable fiscal adjustment. This must be anchored in a credible medium-term strategy that enables agents' expectations to be stabilised and long-term interest rates to be kept low. Strict compliance with the current framework of national and European fiscal rules is fundamental for this purpose. It is also important that this process be accompanied by further structural reforms that make an improvement in the medium-term economic growth outlook possible, permitting the latter to make a greater contribution to the process of public-sector deleveraging.

ANNUAL ACCOUNTS OF THE BANCO DE ESPAÑA 2013

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 2012 are presented solely for comparison with 2013. To this end, the information for 2012 on some expense accounts has been reorganised as explained in the related notes to the profit and loss account. 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 2013. Section 2 includes the balance sheet and profit and loss account at 31 December 2013; 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, the changes in equity and the management of risk exposures; 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 2013

EUR m

		Note Number	2013	2012	Change
ASSETS					
1	**Gold and gold receivables**	**1**	**7,887.81**	**11,418.40**	**-3,530.59**
2	**Claims on non-euro area residents denominated in foreign currency**		**25,611.86**	**26,593.16**	**-981.30**
2.1	Receivables from the IMF	2	5,593.31	5,907.82	**-314.51**
2.2	Balances with banks and security investments, external loans and other external assets	3	20,018.55	20,685.34	**-666.79**
3	**Claims on euro area residents denominated in foreign currency**	**4**	**2,175.35**	**2,576.94**	**-401.60**
4	**Claims on non-euro area residents denominated in euro**		**402.28**	**812.81**	**-410.53**
4.1	Balances with banks, securities investments and loans	5	402.28	812.81	**-410.53**
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**	**195,170.41**	**361,086.88**	**-165,916.47**
5.1	Main refinancing operations		17,106.70	45,735.00	**-28,628.30**
5.2	Longer-term refinancing operations		178,063.59	315,351.79	**-137,288.20**
5.3	Fine-tuning reverse operations		–	–	–
5.4	Structural reverse operations		–	–	–
5.5	Marginal lending facility		–	–	–
5.6	Credits related to margin calls		0.12	0.09	**0.03**
6	**Other claims on euro area credit institutions denominated in euro**		**3.78**	**0.87**	**2.92**
7	**Securities of euro area residents denominated in euro**	**7**	**88,211.85**	**96,930.56**	**-8,718.71**
7.1	Securities held for monetary policy purposes		29,586.07	32,989.53	**-3,403.45**
7.2	Other securities		58,625.78	63,941.03	**-5,315.26**
8	**General government debt denominated in euro**	**8**	**1,943.37**	**2,915.05**	**-971.68**
9	**Intra-Eurosystem claims**	**9**	**53,105.07**	**40,078.29**	**13,026.78**
9.1	Participating interest in ECB		1,077.72	1,078.50	**-0.78**
9.2	Claims equivalent to the transfer of foreign reserves		4,782.87	4,783.65	**-0.77**
9.4	Net claims related to the allocation of euro banknotes within the Eurosystem		47,244.47	34,216.14	**13,028.33**
9.5	Other claims within the Eurosystem (net)		–	–	–
10	**Items in course of settlement**		**2.12**	**1.04**	**1.08**
11	**Other assets**		**6,457.70**	**7,269.06**	**-811.36**
11.2	Tangible and intangible fixed assets	10	257.97	263.67	**-5.70**
11.3	Other financial assets	11	25.25	45.70	**-20.45**
11.4	Off-balance sheet instruments revaluation differences	12	104.07	162.30	**-58.24**
11.5	Accruals and prepaid expenses	13	4,492.89	4,825.31	**-332.42**
11.6	Sundry	14	1,577.52	1,972.07	-394.56
TOTAL ASSETS			**380,971.59**	**549,683.05**	**-168,711.46**

BALANCE SHEET OF THE BANCO DE ESPAÑA AS AT 31 DECEMBER 2013 (cont'd)

EUR m

		Note Number	2013	2012	Change
LIABILITIES					
1	**Banknotes in circulation**	**15**	**104,377.15**	**99,641.36**	**4,735.80**
2	**Liabilities to euro area credit institutions related to monetary policy operations denominated in euro**	**16**	**30,783.49**	**72,004.69**	**-41,221.20**
2.1	Current accounts (covering the minimum reserve system)		15,949.79	12,851.75	3,098.04
2.2	Deposit facility		14,833.00	59,046.50	-44,213.50
2.3	Fixed-term deposits		–	–	–
2.4	Fine-tuning reverse operations		–	–	–
2.5	Deposits related to margin calls		0.70	106.45	-105.74
3	**Other liabilities to euro area credit institutions denominated in euro**	**17**	**0.63**	**110.01**	**-109.38**
5	**Liabilities to other euro area residents denominated in euro**		**4,164.40**	**10,951.86**	**-6,787.46**
5.1	General government	18	2,116.77	9,009.99	-6,893.22
5.2	Other liabilities	19	2,047.62	1,941.86	105.76
6	**Liabilities to non-euro area residents denominated in euro**	**20**	**144.98**	**141.68**	**3.29**
7	**Liabilities to euro area residents denominated in foreign currency**		**0.95**	**0.85**	**0.10**
8	**Liabilities to non-euro area residents denominated in foreign currency**		**0.73**	**0.77**	**-0.03**
8.1	Deposits, balances and other liabilities		0.73	0.77	-0.03
8.2	Liabilities arising from the credit facility under ERM II		–	–	–
9	**Counterpart of special drawing rights allocated by the IMF**	**21**	**3,162.06**	**3,296.08**	**-134.02**
10	**Intra-Eurosystem liabilities**	**22**	**213,382.14**	**336,831.24**	**-123,449.10**
10.2	Liabilities related to promissory notes backing the issuance of ECB debt certificate		–	–	–
10.3	Net liabilities related to the allocation of euro banknotes within the Eurosystem		–	–	–
10.4	Other liabilities within the Eurosystem (net)		213,382.14	336,831.24	-123,449.10
11	**Items in course of settlement**	**23**	**1,679.49**	**183.75**	**1,495.74**
12	**Other liabilities**		176.00	**350.59**	**-174.59**
12.1	Off-balance-sheet instruments revaluation differences	24	–	–	–
12.2	Accruals and income collected in advance	25	55.74	237.54	-181.81
12.3	Sundry	26	120.27	113.05	7.22
13	**Provisions**	**27**	**9,013.67**	**7,806.34**	**1,207.33**
14	**Revaluation accounts**	**28**	**9,038.52**	**12,568.59**	**-3,530.07**
15	**Capital and reserves**		**1,899.81**	**1,950.00**	**-50.19**
15.1	Capital	29	1,000.00	1,000.00	–
15.2	Reserves	**30**	899.81	950.00	-50.19
16	**Profit for the year**	**31**	**3,147.58**	**3,845.23**	**-697.66**
TOTAL LIABILITIES			**380,971.59**	**549,683.05**	**-168,711.46**

PROFIT AND LOSS ACCOUNT OF THE BANCO DE ESPAÑA FOR THE YEAR ENDING 31 DECEMBER 2013

EUR m

		Note Number	2013	2012	Change
1	Interest income	1	6,388.48	8,223.84	-1,835.36
2	Interest expense	2	1,721.62	3,116.53	-1,394.91
3	**Net interest income (1 – 2)**		**4,666.86**	**5,107.31**	-440.45
4	Realised gains/losses arising from financial operations	3	-1.94	132.25	-134.19
5	Write-downs on financial assets and positions	4	285.36	1.01	284.35
6	Transfer to/from provisions for financial risks	5	-1,268.68	-1,565.92	297.25
7	**Net result of financial operations, write-downs and risk provisions (4 – 5 + 6)**		**-1,555.98**	**-1,434.68**	-121.29
8	Fees and commissions income		17.55	19.32	-1.76
9	Fees and commissions expense		10.64	12.04	-1.40
10	**Net income from fees and commissions (8 – 9)**	**6**	**6.91**	**7.27**	**-0.36**
11	Income from equity shares and participating interests	7	221.36	89.58	131.78
12	Net result of pooling of monetary income	8	173.55	514.17	-340.62
13	Other income and losses	9	120.88	-4.55	125.43
14	**TOTAL NET INCOME (3 + 7 + 10 + 11 + 12 + 13)**		**3,633.58**	**4,279.10**	**-645.52**
15	Staff costs	10	217.83	210.91	6.92
16	Administrative expenses	11	125.46	119.38	6.08
17	Depreciation of tangible and intangible fixed assets	12	30.43	30.60	-0.17
18	Banknote production services	13	70.31	47.43	22.88
19	Other expenses		3.21	2.92	0.29
20	**TOTAL OPERATING EXPENSES (15 + 16 + 17 + 18 + 19)**		**447.25**	**411.24**	**36.01**
21	Transfers and additions to other funds and provisions	14	38.75	22.63	16.13
22	**PROFIT FOR THE YEAR (14 – 20 – 21)**	**15**	**3,147.58**	**3,845.23**	**-697.66**

Countersigned by
The Governor,

Luis M. Linde de Castro

The Comptroller,

Javier Pacios Rodríguez

3 NOTES ON THE ACCOUNTS

3.1 Accounting policies

The annual accounts of the Banco de España present fairly its net worth and 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.

1 BASIC PRINCIPLES

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 foreign currency 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 loss 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 and they can be 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 forms 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 loss 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.[3]

3 Securities classified as held-to-maturity may be sold before their maturity in any of the following circumstances: a) if the quantity sold is considered not significant in comparison with the total amount of the held-to-maturity securities portfolio; b) if the securities are sold during the month of the maturity date; and c) under exceptional circumstances, such as a significant deterioration of the issuer's creditworthiness, or following an explicit monetary policy decision of the Governing Council.

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 loss 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. Such losses are considered irreversible in subsequent revaluations. 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, the latter also consisting of held-to-maturity securities, 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, in the case of securities 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 27 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 27 to the balance sheet and Note 5 to the profit and loss account).

Shares and participating interests

The shares in the Bank for International Settlements and the participating interest in the European Central Bank (ECB) are valued at cost.

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, applied to the total acquisition cost of the project.

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 2013 were as follows:

	Depreciation/ Amortisation 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 motorbikes	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.[4] 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.[5]

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.

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.

4 Decision of the European Central Bank of 13 December 2010 on the issue of euro banknotes (ECB/2010/29), as amended.

5 The banknote allocation key is that which results from applying 92% to the Eurosystem subscribed capital key.

These claims or liabilities, which incur interest,[6] 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[7] 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 being divided among the rest of the national central banks according to their respective weightings in the capital key of the ECB. 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.

The ECB's income arising from the euro banknotes in circulation assigned to it and from securities purchased under the Securities Markets Programme are allocated in full to the NCBs in the financial year in which it accrues.[8] Settlement of this income takes place on the last working day in January of the following year, in the form of an interim distribution of the income. The Governing Council may decide to reduce the distributable ECB income on euro banknotes in circulation by the costs incurred by the ECB in connection with the issue and handling of banknotes. The ECB Governing Council shall decide whether all or part of the ECB's income arising from securities purchased under the Securities Markets Programme and 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" in the year in which this income accrued.

