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Abbreviations

AIAF	Association of Securities Dealers
BE	Banco de España
BIS	Bank for International Settlements
CBA	Central Balance Sheet Office annual survey
CBQ	Central Balance Sheet Office quarterly survey
CNE	Spanish National Accounts
CNMV	National Securities Market Commission
CPI	Consumer price index
EAGGF	European Agricultural Guidance and Guarantee Fund
ECB	European Central Bank
ECOFIN	Council of the European Communities (Economic and Financial Affairs)
EDP	Excessive Deficit Procedure
EMU	Economic and Monetary Union
EPA	Official Spanish Labour Force Survey
ERDF	European Regional Development Fund
ERM II	Exchange Rate Mechanism for currencies of countries that have not adopted the euro
ESA 79	European System of Integrated Economic Accounts
ESA 95	European System of National and Regional Accounts
ESCB	European System of Central Banks
EU	European Union
EU15	The fifteen current European Union Member States
EUROSTAT	Statistical Office of the European Communities
FIAMMs	Money-market funds
FIMs	Securities funds
GDP	Gross domestic product
GNP	Gross national product
GVA	Gross value added
HICP	Harmonised index of consumer prices
IMF	International Monetary Fund
INE	National Institute of Statistics
INVERCO	Association of Collective Investment Institutions and Pension Funds
IPI	Industrial Production Index
IPOs	Initial public offerings
LIFO	Last in first out
MEFF	Financial Futures and Options Market
MEFF RF	Fixed-income derivatives market
MEFF RV	Equity derivatives market
MERCOSUR	Southern (American) Common Market
MFIs	Monetary financial institutions
MMFs	Money-market funds
NCBs	National Central Banks
OECD	Organisation for Economic Co-operation and Development
PPI	Producer price index
QNA	Quarterly national accounts
R+D	Research and development
SCLV	Securities Clearing and Settlement Service
SDRs	Special drawing rights
SGP	Stability and Growth Pact
TARGET	Trans-European Automated Real-Time Gross Settlement Express Transfer system
ULCs	Unit labour costs
VAT	Value Added Tax
WB	World Bank

Countries

BE	Belgium
DK	Denmark
DE	Germany
GR	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
LU	Luxembourg
NL	Netherlands
AT	Austria
PT	Portugal
FI	Finland
SE	Sweden
UK	United Kingdom
US	United States

Currencies

ESP	Peseta
EUR	Euro
JPY	Japanese yen
USD	United States dollar

Conventions used

M1 Money supply = Notes and coins held by the public + sight deposits.

M2 M1 + savings deposits.

M3 M2 + time deposits.

ALP Liquid assets held by the public = M3 + other liquid assets.

ALPF ALP + fixed-income mutual funds.

bn Billions (10^9).

m Millions.

a Projection.

p After a month [January (p)], this means that all the related figures are provisional; after a figure, only said figure is provisional.

pp Percentage points.

Anual (1970) or quarterly data with this symbol are averages of the monthly data of the year or quarter; series of monthly, ten-day or weekly data are averages of the daily data for such periods.

... Not available.

— Nil, non-existence of the event considered or insignificance of changes when expressed as rates of growth.

» Less than half the final digit shown in the series.

* Series of seasonally adjusted data.

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CHAPTER I

OVERVIEW

I.1. WORLD ECONOMIC RECOVERY

During 1999 the Spanish economy continued to perform strongly against a foreign background marked by the start of Monetary Union and increasingly firmer worldwide economic conditions. Both aspects have shaped the key features of Spain's recent performance.

Developments in 1999 gradually put behind the bout of low growth and instability on international financial markets that had originated in the emerging south-east Asian economies two years back, and whose effects had spread and been subsequently exacerbated by the Russian debt crisis and the vulnerability of other regions such as Latin America. The expansion of the world economy in 1999 was led by the United States, where growth was robust and the demand for imports strong. And it was seconded by the south-east Asian economies, which recovered forcefully as a result of the gains in competitiveness arising from the devaluation of their currencies and the rapid decline in employment and the restructuring measures adopted. The stabilisation of financial conditions in Latin America also contributed to improving worldwide economic conditions. That said, recovery in this region was slower and less intense than in the Asian countries, although it gained momentum in the final months of the year once the reaction by Brazil and other countries in the area was felt on financial markets.

The euro-area economies and other European countries, such as the United Kingdom, progressively participated in the climate of economic recovery, boosted by the growing buoyancy of foreign demand. The recessionary trends that had emerged in certain countries in late 1998 and early 1999 were thus overcome. Conversely, in the Japanese economy, the signs of recovery in the first half of the year weakened as the fiscal impulse induced by the economic policy measures adopted in recent years petered out.

The economic expansion has been accompanied by a sudden rise in oil prices that has lasted longer than initially thought, owing to the ability of the producer-country cartel to adhere very strictly to the quotas set in the face of growing demand for energy, in the wake of the world recovery. The persistence in the rise in the price of oil products on international markets became a major factor of risk for the world economy and it has been a decisive element in the deterioration of the inflation outlook over the course of the year. The intensity of the rises was further fuelled at the beginning of the year 2000 and the effects continued to pass through, against a backdrop of high growth in global activity, to other price indicators. In late March the Organisation of Petroleum Exporting Countries (OPEC) reached an agreement to raise crude oil production. This should stabilise oil prices in the coming months, although the effects of the lagged feed-through of the rises accumulated in the past will continue to be felt.

Higher growth expectations and the emergence of inflationary risks have been reflected in a gradual rise in long-term interest rates. They have also led the monetary authorities gradually to tighten the stance of their monetary policies, thereby winding up the phase of greater monetary easiness with which it had been sought to counter the financial instability of the preceding years. Given the improved international environment, world growth projections for the coming years have been successively revised upwards. The latest forecasts point to a rate of expansion in the year 2000 exceeding 3 % for the OECD countries and signal a notable reduction in the cyclical differences between the United States and the European Union (EU).

In 1999 the US economy once more performed exceptionally. Output growth was high at around 4 % and there was a lack of inflationary pressures, despite full employment having virtually been achieved (with an unemployment rate of 4 %). The situation has remained unchanged in the opening months of 2000, giving rise to one of the lengthiest expansions in US economic history. The salient feature of this surprisingly long phase of prosperity is the acceleration in apparent labour productivity growth (which is running at over 3 %). This has helped restrain price rises even in the presence of clear signs of demand pressures, largely fuelled by the gains in wealth generated by the strong rise in stock market prices in recent years.

This pattern of growth, however, cannot be said to be proving fully balanced or risk-free in terms of its sustainability. Strong consumption growth is outstripping the expansion in household disposable income, as it is essentially based on the stimulating effects of high asset prices. As a result, it is prompting an ongoing decline in the private-sector saving ratio, which reached a low of 1.4 % of GDP in 1999. Hence, spurred by the opportunities offered by the new information and telecommunications technologies, continuing investor buoyancy is, by running counter to a declining trend in domestic saving, leading to an increase in the borrowing requirements of an economy which had traditionally been the world's main creditor. The US current-account deficit rose to 3.6 % of GDP. This but reflects the deterioration in the US trade deficit, which has been acting as a safety valve for domestic demand pressures and preventing inflationary pressures from emerging.

This greatly prolonged phase of growth with price stability in the US economy, which presides over the new global economic scenario, and the behaviour of international financial markets, is due to the combined action of a broad range of factors. Some of these have had a conjunctural influence. Such is the case with the decline in commodity prices, which had prompted a significant reduction in import prices in the preceding years (accentuated by the appreciation of the dollar), but which turned sharply round in 1999. Notable among the factors of a more structural or long-term nature have been the reforms undertaken in recent decades to add greater flexibility to product and service markets. Particularly relevant here are the gains in efficiency brought about by the deregulation of the economy and the favourable effects on wages and employment that have arisen from a more flexible labour market. Likewise, the presence of deep and highly developed financial markets in the United States has played a very important role in the expansion of new-technology industries, by providing the appropriate means for the financing (mainly through venture capital) of the new firms active in these industries. These structural changes have, moreover, been made against a background of economic globalisation and worldwide financial liberalisation, which has provided for a better allocation of resources. Further, the macroeconomic policies implemented in the most recent past have contributed to shaping this scenario. This has been thanks to the application of a strict fiscal policy allowing fiscal surpluses to be attained and a monetary policy which has proven capable of blending buoyant economic activity with continuing price stability.

However, the most striking features of the recent US economic performance have been the acceleration in productivity, business profitability and the extraordinary surge in stock market prices. These are the factors that have led some analysts to believe that the boom in information and communications technology has engineered a structural change in the growth rate of aggregate supply. This change would warrant talk of the advent of a “new economy” in which the thresholds for non-inflationary growth would be significantly higher than in the past, with all the ensuing economic policy implications.

Advocates of this standpoint consider that the beneficial effects of the new technologies spread to the economy as a whole mainly through two channels. The first, which is more direct and immediate in nature, runs via the growing weight of the high productivity industries in overall output. The second, which is more indirect but has greater medium- and long-run potential, is based on the widespread reduction of production and distribution costs and on the greater availability of information resulting from the intensive use of increasingly more sophisticated IT processes and from the possibilities Internet access offers. It is the second channel which would lead to an overall improvement in efficiency in the economy and to a higher rate of expansion of productive potential, which would ultimately be reflected in a sustained increase in the growth rate of productivity. The intensity of the spread of productivity gains to the economy as a whole is, therefore, the crucial link for justifying a permanent increase in potential growth capacity, as asserted by the advocates of the “new economy”.

On the evidence available, the pace of apparent labour productivity growth has quickened in recent years, although a small portion of this is due to a more accurate measurement of output growth further to the revision of the GDP deflators. Moreover, these increases in productivity appear to have been concentrated in industries producing IT goods. By contrast, evidence of the spread of new technology to traditional productive processes is weak and incipient, although the difficulty of capturing this type of phenomenon drawing on National Accounts information should be mentioned. Undeniably, then, the process of technological innovation has accelerated substantially in recent years. But, on the figures known to date, it is risky to assume that the indirect effects of new information technology on productive industry as a whole will bring about a permanent increase in the growth rate of productivity.

One aspect closely linked to this development has been the strong rise in US stock market prices, especially since 1995. Measured by the Standard and Poor's 500 index, the cumulative increase in equity prices since then has been almost 200 %. The intensity and duration of this bull market is one of the main sources of uncertainty over the sustainability of the US economy's current buoyancy. In principle, low real interest rates and the favourable outlook for business profitability might warrant, at least in part, the rises seen on the general indices. However, their sectoral composition reveals a heavy bias indicating that the rise in prices in recent years has been essentially due to the extraordinary surge in technological and telecommunications stocks. This appears to indicate that the yields implicit in high stock market prices are discounting a future scenario in which the extensive use of information technology will trigger a fundamental change in productive processes, the advantages of which would infuse all sectors of the economy.

If the current uncertainty over this scenario materialising were well-founded, it would be wise not to rule out the possibility of a significant decline in stock market prices, as a result of profits not living up to expectations, or the need to resort to more energetic financial policies to counter inflationary pressures greater than those being anticipated at present. Such an outcome would bear most significantly on the buoyancy of the US economy, and would spread rapidly to the rest of the world. Indeed, concern has begun to be voiced in early 2000 about the level reached by certain prices and there has been an increase in the volatility of technological stocks and a significant fall in their prices which has spread to other markets.

The innovative features marking recent developments in the US economy and expectations that these will gradually spread to other regions are the main basis of the favourable world economic outlook. Indeed, on the latest IMF forecasts, world growth could be running at around 4 % in the coming years. These trends appear to be beginning to take root in Europe. With the weaker growth brought on by the effects of international financial crises behind, a fresh phase of recovery has been set in motion more rapidly than expected in the second half of 1999. However, although this may lead to less of a cyclical discrepancy with the United States, the structural characteristics of the situation in Europe are different. It is thus not possible mechanically to extrapolate the effect of the factors underpinning US buoyancy.

Average GDP growth in the EU has scarcely exceeded 2.5 % since 1994, a figure very close to the available estimates of the trend growth rate. Meantime, employment creation has been subdued, with unemployment, which has a significant structural component, holding at very high levels above 9 % of the labour force. Although the pattern of development of the European economy over the past decade embodies high average growth in productivity (around 2 %), over the past two years there has been a marked decline in this variable which only appears to have turned around as from 1999 Q3 (see Box I.1). In 1997, the latest year for which comparable data are available, the share of the IT and telecommunications industry in GDP was two points lower in Europe than in the United States (5.8 % against 7.9 %). And there are signs that, over the past two years, this difference has tended to widen. More worrying, in any case, is the considerable distance separating the United States from Europe, according to all surveys, as regards the proportion of the population with access to Internet and the development of e-commerce. This is in the light of the impact the Web is apparently having on improving business organisation, productive processes and commercial relations in the US economy.

In turn, despite the changes wrought by the development of the single market and the introduction of the euro, the European institutional framework continues to be afflicted by serious rigidities in certain markets or industries that are inhibiting or checking the introduction of new technologies and the diffusion of their effects. If this delay persists, it could have adverse, long-lasting effects on the competitiveness of the European economy in the medium term and, therefore, on its potential growth. Accordingly, it is essential that the reforms needed to reap the benefits of the new wave of innovation and technological change driving world growth should be undertaken.

At the recent extraordinary European Council in Lisbon, significant efforts were made along these lines. A series of measures were agreed upon by the national and Community authorities for application in the near future. One field of action is to be the liberalisation and integration of product and factor markets, as rigidities in their workings and the lack of competition at the national and EU level are hampering and discouraging innovation and the adoption of new technology. In parallel, administrative formalities for the creation of new companies are to be simplified and the appropriate amendments made for the organisation of a truly integrated market for venture capital, to facilitate the funding of the most innovative business plans. It is also necessary to lower the legal barriers to the development of e-commerce, provide for widespread access to the Internet in schools and, generally, to adapt education and training to the new technological environment.

The US experience shows that if it is wished to harness the growth potential of new technologies, what is needed are sufficiently competitive and flexible factor, product and service markets and efficient financial markets to smooth the dissemination of technological innovation and the adjustments in productive factor allocation that the process entails. This is the major challenge facing Europe further to the successful culmination of the launching of the euro and the start-up of the single monetary policy.

I.2. THE LAUNCH OF THE EURO, THE SINGLE MONETARY POLICY AND THE SPANISH ECONOMY

The key feature in Europe has been the start-up of the common monetary policy in an economic situation in which the outlook has changed in step with the increasingly firm course of the world economy. The establishment and thrust of the new single monetary policy have been determining factors of the behaviour of the Spanish economy and of the challenges faced by domestic economic policy in the recent period.

The launch of the euro at the outset of 1999 was against a backdrop of moderate expectations of economic growth, following the pause in activity in 1998 Q4 which prompted the deterioration of the external environment and a weakening of euro-area exports. The outlook for prices was, at the start of the third stage of EMU, very favourable; throughout 1998, the harmonised index of consumer prices (HICP) had posted ever lower rates, ending that year with a 12-month growth rate slightly lower than 1 %.

Against this background, the benchmark interest rate that would set the tone for the single monetary policy in its initial stage was fixed at 3 %, following concerted action on 3rd December 1998 by the central banks that were to make up the Eurosystem. After 1st January 1999 this would be the level for the ECB's main refinancing operations, and it was to prove consistent with the medium-term price stability outlook derived from the analysis of economic and financial conditions in the euro area. In presenting the elements of the more active policy strategy that it was going to use, the ECB specified the definition of price stability as a situation in which the 12-month growth rate of the HICP for the euro area was, in the medium run, below 2 %.

The prospect of slowing growth in the euro area and of an absence of inflationary risks firmed during the opening months of 1999 and gave rise to an additional cut of half a point in intervention rates. But both these facets of the macroeconomic picture in the euro area were revised upwards as the year unfolded, albeit more slowly so in the case of the inflation outlook, once the firming of the rise in oil prices became clear. Economic activity in the euro area began to pick up after the spring, in the light of the gradual improvement in the area's main export markets and the increase in internal demand. The take-off in exports firmed in the final months of the year, helped by the progressive buoyancy of the emerging economies and by the gains in competitiveness arising from the depreciation of the euro. Exports duly became the main engine of growth for the area.

From mid-1999 onwards, the single monetary policy was conditioned by this change in the price outlook, against a background of improving growth expectations. Thus, in the closing months of 1999, the ECB reviewed its relatively relaxed single monetary policy stance, which had been manifest in an intervention rate level of 3 % to April and 2.5 % to November. The ECB has since raised its official rate on four occasions, the last of which on 27th April this year, taking it to 3.75 % (see Chart I.1).

From the start of EMU the growth of the M3 monetary aggregate in the euro area stood above its reference value of 4.5 %. This was not initially considered worrying for the future course of prices, however, since it proved difficult in the opening months of 1999 to interpret correctly the movements in public portfolios induced by the transition to the Third Stage. Long-term interest rates, for their part, held virtually stable to May at a level close to 4 % for the 10-year maturity, and the euro exchange rate moved on a depreciating trend as from the start of the year.

BOX I.1

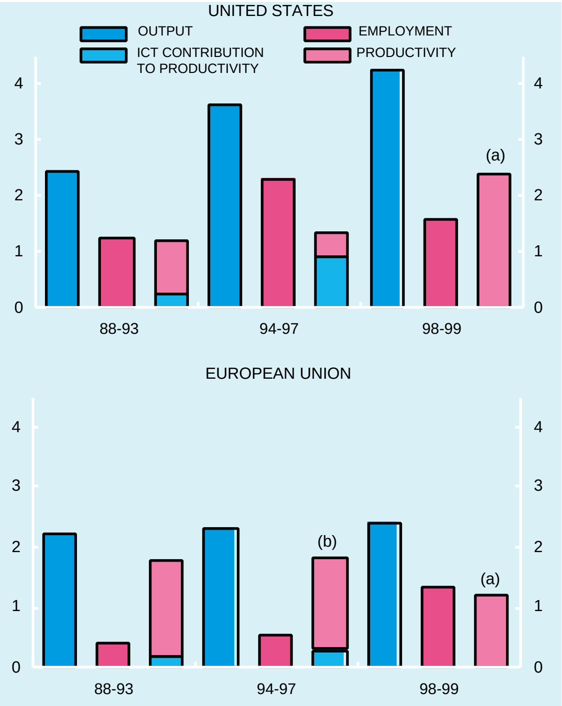
Growth, productivity and information and communciations technology in the United States and Europe

The current strong expansion of the US economy without excessive inflationary pressures is in contrast to developments in the European economy. The latter is characterised by more moderate growth rates that are not sufficient to generate employment at a pace allowing Europe's high structural unemployment rates to be substantially reduced. A comparative analysis of both economies in terms of productivity in recent years may be of use for assessing the challenges facing the European economy.

As can be seen in the accompanying chart, the growth of apparent labour productivity (measured as the difference between the growth of GDP and of employment) ran at a higher rate in the European economy in the period 1988-1997 than in the United States. In the first period studied (1988-1994), average GDP growth was similar in both economies, entailing greater job creation in the case of the US economy. In the years 1994-1997, however, economic buoyancy was greater in the United States than in Europe, although this translated into a smaller increase in apparent labour productivity owing to the favourable trend of employment. In the last two years (1998-1999), productivity in Europe has slowed significantly, accompanied by a slight increase in job creation which, in any event, is still not on a par with US rates. The US economy, by contrast, has shown a simultaneous strong increase in both employment and productivity during this period of expansion.

The pattern of growth of the US economy over the past two years has consisted of a sizeable increase in productivity in the absence of inflationary pressures, despite a situation of close to full employment. This pattern has led some to posit the hypothesis that the development and ubiquitousness of information and communications technology (ICT) is radically changing how the economy works and is providing for gains in efficiency, the reflection of which is a sustained increase in the growth rate of productivity and a reduction in costs, thereby avoiding the emergence of inflationary pressures.

Growth of productivity by component and contribution of ICT industries



Sources: OECD, AMECO, NEWCRONOS.

(a) There is no information on the contribution of the ICT industries for the period 1988-1999.

(b) The calculation only includes Germany, Belgium, France and Italy due to lack of data for the other countries.

The performance of the ICT industries (computers, components and communications) has been exceptionally dynamic in the United States in recent years, with productivity growth of close to 10 %. Indeed, as the chart shows, the contribution of these industries (which represented scarcely 8 % of GDP in 1997) helps account for more than two-thirds of productivity growth in the United States between 1994 and 1997 (1). This result implies that the potential benefits of ICT had not so far made for a substantial increase in the productivity of other industries in the economy. Nonetheless, in the past two years quickening productivity has coincided with incipient signs that that other industries might finally be benefiting from the changes wrought by ICT on productive processes. That should add credence to the viability of the observed pattern of high productivity and output growth in the coming years.

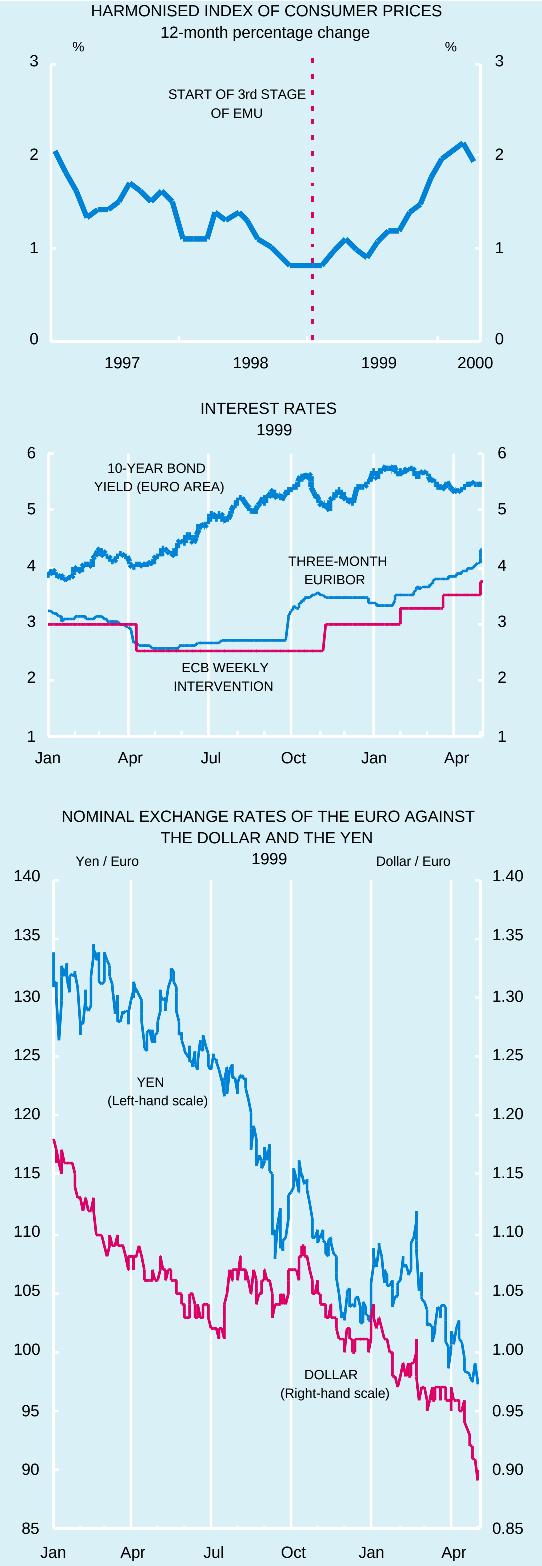
In Europe's case, the contribution of the above-mentioned industries to productivity growth was only 15 % in the period in question, despite the fact the relative size of these industries in Europe (around 6 % of GDP) is only slightly less than the related US figure. Although this figure might be biased owing to data inaccuracy, the comparison with the United States highlights the limited significance of the technologically most advanced industries in explaining productivity growth in Europe.

These results, combined with Europe's relative technological lag in these industries, suggests it is unlikely that the contribution of ICT to economic growth through this direct channel will swiftly acquire the importance it has in the United States in recent years. However, the EU may feasibly benefit from the spread of ICT to the rest of industry although, as stressed, the scale of these indirect effects is uncertain. In any event, the difference in growth pattern between both areas is largely based on the greater flexibility and competition prevailing in US markets. This not only allows greater employment generation but also appears conducive to innovation, to the dissemination of new technology and, therefore, to a more immediate harnessing of the potential benefits.

(1) To calculate the contribution of the ICT industry to productivity growth, a wider-than-usual definition of this industry is taken, owing to data availability restrictions. In particular, the sub-categories of capital goods, office equipment, data processing, optics and precision engineering, electric and electronic products and communications (branches D.29-33, I.64, NACE Rev.1 nomenclature) are included.

CHART I.1

Consumer price indices, interest rates and exchange rates in the euro area



Sources: Eurostat, ECB and Banco de España.

However, a somewhat swifter deterioration was seen in the monetary and financial indicators after the summer months. The growth rate of M3 accelerated and ended the year running at over 6 %. Combined with the expansionary behaviour of credit to the private sector, which posted rates of over 10 %, this appeared to indicate a situation of ample liquidity in the area. As from June, long-term interest rates moved onto an upward course, in parallel with US bond yields, and the euro exchange rate continued to fall, having depreciated by May 2000 by 22.2 % against the dollar compared with its level at the start of 1999. The moderately rising trend of the HICP after June quickened as from 1999 Q3 owing to the recurrent rises in oil prices and the impact of the depreciation of the euro exchange rate. The HICP thus posted a 12-month growth rate of 1.7 % in December 1999, double the euro-area inflation rate at the start at the third stage of EMU, and stood in April 2000 at 1.9 %.

All these factors, combined with improved expectations about demand growth in the euro area, made for a deterioration in the medium-term inflation outlook, the final scale of which could be influenced by the impact of the depreciation of the euro on final prices and by wage bargaining in the year 2000. In response to this bleaker inflation outlook, the ECB altered the single monetary policy stance as from November by means of the above-mentioned increases in its intervention rates. Notwithstanding, real short-term interest rates continued falling owing to the increase in the growth rate of prices during 1999. As a result of this and the depreciation of the euro exchange rate, the indicators of monetary and financial conditions in the area stood in spring 2000 at lower levels than those prevailing in the first half of 1999.

The decline in real interest rates was particularly marked in those euro-area members with higher inflation rates during the year. Moreover, it is these same countries which exhibited growth rates in activity higher than the average for the euro area. The Spanish economy is a case in point. The decline in real interest rates, combined with the depreciation of the euro exchange rate, gave rise to particularly generous monetary and financial conditions in Spain during 1999 (see Box I.2), the expansionary effect of which on aggregate demand compounded those derived from the fall in interest rates during the convergence process. The high growth of credit to the private sector, which climbed to 17 % in 1999, was the clearest exponent of this situation.

Against the above-mentioned background of recovering foreign markets, the generous monetary conditions prevailing and agents' opti-

TABLE I.1

Main indicators of the Spanish economy

	ESA 79	ESA 95			
	Average 90-95	1996	1997	1998	1999
DEMAND AND OUTPUT AT CONSTANT PRICES (a):					
Private consumption	1.5	2.0	2.9	4.1	4.4
Government consumption	3.4	1.3	2.7	2.0	1.8
Gross capital formation	0.4	1.7	4.6	9.6	8.4
Exports of goods and services	9.0	10.3	15.1	7.1	8.5
Imports of goods and services	6.8	8.1	12.8	11.1	12.6
Gross domestic product	1.7	2.3	3.8	4.0	3.7
EMPLOYMENT, WAGES, COSTS AND PRICES (a):					
Total employment	0.2	1.2	2.7	3.7	3.4
Compensation per employee	7.0	4.0	2.8	2.8	2.4
Unit labour costs	5.4	2.9	1.8	2.8	2.6
GDP deflator	5.7	3.4	2.1	2.3	3.1
Consumer price index (annual average)	5.4	3.6	2.0	1.8	2.3
Consumer price index (end-year twelve-month rate)	5.1	3.2	2.0	1.4	2.9
SAVING, INVESTMENT AND FINANCIAL BALANCE (b):					
Resident sectors: saving (c)	20.6	23.1	23.7	23.8	23.7
General government (c)	*–1.2*	*–1.8*	*0.0*	*0.8*	*2.3*
Resident sectors: investment	22.3	21.9	22.1	23.1	24.2
General government	*4.4*	*3.2*	*3.2*	*3.3*	*3.4*
Resident sectors: national net lending (+) or borrowing (–)	–1.6	1.2	1.6	0.8	–0.6
General government	*–5.6*	*–5.0*	*–3.2*	*–2.6*	*–1.1*
Gross general government debt	53.3	68.0	66.7	64.9	63.5
MONETARY AND FINANCIAL INDICATORS (d):					
ECB weekly intervention rate	—	—	—	—	2.7
Banco de España intervention rate	11.4	7.5	5.4	4.2	—
10-year government bond yield	10.8	8.7	6.4	4.8	4.7
Synthetic bank lending rate	14.3	9.7	7.2	5.9	4.9
Madrid Stock Exchange General Index (Dec. 1985 = 100)	272.8	367.3	556.0	817.7	894.4
Dollar/euro exchange rate (e)	1.247	1.270	1.134	1.120	1.067
Index of Spain's competitiveness against the developed countries (nominal) (1990 = 100)	91.0	80.9	77.2	76.9	75.7
Index of Spain's competitiveness against the developed countries (real) (1990 = 100)	94.5	89.2	85.2	85.2	84.8
Liquid financial assets (f)	9.3	9.2	8.7	6.0	4.5
Broad liquid assets (g)	10.0	9.3	10.7	9.4	9.6
Total financing of households	8.2	9.1	11.7	16.8	17.7
Total financing of non-financial corporations	6.4	1.4	8.6	12.8	17.4

Sources: Instituto Nacional de Estadística, Intervención General de la Administración del Estado and Banco de España.

(a) Rate of change.
(b) As a percentage of GDP. The saving and investment figures for 1999 are estimates of the Banco de España.
(c) Includes net capital transfers received.
(d) Average annual levels for interest rates and exchange rates and rates of change for financial assets and liabilities.
(e) Prior to 1999: dollar/ecu exchange rate.
(f) For years 1990-1995: ALP2.
(g) For years 1990-1995: ALPF.

mistic expectations, the growth rate of the Spanish economy throughout 1999 was sustained and significantly higher than the European average. The macroeconomic picture at the outset of Spanish participation in EMU thus depicts the entrenchment of the achievements secured via the convergence and economic liberalisation policies pursued in recent years. Such policies have allowed sustained macroeconomic stability to be reconciled with highly buoyant output and employment.

Real GDP ran at 3.7 % on average in 1999, only three-tenths of a point less than a year earlier. It was on a slightly accelerating path throughout the year, pointing to a somewhat higher growth rate for the year 2000. All the domestic demand components contributed to maintaining a high growth rate in 1999, and the demand for exports progressively recovered as the year advanced. Consumer spending, the real growth rate of which was higher than in 1998, was boosted by the growth of real disposable income, low real interest rates and the increase in wealth. Investment in construction held at high rates of expansion, despite the slowdown in civil engineering works, and investment in capital goods performed favourably, though somewhat down on 1998. Throughout the year the negative contribution of net external demand moderated as exports gradually picked up, in line with the recovery in world demand, although imports remained considerably buoyant. In this way the external component more than offset the marginal slowdown in what was nonetheless highly buoyant domestic demand.

Employment was very robust for the third year running. Its annual average rate of change was, on QNA figures and in terms of equivalent jobs, 3.4 %. Complementing these data is the information provided by the official Labour Force Survey (EPA), according to which almost two million jobs have been created over the past four years and the unemployment rate has fallen 7.4 percentage points to 15.4 % of the labour force. Although the 1999 EPA data are affected by the compilation changes to the Survey at the beginning of the year, the volume of estimated flows leaves no doubt as to the intensity of the employment generation process. Dependent employment was particularly dynamic, growing at 6.7 % in 1999, as was permanent-contract employment (25.5 %), although the proportion of temporary to permanent employees remained high (32.8 %) on average in 1999. The data obtained from companies show, moreover, that medium-sized and small firms have generated most of the employment created, since many large corporations are still adjusting staff numbers as part of restructuring processes. These results reflect the favourable effects on job creation of the liberalising measures adopted and the reforms implemented to improve labour market workings and wage bargaining arrangements, under which price expectations have been adapted to the Monetary Union scenario.

Wage rises trended moderately in 1999, in keeping with price stability requirements. However, this containment of unit labour costs was dampened by the low increase in apparent labour productivity. Further, the behaviour of wage increases was very uniform, belying the diversity of situations seen at the industry or firm level. Corporate profitability levels continued to improve. According to the Central Balance Sheet Office Quarterly Survey, profits reached an all-time high in 1999 due above all to the combination of wage restraint, against a background of buoyant activity, with the ongoing reduction in borrowing costs, since the turnaround in interest rates on financial markets as from mid-1999 has not yet made itself felt in the overall financial burden. The leverage ratio of companies, which measures the difference between the return on assets and the cost of borrowed funds, continued to rise, providing fresh investment incentives.

Among the benefits accruing to the Spanish economy as a result of EMU membership is an increase in the presence of Spanish firms in international markets, channelled through a spectacular increase in direct investment abroad, especially in Latin America. This phenomenon, which has been partly driven by the speedier privatisation of certain large public-sector corporations and by the consolidation of the financial system, attests to growing Spanish participation in the dynamics of economic globalisation. This could hardly have taken place had the decision to target EMU membership as the guiding principle and anchor of economic policy in recent years not been successfully seen through.

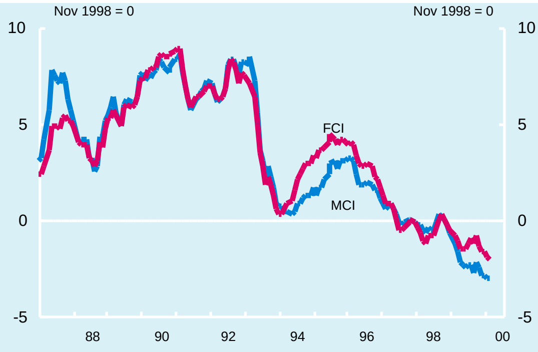
High GDP growth in real terms, its forceful capacity to generate employment and a low inflation rate have made for progress in fiscal consolidation at a higher than envisaged rate. Tax receipts grew more than forecast in 1999 and this meant that, although the increase in public spending was higher than initially budgeted, the reduction in the deficit was greater than stipulated in the Stability and Growth Programme. The deficit stood at 1.1 % of GDP at end-1999 compared with 2.6 % in 1998.

The decline in the budget deficit is particularly significant since it came about in a year in which personal income tax was reformed, a reform entailing a reduction in the household tax

BOX I.2

Monetary and financial conditions in Spain

Monetary and financial conditions indices in Spain



Source: Banco de España.

The analysis of monetary and financial conditions has traditionally been a cornerstone of the diagnosis of the economic situation and the inflation outlook. However, given the absence of a single variable capable of reflecting such conditions in an overall fashion, one recent proposal has been to construct indices in which different monetary and financial variables are weighted in accordance with the estimated effect that the changes in each of them have on expenditure or inflation.

On analysing these indices several considerations relating to their construction and interpretation must be borne in mind (1). Firstly, these indices measure only changes in relation to a base period, whereby the level of the index per se is not interpretable. Secondly, any mechanical interpretation of changes in the index in terms of monetary policy decisions should be avoided, since both real interest rates and exchange rates are strongly endogenous variables and, although monetary policy may exert great influence on them, this is not the only determining factor. Finally, it should not be forgotten that the monetary conditions index, since it is a weighted sum, is highly dependent on the value of the weights used in its construction.

Bearing these caveats in mind, it may be useful to analyse the recent changes in monetary and financial conditions in the Spanish economy as reflected in (i) a monetary conditions index (MCI), which tracks real short-term interest rates and real exchange rates; and (ii) a financial conditions index (FCI), which reflects, moreover, real long-term interest rates and the real growth of listed share prices. Both indices take into account the change entailed by EMU, insofar as they reflect the effect on the Spanish economy both of changes in the monetary and financial variables of the Spanish economy itself and of changes in the monetary and financial variables of the eleven euro-area countries as a whole.

The accompanying chart depicts both indices in the period from January 1987 to March 2000. For much of this period monetary and financial conditions were influenced by the need to guide the Spanish inflation rate towards a level compatible with price stability. Subsequently, the attainment of the inflation targets set and progressive convergence towards a single monetary policy for all the EMU member countries led the indices to move onto a declining trend. As a result, the Spanish economy moved into the third stage of EMU with monetary and financial conditions that could, compared with the recent past, be qualified as generous.

Throughout 1999 and in the opening months of 2000, monetary and financial conditions in Spain have continued to ease. That said, a distinction should be drawn between an initial period (to April 1999) in which the declines in both the MCI and the FCI were most substantial, and a subsequent period in which they were considerably more restrained. The break coincided with the end of the process of reductions in official interest rates in the euro area, which fed through also to market interest rates. Long-term interest rates began to rise already in the second quarter of the year, while short rates did so as from the summer, partly in anticipation of the rises in official interest rates that would subsequently take place. Nonetheless, the rises in nominal interest rates have not translated clearly into a tightening of monetary conditions in Spain due, in part, to the counteracting effect of the increase in the inflation rate and, in part, to the ongoing depreciation of the effective exchange rate of the euro throughout the period. The effect of the stock market was also expansionary in view of the strong growth of Spanish stock market prices in the final months of 1999, though it was of little significance owing to the limited weight of the change in this variable on the FCI.

In sum, according to these indices the most generous monetary and financial conditions seen in the Spanish economy since 1987 took hold during the course of 1999. However, as earlier indicated, this should be interpreted with caution, in particular because the equilibrium value of these indices consistent with neutral monetary conditions may have altered substantially over this period of time. This is particularly true in the light of the structural change that EMU has entailed for the Spanish economy and the changes in fiscal policy and the degree of market flexibility.

(1) The indices presented in this box are constructed by weighting the different variables according to the estimated elasticities of expenditure to changes in the monetary and financial variables making up each of the indices. A more detailed discussion of the construction and interpretation of these indices in general, and of the specific indices shown in the accompanying chart, can be found in the article “Una evaluación de la situación monetaria y financiera en España a partir de un índice de condiciones monetarias”, published in the February 2000 edition of the Boletín Económico.

burden. However, although the breakdown of tax receipts is not yet available, the positive effects of this reform on activity and employment in the short term, via the increase in disposable income and, by extension, in household consumption and saving, are likely to have further boosted receipts from other taxes more related to economic activity, thereby offsetting – at least partly – the initial loss of takings. In the medium and long run, further positive effects may be expected. These will come about for two reasons. First, the stimulating effect on job supply and demand generated by the reduction in the tax gap, i.e. in the difference between real gross wages paid by employers and the real net wages received by employees. And second, improved efficiency in the allocation of saving, given the more favourable and uniform treatment for tax purposes of returns on the main financial and property assets in which households invest.

The progress made in public finances has translated into a reduction in the public debt/GDP ratio, which stood at 63.5 % in 1999. As a result, a balanced budget position can now be viewed as an attainable goal over a relatively immediate horizon.

The buoyant health of firms, the reduction of the budget deficit and the decline in interest rates have been instrumental in Spanish securities markets' participation in the general upswing witnessed internationally in recent years, with a decisive contribution also of technological and telecommunications stocks. This has led to an increase in Spanish households' equity holdings, equating their financial habits to those prevailing in the more advanced economies and contributing to the enlargement and maturity of capital markets.

The foregoing results are favourable in terms of growth, job creation and macroeconomic stability. Moreover, they are a reward for the effort expended during the convergence process and they confirm that Spain is at a good starting point to reap the potential benefits of EMU membership in terms of growth potential and of drawing levels of income and well-being closer to those prevailing in the rest of the area. However, being in a comfortable starting position should not mean forgetting that significant challenges may arise at a given time within EMU. Accordingly, any signs of potential future problems should be carefully monitored. Significant in this connection is the fact that, during 1999, the buoyancy of final demand (which increased at a rate of over 5.5 % for the third year running), in the presence of strong rises in oil prices, has led to a sizeable increase in the trade deficit and a change in the course of consumer prices. The trade deficit rose to 4.6 % of GDP while consumer prices ended the year at a 12-month growth rate of 2.9 %, thereby widening slightly its differential with the euro area.

These difficulties have a transitory component which, in principle, should be corrected over time. The growth of the trade deficit will tend to slow as oil prices stabilise and the pick-up in exports takes root. As to prices, available forecasts of the CPI point to a reduction in its 12-month growth rate in the second half of the year 2000. That said, assessment of these factors requires caution, as they may constitute signs of a situation of excessive demand pressure in relation to the short-term responsiveness of supply (given potential GDP growth and the degree of flexibility in the product and service markets), spurred largely by the relative laxity of the monetary conditions prevailing in the euro area as a whole. Should these signs become clearer, they could have adverse implications for the medium-term competitiveness of the Spanish economy. Fortunately, the turnaround in interest rates since the second half of 1999 and the reduction of cyclical divergence with other euro-area countries, which will likewise be manifest in greater co-ordination between the single monetary policy stance and the degree of monetary restrictiveness required by the Spanish economy, will tend to mitigate these risks.

It should be borne in mind that EMU membership substantially modifies the economy's traditional adjustment mechanisms in the face of potential situations of excess demand. The irrevocability of the exchange rate means that losses in competitiveness built up in relation to EMU members might only be corrected through the adjustment of domestic relative prices. Hence, were rigidities to hinder this, competitiveness could only be sustained through a slowdown in activity and employment. These new conditioning factors mean, in sum, that sustaining the growth of the Spanish economy in Monetary Union hinges more directly on the ultimate determinants of relative costs. That obliges domestic economic policy, whose leeway to tackle divergences has been substantially cut, to monitor with caution any symptom of erosion of the Spanish economy's competitive position.

I.3. FROM STABILITY TO COMPETITIVENESS

The macroeconomic data for recent years reveal that the policies pursued to join EMU have enabled Spain to experience a phase of strong GDP and employment growth against a background of notable headway in macroeconomic stability. As mentioned, the progress in real convergence resides particularly on the economy's competitiveness. The determining factors of competitiveness may be macroeconomic, as is the case of relative costs and their determinants (labour costs, productivity and the exchange rate), or structural. The latter factors are becoming more relevant given the international environment of growing globalisation and interdependence and in view of the more prominent role played by new technology. Notable among the structural determinants of competitiveness is, first, the functioning of factor and product markets. Conditional upon this aspect are the efficiency of productive processes and resource allocation and the existence of incentives for technological innovation and for the creation of new products. The second element is related to firms' ability to adapt to and compete in this situation, which in turn depends on factors such as the quality of training and education, the capacity to improve productive processes, the intensity of investment in research and development, the provision of infrastructure and the efficiency of industrial organisation.

This long-term relationship between competitiveness and growth means it is vital to monitor closely those symptoms which, in the general climate of stability and soundness of growth and employment creation, might pose certain risks for the future of the competitive position. A thoroughgoing analysis of the factors underlying the price differential with the euro area and the recent widening of the trade deficit would thus be advisable.

During 1999 the CPI quickened from a rate of 1.4 % in December 1998 to 3 % in February 2000, an acceleration largely induced by the higher growth rate of its more variable components. As in other European economies, the rise was mainly due to the increase in the price of energy, although there were increases in the prices of other commodities which were passed through by import prices. The fact that energy prices are normally more erratic should not detract from the significance of the increase in the growth rate of prices. The intensity and persistence of the changes recorded in the price of energy and the lag with which the effects spread to other prices (as a result of the important role of energy as an input in the productive apparatus as a whole), combined with the possibility that transitory increases in consumer prices may feed through to wage and other income negotiations, may hamper the resumption of moderate inflation rates, even after the episode of dearer oil is behind. Moreover, it should be borne in mind that the persistence of higher inflation in the service sector (once the effect of the price rises in the more erratic products is discounted), the limited headway in reducing underlying inflation and the acceleration of other price indicators, such as wholesale industrial prices and import unit value indices, may heighten the risks arising from dearer energy.

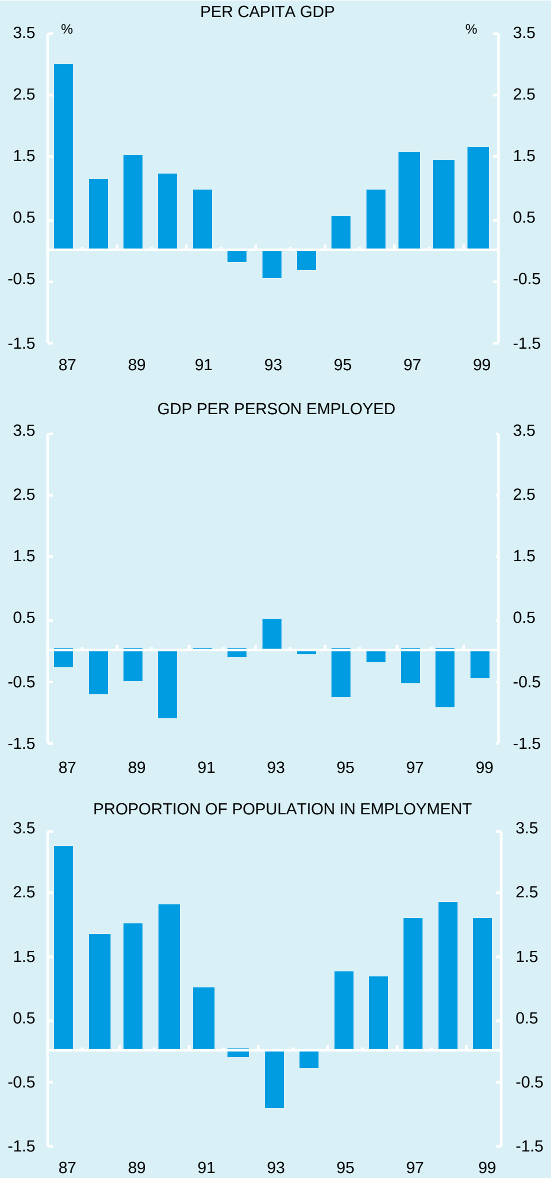
Although the oil price shock affects all countries, Spain's consumer price differential with the euro area widened in 1999 and, at the same time, wholesale prices also grew more, following several years of negligible differences. However, the scale of the differentials in the case of non-energy industrial goods prices (both the wholesale and retail segments) is limited as a result of the greater competition these products face. Nonetheless, unit labour costs continue to grow more in Spain than in the euro area (despite wage moderation in recent years), whereby operating margins in manufacturing industry have narrowed. The deterioration in competitiveness in the euro area arising from the behaviour of unit labour costs is not, however, occurring in relation to the developed countries, owing to the depreciation of the euro against the dollar.

The widening of the trade imbalance is largely in response to the Spanish economy being further along the cycle than the core euro-area countries and to the effect of dearer oil on the cost of imports. But the intensity of the process may point to the continuation of some of the comparative disadvantages of the Spanish productive structure. Thus, the merchandise foreign trade figures in 1999 reflect, first, high import dependency on those goods whose production requires more advanced technology; and second, a relatively high degree of concentration of Spanish exports in specific products, especially the more unskilled-labour-intensive goods, where competitive pressures from the newly industrialised countries are greater. The industries producing these goods were those which underwent the most marked slowdown in sales abroad in the wake of the 1997 international crisis. Their performance in 1999 remained very depressed, owing mainly to the improvements in competitiveness via prices in the emerging countries as a result of the devaluation of their currencies. In turn, imports by the most capital- and technology-intensive (car manufacturing and industrial machinery) industries exhibited high growth, reflecting the continuing technological gap afflicting Spanish industry, despite the investment drive in recent years and the ongoing incorporation of new technology into Spanish companies.

One essential factor for gauging the importance of these events on competitiveness is the

CHART I.2

GDP per capita, productivity and employment as a proportion of total population: growth differentials between Spain and EU15



Source: AMECO (DG. ECFIN).

behaviour of productivity. If the growth rate of productivity in Spain were sufficiently high in relation to the euro area countries, inflation differentials with the euro zone need not entail losses in competitiveness but could be the mere reflection of a process of real convergence underpinned by a high productivity growth rate in manufacturing industry exposed to foreign competition. Under certain circumstances, that might justify continuing modest inflation differentials which would progressively diminish as the differences in levels of per capita income were cut, without jeopardising either competitiveness or potential growth.

In parallel, if the buoyancy of productivity were – as occurs in normal circumstances – to translate into increases in productive capacity, the trade deficit could be interpreted as a transitory imbalance, enabling surplus demand to be absorbed in the short term without placing pressure on domestic supply. This imbalance would tend to be corrected as rises in productivity were progressively reflected in greater aggregate supply and in the reduction of final prices and, therefore, in an improvement in the competitive position and an increase in exports.

Analysis of the behaviour of productivity and its determinants is thus very important in order to assess the potential problems that might lie behind the continuing inflation differential and the trend of the trade deficit. However, this is a complex issue. Productivity is difficult to measure and interpret, especially when structural changes are taking place due to the adoption of the new macroeconomic regime in the euro area, the opening up and liberalisation of the economy, labour market reforms and wage moderation. All these factors have been conducive to a strong increase in employment that has induced a slowdown in apparent labour productivity. Moreover, there are statistical problems arising from the lack of uniformity of the indicators used to estimate the growth of value added and of employment, which National Accounts methodology cannot always fully strip out.

Unsurprisingly, then, the growth rate of apparent labour productivity, defined by the relationship between value added and employment, has been appreciably lower in Spain than in the EU in recent years (see Charts I.2 and I.4). The same occurs when the analysis is at a more detailed level: the moderate growth rate of productivity extends in Spain to the various productive branches, including manufacturing, where apparent labour productivity has traditionally been higher than in services owing to technological innovation prompted by higher exposure to foreign competition and to greater capital endowment. Behind this generalised behaviour of productivity lies the intensity of employment creation in the various productive branches, particularly so in manufacturing. Since the Spanish economy is characterised by a higher unemployment rate and a proportion of people in work that is lower than the European average, it is not only logical but also desirable that output growth should be intensive in terms of employment generation. Only thus could real convergence lead to the twin achievement of raising per capita income levels and the rate of employment closer to the European average. And this is what has been happening in recent years. As can be seen in Chart I.2, the higher growth rate of per capita GDP in Spain compared with the EU average is the outcome of economic growth that is more intensive in terms of employment generation and of a faster increase in the proportion of the employed to the total population. In any event, it should be borne in mind that the moderate increase in productivity, whatever its cause, limits the scope for maintaining inflation differentials with the euro area that are not harmful to competitiveness.

Despite the soundness of the foregoing argument, it would nevertheless be risky fully to attribute the low growth of apparent labour productivity in Spain to the factors that have been conducive in recent years to stepping up employment creation. Accordingly, it cannot be ruled out that this low growth may also reflect less buoyant capital accumulation or the incorporation of technological progress into productive processes at a slacker pace than that of the most advanced areas of the world economy. Advisably then, the information on the trend of apparent labour productivity (which is an imperfect measure of overall productive efficiency) should be supplemented with some estimates of total factor productivity (which attempts to approximate to technological progress) and of changes in the capital/labour ratio.

Analysis of these variables proves complex, since somewhat controversial estimations are involved. Chart I.3 shows the estimations made for the whole of the Spanish economy's non-financial private sector for the period 1986-1999. According to these results (which should be interpreted with the caution befitting the difficulties inherent to the estimation procedure), behind the slowdown in apparent labour productivity there may also be some moderation in the growth rate of total factor productivity and a stabilisation of the capital/labour ratio. That follows the strong labour adjustment and the substitution of capital for labour in the early nineties, when the Spanish economy was last in recession.

It may be deduced from consideration of all the foregoing that recent productivity developments in Spain mirror, in part, the factors that have generated a particularly intensive pattern of growth in employment creation. But they are also indicative of the existence of certain conditioning factors that continue to hold back the incorporation of technological progress and greater capital efficiency. At the same time, continuing obstacles to genuine increases in productivity, which are at the root of the current upswing in the world economy, could lead to demand pressures – such as those the Spanish economy has experienced following EMU membership – prompting a deterioration in competitiveness.

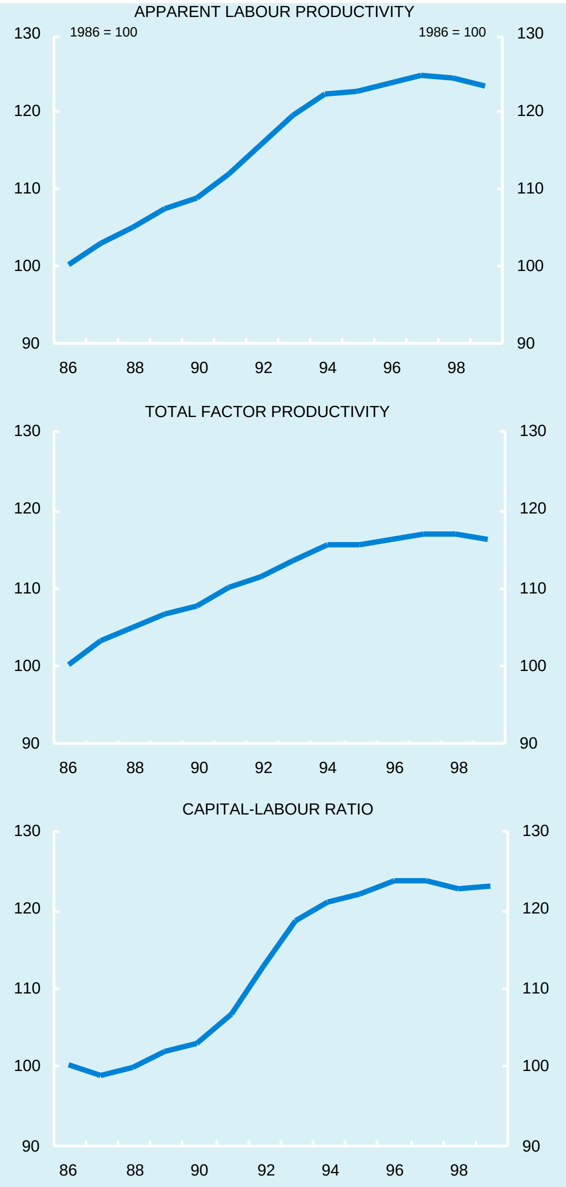
The effects of the modest growth of apparent productivity in Spain compared with the EU are beginning to become discernible in certain indicators of external competitiveness, such as unit labour costs in manufacturing industry. Chart I.4 shows that the slowdown in the growth rate of productivity in Spain has led to higher growth of Spanish unit labour costs, and this despite restraint in real wages. Naturally, were such a situation to persist in a setting where foreign competition is tending to level out the rate of increase of tradable-goods final prices, that would ultimately affect operating margins.

To prevent the risk of losses in competitiveness and to ensure continuation of the economic expansion and the forceful job creation marking Spain's initial participation in EMU, it is of paramount importance to sustain and build on domestic policies aimed at making the economy perform in line with the requirements arising from EMU membership. Monetary and financial conditions, dictated by the needs of the area as a whole, will probably continue to be relatively generous in the near future from the standpoint of domestic requirements. Consequently, it is essential that a tight fiscal policy be implemented so as to lessen the pressure of domestic demand. Fiscal policy should likewise be closely tailored to compliance with the undertaking to cut spending, both in the short and long run, and surplus revenue (if this persists in the immediate future) should be used to improve the sustainability of public finances in the medium term. A tighter fiscal policy would enable the pressures in final demand in recent years to be tempered, via the related impact on household disposable income and consumption. The prompt attainment of budgetary equilibrium across all government levels would have beneficial effects both in terms of macroeconomic stability and of sustainably high growth rates.

Likewise, continuing wage restraint and the appropriateness of pay to the economic and productivity conditions prevailing at the level of industries or individual firms, in tune with the price stability target set pursuant to the single monetary policy and with EU economic policy guidelines, should help provide for the harmonisation of the Spanish economy with the monetary conditions across the euro area as a whole. Pay restraint is a vital prerequisite if the buoyancy of activity is to generate sufficient employment to continue absorbing what is still the

CHART I.3

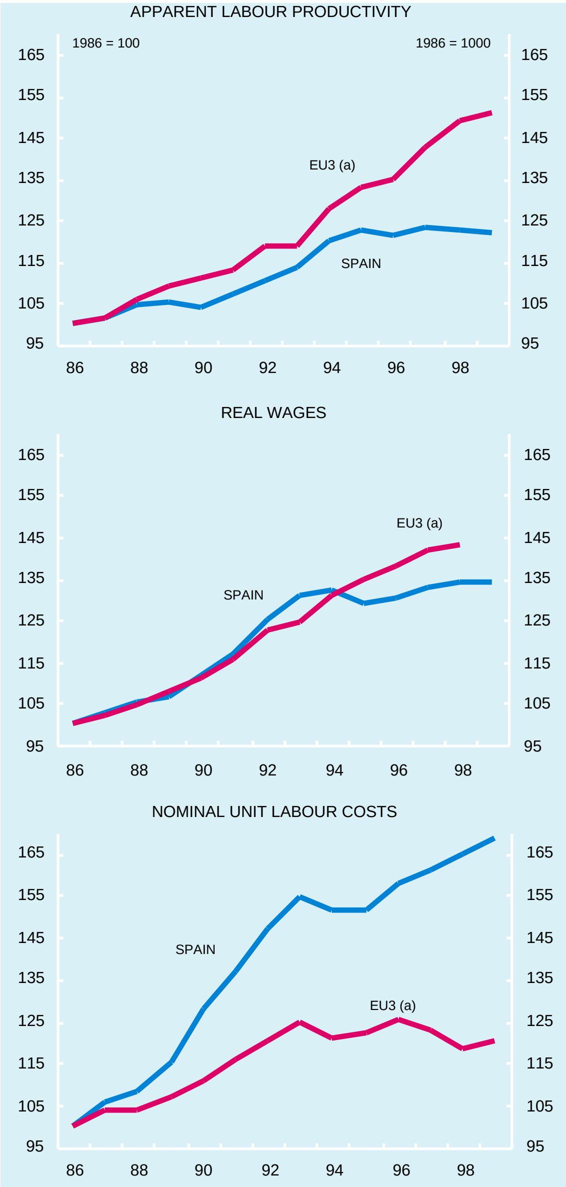
Technical characteristics of the productive process
Private sector
(Cumulative growth)



Sources: Banco de España drawing on INE and Fundación BBV data.

CHART I.4

International comparison of prices and costs in manufacturing
(Cumulative growth)



Sources: Banco de España, drawing on data from INE for Spain and from AMECO (DG ECFIN) for the European countries.
(a) Aggregate made up of Germany, France and Italy.

highest unemployment in the area and raising the proportion of people in work.

Managing the instruments at hand for influencing domestic demand will be all the less complicated the more quickly progress is made in equipping the supply side of the economy with flexibility and the ability to respond to increases in demand without stoking price pressures or worsening the trade balance. The Spanish economy has significant headroom to raise potential output if the appropriate conditions are in place to increase human, physical and technological capital, incorporating it efficiently into the productive process. Making use of such room by deepening and extending the structural reforms of recent years (see Box I.3) would allow a high rate of growth and employment generation to be sustained. And that without needing to confront the dilemma of having to adopt measures restricting domestic demand (with the scant economic policy instruments

BOX I.3

Structural and liberalising measures in product and service markets in 1999

The programme of liberalising reforms was furthered in 1999, in keeping with the schedule laid down or, in certain cases, in advance of the dates required in the Community directives. The progress made in opening up competition was substantial in telecommunications (as befits the situation of full liberalisation of the supply of telephony services in force since December 1998), and somewhat less impressive, though significant, in electricity (which has been immersed in a process of gradual liberalisation since late 1996) and in natural gas (following the adoption of the associated Community directive in 1998). Steps have also been taken to increase competition in the liquid hydrocarbons (petrol, diesel and heating oil) and butane gas retail distribution industry and, elsewhere, to rationalise public spending on pharmaceutical products. It is necessary, however, to build on and extend the measures undertaken in other areas, such as the regulation of land use, wholesale and retail trade and transport in general. Here, differing degrees of co-operation from regional and local government are required, only modest progress having been made in recent years. This box discusses, non-exhaustively, the measures taken in 1999 to speed through the liberalisation of product and service markets (1).

In the telecommunications industry the number of national operators offering fixed telephony services increased from three in 1998 to eight in 1999, there was a most significant increase in fixed telephony licences granted to operators capable of offering services at the local level, or specialising in corporate services, and the third mobile telephony operator commenced providing services. Further, several competitive “beauty contests” were organised to award multimedia (third-generation) mobile telephony and local radio telephony licences, which have been resolved in March this year. Despite this considerable headway, entry barriers restricting competition remain in place, especially in local-call fixed telephony services, and prices and costs are insufficiently aligned in certain services. The increase in the number of operators prompted invoicing innovations and a generalised reduction in telephony prices, including those of the incumbent operator. As a result, the growth rate of the CPI sub-class of telephony and telegraphy (2) fell from 5.3 % at end-1998 to 3.3 % twelve months later. Despite this favourable trend, the decline in telephony prices has been less than in other Community countries. Indeed, in the EU as a whole, the 12-month growth rate of the equivalent HICP component was negative (–5.7 %) at the end of the year.

In the electricity industry during 1999, and in accordance with the schedule set in 1998, there was a notable widening of the qualifying criteria for users deemed to be big electricity consumers, i.e. those who can choose a supplier and negotiate prices. This was complemented by a lowering of prices for domestic consumers. As a result, the decline in the electricity CPI sub-class intensified (moving from a year-on-year rate of –2.7 % in 1998 to –3.9 % in 1999). In Spain, however, electricity prices remain comparatively higher according to OECD estimates, due to the particularities of Spanish resources and to the very structure of the electricity bill, which reflects a series of costs unrelated to electricity generation: nuclear moratorium, coal subsidies, etc. Against this background, the timetable for acquiring big-consumer status was brought forward, and it was approved that by July 2000 an opening up of the market of the order of close to 50 % of final demand would occur. Similar measures were taken in the gas industry, reducing the minimum consumption required to qualify for big-consumer status by half and bringing forward to 2008 (five years earlier than initially scheduled) freedom of choice as regards suppliers. A similar reduction (from fifteen years to ten) was applied to the period during which gas distributors may have an exclusive concession on a given geographical zone, whereby competition in distribution is brought forward to 2008.

In the area of fuel distribution, the government undertook to promote competition between service stations, announcing an increase in the number to be authorised, a change in the system under which new petrol service stations are adjudicated (giving priority to the diversification of ownership into adjacent areas) and greater transparency in price-setting, publicising going prices on motorways. None of these measures have been implemented yet. Accordingly, it will be necessary to wait until they are in place to assess their impact on the degree of concentration in the industry. Clearance for the commercialisation of butane gas canisters was given (with a small discount) to commercial establishments and service stations, thereby eliminating obligatory house-to-house distribution, and individuals were authorised to transport butane gas containers. These measures, along with the launch of a new, lighter canister, have opened up competition in distribution.

Competition policy was also reinforced in 1999. Greater control was established over mergers and corporate concentration, and the time required for rulings on infringements or breaches of rules was shortened. It is hoped hereby to prevent abuse of market power. Steps were also taken to promote research and development and to reduce the technological gap with the EU (investment in research and development totalled 0.9 % of GDP in Spain in 1998 compared with 1.9 % of GDP in the EU that same year). Specifically, a more favourable tax treatment for this type of investment was introduced in corporate income tax and a national plan for scientific research, development and technological innovation spanning the period 2000-2003 was approved, targeting a volume of investment in R+D equivalent to 1.2 % of GDP by 2003. Lastly, with the establishment of the pilot “one-stop shop” for processing administrative formalities in certain regions, some headway has been made in simplifying obstacles to creating new small and medium-sized companies.

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(1) Some of these measures were implemented in Royal Decree-Law 6/1999, addressing urgent liberalisation and competition-increasing measures, and Royal Decree-Law 15/1999, addressing liberalisation, structural reform and competition-increasing measures in the hydrocarbons industry.

(2) Note that the CPI does not include offers which are not across the board and which are not maintained for several months at least. At the same time, new service-suppliers need to have been up and running for at least a year to be included.

available) or assume considerable risks for future competitiveness.

The new rules governing the macroeconomic functioning of the euro area and the need to incorporate new technology mean supply-side policies and economic liberalisation must be brought to the fore. Structural reforms aimed at making factor, product and service markets more competitive are essential not only to achieve better allocation of resources but also to promote high-productivity industries and the diffusion of their advantages to industry and to the public at large. This facet of economy policy must, therefore, play a special and prominent role. The rise in productivity occurring at the world level may thus be taken on board by the Spanish economy, and real convergence may then be furthered, harnessing all the potential advantages stemming from EMU membership.

CHAPTER II

THE EXTERNAL ENVIRONMENT, THE EURO AREA AND THE COMMON MONETARY POLICY

II.1. INTRODUCTION

The world economy trended more favourably in 1999 than in the preceding year. The improvement affected most geographical areas and was particularly patent in the emerging economies and in Japan, although this latter country has yet to show signs of a clear recovery. In the United States, activity was markedly buoyant as in prior years. Meanwhile, the European economy, following the prolongation in the first half of the year of the slowdown begun at the end of 1998, began to pick up firmly in the second half of 1999. This recovery has run into the opening months of the current year.

The progress of the world economy in 1999 was largely determined by the crisis of the emerging market countries being put behind. In the two preceding years, this crisis caused serious turbulence on international financial markets, prompting recession in a large number of south-east Asian and Latin American economies, which in turn shrank the exports of the developed countries. The countries most directly affected by the crisis adopted, in the summer of 1997, more flexible exchange rate regimes. And this, along with the implementation of moderately expansionary monetary and fiscal policies and with progress, in certain cases, in the restructuring of the financial sector, was conducive to their recovery and to the resumption of normal conditions on international goods and capital markets.

The pick-up in the developed Western economies last year did not prompt a sizeable increase in prices. Inflation held at low or moderate levels, despite the marked rise in oil prices following the reduction in production quotas agreed upon by the oil exporting countries in March 1999. Both the favourable behaviour of wages, assisted by the counter-inflationary credibility of the monetary authorities, and the auspicious course – until recently – of commodity prices were propitious to the containment of inflation on both sides of the Atlantic.

Nonetheless, the combination in the United States of high growth and relatively low inflation to date, and the strong increase in employment and in labour productivity, point (as discussed in Chapter I) to the existence of changes in the structure of the economy that may be bearing positively on its potential growth. The diffusion of progress in information and communications technology, against an economic background characterised by the flexible functioning of factor and product markets and by the implementation of policies clearly geared to macroeconomic stability, appears to have increased the headroom for sustainable growth in the US economy.

The pattern of growth in the United States has, however, generated some worrying imbalances, which worsened in 1999. The boom in technological stocks raised stock market indices to levels whose sustainability over time required expectations of the long-term growth of listed companies' profits to remain highly optimistic. In turn, the surge on equity markets fuelled very high increases in private consumption, to the point of placing the household saving ratio at an historical low. Lastly, the shortage of domestic saving, along with the attractiveness of US financial assets for international investors, made for the appreciation of the dollar and the worsening of the external deficit. The vulnerability of the US economy reflected in these imbalances, together with the uncertainty over oil prices and the hesitant performance of the Japanese economy, are the key factors of risk at present for the continuation of the worldwide economic expansion.

In the euro area, the improved economic situation during 1999 was primarily due to cyclical factors. Exports were the most buoyant component of GDP in the second half of the year, and it was the countries most affected by the financial turbulence in south-east Asia which saw their growth rates increase most once the crisis was behind. The domestic demand-based pick-up in activity and low interest rates enabled most member states to improve their public finances, outperforming the budgetary commitments into which they had entered. Nonetheless, the headway made in budgetary consolidation, with regard to the adoption of measures with permanent positive effects on the general government balance and to the attainment of an expenditure/revenue mix conducive to a better use of resources, was generally limited. Turning to structural policies, euro-area governments made significant progress in liberalising certain product and service markets. Yet the scope of reforms to the labour market, where rigidities hampering job creation and a higher participation rate persist, was more modest.

During its first 18 months as the monetary authority for the euro area, the European Central Bank (ECB) has adapted its monetary policy stance to a changing environment. This setting was marked, in the opening months of 1999, by the signs of slowing activity then prevailing and, as from Q3, by the increasingly unequivocal symptoms of latent inflationary pressures. At all times, however, the euro area has enjoyed monetary and financial conditions propitious to the sustaining of domestic demand. Reflecting this have been the strong rates of increase of the monetary and credit aggregates, low interest rates, rising equity prices and the depreciation of the euro.

II.2. THE EXTERNAL ENVIRONMENT OF THE EURO AREA

II.2.1. The developed economies

In the *United States,* the prolonged expansionary phase initiated eight years back was sustained in 1999, while prices grew at moderate rates. GDP expanded by 4.2 %, the third consecutive year of growth of over 4 % (see Table II.1). The strong buoyancy of activity was accompanied by high job creation, and the unemployment rate fell during the year by 0.5 percentage points to 4 % in December.

As in the previous years, the increase in GDP was essentially due to the expansion of domestic demand and, in particular, of consumption. The growth of employment, the historically low level of real and nominal interest rates and, especially, increased wealth all made for an acceleration in private consumption, which grew by 5.3 % in relation to the previous year. The pick-up in exports became manifest in the second half of 1999 although, in the year as a whole, export growth was a modest 3.8 %. This was far below the related increase in imports, which ran at a high rate in line with the firmness of final demand and the appreciation of the dollar.

Prices grew throughout the year at moderate rates, attesting to which was the 1.5 % increase in the GDP deflator, while the consumer prices deflator scarcely exceeded 2 %. This inflation performance was compatible with a significant increase in wages (hourly earnings rose by 4.7 % in 1999), thanks to exceptional productivity gains which paved the way, despite strong job creation and the ensuing tightness of the labour market, for growth in unit labour costs of 1.7 %, down on the related 1998 rate (see Chart II.1). However, the strong increase in oil prices as from March entailed an appreciable acceleration in the energy component of the consumer price index (CPI), which translated into a gradual increase in monthly inflation rates, with figures above or equal to 3 % being posted since February this year.

In principle, it seems likely that the monetary and fiscal policy stance pursued in recent years and the globalisation of the economy will have favoured the stability of the business cycle and, by this means, they will have provided for a more efficient allocation of productive resources. Likewise, the greater openness and flexibility of national and international markets has made it possible to harness economies of scale in industries where the US economy is highly competitive. Lastly, the flexibility added to the labour market has contributed to reducing the structural unemployment rate and, in this way, it has broadened the boundaries of non-inflationary growth. Nonetheless, these factors, though relevant, are insufficient to explain the intense, simultaneous expansion in output, employment and productivity against a background of low inflation. Apparently evidencing this is the fact that other advanced countries – which are equally exposed to globalisation, have pursued disciplined macroeconomic policies and have undertaken reforms enabling the relative rigidity of their products and factor markets to be reduced – have not so far been capable of reaping such favourable macroeconomic benefits. As discussed in Chapter I, what is particularly significant about the recent performance of the US economy is that the acceleration in productivity has been closely linked to the boom in the information and communications technology industry.

In any event, the pattern of economic growth in the United States is also generating certain major imbalances, which were exacerbated in 1999. Such imbalances cast doubt on the conti-

TABLE II.1

United States, Japan and the United Kingdom: main macroeconomic indicators

	1993	1994	1995	1996	1997	1998	1999
UNITED STATES:							
GDP (a)	2.7	4.0	2.7	3.6	4.2	4.3	4.2
Domestic demand (a)	3.2	4.4	2.5	3.7	4.5	5.5	5.3
External demand (b)	–0.6	–0.4	0.1	–0.1	–0.3	–1.3	–1.2
Public-sector balance (c)	–5.1	–3.8	–3.3	–2.4	–1.2	–0.1	0.5
CPI (a)	3.0	2.6	2.8	2.9	2.3	1.6	2.2
Current-account balance (c)	–1.3	–1.7	–1.5	–1.7	–1.7	–2.5	–3.7
Unemployment rate	6.9	6.1	5.6	5.4	4.9	4.5	4.2
ULCs (a)	1.7	0.8	1.1	0.5	1.9	2.4	1.7
JAPAN:							
GDP (a)	0.4	0.7	1.4	5.2	1.6	–2.5	0.3
Domestic demand (a)	0.1	1.0	2.2	5.8	0.2	–3.2	0.7
External demand (b)	0.2	–0.3	–0.8	–0.6	1.4	0.6	–0.3
Public-sector balance (c)	–1.6	–2.3	–3.6	–4.2	–3.4	–4.3	–7.1
CPI (a)	1.2	0.7	–0.1	0.1	1.7	0.7	–0.3
Current-account balance (c)	3.1	2.8	2.2	1.4	2.2	3.2	2.5
Unemployment rate	2.5	2.9	3.1	3.3	3.4	4.1	4.7
ULCs (a)	3.3	–0.7	–2.2	–1.9	–1.6	5.5	–3.5
UNITED KINGDOM:							
GDP (a)	2.3	4.4	2.8	2.6	3.5	2.2	2.1
Domestic demand (a)	2.2	3.5	1.8	3.0	3.7	4.2	3.6
External demand (b)	0.1	0.9	1.0	–0.5	–0.3	–2.1	–1.7
Public-sector balance (c)	–0.8	–6.8	–5.8	–4.4	–2.0	0.2	0.3
CPI (a)	1.6	2.5	3.4	2.5	3.1	3.4	1.6
Current-account balance (c)	–1.7	–0.2	–0.5	–0.1	0.8	–0.1	–1.4
Unemployment rate	10.3	9.4	8.1	7.4	5.7	4.7	4.3
ULCs (a)	0.1	–0.5	1.4	1.7	2.9	3.4	4.0

Sources: IMF, OECD and national statistics.

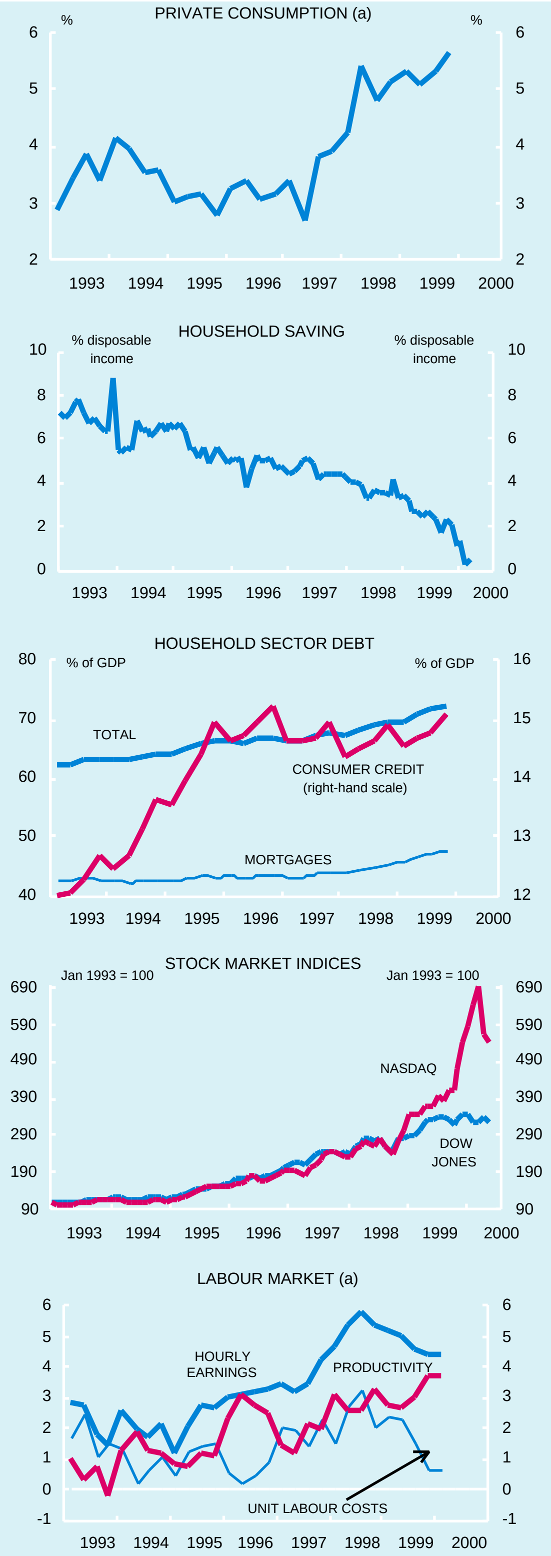
(a) Rate of change. ULCs: non-farm sector for the United States; manufacturing for Japan; whole economy for the United Kingdom.
(b) Contribution to GDP growth.
(c) As a percentage of GDP.

nuity of the expansionary phase and appreciably hamper economic policy implementation. Firstly, the boom in the information and communications technology industry has, despite the correction in March to May this year, prompted an enormous rise in the price of the stocks of the companies in this industry (see Chart II.1), which can only be explained by company profit growth expectations far above historical levels. In this respect, it should be borne in mind that future dividends depend not only on the expansion of the demand for high technology products but also on how the structure of the industry changes and, in particular, on the degree of competition that the companies currently making up the industry will have to face. Consequently, given that this is a relatively young industry, it is clear that both demand and, principally, supply are difficult to predict at present. Accordingly, expectations about the profitability of these companies and, therefore, their stock market value are subject to enormous uncertainty.

Secondly, the increase in the price of equity instruments and, to a lesser extent, of real estate assets has, by raising agents' wealth, been supportive of a substantial expansion of consumption and private-sector indebtedness. The outcome has been a reduction of more than five percentage points in the household saving ratio over the past five years. At the start of 2000 it stood at under 1 %, suggesting high exposure to the risk of a potential fall in asset prices. Nonetheless, despite the strong expansion in consumption, households have shown a degree of prudence when translating the huge rise in asset values into spending decisions. And, at the same time, they have tended to reduce the weight of equity in their portfolios, which has helped sustain the soundness of their net wealth (see Box II.1). In any event, a sharp future correction in share prices greater than that witnessed in the opening months of this year could prompt a severe contraction by reversing the effect of one of the factors that has most

CHART II.1

United States: private consumption and determinants, productivity



Sources: National statistics and Reuters.
(a) Year-on-year growth rate.

contributed to the expansion of domestic demand in recent years.

Thirdly, the strength of the US economy and the shortage of domestic saving have contributed to a highly pronounced current-account deficit, which rose to 3.6 % of GDP in 1999. Most capital flows took the form of direct investment and equity holdings, while private debt securities and the extension of loans to US companies account for a limited proportion of non-residents' US asset holdings. Thus, although high dependence on foreign saving is often considered as a factor of instability, the degree of vulnerability of the US economy resulting from the increase in its liabilities to the rest of the world should not be overstated. The very course of the dollar during 1999, which has held on an appreciating trend in nominal effective terms (see Chart II.2) despite the growing trade deficit, highlights the confidence that market participants have in the US economy. That said, if in the current situation US assets were suddenly to lose their attractiveness for international investors, it is highly likely this would prompt financial turbulence and jeopardise the growth prospects of the US economy.

Both the apparent positive implications of the "new economy" for aggregate supply and the imbalances mentioned directly influenced the implementation of monetary policy by the Federal Reserve throughout 1999. In the opening months of the year, and despite the resilience of activity, the climate of international financial instability, linked in part to the crisis of the emerging economies, was propitious to the maintenance of low interest rates. The federal funds target rate duly stood at 4.75 % until late June. Thereafter, the progressive resumption of normal conditions on financial markets, the ongoing expansion of domestic demand against a background of strongly rising share prices, the rise in oil prices and the tightening of the labour market led the Federal Reserve to raise its main intervention rate, in successive steps, to 6.5 % in May 2000. These measures were applied very gradually (five consecutive increases of 25 basis points to March this year) as a result of the containment observed in the non-energy components of the CPI and due to the confidence of the monetary authority that the increase in potential output would allow the growing pressure of demand to be accommodated, at least in part. Nonetheless, given the absence of signs of a moderation in domestic demand and the prospect that this variable would continue growing above potential output, the Federal Reserve decided to step up the process of monetary tightening by raising the federal funds target rate by 50 basis points on 16th May.

BOX II.1

The financial situation of US households

The buoyancy of the US economy in recent years has been accompanied by a considerable decline in the household saving ratio, which, in April 2000, stood at 0.7 % of disposable income. The outpacing of disposable income growth by that of consumption has been prompted by gains in wealth generated by the strong rise in share prices. This has led to fears that a change in the factors underpinning the level of stock market capitalisation (expectations of earnings, risk premia or interest rates) may place households in a position of financial instability conducive to a greater slowdown in activity in the United States than would arise from the direct dampening effect of the reduction in agents' wealth on consumption. However, a detailed analysis of households' wealth allows us to qualify the vulnerability of their financial position apparently discernible from the ongoing decline in their saving.

As can be seen in the accompanying table, households, despite their low saving ratio, have built up increasing net worth (total physical and financial assets less total liabilities). This stood in 1999 at 590.4 % of their disposable income, compared with 437 % in 1994. On the liabilities side, these agents have increased their debt at an annual average rate of 7.5 % of disposable income, whereby their total liabilities have risen from 89 % to 103 %. With these financial resources added to their current income, they have acquired financial and real assets at an annual rate of 14.5 % of their net income.

Total household assets have climbed from 526 % of disposable income to 693 % between 1994 and 1999, owing to the increase in holdings of financial instruments and, specifically, of equity. As the table shows, the rise in equity holdings is due almost in its entirety to the rise in stock market prices over the period since, during these years, there has been a net disposal of shares at an average rate of 3.3 % of income, brought about by US companies' habitual practice of share buy-backs with the aim, among others, of providing an explicit remuneration to its shareholders. Likewise, during the period under study, there has been a net purchase by households or fixed-income securities and of insurance and pension reserves. Hence, the strong increase seen in recent years of the value of the shares held by households has been accompanied by portfolio restructuring in favour of assets whose prices are much more stable. Moreover, the moderate increase in real assets is mainly due to the volume of purchases, and not to a rise in prices potentially indicative of sustained speculation on property markets. Logically, all the foregoing should contribute to softening the effect on household wealth of any future stock market correction.

In order to analyse the overall effect on household wealth of a hypothetical sharp reduction in stock market prices, a simple simulation exercise has been performed using the information on stocks and flows provided by the financial accounts. In columns 6 and 7 of the accompanying table, wealth in 1999 as a percentage of disposable income has been simulated, after assuming downward corrections of 50 % and 100 %, respectively, of the rise in value since 1994 of the portfolios in which equities are included. As can be seen, a fall of up to 50 % in stock market prices (the value of other assets and liabilities remaining unchanged) would place the net aggregate wealth position of households – measured by net assets as a proportion of disposable income – appreciably above the related 1994 position, at the start of the stock market boom. An even greater revision of the gains in value recorded over the last six years by shares (as can be seen in column 7) would thus be necessary for the sector's net wealth to stand below the 1994 level. Naturally, a reduction in prices on such a scale would give rise to a considerable direct contractionary effect on consumer demand, in addition to prompting a crisis of confidence with a potentially very sizeable impact on activity. Nonetheless, the calculations made (despite their simplicity) illustrate the overall solvency of the household sector, assuaging the risks that the depressive effects indicated might combine with those of a widespread financial crisis.

Households. Stocks of assets and liabilities
(% of disposable income)

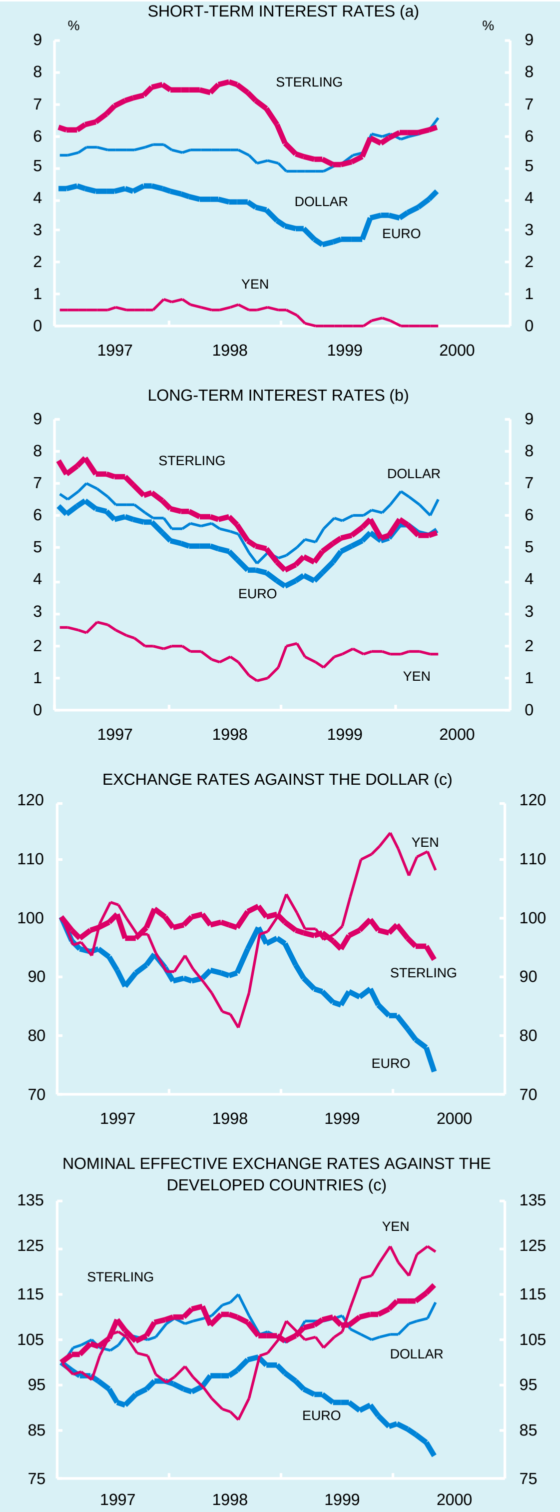
	Stock		Average annual change in stocks	Average annual volume of acquisitions	Average annual revaluation	1999 stock less:	
	1994	1999	1995-1999	1995-1999	1995-1999	50% of 1995-1999 revaluation	100 % of 1995-1999 revaluation
	1	2	3	4	5=3–4	6	7
Assets	**526.3**	**693.4**	**62.8**	**14.5**	**48.3**	**590.7**	**487.1**
Financial	371.1	526.9	52.6	7.1	45.5	423.7	320.9
Of which:							
Deposits	*61.1*	*65.3*	*3.9*	*3.9*	*0.0*	*65.3*	*65.3*
Negotiable instruments	*37.4*	*30.0*	*0.1*	*0.3*	*–0.2*	*30.0*	*30.0*
Equities and shares in funds	*79.8*	*167.4*	*29.0*	*–3.3*	*32.3*	*107.4*	*47.4*
Other equity	*84.8*	*91.7*	*5.7*	*–0.1*	*5.8*	*78.6*	*65.6*
Insurance and pension reserves	*108.0*	*172.5*	*19.6*	*6.2*	*13.4*	*142.3*	*112.0*
Real estate	155.2	167.0	10.2	7.4	2.8	167.0	167.0
Liabilities	**89.3**	**103.2**	**7.4**	**7.5**	**–0.1**	**103.2**	**103.2**
Credit instruments	85.7	97.4	6.8	6.9	–0.1	97.4	97.4
Of which:							
Mortgage loans	*59.4*	*67.5*	*4.7*	*4.8*	*–0.1*	*67.5*	*67.5*
Consumer credit	*19.0*	*21.5*	*1.5*	*1.5*	*0.0*	*21.5*	*21.5*
Other credit	*7.3*	*8.4*	*0.6*	*0.6*	*0.0*	*8.4*	*8.4*
Net worth	**437.0**	**590.4**	**55.4**	**7.1**	**48.3**	**487.5**	**384.7**

Source: Federal Reserve, *Flows of Funds Accounts,* fourth quarter 1999.

Note: The last two columns express what the asset and net worth figures would be in the hypothetical case of the assets in the equity portfolio losing 50% and 100% of their gain in value in the period 1994-1999.

CHART II.2

Interest rates and exchange rates



Sources: Banco de España and BIS.
(a) Three-month interbank market.
(b) Ten-year government bond yields.
(c) A fall in the index denotes a depreciation of the currency against the dollar or the rest of the currencies making up the grouping, and vice versa.

Fiscal policy retained a patently counter-cyclical stance last year, with the general government balance posting a surplus of 0.5 % of GDP. However, the strong growth of spending during the year, though lower than that of receipts, points to some scope for increasing the contribution of the general government budget to restraining domestic demand and containing the decline in national saving derived from the high growth of private consumption.

The *Japanese economy* managed in 1999 to resume positive – albeit modest – growth rates against a deflationary background which was reflected in the fall both in consumer prices and in the GDP deflator.