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[9] 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. In addition, the outcome of the

6 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).

7 The reference period taken has a duration of 24 months and it begins 30 months prior to the euro cash changeover date.

8 Decision of the European Central Bank of 19 December 2012 (ECB/2012/33) amending the European Central Bank Decision of 25 November 2010 (ECB/2010/24) on the interim distribution of the income of the European Central Bank on euro banknotes in circulation and arising from securities purchased under the securities markets programme.

9 Trans-European Automated Real-time Gross settlement Express Transfer system.

contribution and allocation of monetary income to NCBs and the positions vis-à-vis the ECB owing to the deferral of sundry receipts and payments also give rise to intra-Eurosystem balances.

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. The first-in first-out method is used for interest rate futures. 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 effective interest rate 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 joined the Bank after 1 February 1986, are eligible to and do participate in the Scheme, are recognised as a current expense in the year to which they relate.[10]

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 27 on the balance sheet).

Financial derivatives

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 in item 11.4 on the assets side or item 12.1 on the liabilities side, depending on their sign.

10 Contributions made by the Banco de España are established at 7.5% of the so-called "regulating salary" consisting of the salary items determined in the Scheme Rules, although in 2013, in application of Article 22. three of Law 17/2012 of 27 December 2012 on the State Budget for 2013, those contributions were not made.

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. The difference between the spot and forward exchange rates is recorded as interest income or expense, which can be in euro or in foreign currency, in the latter case forming part of the foreign currency position.

The gain or loss on 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 SALIENT FEATURES OF THE ESTIMATES MADE

These annual accounts were prepared using Bank estimates to quantify some of the assets, liabilities, income, expenses, commitments and, in particular, to quantify provisions recorded in them (see Note 27 on the balance sheet). As regards monetary policy operations, since they are conducted jointly in the Eurosystem, the estimates made by the ESCB are also taken into account [see Notes 6 and 7.a) on the balance sheet].

These estimates are based on the best information available at end-2013, and 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 GOLD RECEIVABLES

The Banco de España's gold holdings at year-end amounted to €7,887.81 million, consisting of 9.054 million troy ounces[11] of fine gold valued at a market price of €871.22 per ounce. These holdings did not change during the financial year. The value of these holdings is €3,530.59 million less than in 2012, as a result of the fall in the market price (at end-2012 the price per ounce was €1,261.18). This decrease 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 IMF quota is SDR 4,023.40 million and only the portion disbursed in foreign currency is reflected on the assets side of the balance sheet.

b) Special drawing rights (allocations). These represent the euro equivalent of the successive allocations of this currency by the IMF and their subsequent drawdown. These allocations are made by the IMF simply for being a member and their balancing entry is recorded in item 9 of the liabilities side of the balance sheet "Counterpart of special drawing rights allocated by the IMF", also denominated in SDRs. The changes in their balance are essentially due

11 One troy ounce is equal to 31.1035 grams.

to loan agreement transactions with third countries which are paid out of this account 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 PRGT[12], the NAB[13] and the Bilateral Loan Agreement entered into by the IMF and Spain in 2013. 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-2013 being €320 million (SDR 286.15 million). The NAB agreement, concluded to support the IMF's ability to provide financial assistance to its members, entailed a financial commitment of up to SDR 6,702.18 million, of which €972.36 million (SDR 869.50 million) had been drawn down up to end-2013. The bilateral loan agreement entailed a commitment of €14,860 million, none of which has been drawn down.

The SDRs in which claims on the IMF are denominated are valued at the year-end market rate, calculated by the ECB for all the Eurosystem NCBs, of €1 = SDR 0.894214. 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 SDR interest rate, which is updated weekly, remained at an average of 0.08%, with a high of 0.13% and a low of 0.03% during the year.

The breakdown in 2012 and 2013 is as follows:

EUR m

Type of asset	2013	2012	Change
Reserve tranche position	1,179.29	1,476.44	-297.15
Special drawing rights (allocation)	3,121.65	3,131.73	-10.08
Other claims on the IMF	1,292.37	1,299.65	-7.28
TOTAL	**5,593.31**	**5,907.82**	**-314.51**

The overall amount of claims on the IMF decreased by €314.51 million with respect to the balance at end-2012.

The decrease of €297.15 million in the reserve tranche position account is due to the overall effect of various factors:

— An increase of €148.39 million (SDR 127.30 million) due to the Banco de España's net contributions to the IMF for loans to third countries (Greece, Portugal and Ireland). These loans were made in euro through TARGET2 payments.

— A decrease of €395.56 million (SDR 339.33 million) due to repayments of loans by debtor countries (Romania, Hungary, Greece and Bosnia). These collections were in euro.

12 Poverty Reduction and Growth Facility.
13 New Arrangements to Borrow.

— A decrease of €49.98 million due to the change in the exchange rate of the SDR against the euro.

The "Special drawing rights (allocation)" account decreased by €10.08 million due to the overall effect of various factors:

— An increase of €269.48 million (SDR 231.17 million) due to SDR purchases required by the IMF, to collection of SDRs arising from partial repayment of some PRGT loans and to collection of interest on Spain's claims on the IMF.

— Decrease of €147.25 million (SDR 126.32 million) due to SDR sales required by the IMF and to payment of interest on Spain's liabilities to the IMF.

— Decrease of €132.31 million due to the effect of changes in market exchange rates.

The "Other claims on the IMF" account, which includes loans granted under NAB agreements and under the PRGT programme, decreased by €7.28 million due to the overall effect of certain factors:

— A net increase of €78.45 million (SDR 67.30 million) in NAB loans. The reasons for this increase were the new NAB loans granted for €162.38 million (SDR 139.30 million) and the partial repayments of the first NAB loan to Greece for €83.93 million (SDR 72.00 million). These SDR-denominated loans were made through payments in euro.

— A decrease of €30.96 million (SDR 26.56 million) in PRGTs due to partial repayments of these loans. These loans are in SDRs.

— A decrease of €54.78 million due to the change in the market exchange rate.

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 2013 was €20,018.55 million, with the following breakdown:

EUR m

Type of asset	2013	2012	Change
Deposits	151.00	132.07	18.93
Security investments	19,859.53	20,549.07	-689.54
Trading portfolio	10,933.43	14,523.61	-3,590.18
Held-to-maturity portfolio	8,926.10	6,025.46	2,900.64
Other	8.01	4.19	3.82
TOTAL	**20,018.55**	**20,685.34**	**-666.79**

As at 31 December 2013, 90.14% of these assets were denominated in US dollars and 9.84% in yen. The equivalent value in euro of these US dollar and yen amounts was

transferred to the balance sheet at the year-end market exchange rate (€1 = USD 1.3791 and €1 = YEN 144.72).

The decrease in the balance of this item (€666.79 million) was due to the net effect of the factors listed in the following table:

EUR m

Reason for change	Amount
Net investment	828.42
Changes of market exchange rates as at 31 December	-1,356.20
Changes of securities market prices as at 31 December	-49.40
Accrued interest receivable	-89.65
Other	0.05
TOTAL	**-666.79**

4 CLAIMS ON EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY

This balance sheet item may include current accounts, balances with banks and security investments. As at 31 December 2013, US dollar denominated time deposits at monetary financial institutions equivalent to €2,175.33 million (USD 3,000 million) were held.

The decrease of €401.60 million in this item with respect to the previous year was due to the discontinuation in late 2013 of reverse operations with Eurosystem credit institutions in connection with the US dollar Term Auction Facility, the year-end balance of which was €303.17 million. It was also due to the change in the exchange rate of the US dollar against the euro, which resulted in a decrease in the equivalent value in euro (€80.00 million) of the US dollar time deposits referred to above.

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	2013	2012	Change
Deposits	0.11	0.11	–
Security investments	402.17	812.69	-410.53
Trading portfolio	–	–	–
Held-to-maturity portfolio	402.17	812.69	-410.53
TOTAL	**402.28**	**812.81**	**-410.53**

Of the total of this heading (€402.28 million), most (€402.17 million) relates to fixed-income securities included in the held-to-maturity portfolio, which decreased by €410.53 million with respect to the balance as at 31 December 2012. This portfolio consists of euro-denominated securities issued by international organisations (the European Investment Bank and the Bank for International Settlements). The trading portfolio, as in 2012, 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 €752,288 million, of which €195,170.41 million 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 27.- Provisions). The losses may only be recognised if the counterparty fails and insufficient funds are received from resolution of the collateral received from the institution. The Governing Council of the ECB has, in certain cases, excluded from risk sharing a portion of the collateral accepted by central banks.[14]

The breakdown by type of transaction is as follows:

EUR m

Type of operation	2013	2012	Change
Main financing operations	17,106.70	45,735.00	-28,628.30
Longer-term refinancing operations	178,063.59	315,351.79	-137,288.20
Fine-tuning reverse operations	–	–	–
Structural reverse operations	–	–	–
Marginal lending facility	–	–	–
Credits related to margin calls	0.12	0.09	0.03
TOTAL	**195,170.41**	**361,086.88**	**-165,916.47**

Throughout the whole of 2013, the improvement in the market situation reduced the precautionary demand for liquidity, while Spanish banks found it easier to access wholesale funding. This was reflected in a decline in the amounts requested in Eurosystem refinancing operations.

As a result, the balance of this item as at 31 December 2013 is 45.9% lower than that of 2012. The average daily balance of the financing granted during the year decreased by 21.8% (€258,300.27 million in 2013, against €330,404.71 million in 2012).

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 2013, continuing the trend initiated in previous years, they were used less than longer-term refinancing operations. In this connection, it should be noted that 8.8% of annual average financing was extended through them. In 2013 these operations were conducted at fixed rate with allotment of the total amount bid.

The balance of this item at 31 December 2013 was €17,106.70 million (€45,735.00 million at 31 December 2012) and its daily average balance during the year was €22,713.90 million (€35,640.50 million in 2012).

b Longer-term refinancing operations

These operations aim to provide counterparties with additional longer-term refinancing. In 2013 operations were conducted with maturities equal to the reserve maintenance period

14 The total collateral provided by institutions under loan agreements, valued by Eurosystem rules and applying the related haircuts, amounted to €341,995.87 million at 2013 year-end. Of this amount, €489.23 million relate to collateral excluded from risk sharing.

and with maturities of three months. These operations were conducted at fixed rate with allotment of the total amount bid.

The balance of these operations at 2013 year-end was €178,063.59 million (91.2% of the total) and arose mainly from three-year refinancing operations carried out exceptionally in 2011 and 2012. Compared with 2012, their balance decreased by €137,288.20 million. Also, the average balance decreased (from €294,562.87 million in 2012 to €235,585.93 million in 2013), representing 91.2% of annual average financing from monetary policy operations. Most of the decrease in this balance took place in January when institutions availed themselves of the early redemption option offered by three-year refinancing operations.

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.

No fine-tuning reverse operations took place in the Eurosystem in 2013. Their end-2013 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-2013 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 2013 was zero, no Spanish institutions having had recourse to this type of funding.

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, if so envisaged).

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 until November 2013 and at the deposit facility rate from December.