During the year Japanese GDP growth was only 0.3 %, far lower than forecast. This was due to the low rate of expansion of domestic demand (which scarcely grew 0.7 %) and to the negative contribution of the external sector (see Table II.1). Despite the signs of recovery witnessed in the first half of the year, largely linked to the fiscal stimulation package approved earlier, the slowdown in domestic demand during the second half of 1999 considerably checked the pace of activity. Under domestic demand, private consumption was a component that performed most unfavourably. This was due in part to the high rate of unemployment (4.7 %), by Japanese standards, and the fall in nominal and real wages, but it was mainly attributable to the persistent deflationary expectations. Investment, though it underwent negative growth in the year as a whole, held on a rising profile which appears to have run into the months elapsed to date in 2000. Finally, the external sector suffered the consequences of the appreciation of the yen (close to 17 % in nominal effective terms), despite the pick-up in the economies of its south-east Asian trading partners (see Chart II.2).

The main problem facing the Japanese authorities is that, given the current flagging rate of activity, the margin for manoeuvre of demand-side policies appears to be almost exhausted. Thus, fiscal policy, despite running a very high budget deficit (7 % of GDP in 1999) and raising debt to unprecedented levels in this country (125 % of GDP), has shown itself capable of achieving only temporary increases in the level of activity. In turn, monetary policy, though it has held the cost of banks' liquid liabilities close to zero, has not succeeded in curbing deflationary expectations. Accordingly, real interest rates remain relatively high for kick-starting private spending. Hence, the ability of traditional demand-side expansionary policies to boost activity in a durable manner in Japan is uncertain insofar as the weakness of domestic demand is not the result of the variables that make up the habitual monetary and fiscal policy transmission mechanism but is rather due to a deep-seated investor and – above all – consumer confidence crisis.

Of much greater effectiveness are policies aimed at restructuring the Japanese industrial and, above all, financial fabric, even though they take much longer to apply. In this connection, the bank restructuring plan approved in March 1999 is a first step in the right direction. Specifically, the plan establishes the contribution of public funds to the banking system, conditional upon the submission and approval of restructuring programmes by the country's biggest financial institutions. However, the initial budget for the plan (JPY 7.5 trillion) may prove insufficient in the light of the volume of non-performing loans in the banking sector, estimated officially at JPY 64.3 trillion in March 1999. Further, there are doubts about the soundness of the procedures established for monitoring the rate at which the restructuring programmed by financial institutions advances.

Moving closer to the euro area, the *United Kingdom* economy had slowed markedly in 1998 and during 1999 Q1 as a result of the weakness of the external sector owing to the Asian crisis and the strength of sterling. But it picked up with growing intensity thereafter, ultimately expanding by 2.1 % in 1999 as a whole (see Table II.1). Throughout the year, domestic demand was steady and relatively resilient, enabling the strong fluctuations in exports to be partly offset. Job creation in the British economy held on a sustained path, despite cyclical fluctuations, and this provided for a one percentage point reduction in the unemployment rate over the course of 1999, placing it at 4 % in January 2000. The effectiveness of the measures adopted in recent years to make the labour market more flexible was thus vindicated.

The firmness of domestic demand and the gradual tightening of the labour market (in which labour shortages in certain segments are already evident) during 1999, along with dearer energy products and the surge in the price of real estate assets, caused signs of overheating to appear in the economy. The Bank of England responded with successive increases in its main intervention rate, raising it to 6 % in February 2000. Nonetheless, the inflation rate (measured by the CPI excluding mortgage interest payments) held at all times at around 2 %, thus meeting the inflation target set by the British authorities.

II.2.2. The emerging economies

In step with the pick-up in activity in the developed economies last year, the emerging market economies left behind the crisis which, in the preceding years, had so seriously affected them. Nonetheless, there were significant differences in the patterns of recovery of the main areas, i.e. south-east Asia, Russia and Latin America. This was due to the various adjustment and restructuring policies pursued and to how these areas were affected by developments on world commodity markets and by the expansion of world trade.

In contrast to the intense recession following the financial crisis that began in the summer of 1997, the *south-east* Asian economies experienced a notable economic recovery in 1999 albeit without managing, in many cases, to resume the high growth rates recorded prior to the crisis. GDP in South Korea grew by 10 % while the related figures in Malaysia, Singapore, Thailand and the Philippines were between 3 % and 5.5 % (see Table II.2). Hong Kong, which retained its strict currency board during the crisis and was beset by a strong recession in 1998, expanded by 2 % in 1999. Indonesia, beleaguered by political upheaval, was alone in experiencing negative growth (–0.5 %) last year.

The aforementioned recovery, which was generally accompanied by low inflation rates, was essentially due to three factors. First, the sound performance of the external sector, as a result – with the exception of Hong Kong – of the sharp depreciation in currencies that took place following the bouts of speculation during the summer of 1997 (see Chart II.3). Next, the moderately expansive stance of the fiscal policies implemented, which acted to contain the decline in domestic demand at a time when deflationary pressures were becoming apparent in certain countries. And finally, the return to normal conditions on financial markets, allowing the reduction of interest rates on debt issues in domestic and foreign currency (see Chart II.4), which was conducive to the recovery in consumption and investment. Nonetheless, net flows of financing into the area remained negative in 1999, in circumstances in which there was significant but uneven progress in the reorganisation and restructuring of national financial systems.

China was also favourably affected by the return to normal economic and financial conditions in south-east Asia. Chinese GDP expanded by 7 % in 1998, chiefly as a result of the pick-up in export markets, the gains in competitiveness arising from the appreciation of the exchange rates of its main competitors in the second half of the year, and continuing negative inflation rates. However, domestic demand continued to flag despite the expansive fiscal mea-

TABLE II.2

Emerging-market economies: main macroeconomic indicators

	1993	1994	1995	1996	1997	1998	1999
GDP (a):							
Asia							
South Korea	5.5	8.3	8.9	6.8	5.0	–6.7	10.7
Thailand	8.4	9.0	8.9	5.9	–1.8	–10.4	4.2
Indonesia	7.3	7.5	8.2	8.0	4.5	–13.2	0.2
Malaysia	9.9	9.2	9.8	10.0	7.5	–7.5	5.4
Russia	**–10.4**	**–11.6**	**–4.2**	**–3.4**	**0.9**	**–4.5**	**3.2**
Latin America	**4.1**	**5.0**	**1.7**	**3.6**	**5.4**	**2.1**	**0.1**
Argentina	6.3	5.8	–2.8	5.5	8.1	3.9	–3.0
Brazil	4.9	5.9	4.2	2.7	3.6	–0.1	0.8
Chile	7.0	5.7	10.6	7.4	7.6	3.4	–1.1
Mexico	2.0	4.5	–6.2	5.1	6.8	4.8	3.7
INFLATION:							
Asia							
South Korea	4.8	6.2	4.5	4.9	4.4	7.5	0.8
Thailand	3.4	5.1	5.8	5.9	5.6	8.1	0.3
Indonesia	9.7	8.5	9.4	7.9	6.6	58.4	20.5
Malaysia	3.5	3.7	3.4	3.5	2.7	5.3	2.7
Russia	**874.7**	**307.4**	**197.4**	**47.6**	**14.7**	**27.7**	**85.9**
Latin America	**202.6**	**202.5**	**34.4**	**21.4**	**13.0**	**9.8**	**8.8**
Argentina	10.6	4.2	3.4	0.2	0.8	0.9	–1.2
Brazil	2,103.3	2,123.7	60.3	15.8	6.9	3.2	4.9
Chile	12.7	11.4	8.2	7.4	6.1	5.1	3.3
Mexico	9.8	7.0	34.8	35.3	20.8	15.9	16.6
PUBLIC-SECTOR BALANCE (b):							
Asia							
South Korea	1.3	1.0	1.3	1.0	–0.9	–4.0	–2.9
Thailand	2.1	1.9	3.0	2.5	–0.9	–2.5	–3.0
Indonesia	–0.7	0.0	0.8	1.2	–0.7	–1.9	–2.3
Malaysia	–2.6	3.3	2.2	2.1	4.0	–1.0	–4.1
Russia	**–9.4**	**–10.4**	**–5.4**	**–7.0**	**–7.0**	**–5.0**	**–1.7**
Latin America	**–0.2**	**–0.8**	**–1.9**	**–1.7**	**–1.6**	**–3.2**	**–4.1**
Argentina	–0.8	–1.8	–2.3	–3.2	–2.0	–2.1	–3.8
Brazil	–58.1	–44.3	–7.1	–5.9	–6.3	–8.1	–10.0
Chile	1.8	2.5	3.9	3.1	2.5	0.1	–2.0
Mexico	0.7	–0.1	–0.9	–0.3	–1.4	–1.2	–1.6
CURRENT-ACCOUNT BALANCE (b):							
Asia							
South Korea	0.3	–1.0	–1.7	–4.4	–1.7	12.7	6.1
Thailand	–5.1	–5.6	–8.1	–8.1	–0.9	12.7	9.1
Indonesia	–1.3	–1.6	–3.2	–3.4	–2.3	4.2	3.6
Malaysia	–4.5	–6.1	–9.5	–4.6	–4.8	12.9	18.4
Russia	**3.4**	**3.2**	**2.2**	**2.8**	**0.9**	**0.9**	**10.8**
Latin America							
Argentina	–3.4	–4.3	–1.9	–2.4	–4.1	–4.9	–4.3
Brazil	–0.1	–0.3	–2.6	–3.0	–4.2	–4.3	–4.1
Chile	–5.7	–3.1	–2.1	–5.1	–4.9	–5.7	–0.1
Mexico	–5.8	–7.1	–0.6	–0.7	–1.9	–3.7	–2.9
EUROBOND SPREAD OVER THE DOLLAR (basis points):							
Asia							
South Korea	—	95	70	70	800	380	106
Indonesia	—	511	506	335	575	1,022	534
Malaysia	—	—	—	—	—	—	152
Russia	**—**	**—**	**—**	**—**	**498**	**5,525**	**1,739**
Latin America							
Argentina	—	—	—	451	477	657	503
Brazil	—	—	—	—	—	1,117	513
Mexico	—	—	—	383	391	574	312

Sources: IMF and Russian European Centre for Economic Policy.

(a) Rate of change.
(b) As a percentage of GDP. Total general government.

sures adopted. The continuity of the current growth phase appears largely to depend on swifter privatisation, liberalisation and the opening up of the economy, processes to which China's envisaged membership of the World Trade Organisation should in principle contribute.

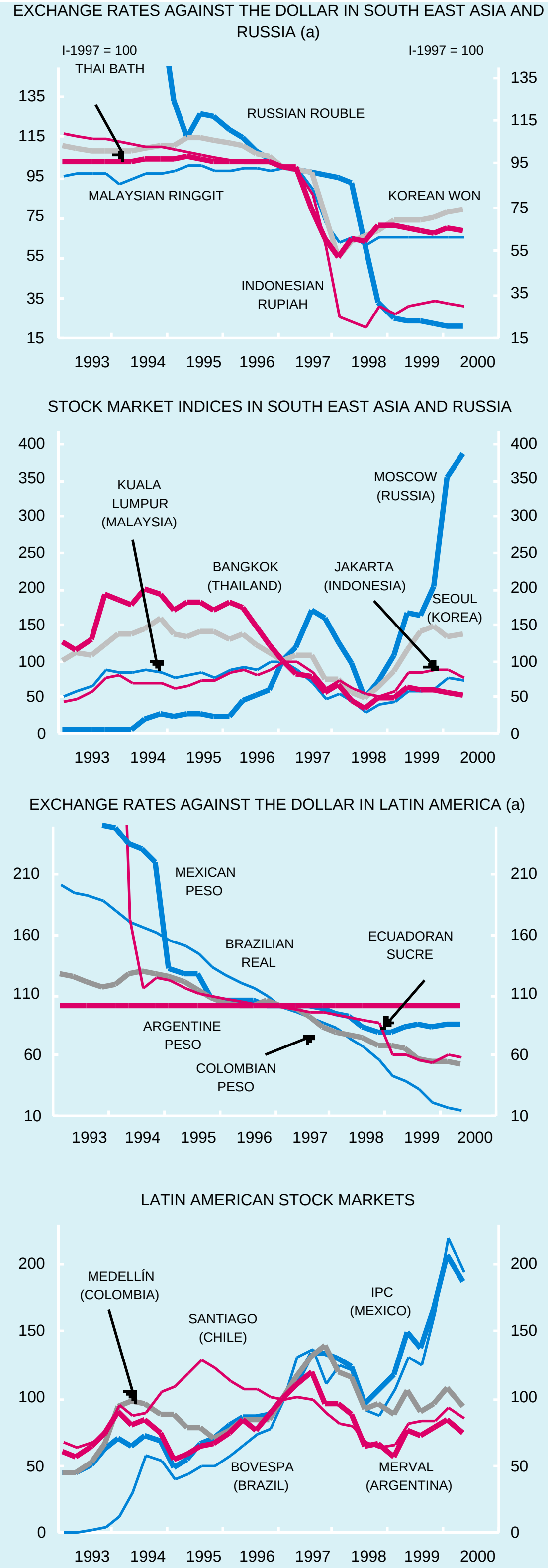
In *Russia,* economic developments were appreciably better than expected. GDP increased by 3.2 % in 1999 and price rises moderated over the year as a whole, although the annual rate of inflation was still 86 % (see Table II.2). Nonetheless, the recovery appears to be the circumstantial effect of the strong reduction in imports, which is partly attributable to the devaluation of the rouble in 1998, and, above all, of the increase in the value of Russian oil exports further to the rise in international crude oil prices. The extreme weakness of domestic demand (particularly private consumption), prompted by the decline in real wages and higher unemployment, is currently the chief obstacle to continuing expansion.

As a result of the recovery in activity, the budget deficit fell substantially to 1.7 % of GDP in 1999. Russia has likewise reached agreement recently with private creditors belonging to the London Club on the restructuring of a portion of the high debt incurred by the Soviet Union. And negotiations are also currently open with the Paris Club, grouping government creditors. However, serious structural shortcomings persist in the Russian economy. These hamper the enlargement of tax bases and lead sizeable public funds to be earmarked to sustaining inviable companies, considerably hindering headway in fiscal consolidation.

In 1999 the *Latin American* economies felt the contractionary effect of the financial and foreign exchange turbulence unleashed in the wake of the problems beleaguering many emerging economies in the two preceding years. The financial crises in south-east Asia in 1997 and in Russia in 1998, against a background of deep-seated imbalances in certain Latin American economies, caused a sharp and generalised reduction in capital flows to this geographical area. In addition, the terms for the financing of the region's high foreign debts were tightened, and there were speculative attacks against the currencies of the countries that retained fixed exchange rate regimes. Hence, the Brazilian real crisis in January 1999 exacerbated financial tension in the area, while aggravating the chronic balance of payments difficulties affecting Brazil's main trading partners. Adding to the general climate of financial instability in the first half of the year was the continuing downtrend of commodity prices, which reached historical lows in certain cases in this period.

CHART II.3

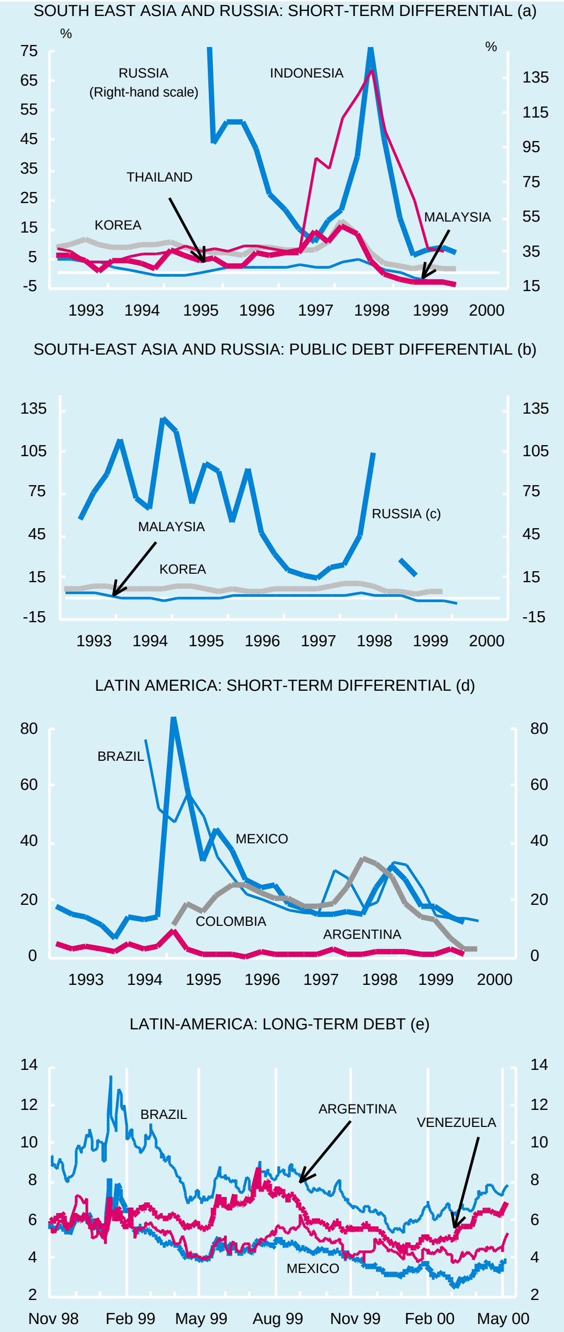
Emerging markets: exchange rates and stock markets



Sources: IMF and Reuters.
(a) A fall in the index denotes a depreciation of the currency against the dollar, and vice versa.

CHART II.4

Emerging markets: interest rate differentials vis-à-vis the dollar



Sources: IMF, Reuters, FinancialTimes and national statistics.

(a) Korea: 3-month certificates of deposit. Indonesia, Malaysia, Thailand, Russia: onvernight interbank. National currency for all countries.

(b) Korea: mortgage bonds. Malaysia: 3-month bills. Russia: GKO bonds. National currency for all the countries.

(c) Trading suspended from August 1998 to February 1999, and from July 1999.

(d) Argentina: fortnightly interbank. Brazil: overnight SELIC. Colombia and Mexico: 3-month interbank. National currency for all countries.

(e) Dollar-denominated 30-year bonds, exceptVenezuela (Brady bond).

Lastly, the deterioration in competitiveness vis-à-vis the south-east Asian countries, which were heavy importers of Latin American commodities, and the scant buoyancy of activity in these countries in the opening months of 1999 appreciably affected the region's exports. The outcome of all these factors was low or negative year-on-year growth rates in the first half of the year in the biggest countries in the area, with the exception of Mexico, which expanded moderately throughout 1999 (see Table II.2).

As from the second half of 1999 there were increasingly clearer signs of a pick-up in activity in most of the countries. The interest rates on private and public debt fell considerably (see Chart II.4) as a result of the greater stability prevailing on international financial markets, the adoption of structural (in particular budgetary) reforms and, in certain countries (Brazil, Chile and Colombia), the greater flexibility of the exchange rate regime. This easing of financial conditions was particularly favourable to private investment, which appears to have regained some momentum recently following its heavy decline in the first half of 1999. Moreover, the rise in commodity prices on international markets offered some relief to the exporting countries' trade balances. With the exception of Colombia, Ecuador and Venezuela, the foregoing factors allowed the rest of the biggest economies in the area to post positive growth in 1999 Q4, ushering in an upturn which, on the latest indicators, has gathered steam in the period to date in 2000.

Nonetheless, the enormous dependency of most of these economies on obtaining financing on international markets, as a result of their chronic budget and trade deficits, makes them significantly vulnerable. To prevent this, ambitious market reforms need to be adopted and effective mechanisms introduced to contain public spending and broaden tax bases. Further, macroeconomic policies should be pursued enabling the latent inflationary pressures in most countries of the region to be curbed now that flexible exchange rate regimes are widely in place.

As regards the biggest economies in the area, Brazil emerged from the 1998 recession relatively swiftly (it grew 0.8 % in 1999), benefiting from the gains in competitiveness arising from the depreciation of its currency, which fell by more than 30 % against the dollar last year. In turn, it successfully and notably improved the financing terms of its external debt, partly thanks to the favourable reception by the markets of its efforts to cut the budget deficit and contain the inflationary effects of the devaluation through the adoption of a monetary policy framework based on direct inflation targeting. Conversely, in Argentina, the combination of high interest rates (due largely to speculation against the currency board regime) and losses in competitiveness (associated with the devaluation of the real) gave rise to a decline in GDP of around 3 % and a fall in consumer prices. Notably, however, as from the second half of 1999, the easing of trade problems with Brazil in MERCOSUR, the recovery of its main trading partner and the greater stability of international financial markets all made for a pick-up in domestic demand, particularly in investment and in the external sector. The outlook for the current year is thus more favourable. Finally, in Mexico, and despite the crisis assailing the region in the first half of 1999, economic activity was firm throughout the year, with GDP increasing by 3.7 %. Mexico's strength was connected to the sustained and marked expansive phase of the US economy, with which it has close trade links under the Free Trade Treaty. Like the rest of the area, Mexico also benefited from the reduction of its external debt interest burden. However, matters worsened somewhat in 1999 in terms of inflation, although at the end of the year price rises began to moderate, with this trend running into the opening months of 2000.

Lastly, economic activity in *Africa* was less buoyant in 1999 than in other geographical areas. Aggregate GDP for the region expanded by 2.5 %. This moderate growth figure was a result, among other factors, of scant rainfall during the year and low international prices for many export products. Nonetheless, the recovery in the price of metal and energy commodities, despite contained farm prices, will foreseeably provide for an acceleration in activity this year, with many countries of the area having made significant headway in terms of macroeconomic stability.

II.3. ECONOMIC CONDITIONS IN THE EURO AREA

On provisional data released by Eurostat, GDP in the euro area grew at a rate of 2.4 % in real terms in 1999, three-tenths of a point down on the previous year. Despite the lower average increase in GDP, economic activity was on a clearly rising trend, and the signs of deceleration manifest at the end of 1998 dissipated as from Q2. The driving force of activity was external demand. Domestic demand remained weaker as a result of lower stockbuilding and the moderation of the pace of private consumption. Employment increased by 1.6 %, enabling the unemployment rate to fall, while inflation held at low levels although it increased gradually further to the rise in oil prices on international markets (see Box II.2), against the backdrop of the weak euro exchange rate.

As regards demand components, the growth rate of private consumption fell to 2.5 % from 3 % the previous year. On European Commission estimates, however, the increase in consumption was greater than that in disposable income. Consequently, the household saving ratio deteriorated. The decline in this ratio was assisted by the rise in the value of wealth stemming from increases on stock market indices, by the low real cost of consumer credit and by the improvement in consumer expectations.

Gross fixed capital formation grew by 4.9 %, four-tenths of a point above the related increase in 1998, and somewhat over two points higher than the average increase in the five preceding years (see Table II.3). The buoyancy of investment in fixed capital is particularly notable given the strong pro-cyclical nature of this variable in respect of GDP, although its acceleration was essentially due to the increase in public investment. By contrast, the expansion of private investment, despite the low real interest rates prevailing and higher returns on capital in recent years, moderated slightly in relation to 1998 as a result of the diminished momentum of final demand. Finally, the change in stockbuilding made a positive contribution of one-tenth of a percentage point to GDP growth, appreciably less than a year earlier.

Exports of goods and services in 1999 were greatly influenced by the fall-out of and subsequent emergence from the recent international financial crisis. Over the year as a whole they grew by 4.4 %, compared with 6.9 % in 1998. That said, they evidenced a clear line of improvement brought on by the brisk economic recovery in the rest of the world and by the gains in competitiveness arising from the depreciation of the euro against the currencies of the main trading partners. Imports of goods and services increased by 6 % in 1999, far down on the 1998 figure of 9.4 %. Throughout the year, imports were on a rising trend – albeit one less pronounced than that of exports –, in line with the increase in final demand, despite the acceleration in import prices. This trend in trade flows, along with the deterioration of the terms of trade, contributed to reducing the current-account surplus from EUR 60.3 billion in 1998 to EUR 43.2 billion in 1999.

Concerning the distribution of growth rates among the countries making up the euro area, 1999 saw a moderate reduction in their dispersion (see Table II.4). In this respect, it should be remembered that the existing divergence is

TABLE II.3

Euro area: main macroeconomic indicators
(annual percentage change)

	1994	1995	1996	1997	1998	1999	1999 Q1	1999 Q2	1999 Q3	1999 Q4
DEMAND AND OUTPUT:										
Gross domestic product	2.4	2.2	1.4	2.3	2.7	2.4	1.9	2.0	2.5	3.1
Domestic demand	2.2	2.0	1.0	1.7	3.4	2.9	2.9	2.9	3.0	2.6
Private consumption	1.3	1.8	1.5	1.5	3.0	2.5	2.8	2.4	2.4	2.5
Government consumption	1.2	0.6	1.8	0.8	0.9	1.4	1.5	1.3	1.6	1.4
Gross fixed-capital formation	2.6	2.5	1.1	2.1	4.5	4.9	4.0	5.5	5.1	4.9
Exports	8.6	7.8	4.3	10.3	6.9	4.4	0.6	2.3	5.5	9.1
Imports	8.0	7.4	3.2	8.8	9.4	6.0	3.8	5.2	7.0	8.0
Contributions to GDP growth (a):										
Domestic demand	2.1	2.0	1.0	1.6	3.3	2.8	2.9	2.9	2.9	2.6
Change in stocks	*0.6*	*0.3*	*–0.5*	*0.2*	*0.5*	*0.1*	*0.2*	*0.1*	*0.1*	*–0.2*
External demand	0.3	0.2	0.4	0.6	–0.6	–0.4	–1.0	–0.9	–0.4	0.5
PRICES AND COSTS:										
Consumer prices (annual average)	2.7	2.5	2.2	1.6	1.1	1.1	0.8	1.0	1.1	1.5
Consumer prices (end-year twelve-month rate)	2.6	2.5	1.9	1.5	0.8	1.7	—	—	—	—
Unit labour costs	0.1	1.5	2.0	0.7	0.0	1.1	1.6	1.6	0.8	0.4
Compensation per employee	2.8	3.4	3.1	2.4	1.4	1.9	1.7	2.1	2.0	2.1
GENERAL GOVERNMENT ACCOUNTS (c):										
Total expenditure	—	50.9	51.0	49.6	48.6	48.4	–	—	—	—
Current expenditure	—	46.5	47.1	46.1	45.0	44.7	—	—	—	—
Interest charges	—	*5.5*	*5.6*	*5.1*	*4.7*	*4.3*	—	—	—	—
Public investment	—	2.7	2.6	2.4	2.4	2.5	—	—	—	—
Total receipts	—	45.9	46.7	47.1	46.6	47.2	—	—	—	—
Primary deficit (–)/surplus (+)	—	0.6	1.4	2.5	2.7	3.1	—	—	—	—
Deficit (–)/surplus (+)	—	–5.0	–4.3	–2.6	–2.0	–1.2	—	—	—	—
LABOUR MARKET:										
Total employment (b)	–0.5	0.5	0.4	0.7	1.5	1.6	1.7	1.7	1.6	—
Unemployment (d)	11.6	11.3	11.6	11.6	10.9	10.0	10.3	10.0	9.9	9.7

Sources: European Central Bank and European Commission.
(a) Rate of change of GDP in percentage points.
(b) Estimate for 1999.
(c) As a percentage of GDP.
(d) As a percentage of labour force.

the outcome of at least three factors: differing trade exposure to the emerging economies affected by the recent financial turbulence; the lagged effects of the convergence of interest rates and the fiscal policy adjustments made to meet the Maastricht criteria; and different rates of potential growth. The least economically buoyant countries continued to be Italy and Germany, whose external sector was significantly impacted by the crisis. Moreover, the slackness of activity in Italy may have reflected the significant fiscal consolidation drive made in the preceding period. Meanwhile, in Germany, the relative lesser easing of monetary conditions compared with the area as a whole may have contributed to the scant growth of its domestic demand. Conversely, countries such as Ireland and, to a lesser extent, Spain, whose GDP expanded far above the area average, felt the effects of a very pronounced reduction in nominal and real interest rates and enjoyed higher potential growth than that of the euro area as a whole. Lastly, the latest indicators show an additional reduction in the dispersion of the member countries' economic growth rates this year which is consistent with the effects stemming from convergence having run their course and with the return to normality of the economic and financial situation in the emerging markets.

Despite the slowdown in GDP and the increase in costs, the rate of job creation in the euro area rose to 1.6 %, one-tenth of a point more than in 1998. Consequently, apparent labour productivity growth was notably stalled, posting an average increase of 0.9 %, although it progressively rose as the year unfolded. This

Recent oil price developments

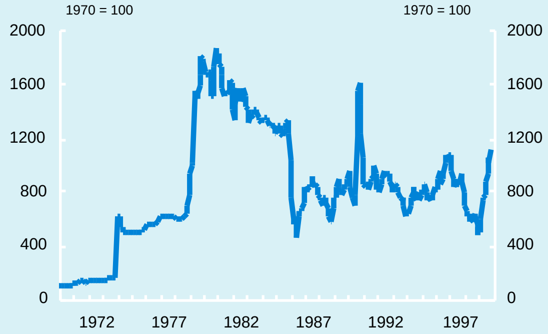
From late 1998 to March 2000, oil prices in US$/barrel terms soared to levels not seen since mid-1985, excepting the rebound in late 1990 as a result of the Gulf war. This was in contrast to the two previous years, when oil prices were on a downward trend, falling by 50 % from December 1996 to December 1998. The recent increase in prices on the market for crude was a consequence of the reaction of the major world exporters to the significant slide in their main source of income owing to weak international demand. Between March 1998 and March 1999 they rationed production, lowering it to 4.5 million barrels per day (6 % of 1998 average worldwide daily production) starting in March 1999.

At end-March 2000, the OPEC countries decided to raise their production by 7 % in order to stabilise crude prices – the so-called OPEC basket – within a range of US$22-28 per barrel. However, although oil prices fell after this agreement to nearly US$22 per barrel in mid-April, in the following weeks they picked up to a level of almost US$30 by end-May. It appears the increase in production by OPEC, against a background of stronger than expected demand, did not suffice to stabilise oil prices around the mid-point of the reference range during Q2. As for developments in Q3, the possibility of a fresh increase in crude prices due to stronger seasonal demand cannot be dismissed, unless supply is revised upwards to the extent necessary, both by OPEC and non-OPEC producers (OPEC has scheduled a meeting for June 21st to assess market conditions and take a decision).

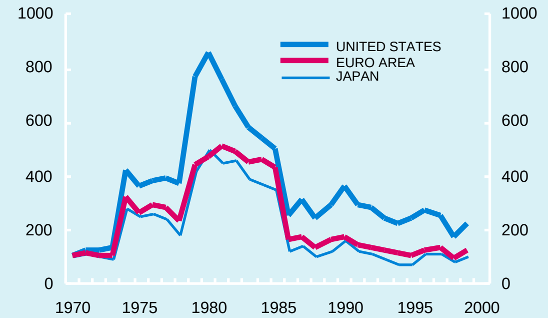
So far, the increase in oil prices has had no major contractionary impact on Western economies. Indeed, as can be seen in the Chart, crude prices in real terms, despite increasing in 1999, have been on a gradual downtrend since the mid-eighties, reaching levels in the euro area and Japan comparable with those prevailing before the 1973 oil shock. Additionally, the major non-producer countries' dependence on oil (measured by oil imports relative to GDP) has declined by almost 50 % since 1970. However, the dependence on imported oil has increased by almost 25 % over the same period in the United States, which is a producer though not a net exporter.

The increase in crude prices has prompted a significant rise in the inflation rate. Thus, in the euro area, the energy component of the HICP has grown more than 15 % between March 1999 and March 2000, this having principally determined the increase by more than one percentage point in inflation over the same period. Notwithstanding, the feed-through of the increase in oil prices to the HICP has so far been less acute than in the recent past. Hence, as the chart reveals, the continuous rise in oil prices between 1994 and 1997 had, in proportional terms, an overall impact on the energy sub-index that was stronger than that observed in recent months. This lesser influence not only reflects the slight fall in the weight of liquid fuels in the HICP in recent years, but might also point to time-lags in some country's between the increase in oil prices and the pass-through to the prices of oil products charged to consumers. Moreover, it is likely that the indirect impact of higher oil prices on inflation rates, via increases in production costs, has not yet become fully manifest (as the positive differential between the rise in producer prices and the HICP would appear to indicate). Nonetheless, wage restraint, if maintained, would help reduce the quantitative significance of these effects.

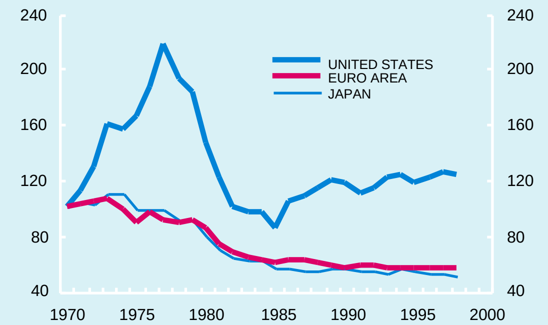
OIL PRICE IN DOLLARS PER BARREL



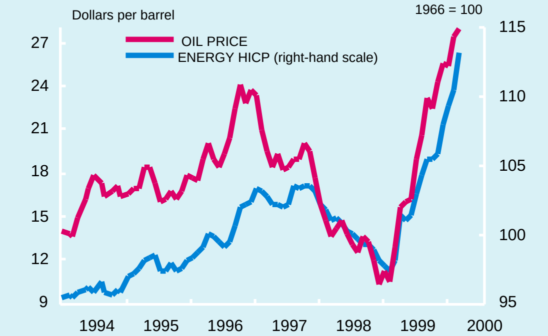
OIL PRICES IN REAL TERMS (a)



OIL DEPENDENCE (b)



ENERGY HICP AND OIL PRICE



Sources: IMF, Eurostat and International Energy Agency.
(a) Deflated with the GDP deflator.
(b) Net oil imports (000s of tons) / real GDP.

TABLE II.4

Euro-area countries: annual GDP growth

	1994	1995	1996	1997	1998	1999
Belgium	3.0	2.5	1.0	3.5	2.7	2.5
Germany	2.3	1.7	0.8	1.5	2.2	1.5
Spain (a)	2.3	2.7	2.3	3.8	4.0	3.7
France	1.8	1.8	1.2	2.0	3.4	2.7
Ireland	5.8	9.5	7.7	10.7	8.9	8.3
Italy	2.2	2.9	1.1	1.8	1.5	1.4
Luxembourg (a)	4.2	3.8	2.9	7.3	5.0	5.0
Netherlands	3.2	2.3	3.0	3.8	3.7	3.5
Austria (a)	2.4	1.7	2.0	1.2	2.9	2.1
Portugal	2.5	2.9	3.2	3.5	3.5	3.1
Finland	4.0	3.8	4.0	6.3	5.0	3.5
Euro area	2.4	2.2	1.4	2.3	2.7	2.4

Sources: Eurostat, European Commission and national statistics.

(a) 1994 and 1995 data calculated on the basis of ESA 79.

pattern of growth, which is more labour-intensive than is usual in Europe, may be related to the moderation of nominal and real wage costs in recent years (see Chart II.5); to the growth of the service sector, which is more labour-intensive; and, to a lesser extent, to the introduction of structural labour market reforms.

Job creation was concentrated in the service sector, where already more than 65 % of the euro-area work force is employed, while there was a net destruction of jobs in manufacturing industry. The expansion of employment and the mild slowdown in the rate of increase of the labour force were conducive to the decline in the number of unemployed. Accordingly, the unemployment rate stood on average for the year at what is, at 10 %, still a very high rate, evidencing that notorious structural flaws remain in place in the labour markets of the euro area. By group, the highest unemployment was among those aged under 25, the long-term unemployed and the female population. Lastly, the dispersion of the unemployment rate was once more reduced in 1999, although it continued to reflect the uneven progress made by member countries in applying effective labour reforms.

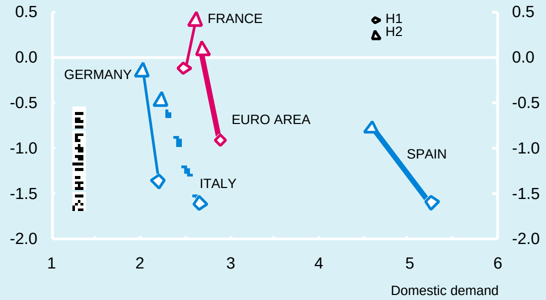
According to most price indicators, the inflationary situation in the euro area worsened relatively in 1999. This was essentially due to the rise in oil prices and to the depreciation of the euro by approximately 8 % in nominal effective terms during 1999. All the components of the final demand deflator showed an accelerating profile, this being more pronounced in the case of the prices of imported factors than in that of domestic costs. Among the latter, unit labour costs rose last year by more than in 1998 since, on one hand, compensation per employee increased by four-tenths of a point more than the previous year and, on the other, apparent productivity slowed. In turn, the high increase in net indirect tax led the growth rate of the gross operating surplus per unit of output to moderate, with margins being squeezed.

The average rate of change of the harmonised index of consumer prices (HICP) was 1.1 % in 1999. Although this figure matches that of the previous year, it nevertheless masks a marked rise in the 12-month growth rate from 0.9 % in December 1998 to 1.7 % in December 1999. And this has continued so far in 2000, to 1.9 % in April. As Chart II.6 shows, the energy consumer goods component alone increased, on average, its contribution to the growth of the area-wide HICP, while the index excluding seasonal food and energy, which proxies underlying inflation, clearly improved on the preceding year, posting an increase of 1 % in 1999 compared with 1.4 % in 1998. Nevertheless, this indicator also deteriorated somewhat in the final months of the year as a result of the higher cost in national currency of imported goods and of the pass-through of increases in production costs (linked to commodity prices and to the exchange rate) to the price of consumer goods produced in the euro area. Under the HICP, goods prices grew by 0.8 %, two-tenths of a point more than in 1998, and service prices by 1.5 %, four-tenths of a point down on the previous year. As a result, the inflation differential narrowed by 0.6 percentage points. The decline in prices triggered by the deregulation of certain markets, particularly in telecommunications,

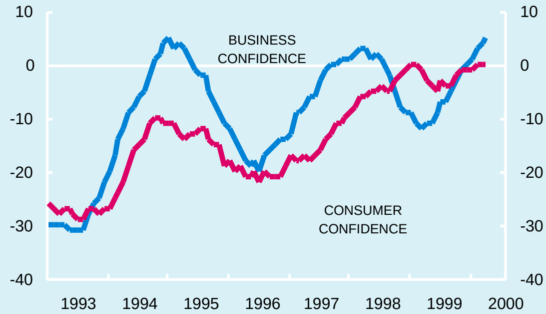
CHART II.5

Euro area: composition of growth, confidence indicators and performance of employment, real wages and productivity over the course of the cycle

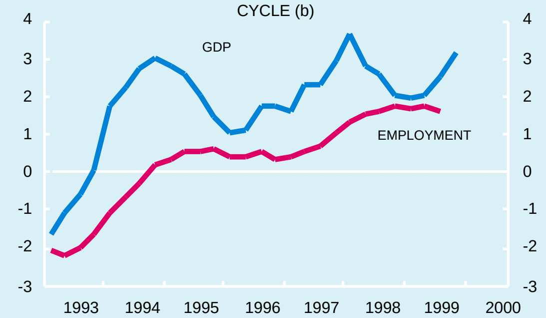
CONTRIBUTIONS OF EXTERNAL AND DOMESTIC DEMAND TO GDP GROWTH IN 1999



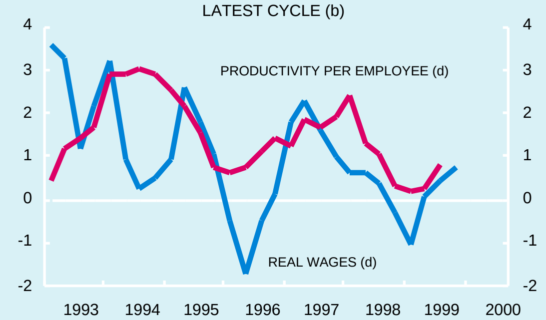
CONFIDENCE INDICATORS (a)



OUTPUT AND EMPLOYMENT DEVELOPMENTS OVER THE LATEST CYCLE (b)



REAL WAGE AND PRODUCTIVITY DEVELOPMENTS OVER THE LATEST CYCLE (b)

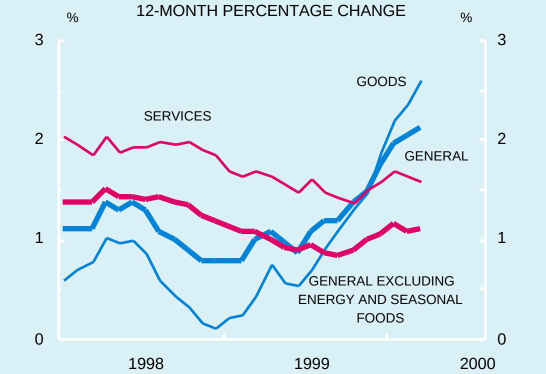


Sources: Banco de España, European Central Bank, European Commission and national statistics.

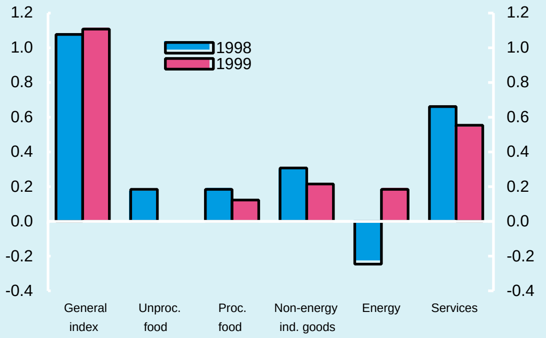
(a) Percentage balance of optimistic/pessimistic replies.
(b) Year-on-year rate of change.
(c) Difference between change in GDP and in employment.
(d) Difference between change in compensation per employee and the GDP deflator.

CHART II.6

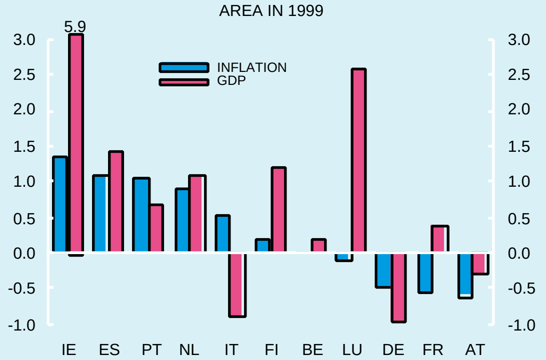
Euro area
Harmonised indices of consumer prices



CONTRIBUTION OF HICP COMPONENTS TO ANNUAL CHANGE



INFLATION AND GDP GROWTH DIFFERENTIALS VIS-À-VIS THE EURO AREA IN 1999



Sources: Eurostat and national statistics.

contributed favourably to moderating the service component of the HICP.

Along with the aforementioned aggregate developments, the dispersion of national inflation rates increased in 1999. Across the area, it was generally the countries with the highest GDP growth which had higher inflation rates (see Chart II.6). This positive correlation between output and prices, though it might be reflecting real and productivity convergence by the less developed countries towards the European average, is also likely to be the outcome of excessive demand pressures in certain countries.

Looking ahead, inflation in the euro area would be on a favourable course if the expectations of oil prices holding around a more moderate level and of productivity picking up were to be confirmed, and also if wage demands were not to incorporate the transitory factors that have most influenced price increases in recent months. Nonetheless, if the depreciation of the euro becomes embedded and the expected greater buoyancy of activity is confirmed, the possibility of the inflationary upsurge lasting longer than expected cannot be ruled out.

II.4. ECONOMIC POLICIES IN THE EURO AREA

Budgetary disequilibria continued to moderate in the euro area countries in 1999. The general government deficit stood at 1.2 % of GDP, eight-tenths of a point less than a year earlier, and the public debt/GDP ratio edged down from 73.1 % in 1998 to 72.3 % in 1999. Yet although the reduction in the deficit was significant, the composition of this adjustment did not prove so favourable, since half of the improvement in the budget balance was due to the reduction in interest payments, whereby the primary balance improved by only four-tenths of a point of GDP. Moreover, in contrast to the previous year, the contribution of primary spending to the adjustment was negative in 1999, so it was the growth of receipts in proportion to GDP which made for the increase in the primary surplus (see Chart II.7). The far better-than-expected performance of receipts cannot be readily reconciled with the slowdown in economic activity in 1999 as a whole, nor with the adoption in numerous countries of tax reforms aimed at lessening the tax burden. One possible explanation, which is difficult to verify, would be the disclosure of tax bases and an increase in the degree of compliance with fiscal obligations, induced perhaps by greater efficiency in tax management. In any event, as it is difficult to discern to what extent the favourable revenue-raising performance may be temporary or more permanent, it would be unwise to extrapolate mechanically, in budgetary plans, the proportion of receipts per unit of output obtained in 1999 to future years. Accordingly, it is highly likely that continuing fiscal consolidation will require firmer resolve to improve the primary balance through the containment of current expenditure.

The primary aim of fiscal policy in recent years has been to correct the sizeable budgetary disequilibria which arose early in the previous decade and which, by leading to heavy increases in public debt, hindered the maintenance of a stable macroeconomic environment. However, despite the headway made, the process of adjustment is far from having concluded, particularly as far as debt reduction is concerned. This is especially so given the future challenge to public finances that an ageing population may pose. In turn, as progress has been made in fiscal consolidation, the focus has increasingly been turned on the analysis of the structure of public finances, in order to determine the composition which may best underpin sustained growth and job creation.

Specifically, there seems to be broad consensus on the need to contain current expenditure and to promote higher public investment, and also on the advisability of reducing, in most countries (see Table II.5), the so-called “tax wedge” or gap separating the cost of labour for the employer from the net wage received by the employee, so as to provide more readily for participation and employment. Public investment in the euro area in 1999 increased by somewhat over 7 % in nominal terms, following two years of very low growth. Further progress seems necessary, particularly in those countries with lower stocks of infrastructure, provided it entails a set-off against other expenditure headings. As regards the “tax wedge”, most member states have, under their stability programmes, adopted or plan to adopt concessions on social security contributions or tax cuts on wage income. Occasionally, however, planned fiscal reforms are not accompanied by compensatory budgetary measures. Accordingly, at least in the short run, they may lead the fiscal consolidation process to slow, which is particularly inappropriate for countries with high public debt or which are far ahead in the business cycle.

Turning to structural policies, some progress was made in 1999 in liberalising and promoting the integration of product and factor markets, which should contribute to increasing potential output and employment. So far, the most significant headway has been in product and service markets and in the capital markets. But the adoption of measures allowing for a more effective functioning of the labour market is lagging behind, despite the fact that the countries that have most advanced in this area have reaped most favourable benefits in terms of job creation.

In recent years the single market for goods and services has been shored up by the reduction of state aid and the lowering of administrative barriers to cross-border competition, and there has been a gradual narrowing in the dispersion between national price levels. Liberalising measures have proven particularly effective

TABLE II.5

Indicators of structural aspects

	Euro area		United States		EU-15	
	1998	1999	1998	1999	1998	1999
Dispersion in price level, taxes excluded (a)	13.7 (1997)	…	…	11.0	15.0 (1997)	15.0 (1998)
Labour productivity (change in)	1.4	0.9	2.2	2.4	1.3	0.9
R+D spending (% of GDP)	…	1.8	2.8	…	1.8	1.8
Public investment (% of GDP)	2.4	2.5	2.7	3.2	2.2	2.3
Unemployment rate (%)	10.9	10.0	4.5	4.2	9.9	9.2
Long-term unemployment rate (b)	…	…	14.1	12.3	50.1	…
Participation rate (labour force/population of working age)	65.4	65.6	67.1	67.1	67.3	63.4
The employed as % of population of working age	57.9	58.7	64.1	64.3	60.3	61.0
Change in employment (%)	1.5	1.6	2.1	1.5	1.5	1.5
General government balance (% of GDP)	–2.0	–1.2	–0.1	0.5	–1.5	–0.7
Tax wedge (% of gross wage)	…	…	…	26.1	…	37.2

Sources: European Commission, OECD and national statistics.

(a) Coefficient of variation of price level indices (EU = 100).

(b) For the EU: the unemployed for over twelve months as % of total unemployment. For the United States: the unemployed for over 27 weeks as % of total unemployment.

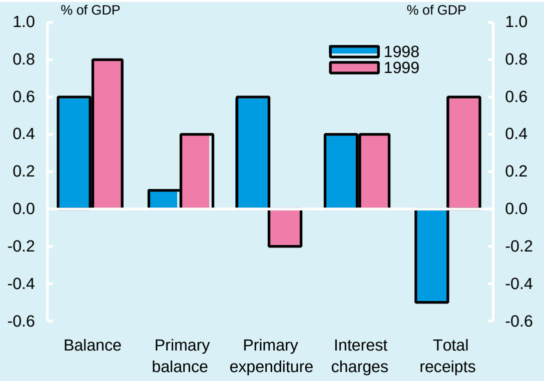
in telecommunications (where they have led to notably lower prices) and, to lesser extent, in electricity and gas. As regards the water utilities, rail transport, postal services and retail distribution, progress has been much more limited. As a result of the introduction of the euro, the degree of integration of European capital markets has increased appreciably thanks to the elimination of exchange rate risk and the virtual disappearance of transaction costs associated with changing currency. However, obstacles remain that are preventing the full development of the single market in the financial area. These include the diversity of financial regulation systems, the tax treatment of saving and the legal or administrative difficulties certain types of issuers or investors face in raising finance (the former) or purchasing assets (the latter) outside their countries.

The measures adopted aimed at reforming and adding flexibility to labour markets have tended to give priority to active or preventive policies geared to raising the participation rate and reducing unemployment among the young, women and the long-term unemployed. In certain countries, this approach has been combined with the review of traditional passive policies, particularly regarding the duration of unemployment benefits and eligibility criteria. That said, only a few countries have systematically overhauled the arrangements for subsidies, whether for unemployment and illness or for early retirement, the spurious use of which as a substitute for unemployment benefits is a disincentive to participation in the labour market. Turning to the apportionment of working hours, the policies applied have generally been aimed at making part-time employment easier, the progress has been slower in setting in place arrangements for the flexible distribution of annual working hours. In certain cases, measures to reduce the working day have recently been applied, the effects of which on employment, wage costs and productivity are so far very uncertain, although it cannot be ruled out that they may ultimately affect these variables unfavourably. Lastly, aspects of labour legislation that significantly penalise stable as opposed to temporary hiring persist in most countries.

One area where the European economy lags the United States is in the development of new information and communications technology and its introduction into productive processes and trade transactions (see Table II.5). Despite the fact that all countries have, in recent years, applied policies to promote R+D spending, such policies have proven insufficient to ensure the full incorporation of the European economy into the new technological environment. Given the importance of the advances in this field for economic development (drawing on the US experience), the European Council summit meeting in Lisbon in March 2000 identified a series of policies that should allow progress in producing and disseminating the new technology and the full integration of telecommunica-

CHART II.7

Euro area: composition of the budgetary adjustment in 1998 and 1999 in relation to previous years (a)



Source: European Commission.

(a) A plus sign denotes a positive contribution to the adjustment, and vice versa.

tions markets by the end of 2001. These measures include most notably: the elimination of economic and legal obstacles to heightened use of the Internet; the adaptation of education and training to advances in IT; and the reduction of administrative barriers hampering the creation of innovative companies.

II.5. THE COMMON MONETARY POLICY AND MONETARY AND FINANCIAL CONDITIONS IN THE EURO AREA AND IN SPAIN

II.5.1. The single monetary policy strategy

On 1st January 1999, the euro was established as the single currency for 11 European countries and the monetary policy of the Eurosystem began operating. This saw the culmination of a process embarked on in 1989 with the approval at the Madrid European Summit of the Delors Report. In the run-up to 1999, intensive preparations had to be made in order to define the single monetary policy strategy and the instruments needed to implement it effectively.

The satisfactory preparatory work carried out and the nominal convergence attained by the countries making up the euro area did not prevent the start-up of the single monetary policy from having to face, in early 1999, the challenges stemming from the creation of the new currency and its acceptance by the markets. A further challenge involved setting up the operational framework which, from 1st January, would govern the implementation of the single monetary policy.

At the start of 1999, the monitoring by the Eurosystem of the economic, monetary and financial conditions in the euro area proved particularly complex because the construction of indicators and compilation of time series of the relevant aggregate variables for the area faced considerable obstacles. In particular, although in early 1999 considerable progress had been made in homogenising the statistical sources of the information from the member states, it was vital to move ahead with the construction of data bases for the area and to improve the speed and efficiency of the transmission of such data within the Eurosystem. Likewise, the structural changes that the creation of EMU would involve could affect the relationships observed in the past between the different macroeconomic variables. And this required particular caution in analysing the results of the models estimated for the area.

The elements of the single monetary policy strategy took definitive shape in late 1998, as detailed in last year's *Annual report.* The target of monetary policy, namely price stability, was defined as a 12-month increase in the euro-area HICP of less than 2 %. This definition ruled out both inflation and deflation as equally incompatible with the goal of stability. Moreover, the target was stated to have a medium-term orientation, which involved acknowledging that, in the short run, there are factors that may cause erratic and temporary movements in prices to which monetary policy should not react. It was further acknowledged that, even when monetary policy seeks to offset genuinely inflationary disturbances, its effects are not immediate but impact price developments with some delay.

In accordance with the principles characterising the strategy selected, the ECB announced that its monetary policy decisions would be taken on the basis of an overall and ongoing assessment of a broad set of economic, monetary and financial indicators capable of providing information on future price developments. However, given the essentially monetary nature of inflation in the medium and long term, a prominent role was given to the monetary aggregates.

Following in-house analysis at the ECB on the relative properties of different monetary aggregates, the monetary aggregate M3 was considered to be the variable with the best qualities (for its definition, see the 1998 Banco de España *Annual report*). Moreover, a *reference value* of 4.5 %, compatible with price stability, was set for the medium-term growth of this aggregate. At the end of 1999, this reference value was reassessed and maintained at this level. It was further established that, thereafter, its level would be examined annually. As became evident during the course of 1999, thereby confirming what was stated at the end of the previous year when the basic principles that were to govern the single monetary policy were set out, the reference value did not constitute a target and nor did the deviations of monetary growth therefrom, on their own, lead to an automatic response by the monetary authority.

Along with the information on monetary growth, the euro system uses an additional set of indicators to evaluate inflationary risks at each moment in time. Among these indicators are financial variables (such as the exchange rate, long-term interest rates, the yield curve or stock market trends) and non-financial indicators (information from various prices and costs, fiscal policy variables, inflation expectations, etc.) which, in general, help assess the various factors influencing the foreseeable trend of prices.

II.5.2. Monetary policy decisions in 1999

During 1999, the Eurosystem conducted the single monetary policy in keeping with the strategy adopted, taking into consideration the various risks affecting price stability in the area. The first steps of the single monetary policy were thus taken against a background of decelerating economic activity in the industrialised countries. Subsequently, the progressive improvement in the international economic situation bore significantly on the shifting balance of risks for prices that the ECB considered during the year. The ECB publicly explained the nature of the policy applied via numerous communications and interventions by its governing bodies and, periodically, it set out its assessment of the economic, monetary and financial situation in the area in relation to the goal of maintaining price stability. The decisions adopted on the stance of monetary policy translated into movements in the rates on its main refinancing operations and on its standing marginal lending and deposit facilities.

Although the new monetary control framework came into force on 1st January 1999, the interest rates on the first main refinancing operation, conducted on 4th January, and on the standing marginal lending and deposit facilities were announced the previous month. This was done to make the transition to the single monetary policy as smooth as possible and to dispel any uncertainty in the euro's early days. The interest rate on the first main refinancing operation was set at 3 %, the level on which the intervention rates applied by the national central banks making up the Eurosystem had previously converged in late 1998.

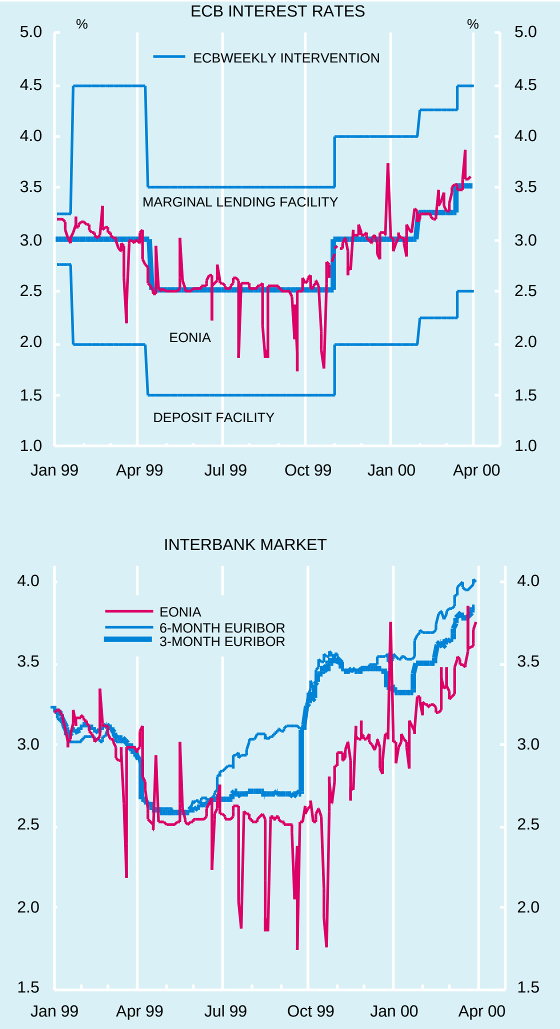
At the outset of 1999 and in the period to around May, most indicators of the international environment and, in particular, of the common monetary area progressively confirmed the persistence of the slowdown in economic activity perceptible since October the previous year. Along with other factors, this situation helped keep inflation expectations low, with the balance of risks for price stability leaning towards the possibility of a deflationary process. However, even at that time not all indicators were pointing in the same direction. Indeed, certain factors, such as the vigorous rate of expansion of the monetary and credit aggregates, the rise in oil prices and the onset of the depreciation of the euro, were all subject to scrutiny thereafter by the authorities. Nonetheless, given the predominantly downward pressures on prices and the absence of clear signs of an improvement on the international front, the Governing Council of the ECB decided on 8th April to cut the rate on its main refinancing operations by 0.5 percentage points to 2.5 %.

As from May, the indicators available on the economic outlook began to show signs of recovery, while inflationary pressures became more patent, in step with the progressive firming of the pick-up in the common monetary area and the continuing high levels of oil prices. Thereafter, the situation became more entrenched, and the periodic assessment of the economic situation by the ECB Governing Council pointed increasingly clearly towards possible price pressures in the future.

At its meeting on 4th November 1999, the ECB Governing Council decided to raise the weekly tender rate by 50 basis points to 3 %. This measure also contributed to easing the uncertainty on financial markets over the course of interest rates in the run-up to the year 2000. Nonetheless, in the wake of this measure the risks for price stability persisted and even heightened. In particular, continuous upward deviations by M3 from its medium-term reference value, the rising trend of oil prices, the persistent weakening of the euro against the dollar and higher-than-expected price rises in the area alerted the monetary authority to the dangers for price stability in the euro area. Consequently, on 3rd February, 16th March and 27th April this year, the ECB governing council once more raised its intervention rates by 25 basis points on each occasion, taking the rate on its main refinancing operations to 3.75 % on the latter date. The three-step rise in official rates in recent months is part of a process of gradual monetary policy tightening, though with

CHART II.8

Eurosystem interest rates



Sources: Banco de España and ECB.

a relatively accommodating stance, aimed at ensuring the maintenance of price stability in the new economic conditions.

II.5.3. Monetary and financial conditions in the euro area and in Spain

Monetary and financial conditions in the euro area in 1999 were relatively generous. Nominal and real interest rates held at historically low levels, the euro was on a depreciating trend in effective terms, the monetary and credit aggregates grew at high rates, and there were significant increases in share prices. Broadly, this pattern was common to all the countries making up the area, due in part to the satisfactory process of integration of money markets. However, the differences in monetary transmission mechanisms (owing to structural factors proper to each economy), inflation differentials and the different cyclical positions of the EMU members meant that the degree of monetary and financial easiness varied from country to country. In Spain's case, in particular, real interest rates (especially short rates) stood at lower levels than the average for the area, and finance extended to the private sector ran at a rate of expansion far higher than in the euro zone.

Euro area money market interest rates in 1999 were generally marked by considerable stability, with the exception of certain bouts linked to the anticipation of changes in the ECB's intervention rates and greater uncertainty associated with the Y2K effect (see Chart II.8). Notably, too, national money market interest rates were very similar, so that the euro, from its inception, had a single Europe-wide money market.

Long-term interest rates in the area, like those for other industrialised countries, ceased in 1999 to trend downwards as they had since 1996 (see Chart II.2). After bottoming out early in 1999, they embarked on a rising trend that took them to around 5.5 % in the opening months of 2000. These movements responded to a combination of domestic and external factors whose relative importance varied over the course of the year. In effect, the movements in long-term interest rates were largely influenced by the prospect of growth in the world economy, especially in the United States and in the euro area countries. Thus, as growth expectations were revised upwards, long-term rates also increased (see Box II.3). In 1999 as a whole ten-year interest rates increased by around 150 basis points in the area, while the related rise in the United States was 180 basis points. As a result, the US/euro area interest rate spread widened – although movements in the opposite direction were recorded during the year – in net terms in relation to 1998 levels and stood at around 100 basis points at the close of 1999.

The exchange rate of the euro depreciated by 8 % in nominal effective terms between the first and fourth quarters of 1999, entailing dearer import prices. The depreciation were sharper in the first half of 1999, while in the following six months the improved economic outlook in the area contributed to stabilising the exchange rate. However, in the opening months of 2000 the euro once more turned downwards, falling to a level below $0.90, although it began to pick up appreciably in late May.

Long-term interest rate movements in 1999 were fairly uniform across the various countries in the area, although minor differentials persist-

BOX II.3

Long-term interest rates in the euro area

During 1999, the nominal long-term interest rate in the euro area, measured by the yield on ten-year government bonds, was on a rising trajectory (see accompanying chart). To understand this course, it is worth resorting to the approach that explains the nominal interest rate as the sum of the real long-term interest rate and expected inflation (and a premium associated with different types of risk such as, for instance, that associated with error in inflation expectations). It is very important that the monetary authorities should know the contribution of these components since, if the rising trajectory were attributable to greater inflation expectations, that would denote the possible presence of risks to price stability.

Often, the course of nominal long-term interest rates is explained in terms of changes in inflation expectations, it being understood that the real interest rate (and the risk premia) is a more structural variable and, therefore, moves more steadily. Nonetheless, it does not seem reasonable to rule out a priori that changes in the real long-term interest rate may also play a significant role.

The real long-term interest rate is determined on the basis of economic agents' saving and investment decisions and reflects the cost of capital and the compensation for the deferral of consumption over time. There are several alternatives for estimating real interest rates. The first involves observing the course of ex-post interest rates, which adjust the nominal rate for the average inflation outturn. This estimation cannot be made for the year 1999, since it is not currently known what the long-term inflation outturn will be. The second alternative, which is frequently used, is the calculation of the ex-ante interest rate, which is based on the estimation of expected inflation drawing on time series and econometric models or surveys, and of the possible risk premia. However, if these methods approximated long-term inflation expectations closely, it would be possible to ascertain directly their contribution to changes in nominal interest rates. Finally, the third option, which is the most appropriate in this case, is based on the prices of index-linked bonds. The yield on these instruments is an approximation to the real interest rate, although it includes measurement errors due to the existence of liquidity premia, the presence of lags between actual inflation and the adjusted payment on the bond, and to the method of calculating the yield drawing on market prices. For the euro area, the only index-linked bonds available are French bonds(1).

The yield on French index-linked bonds (see adjoining chart) held stable during 1999 Q1 and, after a minor fall, continued on a rising trend. Overall, the yield increased by around 50 basis points during the year.

Given the difficulties associated with the foregoing estimates of real interest rates, it is important they should be complemented by factors which, according to economic theory, are their basic determinants. It should be noted firstly that these factors are manifold, especially in open economies. And, secondly, that the current degree of integration on capital markets has led to the belief that there could be a single worldwide real interest rate and that the differences between countries would be in response to country risk premia and to exchange rate expectations. That said, the empirical evidence available(2) suggests that, although real interest rates are closely linked to international factors, the domestic economic situation is very important.

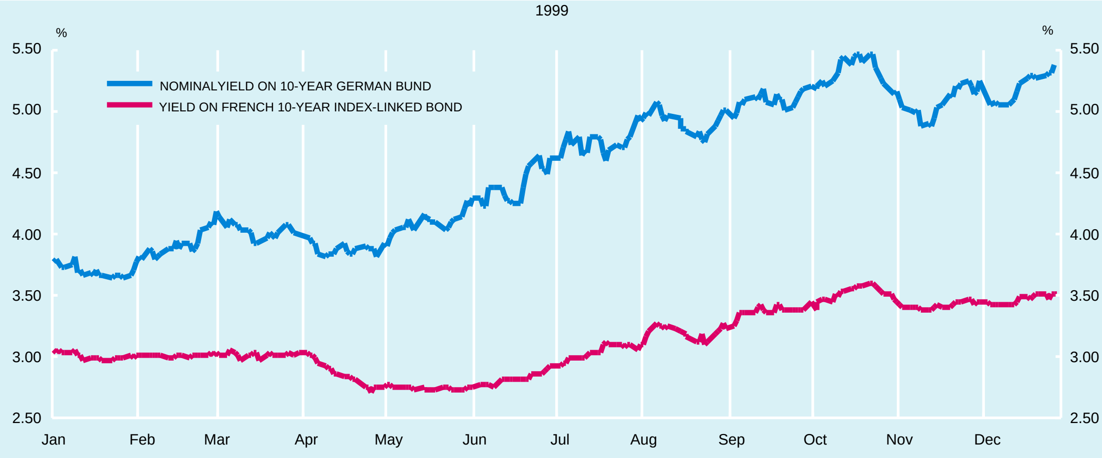
In the current economic setting, there are three key factors that could explain real long-term interest rate developments in the euro area. The first factor, which is of a global nature, is the development and introduction of new technology, which is generating expectations of higher future productivity. According to various empirical studies, this could give rise to an increase in real long-term interest rates as a result of the reduction in present saving in response to expectations of greater future income and to the wish for a smooth consumption path. The second factor, and one of growing relevance, is demographic developments. The gradual ageing of the population in the euro area reduces the proportion of the labour force, which would lessen saving, thereby raising real long-term interest rates. The third and final relevant factor is the sustained reduction in the deficit and public debt in the euro area which, other things being equal and unlike the previous factors, could give rise to a decline in real interest rates.

In any event, it is worth noting that, given the structural nature of these economic factors, real interest rates should follow a smooth course over time. Such smoothness, however, is not seen in the course of index-linked bond yields and, therefore, some caution should be exercised in interpreting short-term movements in the prices of these instruments, which may respond largely to the above-mentioned measurement errors.

In sum, these economic factors combined with the trend of French index-linked bonds appear to indicate that, although there has been a rise in real interest rates in the euro area, greater inflation expectations (and risk premia) have also played a significant role in shaping nominal long-term interest rates in the area. Changes in oil prices and in the euro exchange rate have probably contributed to the rise in inflation expectations.

(1) See Box 2 of the February 1999 edition of the *ECB Monthly Bulletin* for more information on these instruments.
(2) F. Breedon, B. Henry and G. Williams, *Oxford Review of Economic Policy,* vol. 15, nº2.

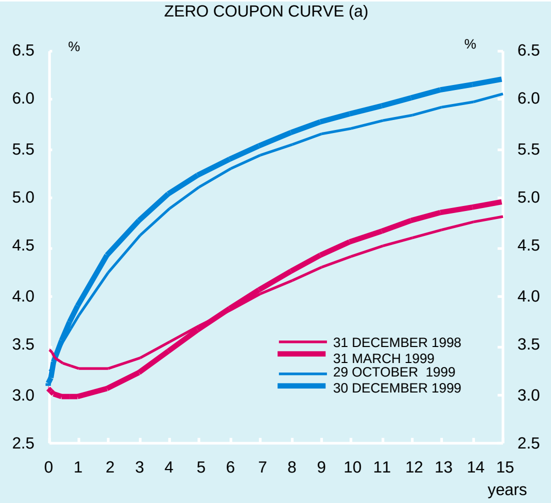
Long-term interest rates in the euro area



Sources: Banco de España and Reuters.

CHART II.9

Interest rates in the euro area



Sources: Banco de España and ECB.
(a) Estimated with money market and swaps data.

ed without generally varying significantly. These differentials may have been due both to the different credit rating of issuers and to aspects related to the workings and size of national public debt markets. In Spain's case, the 10-year rate stood in December 1999 at 5.7 %, having maintained during the year a very stable average spread over Germany of around 23 basis points.

The changes in interest rates at different terms gave rise to changes in the slope and position of the area's yield curve (see Chart II.9). Hence, the slope of the zero-coupon curve, measured via the difference between ten-year debt yields and the interest rates on three-month interbank deposits, increased in 1999, which may be interpreted as the outcome of the improved growth prospects and the upside risks to prices which were simultaneously observed.

The movements in the yield curve passed through to the other interest rates of relevance for agents' spending decisions, such as bank rates. Generally, bank lending rates to non-financial corporations and households in the euro area as a whole tended to fall in the first six months of the year, rising subsequently in the following six months when the increase in long-term debt yields combined with expectations of a rise in official interest rates. Nonetheless, at the start of 2000 bank lending rates in the euro area remained generally lower than those observed in 1998. Lastly, although there is some heterogeneity regarding the transactions to which bank interest rates refer in each country, it may be said that lending rates to non-financial corporations and households in Spain tended to be below the average for the area. Moreover, since they depend less on the trend of long-term rates, short term bank lending rates in Spain diminished more than their European counterparts in the first half of 1999.

As earlier indicated, the above-mentioned course of nominal interest rates in the euro area meant that real long-term interest rates held during the first half of the year at below their related level in 1998, although they subsequently increased as the economic outlook in the area improved. Real short term interest rates fell in relation to 1998 owing to the decline in nominal short term rates and to the rise in inflation. In Spain, the higher inflation rate meant that real rates were lower than those in the euro area as a whole. This contributed, along with the high growth of finance granted to the private sector, to shaping relatively easier monetary and financial conditions, in a setting in which economic growth was also higher than that of the euro area.

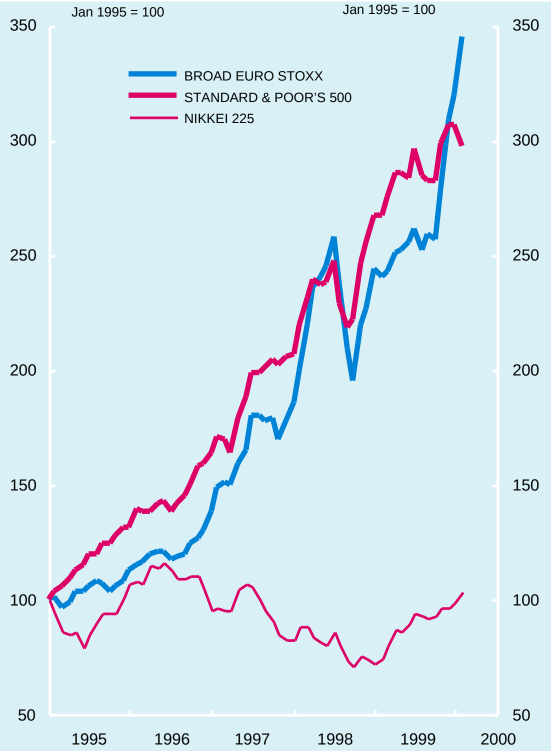
Stock market developments in the euro area were relatively unrelated to the course of bond market yields, and responded essentially to the improvement in growth expectations and to higher expected profits. Generally, European stock markets followed the rising trend (not exempt from some volatility) observed in the other industrialised countries. This trend was particularly marked in Europe (see Chart II.10). The broad Dow Jones Euro Stoxx index, which lists the main European stocks, stood in December 1999 at 40 % above its end-1998 level. This rise was greater than that for the same period in the US Standard and Poor's index (19 %) and similar to that for the Japanese Nikkei 225 index (37 %).

The stock market performance last year led to an increase in household wealth in the area. And as discussed earlier in this chapter, this may have affected agents' saving and investment decisions and, in all likelihood, the composition of their portfolios. However, as was to be expected, these processes were not uniform in all the countries of the area. In Spain, stock market earnings were generally lower than those in the other European markets; the Madrid General Stock Market Index rose 16 % during the year, down on both 1998 (37 %) and on the common monetary area (40 %).

In the foregoing environment, the trend of the monetary and credit aggregates in the euro area observed during the previous year was accentuated in 1999; monetary growth exceeded 5 % and financing extended to the private sec-

CHART II.10

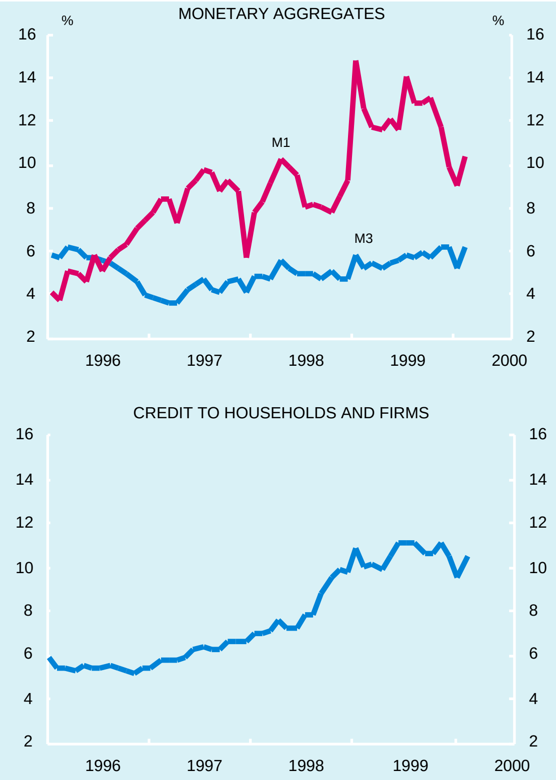
Stock market indices



Sources: Banco de España and ECB.

CHART II.11

Monetary and credit aggregates in the euro area
Year-on-year rates of change



Sources: Banco de España and ECB.

tor of the economy accelerated strongly, growing at the year-on-year rate of over 10 % (see Chart II.11). The relatively low opportunity cost of holding liquid financial assets contributed to increasing the rate of expansion of the narrower monetary aggregates, especially in those European countries with higher rates of economic activity. In turn, the improvement in economic prospects during the year and low debt costs, in nominal and real terms, were propitious, among other factors, to the quickening in lending extended to non-financial corporations and households. Such lending was also fuelled by rising real estate asset prices and by the intense activity in corporate mergers and acquisitions. Given the moderate and stable growth rate of financing to general government, the situation led to a forceful expansion of total financing to residents sectors across the area.

Monetary growth in the euro area, defined as the year-on-year rate of increase of the M3 aggregate, held in 1999 and during the first four months of 2000 at above the reference value of 4.5 %. In early 1999, the strong rates of expansion recorded were attributed in part to a temporary step-up in liquidity associated with the introduction of the euro and the start-up of the new monetary policy framework, along with a degree of asset switching due to structural factors in certain countries in the area. Nonetheless, the deviations during the year from the reference monetary growth value not solely persisted, but became more significant, against the background of the clear improvement in the economic outlook. The data on the monetary aggregates for the first four months of 2000 have confirmed the high monetary growth rate in the area, suggesting that the behaviour of M3 has been in response not so much to those special factors but, above all, to a genuine and more permanent process of liquidity expansion.

Turning to the counterparts of M3, the monetary expansion was compatible with a high growth rate of financing to non-financial corporations and households, which held at year-on-year rates of around 11 %-12 %. Notably, despite the increase in bank lending rates in the second half of the year, the rate of expansion of lending remained highly in that period. That suggests that the restrictive impact of dearer credit was offset by greater demand linked to improved economic prospects in the euro area and, possibly, to the financing of a portion of capital outflows.

The expansion of financing to general government in 1999 was low in year-on-year terms and very stable at around 1.1 %, the result of the reduction in the public sector borrowing requirement in the area. Other long-term liabilities of MFIs in the area, not included in M3, were more buoyant. This was particularly so in the second half of the year, owing probably to the upward movement in longer-dated interest rates. Finally, given that the increase in MFIs' claims on residents in the area was greater than that of their liabilities to this sector, MFIs had to finance this shortfall through net indebtedness abroad. Consequently, the net external position of MFIs in the area declined by EUR 166 billion in 1999.

The generous liquidity conditions in the area were generally common to all the member states, although they varied depending on the economic growth rates of each country and on the differences in their monetary transmission mechanisms. In Spain, these conditions tended to be relatively more expansive, as reflected in rates of increase of liquidity and, above all, of financing that were higher than in the area as a whole. Nonetheless, the relevant definitions of monetary and credit aggregates for the euro area as a whole are not always the most appropriate ones for characterising the tone of the monetary and financial conditions prevailing in each country.

In Spain's case, it is the so-called liquid financial assets – which include cash and cash equivalents (cash and sight deposits), other deposits at any maturity, repos, bank securities and shares in money market and equity funds held by non-financial corporations and households – which appear to show a more stable relationship to expenditure and which are a representative measure of liquidity given the characteristics of the economy. This aggregate displayed relatively moderate annual growth in 1999, although cash and cash equivalents were very buoyant, growing at a year-on-year growth rate of around 17 % for much of the year. Moreover, there was a significant acceleration in financing obtained by non-financial corporations and households resident in Spain, with a year-on-year growth rate of close to 20 % in the second half of the year. In Spain, then, whose expansive cyclical profile is more marked than in other euro area countries and whose inflation differential is positive in relation to the average for the area, monetary and financial conditions during 1999 were relatively looser than in the EMU members as a whole, with regard both to interest rate levels and to the rate of expansion of liquidity and of financing extended to agents.

CHAPTER III

THE SPANISH ECONOMY

III.1. INTRODUCTION

The Spanish economy achieved excellent results in terms of growth and job creation in its first year of membership of the Monetary Union. Drawing on the initial estimates published by the INE (National Institute of Statistics), GDP grew by 3.7 % in 1999, only slightly down on the estimate for 1998, despite the effect of the international economic crisis on activity. This effect was particularly significant at the start of the year, but was rapidly corrected as the euro area's external environment recovered and the euro area economies themselves reacted to the beneficial impact of that recovery. Domestic demand was highly buoyant throughout the year – with a slight moderation in this buoyancy in the final quarter – growing by nearly 5 % for the second year running.

The growth in domestic demand was underpinned by the strength of spending by households and firms, while general government final demand moderated, in accordance with Government plans. Household consumption and investment spending tended to accelerate over the year, based on easy monetary and financial conditions, high rates of job creation and gains in wealth, as well as on the impact of the reform of direct taxation. On the available estimates, productive investment by firms held steady at high rates without any sign of acceleration, against a background conducive to the execution of investment plans (buoyant demand and low interest rates).

The strength of domestic spending and the progressive recovery of exports made domestic activity highly buoyant. However, these developments were also accompanied by a substantial boost to imports and a significant widening of the trade deficit. This led to net borrowing – initially estimated at 0.6 % of GDP – by the economy for the first time since 1994. The Spanish economy has proved capable of benefiting considerably from the pick-up in external demand, but these results show that it is still highly import-dependent and they signal the need to maintain and improve its competitive capacity.

In any event, the buoyancy of GDP in 1999 led to strong job growth and a notable reduction in the unemployment rate. A basic factor behind this result was, without doubt, the ongoing moderation in wage settlements, which were basically held down by the expectations of stability arising from membership of the Monetary Union. The lower dismissal costs and reductions in social contributions introduced through contracts for the promotion of stable employment enabled the costs of hiring certain types of workers to be further reduced and also stimulated employment generation.

The behaviour of wage settlements was a significant element in the containment of inflation, in a year in which various factors exerted upward pressure on prices. The most important of these was the surge in the price of crude oil and, to a lesser extent, in other imported commodities, which translated into strong growth in import prices and a significant rise in production costs. The growth in import prices was also bolstered by the depreciation of the euro. At the same time, the expansion of demand enabled the rise in non-wage costs to be passed through to final prices and operating margins to widen. The result was a rise in inflation, with the 12-month growth rate of the CPI up from 1.8 % in 1998 to 2.3 % in 1999, and the opening up of an inflation differential with the euro area. That said, the widening of the differential took place mainly in the first quarter of the year, and thereafter the differential held steady.

In short, during its first year of membership of the Monetary Union, the standards of macroeconomic stability that enabled the Spanish economy to join were maintained, and some of the imbalances that still remain, such as the budget deficit, were further corrected. Also, the

TABLE III.1

Main macroeconomic aggregates (a)

Real rate of change

	% GDP 1999	1996	1997	1998	1999	1999 (a) Q1	Q2	Q3	Q4
Household final consumption expenditure (b)	59.6	2.0	2.9	4.1	4.4	4.6	4.6	4.5	4.2
General government final consumption expenditure	17.0	1.3	2.7	2.0	1.8	2.7	2.6	1.7	0.3
Gross fixed capital formation	24.3	2.0	5.0	9.2	8.3	9.5	8.8	8.0	7.0
Construction	*15.2*	*–1.0*	*2.3*	*7.0*	*8.3*	*9.3*	*8.6*	*8.1*	*7.1*
Capital goods and other	*9.1*	*8.3*	*9.9*	*13.0*	*8.4*	*10.0*	*9.0*	*7.9*	*6.8*
Change in stocks (c)	0.3	–0.1	–0.1	0.1	0.1	0.0	0.1	0.1	0.1
National demand	**101.2**	**1.8**	**3.2**	**5.0**	**4.9**	**5.3**	**5.2**	**4.9**	**4.2**
Exports of goods and services	29.1	10.3	15.1	7.1	8.5	6.4	7.9	8.7	10.7
Final demand	**130.3**	**3.4**	**5.6**	**5.4**	**5.7**	**5.6**	**5.8**	**5.7**	**5.7**
Imports of goods and services	30.3	8.1	12.8	11.1	12.6	12.6	13.5	12.7	11.8
Gross domestic product	**100.0**	**2.3**	**3.8**	**4.0**	**3.7**	**3.6**	**3.7**	**3.8**	**3.9**
MEMORANDUM ITEM:									
Net external demand (c)	–1.2	0.5	0.6	–1.0	–1.2	–1.6	–1.5	–1.1	–0.4

Source: Instituto Nacional de Estadística.

(a) Year-on-year rate of change based on trend-cycle series.
(b) Includes final consumption expenditure of non-profit institutions serving households.
(c) Contribution to GDP growth.

increase in inflation stemming from rising energy prices was kept under control. At the same time, activity and employment displayed high rates of growth, leading to further real convergence with the euro area. However, the deterioration in the trade deficit and the persistence of the inflation differential show the need to monitor the expansion of overall demand and to make the supply side of the economy more flexible, thereby removing obstacles of a structural nature that are limiting potential growth.

III.2. DEMAND

As mentioned above, the high rate of growth of GDP in 1999 was based, as in the two previous years, on the buoyancy of domestic demand. According to provisional Quarterly National Accounts (QNA) data, the latter grew by 4.9 % in real terms (see Table III.1). Amid the favourable expectations prompted by the introduction of the single currency, which also entailed relatively easy financial conditions, the strength of national demand was largely based on the buoyancy of household final consumption spending, which accelerated from a growth rate of 4.1 % in 1998 to 4.4 %. By contrast, gross fixed capital formation slowed. This reflected a certain restraint in capital goods investment following the notable expansion in the preceding year, while construction investment rose on average at a higher rate in 1999, although with a profile showing a slowdown over the year.

Net external demand became slightly more contractionary, as a consequence of the weakness of exports at the beginning of the year in an adverse international environment, reducing GDP growth by 1.2 percentage points. However, both exports and imports accelerated in 1999, leading to a further increase in the degree of openness of the Spanish economy, which reached higher levels than in most of the euro-area countries. The composition of demand changed over the year. As the effects of the international economic crisis were overcome and the international environment became more favourable, exports gathered momentum, leading to a reduction in the negative contribution from external demand, which made up for the moderate loss of strength of national demand.

III.2.1. National demand

Table III.2 shows the main components of national demand, classified in terms of the agents responsible for spending. Their paths have been estimated on the basis of National

TABLE III.2

Consumption and gross fixed capital formation by institutional sector (a)

	% GDP		Real rate of change			
	1995	1999	1996	1997	1998	1999
Households (b)						
Final consumption expenditure	59.8	59.6	2.0	2.9	4.1	4.4
Gross fixed capital formation (c)	4.6	5.2	9.1	–0.7	8.0	11.0
Firms						
Gross fixed capital formation (d)	13.7	15.8	3.9	7.5	9.4	8.1
Construction	*7.3*	*7.5*	*–0.4*	*5.6*	*5.1*	*7.2*
Equipment	*6.4*	*8.3*	*8.7*	*9.5*	*13.6*	*9.0*
General government						
Final consumption expenditure	18.1	17.0	1.3	2.7	2.0	1.8
Gross fixed capital formation	3.7	3.3	–13.6	2.6	10.2	5.1
Of which:						
Construction	*3.0*	*2.5*	*–18.0*	*–1.0*	*11.0*	*6.0*
MEMORANDUM ITEM:						
Gross fixed capital formation	22.0	24.3	2.0	5.0	9.2	8.3
Construction	*14.8*	*15.2*	*–1.0*	*2.3*	*7.0*	*8.3*
Equipment	*7.2*	*9.1*	*8.3*	*9.9*	*13.0*	*8.4*

Sources: Instituto Nacional de Estadística and Banco de España.

(a) Data in real terms.
(b) Includes expenditure by non-profit institutions serving households.
(c) Domestic residential investment.
(d) Private productive investment: includes investment by individual entrepreneurs.

Accounts aggregates and certain supplementary information. The expansion of household expenditure in 1999 can be seen in the table, the growth rates of both the consumption and residential-investment components accelerating significantly. Spending by firms, estimated on the basis of provisional INE data, continued to grow at high rates, although they were somewhat lower than those in the preceding year, due to a slowdown in capital-goods investment. Finally, general government demand continued to show the restraint that has characterised it in recent years, with a slowdown in real public-sector investment being detected. Overall, the share of general government demand in GDP edged down in 1999, while the relative importance of the spending of households and firms continued to rise.

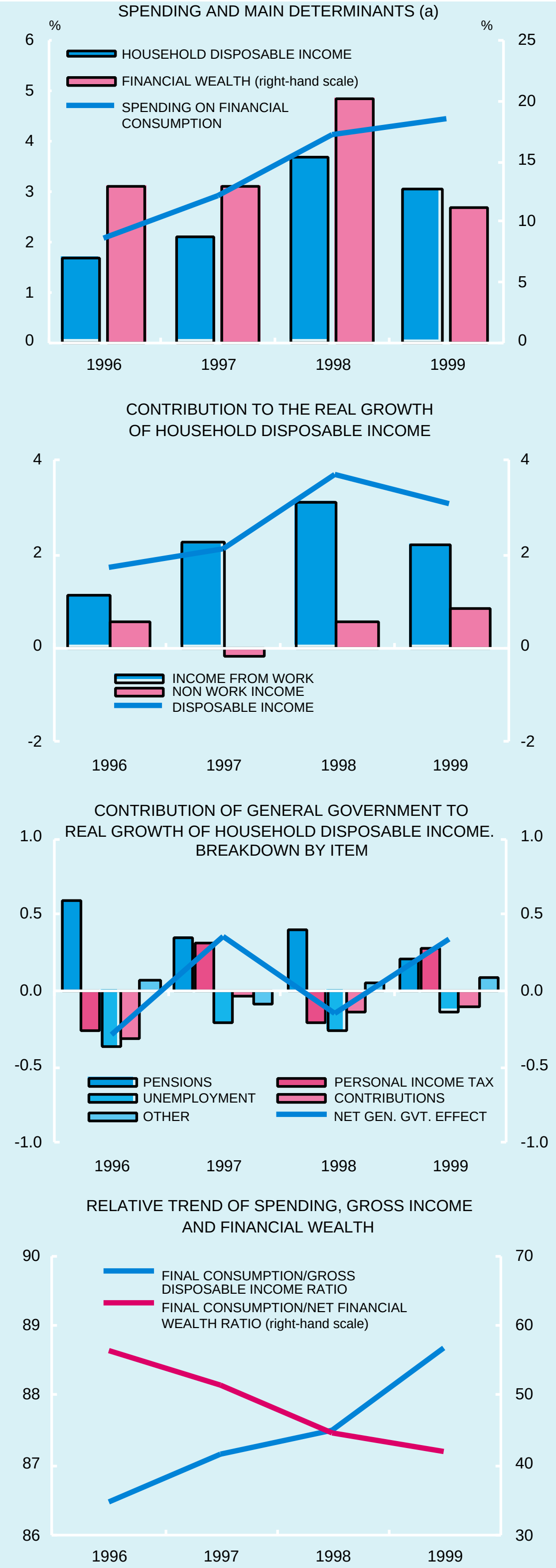
Household final consumption expenditure grew by 4.4 % in real terms in 1999, as against 4.1 % in 1998. However, the gradual acceleration by this component of spending since the beginning of 1997 came to a halt during the year, with a slight slowdown in the final quarter. The high degree of confidence of Spanish households during the year, the favourable financial conditions and the effects of gains in wealth in recent years help to explain the strength of household consumption on average during the year, despite the somewhat lower rate of growth of real household disposable income than in 1998.