As at 31 December 2013 this item had a balance of €0.12 million, up €0.03 million with respect to the previous year. However, its average balance decreased from €69.17 million in 2012 to €0.44 million in 2013.

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[15] and under the Securities Markets Programme.[16] These securities were classified as held-to-maturity (see "Securities" in Section 3.1 "Accounting policies") and are subject to a yearly impairment test. The balance of this item as at 31 December 2013 was €29,586.07 million. The breakdown is as follows:

EUR m

Monetary policy portfolio	2013	2012	Change
Covered bond purchase programme	5,508.79	6,220.63	-711.83
Second covered bond purchase programme	2,326.50	2,299.99	26.52
Securities markets programme	21,750.78	24,468.91	-2,718.13
TOTAL	**29,586.07**	**32,989.53**	**-3,403.45**

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 throughout 2013.

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. These purchases were completed at the end of October 2012, when the programme ended. The net increase in this item in 2013 was due to accrual of the premiums and discounts relating to these securities.

Under the Securities Markets Programme established in May 2010, the Eurosystem central banks could 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 was to address the poor functioning of securities markets and re-establish an appropriate monetary policy transmission mechanism. On 6 September 2012 the ECB Governing Council decided to end this programme, the securities in this portfolio being held until maturity. The net decrease in the balance of this item in 2013 was due to the redemption of securities throughout the year.

The ECB Governing Council periodically evaluates the financial risks associated with the securities held under the Securities Markets Programme and the two covered bond purchase programmes.

The total amount of the securities acquired by all Eurosystem NCBs under the aforementioned Securities Markets Programme amounted to €165,846 million, of which €21,750.78 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.

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15 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).

16 Decision of the ECB of 14 May 2010 establishing a Securities Markets Programme (ECB/2010/5).

As a result of the impairment test conducted at end-2013, the ECB Governing Council identified an impairment indicator relating to the holdings of Irish bonds. The ECB Governing Council considered that this development did not signify any impairment of the securities purchased under the Securities Markets Programme and that, according to the information available as at 31 December 2013, there was no evidence of any change in the estimated future cash flows. Hence no impairment losses were recorded on the holdings of Irish bonds purchased under the Securities Markets Programme or on any of the other securities purchased under that programme.

As regards the impairment test conducted on the securities purchased under the covered bond purchase programmes, it was considered that, although some of the issuers of those securities were subject to restructurings in 2013, this did not affect the expected cash flows and therefore no impairment losses were recorded.

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	2013	2012	Change
Trading portfolio	29,831.44	36,408.59	-6,577.15
Held-to-maturity portfolio	28,794.34	27,532.44	1,261.90
TOTAL	**58,625.78**	**63,941.03**	**-5,315.26**

The balance of this item as at 31 December 2013 was €58,625.78 million, of which 50.9% relate to trading portfolio securities and the remainder (49.1%) to held-to-maturity securities, with no evidence of impairment at year-end.

Overall, these securities decreased by €5,315.26 million in 2013. It was, however, trading securities which underwent a decrease, of €6,577.15 million, whereas held-to-maturity securities increased by €1,261.90 million, for the purpose of equalising the balances of these two portfolios.

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/amortisation of securities	-7,657.32	1,264.26	-6,393.06
Unrealised gains at year-end (a)	954.93	—	954.93
Unrealised losses at year-end (a)	-0.03	—	-0.03
Accrued implicit interest	125.26	-2.37	122.90
TOTAL	**-6,577.15**	**1,261.90**	**-5,315.26**

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.

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. Since these loans are recorded at their nominal amount, a provision has been set up for possible losses from early repayment (see Note 27 on the balance sheet).

In accordance with this agreement, two instalments of each loan (that for 2013 and the last instalment outstanding under the original repayment schedule) were received in 2013.

The outstanding nominal balance as at 31 December 2013 of the loans granted to the State amounted to €1,943.37 million, broken down as follows:

EUR m

	2013	2012	Change
Treasury. Law 3/1983 special account	390.50	585.75	-195.25
Treasury. Law 4/1990 special account	1,389.59	2,084.39	-694.80
Treasury. Credits arising from subscription for participating interests, contributions and quotas in international agencies	163.27	244.90	-81.63
TOTAL	**1,943.37**	**2,915.05**	**-971.68**

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 BALANCES

This heading includes the amounts of the following items:

EUR m

Type of asset	2013	2012	Change
Participating interest in the ECB	1,077.72	1,078.50	-0.78
Claims equivalent to the transfer of foreign reserve assets to the ECB	4,782.87	4,783.65	-0.77
Net claims related to the allocation of euro banknotes within the Eurosystem	47,244.47	34,216.14	13,028.33
TOTAL	**53,105.07**	**40,078.29**	**13,026.78**

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. On 1 July 2013 the ECB capital key was again changed as a result of the Croatian central bank joining the ESCB. Accordingly, based on the Council Decision of 15 July 2003 on the statistical data to be used for the determination of the key for subscription of the

capital of the European Central Bank, the capital keys of the NCBs were adjusted on 1 July 2013 by means of transfers among the NCBs. On 1 July 2013 the Banco de España's key for subscription of ECB capital was changed from 8.3040% to 8.2533%.

In accordance with Article 48.3 of the Statute of the ESCB, the ECB's subscribed capital is automatically increased when a new member joins the EU and its NCB joins the ESCB. The increase is determined by multiplying the prevailing amount of the subscribed capital (in this case €10,760.65 million) by the ratio, within the expanded capital key, between the weighting of the entering NCB(s) and the weighting of those NCBs that are already members of the ESCB. Therefore, on 1 July 2013 the subscribed capital of the ECB was increased to €10,825.01 million. Consequently, on 1 July 2013, the share that the Banco de España held in the increased subscribed capital of the ECB decreased from 8.3040% to 8.2533% and the participating interest in the ECB went from €893.56 million to €893.42 million.

The ECB capital key is as follows:

	Key for subscription to the ECB's capital (%)	
	Until 30 June 2013	Since 1 July 2013
Nationale Bank van België/Banque Nationale de Belgique	2.4256	2.4176
Deutsche Bundesbank	18.9373	18.7603
Eesti Pank	0.1790	0.1780
Central Bank and Financial Services Authority of Ireland	1.1107	1.1111
Bank of Greece	1.9649	1.9483
Banco de España	8.3040	8.2533
Banque de France	14.2212	14.1342
Banca d'Italia	12.4966	12.4570
Central Bank of Cyprus	0.1369	0.1333
Banque centrale du Luxembourg	0.1747	0.1739
Central Bank of Malta	0.0632	0.0635
De Nederlandsche Bank	3.9882	3.9663
Oesterreichische Nationalbank	1.9417	1.9370
Banco de Portugal	1.7504	1.7636
Banka Slovenije	0.3288	0.3270
Národná banka Slovenska	0.6934	0.6881
Suomen Pankki – Finlands Bank	1.2539	1.2456
Subtotal for euro area NCBs	**69.9705**	**69.5581**
Българска народна банка (Bulgarian National Bank)	0.8686	0.8644
Česká národní banka	1.4472	1.4539
Danmarks Nationalbank	1.4835	1.4754
Latvijas Banka	0.2837	0.2742
Lietuvos bankas	0.4256	0.4093
Magyar Nemzeti Bank	1.3856	1.3740
Narodowy Bank Polski	4.8954	4.8581
Banca Națională a României	2.4645	2.4449
Sveriges Riksbank	2.2582	2.2612
Bank of England	14.5172	14.4320
Hrvatska narodna banka	–	0.5945
Subtotal for non-euro area NCBs	**30.0295**	**30.4419**
TOTAL (a)	**100.0000**	**100.0000**

a Due to rounding, the subtotals and totals may not equal the sum of the individual figures in the table.

This item also includes the participating interest in the rest of ECB equity. Its balance of €184.30 million at 31 December 2013 is the amount paid 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. In 2013, as a result of the aforementioned change in the capital key, this participating interest decreased by €0.78 million. Accordingly, the Banco de España's share in ECB capital is €1,077.72 million.

A noteworthy post-balance-sheet event was that, as a result of the third five-yearly change in the capital keys, on 1 January 2014 the key for subscription of ECB capital increased from 8.2533% to 8.8409%.

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 latest available marginal rate for the Eurosystem's main refinancing operations, reduced by 15% to reflect a zero return on the gold component, which at the time accounted for 15% of the total reserves transferred. Their year-end balance amounted to €4,782.87 million, down €0.77 million from the previous year. The reasons for this decrease is that the adjustments to the capital key and the resulting changes in the NCBs' participating interests in the subscribed capital of the ECB made it necessary to also adjust the assets that the ECB credited to the NCBs for their contributions of external reserve assets to it.

A noteworthy post-balance-sheet event was that, due to the increase in the Banco de España's share of the ECB capital key on 1 January 2014, an additional contribution of foreign reserve assets was made to the ECB for the equivalent of €340.52 million, as a result of which the balance this year rose to €5,123.39 million.

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

This item, the balance of which amounted to €47,244.47 million at end-2013, 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 2012 (€13,028.33 million) was basically due to the decrease in banknotes put into circulation by the Banco de España in 2013 (-12.7%, €8,292.53 million) and the contrasting rise in the Eurosystem as a whole (growth of 4.8%), which resulted in the aforementioned increase in the balance of these accounts.[17]

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 22 on the balance sheet).

10 OTHER ASSETS. TANGIBLE AND INTANGIBLE FIXED ASSETS

The balance of this item amounted to €257.97 million at end-2013, of which €664.05 million related to cost and €406.07 million to accumulated depreciation.

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

17 The increase in the Eurosystem as a whole was €43,593.28 million, of which €4,758.64 million related to the Banco de España.

EUR m

	2013	2012	Change
Tangible fixed assets	521.19	511.86	9.34
Land and unbuilt plots	5.35	5.35	–
Buildings, structures and renovation work	111.51	109.96	1.55
Plant in buildings	191.28	185.41	5.87
Furniture and fittings	38.78	38.09	0.68
Office machines other than computer equipment	54.77	54.16	0.61
Computer equipment	61.48	60.97	0.52
Transport equipment	8.12	8.12	–
Libraries	5.02	5.29	-0.28
Other tangible fixed assets	5.11	5.07	0.04
Art collection	39.78	39.43	0.34
Intangible fixed assets	89.10	83.43	5.66
Computer applications	89.04	83.38	5.66
Industrial property	0.06	0.06	–
Fixed assets in progress	53.76	47.77	5.99
Buildings, plant in buildings and other structures	8.15	9.41	-1.26
Computer applications of Banco de España	18.60	13.05	5.55
Computer applications of Eurosystem	25.90	24.43	1.47
Other fixed assets in progress	1.10	0.87	0.23
TOTAL	**664.05**	**643.06**	**20.99**

EUR m

Accumulated depreciation or amortisation	2013	2012	Change
Tangible fixed assets	-338.00	-319.88	-18.11
Buildings, structures and renovation work	-41.50	-38.96	-2.55
Plant in buildings	-151.44	-143.01	-8.44
Furniture and fittings	-31.43	-28.95	-2.48
Office machines other than computer equipment	-45.42	-44.36	-1.06
Computer equipment	-52.96	-49.97	-2.99
Transport equipment	-7.67	-7.29	-0.38
Libraries	-3.06	-3.13	0.07
Other tangible fixed assets	-4.52	-4.22	-0.30
Intangible fixed assets	-68.08	-59.50	-8.58
Computer applications	-68.02	-59.45	-8.58
Industrial property	-0.06	-0.06	–
TOTAL	**-406.07**	**-379.39**	**-26.69**

The increase in fixed assets in 2013 basically arose from increased investment in development of certain computer applications, from the acquisition and updating of software licences and from the implementation of various projects for the Eurosystem. It was also due to the new security control centre of the Cibeles building and to the continuing refurbishment of the banking hall and adjacent areas at the Cibeles building. Notwithstanding the above, fixed assets net of depreciation decreased with respect to the previous year by €5.70 million.