In fact, household disposable income is estimated to have grown by 3.1 %, in real terms, in 1999, as against 3.7 % in 1998. The slowdown mainly reflected the increase in the rate of consumer-price inflation, since the growth of disposable income, in nominal terms, was even higher than in the preceding year. The middle panel of Chart III.1 shows the contributions of some of the main components of disposable income to its real rate of growth. The smaller contribution of income from employment in 1999 was a consequence of wage moderation and less buoyant employment, compared with 1998. However, it is worth pointing out that the loss of purchasing power of wages caused by prices rising faster than forecast was partly temporary, as a large percentage of employees were subject to collective agreements with inflation-adjustment clauses protecting them from deviations from the reference inflation rate in the agreement.

In this respect, although wage-earners received the payments due under these clauses at the beginning of 2000, some households may have kept their consumption steady, in anticipation of this income. As against the lower buoyancy of wage income, the contribution of

CHART III.1

Household final consumption



Sources: Instituto Nacional de Estadística and Banco de España.
(a) Real rates of change.

general government to the growth in household income became positive in 1999, as a consequence of the impact of the reform of personal income tax (see Box III.1). Also, income relating to the own-account business activities of households was expansionary. Finally, the contribution of income relating to the remuneration of savings continued to be negative, although to a lesser degree than in 1998. The maintenance of low interest rates resulted, on one hand, in lower income from holding financial assets and, on the other, in a further increase in household indebtedness and related payments.

The strength of household consumption, despite the slowdown in real disposable income, led to a decline in the saving ratio to slightly above 12 % of disposable income. The decline in the household saving ratio in 1999, coming on top of those of previous years, reflects the impact on spending of other determinants of consumption. The easing of monetary conditions continued to exert an expansionary effect on household demand, with real interest rates falling further. Also, although the gains in financial wealth obtained by households in 1999 as a consequence of rising stock markets were less than in 1998, the cumulative effect of the gains made in recent years was again significant. In addition the increase in wealth stemming from higher house prices, may also have boosted spending. All these factors, as well as others, tended to improve household expectations and, following some hesitancy, the consumer confidence index reached another historic high at the end of the year, surpassing the levels reached in the previous economic expansion. The fact that the pattern of growth followed by the Spanish economy in recent years has been characterised by high employment generation and by greater job stability among the youngest sections of the population, helps to explain this improvement in household confidence.

The effect of the decline in real interest rates was particularly significant in the case of consumer durables. Consumption of these goods (particularly of cars) was extraordinarily buoyant during the last four years, although at the end of 1999 signs of a slowdown began to be discerned. Meanwhile, services consumption was expansionary in 1999, while spending on food was subdued.

Residential investment, the other component of household spending, strengthened further in 1999. It is estimated to have reached a real growth rate of around 11 %, as against the 8 % estimate for 1998. This buoyancy reflects the notable expansion of purchases of new dwellings, since spending on refurbishment and alterations slowed, showing the counter-cyclical

BOX III.1

Reform of personal income tax

On 1 January 1999, Law 40/1998 of 9 December 1998 on personal income tax entered into force, introducing a far-reaching reform of the structure and content of this tax. The main changes are detailed below and the initial data available on the revenue raised in 1999 are described:

— The new tax is charged on the taxpayer's income after deduction of the amount of a tax-free personal allowance, set at the basic rate of ESP 550,000 per annum, which may be higher depending on the taxpayer's personal and family circumstances.

— The distinction between the regular and irregular tax base has been abolished, with both now incorporated in a general tax base which includes income from short- and long-term capital and short-term capital gains and losses. Long-term capital gains and losses (those generated over a period of more than two years) are set off against each other and included in a single special base. The exempt amount is applied so as to reduce – in this order – the general tax base and the special tax base, without it being possible to make either base negative. Furthermore, negative general and special tax bases can be set off against positive general and special tax bases, respectively, declared in the following four years. Set-offs between the general and special tax bases are not permitted.

  In relation to the general tax base, earned income is included after the deduction of amounts ranging from ESP 375,000 to 500,000 per annum. Short-term investment income is included in its entirety, and long-term investment income after application of a reducing coefficient, which varies depending on the type of income. For short-term capital losses, a limit is imposed on the extent to which they can be set off against income for the year (10 % of the general tax base attributable to the latter).

— A new single tax rate schedule is established, applicable to the general tax base, which replaces the former individual and joint schedules. The lowest tax rate is reduced from 20 % to 18 % (with no exempt amount), and the highest from 56 % to 48 % (for income exceeding ESP 11,000,000). The number of rate bands is reduced from eight to six. The special tax base is taxed at a single rate of 20 %.

— The Law maintains deductions for habitual dwellings, economic activities, donations and investment in objects of cultural interest (subject to an overall limit of 10 % of the tax base), for income obtained in Ceuta and Melilla, for amounts deposited in housing accounts and for double taxation of dividends and international double taxation. The deduction for investment in habitual dwellings is set at 15 % of the amounts (up to a maximum of ESP 1,500,000) paid in the period, and the imputed income from property is abolished, as is the deduction from the base for interest on loans to finance such property. Taxpayers who have acquired an ordinary residence before 24 April 1998 shall be compensated if the new regime proves unfavourable to them.

This reform of personal income tax involves a reduction in the average tax burden, which during the first year the reform was in effect, affected revenue basically through the reduction in withholdings, since the previous rules still applied to the net tax payable and rebates in 1999. State revenue from personal income tax grew, in cash terms, by 2.1 % in 1999, entailing a fall in proportion to GDP of 0.3 percentage points (see adjoining table). By component, withholdings on earned income increased by 3.6 % despite the reduction in the rates of withholding deriving from the reform of the tax. However, it should be taken into account that the withholding figures for 1998 and 1999 are not strictly comparable. In 1999, around ESP 192 billion of revenue relating to the payment of amounts due from the Social Security System and the regional (autonomous) governments were included in this item, as against somewhat more than ESP 30 billion in 1998, and the reduction in withholding rates in 1999 was only applied to 11 months in the case of large firms and to three quarters in the case of small and medium-sized firms and professionals. After adjusting for the first of these factors the rate remains positive, although it is reduced to 0.4 %, which could be mainly reflecting the growth in the number of employees. For their part, withholdings on capital declined by 19.1 %, which may be explained by interest rate developments and the reduction in the withholding rate for returns on bank deposits, fixed income securities and promissory notes from 25 % to 18 %. It should also be taken into account that the 1999 revenue was affected by the establishment of withholdings on mutual fund capital gains, which raised ESP 90 billion. Finally, it should be noted that withholdings on property rentals (included in the adjoining table under the heading "net tax payable and other") came into force in March 1998. Accordingly, if the 1999 revenue is adjusted (for the purposes of a more homogeneous comparison with 1998) for the amounts due from the Social Security System and the regional (autonomous) governments and for the withholdings on property rentals and on mutual fund capital gains, then personal income tax revenue was down 3.6 % (0.6 percentage points of GDP). This figure should not be interpreted as the revenue cost of the reform, since among other factors it is based exclusively on State data and does not include the revenue of the regional (autonomous) governments nor take into account the increases in revenue from indirect taxes which have taken place as a consequence of the reform.

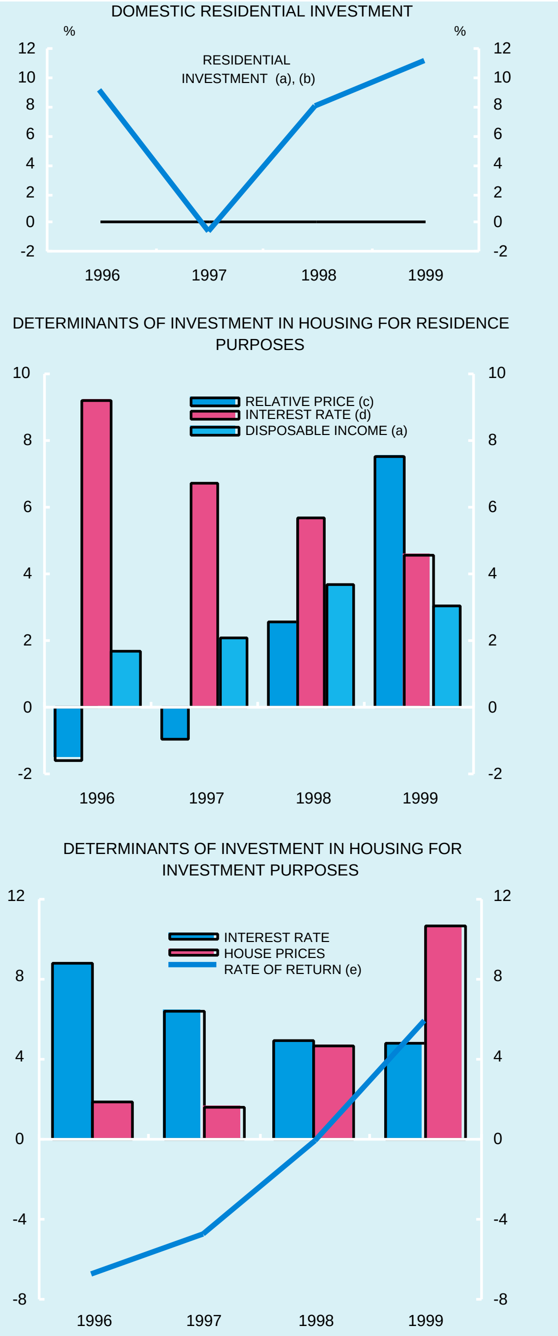
State personal income tax receipts (cash-basis)

Item	1998	1999	%
Withholdings on earned income	4,956.3	5,136.0	3.6
Withholdings on investment income	611.4	494.7	–19.1
Withholdings on mutual funds	—	90.2	—
Instalment payments	412.4	400.1	–3.0
Net tax payable and other	–315.4	–220.9	32.2
Share of regional (autonomous) governments	–672.7	–802.2	19.3
Personal income tax	**4,992.0**	**5,097.9**	**2.1**

Source: Secretaría de Estado de Presupuestos y Gastos, del Ministerio de Economía y Hacienda.

CHART III.2

Residential investment



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

(a) Real rates of change.
(b) Banco de España estimates.
(c) Price of new housing in relation to the private consumption deflator.
(d) Nominal interest rates on mortgage loans.
(e) Difference between the rate of change of house prices and the interest rate on the alternative asset (proxied by 10-year government bond yields).

behaviour of the latter in relation to new construction. The strength of the demand for dwellings in the last two years was based on the high growth rates of real household disposable income and on the decline in mortgage interest rates. In 1999 as a whole, mortgage interest rates dipped by around one percentage point, despite embarking on an upward path in the second half. The significant growth in the financial wealth of households in recent years may also have had a positive impact on the demand for dwellings, along with demographic factors. However, the latter must have had a smaller impact in 1999 than in previous years, as the growth rate of new household formation weakened.

Overall, the above-mentioned factors helped to maintain favourable terms for household access to the purchase of dwellings in 1999, despite the notable increase in their relative price (see Chart III.2). In fact, the pressure exerted by demand on the property market translated into a strong increase in house prices in 1999, despite the high volume of house starts (more than 500,000), at a level not seen since the seventies. However, determining the precise impact on overall demand of the rise in the relative price of housing is not at all straightforward. On the one hand, it curbs demand for housing as a residence, while on the other, expectations of capital gains stimulate the purchase of dwellings as an alternative asset in which to hold wealth. This latter component of demand has also been driven by the decline in the yield on financial assets (see the bottom panel of Chart III.2). In any event, the pressure on prices was passed through to the market for existing houses. There, as from the second quarter, the acceleration in prices was even sharper, reflecting the inadequate supply of new housing relative to current demand. Moreover, price growth was very uneven across geographic areas. Increases were higher than average in coastal areas, owing to the increase in the demand of non-residents as well as the demand of residents for second homes.

In 1999, general government final demand continued to be governed by the commitment to control public spending. Once again the bulk of the adjustment fell on consumption spending, which continued to follow the path of moderation established in previous years. The growth rate of investment was higher, but significantly down on 1998. On figures released by INE, government consumption grew by 1.8 % in real terms (against 2 % in 1998), while in nominal terms it grew by 5.5 % (up from 4.7 % in 1998). The divergence between growth in current pesetas and in real terms is associated with the acceleration in compensation per employee, as well as a strong expansion of net purchases of goods and services. The slowdown in public-sector investment was particularly important in local government, which had made a stronger investment drive in 1998, while the regional (autonomous) governments sustained the expansionary momentum of their spending. By type of investment, there was a slowdown in both capital goods and construction. The trend in the latter partly reflects the sharp fall in official tenders in 1999, which was more important in civil engineering than in building.

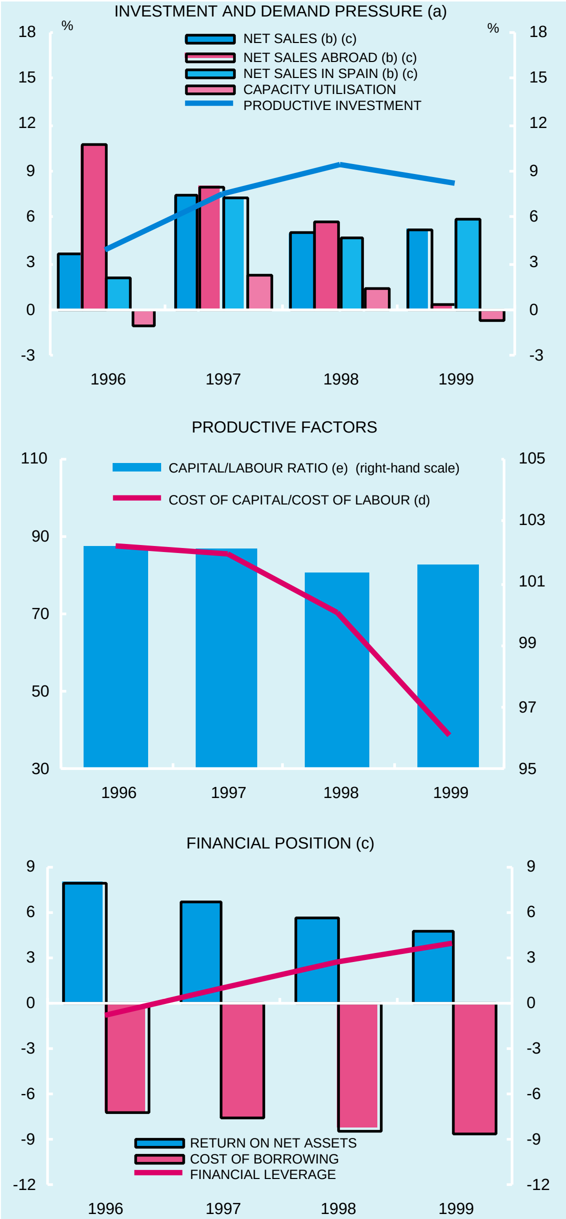
In 1999, gross fixed capital formation by firms slowed slightly, in comparison with the preceding year. However, its growth – estimated at 8.1 %, in real terms – ended up exceeding the forecasts made by some employers at the beginning of the year, which were strongly influenced by the deterioration in demand expectations prompted by the international crisis. Private productive investment in 1999 is explained by the expansion of final demand, by firms' healthy financial position and high profits, and by the favourable behaviour of the relative cost of capital. According to the Ministry of Industry and Energy's half-yearly survey of investment by industrial firms, the first two factors had the greatest impact on investment in 1999.

As seen in Chart III.3, the strength of the demand for firms' products – particularly of its domestic component – was sustained in 1999, while exports were less buoyant during the year as a whole. Nonetheless, the profile of external demand was one of recovery over the year, which helped to increase the pressure exerted by spending in the second half. This higher pressure from demand eventually translated into a significant increase in the degree of capacity utilisation in industry in the final quarter. On average, capacity utilisation was down slightly in 1999. Yet by the end of the year it had reached very high levels (81.2 %), increasing the need to widen the stock of capital goods. According to the survey mentioned above, since 1997 capital widening has been the main aim of industrial investment expenditure. Efficiency improvements – a concept that covers labour saving, the introduction of new technologies and the saving of raw materials – are also a significant motivation for corporate investment plans.

The decline in recent years in Spanish interest rates largely explains the decline in real terms in the user cost of capital since 1997. In 1999, the rise in the inflation rate also contributed to this decline. It is estimated that, in real terms, the fall in the user cost of capital during 1999 was greater than the decline in the cost of labour. This movement in relative factor prices

CHART III.3

Private productive investment



Sources: Instituto Nacional de Estadística, Ministerio de Industria y Energía and Banco de España.

(a) Real rates of change and differences for the degree of plant capacity utilisation.

(b) Net turnover deflated by the final demand deflator. For the domestic and external components the domestic demand and exports deflators, respectively, have been used.

(c) Data obtained from the CBA annual survey until 1998 and from the CBQ quarterly survey for 1999.

(d) Relative costs measure the user cost of capital divided by the user cost of labour, proxied by compensation per employee.

(e) Ratio of the stock of private productive capital, obtained from an initial condition estimated by Fundación BBV/IVIE, to the total number of private-sector employees according to National Accounts.

was conducive to a more intensive use of capital in productive processes. In fact, the capital/labour ratio recorded a mild recovery in 1999, as seen in the middle panel of Chart III.3. This recovery seems somewhat timid in the light of the fall in the relative price of capital in recent years. However, this fall may be overestimated by the indicator of relative prices shown in the chart, since it does not incorporate some of the measures taken in recent years to reduce the cost of labour in order to promote the creation of employment.

Meanwhile, the financial environment in which firms conducted their activities in 1999 continued to improve. This, together with the high levels of profitability achieved, helps to explain the expansionary path of productive investment. According to Central Balance Sheet Office Quarterly Survey (CBQ) data, the rise in the rate of profitability in 1999 was a consequence of the expansion of firms' productive activity, of the containment of operating costs (due to the slowdown in personnel costs) and of the lower growth of financial costs (despite the strong increase in borrowing). The high rate of return on assets and the low cost of borrowed funds gave rise to a considerable increase in financial leverage (the difference between the two rates), which reached historic highs of close to 4 % and, in turn, boosted investment. Against this background, the recourse to external financing, extended both by resident and non-resident credit institutions, continued to grow, even though the financial situation of firms remained very healthy owing to the strong generation of own funds.

Despite such positive behaviour by the main determinants of corporate investment, the available estimates show, as mentioned above, a slight slowdown in this component of spending in 1999. This slowdown, if confirmed, may partly be explained by the weakness of demand expectations at the beginning of the year, but it also seems to shown a certain reluctance by firms to implement their investment plans. In fact, the ratio of investment in capital goods to GDP has grown less sharply in Spain than in other economies growing strongly in the current upswing. This result may reflect the fact that Spanish firms have capitalised on such positive circumstances as currently exist to increase their international profile, as the momentum achieved by foreign direct investment in recent years would testify. If so, their investment activity will have been more significant than the figures for private productive investment alone would suggest.

As regards the breakdown by component of firms' investment, construction was highly buoyant in 1999, driven by investment in new industrial and commercial premises. Office building also rose very significantly, but represents only a small percentage of total construction. Spending on capital goods, meanwhile, slowed during the year.

Finally, stockbuilding contributed 0.1 percentage points to GDP growth in 1999, which was similar to its contribution in 1998. In general, the persistence of low costs of holding stocks, as a consequence of the low levels of interest rates and non-energy commodity prices (although the latter tended to rise as the year elapsed) may have led to an increase in the desired levels of stocks in certain industries. Moreover, the involuntary component of stocks must have increased in the first half of the year, when the percentage of firms reporting higher-than-desired levels of stocks rose considerably, as a consequence of the weakness of exports. This percentage declined in the second half. By contrast, in the oil refining industry stocks fell sharply as the year unfolded, owing to the rise in the price of oil on international markets.

III.2.2. External demand

In 1999, net external demand continued to have a notably contractionary effect on GDP growth. On provisional QNA estimates, this effect was 1.2 percentage points on average during the year, somewhat higher than the estimate for 1998 (one percentage point). This negative effect was particularly severe in the first quarter, when exports (especially goods exports) felt the impact of the international economic crisis and grew at very moderate rates, while imports were highly vigorous. However, the negative contribution fell significantly over the rest of the year, as the very sharp recovery in exports firmed, boosted by the improvement in the external environment and, to a lesser extent, by the improvements in competitiveness in certain markets, as a consequence of the depreciation of the euro. In 1999 as a whole, goods and services exports grew by 8.5 %, in real terms, while imports rose by 12.6 % (see Chart III.4).

Goods exports were markedly weak at the beginning of 1999, prolonging the trend that had begun in the second half of 1998. This was against an adverse international backdrop, characterised by the slackness of demand in the euro area economies and by recession in most emerging Latin American and, to a lesser extent, south-east Asian economies. However, the swiftness of recovery in the emerging economies of the latter region and the gradual improvement in the euro area countries led to an increase in exports in the second quarter of the year, which gained momentum as the improvement in the business climate spread and strengthened. Consequently, goods exports, which had grown at a real year-on-year rate of 3.8 % in the first quarter, were growing at rates of more than 10 % by the end of the year.

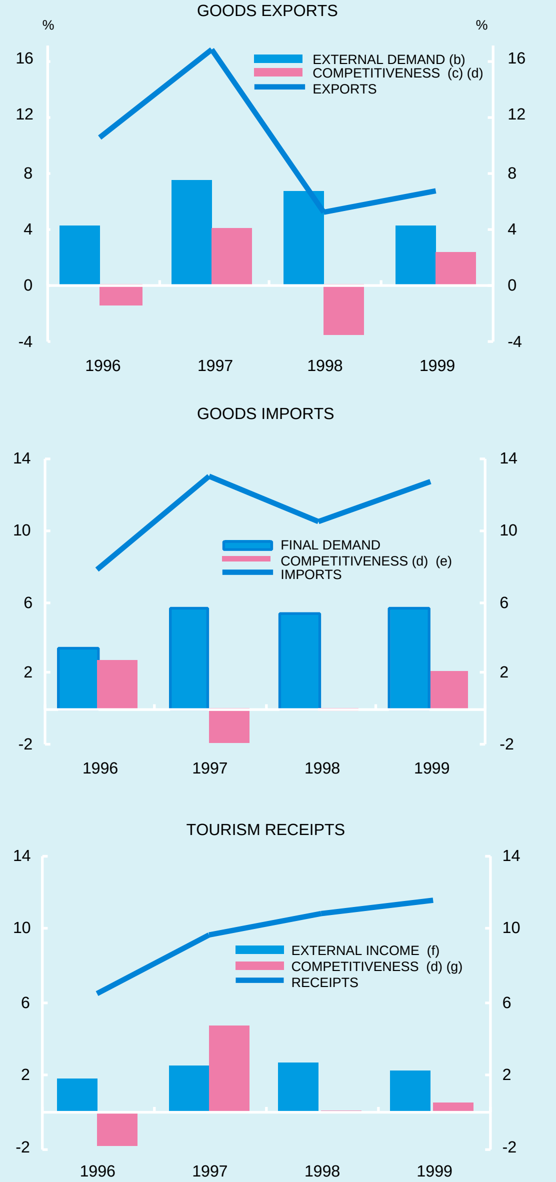
As already mentioned, this recovery in exports was also assisted by the improvements in competitiveness in markets outside the euro area, mainly as a consequence of the depreciation of the exchange rate of the euro. However, developments in competitiveness vis-à-vis the euro area economies (Spain’s main trading partners) continued to display certain adverse features (see Chart III.5). In particular, although export prices held at very similar growth rates to those of this area (or were even somewhat lower), unit labour costs grew at comparatively high rates, leading to a further narrowing of operating margins in those sectors most exposed to international competition. As mentioned in Chapter I above, should this situation (which could spread to other markets, when the exchange rate of the euro reverses its recent course) persist, it could hinder export growth, jeopardising the presence of Spanish firms abroad and, at the same time, making it easier for foreign products to increase their penetration of the Spanish market.

Analysing exports at a disaggregated level, it can be seen that their acceleration during 1999 was across the board, as regards both the main product groups and geographical and economic areas. Specifically, exports to the euro area, which were practically stagnant in Q1, grew by 6.3 % in the year as a whole, boosted by the pick-up in demand in the countries of this area, while those to the rest of the world increased by 2.9 %, after sharp falls in Q1.

Within the euro area, there was some divergence between the growth of sales to Portugal and the smaller economies, which recorded relatively high rates in Q2, and those to Germany, France and Italy, which only gained momentum towards the end of the year. Exports to the United States were very slack during the first half of the year, a result which contrasts with the durability of the cyclical upswing in that economy and with the strength of the US dollar against the euro. Spanish products may have been displaced from this market as a result of the gains in competitiveness made by the Asian countries in preceding years. Among these products, certain consumer manufactures and intermediate products predominate, in the production of which the emerging south-east Asian economies strongly specialise. In any event, ex-

CHART III.4

External demand and main determinants (a)



Sources: IMF, OECD, Instituto Nacional de Estadística and Banco de España.

(a) Real rates of change on a year ago.

(b) Average of the industrialised countries' imports, at constant prices, weighted according to the significance of each country in Spanish exports.

(c) Inverse of the Spanish exports deflator in relation to rest-of-the-world exchange-rate-adjusted export prices.

(d) Positive values denote a gain in the competitiveness of exports, imports and the Spanish tourism sector, respectively; negative values denote a loss.

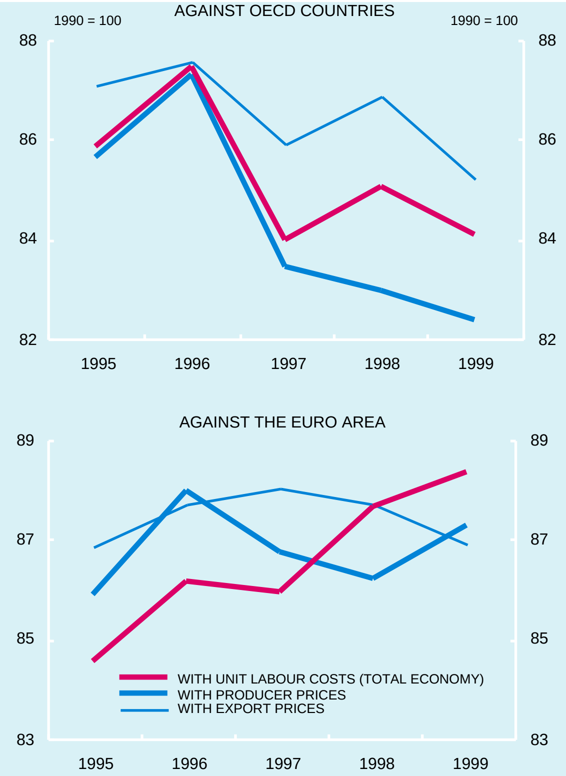
(e) Producer price index in relation to Spanish imports deflator.

(f) Average of the GDP of the countries of origin of tourism to Spain, weighted according to the relative significance of the number of visitors.

(g) Inverse of the real effecftive exchange rate against the OECD countries.

CHART III.5

Competitiveness indices (a)



Source: Banco de España.
(a) A rise in the index denotes a loss in competitiveness.

ports to the United States rebounded in the second half of the year, assisted by the gains in competitiveness arising from the depreciation of the euro.

As for other markets, exports began the year by recording very sharp falls. Thereafter a general recovery was discernible, though it varied in strength. In particular, sales to south-east Asian countries showed renewed buoyancy from the second quarter, recording growth of 8.6 % for the year as a whole. By contrast, sales to Latin America declined by 2.1 % in the year as a whole, as their recovery was slower to arrive. Finally, in the case of the CIS and other central and eastern European countries, there was a contrast between the patterns of behaviour in those countries that have in recent years signed trade agreements with the European Union, where Spanish exports grew in strength as the year elapsed, and in the others, such as Russia, where the recovery in exports was weaker.

Tourism receipts were very expansionary in 1999, surpassing even the excellent results achieved in the two previous years. The strong expansion in this aggregate in recent years is closely linked to the progressive appreciation of sterling, which has permitted a massive inflow of tourists from the United Kingdom, with a considerable rise in the UK's share in the total tourist inflow. The gradual improvement in the economic situation in Germany, France and Italy in 1999 also had a favourable impact on tourism receipts. In addition, the effects of the campaigns of recent years that have aimed to diversify the Spanish tourist industry offering should be noted. These have stimulated the influx of tourists outside the summer season.

Goods imports recorded high rates of growth for the fifth year running. They were mainly driven by the strength of domestic demand and, to a lesser extent, by the slight improvement in the competitiveness of imported products in 1999. The prices of non-energy imports rose moderately, and at a lower rate than domestically produced industrial goods, although in the last few months of the year an acceleration was discernible, as the inflationary pressures in the main supplier countries of the Spanish market became more acute.

As regards the composition of imports by product group, imports of capital goods were extraordinarily buoyant, exceeding even the notable growth of the preceding three years. This result, which is consistent with the investment taking place in the Spanish economy in the current upswing, also reflects the weakness of the domestic supply of technological products, which makes it necessary to resort to imports in order to gain access to the most advanced technologies. Non-food consumer good imports have also been highly expansionary in recent years, especially in the case of cars. As mentioned above, the low interest rates prevailing in the Spanish economy have particularly affected the demand for cars. The shift in consumer preferences towards middle and top-range higher capacity segments, in which the Spanish industry does not specialise, should also be noted. Imports of non-energy intermediate products displayed an upward trend over the year, as the pick-up in industrial activity strengthened, while those of food products grew at high rates, driven by the declining prices seen during most of the year and by the scantness of the domestic supply of these products. Finally, imports of energy products recorded very heavy declines from Q2, as a consequence of the surge in oil prices on international markets, which led Spanish refineries to use reserves built up in previous years, prompting a sharp fall in stocks.

In 1999, the buoyancy of goods imports was accompanied by vigorous growth in tourism payments, which can be explained by the increase in the spending capacity of Spanish consumers and the high level of consumer confidence. Moreover, this outcome is part of the growing trend in Spaniards' propensity to travel, as higher levels of income have enabled consumption patterns to be transformed. Finally, payments for other services again recorded very high rates of growth.

III.3. OUTPUT AND EMPLOYMENT

As seen above, national demand grew briskly in 1999, at a rate of close to 5 %. This, together with the progressive acceleration of exports, gave rise to an increase of 5.7 % in final demand, 0.3 percentage points up on 1998, according to provisional QNA estimates. This strong demand was satisfied through imports to a greater extent than in 1998. Imports of goods and services grew by 12.6 %, one-and-a-half percentage points higher than in 1998, while GDP rose by 3.7 %, 0.3 percentage points less than in the preceding year. According to most estimates, Spanish GDP was growing at above its trend rate in 1999, although the difference between these two rates (the output gap) was similar to that in the previous year. The slowdown in GDP did not affect all branches of activity. While gross value added (GVA) fell in agriculture and decelerated in non-market services and in industry, in market services and especially in construction expansion was more rapid than in the preceding year (in terms of annual averages, in all cases).

The vigorous growth in activity was accompanied by strong employment generation, which was also helped by the containment of real labour costs, as seen in Chart III.6. In fact, on QNA estimates, the growth in the number of full-time equivalent jobs ran at 3.4 %, 0.3 percentage points less than in 1998, with a profile of slowdown over the year. In consequence, apparent labour productivity grew at a very low rate for the second year running a (0.3 %), although it picked up as the year elapsed. In any case, according to Labour Force Survey (EPA) data discussed below, the surge in employment in 1999 was translated into a significant reduction in the unemployment rate, of almost three percentage points, which made for an average unemployment rate of 15.9 % in 1999.

III.3.1. Output and employment by industry

Activity in the primary sector was contractionary during 1999. Gross value added (GVA), in real terms, fell by 2.1 %, in contrast to the

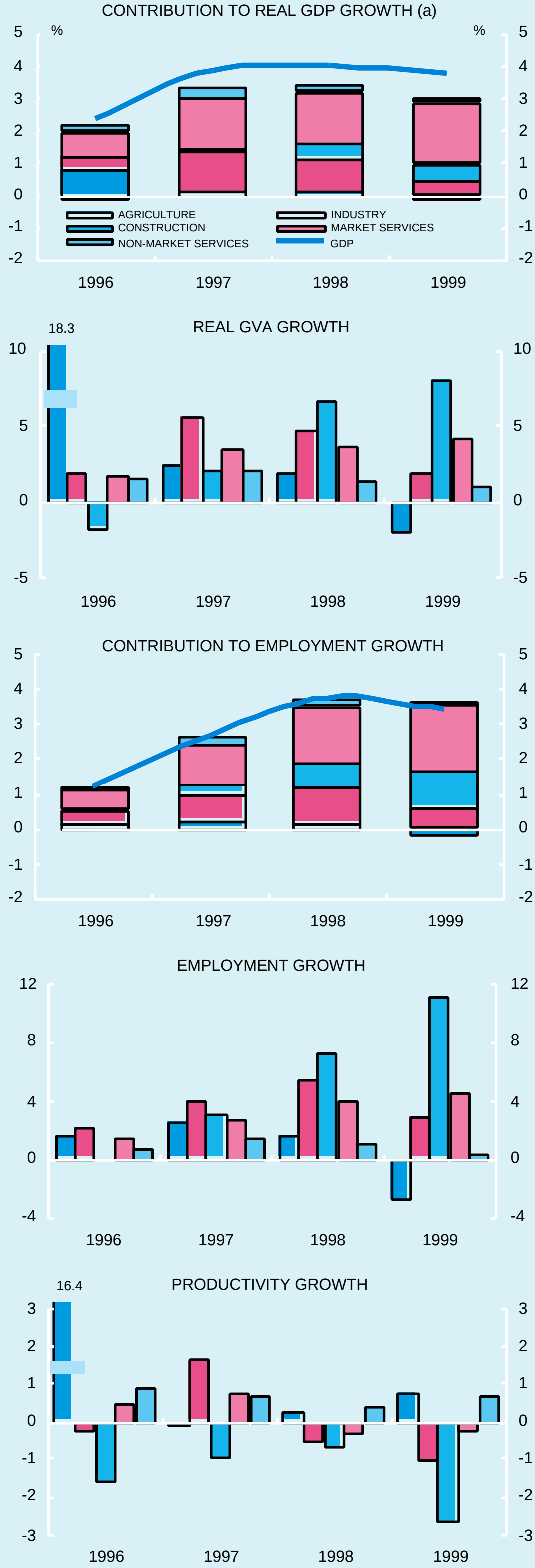
CHART III.6

Real growth and main labour market variables

Source: Instituto Nacional de Estadística.
(a) Non-centred year-on-year rates of the QNA trend-cycle series.
(b) GDP at constant prices.
(c) Persons in employment. Full-time-equivalent jobs.
(d) Ratio of GDP to employment.
(e) Ratio of compensation per employee to GDP deflator.
(f) Labour Force Survey. Ratio of unemployed to labour force.

CHART III.7

Gross value added, employment and productivity



Source: Instituto Nacional de Estadística.
(a) The chart does not depict the contribution of taxes to GDP growth.

growth recorded in the three previous years. Activity in the sector deteriorated markedly in the first half of the year, declining less rapidly in the second half, as a result of the scant rainfall recorded across most of Spain, with cereal and olive production especially affected. The decline in activity in the primary sector translated into an even sharper fall in employment (–2.8 %), which enabled apparent labour productivity to recover somewhat (see Chart III.7).

In 1999 as a whole, industrial activity recorded modest growth. In terms of GVA, it grew by 1.8 %, well down on the 4.8 % rate recorded in 1998. As a result, it contributed only 0.4 percentage points to GDP growth, as against one percentage point in 1998. During the year, however, industrial activity displayed a profile of fairly marked recovery, driven by the impact the upturn in the world economy and the depreciation of the euro against the US dollar had on exports.

The pick-up in activity was not common to all branches of industry. In particular, energy suffered a slight reduction in its GVA, according to QNA figures, although its output, in real terms, rose by 3.8 %. The difference between these two results reflects the increase in the volume of its inputs, in a year characterised by drought. GVA in manufacturing grew by 2.3 % in the year as a whole, with a clearly expansionary quarterly profile that took the year-on-year rate to 3.8 % by year-end. The recovery in manufacturing was also uneven. The most dynamic branches included some of the most traditional ones with little weight in industry as a whole, such as leather and footwear, and wood and cork, growth in rubber and plastics also being notably high. Among the branches with greater weight in Spanish industry, the healthy performance of the chemicals and the paper, graphic art and publishing industries was notable. These recorded above-average growth and paths of recovery over the year. By contrast, food production was blatantly stagnant, and transport equipment manufacturing showed modest growth, with a slowdown over the year.

Industrial employment rose by 3.1 % in 1999, which translated into a decline in apparent labour productivity for the second year running. The disaggregated employment information provided by EPA, shows that the fall in productivity resulted from uneven behaviour by output and employment in certain industries, such as textiles and electrical equipment, where real output contracted at the same time as employment expanded, and in metals where, despite the low growth of activity, employment rose by almost 8 %. Most industries, however, recorded either nil or slightly positive apparent productivity growth.

Construction was the most dynamic industry in 1999. Its GVA grew on average by 0.1 % in 1999, contributing 0.6 percentage points to GDP growth (as against 0.4 in 1998). Construction activity was on an upswing during 1998, which extended into the first half of 1999, with a slight slowdown commencing in the second half. The loss of momentum in construction was seen across the various types of work, although it was stronger in civil engineering than in building, according to the monthly construction industry survey. The strength of activity resulted in strong employment creation, which ran at a rate of around 11 % during 1999. In consequence, apparent labour productivity fell much more sharply than in the preceding three years. This outcome may have been partly determined by the lower relative growth of civil engineering, which is characterised by a higher level of productivity than building. Also, the strong growth in housing completion certificates should be noted, since labour requirements are heaviest in the final stages of construction.

The services sector recorded GVA growth of 3.5 % last year, 0.4 percentage points higher than in 1998, which increased its contribution to GDP growth to 2 percentage points. The greater buoyancy of the tertiary sector was concentrated in market services, which grew by 4.2 % in the year as a whole, with a profile showing acceleration in the second half of the year. Non-market services, by contrast, recorded modest growth in 1999 (1.1 %), with a sharp slowdown in the second half. The expansion in market services was not across-the-board. The highest growth was in communications and, to a lesser extent, personal and corporate services and hotels and restaurants, where vigorous growth was a consequence of the large influx of tourists last year. The distributive trade posted steady growth, in line with private consumption. Finally, transport was weak, with the exception of air transport, which was somewhat more expansionary.

Employment in services followed the same pattern as GVA, rising by 3.2 % on aggregate, slightly up on the previous year. This result was a consequence of strong employment generation in market services, which sustained a steady rate of growth throughout the year of around 4.5 % (3.9 % on average in 1998), while in non-market services employment slowed continuously. Apparent labour productivity displayed a profile of moderate recovery over the year, determined by the behaviour of market services, where the higher growth of activity in the second half did not translate into an equivalent acceleration of employment. Nonetheless, on average in 1999, apparent labour productivity in market services fell by 0.3 %, which was similar to the rate seen in 1998.

III.3.2. Employment

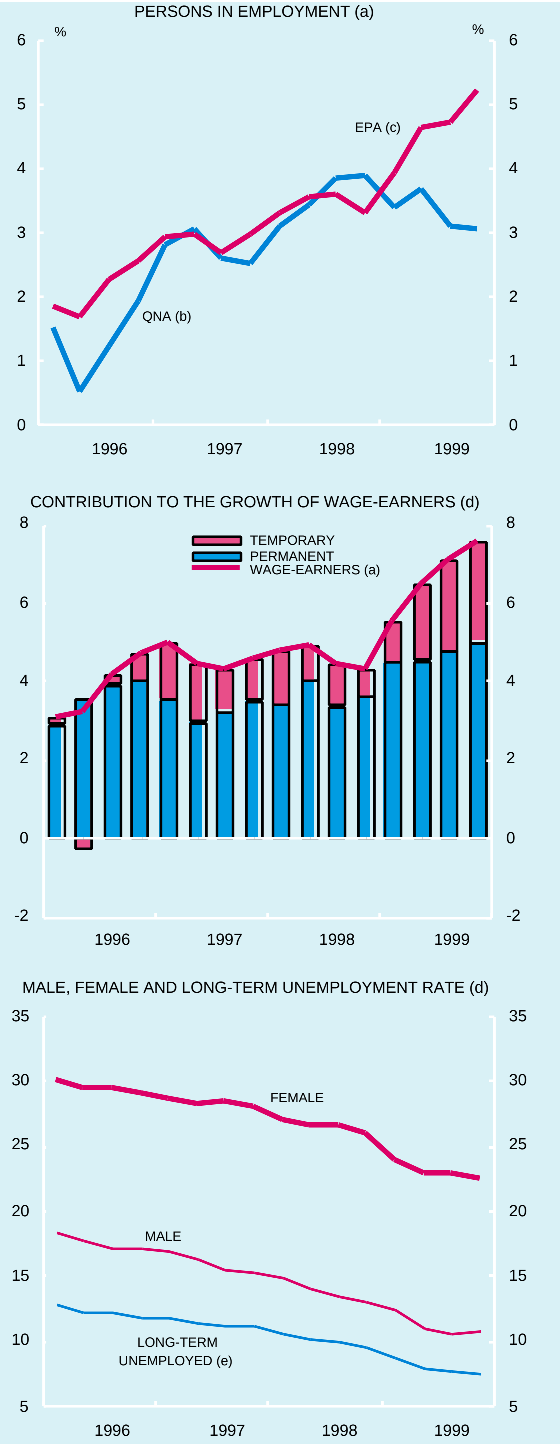
As mentioned above, the strength of activity and the decline in real wage costs enabled employment generation to display notable vigour in 1999. The high employment growth recorded by QNA data was confirmed by other indicators, such as the EPA and social security registrations, which reflected an even stronger rise in employment. Specifically, employment grew by 4.6 % according to the EPA, which is more than one percentage point higher than the QNA figure (see Chart III.8). This difference, which was much more pronounced than in previous years, was largely due to the changes made to the survey in January 1999 in order to adapt it to the new harmonised European Labour Force Survey (1). As a consequence of the improvements made to the survey, the levels of employment estimated by the EPA have to a large extent converged with those according to the National Accounts, although the rates of change of the variables of this survey have been temporarily distorted.

The expansion of employment and increase in the labour force (1 %) recorded by the EPA in 1999 led to a reduction of almost three percentage points in the rate of unemployment, which stood at 15.9 % in 1999 (15.4 % in Q4). Furthermore, the participation rate for the population between 16 and 64 years of age increased by almost one percentage point to 63.9 %, stepping up convergence with European levels. The increase in participation was particularly significant in the case of women, where it rose to more than 50 %, and among young people. Despite this, the reduction in the rate of unemployment was also largest in these groups. In the case of women the unemployment rate was three-and-a-half percentage points down on 1998, although it still stood at 23.3 %, which was considerably higher than the male unemployment rate (11.2 %). In the case of the under 30s, the unemployment rate fell by more than five percentage points, to stand at around 25 %. Other groups particularly hard hit by unemployment also saw their relative position improve. The rate of long-term unemployment fell to 8 %, to represent somewhat less than 50 % of all unemployment. It should be noted that both women and young people and the long-term unem-

(1) In application of Council Regulation (EC) No 577/98, and No 1571/98 which develops it.

CHART III.8

Employment and unemployment



Sources: Instituto Nacional de Estadística and Banco de España.

(a) Non-centred year-on-year rates.

(b) Gross data.

(c) Labour Force Survey: adjusted for censual change 1995-96.

(d) Labour Force Survey.

(e) People unemployed for more than one year as a proportion of total labour force.

ployed are the groups at which employment promotion measures have been particularly aimed. By level of education, the best results were among those with secondary qualifications.

Both the QNA and the EPA show that, in net terms, all the jobs created in 1999 were in dependent employment. According to the survey, the number of wage earners increased by 6.7 %, while self-employment was down by 2.2 %. The number of wage earners with permanent contracts increased by 7 %, while those with temporary contracts rose by 6 %, so that the favourable effect of the measures to promote stable employment introduced in 1997, and backed up by concessions on social security contributions for certain groups of newly-hired workers, continued to be observed. These concessions, which expired in May 1999, were extended to 31 December, although their size was reduced by a different amount for each group. The duration of the concessions remains two years, except in the case of the over 45s, to whom they apply as long as the contract lasts. Despite this, the ratio of temporary to permanent employment has only fallen by 0.2 percentage points, to stand at 32.8 %, and a further increase was discerned in the rate of turnover of temporary workers, as well as a reduction in the average duration of their contracts (see Box III.2).