11 OTHER ASSETS. OTHER FINANCIAL ASSETS

This item includes €25.25 million of financial investments relating to the Banco de España's participating interests in the Bank for International Settlements. The decrease of €20.45 million in these financial assets was due to the sale of Banco de España's holding in Sociedad Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A. (see Note 9 on the profit and loss account).

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, it is recorded under the same heading in liability item 12.1. Its debit balance of €104.07 million as at end-2013 is the net value of the swap and forward transactions outstanding at that date that are listed below:

		2013				2012
Operation	Position	Currency	Currency amount (million)	Market exchange rate	Equivalent (million €)	Equivalent (million €)
Swap	Debtor	EUR	–	1.0000	–	304.95
		USD	2,858.83	1.3791	2,072.97	2,232.73
	Creditor	JPY	284,942.93	144.7200	1,968.93	2,072.26
		USD	–	1.3791	–	303.17
Forward	Debtor	USD	0.58	1.3791	0.42	0.67
	Creditor	JPY	57.08	144.7200	0.39	0.62
NET POSITION					**104.07**	**162.30**

At year-end there were unexpired US dollar-yen swaps and forward sales of yen against US dollars yet to be executed.

The purpose of the US dollar-yen swaps is to cover the yen-US dollar exchange rate risk on investments in yen-denominated securities.

Regarding the exceptional liquidity-providing transactions in the form of swaps, it should be noted that on 4 December 2012 the ECB Governing Council decided, in agreement with the central banks involved, to prolong the liquidity provision agreements (swap line) with the Federal Reserve until 1 February 2014. Previously, these agreements had been authorised until 1 February 2013. However, at year-end there were no outstanding transactions.

13 OTHER ASSETS. ACCRUALS AND PREPAID EXPENSES

The main components of this item, the balance of which amounts to €4,492.89 million, are as follows:

EUR m

	2013	2012	Change
Accrued interest arising from securities acquisitions and accrued coupon interest receivable	2,069.67	2,183.95	-114.28
Trading portfolio	763.85	873.78	-109.93
Denominated in foreign currency	34.17	54.59	-20.42
Denominated in euro	729.68	819.19	-89.50
Held-to-maturity portfolio	700.80	643.12	57.67
Denominated in foreign currency	54.46	37.97	16.50
Denominated in euro	646.33	605.16	41.18
Held for monetary policy purposes	605.02	667.04	-62.02
Other accrued interest receivable	2,418.18	2,636.78	-218.60
On monetary policy operations	2,347.68	2,521.93	-174.26
On intra-Eurosystem claims arising from banknotes adjustments	41.84	59.99	-18.15
On claims equivalent to the transfer of foreign reserves to the ECB	22.81	36.43	-13.61
On foreign currency deposits	3.57	15.11	-11.54
Claims on the IMF	1.28	1.54	-0.26
On swaps operations	0.96	1.58	-0.61
Other	0.04	0.20	-0.16
Accrued commissions receivable and prepaid expenses	5.04	4.58	0.46
TOTAL	**4,492.89**	**4,825.31**	**-332.42**

As can be seen in the above table, the most significant item relates to accrued interest receivable on monetary policy operations, which decreased (by €174.26 million) due to the smaller volume of outstanding long-term transactions at year-end, as institutions availed themselves of the early redemption options offered by the three-year refinancing operation. The other main accounts are accrued interest arising from securities purchases and accrued coupon interest receivable denominated in euro arising from the trading portfolio (€729.68 million), from the held-to maturity portfolio (€646.33 million) and from monetary policy operations (€605.02 million). Overall, this interest decreased by €114.28 million from the previous year, due to the smaller year-end balance of the trading and monetary policy operations portfolios. There was also a decrease in interest receivable on claims equivalent to the transfer of foreign reserve assets to the ECB, the interest accrued on intra-Eurosystem banknote adjustment and offsetting accounts as a result of the lower interest rate on main refinancing operations and the lesser interest receivable on foreign-currency deposits .

14 OTHER ASSETS. SUNDRY

The most significant components of this item, which totals €1,577.52 million, are the transfer to the Treasury on 2 December 2013 of €1,385.56 million, equivalent to 70% of the Bank's profits earned to 30 September 2013, adjusted in line with the projected performance of profits up to year-end (see Note 15 on the profit and loss account), which was €346.98 million lower than in the previous year, and the home loans and repayable advances granted to Bank employees, the balance of which, at €177.57 million, was down by €11.20 million from 2012.

15 BANKNOTES IN CIRCULATION

The balance of banknotes in circulation (€104,377.15 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, which went from 10.9185% of the total issue by all central banks to 10.9160% of the total. This key is obtained by taking the Eurosystem capital key and deducting the 8% of the total corresponding to the ECB. The decrease arose from the changes in the ECB capital key as a result of the central bank of Croatia joining the ESCB on 1 July 2013.[18]

This balance was €4,735.80 million higher than in the previous year because of the greater volume of euro banknotes in circulation in the Eurosystem. The difference between the balance of the banknotes allocated as per the balance sheet and those put into circulation by the Banco de España is recorded in an adjustment account under this heading, with a balancing entry in item 9.4 on the assets side of the balance sheet.

The composition of the banknotes put into circulation by the Banco de España as at end-2013 is as follows:

Series	Number of banknotes (thousands)	Millions of euro
€500	80,976	40,487.80
€200	13,048	2,609.69
€100	23,663	2,366.29
€50	862,136	43,106.80
€20	-1,132,119	-22,642.38
€10	-839,848	-8,398.48
€5	-79,408	-397.04
Euro banknotes put into circulation by the Banco de España		57,132.68
Adjustment as per banknote allocation key		47,244.47
Banknotes in circulation		104,377.15

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 €30,783.49 million at end-2013, €41,221.20 million less than in the previous year. This decline was basically due to the sharp decrease in the deposit facility, minimally offset by the increase in the balances of credit institution current accounts (including minimum reserves).

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

EUR m

Type of liability	2013	2012	Change
Current accounts (covering the minimum reserve system)	15,949.79	12,851.75	3,098.04
Deposit facility	14,833.00	59,046.50	-44,213.50
Fixed-term deposits	–	–	–
Fine-tuning reverse operations	–	–	–
Deposits related to margin calls	0.70	106.45	-105.74
TOTAL	**30,783.49**	**72,004.69**	**-41,221.20**

18 Following the five-yearly revision of the central banks' share of ECB capital and the accession of the Latvian central bank to the Eurosystem on 1 January 2014, the banknote allocation key increased to 11.6230%.

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 an increase of €3,098.04 million (24.1%). These accounts are remunerated at the average of the marginal interest rate on main refinancing operations in the period. Its average balance also increased during the year, rising from €12,338.95 million in 2012 to €13,446.87 million in 2013 (9.0%).

The item "Deposit facility", which includes overnight deposits remunerated at a fixed interest rate (lower than the interest rate on main refinancing operations), decreased sharply from €59,046.50 million in 2012 to €14,833.00 million in 2013. Its average balance also decreased (€9,446.23 million in 2013 compared with €35,059.14 million in 2012), since remuneration of these deposits ceased on 11 July 2012.

The balance of fixed-term deposits was zero as at 31 December 2013. They are fine-tuning operations (liquidity withdrawals) that take the form of deposits. During 2013 the Eurosystem carried out 53 operations of this type. The average balance decreased during the year from €39.50 million in 2012 to €4.57 million in 2013.

The other captions in this item relate to fine tuning reverse operations and deposits related to margin calls. Fine tuning reverse operations are used to withdraw liquidity. As at 31 December 2013, fine tuning reverse operations had a zero balance, while institutions' deposits related to margin calls (see Note 6 on the balance sheet) amounted to €0.70 million (€106.45 million in 2012).

17 OTHER LIABILITIES TO EURO AREA CREDIT INSTITUTIONS DENOMINATED IN EURO

This item includes the deposits held by credit institutions at the Banco de España which are not related to monetary policy operations.

Its balance was €0.63 million at end-2013, €109.38 million less than in 2012, because of the release in the reporting year of the deposit of a credit institution which had been frozen in 2012 to prevent the legal limit on covered bond issuance being breached as a result of the transfer of assets to Sareb (asset management company for assets arising from bank restructuring).

18 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 €2,116.77 million, which breaks down as follows:

EUR m

	2013	2012	Change
Central government (State)	410.92	6,306.83	-5,895.91
Treasury current account	100.12	2,500.42	-2,400.30
Other central government agencies and similar bodies	310.80	3,806.41	-3,495.61
Territorial government	555.44	498.88	56.57
Regional (autonomous) governments, administrative agencies and similar bodies	554.76	498.53	56.23
Local government	0.68	0.35	0.34
Social security funds	1,150.41	2,204.28	-1,053.88
Social Security System	1,148.60	2,203.36	-1,054.76
Other	1.81	0.92	0.89
TOTAL	**2,116.77**	**9,009.99**	**-6,893.22**

The decrease in this item (€6,893.22 million) was due to the lower balances held by central government (down €5,895.91 million from 2012) and by social security funds (€1,053.88 million). The balances held by territorial governments increased by €56.57 million. As regards average balances, there was a decrease in those held by central government (€4,631.23 million in 2013 against €6,017.80 million in 2012) and by social security funds (€2,820.82 million in 2013 against €3,657.87 in 2012). By contrast, there was an increase in the average balances held by regional governments (€534.94 million in 2013 against €364.60 million in 2012).

Most of the balances held by central government are subject to a collateralised assignment to credit institutions through an auction conducted on behalf of the Treasury.

19 LIABILITIES TO OTHER EURO AREA RESIDENTS DENOMINATED IN EURO.- OTHER LIABILITIES

Included here are the current accounts of financial institutions other than credit institutions, such as the Deposit Guarantee 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 of €2,047.62 million at end-2013 was €105.76 million higher than at end-2012, basically due to the opening of new deposits in the name of the securitisation special purpose entities which so requested (€78.61 million) and to the larger balance held in deposits by legal entities classified in "Other resident non-financial sectors" (€42.07 million).

20 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 €144.98 million was €3.29 million higher than a year earlier due to an increase in deposits of international organisations and non-Eurosystem monetary authorities and to a decrease in deposits of central banks to which reserve management services are provided.