One of the main changes to labour market regulations in 1999 was the new regulation of part-time contracts, approved by Royal Legislative Decree 15/1998, which was intended to stimulate the permanent variety of this form of employment. In general, the new regulation defines more strictly both what is meant by part-time employment and the possibilities for distributing the working hours. Also, it raises the level of social protection for these workers and replaces overtime by supplementary hours, in the permanent contract, abolishing it in the case of the temporary contract. In addition, since January 1999, there have been concessions on social security payments for the same groups as for other permanent contracts, while temporary hiring was penalised, with a rise in the unemployment contribution rate. Although permanent part-time contracts increased by 34.5 % in 1999, they continued to account for a very low proportion of all contracts (1.5 %). The moderate acceptance that the new stable part-time contract seems to have had is probably the result of the excessive rigidity involved in the forward planning of the working day and supplementary hours during the year, although the latter are less expensive than overtime. According to information supplied by the EPA, the percentage of part-time wage earners rose slightly in

The impact of measures to promote stable employment

Since 1996 a number of reforms have been introduced to encourage the hiring of workers on a permanent basis, to delimit the segments using temporary employment contracts and to promote stable part-time employment. The measures to promote stable employment have mostly been designed to target particular groups of the population characterised by higher rates of unemployment and temporary employment: the under-30s, the long-term unemployed and the over-45s. A special employment-promoting permanent contract has been established for these groups (in force from May 1997 to May 2001) with lower dismissal costs than under normal contracts and eligible for concessions on social security contributions that temporarily reduce labour costs further. This regime is also being applied to temporary contracts signed prior to May 1998 that are converted into permanent contracts, irrespective of the segment of population concerned, and from that date to all contract conversions agreed through collective bargaining. However, in the latter case, since January 2000, the concessions have been granted more selectively (only for the conversion of apprenticeship, work-experience, training or stand-in contracts).

On Labour Force Survey (EPA) data, permanent employment has been the decisive element in the expansion of dependent employment since 1996, accounting for somewhat more than 70 % of the net employment created in 1999. Although this statistical source does not give figures for the number of workers hired under employment-promoting permanent contracts, a preliminary estimate indicates that, of the 1,078,500 permanent jobs created since the third quarter of 1997, a very high percentage are based on stable-employment-promoting contracts (around 14 % of all permanent employees). This new form of contract has therefore had a relatively significant impact. The complementary information provided by contract statistics confirms this estimate. From 1997 permanent contracts began to acquire importance. From representing 4 % in 1996, they amounted to 9.2 % in 1999, with a rate of growth of 25.5 % that year (see adjoining table). As seen in the adjoining chart, a substantial increase in employment-promoting contracts lies behind these overall figures, in the case of both new contracts and, above all, converted contracts. In 1999, however, there was a certain slowdown in the rate of growth of new employment-promoting contracts, which became more pronounced in the first few months of 2000 and, in addition, there has been a loss of momentum in conversions of temporary into permanent contracts following the change in the rules governing concessions.

In the period of 1997 to 1999 the ratio of temporary employment only declined moderately (by one percentage point) to stand at 32.8 % in 1999, despite the intense growth in permanent contracts, since temporary employment continued to grow strongly. In fact, according to the contract statistics, the share of full-time temporary contracts rose during 1999, after two years of moderate decline (see adjoining table). This outcome may have been the result of a certain shift from part-time temporary employment, which has fallen significantly after the entry into force of new regulations which, in comparison with the previous situation, are more restrictive. As for the type of temporary contract, there has been a shift towards task or services contracts, which are more flexible insofar as the duration of the employment relationship is concerned. Although the cut in the temporary employment ratio at the aggregate level has been small, it should be noted that in the public sector the ratio of temporary employment rose by 1.6 percentage points in the 1999, while in the private sector there was a somewhat more pronounced cut, of one percentage point. In addition, the chart shows how the largest reductions have occurred in the groups most affected by this situation: young people (with a temporary employment ratio of 56.2 %) and women (with a ratio of 34.8 %). The gap between the sexes is now considerably narrower, while significant differences persist across age groups.

In short, the measures implemented in recent years to promote stable employment have had positive effects on employment, unemployment and temporary employment within the groups targeted. However, the persistence of a high temporary employment ratio at the aggregate level and the discernible falling-off in employment-promoting contracts, suggests that there is room for the reforms to be extended, using the employment-promoting contract formula to target other groups that have considerable difficulty finding employment and the core of firms which, due to their size and administrative set-up, continue to account for most temporary employment.

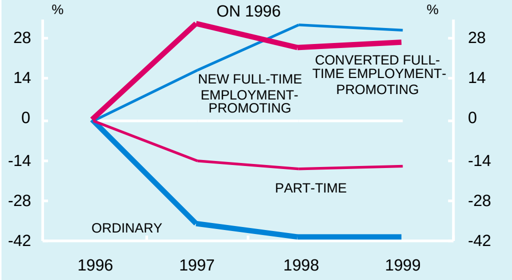
Contract statistics

	Structure (%)				Growth rate (%)
	1996	1997	1998	1999	1999
TOTAL CONTRACTS	**100.0**	**100.0**	**100.0**	**100.0**	**13.5**
Permanent	**4.0**	**7.0**	**8.3**	**9.2**	**25.5**
Full-time	2.7	5.8	7.1	7.7	23.9
Ordinary	2.4	1.6	1.5	1.7	24.0
Emp.-promoting	0.4	4.1	5.5	6.0	23.8
New	*0.1*	*1.3*	*2.8*	*2.9*	*17.2*
Converted	*0.3*	*2.8*	*2.7*	*3.1*	*30.8*
Part-time	1.3	1.2	1.3	1.5	34.5
Temporary	**96.0**	**93.0**	**91.7**	**90.8**	**12.4**
Full-time	78.4	74.6	72.6	74.1	15.7
Task	29.3	27.4	27.2	29.3	22.1
Casual	32.3	34.4	35.3	34.4	10.5
Substitution	10.1	7.1	5.0	5.4	20.9
Work-experience	0.8	0.8	0.8	0.7	–0.3
Training	2.1	1.5	1.3	1.2	4.5
Other	3.8	3.4	3.0	3.2	18.7
Part-time	17.6	18.4	19.0	16.7	–0.2

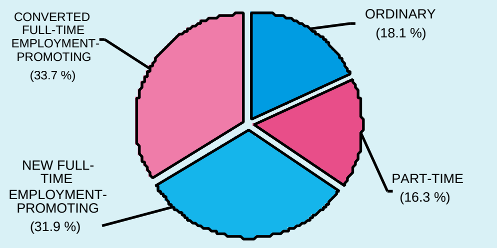
Sources: Instituto Nacional de Empleo and Newcronos.

Changes in permanent employment

CHANGE IN PERCENTAGE WEIGHT OF EACH CONTRACT ON 1996

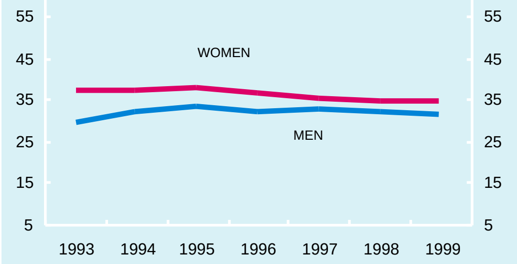


BREAKDOWN OF PERMANENT CONTRACTS 1999

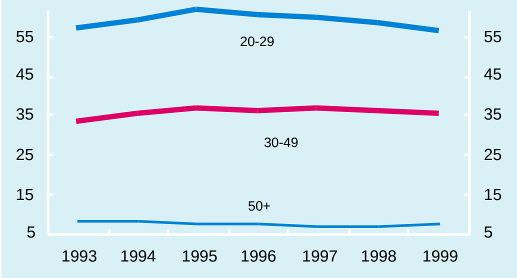


Changes in temporary employment

TEMPORARY MALE AND FEMALE EMPLOYEES AS PROPORTION OF TOTAL



AGE BRACKET PROPORTIONS OF TEMPORARY TO TOTAL EMPLOYEES



Sources: INEM and NEWCRONOS.

1999, to 8.2 %, although surprisingly this increase is due to growth in the numbers of temporary workers (13.6 %), those with permanent contracts increasing by 1.9 %.

III.4. PRICES AND COSTS

In 1999, the main price indicators recorded higher average growth rates than in a 1998. Specifically, the CPI grew on average by 2.3 %, as against 1.8 % in 1998, while the growth in the final-demand and GDP deflators was 2.5 % and 3.1 %, respectively (1.6 % and 2.3 %, in 1998). A large part of the rise in the inflation rate in 1999 is attributable to exogenous factors, including the higher prices for energy products (and other commodities) on international markets, the depreciation of the euro and the adverse weather conditions. That said, the strength of domestic demand was also conducive to price rises.

On average in 1999, there was an acceleration in both the domestic component of costs and that associated with imported products, which was somewhat more marked in the case of the latter. As regards domestic costs, the different paths followed by labour costs and the unit surplus should be noted. While the former slowed, the growth rate of the latter rose considerably. The slowdown in the unit labour cost was the result of the moderate behaviour of compensation per employee, which more than offset the low growth in apparent labour productivity. The expansion of the unit surplus, meanwhile, was not generalised, since it contracted in both industry (which is more exposed to foreign competition and where activity was at its slackest in the year as a whole) and construction.

III.4.1. Costs and price formation

The final-demand deflator, as pointed out above, grew by 2.5 % in 1999, 0.9 percentage points more than in 1998. This acceleration, which became stronger in the second half of the year, when the year-on-year growth rate reached 3.3 %, was the result of the upward movement in the GDP deflator and, above all, of the greater momentum of the imports deflator which, notwithstanding this, continued on average during the year to display greater moderation than the GDP deflator (Chart III.3). As can be seen in Chart III.9, the heightened vigour of the imports deflator in the second half of the year was a consequence mainly of the upward movement in oil prices on international markets, which gave rise to a year-on-year increase of 79.5 % in the unit value index for imported energy products from the summer, as against a decline of 9.8 % in the first half of the year. The unit value indices for imported manufactures also accelerated somewhat in the second half of the year, although less sharply, while those for non-energy commodities decreased to a lesser extent. These results are in line with the progressive improvement in world activity during the year, and with the depreciation of the euro on the foreign exchange markets.

The GDP deflator posted growth of 3.1 % in 1999, 0.8 percentage points up on 1998. As has been becoming normal in recent years, the growth in this deflator, which incorporates the taxes net of subsidies that are levied on output, was greater than that of the GVA deflator (2.9 %), which more closely approximates the prices received by producers, although the latter also accelerated by 0.8 percentage points with respect to 1998. The difference between the growth rates of these two deflators reflects the change in net taxes per unit of output, which have been notably buoyant in recent years, and particularly in 1999, when their share in GDP rose by 0.7 percentage points. This increase was primarily a consequence of the strong growth in tax receipts, which occurred despite there being no significant changes in tax rates. Nor were any shifts in demand towards products bearing a higher tax burden detected.

As Table III.3 shows, the acceleration of the GVA deflator in 1999 was a consequence of stronger growth in the gross unit surplus, since the growth rate of the cost of labour per unit of value added fell by 0.2 percentage points, to stand at 2.6 %. This led to a slight decrease in the share of labour in GVA, although it was not enough to wipe out the large increase in 1998. The slowdown in labour costs stemmed from the lower rate of growth of compensation per employee, which fell from 2.8 % in 1998 to 2.4 % in 1999. By contrast, value added per person employed fell by 0.2 % for the second year running, a phenomenon rarely observed in the past. As indicated above, apparent labour productivity, measured using GDP, also recorded low growth in 1999 (0.3 %), which was abnormally below its historical average.

The lower growth in compensation per employee in 1999 was confined to those industries that make up the market sector of the economy, since in non-market services, an aggregate which basically includes general government, the growth rate of compensation rose from 3.3 % in 1998 to 4 % in 1999. The significant public-sector wage drift implicit in these data (civil servants' basic pay rose by 1.8 %) is not anomalous when compared with previous years. However, it shows the need to tighten control of this spending item, especially in territorial government, where the phenomenon of wage drift is most pronounced.

Compensation per employee in the market sector slowed by 0.7 percentage points during 1999, to 1.9 %, although as the year elapsed this loss of momentum became less marked, in line with the increase in inflation. Very preliminary estimates of the growth of actual and imputed social contributions paid by employers in 1999 (items included in compensation per employee), seem to indicate that the slowdown of gross wages and salaries was somewhat greater than that of total compensation (by almost one percentage point), although their growth rate would also have stood at 1.9 %. This growth is well below that of wage rates in the same year (2.4 %) and of total hourly earnings as estimated by the Wages Survey (2.5 %). In any event, there was clearly a reduction in wage drift in the private sector. This phenomenon is associated with the high weight of temporary employment and the increase in employee turnover, with the disappearance of seniority supplements in certain firms and with a more intensive use of overtime, as already seen in 1998.

As usual, the growth of wage rates across industries was very uniform in 1999, the differences in the growth of total hourly earnings being more appreciable. Thus, while in services the latter variable grew by 2.2 % and in industry by 2.7 %, the increase in construction was 4 %. Indeed, construction was the only industry in which an increase in wage drift was recorded, in line with the pick-up in its activity.

It should be pointed out that part of the wage moderation in 1999 is attributable to the fact that the inflation forecast initially established in the budget (1.8 % for the December-on-December CPI), which was taken as reference in many collective agreements and was used as the basis for determining the wage increases of civil servants, was widely exceeded at the end of the year. The overshooting of this forecast, largely due to factors that were difficult to foresee when the budget was approved, triggered the inflation-adjustment clauses included in many of the agreements signed in 1999. Payments under these clauses are being paid in the year 2000 and will be included in the compensation for that year, although they arise from wage bargaining in 1999.

Finally, the gross operating surplus per unit of value added increased by 3.6 % in 1999, giving rise to a widening of margins (see Table III.3). When estimating this variable, the com-

TABLE III.3

Composition of final demand and GDP deflators

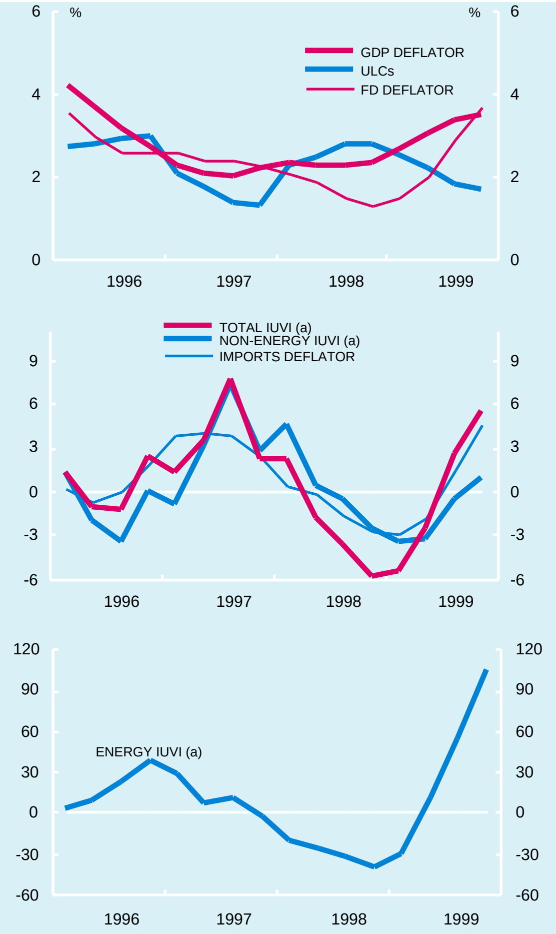
Rate of change

	1996	1997	1998	1999
Final demand deflator	**2.9**	**2.4**	**1.6**	**2.5**
Domestic component	2.4	0.5	0.9	1.3
GDP per unit of final demand	*–1.0*	*–1.7*	*–1.4*	*–1.8*
GDP deflator	*3.4*	*2.1*	*2.3*	*3.1*
Import component	5.2	10.8	4.7	7.3
Imports per unit of final demand	*4.5*	*6.9*	*5.4*	*6.6*
Imports deflator	*0.7*	*3.7*	*–0.6*	*0.7*
GDP deflator	**3.4**	**2.1**	**2.3**	**3.1**
GVA deflator	3.3	1.9	2.1	2.9
Labour cost per unit of value added	2.9	1.8	2.8	2.6
Compensation per person employed	*4.0*	*2.8*	*2.8*	*2.4*
Value added per person employed	*1.0*	*0.9*	*–0.1*	*–0.2*
Gross operating surplus (a)	4.0	2.0	0.6	3.6
Taxes on goods (b)	6.5	7.7	7.4	11.3
MEMORANDUM ITEM:				
Share of net taxes in GDP	8.8	9.3	9.5	10.2
Share of income from work in GVA	66.5	66.5	67.0	66.8
ULCs (with GDP per person employed)	2.8	1.6	2.6	2.0

Sources: Instituto Nacional de Estadística and Banco de España.
(a) Per unit of value added. Includes other taxes on production.
(b) Net of subsidies and per unit of output.

CHART III.9

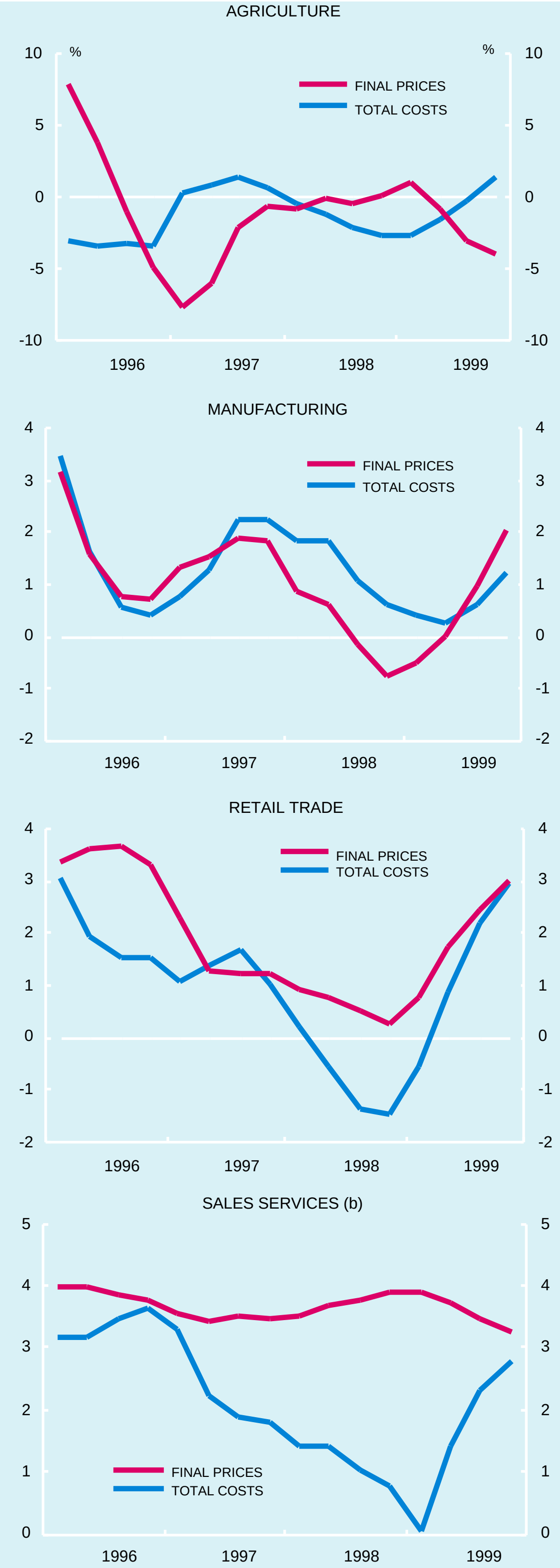
GDP and final demand deflators
Year-on-year rates of change



Sources: Instituto Nacional de Estadística and Ministerio de Economía y Hacienda.
(a) Goods imports unit value index.

CHART III.10

Price formation (a)



Sources: Instituto Nacional de Estadística, Banco de España and Ministerio de Economía y Hacienda.
(a) Year-on-year rate of change based on trend.
(b) Excluding the distributive trade.

pensation attributed to self-employed workers (which matches compensation per employee) was excluded, but the taxes on production net of subsidies that are included in value added at basic prices were maintained. When these taxes net of subsidies are also excluded, the growth of the unit surplus rises to 3.9 %. It should be noted that the concessions with respect to social contributions – to promote stable employment – are considered subsidies on production. In any event, the growth in the unit surplus must have been affected by the strength of demand in the last two years. As seen in the following section, this widening of margins at the aggregate level did not extend to all industries.

III.4.2. Price formation across industries

The purpose of this section is to give an overview of the price formation process industry by industry (except in financial and non-market services). The indicators used combine information on the final prices set by firms (excluding taxes) and on their variable costs. Moreover, the variable costs include both those attributable to the labour factor and those attributable to inputs. The latter were of particular interest in 1999, when the prices of energy products increased considerably.

In agriculture, final prices fell in 1999 as a whole, by somewhat more than in 1998. This decline in selling prices, which was more pronounced in the case of goods for export, is explained both by the reduction in variable costs and by the lower demand pressure in this industry. The reduction in variable costs over the year as a whole, which enabled unit margins to rise slightly, was a consequence of the sharp slowdown in unit labour costs, stemming from both greater wage moderation and a larger increase in productivity. As seen in Chart III.10, intermediate costs accelerated during 1999 – driven by higher energy prices – and pushed up total costs.

The final prices of energy products accelerated sharply in 1999, recording a growth rate of over 6 %. This increase was much greater in the case of exported products. However, it should be noted that electricity is the most important product among those produced for the domestic market, and its prices decreased as a consequence of measures taken to liberalise the sector, while only oil products are exported, and their prices also surged on domestic markets. Undoubtedly, the acceleration in the final prices of this industry was the result of an even greater acceleration in its variable costs, of which the most significant component is imported crude oil. Over the year as a whole, unit margins narrowed.

In manufacturing, final prices grew at stable moderate rates, although they accelerated as the year elapsed, with no significant difference between domestic and export prices in 1999 as a whole. This behaviour was similar to that of final prices, in pesetas, for equivalent products on international markets. Variable costs grew at higher rates than final prices, so that unit margins continued to narrow. Among variable costs, labour costs decelerated, as a consequence of the lower growth of wages. Inputs, by contrast, accelerated owing to the behaviour of energy prices, although these products account for only 4.5 % of variable costs. At a more disaggregated level, the reduction in margins did not extend to all industries. In wood, transport material and rubber and plastics margins widened, and in food they were unchanged.

The link between consumer prices and output and goods import prices can be seen in the distributive trade, its gross earnings margin being roughly equal to the difference between them. In 1999, the growth rate of selling prices in this industry rose markedly, particularly in the case of energy products. The costs of purchasing these goods also accelerated, but to a lesser extent, since import prices grew moderately on average during the year. This enabled the gross earnings margin to increase, against a background of sustained private consumption buoyancy. The increase in the gross earnings margin was passed through to the operating margin since, despite accelerating significantly, labour costs in this industry grew by less than selling prices.

In construction, the growth rate of prices rose sharply during 1999 without any widening in unit margins, since variable costs accelerated to the same extent. This acceleration stemmed from unit labour costs, owing to the larger increase in wages and the strong decline in productivity. The growth rates of inputs held steady, given the low weight of energy products in this industry.

Finally, the growth rate of the prices of market services remained unchanged in 1999, while their variable costs accelerated. However, the latter continued to grow at a lower rate than prices, so that the gross unit margin widened, against a background of increasingly buoyant activity. The acceleration in variable costs stemmed from inputs, since the growth rate of unit labour costs fell significantly. The increase in intermediate costs was very much greater than in other industries (except energy), since the weight of energy products is highest. The widening of margins in services did not extend to all sub-sectors, and they declined in communications and in other services. The liberalisation measures and tariff authorisation policy implemented in these industries undoubtedly explain these declines, and clearly show their effectiveness in reducing inflationary pressures.

III.4.3. Final demand deflators

The acceleration of the final demand deflator, which has been analysed from the viewpoint of price formation in the previous section, extended to all its components on the expenditure side, with the sole exception of exports. The exports deflator grew at a lower rate than in 1998, although it also accelerated during the year.

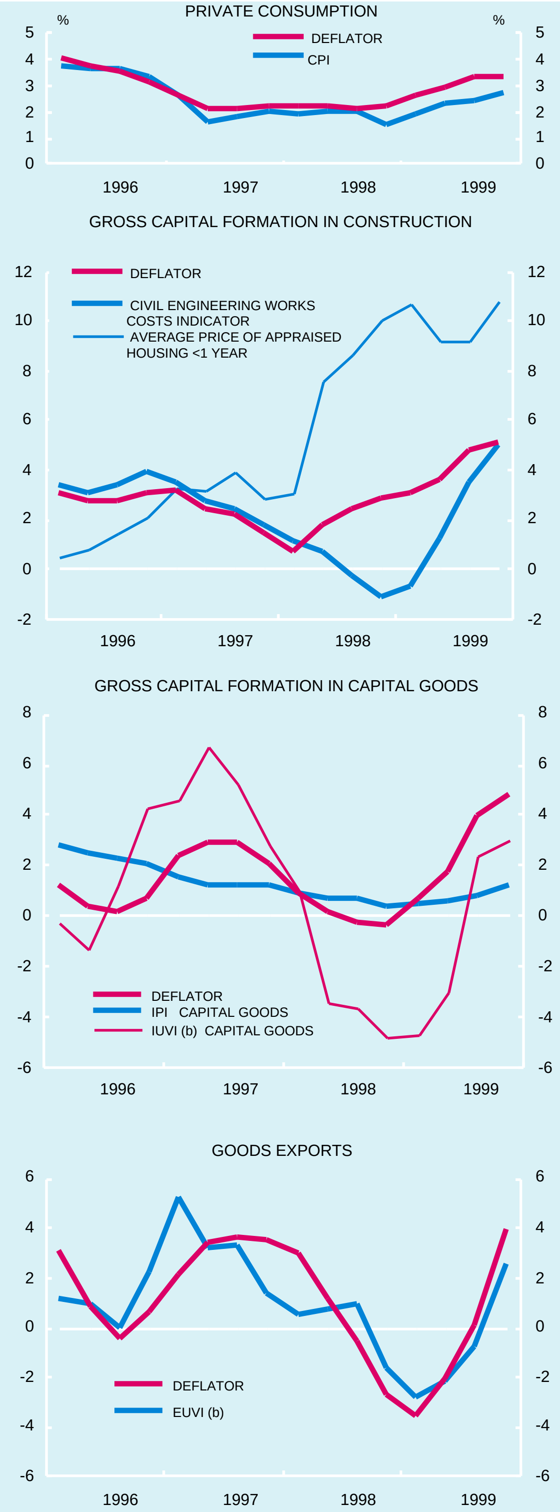
The private consumption deflator grew by 2.8 % in 1999, 0.8 percentage points up on 1998. This growth exceeded that of the CPI (2.3 %), its main short-term indicator, although both displayed a profile of acceleration, as seen in Chart III.11. The difference between these two measures of inflation in private consumption lies, as usual in recent years, in the different systems used to weight their components. In particular, the hotel and restaurant headings (which include food outside the home) have a higher weighting in the deflator than in the CPI, while food, beverages and tobacco (food consumed at home) have a lower weight. Moreover, rentals also have a higher weight in the deflator, since the CPI does not include the imputed rentals paid by owner-occupiers. A large part of the difference between the rates of change of these indices is explained by the higher growth in the items that are given a higher weighting in the deflator.

The CPI grew by 2.9 % during 1999, compared with a 12-month rate of 1.4 % in December 1998. This pick-up was mainly a consequence of the rises in energy products and processed foods. Nonetheless, some of the measures customarily used to determine the underlying growth of consumer prices also displayed an upward trend during the year (see Box III.3). Meanwhile, a number of measures were taken by the government during the year that had an immediate impact on the CPI growth rate (see Table III.4). These measures, adopted in the broader framework of structural reform policy to improve and liberalise the workings of the economy, had an estimated overall impact on the 12-month growth rate of the CPI of about 0.2 percentage points.

In 1999, the energy prices component of the CPI grew by 3.3 % on average (9.4 % in Q4),

CHART III.11

Final demand deflators (a)



Sources: Instituto Nacional de Estadística, Banco de España and Ministerio de Economía y Hacienda.

(a) Year-on-year rates of change based on the trend.

(b) IUVI and EUVI are the import and export unit value indices, respectively (1995=100).

seven percentage points up on the previous year. This rise is in line with that seen in energy output prices, after taking into account the differences in the coverage of these two indices. In the case of processed food, prices rose by 2.1 %, in 1999 as a whole, 0.8 percentage points more than in 1998. These prices accelerated during the year primarily as a result of the rise in oil and wine prices. By contrast, the prices of processed food slowed, recording an increase of 1.2 %, which was higher than the increase in farm-gate prices. Finally, the moderate growth of the prices of non-energy industrial goods was sustained, while the average annual growth rate of service prices slowed by 0.2 percentage points, the growth rate of the former remaining well below that of the latter (1.5 % against 3.4 %). In the case of industrial goods, both the producer price index (PPI) for this type of goods and the import unit value indices recorded a slowdown in their annual average rates. In the case of services, the moderate growth of their variable costs has already been mentioned.

The deflator of general-government final consumption expenditure grew by 3.6 % in 1999, one percentage point up on 1998. All its components picked up somewhat, but the largest contribution came from the compensation of general-government employees, owing to the notable wage drift mentioned above.

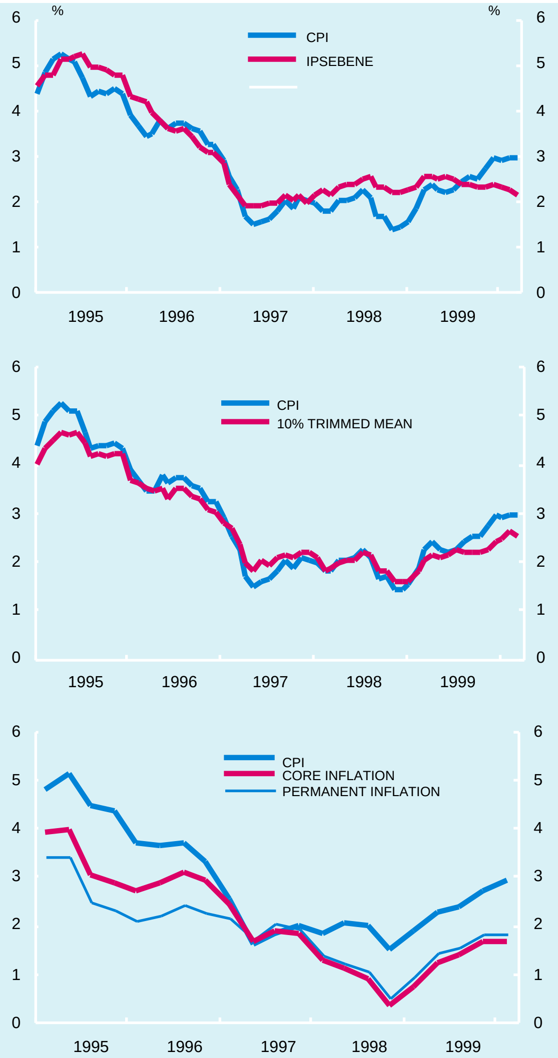
The deflator that accelerated most in 1999 was undoubtedly that of gross fixed capital formation, which recorded growth of 3.7 %, as against 1.2 % in the previous year. The growth of capital goods prices was somewhat lower (2.8 %) than that in construction (4.1 %), although the acceleration on 1998 was greater. These developments are in line with the behaviour of import prices, since the growth rate of domestic prices remained unchanged. In the case of construction, both the indicator of civil engineering costs, which accelerated over the course of the year, and housing prices, which held at a high rate of growth (of around 10 %), explain the strong rise in the deflator, which exceeded that of other final demand components.

Finally, the deflator of goods and services exports was the only one to slow slightly in 1999 on average, with a growth rate of 0.4 %. This loss of momentum stemmed from the goods component, since the growth rate of the deflator of services exports, consisting essentially of tourism, increased. In fact, the deflator of goods exports fell by 0.4 %, in line with the unit value index, although it displayed a profile of acceleration over the year. It is perhaps surprising that, in a year in which international prices were somewhat more inflationary and in

Underlying inflation in 1999

In 1999, the year-on-year growth rate of the CPI rose significantly, from 1.4 % in December 1998 to 2.9 % twelve months later. A large part of this increase was due to the surge in the prices of oil products from the spring of last year. Nonetheless, given that the CPI is the indicator most widely used to monitor the economy's inflation rate, it is important to determine to what extent this behaviour may be considered to be isolated and transitory or to be accompanied by a more general upward movement in prices. Generally, the concept of underlying inflation is resorted to when responding to this type of question. This specifically tries to identify the trend in the general level of prices, eliminating the effects of transitory movements in individual prices on the observed rate of inflation. However, the fact that underlying inflation is a concept that is difficult to pinpoint means that there are several measures that attempt to approximate it. These do not always give the same results and should be assessed jointly.

Consumer Price Index and measures of the inflationary core



Sources: Instituto Nacional de Estadística and Banco de España.

A first approximation of underlying inflation is the index of non-energy processed goods and service prices (IPSEBENE), i.e. the CPI excluding the components (energy and unprocessed food) that are considered to be the most variable. As seen in the adjoining chart, the profile displayed by the IPSEBENE during 1999 was almost the opposite of that of the CPI, especially in the second half of the year when it slowed moderately. Overall, the IPSEBENE was more stable than the CPI, staying within the range of 2.2 % to 2.5 %, which would imply that the sharp acceleration in the general index was the result of isolated movements of certain prices, downwards at the beginning of the year and upwards from the third quarter.

Other measures of underlying inflation, however, displayed profiles closer to that of the CPI during 1999. The mean of the CPI trimmed by 10 % (which excludes the items of the index which recorded the largest and smallest price increases, corresponding to 5 % of the weight of the index at each extreme) accelerated markedly, although not as strongly as the general index. A detailed analysis of the items excluded from the calculation of the trimmed mean reveals that most of the energy items were excluded almost throughout 1999 (at the beginning of the year due to their negative 12-month rates and subsequently due to their very high rates). Olive oil and hotels and restaurants, whose prices had a strongly expansionary component last year, were also excluded, as were a number of industrial goods (personal computers, books, television sets) whose prices, by contrast, displayed extremely moderate behaviour. Note that many of these items do not belong to the components considered most variable.

Nonetheless, little stability is observed in the items excluded from the top and bottom ends of the spectrum when calculating the trimmed mean: only one of the eight items excluded as being the most inflationary in January 1999 (table wine) was still in this category in December, as were only two of the nine excluded as being the most moderate (poultry meat and personal computers). Meanwhile, four items moved from one extreme to the other, including edible oils and fuels (as mentioned above). In any event, these products having been removed, the trimmed mean recorded a rising trend over the year, exceeding the inflation rates indicated by the IPSEBENE by the end of the period.

Another way of approximating underlying inflation is to estimate such measures with structural VAR models, which use the information provided by the changes in both prices and output. Following the methodology established by Blanchard and Quah, a joint GDP/CPI model has been estimated for the Spanish economy from which two measures of inflation can be obtained: permanent inflation, which incorporates only those disturbances with lasting effects on prices, and core inflation, which incorporates those disturbances to inflation that have no long-run effects on output. It should be pointed out that the level of inflation indicated by these measures is fixed arbitrarily, only its profile being relevant. As seen in the chart, both core and permanent inflation display a rising profile during 1999, especially marked in the first half of the year, showing the impact of expansionary factors of a permanent and general nature on the inflation rate.

In all, the various measures of underlying inflation analysed above show, either the persistence of relatively high inflation rates (IPSEBENE), or else an upward movement in the inflation rate during 1999, partly reversing the improvement that the same measures had identified in 1998 (trimmed mean and core and permanent inflation).

TABLE III.4

Application of measures in 1999 with immediate effects on prices

Measure	Reduction
— Telephony: former monopoly's rates	
• Connection charge	In May, 5 %-10 %.
• Local calls	In November, 13 % on average.
• Provincial calls	In June, 6.5 %; in November, 4.36 %.
• Inter-provincial calls	In June, 10.56 %; in November, 17.56 %.
• International calls	In June, 6.19 %; in December, 6.68 %.
• Landline-to-mobile calls	In June, 6.4 %-15.4 %.
• Digital line rental	In May, 5 %.
• Analogue mobile phone interconnection	In July, 10 % cut in maximum level and elimination of minimum limit.
— Electricity	
• Tariff (domestic users)	In January, 2.5 %; in April, 1.5 %.
• Tariff for third-party access to electricity transport and distribution	In January, 25 %.
— Natural gas: revision of maximum price formula	In May.
— Butane canister: maximum price	In May, 1.4 %; in October, 15 % and elimination for one year of maximum price system.
— Drugs	
• Distributor's margin for normal packaging	In May, from 11 % to 9.6 %.
• Prescription drug prices above PTA 558	From 15 September, between 4.6 % and 10%.
— Fees of notaries-public and registrars of mortgaged property and of house sales/purchases	In April, 25 %.
— Costs of company registration in Mercantile Registries	In April, 25 %.

which the euro fell significantly, export prices did not grow by more. The explanation is to be found in the orientation of goods exports, both in terms of the geographical areas in which they are concentrated (the euro area) and in terms of the product sold (medium and low-technology), which were subject to severe price competition on international markets. In the case of tourism, the growth of its deflator must have reflected, in part, the notable and sustained buoyancy of the demand for these services.

III.5. GENERAL GOVERNMENT ACTIVITY

The impact of general government activity on the behaviour of other sectors of the Spanish economy in 1999 and its contribution to demand, activity and price developments have been described in the foregoing sections. It is now necessary to analyse what consequences this general government activity has had for the consolidation of government finances.

The 1999 budget set a target of 0.5 percentage points for the reduction in the general government borrowing requirement (to achieve a deficit, defined in terms of the ESA-79 accounting framework, of 1.6 %). The budget figures were based on a macroeconomic scenario conducive to reducing the general government borrowing requirement. This scenario was characterised by real GDP growth of 3.8 %, underpinned by more buoyant domestic demand, high employment generation and an increase in consumer prices during the year of 1.8 %. On the provisional figures available (see Table III.5), the general government borrowing requirement in 1999 stood finally at 1.1 % of GDP, as against a 2.6 % deficit in 1998 (both measured in accordance with the ESA-95 accounting framework). This was against a backdrop of an economic performance not far off that initially forecast in terms of growth and employment, although the increase in consumer prices was significantly higher.

Besides the risk associated with economic growth being lower than in the budget scenario (a risk which, as has just been pointed out, did not materialise in 1999), there was another element of uncertainty at the beginning of 1999 that might have curtailed the planned cut in the general government borrowing requirement. This concerned the impact on revenue of the comprehensive reform of personal income taxation. As explained in more detail later in this section, the partial information available suggests that there was a moderate loss of personal-income-tax revenue, in line with the official estimates supplied in the December 1998 Stability Programme.

It is important to point out that the change in the accounting framework, from ESA 79 to ESA 95, gives rise to certain difficulties when making comparisons between the results observed and what was programmed in National Accounts terms (see Box III.4 for a detailed explanation of the changes). That said, any assessment of the results observed in 1999 can also draw on the cash-basis State budget data. According to the latter, the 1999 budget outturn was a deficit of ESP 1,057 billion, which was around PTA 360 billion less than initially forecast and 5.1 % below the 1998 outturn. This outcome was due to the better-than-expected behaviour of revenue (tax revenue, in particular), since expenditure rose by slightly more than budgeted. Here, it is again necessary to note a relatively high volume of changes to State spending appropriations (around ESP 875 billion), although these were somewhat less in 1998 and were partly used for the debt conversion operations carried out during the year.

TABLE III.5

Main general government non-financial transactions (ESA 95)

% of GDP

	1996	1997	1998	1999
Total revenue	**39.3**	**39.6**	**39.6**	**40.0**
Current revenue	37.9	38.2	38.3	38.8
Taxes on production and imports	*10.2*	*10.5*	*11.1*	*11.7*
Taxes on income and wealth	*10.3*	*10.5*	*10.3*	*10.3*
Social contributions	*13.2*	*13.2*	*13.2*	*13.2*
Other revenue (a)	*4.2*	*4.0*	*3.7*	*3.6*
Capital revenue	1.4	1.3	1.3	1.3
Total expenditure	**44.3**	**42.7**	**42.2**	**41.1**
Current expenditure	39.1	37.8	37.1	35.8
Final consumption expenditure	*18.0*	*17.6*	*17.4*	*17.1*
Social benefits in cash	*13.8*	*13.4*	*13.0*	*12.6*
Actual interest payments	*5.4*	*4.8*	*4.4*	*3.7*
Subsidies	*1.0*	*0.9*	*1.2*	*1.2*
Other transfers	*1.0*	*1.1*	*1.2*	*1.3*
Capital spending	5.1	5.0	5.1	5.3
Gross capital formation (b)	*3.2*	*3.2*	*3.3*	*3.4*
Other expenditure	*2.0*	*1.8*	*1.8*	*1.9*
Net lending (+)/borrowing (–)	**–5.0**	**–3.2**	**–2.6**	**–1.1**
MEMORANDUM ITEM:				
Primary balance	0.4	1.6	1.8	2.5
Gross debt	68.0	66.7	64.9	63.5

Sources: Instituto Nacional de Estadística and Banco de España.
(a) Includes fixed capital consumption.
(b) Includes net acquisition of non-financial non-produced assets.

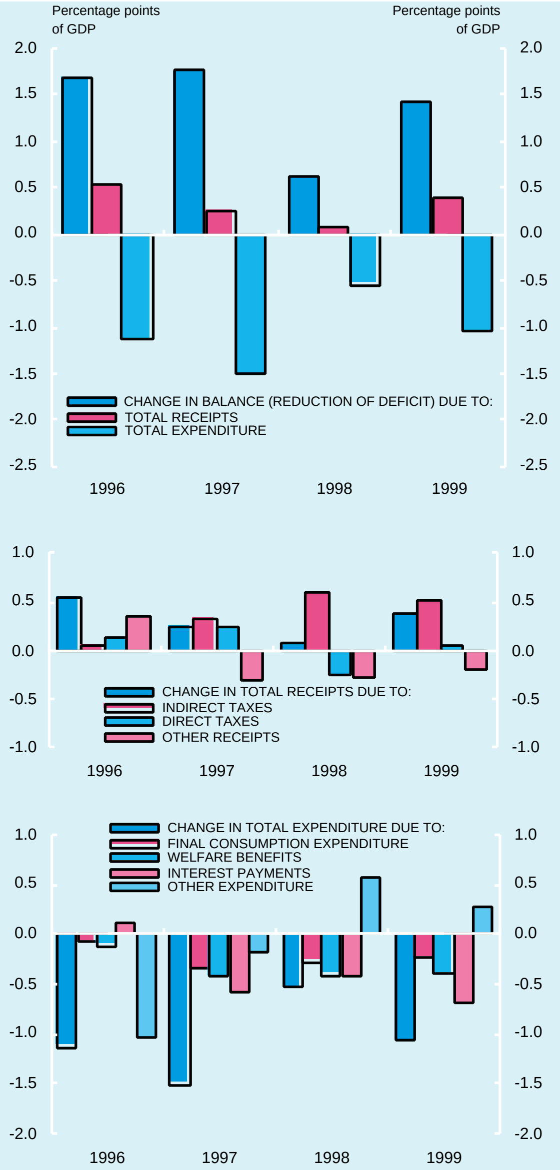
This improvement on the 1999 results was also apparent in the data published for general government as a whole in National Accounts terms, despite the changes and modifications that may have been occasioned by the introduction of ESA 95. As seen in Chart III.12, the reduction in the deficit in 1999 continued to stem primarily from expenditure moderation, although tax receipts also played a prominent role in reducing net borrowing. The reduction in the public deficit in 1999 was 1.5 percentage points of GDP, of which 0.4 points were attributable to the increase in total receipts and the other 1.1 points to the fall in total expenditure. As general government capital expenditure rose by around 0.2 percentage points (in line with the Spanish economy's real-convergence requirements), the decline in current expenditure totalled 1.3 percentage points of GDP. Of these, 0.7 points were attributable to the decline in public-debt interest payments, so that there was also a notable contraction in primary current spending (which excludes interest payments) of nearly 0.6 percentage points of GDP.

On the revenue side, the notable growth in indirect tax receipts should be mentioned. Revenue from taxes on products grew at rates of 8.2 %, bolstered partly by the increase in receipts from taxes on hydrocarbons and on certain means of transport, reflecting the buoyancy of new car registrations and fuel consumption. However, the main element determining the profile of tax revenue in 1999 was the strong increase in VAT receipts (up by more than 17 %), which cannot be fully explained by their main determinants, namely domestic consumption, imports and purchases of new dwellings. The increase in indirect tax revenues in 1999 contributed about 0.6 percentage points of GDP to the reduction in the deficit. Some of the acceleration in receipts from taxes on production and consumption can be explained by the strong increase in energy prices last year, as well as by the path of household consumption expenditure. However, the only explanation for the vigorous growth recorded is a certain surfacing of irregular economic activity. This hypothesis would also be consistent with the growth in personal income tax revenue and, in particular, with the increase in the number of Social Security registrations last year.

As regards personal income tax, the data available show that during 1999 there was no significant reduction in the funds raised by this tax. This must have been partly thanks to the significant generation of dependent employment recorded last year and to the related impact on tax withheld from pay. The 7.4 % growth rate for total receipts from income and wealth taxes (the only National Accounts information available on direct taxation) reflects, as in other years, very strong growth in corporate income tax, which seems to have easily made up for the practical stagnation of personal income tax revenue. In any event, it is estimated that the overall impact of general government

CHART III.12

Breakdown of the change in the general government deficit (ESA 95)



Sources: Ministerio de Economía y Hacienda, and Banco de España.

last year (through the interplay of benefits and taxes) would explain around 0.7 percentage points of the nominal growth in household disposable income (6.4 %), as compared with only 0.2 percentage points in 1998.

Similarly, the sharp increase in the total number of persons registered with the Social Security System would explain the positive growth in revenue from contributions, which rose by 7.3 % in 1999 (against 6.2 % in 1998), given that contribution rates remained practically unchanged and only the bases of calculation of certain groups were increased. In particular, the total number of persons registered grew by 5.5 % in 1999, thanks to the growth in registered employees and, among these, the sharp increase in those in the construction sector (16.8 % up on 1998). This growth in revenue from social contributions largely explains the turnaround in the Social Security System's non-financial transactions balance from a deficit of 0.1 % of GDP in 1998 to a surplus of 0.2 % in 1999.

As mentioned above, it was primarily through developments on the expenditure side that the public deficit was contained in 1999, with notable reductions in expenditure on public-debt interest payments. These savings were attributable to the debt-conversion policy (which was particularly significant in 1998) and to the recent lengthening of the average life of debt (from 3.7 years at the beginning of 1998 to 5.3 years at end-1999). As a result, the average implicit interest rate on all outstanding general government debt was significantly reduced in 1999 to stand at 6 % (6.9 % in 1998), practically one percentage point below the nominal GDP growth rate. Two other items also helped to reduce total spending: general government final consumption expenditure fell relative to GDP, and social benefits moderated somewhat.

In 1999, general government final consumption expenditure declined notably relative to nominal GDP (by around 0.3 percentage points), although there was a deterioration over the year with respect to the initial estimates for this component of expenditure. The information available during the first three quarters of 1999 indicated notable control over this expenditure, with relatively low nominal growth rates of close to 4.5 %. However, the incorporation at the end of the year of the provisional territorial government figures raised these initial estimates to an average rate of 5.5 %, for general government as a whole, due to higher growth of compensation of employees and of intermediate consumption. This expenditure therefore accelerated in 1999 (with respect to the 4.7 % growth recorded in 1998), highlighting the importance of stronger budget discipline mechanisms and of co-ordination between central and territorial government.

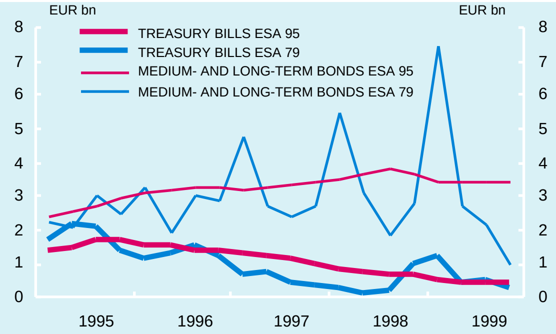
Finally, the reduction in spending on social benefits (by 0.4 percentage points of GDP) was primarily due to the moderate growth in the number of pensions paid in 1999 (1.1 % against 1.5 % in 1998) and the significant saving on unemployment benefit, which fell by around two percentage points of GDP. This was prompted by the notable reduction in the number of recipients (9.5 %), which was nonetheless smaller than the fall in registered non-agricultural unem-

BOX III.4

ESA 95 and measurement of the general government deficit

As announced in Box IV.1 of the 1998 Annual report, the March 2000 deficit and public-debt notification, submitted under the Excessive Deficit Procedure/Stability and Growth Pact (EDP/SGP), was based on the conceptual framework established by the European System of National and Regional Accounts (ESA 95) and its supplementary provisions. The application of these provisions has involved new estimates of the deficit and debt of Spanish general government for the years 1995 to 1998, which differ from those included in the notification sent to the Commission in September 1999, which were based on ESA 79 and its supplementary provisions. The March 2000 notification also included data for 1999, a year for which no calculations have been made in terms of ESA 79(1).

Interest burden. State issues (Originally issued in pesetas/euro)



Source: Banco de España.

The adjoining table gives estimates of the public deficit for the period 1995-1998, in terms of both conceptual frameworks. The main differences are explained by the new criteria established for the time of recording of interest, by the fact that the accounting dividends paid by the Banco de España to the Treasury (which arise from net capital gains) are considered not to reduce the deficit and by the changes in the definition of the general government sector. These differences are reflected both in the determination of the non-financial transactions of general government and in that of their financial counterpart. It is important to take into account that, in relative terms, the ratios of the new variables to GDP are also affected by the upward revision of this aggregate following the introduction of ESA 95.

The differences arising from the different criterion applied to the recording of interest are not only due to interest being recorded at the time of accrual (ESA 95) rather than at the time of payment (ESA 79). Also, some of the financial costs that were previously not considered to be interest are now included as such (2). As a consequence of these methodological changes, significant differences can be discerned in the adjoining chart in the path of interest costs according to ESA 79 (under which their absolute value is lower and much more erratic) and ESA 95, under which the level is higher and the path much smoother.

The differences in the determination of the public deficit which appear in the table due to the new recording of payments from the Banco de España to the Treasury are not strictly due to any conceptual difference between ESA 79 and ESA 95, but rather to the fact that there has now been a clarification (published in the manual cited in Footnote 1) as to how these transactions should be recorded. Specifically, the adjustment is intended to make it clear that in the National Accounts dividends cannot incorporate the result of realised capital gains, since these operations do not involve the generation of income, but rather a change in the valuation of the assets of the unit affected.

As regards the definition of the sector, the main changes arising from ESA 95 have involved the inclusion of units previously classified as public enterprises. Their effect on the deficit has been small (see adjoining table), but their impact on the valuation of public debt has been more significant, entailing an average increase in its absolute value of approximately EUR 3 billion in each of the years from 1995 to 1998. However, as a percentage of GDP, debt is from 0.3 to 0.5 percentage points lower than under ESA 79, due to the higher value of nominal GDP under ESA 95, as mentioned above. The level of public debt at end-1999 was 63.5 % of GDP, as against 63.8 % in 1995.

Finally, it should be taken into account that a draft Council and Parliament Regulation is currently being debated in the European Parliament which is intended to clarify the principles for recording taxes and social contributions under ESA 95. The purpose of this draft is to avoid the recording of unpaid taxes and contributions. When the current legal process is concluded it will be possible to assess whether the estimates now available for the deficit are affected and, if so, to what extent.

(1) The supplementary provisions to ESA 79 are Regulation (EC) No 3605/1993 and all the Press Releases disseminated by Eurostat between 1996 and 1998, relating to the homogeneous criteria to be followed by the countries in those cases not covered, or not sufficiently explicit, in ESA 79. The supplementary provisions to ESA 95 are Regulation (EC) No 475/2000 of 28 February 2000, which revises Regulation (EC) No 3605/1993, and the deficit and public debt manual published by Eurostat in January 2000.

(2) Specifically, the supplementary provisions to ESA 79 established that premiums/discounts on bonds, in the case of tranches issued within twelve months of the initial placement, were not considered interest. Such premiums/discounts were considered instead to be capital gains/losses.

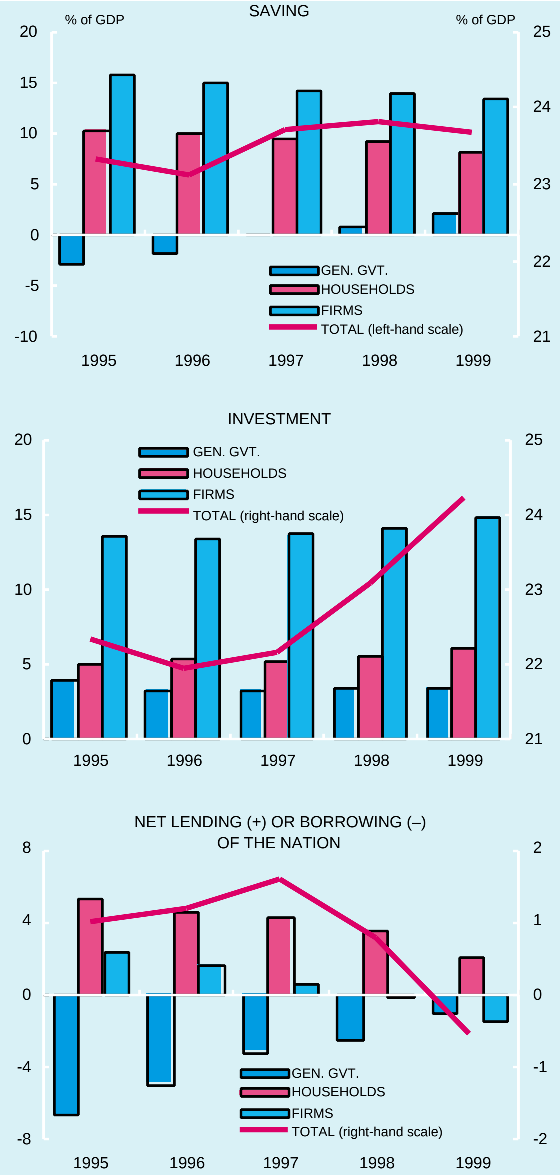
General government deficit according to the EDP/SGP

% of GDP

	1995	1996	1997	1998	1999
1. September 1999 notification (ESA 79)	–7.1	–4.5	–2.5	–1.7	…
2. March 2000 notification (ESA 95)	–6.6	–5.0	–3.2	–2.6	–1.1
3. Differences (2 – 1). Non-financial transactions	0.5	–0.4	–0.7	–0.9	…
Adjustment for different time of recording of interest	*0.1*	*–0.5*	*–0.5*	*–0.5*	…
Adjustment for different recording of Banco de España dividends	*0.3*	*0.1*	*–0.1*	*–0.3*	…
Adjustments for changes in definition and other adjustments	*0.0*	*–0.1*	*–0.2*	*–0.1*	…
Effect of the change in GDP	*0.1*	*0.1*	*0.1*	*0.0*	…
MEMORANDUM ITEM:					
GDP at market prices (GNP Directive) (ESA 79) (PTA bn)	71,771.2	75,953.2	80,465.0	85,591.5	…
GDP at market prices ESA 95 (PTA bn)	72,841.7	77,113.4	81,782.0	86,968.5	93,068.3

CHART III.13

Saving, investment and net lending (+) or borrowing (–) of the nation



Sources: Instituto Nacional de Estadística and Banco de España.

ployment (counting only those previously employed) of 11.7 %. As a result, the net eligibility ratio rose to 63.5 % (61.9 % in 1998).

The results recorded in 1999 are a good starting point for making headway in 2000 in the necessary process of consolidation of Spain's public finances, which should continue to be reflected in further increases in the primary surplus. The updated Spanish Stability Programme, presented at the beginning of 2000, set a deficit target for the year of 0.8 % of GDP, as against an estimate of 1.3 % for 1999, which as already mentioned was subsequently revised down. The macroeconomic scenario underlying these targets is in line with the official forecasts used in the preparation of the 2000 budget (real GDP growth of 3.7 %). Current forecasts point to higher growth (probably over 4 %) which should facilitate the attainment of the targets set and permit more rapid progress than initially planned towards a balanced budget.

III.6. BALANCE OF PAYMENTS AND CAPITAL ACCOUNT OF THE INSTITUTIONAL SECTORS

As implied by the analysis in the previous section, the reduction in the public deficit in 1999 gave rise to a significant increase in general government saving. However, this improvement in public saving was offset by lower saving on the part of firms and households, whose consumption expenditure remained highly buoyant throughout the year. The saving ratio of the economy thus remained unchanged at around 24 % of GDP. Meanwhile, the strength of investment by households and firms resulted in a significant rise in the economy's investment ratio, which approached levels of 25 % of GDP. For the third year running investment rose as a percentage of GDP, driven by the extended upswing in the Spanish economy, with rates of growth of close to 4 % in this period. As seen in Chart III.13, the buoyancy of investment and the stable saving ratio first of all reduced the economy's net lending (in 1998), which subsequently turned into net borrowing by the nation (in 1999).

The balance of payments figures reflected the change from a situation of net lending by the economy to one of net borrowing. According to these figures, the overall deficit on current and capital account amounted to EUR 5,414 million in 1999, a significant change given the surplus of EUR 3,082 million in 1998. This result stemmed from the progressive widening of the current deficit as the year unfolded, set against the smaller improvement in the capital account surplus. In terms of GDP, the overall balance on current and capital account stood at –1 % of GDP (2), compared with an average surplus of 0.6 % in 1998 (see Table III.6 and Chart III.14).

The widening of the current account deficit was a consequence of the significant deterioration in the balance of goods and services trade,

(2) This figure does not exactly coincide with national net borrowing, in National Accounts terms, which is provisionally estimated at –0.6 % of GDP in 1999.

given the weakness of sales of merchandise abroad in the first few months of the year and the sustained high growth rates of imports, bolstered by the buoyant demand. The growth differential between goods exports and imports in real terms was significant, though even more so in nominal terms, since in 1999 there was a marked deterioration in the terms of trade, due to the impact of dearer energy on import prices. The excellent results recorded by tourism receipts, which rose by 13.7 %, and the consequent improvement in the tourism surplus could only partly make up for the notable widening of the merchandise deficit.

As for other current transactions, in 1999, as in preceding years, the income deficit continued to increase, due to the fall in receipts, while payments grew moderately. The fall in investment income receipts was closely linked to the decline in the reserve assets of the Banco de España, which led to a significant fall in the returns received by the credit system. By contrast, the receipts of the non-financial private sector sustained high growth rates, in line with the expansion in the external assets of Spanish firms. As regards payments, those corresponding to the credit system remained practically unchanged, due to the reduced buoyancy of foreign investment in the form of short-term deposits, while those made by general government accelerated reflecting the increase in acquisitions of public debt by non-residents. There was a slight decline in the current transfers surplus, stemming from the deterioration in the general government balance, which was essentially due to an increase in the payments corresponding to VAT Resource and additional GNP Resource (in both cases to finance the EU budget).

Finally, the surplus on capital account (which basically reflects capital transfers between the EU and Spain) increased as a consequence of the notable increase in receipts from the ERDF and the EAGGF-Guidance.

The negative balance on current and capital account shows that the level of saving in the economy was not sufficient to finance the investment made in 1999. A sectoral breakdown of the information shows that the increase in the general government saving ratio translated into a notable fall in its net borrowing, but that this was insufficient to offset the significant fall in the net lending of the private sector (see Chart III.13). These developments mean that there has been a significant change with respect to the previous cyclical expansion. Then, general government net borrowing held practically unchanged, and even rose in some years, while in the current expansion public spending has con-

TABLE III.6

Balance of payments: summary table

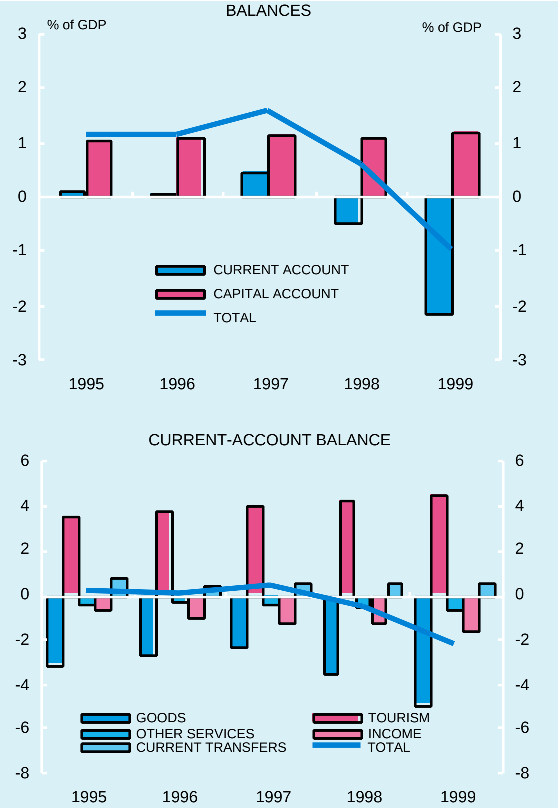
% of GDP

	1996	1997	1998	1999
	RECEIPTS			
Current account	**28.3**	**31.5**	**32.4**	**31.9**
Goods	16.9	19.1	19.2	18.6
Services	7.3	7.9	8.5	9.0
Tourism	*4.5*	*4.8*	*5.1*	*5.4*
Other services	*2.8*	*3.1*	*3.3*	*3.5*
Income	2.3	2.4	2.5	2.1
Current transfers	1.8	2.1	2.2	2.2
Capital account	**1.3**	**1.3**	**1.2**	**1.4**
	PAYMENTS			
Current account	**28.2**	**31.1**	**32.9**	**34.1**
Goods	19.6	21.5	22.8	23.6
Services	3.9	4.4	4.7	5.1
Tourism	*0.8*	*0.8*	*0.9*	*0.9*
Other services	*3.1*	*3.6*	*3.8*	*4.2*
Income	3.3	3.6	3.8	3.7
Current transfers	1.4	1.6	1.6	1.7
Capital account	**0.2**	**0.2**	**0.1**	**0.2**
	BALANCE			
Current account	**0.1**	**0.5**	**–0.5**	**–2.2**
Goods	–2.7	–2.4	–3.5	–4.9
Services	3.4	3.6	3.8	3.9
Tourism	*3.7*	*4.0*	*4.3*	*4.5*
Other services	*–0.4*	*–0.4*	*–0.5*	*–0.7*
Income	–1.0	–1.2	–1.3	–1.6
Current transfers	0.4	0.5	0.6	0.5
Capital account	**1.1**	**1.1**	**1.1**	**1.2**
MEMORANDUM ITEM:				
Overall balance on current and capital account	1.2	1.6	0.6	–1.0

Source: Banco de España.

CHART III.14

Current- and capital-account balances



Source: Banco de España.

tracted considerably (in the context of the requirements of the Stability Pact) leading to a reduction in general government net borrowing as a percentage of GDP.

As regards the firms sector, there was an ongoing fall in its net lending, which turned negative in 1999 (to the extent of around –1.5 % of GDP) due to the buoyancy of gross fixed capital formation in recent years, together with the smooth decline in the saving ratio. However, the healthy financial position of firms at the beginning of the current upswing and the positive performance of funds generated have allowed them to finance the increase in their productive capacity without a significant increase in their net borrowing, at least to 1999.

With regard to household net lending, the downward trend that has prevailed since 1995 continued in 1999, owing to higher growth in private consumption than in disposable income (and to the consequent reduction in the household saving ratio) and to the growth in purchases of dwellings. As already mentioned, the expansion of disposable income, the decline in interest rates, the revaluation of financial wealth and the favourable climate of confidence among Spanish households are the factors that sustained their spending.

CHAPTER IV

SPANISH FINANCIAL MARKETS, INTERMEDIARIES AND FLOWS

IV.1. INTRODUCTION

As indicated in previous chapters, the financial performance of the Spanish economy in 1999 was closely governed by the establishment and implementation of the single monetary policy. However, the existence of this policy does not, per se, ensure that monetary and financial conditions are uniform throughout the various countries of the area. Such conditions depend, among other factors, on the mechanisms through which monetary impulses are transmitted, and these mechanisms reside in the structure and workings of the national financial systems.

In Spain, three important events shaped developments in financial markets and financial flows in 1999: the start of Stage Three of Economic and Monetary Union (EMU); the entry into force of the reform of the Securities Market Law; and the changes in the taxation of a large number of financial assets. Broadly, these events tended to promote competition in the markets as well as giving a further boost to processes that have been running for some years: financial disintermediation and international diversification of investors' portfolios and of borrowers' sources of financing.

Against this backdrop, there was a break with the main trends observed in recent years in the prices of assets quoted on the Spanish *financial markets.* While the yields negotiated on the public-debt markets increased over the year as a whole, cutting short the downward path that began in 1995, the general upward movement in equity prices was at first checked and then subsequently resumed, with behaviour varying widely across sectors. Both these developments were in tune with those recorded by most European countries.

As regards turnover, there were two notable developments in 1999. On one hand, private fixed-income markets grew strongly, stimulated by an unprecedented boom in new issuance (especially by credit institutions) that offset the effects of lower growth in public debt markets. This increased the opportunities for final investors and borrowers to diversify their portfolios and sources of financing, respectively. On the other hand, there was a drastic fall in turnover on the fixed-income derivatives market. With the advent of the euro the products offered by the various European markets became highly substitutable, leading to strong concentration of these transactions, in the British market (for the short maturities) and in the Swiss/German market (for the medium and long maturities).

Unlike in the previous three years, the *financial intermediaries* channelled a relatively smaller volume of funds in 1999, reflecting the higher level of financial disintermediation. However, the most notable feature of the activity of deposit money institutions was, yet again, the strong growth in the total financing extended to the resident private sector, against a backdrop of highly buoyant aggregate demand and relatively low interest rates. Despite the recovery in deposits and the greater recourse to national capital markets mentioned above, this increase obliged the institutions to raise a significant volume of net funds abroad. The net interest income, gross income and net income of the institutions, measured as a percentage of their average total assets, fell again in 1999, as in previous years, although pre-tax profits continued to improve thanks to the fresh reduction in write-downs and provisions. It should be noted that the start of Stage Three of EMU, by modifying the framework in which the deposit money institutions operate, prompted the adoption of strategic decisions. This, above all, boosted the process of bank consolidation, leading to the emergence of two major banking groups (BBVA and BSCH).

The growth in the funds raised by institutional investors declined considerably. This was a consequence of the degree of maturity attained by the mutual funds industry (especially by money market funds) and of the reduction, for certain maturities and levels of income, in the fiscal attractiveness of mutual fund shares in relation to other investments following the latest reforms. By contrast, growth in pension funds and insurance products was clearly higher, essentially due to their scant relative level of development and, in the case of insurance, to the improved tax treatment of certain products, again depending on maturities and income levels.

The growing financial internationalisation mentioned above also shaped the developments in *financial flows between the sectors of the economy.* The Spanish economy, after five consecutive years of positive net financial saving recorded net dissaving of approximately one-half of a percentage point of GDP in 1999 as a consequence of the significant increase in gross capital formation and a stagnant level of gross saving. This net dissaving did not, however, prevent resident sectors from seizing investment opportunities abroad, as shown for example by the international diversification of their portfolios and the external expansion of major Spanish companies, including through the acquisition of foreign firms. Indeed, financial transactions with the rest of the world grew significantly, involving both increases in liabilities and the acquisition of financial assets.

In terms of sectors, the net financial saving of firms and households fell to zero, essentially due to the strong growth in private consumption and investment expenditure. General government again decreased its net financial dissaving, as a result of the significant growth in its gross saving, combined with moderate expansion in its gross capital formation. This behaviour, which was fairly uniform across the public-sector, enabled outstanding public debt to be reduced again relative to GDP.

IV.2. THE FINANCIAL MARKETS

At the beginning of 1999, cash and securities accounts for the trading, quotation and settlement of transactions on Spanish financial markets were re-denominated in euro. This change, linked to the start of Stage Three of EMU, coincided with the entry into force of the reform of the Securities Market Law (Law 37/1998). This adapts Spanish law to various Community directives and completes the process of opening up Spanish markets to foreign competition, by enshrining the principle of the right of establishment and the freedom to provide investment services within the EU. A tax reform also entered into force in 1999, which equalises the tax treatment for legal persons of fixed-income assets issued by private companies (provided that they fulfil certain requirements) with that for State debt.

The completion of Monetary Union entailed the integration of the money markets of the countries that make up the area. It has also enabled the yield spreads on the debt issued by the various member countries to hold at low and stable levels, and movements in yields to be highly correlated. In turn the institutional and legal changes made in 1999 helped to reduce the barriers between national capital markets, thereby reinforcing the tendency, which already existed in previous years, for greater international diversification of residents' assets and liabilities. This boosted competition in markets in the euro area. Finally, the improved tax treatment for private debt stimulated its issuance.

Developments on the Spanish financial markets in 1999 are analysed below against this backdrop, starting with the behaviour of the prices of quoted assets and then moving on to consider the growth of turnover on primary and secondary markets.

In 1999, there was a change in the trends that had prevailed in the immediately preceding years in the *prices of assets quoted* on Spanish financial markets. Public-debt yields, on a downward path since 1995, began to climb in parallel with the sovereign debt of the other euro area states (see Chart IV.1), with interest spreads holding steady (at around 20-25 basis points in the case of Spanish and German debt).

The change in the course of yields began to be discerned in February at the medium and long maturities, and was apparently caused by the spillover effect on euro-denominated debt of the fall in debt prices in the US since October 1998, which reflected market fears that the vigorous growth recorded by the US economy would give rise to inflationary pressures. However, transmission was not complete, given the different cyclical position of the economies of the member countries. By contrast, expectations of an easing of European monetary policy caused public-debt yields at the short maturities to edge even lower during the first few months of the year.

Towards the middle of the year, the rise in yields accelerated and extended to all maturities, amid the increasingly palpable signs of economic recovery in the euro area displayed by some indicators. In this new scenario, short-term yields began to reflect expectations of rising intervention rates in the euro area and, subsequently, they adjusted to the 50 basis point increase in the interest rate on the main refinancing operations of the Eurosystem that took place in November. At the medium and long maturities, the rise in yields may have reflected both an upward revision in inflation expectations, partly fuelled by the upward path of oil prices and by the depreciation of the euro, and also by an improvement in the outlook for economic growth.

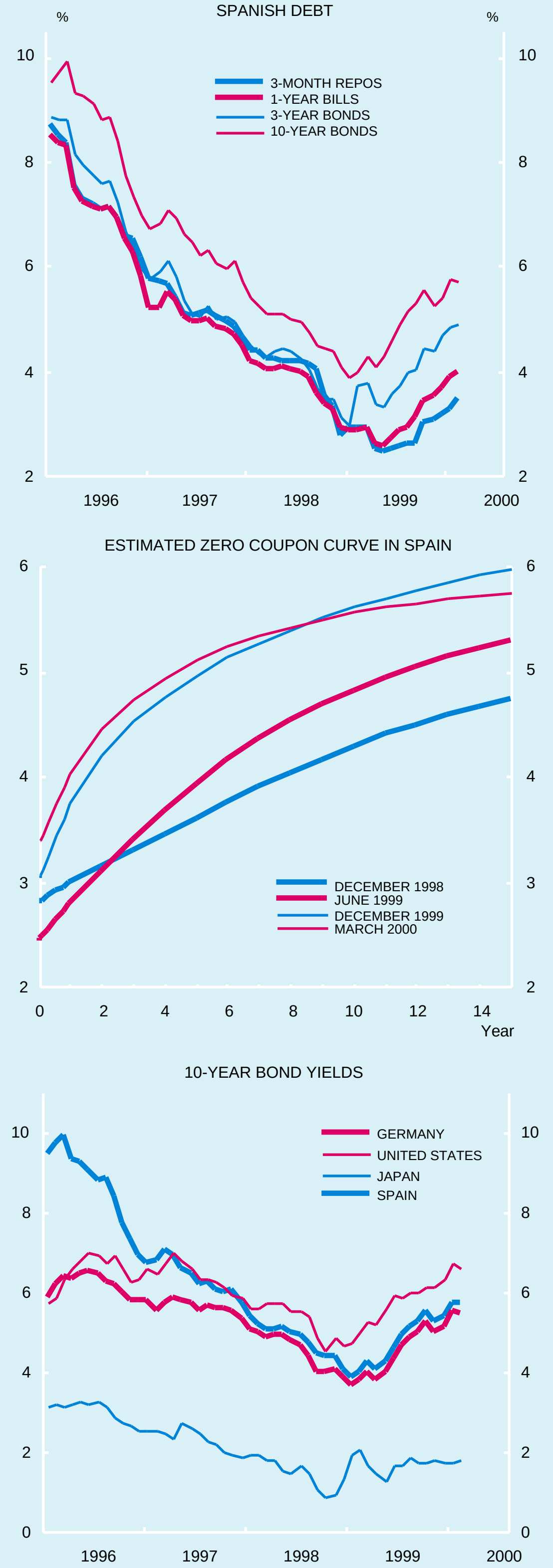
In the year as a whole, yields rose by around 40 basis points on three-month repos, by around 80 basis points on issues of one-year bills and by around 130 basis points on issues of ten-year debt. As a result, the slope of the zero-coupon yield curve, as measured by the difference between overnight and 15-year rates, steepened from 190 basis points at end-1998 to 290 basis points at end-1999. So far during the current year, the zero-coupon public-debt curve has flattened slightly, with an increase in the short rates and a decline in long rates (see Chart IV.1).

During most of 1999, in contrast to the general upward movement that had continued since 1995, equity prices were characterised by a lack of direction. From November however, the general indices turned sharply upwards again. As a result, the Spanish Stock Exchange Ibex-35 index was 18.3 % higher at the end of 1999 than at the beginning of the year.

Equity prices in 1999 were influenced by several factors pushing in different directions, which were also present in most of the main international markets and, in particular, in those of the euro area. The progressive signs of improvement in the international economic environment and, in particular, the increasingly firm prospects for recovery in activity in the euro area had a positive impact on the prospective earnings of listed firms and, especially, of those with the most pro-cyclical profits. This change in outlook was also bolstered by, in most cases, better-than-expected earnings figures. However, these favourable effects were at least partially offset by the increase in long-term interest rates. Finally, during the last few months of the year there was a notable increase in the demand for shares in firms whose business is directly or indirectly related to new technologies. Many of these firms obtained their stock exchange listing in 1999. This demand led to sharp increases in the prices of the firms in these sectors which, in many cases, came on top of the considerable price rises seen in previous years. Although the increase in prices partly reflected an upward revision in expected profits, the size of the cumulative increases gave

CHART IV.1

Government debt yields (a)



Source: Banco de España.
(a) Monthly averages.

rise to mounting fears of a possible correction in the prices of the shares that had risen most.

The different impact of the above-mentioned factors resulted in widely varying behaviour across sectors. Notable in the Madrid Stock Exchange indices was the growth in the communications sector, which rose by 86.6 % on its end-1998 level. This was basically attributable to the price of Telefónica which, like those of other European telephony operators, surged. Also, oil companies outstripped the general index (41.9 %), some being helped by the upward movement in oil prices, while the banking sector also performed better than the general index (19.4 %). By contrast, most other firms listed on the Stock Exchange suffered price falls in 1999, including firms in the construction sector (–26.3 %), in the food industry (–26.2 %), in other industries (–27.2 %) and in the electricity sector (–12.1 %). As mentioned in Chapter II, Spanish indices performed poorly relative to the main international stock exchanges.

In 2000 to date, prices have been more volatile, basically owing to the behaviour of the shares in firms connected with new technologies. Prices continued to rise in these sectors to mid-March, while in most other sectors they continued to fall slightly. However, from mid-March there were significant reductions in the prices of many of the shares that had previously risen most, amid an international sell-off of technology securities.

On the *primary markets,* the most significant development in 1999 was the boom in private-sector fixed-income issuance, with net volumes five times higher than in 1998 and, for the first time, significantly above those of general government (see Table IV.1). Credit institutions and, to a lesser extent, asset-backed securities funds, played a leading role in this boom, which was the result of several causes. On the demand side, the surge in issuance was stimulated by two factors that reduced the disadvantages of private debt compared with public. On one hand, in the operational framework for the single monetary policy, private fixed-income securities were included in the lists of eligible collateral for Eurosystem monetary policy operations. On the other hand, the tax reforms introduced exempted legal persons from withholding tax on the returns obtained on private debt fulfilling certain requirements, putting the tax treatment of such debt on an equal footing with that of State debt. Besides these factors, the increased stability of the Spanish economy and the lower nominal returns on low-risk assets may have stimulated a shift in investment from public debt towards other instruments with higher expected returns, but greater risk, such as the debt issued by private-sector firms.

The growth in issuance was also assisted by the heavy fund-raising requirements of some agents, such as credit institutions and certain non-financial corporations that are currently expanding abroad, while the smaller State borrowing requirement left room for issuance by other sectors. Also, the regulatory changes introduced in 1998 had made the process of issuing securities simpler and less costly for private-sector firms (1).

It should be pointed out that this growth in the weight of debt issued by the private sector is part of a general trend, which will foreseeably strengthen in future and which also affected other countries, particularly those of the euro area. The Stability and Growth Pact will tend to reduce the weight of public debt in financial markets and the environment of economic stability will be conducive to investment in instruments with greater risk. In addition, in the case of Spain, the potential for growth in private-debt markets is very great, since they are still relatively underdeveloped.

The expansion of private-debt markets offset the shrinking of the public-debt market and broadened potential sources of funds and the possibilities for portfolio diversification. The development of private-debt markets also made it possible for deposit money institutions to increase their holdings of eligible assets available for Eurosystem tenders.

Net issuance of other instruments – public debt and equity – also increased, although at much more moderate rates than that of private debt (see Table IV.1). As already mentioned above, the slowdown in the growth of the supply of Treasury securities is a consequence of the lower State borrowing requirements.

New share issues having reached a very high level in 1998, the amounts placed through public offerings in 1999 were well below those of the two preceding years, as a consequence of the smaller number of privatisations of public enterprises. However, other public offerings surged due, above all, to initial public offerings (IPOs). These operations were generally received favourably by investors, who were increasingly ready to invest in equities. In this re-

(1) Specifically, Royal Decree 2590/1998, on changes in the legal regime for the securities markets, introduced the programme prospectus – which enables several issues to be made without the need to submit a complete prospectus for each – and abolished the prospectus for admission to listing.

TABLE IV.1

Issuance and public offerings of marketable securities (a)

EUR millions

	1996	1997	1998	1999
Net issuance	**33,231**	**17,096**	**29,931**	**58,326**
Fixed income	31,105	16,107	20,799	47,841
State	*29,893*	*13,139*	*12,354*	*13,571*
Territorial government	*2,180*	*1,421*	*1,634*	*1,492*
Credit institutions (a)	*264*	*2,645*	*3,889*	*24,676*
Other financial corporations	*1,005*	*77*	*3,211*	*5,287*
Non-financial corporations	*–2,237*	*–1,175*	*–289*	*2,815*
Equities	2,126	989	9,132	10,485
Credit institutions	*202*	*208*	*4,869*	*944*
Other financial corporations	*122*	*52*	*178*	*1,010*
Non-financial corporations	*1,802*	*729*	*4,085*	*8,531*
Public offerings	**2,103**	**10,652**	**11,240**	**5,042**
Privatisations	1,701	9,852	10,857	772
Other	402	800	383	4,270

Source: Banco de España.

(a) Includes resident issues in both domestic and foreign currency.

spect, it should be pointed out that a not insignificant proportion of IPOs were by firms belonging to sectors that are poorly represented on the Spanish exchange, such as the technology sector (TPI, Amadeus and Terra Networks) and the media (Sogecable).

Developments on the *secondary markets* were influenced not only by developments on the primary markets, but also by the background of greater intra-European competition. It was in the trading of fixed-income derivatives that the introduction of the euro entailed the most fundamental transformation. The high degree of substitutability between the products offered by the various European markets was conducive to the geographical concentration of activity. In these circumstances, the managing companies of the Spanish derivatives markets decided to establish an alliance with their French, Portuguese and Italian counterparts, giving their members direct access to the trading of contracts on the other markets in the alliance. Nonetheless, despite the efforts made, activity in euro interest-rate derivatives ended up concentrated in the Swiss/German Eurex market (in the case of the medium and long-term section of the rate curve) and in the British LIFFE market (in the case of the short-term maturities). This involved a drastic shrinking of the turnover on MEFF RF (see Table IV.2). Given this situation, the managing company of MEFF RF is currently concentrating its activities on the sale among its members of products offered on other markets. Since March 2000, it has been acting as a Eurex intermediary, thereby enabling its members to trade the contracts on debt of this latter market from their screens, as if they were MEFF RF products.

The introduction of the euro did not involve such radical changes in trading on the rest of the Spanish secondary markets, although reforms were undertaken in most cases to adapt them to the new competitive environment. Turnover on private fixed-income markets grew significantly in 1999 (see Table IV.2). This was a consequence of the boom in issuance on the primary market, the operations relating to the securing of liquidity in Eurosystem tenders by deposit money institutions, the improvements in the taxation of transactions based on commercial paper and the listing of preferential equity holdings *(participaciones preferentes).* The latter are hybrid instruments combining fixed income and equity features, usually issued by the subsidiaries of Spanish credit institutions located abroad. The attractiveness of Spanish private fixed-income markets can be expected to be bolstered in future by the agreement reached between AIAF (Association of Securities Dealers), the stock exchanges and the SCLV (Securities Clearing and Settlement Service) to create a common recording, clearing and settlement platform that will standardise and simplify such procedures for fixed-income securities trades on the AIAF and the Spanish stock exchanges. When it enters into force, this initiative will help to strengthen the competitive position of the markets insofar as the transaction costs of operating on them are reduced.

On the Public Debt Book-Entry Market, although activity may have suffered from the shift

TABLE IV.2

Turnover on secondary and derivatives markets

EUR millions

	1996	1997	1998	1999
Public-debt book-entry market (a) (b)	**8,439,406**	**11,684,345**	**14,035,896**	**13,109,674**
Spot	1,608,197	2,110,187	2,311,155	1,817,465
Repos	6,800,842	9,544,534	11,700,054	11,254,308
Forward	30,367	29,624	24,687	37,901
AIAF fixed-income market (a)	**14,929**	**21,173**	**43,120**	**86,269**
Commercial paper	3,474	4,447	7,935	25,284
Ordinary and asset-backed bonds and mortgage certificates	8,823	10,950	28,761	58,572
Matador bonds	2,632	5,776	6,424	2,413
Stock exchange: fixed-income (a)	**78,070**	**54,217**	**53,148**	**44,718**
State debt	53,226	21,890	603	160
Territorial government debt	21,045	30,043	51,791	42,858
Other	3,799	2,284	754	1,700
Stock exchange: equities	**77,145**	**163,261**	**261,276**	**291,975**
MEFF derivatives markets (c)	**2,285,515**	**3,286,810**	**2,668,336**	**960,964**
Fixed-income	2,194,386	3,012,658	2,111,985	376,118
Short-term	*904,867*	*1,631,754*	*1,125,442*	*19,972*
Medium and long-term	*1,289,519*	*1,380,904*	*986,543*	*356,146*
Equities	91,129	274,152	556,351	584,846
Ibex 35	*89,642*	*270,719*	*549,329*	*570,032*
Stock options	*1,487*	*3,433*	*7,022*	*14,814*

Sources: AIAF, MEFF, Spanish stock exchanges, CNMV and Banco de España.

(a) Nominal turnover.
(b) Only includes transactions with State securities.
(c) Volumes are expressed in monetary units and have been obtained by multiplying the number of contracts traded by their size.

in derivatives trading towards contracts traded on other markets (since Spanish debt is not the underlying asset for such contracts), the reforms implemented have improved the market's attractiveness by lowering transaction costs. Such reforms involved, on one hand, an increase in the rights and obligations of market makers and, the possibility that, for the first time, non-resident entities could enjoy such status. On the other hand, in 1999 the four screen networks of the "blind" broker system were merged into a single electronic platform to which debt traders have access. At the European level, a pan European trading platform located in London was set up at the end of 1999 for fixed-income instruments, called Euro MTS. Along with the debt of other European countries, benchmark Spanish Treasury issues began to be traded on this platform, with settlement through the State Debt Book-Entry System (CADE). The overall result of these factors, combined with the slowdown in debt issuance, was a moderate decline in turnover on the Public Debt Book-Entry Market (see Table IV.2).

As regards equities, turnover grew in 1999 at more moderate rates than in recent years, amid the initiation of certain structural transformations (see Table IV.2). At the end of the year a market, called Latibex, was created for Latin-American firms, with trading in euro through the Spanish Stock Exchange electronic system and with settlement through the SCLV. At the same time, the Spanish stock exchanges reached an agreement with seven other European stock exchanges to establish an interlinking system to permit pan-European trading, although little headway was made during 1999, given the difficulty in harmonising the various criteria and procedures used. In April 2000, the Spanish stock exchanges set up a new trading segment, called the Nuevo Mercado, with listing and information requirements tailored to the particular needs of high-growth firms (see Box IV.1). With this initiative, the Spanish securities markets came into line with other European markets, so that it is to be hoped that it will help to improve their competitive position and to facilitate the financing of high-growth Spanish firms.

On the equity derivatives market (MEFF RV) turnover continued to grow, albeit at lower rates than in previous years, in line with developments on the spot market (see Table IV.2). It should be pointed out that the agreement with

BOX IV.1

The new stock markets for high growth companies

The so-called “New Markets” are segments of traditional stock markets (or independent stock exchanges) on which the shares of new-technology and high-growth companies are quoted and traded and information is disseminated. These markets are characterised by rules on listing, quotation and information transparency that are better adapted to the particular nature of this kind of firm. Specifically, the New Markets have more flexible listing requirements. Given the uncertainty associated with the future profits of growth companies, New Markets require more information to be made available to investors on the future course and the risks of these firms. Finally, given the greater volatility of their share prices, the fluctuation limits are wider than in traditional stock markets.

The paradigm of New Markets is Nasdaq, a market located in the US which began to operate in 1971 and was formed independently of other US markets. In terms of capitalisation this market is now second only in the world to the New York Stock Exchange. In Europe, the creation of New Markets has been more recent and they have generally been set up as segments of traditional stock exchanges. The first, Le Nouveau Marché, was set up as a segment of the Paris Bourse in 1996. Subsequently, other markets emerged in the Frankfurt, Amsterdam, Brussels and Milan exchanges. At the end of 1999 the London Stock Exchange also created a segment called Techmark, listing technology firms. Besides these markets, there is another one in Europe for high growth firms, the EASDAQ, located in Brussels which, unlike the other European New Markets, is an independent market like Nasdaq.

The supply of marketable securities on all the New Markets grew strongly in 1999 owing to IPOs, which also represented a significant part of all the IPOs on the main stock markets (see Table 1). Although Nasdaq remained in the lead, the growth of the European markets was striking, especially in the case of the German new market.

The boom in New Market placements is the result of a combination of the large financing requirements of an increasing number of high growth firms and high demand on the part of investors for their equity, bolstered by revaluation expectations. In this respect, the existence of the New Markets has helped to satisfy part of such demand insofar as, in many cases, the latter could not have been channelled through traditional markets. From the point of view of investors, the expansion of the supply of securities has helped to increase the sectoral diversification of their portfolios, enabling the weight of sectors with higher growth prospects (basically those relating to new technologies) to be increased. From the firms’ viewpoint, the boom in the New Markets has increased their financing possibilities.

As regards the size of the New Markets, in terms of their capitalisation at end-March 2000 and 1999 turnover, the information supplied in the table shows the underdevelopment of the European New Markets vis-à-vis Nasdaq, both when comparing levels and considering their importance in relation to traditional markets. This suggests that there is very significant growth potential for the New Markets in Europe.

In Spain, the *Nuevo Mercado* (1) has been formed as a special segment of the continuous market or Stock Exchange Interlinking System run by the Sociedad de Bolsas. The segment began to operate on 10 April 2000 with ten securities and a capitalisation of EUR 40.2 billion, making it the third largest New Market in the euro area (see Table 2). There are certain significant differences between the Nuevo Mercado and the traditional stock market. As regards the listing requirements, the requirement to obtain profits in future years (2) is replaced by the filing of a report by the company on its business prospects and results in future years. At the same time, there is greater information transparency in this segment, as a result of: the description, in the listing prospectus of the risks associated with the firm’s activity; the disclosure of the lock-ups affecting shareholders with significant holdings; and, at least once a year, publication of the progress of the business and its future prospects. Finally, as regards quotation, the fluctuation limits are made more flexible – there are no limits upon quotation and subsequently they are 25% (and may be increased during the session), as opposed to 15% in the traditional market.