21 COUNTERPART OF SPECIAL DRAWING RIGHTS ALLOCATED BY THE IMF

This item of €3,162.06 million shows the equivalent amount of the special drawing rights allocated to Spain by the IMF, the balancing entry to the initial allocation of SDRs recorded in item 2.1 on the assets side of the balance sheet. The total amount of this item decreased by €134.02 million with respect to the previous year, due to the variation in the exchange rate.

22 INTRA-EUROSYSTEM BALANCES

This item, which as at 31 December 2013 had a balance of €213,382.14 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 (see Note 9 on the balance sheet).

b Other liabilities within the Eurosystem (net)

The balance of €213,382.14 million as at 31 December 2013 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 income on securities acquired by the ECB under the Securities Markets Programme.

The breakdown of the balance of this item is as follows:

EUR m

	2013	2012	Change
BDE's position vis-à-vis ECB due to transfers made and received through TARGET2 and correspondent banking	213,684.62	337,344.39	-123,659.77
Position with BCE due to contribution and allocation of monetary income	-139.97	-444.95	304.99
Dividend from banknote seigniorage and SMP income	-162.52	-68.20	-94.32
TOTAL	**213,382.14**	**336,831.24**	**-123,449.10**

Regarding the first component, the year-end net transfers via TARGET2 had a credit balance of €213,684.70 million, while the correspondent accounts showed a debit balance of €0.07 million. The remuneration of this position is calculated daily at the marginal interest rate of Eurosystem main refinancing operations. Its average balance decreased considerably during the year from €329,060.42 million in 2012 to €283,518.09 million in 2013 as a result of the decrease in the monetary policy loans on the assets side of the balance sheet.

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 €139.97 million at year-end (see "Net result of pooling of monetary income" in Note 8 on the profit and loss account).

Finally, in 2014 the ECB Governing Council resolved to distribute substantially all the income obtained from the securities purchased under the securities markets programme and from the seigniorage of euro banknotes.[19] The amount corresponding to the Banco de España was recorded as 2013 income and received on 31 January 2014. Its debit balance as at 31 December 2013 was €162.52 million (see "Income from equity shares and participating interests" in Note 7 on the profit and loss account).

23 ITEMS IN COURSE OF SETTLEMENT

Included here are various accounts which as at 31 December 2013 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 €1,679.49 million at end-2013, of which most notably €1,656.92 million related to transfers ordered by customers of the Banco de España not yet paid to the receiving entities and €20.44 million to transfers received from the TARGET2 Platform but yet to be processed.

19 Decision of the European Central Bank of 19 December 2012 (ECB/2012/33) amending Decision ECB/2010/24 on the interim distribution of the income of the European Central Bank on euro banknotes in circulation and arising from securities purchased under the Securities Markets Programme.

24 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, as in the reporting year, it is recorded under the same heading in asset item 11.4 (see Note 12 on the balance sheet).

25 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 2013, its balance amounted to €55.74 million and the main component was interest incurred on intra-Eurosystem accounts relating to TARGET2 transactions (€51.42 million), the balance of which was €175.53 million less than a year earlier due to decreases in both its balance and its interest rate.

26 OTHER LIABILITIES. SUNDRY

This includes other liabilities not classifiable above.

As at 31 December 2013 the balance of this item amounted to €120.27 million (€7.22 million more than in 2012) and its main sub-items were the "Cash immobilised under EU legislation drawn from book-entry government debt. Redemptions and interest" (€27.56 million) and "Sundry accounts payable and unallocated items. Accrued operating expenses" (€26.98 million).

27 PROVISIONS

With the exception of country-risk provisions, which are presented in the balance sheet as reductions of the value of the assets concerned, provisions are recorded under this item, with the following breakdown:

EUR m

	2013	2012	Change
For financial risks	8,713.12	7,274.95	1,438.17
For early repayment of special loans	99.17	363.89	-264.73
For exchange of withdrawn peseta banknotes	59.86	22.54	37.32
For counterparty risks in Eurosystem monetary policy operations	–	33.58	-33.58
For operational risk	40.75	24.83	15.92
For 2011-2014 collective labour agreement	7.28	–	7.28
For death and retirement assistance	61.35	56.74	4.61
For early and regular retirement	27.05	28.66	-1.61
For sundry liabilities and charges	5.10	1.14	3.95
TOTAL	**9,013.67**	**7,806.34**	**1,207.33**

Provision for financial risks

This is the most important provision. It results from merging the provision for exchange rate and interest rate risks with the provision for credit risks.

The balance of this provision as at 31 December 2013 amounted to €8,713.12 million, which was €1,438.17 million more than in 2012. Of the balance as at 31 December 2012 (€7,274.95 million), €241.40 million were used to cover exchange losses and €43.96 million to cover interest rate losses (no credit risk losses were incurred) and €1,723.53 million were provisioned for the estimated risk as at 31 December 2013 (see Note 5 to 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. In this connection,

on 7 February 2014 the Executive Commission reviewed the methodology for calculating the provision and, as a result, decided to increase the level of risk coverage.

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 at that time instead of their nominal amount, led the Banco de España to set up in that year a provision for the possible losses that may arise from early repayment of special 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. As at 31 December 2013 it had a balance of €99.17 million, down €264.73 million from the previous year (€95.24 million used in relation to repayment of the amount due in the year and €169.49 million for adjustment of loans to their market value).

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.[20] 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.

According to current estimates, the balance of the provision as at 31 December 2013 (€8.77 million) will foreseeably be exhausted by October 2014, so an additional amount has been provisioned to raise the balance to €58.96 million, which, according to the analysis by the Cash and Issue Department, is the estimated amount of banknotes which may be tendered for exchange up to 2020, the scheduled end-date of the exchange period.

Provision for counterparty risk in Eurosystem monetary policy operations

Based on the general accounting principle of prudence, the ECB Governing Council considered it appropriate in 2008 to create a buffer totalling €5,736 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 the national central banks of participating Member States 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 in that year. This provision is revised annually and its balance in the Eurosystem as a whole was €310 million at 31 December 2012 (€33.58 at the Banco de España). On 23 January 2014 the ECB Governing Council reviewed the adequacy of the amount of this provision with effect as at 31 December 2013 and decided to cancel it due to the disappearance of the risks covered. As a result of this, the Banco de España released in full the provision, which had a balance of zero at the end of the year (see Note 8 on the profit and loss account).

20 The provisions for exchange of peseta banknotes withdrawn from circulation also include another one for €0.90 million.

Provision for operational risk

The Executive Commission approved in 2009 a methodology for calculating operational risk with a view to setting aside a provision for any losses arising from operational risk. It recorded a provision equal to 10% of the operational risk exposure. This exposure is quantified on the basis of one-year VaR (value at risk) with a confidence level of 99.9%.

This provision was used to cover the operational risk events which occurred in 2013 (see Note 14 on the profit and loss account) for an amount of €0.03 million, and the €15.95 million set aside took its balance to €40.75 million.

The increase in operational risk was mainly caused by the impact on VaR calculation of the losses recorded in 2012 as a result of discontinuation of the Eurosystem CCBM2 project.

Other provisions

In the reporting year there was a decrease in the provision for the expense of payments to early and regular retirees (€1.61 million), basically due to the provisioning of payments to be made under Article 184 of the Banco de España Conditions of Employment, the fifth transitional provision of the collective labour agreement for 2001 and the 2011 branch closure agreement.

The report year also saw an increase of €4.61 million in the provision for death and retirement assistance and a new provision of €7.28 million as a result of signature of the collective labour agreement for 2011-2014 (see Notes 10 and 14 on the profit and loss account).

28 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	2013	2012	Change
Gold	7,037.38	10,567.97	-3,530.59
Foreign currency	0.02	888.44	-888.43
Securities (trading portfolio)	2,001.13	1,096.14	904.99
Issued in foreign currency by non-euro area residents	11.92	61.87	-49.95
Issued in euro by euro area residents	1,989.21	1,034.28	954.93
Other	–	16.04	-16.04
TOTAL	**9,038.52**	**12,568.59**	**-3,530.07**

The balance of revaluation accounts at end-2013 was €9,038.52 million, down €3,530.07 million on 2012. The main change was in gold, the unrealised gains on which were €3,530.59 million lower as a result of the change in its market price (down from €1,261.18 per ounce at 31 December 2012 to €871.22 per ounce at 31 December 2013).

With regard to securities price revaluation accounts, the main change was in trading-book debt securities of euro area residents denominated in euro, the unrealised gains on which increased by €954.93 million as a result of the fall in interest rates.

As regards the foreign exchange revaluation accounts, the unrealised gains on foreign currencies decreased by €888.43 million, basically due to the depreciation of the US dollar and the SDR against the euro (€814.86 million and €73.57 million, respectively).

Losses on both currencies were recorded at year-end (see Note 4 on the profit and loss account)

29 CAPITAL

As at 31 December 2013 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.

30 RESERVES

As at 31 December 2013 the reserves of the Banco de España amounted to €899.81 million, down €50.19 million from the previous 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. The balance of the reserves derived from 2005 profits decreased as a result of the recording of the provision for exchange of peseta banknotes withdrawn from circulation due to the introduction of the euro (see Note 27 on the balance sheet).

31 PROFIT FOR THE YEAR

The net profit for 2013 amounted to €3,147.58 million, down 18.1% from 2012. Of this amount, €1,385.56 million was paid to the Treasury on 2 December 2013, in accordance with Royal Decree 2059/2008 of 12 December 2008 (see Note 15 on the profit and loss account "Profit for the year") and are included in asset item 11.6.

During the year, the following amounts were also paid to the Treasury out of 2012 profits:

a) On 1 March 2013, €1,728.17 million, which, together with the payment in December 2012, amounted to 90% of the €3,845.23 million of distributable profit for that year.

b) On 13 August 2013, once the balance sheet and profit and loss account for the year 2012 had been approved by the Council of Ministers, €384.52 million, representing the rest of the distributable profit for that year.

The details of the various components of the profit for 2013 and the reasons for the changes in them with respect to 2012 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 financial assets of the Banco de España. The breakdown in 2013 and 2012 is as follows:

1 INTEREST INCOME

EUR m and %

	Interest income			Average investment		Average return	
	2013	2012	Change	2013	2012	2013	2012
Foreign currency	242.12	278.32	-36.20	28,269	26,016	0.8	1.1
Securities	205.21	225.34	-20.13	20,495	19,174	1.0	1.2
Deposits and other assets	25.34	24.05	1.29	7,774	6,842	0.3	0.3
Exceptional liquidity-providing operations, swap, forward and other transactions	11.57	28.94	-17.36				
Euro	6,146.36	7,945.52	-1,799.16	393,341	464,151	1.5	1.7
Securities	4,409.83	4,745.77	-335.94	91,085	100,454	4.8	4.6
Trading portfolio	1,728.85	1,818.05	-89.20	32,809	36,188	5.2	4.9
Held-to-maturity portfolio	977.24	1,159.58	-182.34	27,196	31,683	3.5	3.6
SMP	1,347.00	1,438.98	-91.98	22,996	24,701	5.8	5.7
CBPP and CBPP2	356.74	329.16	27.58	8,083	7,883	4.4	4.1
Monetary policy operations	1,494.88	2,896.35	-1,401.46	258,300	330,405	0.6	0.9
Main refinancing operations	133.30	293.47	-160.17	22,714	35,640	0.6	0.8
Longer-term refinancing operations	1,361.58	2,600.93	-1,239.35	235,586	294,563	0.6	0.9
Other monetary policy operations	–	1.94	-1.94	–	201	0.5	0.9
Intra-Eurosystem accounts	236.86	290.87	-54.01	43,956	33,293	0.5	0.9
Claims equivalent to the transfer of foreign reserves to the ECB	22.81	36.43	-13.61	4,783	4,784	0.5	0.7
Claims related to allocation of euro banknotes within the Eurosystem	213.78	254.39	-40.61	39,136	28,501	0.5	0.9
Other claims within the Eurosystem (net)	0.27	0.06	0.21	37	7	0.7	0.8
Other assets	4.78	12.53	-7.74				
TOTAL	**6,388.48**	**8,223.84**	**-1,835.36**	**421,610**	**490,167**	**1.5**	**1.7**

Interest income in 2013 amounted to €6,388.48 million, of which €6,146.36 million was euro-denominated interest income, basically from euro-denominated securities portfolios (€4,409.83 million) and monetary policy operations (€1,494.88 million), the average yield on securities portfolios (4.8%) being notably higher than that on monetary policy operations (0.6%).

This income decreased by €1,835.36 million in 2013 compared with 2012 as a result of declines in interest on foreign-currency investments (€36.20 million) and particularly in euro-denominated investments (€1,799.16 million).

The main reasons for the decrease of €1,799.16 million in euro-denominated income were the smaller remunerated average balance (down from €464,151 million in 2012 to €393,341 million in 2013) and the lower average yield on monetary policy operations (down from 0.9% in 2012 to 0.6% in 2013).

Specifically, analysis of the average investment made discloses the significant decreases in monetary policy operations (€330,405 million in 2012 against €258,300 million in 2013), derived from the lower funding requested by Spanish financial institutions from the ECB (see Note 6 on the balance sheet) and in securities (down from €100,454 million in 2012 to €91,085 million in 2013). Furthermore, there was an increase in claims related to the allocation of euro banknotes, the average balance of which rose from €28,501 million in 2012 to €39,136 million in 2013 as a result of changes in banknotes put into circulation (down 12.7% in Spain, compared with 4.8% in the Eurosystem as a whole).

2 INTEREST EXPENSES

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

EUR m and %

	Interest expense			Average financing		Average cost	
	2013	2012	Change	2013	2012	2013	2012
Foreign currency	6.81	20.52	-13.72				
Exceptional liquidity-providing operations and other liabilities	6.81	20.52	-13.72				
Euro	1,714.81	3,096.00	-1,381.19	313,023	385,967	0.5	0.8
Monetary policy operations	60.64	167.62	-106.98	22,908	48,191	0.3	0.3
Remuneration of minimum reserves	60.56	104.97	-44.41	13,447	12,339	0.4	0.8
Deposit facility	–	56.20	-56.20	9,446	35,059	–	0.2
Fixed-term deposits	–	0.19	-0.19	5	39	0.1	0.5
Changes in the value of collateral	0.07	6.26	-6.19	11	754	0.7	0.8
General government deposits	17.71	50.37	-32.66	6,597	8,716	0.3	0.6
Other liabilities within the Eurosystem (net)	1,625.49	2,871.65	-1,246.17	283,518	329,060	0.6	0.9
Other liabilities denominated in euro	10.98	6.36	4.62				
TOTAL	**1,721.62**	**3,116.53**	**-1,394.91**	**313,023**	**385,967**	**0.5**	**0.8**

In 2013 various items previously classified under "Transfers and applications to other funds and provisions" are included under this heading because it is considered that their nature coincides more closely with this caption. The amount relating to 2012 which was reclassified was €3.71 million.

The euro-denominated interest expenses (€1,714.81 million) arise mainly from the remuneration of intra-Eurosystem TARGET2-related balances on the liabilities-side of the balance sheet (€1,625.49 million) and, to a much lesser extent, from remuneration of monetary policy operations (€60.64 million).

Overall, interest expenses decreased by €1,394.91 million in 2013, mainly due to the lower expense of euro-denominated liabilities (€1,381.19 million).

The decrease in euro-denominated expenses (€1,381.19 million) was basically due to the lower average cost at which liabilities were remunerated, which fell from 0.8% in 2012 to 0.5% in 2013 due to the lower interest rate on main refinancing operations and to the smaller average balance of liabilities to be remunerated (€385,967 million in 2012 compared with €313,023 in 2013). Specifically, the net credit balance of intra-Eurosystem balances (TARGET2) decreased from €329,060 million in 2012 to €283,518 million in 2013.

Also notable was the significant decrease in the average balance of the deposit facility, which was down from €35,059 million in 2012 to €9,446 million in 2013, coinciding with the change in status of these deposits, which stopped being remunerated on 11 July 2012.

The decrease of €32.66 million in interest expenses for general government deposits was basically due to the lower average cost (0.6% in 2012 against 0.3% in 2013) and to

the average balance remunerated (down from €8,716 million in 2012 to €6,597 million in 2013).

3 REALISED GAINS/LOSSES ARISING FROM FINANCIAL OPERATIONS

This item includes the profits and losses arising from dealing in financial assets. In 2013 the net loss in this connection amounted to €1.94 million, arising from the following sources:

EUR m

	2013	2012	Change
Foreign currency	-15.25	64.05	-79.30
Sale of gold	–	–	–
Sale of foreign currency (exchange gains)	10.66	14.09	-3.43
Sale of securities (price losses)	-33.42	64.06	-97.49
Other gains/losses	7.51	-14.10	21.61
Euro	13.32	68.20	-54.89
Sale of securities	13.32	68.20	-54.89
TOTAL	**-1.94**	**132.25**	**-134.19**

With respect to the prior year, the total amount recorded in 2013 decreased by €134.19 million due to losses on the sale of securities denominated in US dollars as a result of the tighter unit margin and to the lower gains on the sale of fixed-income securities denominated in euro, basically because of the smaller volume of sales.

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 2013 and 2012 is as follows:

EUR m

	2013	2012	Change
Foreign currency	285.34	0.99	284.35
Foreign currency (exchange rate losses)	241.40	0.10	241.30
Securities (price losses)	43.94	0.89	43.04
Euro	0.03	0.02	–
Securities (price losses)	0.03	0.02	–
TOTAL	**285.36**	**1.01**	**284.35**

Unrealised losses in 2013 amounted to €285.36 million. They mostly related to unrealised foreign currency exchange rate losses (€241.40 million), basically due to depreciation of the US dollar and the SDR, but a smaller portion related to unrealised price losses on fixed-income securities denominated in foreign currency (€43.94 million), basically due to changes in the market price of these securities.

5 TRANSFERS TO/FROM PROVISIONS FOR FINANCIAL RISKS

In the reporting year the provision for exchange rate and interest rate risks and the provision for credit risk were merged into a single provision for financial risks as recommended by the Risk Management Committee.

The breakdown of and change in this item are as follows:

EUR m

	2013	2012	Change
Net transfers to provisions for financial risks	-1,438.17	-1,737.99	299.82
Transfers to provision	-1,723.53	-1,739.00	15.47
Reversal/transfer from provision	285.36	1.01	284.35
Transfer/reversal from provision for losses arising from early repayment of special loans	169.49	172.06	-2.58
TOTAL	**-1,268.68**	**-1,565.92**	**297.25**

This includes, first, the transfer of €285.36 million from the provision for financial risks to cover the losses recorded at end-2013 and, second, the transfer of €1,723.53 million to this provision to cover the estimated exposures in the financial positions subject to such risks, in accordance with the criteria for valuing these risks approved by the Executive Commission resolution on 7 February 2014.

Lastly, regarding the provision for losses arising from early repayment of special loans derived from the adjustment of the market value of these assets, in 2013 the provisioning expense underwent a negative change of €2.58 million with respect to 2012, due to the recovery of €169.49 million in 2013 as against the recovery of €172.06 million in 2012.

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

	2013	2012	Change
1 Income from fees and commissions	17.55	19.32	-1.76
Foreign operations	–	–	–
Domestic operations	17.55	19.32	-1.76
2 Expenses from fees and commissions	10.64	12.04	-1.40
Foreign operations	2.78	3.10	-0.32
Domestic operations	7.86	8.94	-1.08
NET INCOME FROM FEES AND COMMISSIONS (1-2)	6.91	7.27	-0.36

Net fee and commission income in 2013 (€6.91 million) was €0.36 million less than in 2012. This variation relates basically to the lower fee income from securities transactions. This decrease in income was partially offset by the lower expense of fees and commissions paid on securities transactions. Both the lower fee income from securities transactions and the lower fees and commissions paid were due to the decrease in the volume of 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 and income generated by the ECB portfolio derived from the Securities Markets Programme. It also includes the dividends on other shares and participating interests.

EUR m

	2013	2012	Change
ECB	212.77	77.23	135.54
Ordinary dividend	50.25	9.04	41.21
Dividend from banknote seigniorage income and SMP income	162.52	68.20	94.32
OTHER	8.59	12.35	-3.76
TOTAL	**221.36**	**89.58**	**131.78**

Of the total amount of €221.36 million recorded, €162.52 million relate to the ECB dividend from banknote seigniorage income and income from the SMP portfolio, €50.25 million to the ECB ordinary dividend for 2012, €5.09 million to dividends on the participating interest in Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, SA (BME) and €3.49 million to dividends from holdings in the Bank for International Settlements.

On 9 January 2014 the ECB Governing Council decided to distribute among Eurosystem NCBs €1,369.69 million relating to substantially all the seigniorage income from its banknotes and to the income from its securities portfolio purchased within the framework of the securities market programme. The Banco de España received €162.52 million of this amount. The amount retained by the ECB to add to the provision for financial risks amounted to €0.39 million and with this addition the upper limit of this provision was reached.

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 net of the financial expenses incurred for the related liabilities. 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 income in 2012 and 2013 is as follows:

EUR m

	2013	2012	Change
Monetary income pooled	-1,840.53	-2,342.71	502.18
Monetary income allocated	1,980.50	2,787.66	-807.16
Provision for counterparty risk in monetary policy operations	33.58	69.22	-35.64
TOTAL	**173.55**	**514.17**	**-340.62**

The monetary income pooled by the Eurosystem is to be allocated or pooled among NCBs according to the ECB subscribed capital key. The difference between the monetary income pooled by the Banco de España in 2013, amounting to €1,840.53 million, and that reallocated to it, amounting to €1,980.29 million, is equivalent to a net allocation of €139.76 million. This net allocation has to be increased by €0.20 million for the Banco de España's share in the recovery of prior year expenses and realised losses. Compared with 2012, there was a decrease of €340.62 million in these results.

The basic reason for the positive net allocation of €139.97 million was that certain Eurosystem central banks held deposit facilities and fixed-term deposits which were overly large in proportion to their capital keys and remunerated at very low interest rates, so the financial expenses that can be deducted by these NCBs in determining monetary income are small.

Also, on 23 January 2014 the ECB Governing Council approved the cancellation of the provision for counterparty risk in Eurosystem monetary policy operations. Accordingly, the Banco de España released the provision recorded (€33.58 million), which had a balance of zero as at 31 December 2013 due to the inexistence of the risks covered.

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

	2013	2012	Change
Extraordinary profit	0.58	-7.18	7.76
Employee social welfare scheme	–	-2.24	2.24
Sundry	120.30	4.87	115.43
TOTAL	120.88	-4.55	125.43

This item discloses net income and losses of €120.88 million, compared with the losses of €4.55 million reported in 2012.

With respect to the previous year, the net income and losses increased by €125.43 million, basically due to the income on the sale in November of the shares of Bolsas y Mercados españoles, Sociedad Holding de Mercados y Sistemas Financieros S.A. (€117.42 million).

10 STAFF COSTS

This item includes wages and salaries, social insurance payments, staff welfare expenses and contributions to the pension scheme.

The breakdown of changes by component is as follows:

EUR m and %

	2013	2012	Change	(%)
Gross staff costs	219.34	212.18	7.16	3.4
Wages and salaries	162.68	160.27	2.41	1.5
Social Security	32.11	31.05	1.06	3.4
Staff welfare expenses and contributions to pension scheme	24.55	20.85	3.70	17.7
Reversal of staff costs due to capitalisation of computer applications	-1.51	-1.27	-0.24	18.9
TOTAL	**217.83**	**210.91**	**6.92**	**3.3**

Its balance increased from €210.91 million in 2012 to €217.83 million in 2013, a rise of €6.92 million (3.3%). The main reasons for this increase were the disbursement of the December 2013 "extraordinary" salary payment, equivalent to one-fourteenth of annual wages (not paid in 2012), and the provision recorded due to the conclusion of the collective labour agreement for years 2011-2014 (see Note 27 on the balance sheet).

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

	2013	2012	Change	%
Average number of employees	2,655.3	2,655.9	-0.7	–
Managerial staff	1,656.3	1,637.1	19.2	1.2
Administrative staff	826.6	840.4	-13.8	-1.6
Other	172.4	178.4	-6.0	-3.4

As at 31 December 2013, the Bank's total staff numbered 2,645 employees, 25 more than at the same date of the previous year. Regarding the staff composition by gender, at 31 December 2013 women accounted for 44.1% 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. In 2013 the Governor received a gross annual wage of €166,350 and the Deputy Governor received €195,730 in this connection. The elected members of the Governing Council received a gross annual wage of €51,800; if they belonged to the Executive Commission, the gross annual wage was €64,980.

In addition to the foregoing, the members of the governing bodies received equal amounts of fees for attending meetings of the body to which they belonged, set at €1,026.79 per meeting of the Governing Council and €492.46 per meeting of the Executive Commission.

11 ADMINISTRATIVE EXPENSES

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

EUR m and %

	2013	2012	Change	%
Gross administrative expenses	129.44	123.54	5.90	4.8
Rental and maintenance	33.09	34.74	-1.65	-4.7
Material and supply	11.59	11.67	-0.08	-0.7
External services	67.27	61.67	5.59	9.1
Training, promotion and selection	4.51	3.74	0.77	20.6
Sundry operating expenses	12.99	11.73	1.26	10.7
Reversal of administrative expenses due to capitalisation of computer applications	-3.97	-4.16	0.18	-4.4
TOTAL	**125.46**	**119.38**	**6.08**	**5.1**

The above table shows that, as in 2012, in 2013 the most significant administrative expenses were external services (€67.27 million), mainly IT services (€41.10 million) and rental and maintenance (€33.09 million), composed mainly of hardware and software rental and maintenance (€17.44 million) and property rental and maintenance (€10.54 million).

Goods and services expenses increased in 2013 (€6.08 million). The largest increase in the item was in "External services" (€5.59 million), basically due to higher IT expenses (€4.37 million) and in operating expenses, due to SEPA advertising expenses (€1.05 million).

"External services" include €128,470.87 (including VAT) relating to the fees of the external auditors (Deloitte, SL: €74,115.37 and KPMG Auditores, SL: €54,355.50) for the audits 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 2013 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 %

	2013	2012	Change	%
Depreciation of buildings, structures and renovation work	2.54	2.49	0.05	2.0
Depreciation of plant in buildings	9.06	9.00	0.06	0.7
Depreciation of furniture and fittings	2.15	2.11	0.05	2.2
Depreciation of office machines other than computer equipment	1.58	2.10	-0.52	-24.9
Depreciation of computer equipment	5.39	5.58	-0.19	-3.4
Depreciation of transport equipment	0.37	0.48	-0.11	-23.0
Depreciation of other tangible fixed assets	0.31	0.33	-0.02	-6.0
Depreciation of libraries	0.46	0.49	-0.02	-4.6
Amortisation of computer applications	8.56	8.02	0.54	6.7
TOTAL	**30.43**	**30.60**	**-0.17**	**-0.6**

13 BANKNOTE PRODUCTION SERVICES

This amount (€70.31 million) corresponds to payments made by the Banco de España to purchase banknotes from the Spanish Royal Mint. The increase with respect to the previous year (€22.88 million) was due to the larger volume of banknotes supplied by the National Mint, as follows:

		Banknotes charged (millions of banknotes)	
Series	Denomination	December 2013	December 2012
1	€50	414.7	155.7
2	€10	80.1	–
2	€5	483.5	499.2
	TOTAL	**978.3**	**654.9**

14 TRANSFERS AND ADDITIONS TO OTHER FUNDS AND PROVISIONS

Included here are sundry amounts provisioned for varying reasons, the provisions used and the additions to the Beneficent Social Fund.

In 2013 various items were reclassified from this heading to the caption "Interest expenses" because it is considered that their nature coincides more closely with that caption. The amount relating to 2012 which was reclassified was €-3.71 million.

The net transfers to these funds were as follows:

EUR m

	2013	2012	Change
Provision for operational risk	15.92	0.33	15.59
Provision for death and retirement assistance	5.27	2.57	2.70
Provision for early and regular retirement	5.25	8.01	-2.76
Provision for sundry liabilities and charges	3.78	0.15	3.63
Other	-0.93	–	-0.93
Beneficent social fund	9.47	11.57	-2.10
TOTAL	**38.75**	**22.63**	**16.13**

The net balance of transfers and applications to other funds and provisions in 2013 amounted to €38.75 million, compared with €22.63 million in 2012. Noteworthy was the net provisioning for operational risk of €15.92 million (see Note 27 on the balance sheet) and the provision of €9.47 million to the Beneficent Social Fund in 2013, compared with €11.57 million in 2012, meaning that the expense was €2.10 million lower. In 2013 €5.35 million were transferred to the provision for expenses relating to early and regular retirees, €5.27 million to the provision for death and retirement assistance and €3.96 million to the provision for litigation risk.

The Banco de España, because of the nature of its activity, is not an institution with a high environmental risk. Accordingly, in 2013 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, 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 2 December 2013 the Banco de España paid into the Treasury €1,385.56 million, equal to 70% of the profit recorded as at 30 September 2013.[21]

Given that the profit for the year amounted to €3,147.58 million, on 3 March 2014 €1,447.26 million were paid into the Treasury to complete the distribution of 90% of profits.

The payments to the Treasury of 2013 profit are as follows:

EUR m

1	Total profit for 2013	3,147.58
2	Payments to the Treasury	2,832.82
	On 2.12.2013	1,385.56
	On 3.3.2014. Difference between the above amount and 90% of profit as at 31.12.2013	1,447.26
3	Profit payable to the Treasury	314.76
	At date of approval of the 2013 accounts	314.76

21 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 €1,443.08 million. Accordingly, this amount was subtracted from the Banco de España profit of €3,422.45 million as at 30 September, resulting in a profit of €1,979.37 million, 70% of which was paid into the Treasury.

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	Undistributed profit	Provisions for risks	Total
A) 2013 OPENING BALANCE	**1,000.00**	**950.00**	**12,568.59**	**2,112.69**	**7,299.78**	**23,931.07**
1 Unrecognised net gains in profit and loss			-3,530.07			-3,530.07
In gold			-3,530.59			-3,530.59
In foreign currency			-888.43			-888.43
In securities			904.99			904.99
Other			-16.04			-16.04
2 Change in provisions		-50.19			1,454.09	1,403.89
3 2013 profit				3,147.58		3,147.58
4 Appropriation of profit				-3,498.25		-3,498.25
Payment to the Treasury of 2012 profit				-2,112.69		-2,112.69
Payment to the Treasury of 2013 profit				-1,385.56		-1,385.56
B) CHANGES IN THE YEAR B = 1+2+3+4		**-50.19**	**-3,530.07**	**-350.68**	**1,454.09**	**-2,476.86**
C) 2013 CLOSING BALANCES C = A + B	**1,000.00**	**899.81**	**9,038.52**	**1,762.02**	**8,753.87**	**21,454.21**

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 27 on the balance sheet), revaluation accounts (Note 28 on the balance sheet), capital (Note 29 on the balance sheet), reserves (Note 30 on the balance sheet) and profit for the year (Note 31 on the balance sheet and Note 15 on the profit and loss account).

Equity decreased by €2,476.86 million in 2013 due to the lower unrealised gains on gold (€3,530.59 million) and the higher provision for financial risks.

3.5 Risk management

The Banco de España is exposed to financial risks (market risk and credit risk) and to an operational risk which, as a result of its activity, could have a significant financial and reputational impact and affect the Bank's ability to continue meeting its objectives.

The Banco de España manages all its risks taking into account their differing nature.

All the systems and procedures used to assess, control, monitor and mitigate risks are evaluated periodically to ensure they are suitable for their intended purpose and are applied consistently.

Currently the Operations Department and the Control, Budget and Accounting Department are responsible for identifying, assessing, controlling, monitoring, mitigating and reporting risks.

The Executive Commission is entrusted with approving the rules on financial asset management at the Banco de España and the methodologies to be applied for estimating and mitigating financial risks.

The Operations Committee, at its daily meetings, proposes the distribution by currency, the authorised instruments and the limits per issuer and counterparty. It is the body entrusted with setting the modified duration target of the strategic (long-term) and tactical (short-term) benchmarks of the euro-denominated and US dollar-denominated trading portfolios. The Risk Management Committee is entrusted with proposing the risk assessment methodologies and provisioning levels to be forwarded to the Executive Commission.

At end-2013 a Financial Risk Department was created which in the future will be responsible for defining, developing and implementing risk policies and for measuring and controlling risks and reporting on them to the governing bodies of the Banco de España.

1 FINANCIAL RISKS

Financial risks comprise market risk, liquidity risk and credit risk. The risk assessment carried out by the Banco de España in 2013 found that the main risk, from a quantitative standpoint, is the market risk derived from foreign exchange rate and interest rate fluctuations. The Banco de España is also exposed, to a lesser extent, to credit risk.

1.1 Market risk

Market risk includes interest rate, foreign exchange rate and gold price risks.

Interest rate risk

Interest rate risk is the probability or possibility that the Banco de España may incur losses as a result of interest rate fluctuations.

The Bank's exposure to this type of risk derives mainly from the fixed-income securities in the trading portfolio, since their market value is affected by interest rate movements.[22] The level of exposure to this risk depends on the volume and maturity of holdings in this portfolio and on the volatility of interest rates.

The Bank's Operations Committee sets the modified duration of the strategic and tactical benchmarks of the euro-denominated and US dollar-denominated trading portfolios and establishes limits by means of +/- 0.25 fluctuation banks. On 17 December 2013 the target durations of the tactical benchmarks of US dollar-denominated and euro-denominated portfolios were set at 1 and 3, respectively.

Also, the level of risk is quantified through Value-at-Risk methodology (VaR) by calculating the maximum expected loss from interest rate fluctuations, with a one-year time horizon and a 99% confidence interval. The VaR figure calculated with this methodology for the trading portfolio is the main factor used to determine the amount to be provisioned for interest rate risk.

As at 31 December 2013 the interest rate exposure on the trading portfolio is assessed at €2,288 million and is covered in full by the provision for financial risks.

Foreign exchange rate and gold price risks

Foreign exchange rate risk is the probability or possibility that the Banco de España may incur losses as a result of movements in the exchange rates of the currencies forming part of its position.

The exposure to this risk derives from the currency position and from the volatility of exchange rates.

22 For accounting purposes, the Bank's trading portfolio is valued at market prices and its held-to-maturity portfolio is valued at amortised cost.

Foreign exchange rate risk is managed by setting ceilings on investment in each currency.

The Banco de España quantifies the exposure to this risk for the main currencies (USD and SDR) through Value-at-Risk methodology (VaR) by calculating the maximum expected loss with a one-year time horizon and a 99% confidence interval.

Based on the VaR as at 31 December 2013, the exchange rate risk amounts to €4,919 million and is covered in full by the provision for financial risks.

The exposure to gold price risk, which depends on the holdings of gold and on the volatility of its price, is covered in full by the existing revaluation accounts.

1.2 Liquidity risk

Liquidity risk is the probability or possibility of incurring losses because the institution is forced to liquidate its assets before maturity to meet its obligations.

As a central bank belonging to the Eurosystem, the Banco de España has no liquidity risk.

1.3 Credit risk

Credit risk is the probability or possibility that the Banco de España may incur losses as a result of total or partial non-compliance with their contractual obligations by the issuers, counterparties or depositors of its financial assets, or that it may incur losses derived from impairment of its credit quality.

The exposure to credit risk depends on the volume of the investment and on the credit quality of the counterparties.

Credit risk is managed by selecting creditworthy counterparties and setting quantitative limits per counterparty, issuer and asset, while assuring safety in investments and avoiding concentration risk.

The Banco de España assesses credit risk by VaR methodology with a one-year time horizon and a 99% confidence interval.

Based on VaR methodology, the estimated credit risk as at 31 December 2013 is €1,506 million, which is the total amount to be provisioned for credit risk.

The credit risk on monetary policy loans is not assessed because the transactions are adequately collateralised and, accordingly, the residual risk is small. This risk is managed in accordance with Eurosystem rules.

Also, the risks derived from the securities purchased under the Securities Markets Programme and under monetary policy loans are shared by the Banco de España in accordance with the ECB capital key, which is 11.87% for 2013.

2 OPERATIONAL RISK

The Banco de España defines operational risk as the risk of incurring losses due to the inadequacy or failure of internal processes, personnel and systems, or due to events outside the organisation. These losses are determined by how strongly the Bank's balance sheet, reputation or objectives are impacted by the materialisation of a risk event.

The Operational Risk Management System developed by the Bank following the guidelines set in the document entitled "International Convergence of Capital Measurement and

Capital Standards" (BIS, Basel II, June 2004) sets out policies, functions and procedures for proper operational risk management.

This system takes as its starting point an inventory of the functions, processes and activities of each organisational area of the Bank, which make up the Process Map. This inventory is needed to subsequently identify the attendant risks, which together constitute the Risk Map. This identification is based on an analysis of possible contingencies which may affect the Bank's functioning and of the specific measures taken to prevent them from occurring and/or to reduce damage if they do occur.

To determine the relative importance of the risks identified, these are assessed qualitatively according to: 1) the impact or damage they may cause (whether financial, reputational and/or in the form of non-compliance with objectives) and 2) how often they may occur. The risks thus measured are entered in the Risk Tolerance Matrix to establish the action levels and the trigger thresholds for notification to the related decision-making bodies The business areas inform the Risk Management Committee of the most significant risks and of the possible mitigation measures to reduce the severity and frequency of the contingencies identified. This committee is responsible for approving them and accepting the residual risks. The results of the assessment conducted by the areas are compared with the information drawn from the systematic register of loss events in order to adjust their impact and/or frequency of occurrence in line with actual events.

Also, the system includes a VaR-type quantitative approach for calculating operational risk exposure, which stems from the Advanced Measurement Approach (AMA), which may serve as a reference for deciding on the possible general provisioning for this risk through the related allowance. The Bank's VaR methodology estimates the maximum financial loss or value at risk due to operational losses affecting net worth, with a one-year time horizon and a 99% confidence interval.

The exposure to operational risk as at 31 December 2013 amounted to €407 million and a provision for operational risk was recorded for 10% of this amount.

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 2013 the Banco de España made no contributions whatsoever to this Fund.

4.2 Loss of profit

The table below shows the loans outstanding in 2013 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 2013	Interest rate received (%)	Reference interest rate (%)	Estimated loss of profit
Net State debt	1,441.64	–	0.55	7.93
Housing loans and repayable advances to employees	36.59	0.05	0.55	0.18
Housing loans	6.04	0.28	0.55	0.02
Repayable advances	30.55	–	0.55	0.17
TOTAL	**1,478.23**	–	**0.55**	**8.11**

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 1994 (Law 3/1983 loan, Law 4/1990 loan and credits arising from subscription for participating interests, contributions and quotas in international agencies), such that they all reach final maturity by 2015 at the latest and the Treasury can request early repayment of part or all of these facilities, paying on the due date the effective market price instead of the nominal amount. Under this agreement, in 2013 payment was received of two instalments of the aforementioned facilities (that for the reporting year and the last outstanding instalment of the original repayment schedule), the repayment date of all of them being brought forward from 31 December to 30 April. In accordance with the foregoing, on 30 April 2013 the Treasury paid to the Banco de España the amount of €876.44 million, the effective market price of the debt repaid on that date, equivalent to a nominal amount of €971.68 million.

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(Translation from the original in Spanish. In the event of discrepancy, the Spanish-language version prevails.)

Independent Auditors' Report on the Annual Accounts

To the Honourable Governor of the Banco de España,

We have audited the annual accounts of the Banco de España which, in accordance with article 29.1 of its Internal Rules, comprise the balance sheet at 31 December 2013, the income statement for the year then ended and the notes thereto.

Responsibility for the annual accounts

The Executive Commission of the Banco de España is responsible for organising the Bank and appointing its general managers. Under the Internal Rules of the Banco de España, the Directorate General Services is responsible for preparing the annual accounts in accordance with the internal accounting principles of the Banco de España, which are specified in note 3.1 to the accompanying annual accounts, based on the accounting regulations stipulated for the central banks that are members of the European System of Central Banks. This responsibility, which is exercised through the Control, Budget and Accounting Department, includes the audit of operations and, therefore, the design, implementation and maintenance of the relevant internal controls required for the preparation and appropriate presentation of annual accounts that are free from material misstatement due to fraud or error, the selection and application of the pertinent accounting principles, and making such estimates as deemed reasonable in the circumstances (see note 3.1.3 to the accompanying annual accounts). Pursuant to article 21.G) of Law 13/1994 of 1 June 1994 on the autonomy of the Banco de España, these annual accounts are prepared by the Governing Council of the Banco de España.

The auditors' responsibility

Our responsibility is to express an opinion on these annual accounts taken as a whole, based on our audit. We conducted our audit in accordance with International Standards on Auditing, which require that we comply with certain ethical standards and plan and perform the audit in such a way as to obtain reasonable assurance that the annual accounts are free from material misstatement or irregularities.

An audit entails the performance of procedures designed to obtain supporting evidence of the amounts and disclosures contained in the annual accounts. The procedures selected depend on the auditor's judgement, and include an assessment of the risk of material misstatements or irregularities arising in the annual accounts due to fraud or error. In assessing these risks the auditor takes into account the internal control system applied by the entity for the preparation and appropriate presentation of the annual accounts in order to design audit procedures that are suitable in 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 an evaluation of the appropriateness of the accounting policies used, the reasonableness of the entity's accounting estimates, and the overall presentation of the annual accounts. We consider that the evidence obtained is sufficient and adequate to provide a basis on which to express our auditors' opinion.

Opinion

In our opinion the accompanying annual accounts for 2013 present fairly, in all material respects, the equity and financial position of the Banco de España at 31 December 2013 and its financial performance for the year then ended, in accordance with the internal accounting principles of the Banco de España, which are specified in note 3.1 to the accompanying annual accounts, based on the accounting regulations stipulated for the central banks that are members of the European System of Central Banks.

KPMG Auditores, S.L.

María Eugenia Fernández-Villarán Ara

30 April 2014

2 REPORT OF THE BANCO DE ESPAÑA AUDIT COMMITTEE

We the undersigned, Ángel Luis López Roa, Carmen Alonso Ledesma and Maximino Carpio García, 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 2013.

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 2013, 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 2013, 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 of the accounting procedures, of the accounting records and of the internal controls in place, it can be inferred that the annual accounts for the year 2013 give a true and fair view of the net worth and financial position of the Banco de España.

Madrid, 7 April 2014.

Ángel Luis López Roa

Carmen Alonso Ledesma

Maximino Carpio García

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/f/webbde/Secciones/Publicaciones/Relacionados/Fic/cat_publ.pdf.

The list of articles published in the Economic Bulletin since 1990 can be consulted at http://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/indice_general_ingles.pdf.

Most of these documents are available in pdf format and can be downloaded free of charge from the Banco de España website at http://www.bde.es/webbde/en/secciones/informes/. Requests for others should be addressed to publicaciones@bde.es.

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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
CBA	Central Balance Sheet Data Office Annual Survey
CBQ	Central Balance Sheet Data Office Quarterly Survey
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 2010	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
GOP	Gross operating profit
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
NCBs	National central banks
NFCs	Non-financial corporations
NPISHs	Non-profit institutions serving households
OECD	Organisation for Economic Co-operation and Development
OJ L	Official Journal of the European Union (Legislation)
ONP	Ordinary net profit
OPEC	Organisation of Petroleum Exporting Countries
PMI	Purchasing Managers' Index
PPP	Purchasing power parity
QNA	Quarterly National Accounts
SDRs	Special Drawing Rights
SEPA	Single Euro Payments Area
SGP	Stability and Growth Pact
SMEs	Small and medium-sized enterprises
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
TFP	Total factor productivity
ULCs	Unit labour costs
VAT	Value Added Tax

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	EUR (euro)
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.