The creation of the Nuevo Mercado in Spain has involved the Spanish securities markets coming into line with those of other European countries. The Nuevo Mercado will help to improve Spain’s competitive position, making it easier for Spanish high-growth firms to obtain financing and it will stimulate the supply of securities issued by such firms, thereby helping to absorb the growing demand for this type of security.

TABLE 1

Launches on the new stock markets: 1999

	No. offerings	Amounts placed: 1999 (EUR millions)	Amounts placed: Change 99/98 (%)	Amounts placed: % of national stock markets(a)
NASDAQ	485	47,313	266.5	48.1
EASDAQ	12	774	–22.2	—
Techmark (London)	9	2,282	—	68.1
Neuer Markt (Germany)	136	7,633	342.5	40.2
Le Nouveau Marché (Paris)	32	570	9.6	8.2
Nuovo Mercato (Milan)	6	234	—	49.4
Nieuwe Markt NMAX (Amsterdam)(b)	1	77	–85.7	0.4
EURO NM (Brussels) (b)	6	40	189.2	1.8

Sources: FESE, NASDAQ, London Stock Exchange, Paris Bourse, EASDAQ and EURONM.

(a) National stock markets are taken to be the sum of the new market and the traditional market. In the case of NASDAQ, the national stock market is the sum of the latter to the New York Stock Exchange. In the case of Techmark and the Nuovo Mercato, only the period November-December 1999 is included.

(b) Amounts placed by domestic companies.

TABLE 2

Size of the new markets

	No. of Issuers (a)	Capitalisation (EUR m) (a)	Turnover (EUR m) (a)	As % of national markets (c): Capitalis. (a) (d)	As % of national markets (c): Turnover (b)
NASDAQ	4,830	6.551,874	861,125	34.1	50.6
EASDAQ	58	59,500	28	—	—
Techmark (London)	202	1.196,222	33,569	40.3	11.1
Neuer Markt (Germnay)	242	193,677	10,679	8.6	8.9
Le Nouveau Marché (Paris)	117	31,106	320	1.9	0.5
Nuovo Mercato (Milan)	8	28,037	588	3.4	1.2
Nieuwe Markt NMAX (Amsterdam)	14	1,690	52	0.2	0.1
EURO NM (Brussels)	13	564	10	0.1	0.2
Nuevo Mercado (Spain)	10	40,268	—	10.0	—

Sources: NASDAQ, FIBV, London, Milan, German, Paris, Madrid, EASDAQ and EURO NM Stock Exchanges.

(a) As at 31.3.2000, except Easdaq (as at 7.4.2000) and the Nuevo Mercado (as at 10.4.2000).

(b) Monthly average for 1999. Trading System View: Germany, Paris, Italy, Brussels. Regulated Environment View: NASDAQ, London, Amsterdam. In the case of Techmark and Nuovo Mercato, only the part of the year these markets were operating is considered (as from November and June, respectively).

(c) National stock markets are taken to be the sum of the new markets and the traditional markets. In the case of NASDAQ, the total stock market is taken as the sum of the latter and the New York Stock Exchange.

(d) National companies only.

(1) The Ministerial Order of 22 December 1999 authorised the creation of a special trading segment called the “Nuevo Mercado”. Subsequently, the more detailed aspects of listing were specified in CNMV Circular 1/2000 of 9 February 2000. Later, Sociedad de Bolsas Circular 1/ 2000 established the rules for trading on the Nuevo Mercado and Circular 2/2000 the rules for acting as a specialist on the Nuevo Mercado.

(2) The 1967 Stock Exchange Regulations originally established the requirement for profits to have been reported in the last two years or in three of the last five years. Subsequently, this requirement was replaced by the Ministerial Order of 19 July 1997 with another for the provision of evidence that profits will be earned in future years. The purpose of this change was, to a certain extent, to make listing requirements more flexible, with a view to the privatisation of public enterprises.

other European derivatives markets, whereby the members of each have access to the trading of the products traded on the others, also applies here.

To sum up, in the medium and long term Spanish markets will continue to be shaped by an increasingly competitive environment, and to be in accelerated transformation due to the ongoing introduction of reforms. Irrespective of the (foreseeably significant) effects of these transformations on the location of financial business, they will help to reduce the costs of operating on the markets, which will facilitate the diversification of investors' portfolios and widen firm's financing possibilities.

IV.3. FINANCIAL INTERMEDIARIES

In Spain, the growing process of financial internationalisation and the consequent possibility of tapping external savings have enabled the private sector to sustain a high rate of growth of capital formation, to diversify its portfolios internationally and to undertake external expansion, including the acquisition of foreign firms. Naturally this process has largely been based on the activity of Spanish financial intermediaries (and, in particular, of deposit money institutions). These institutions have raised a large volume of funds abroad, thereby assuming risks that it will be very important to monitor closely in order to preserve the financial stability required by the sound functioning of the economy.

Overall, the volume of funds channelled by the financial intermediaries (the credit system, portfolio investment institutions, securities-dealer companies and securities agencies, insurance corporations, pension funds and other financial intermediaries), taken to include all the assets and financial liabilities acquired by the various institutions belonging to the sector, fell by 1.3 % in 1999, to stand at 43 % of GDP, as against 46 % in 1998. This decline was in stark contrast to the high growth of the previous three years and is explained by the collapse in the acquisition of financial assets and liabilities by portfolio investment institutions. The main groups of institutions are analysed in greater detail below.

IV.3.1. Deposit money institutions

During 1999, deposit money institutions had to confront various challenges. These derived from the creation of a single money market throughout the euro area, from the changes in the monetary-policy implementation arrangements and from greater competition with the deposit money institutions of the other euro area countries, which now operate in the same market. These fundamental changes to the framework in which the institutions operate, in turn, prompted significant reactions from them, in an attempt to adapt to the new environment and capitalise on their potential advantages. In this respect, the fresh round of consolidation in the credit system should be noted, particularly among the major institutions. This led to the emergence of two significant banking groups (BBVA and BSCH), which between them account for around 40 % of the total assets of all deposit money institutions. Also the activity of the branches of foreign banks in Spain, basically engaged in interbank business, was particularly affected by the start of Stage Three of EMU. In the last two years, twelve foreign branches operating in Spain (out of a total of 53 as at end-1997) have closed, while the activity of some of the remaining branches of foreign banks still operating in Spain has diminished as a consequence of the concentration of their Treasury operations in other European centres (2).

The reduction in the activity of foreign branches and the unwinding of interbank positions between merged institutions (3) account for practically the whole decline in the rate of expansion of the total assets of deposit money institutions between 1998 and 1999 (see Table IV.3). In fact, this decline occurred only among the banks, while savings banks and credit co-operatives continued last year to record similar or higher rates of growth in their balance sheets to those of the previous year.

The start of Stage Three of EMU also gave rise to operational changes, notable among them being the new system of tenders adopted by the Eurosystem for its main refinancing operations. The use of fixed rate tenders, together with determination by the monetary authority of the total amount to be provided to the system, led to a high degree of rationing in proportion to counterparties' bids. This entailed certain problems for Spanish deposit money institutions which, in comparison with those of the other countries of the area, are characterised by having a smaller volume of assets eligible as collateral for such tenders. The result of this was a fall in the financing obtained by the Spanish counterparties from the Banco de España (EUR 7.4 billion on average in the year) and an incen-

(2) There were also twelve new branches, mainly of euro area institutions, but their impact on the volume of total assets has been small.

(3) In particular, between Banco Exterior, Banco Hipotecario, Caja Postal and Corporación Bancaria de España, which were merged in 1998.

TABLE IV.3

Deposit money institutions
Structure of balance sheet and profit and loss account

% of average total assets

	Total (a)		Banks		Savings Banks	
	1998	1999	1998	1999	1998	1999
ASSETS:						
Cash and central banks (b)	1.9	1.8	1.4	1.4	2.8	2.3
Interbank market assets (c)	25.3	20.0	31.1	24.1	15.2	14.2
Lending	47.1	50.4	42.8	46.1	54.2	56.9
General government	*3.4*	*3.0*	*3.2*	*3.0*	*4.0*	*3.2*
Other resident sectors	*40.0*	*44.1*	*34.2*	*38.2*	*49.3*	*52.7*
Non-residents	*3.7*	*3.4*	*5.3*	*4.9*	*0.9*	*1.0*
Securities portfolio	18.8	19.9	17.8	20.2	21.2	19.9
Of which:						
Government debt	*11.3*	*10.1*	*10.4*	*9.6*	*13.3*	*11.0*
Equities	*4.1*	*4.6*	*4.1*	*4.8*	*4.3*	*4.5*
Other assets (d)	7.0	7.9	6.9	8.3	6.7	6.7
LIABILITIES:						
Banco de España	2.6	1.5	2.9	2.0	2.3	0.8
Interbank market liabilities (e)	27.2	25.6	37.2	34.8	10.0	11.5
Customer funds	55.0	56.5	44.1	45.7	73.8	73.3
Asset repo sales to customers	*10.8*	*8.9*	*9.1*	*7.8*	*14.6*	*11.3*
Accounts payable: general government	*1.6*	*1.8*	*1.6*	*1.7*	*1.8*	*1.9*
Accounts payable: other resident sectors	*36.0*	*37.5*	*25.3*	*25.7*	*53.0*	*54.7*
Accounts payable: non-residents	*4.9*	*5.9*	*6.7*	*8.2*	*1.9*	*2.3*
Borrowing	*1.7*	*2.5*	*1.4*	*2.2*	*2.5*	*3.1*
Own funds, special reserves and subordinated financing	9.8	10.1	9.5	9.9	10.2	10.5
Of which:						
Subordinated financing	*1.6*	*1.9*	*2.1*	*2.5*	*0.8*	*1.2*
Other liabilities (f)	5.3	6.3	6.2	7.7	3.7	4.0
PROFIT AND LOSS ACCOUNT:						
(+) Interest income	5.70	4.73	5.62	4.69	5.82	4.78
(–) Interest expenses	3.39	2.53	3.70	2.89	2.88	1.99
Net interest income	**2.31**	**2.20**	**1.92**	**1.80**	**2.94**	**2.78**
(+) Commissions	0.67	0.70	0.68	0.74	0.64	0.65
(+) Profits on financial operations	0.14	0.09	0.13	0.09	0.15	0.09
Gross income	**3.12**	**2.99**	**2.73**	**2.62**	**3.73**	**3.52**
(–) Operating expenses	2.01	1.96	1.78	1.76	2.38	2.26
Net income	**1.11**	**1.03**	**0.95**	**0.86**	**1.35**	**1.26**
(–) Write-downs and provisions	0.41	0.24	0.38	0.20	0.46	0.30
(+) Other income	0.22	0.15	0.19	0.12	0.30	0.21
Pre-tax profit	**0.93**	**0.94**	**0.77**	**0.78**	**1.19**	**1.17**
MEMORANDUM ITEM:						
Pre-tax profit (as a % of own funds)	16.2	16.7	14.8	15.7	18.5	18.3
Average total assets (EUR m)	900,207	948,225	573,578	584,529	297,242	331,337
Year-on-year growth rate (%)	*8.2*	*5.3*	*7.5*	*1.9*	*9.5*	*11.5*

Source: Banco de España.

(a) Banks, savings banks, and credit co-operatives. Total turnover figures, including banks' foreign branches but not subsidiaries, which refer to all the institutions existing in each period.
(b) Cash, central banks (except BE repos) and ECB.
(c) Credit and savings institutions (forward accounts, repos and recurities lending) and repo purchases from the BE.
(d) Premises and equipment, sundry accounts and other assets with credit and savings institutions.
(e) Credit and savings institutions (forward accounts, repos and creditors on short sales).
(f) Sundry accounts and other liabilities with credit and savings institutions.

tive to increase the available volume of securities eligible as collateral in their portfolios. In consequence, there was a considerable decline in sales of assets to the private sector under repos (which may have been caused by the lower demand from mutual funds) and a significant increase in the portfolio of private fixed-income securities. The latter was possible due to the major development of the Spanish private fixed-income market in 1999, as already mentioned in the previous section of this chapter. However, its continued narrowness and the lower issuance of securities by general government meant that a large part of the increase in the total fixed-income portfolio of the institutions took the form of securities issued by non-residents.

The Spanish deposit money institutions, as a whole, were able to offset the decline in the financing extended by the Banco de España with loans from the rest of the euro area, obtained through the single interbank market. There were some significant changes, under this new framework, in the customary positions in the interbank market between the various groups of Spanish institutions. The institutions traditionally in surplus (savings banks and credit co-operatives) reduced their net creditor position vis-à-vis other Spanish credit institutions, while the branches of foreign banks drastically reduced their net debtor position. These branches, which usually raise funds in the domestic market, fulfilled a very important role in securing net funds from abroad, possibly through their own parent institutions, to on-lend to other Spanish institutions (4).

The other notable element of the activity of Spanish deposit money institutions in 1999 was another major expansion in lending to the resident private sector, which continued to gain weight in the balance sheet (see Table IV.3). Specifically, considering both lending in the strict sense and the private fixed-income portfolio (which also includes the institutions' holdings of shares in mortgage-backed securities funds), total financing from Spanish deposit money institutions to the resident private sector grew by 17.6 % in 1999, almost two percentage points more than in the previous year.

The main factors behind this strong growth in lending are basically the same as those mentioned in the 1998 *Annual Report.* Low interest rates, the buoyant economy and corporate restructuring, including the acquisition of firms in Spain and abroad, have continued to strongly boost the demand for credit. This demand must also have been strengthened by the improvement in the financial situation of firms and households as a consequence of the reduction in interest payments on debt and the revaluation of financial assets in recent years. The strong competition between institutions and the low default rates have contributed to lending growth through an easing of the conditions applied to its extension. In this respect, it should be noted that, in 1999, the default rate on private sector non-financial credit fell further, to the historical low of 1.4 %, so that net write-downs owing to bad debts were down to 0.25 % of total lending. In comparative terms, the relative weight of provisions on loans in 1999 was very low in relation to historical levels in Spain.

The high rates of credit expansion were only partially financed by deposits, even though there was a significant recovery in 1999 in those of the resident private-sector. This recovery was helped by the recent reform of personal income tax, which made deposits more attractive from a tax point of view and mutual funds less attractive, against a background of low returns on low risk assets and greater uncertainty on stock markets. On average in 1999, the deposits of "other residents sectors" (mostly households and firms) grew by 9.8 %, as against 6.5 % in 1998, with a very sharp increase in sight deposits and a notable recovery in time deposits, particularly those with maturities of more than two years, which have benefited most from the new tax arrangements. Nonetheless, the increase in deposits was offset by a strong fall in sales of assets to the private sector under repos (see Table IV.3). This is explained by the lower demand from mutual funds, the deposit money institutions' own need to have securities, not subject to repos, available in their portfolios for use as collateral in Eurosystem liquidity tenders and, perhaps also, due to the substitution of deposits for repos. Overall, funds from resident private-sector customers (without including the loan issues made) rose by 4 % in 1999, which was clearly insufficient to finance the increase in credit.

In fact, the vigorous expansion of credit in 1999 could be sustained because the deposit money institutions, as a whole, again raised significant net funds abroad (see Chart IV.2), the commercial banks being the most active in this respect. However, there were certain differences in how the institutions obtained financing compared with previous years, which should be pointed out.

(4) Another example of the centralisation of Treasury operations entailed by the advent of the euro is the fact that the branches of foreign banks cut back their recourse to the Banco de España drastically, reducing it to 5 % of the 1998 level.

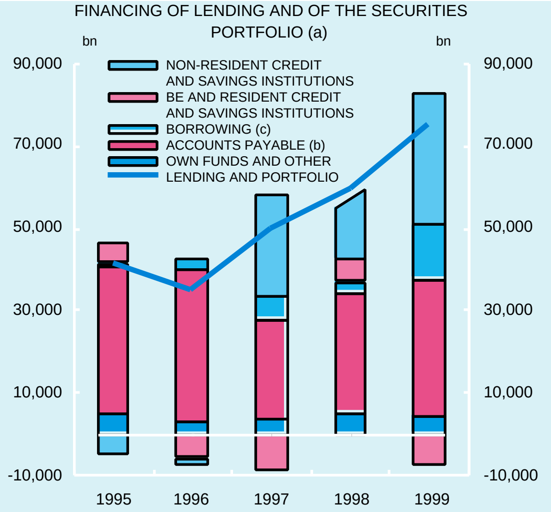
On one hand, the deposit money institutions resorted to a greater extent to capital markets (domestic and international) as a source of financing, in order to limit the liquidity risks involved in interbank financing and to take advantage of their recent development. Both the banks and savings banks exploited the improved conditions on Spanish private fixed-income markets, by significantly increasing the volume of debt issues in the domestic market, as already mentioned in the previous section of this chapter. As a result, for the first time in recent years, loan and subordinated issues covered a significant volume of the institutions' net borrowing (around 18 %, as shown in Chart IV.2). In turn, under the creditors heading, the strong growth in non-resident creditors was attributable to the channelling to parent companies, through deposits, of funds raised by subsidiary non-bank financial institutions, through debt issues and preference shares on international markets.

On the other hand, the existence of a single money market in the euro area encouraged net interbank borrowing abroad by Spanish deposit money institutions to start to shift towards this market (5), owing to the absence of currency risk and to the operational advantages entailed by TARGET and access to the Eurosystem lending and deposit facilities. However, it should be noted that excessive recourse to the euro interbank market, where the only security for (uncollateralised) loans is the borrower's credit quality, could involve a liquidity risk for Spanish institutions.

The *profit and loss accounts* of deposit money institutions displayed the same trends as in previous years. Measured as a percentage of average total assets, net interest income, gross income and net income fell again, yet pre-tax profits continued to rise (see Table IV.3). Notably, net income declined in absolute terms, as well as in terms of average total assets. Besides from the fall in net interest income, this outcome stemmed from the lower growth of commissions on the sale of mutual fund shares, from the negative impact of developments in the financial markets during the year on profits on financial operations and from the increase in operating expenses. The latter, despite moderating in 1999, still grew faster than gross income, so that there was a deterioration in the efficiency ratio (operating expenses to gross income) of the deposit money institutions as a whole, from 64.4 % to 65.6 %. The growth in

CHART IV.2

Deposit money institutions



Source: Banco de España.
(a) Change in annual average balances.
(b) Includes repo sales and accounts payable to non-residents.
(c) Includes subordinated financing.

operating expenses was significantly higher in the case of savings banks, which increased the numbers of their employees and branches, than in that of banks.

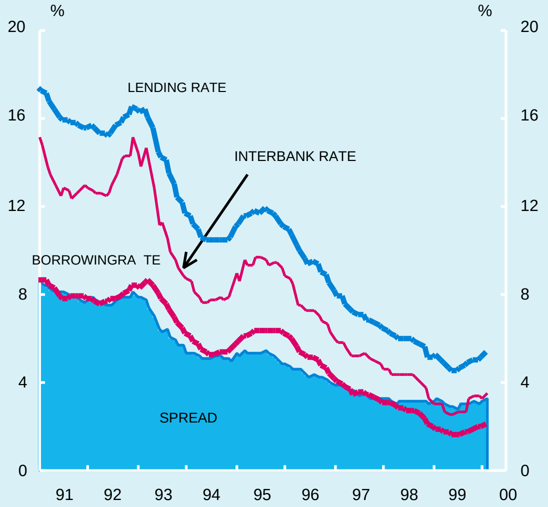
As in previous years, the decline in net income was more than offset by lower write-downs and provisions, against the backdrop of a very favourable economic situation, which translated into an increase in pre-tax profits. In particular, in 1999 there were declines in provisions for country risk (which had been relatively high in the two preceding years, as a consequence of the international crisis in emerging market countries), in write-downs in the portfolio of permanent holdings of commercial banks (also very high in 1998) and in other transfers to specific provisions. In turn, transfers to provisions for bad debts in the loan portfolio continued to fall, despite the low levels already reached. In this respect, the Banco de España has recently modified the regulations on provisions for bad debts, introducing the so-called "provision for the statistical coverage of insolvency" (6). The application of the new regulations from the middle of this year can be expected to reverse the ongoing decline in provisions for credit risk since 1993, and at the same time induce the institutions to seek ways of in-

(5) Although, two thirds of the net external interbank position is still vis-à-vis credit institutions outside the euro area.

(6) The new regulation is explained in detail in the January 2000 issue of the Banco de España *Economic bulletin.*

CHART IV.3

Interest rates: banks and savings banks



Source: Banco de España.

creasing their net income in order to preserve profit levels.

In any event, the signs point to a recovery in net income, since the long downswing in market interest rates came to an end in 1999, with interbank rates currently more than six percentage points below their average 1995 level (see Chart IV.3). In the new environment of rising interest rates, the existence of unremunerated liabilities or liabilities remunerated at low rates will allow the net interest income of deposit money institutions to recover somewhat. However, given the strong competition existing and the significant technological transformations that have occurred, the gains to be obtained through net interest income might be expected to be small.

By contrast, the possibilities arising from adaptation to the new environment, in which capital markets and new distribution channels will play a much more prominent role than at present, are much more important. In this respect, some institutions have taken significant steps to increase the degree of diversification of their income sources (see Box IV.2), both inside Spain (increasing their activity in portfolio management and the sale of products through non-bank subsidiaries) and outside Spain.

In particular, during recent years Spanish institutions have undertaken a significant expansion in Latin America, a market that is especially attractive for Spanish banks. The Latin American economies have high growth potential, their banking systems are still underdeveloped and characterised by the persistence of wide net interest margins, which suggest higher levels of risk and also room for improvement in efficiency levels. The experience acquired from the growing competition in the Spanish domestic market has particularly favoured expansion in these markets.

Finally, some institutions have taken steps to introduce the latest technological advances into their productive processes, have begun to provide other financial services through modern distribution channels and have entered into alliances with enterprises in the new technology sector to develop new products and business opportunities.

IV.3.2. Other financial intermediaries

This section analyses the so-called institutional investors (investment companies, mutual funds, pension funds and insurance corporations). These offer diverse financial services to companies and households, but have in common the fact that they take the savings of these agents and invest them in the various financial assets available. They therefore play an important role both in channelling savings and in the operation of capital markets. This, together with their growing weight in the Spanish financial system as a whole, makes the analysis of their behaviour increasingly important.

The net asset value of mutual funds, having grown very strongly in previous years, grew by only EUR 2.5 billion last year. The net asset value of securities funds (FIMs) rose by EUR 10.6 billion, while that of money market mutual funds (FIAMMs) fell again, by EUR 8.1 billion. The high fees charged by the latter, which in an environment of low nominal interest rates entail a significant reduction in the net return on this product, must have contributed to this decline. The smaller increase in the net asset value of mutual funds stemmed from the lower portfolio revaluation, due to the behaviour of financial asset prices and lower net share subscriptions by firms and households. These lower net subscriptions were, in turn, influenced by the loss of attractiveness of mutual fund shares in relation to alternative investments. The recent tax reforms reduced, for certain levels of income and maturities, the tax advantages of this type of product vis-à-vis others, such as bank deposits, pension funds and insurance products.

By contrast, pension funds and insurance products continued to experience growing de-

BOX IV.2

The main differences between the activity of banking groups and their parent banks

In recent years, Spanish banks and, in particular, the major banking groups, have pursued strategies for the diversification of their business, mainly through the development of mutual funds and pension funds and through expansion in the markets of other countries, especially in Latin America. This process has largely been carried out through subsidiaries of banking groups, so that its reflection in the individual balance sheets of the banks (those analysed in the main text of this report) has been very limited. Accordingly, this box briefly analyses the activity of banking groups (in which the weight of subsidiaries is more significant) (1) in comparison with that of individual parent banks, in order to examine the impact of these strategies on the structure of banking business, the generation of income and costs and the banks' general risk profile.

The growing weight of the activity of Spanish banks through mutual funds is reflected, on one hand, in the growth in the net asset value of mutual funds managed by subsidiary banks. As a percentage of the total balance sheet of banking groups, this value rose from 8.3 % in 1995 to 21 % in 1999. On the other hand, the rise in commission income as a percentage of the groups' gross income is also notable (from 44 % to 55 % over the same period) as is the growing difference between the commission income recorded by the groups and that recorded in the individual statements of the parent banks, which roughly shows the income obtained from this activity by subsidiary management companies (0.16 % of average total assets in 1995 and 0.49 % in 1999).

The importance of international geographical diversification, largely focused on Latin America, is shown by the trends in the differences in the information provided by the individual financial statements and by those of the group on the margin between loans and deposits, on the net interest margin, on operating expenses and on the default rate and net write-downs. The main effect of the incorporation into the balance sheet of foreign subsidiaries has been to moderate the decline in the margin between loans and deposits, due to the inclusion of banks with margins that are almost double those obtained by the banks in their domestic market business. This is clearly reflected in the consolidated net interest margin of banking groups, which is significantly higher than in individual statements. However the international expansion of business has also affected operating expenses, which have increased as a consequence of the inclusion of less efficient banks, and solvency risks, which are higher as a consequence of the inclusion of assets of lesser credit quality.

In any event, the comparative analysis of banking groups and their parent banks shows that the diversification strategies adopted by banks in recent years have had a positive overall effect. First, the development of mutual funds has enabled banks: to avoid losing market share in the attraction of savings; to increase the efficiency of their distribution network, by exploiting it to sell new products; and to reduce the impact on their income of the shift from intermediation between loans and deposits to other more sophisticated forms of intermediation. Second, the strategy of diversification through expansion in other countries has enabled the impact of the decline in operating margins in domestic business to be reduced, as well as allowing Spanish banks to secure a privileged position in the main Latin American financial markets. That said, these investments have a component of higher risk, which must be taken into account by banks' management and by the supervisory authorities.

(1) In the other groups included in the aggregate of deposit money institutions, subsidiaries are much less important, although the larger savings banks are beginning to develop growing activity in this respect.

Main differences between banking groups' balance sheets and those of their parent banks

	1995	1996	1997	1998	1999
I) MANAGEMENT OF MUTUAL FUNDS:					
Net asset value of mutual funds as % of group balance sheet	8.3	12.2	17.8	20.5	21.0
Commission income as % of group's gross income	43.5	39.6	46.4	52.9	54.9
Commission income as % of average total assets (ATA): difference between the group and the parent bank	0.16	0.17	0.27	0.39	0.49
II) REGIONAL DIVERSIFICATION:					
Differences between the group and the parent bank					
Lending/deposit margin (as % of ATA)	–1.25	–0.95	–0.49	0.78	0.76
Net interest margin (as % of ATA)	–0.04	0.13	0.33	0.52	0.79
Operating expenses (as % of ATA)	–0.22	–0.27	–0.47	–0.69	–0.83
Default rate (as % of total credit)	0.27	0.22	0.23	0.54	0.69
Loan write-downs (as % of ATA)	–0.05	–0.02	0.07	0.16	0.18

TABLE IV.4

Funds raised by other financial intermediaries

EUR millions

	1996	1997	1998	1999	1999 Balances (a)
Total (b)	**37,839**	**47,998**	**35,436**		
Pension funds					
Net contributions (c)	*2,365*	*2,322*	*2,692*	*3,014*	
Change in net asset value	*4,619*	*4,469*	*5,251*	*4,439*	*31,600*
Life assurance					
Premiums net of claims	*4,697*	*5,389*	*4,578*		
Change in mathematical provisions	*6,341*	*10,791*	*7,678*	*11,726*	*61,904*
Mutual funds					
Net subscriptions	*30,777*	*40,287*	*28,166*	*2,877*	*206,294*
FIAMMs	*11,668*	*1,532*	*–12,267*	*–5,752*	*42,598*
FIMs	*19,109*	*38,755*	*40,433*	*8,629*	*163,696*
MEMORANDUM ITEM:					
Deposit money institutions: change in accounts payable: other resident sectors	21,091	25,388	15,917	18,795	453,938

Sources: Banco de España, CNMV, INVERCO and Dirección General de Seguros.

(a) Balances to December. Net asset value in the case of funds, and mathematical provisions in the case of insurance.
(b) Sum of contributions, premiums and net subscriptions.
(c) INVERCO estimate for 1999. Prior to that year: own estimate based on the change in net asset value of and annual return on funds.

mand, as a result of the maintenance of significant tax advantages and their lower degree of maturity (see Table IV.4). For example, according to provisional data supplied by the Directorate General of Insurance, life assurance premiums grew by almost 40 % in 1999. Of this growth, a substantial part must have corresponded to life assurance premiums whose mathematical provisions are invested in unit linked, the main attraction of this product being that, under certain circumstances, it is possible to switch mutual fund without any tax cost.

In any case, whatever the institutional vehicle chosen, the channelling in recent years of growing portions of the saving of the firm and household sector towards institutional investors has helped to change the distribution of the wealth of the sector significantly. This has had important consequences both for the behaviour of firms and households and for the transmission mechanisms of monetary impulses, which are now much more closely linked to developments on financial markets.

At the same time, end-savers also had recourse to these institutional investors as their preferred means of securing greater diversification of their assets. This process remained intense during 1999, assisted by the fact that savers continued to demand products with a higher expected return, but also with more risk, to a greater extent. Consequently, institutional investors' portfolios displayed further reductions in investment in public debt and in repos, and more investment in equities, in securities issued by non-residents and in private fixed income (see Chart IV.4). Especially notable in 1999 was the internationalisation of portfolios, which was accentuated by the advent of the euro. It should be pointed out that at end-1999, the external portfolio of securities funds represented approximately 32 % of total net asset value (with a balanced distribution between equities and fixed income), as against 18 % twelve months earlier, while the equivalent percentage for money market mutual funds was 20 % (12 % in 1998).

Part of this intense process of internationalisation can be explained by a desire to diversify the portfolio risk, although another part is, in all probability, due to the narrowness of some domestic financial markets. This may be the explanation for the strong investment in euro area fixed-income securities. Nonetheless, the positive response of mutual funds to the development of the commercial paper market in 1999 confirms that there is significant room for domestic financial markets to develop and expand.

BOX IV.3

The implications for monetary and financial analysis of financial accounts based on ESA 95

The preparation of financial accounts in accordance with the methodology of the ESA 95 system of national accounts entails alterations to the information on the financial assets and liabilities of the various institutional sectors that has been used for monetary and financial analysis. The changes made affect all sectors although, from the viewpoint of the analysis of the saving and financing decisions of private agents, the most important are those affecting the households and non-financial corporations sectors. This box details some of the implications for analysis of the figures provided by the new Financial Accounts prepared in accordance with ESA 95.

In addition to the changes in the Financial Accounts due to the incorporation of the methodological criteria of ESA 95, there have been others owing to the availability of more information, especially on small and medium-sized firms. This has involved a number of alterations of various kinds(1), which have affected most of the financial assets and liabilities of households and corporations. The alterations with the most important impact include the following:

a) Under ESA 95 methodology, *shares* are now valued at market prices. Likewise, the share portfolios of the various institutional sectors are also now valued at market prices. This has led to a significant increase in the value of the share portfolios held by corporations and households, according to the Financial Accounts, which now therefore better reflects their market value. This alteration to the criterion for valuing shares is one of the elements that most contributes to increasing the value of the financial wealth of these sectors.

b) The incorporation of information on small and medium-sized firms, supplied by the mercantile registries, has led to a significant revision in the stock of unquoted shares and equity in firms other than public limited companies. As a result, the stock of shares and, especially, of *other equity* issued by non-financial corporations has increased significantly, as have the holdings of the households and private non-profit entities sector, which is referred to as “households” for short.

c) The information on small firms has led to a revision of the estimates of trade credit between the various sectors. The result of this revision has been a significant increase in the outstanding trade credit between non-financial corporations (both on the assets and liabilities side) and a reduction in the trade credit granted to households. Trade credit granted by non-financial corporations to general government, previously included under *other,* is now included under the trade credit heading.

d) Under ESA 95 methodology, interest payable on securities is now recorded in accordance with the accruals principle, with interest accrued and unpaid recorded at the value of the financial transaction giving rise thereto. This change in criterion with respect to ESA 79 gives rise to changes in the flows of securities transactions. In quantitative terms, these are not as important as the three foregoing changes. Yet the significance of this change in criterion is greater, as it enables adjustments for discrepancies between the criteria for recording interest used by the various sectors to be eliminated, thus helping to reduce the amount of the *other* heading, as discussed below.

e) The stock and, sometimes, the flow of the *other* heading have generally been reduced by the change in the set of transactions it includes. This heading included a broad range of transactions pending receipt or payment and statistical adjustments for differences in valuation criteria and of other types, which largely disappear or are reclassified with the application of the ESA 95 methodological criteria.

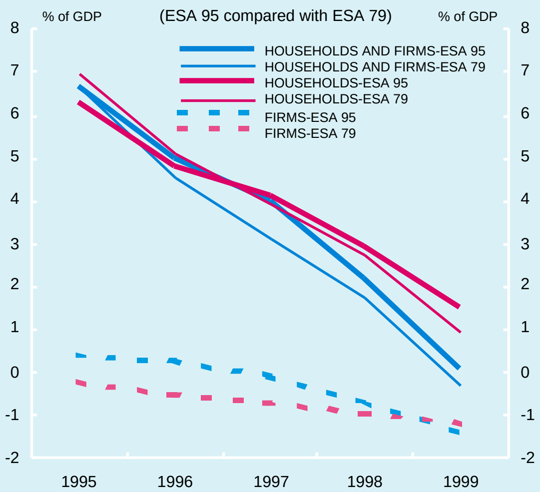
As a consequence of the changes indicated, and of other less significant ones, there has been a small change in the net financial saving (*net financial transactions,* according to the ESA 95 nomenclature) of the households and corporations sector (see the left-hand chart below). This change involves a slower reduction in household financial saving under ESA 95 than under ESA 79, which is partly offset by the somewhat faster deterioration in the saving of non-financial corporations. Also, the financial saving of these two sectors is closer, under ESA 95, to the amount of the net lending/net borrowing according to the national accounts.

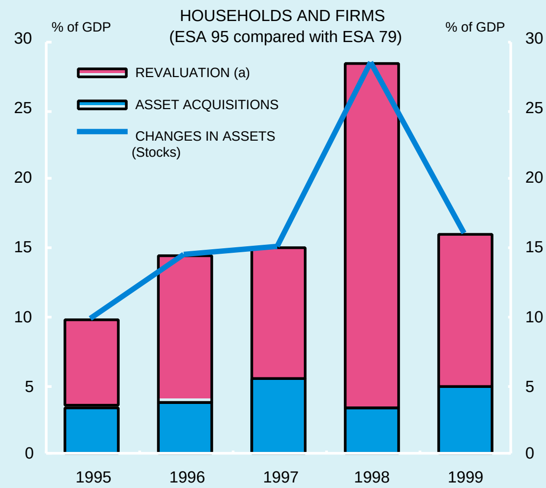
The introduction of the market price valuation criterion, along with the incorporation of more information, has led to an upward revision to the growth of *gross wealth* (financial assets) and of the liabilities of the households and corporations sector, as well as an increase in the level of these variables. The stock of financial assets at end-1999 was 259% of GDP under ESA 79 and 363 % of GDP under ESA 95. Similarly, the level of liabilities according to ESA 79 (223 % of GDP) was less than under ESA 95 (348 % of GDP). This revision has also been reflected in an increase in the level of the *net financial wealth* of households and non-financial corporations (defined so as to exclude shares from the liabilities of corporations) and in its rate of growth. Since 1995, there has been a cumulative increase in the value of net wealth of 80 % of GDP, according to ESA 95, while under ESA 79 this increase was hardly 37 % of GDP. This higher growth under the latest version of the financial accounts is attributable both to the increase in the value of the share portfolio of non-financial corporations and to that of households. By contrast, under ESA 79 the increase in the value of the net wealth of households and corporations was basically attributable to the increase in the value of the portfolio of households.

Although the revision to the value of the financial wealth of households and corporations has basically been the result of the introduction of the market price valuation criterion in the financial accounts under the ESA 95 methodology, some of the other changes mentioned have also involved a change in the volume of financial transactions of the sector (acquisition of financial assets or increase in liabilities). The right-hand chart below shows the relative contribution of each of these elements to the higher growth in gross wealth under ESA 95 compared with ESA 79. It can be seen that the higher volume of financial assets acquired by households and corporations, under ESA 95, helps to explain the differences in the value of gross wealth to a much lesser extent than the increase arising from the change in valuation criteria.

(1) See the forthcoming *Economic bulletin* article “Presentation of the Financial Accounts of the Spanish Economy. ESA 95. 1995-1999”.

The implications for monetary and financial analysis of financial accounts according to ESA 95



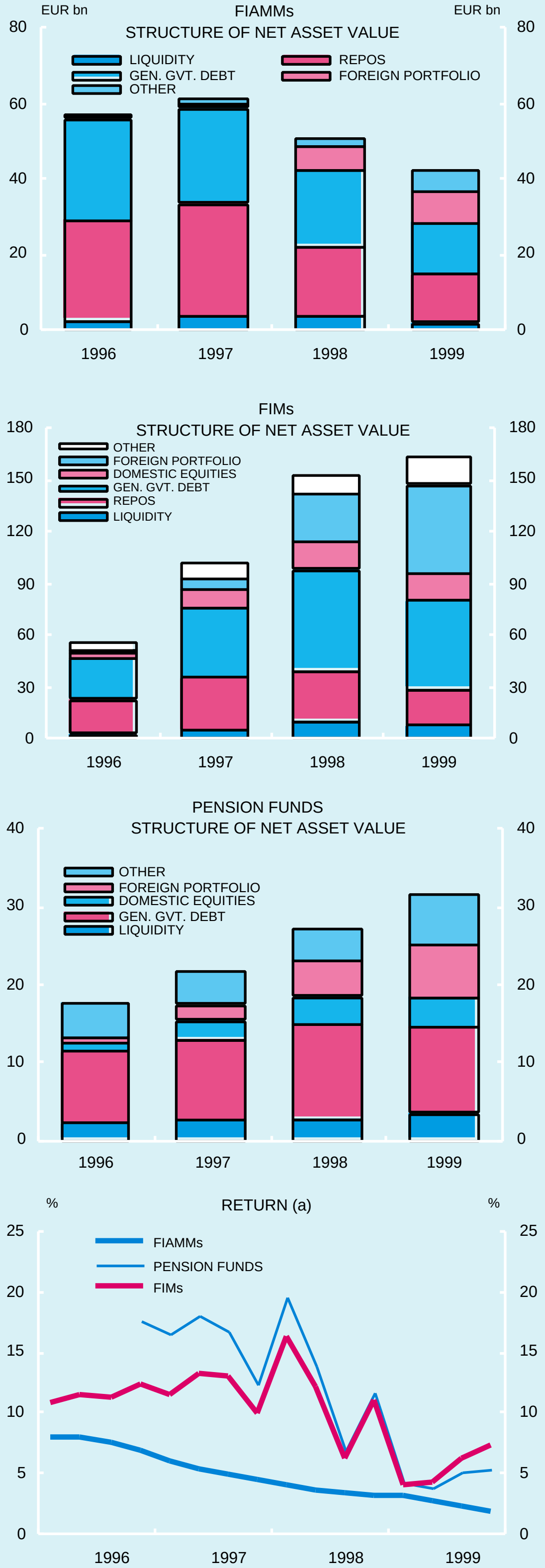


Source: Banco de España.

(a) Calculated as the changes in stocks less financial transactions.

CHART IV.4

Institutional investors



Sources: CNMV, Banco de España and INVERCO.
(a) Cumulative return over last 12 months.

IV.4. SAVING AND ECONOMIC AND FINANCIAL FLOWS (7)

In 1999, the Spanish economy once again required net financing from the rest of the world, following a four-year period of net lending. In 1999, the nation's net lending was –0.6 % of GDP, 1.4 percentage points down on 1998. As seen in Table IV.5, this decline stemmed from a reduction in gross national saving and, above all, from the increase in gross capital formation. In terms of net financial saving (8), the trend of recent years of progressive decline in the net financial saving of non-financial corporations and households continued. This contractionary effect on national net financial saving was only partially offset by the improvement in the financial situation of general government (see Chart IV.5). Financial developments in each of these sectors, as well as the financial flows of the nation as a whole vis-à-vis the external sector, are examined below.

IV.4.1. Households and firms

Following the trend of recent years, the net lending of households and non-financial corporations declined again in 1999. In both sectors this was a consequence of the fall in gross saving and of the strength of private investment. Analysing the flows of financial assets and liabilities, along with these variables, an increase is observed in assets and liabilities, which was greater in the case of the latter. Financial assets and liabilities grew more rapidly in the case of firms. The notable increase in firms' liabilities was used to finance not only gross capital formation, but also the acquisition of financial assets and, in particular, of majority holdings in foreign companies. Insofar as the nature of this direct investment is closer to that of capital investment than to the mere purchase of financial assets, it makes more sense to analyse it in conjunction with national gross capital formation. This analysis shows that Spanish firms' investment activity is much higher than reflected by the capital account figures (see the top panel of Chart IV.6).

The net financial saving of *non-financial corporations* was –1.4 % of GDP in 1999. This was

(7) The financial accounts information analysed here incorporates the methodological criteria of ESA 95, which means that the financial flows and stocks data used in the past to compile the periodic reports of the Banco de España have been revised. Box IV.3 examines the main changes introduced by these new criteria into the analysis of the financial flows of the economy.

(8) Net financial saving is the difference between the flows of financial assets and liabilities, and is equivalent to the concept of *net financial transactions* defined in ESA 95.

TABLE IV.5

Use of income, capital and financial accounts. National economy
Breakdown by sector (% of GDP)

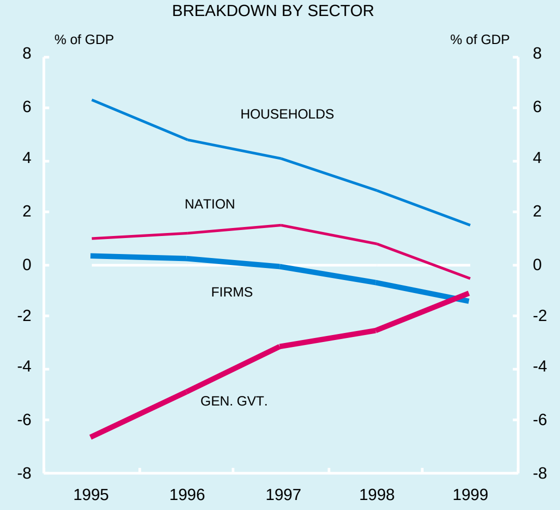
	1995	1996	1997	1998	1999
1. Gross disposable income	**100.2**	**99.6**	**99.5**	**99.3**	**99.0**
General government	16.2	16.7	18.1	18.6	20.1
Financial institutions	2.2	2.0	1.7	1.9	1.4
Non-financial corporations and households	81.7	80.9	79.7	78.8	77.6
Households	*69.4*	*68.9*	*68.1*	*67.7*	*67.1*
Non-financial corporations	*12.4*	*12.0*	*11.6*	*11.1*	*10.5*
2. Consumption	**77.9**	**77.6**	**76.9**	**76.6**	**76.6**
General government	18.1	18.0	17.6	17.4	17.1
Households	59.8	59.6	59.3	59.2	59.5
3. Gross national saving (1 – 2)	**22.3**	**22.0**	**22.5**	**22.7**	**22.4**
General government	–1.8	–1.2	0.5	1.2	3.0
Financial institutions	1.8	1.7	1.4	1.7	1.1
Non-financial corporations and households	22.3	21.5	20.7	19.9	18.4
Households	*10.0*	*9.5*	*9.1*	*8.8*	*7.8*
Non-financial corporations	*12.4*	*12.0*	*11.6*	*11.1*	*10.5*
4. Gross capital formation (a)	**21.3**	**20.8**	**21.0**	**22.0**	**23.0**
General government	4.8	3.7	3.6	3.8	4.1
Financial institutions	0.8	0.6	0.6	0.5	0.6
Non-financial corporations and households	15.7	16.6	16.7	17.7	18.3
Households	*4.7*	*5.2*	*4.9*	*5.3*	*5.8*
Non-financial corporations	*11.0*	*11.3*	*11.8*	*12.4*	*12.5*
5. Net lending (+) or borrowing (–) of the nation (3 – 4)	**1.0**	**1.2**	**1.6**	**0.8**	**–0.6**
General government	–6.6	–5.0	–3.2	–2.6	–1.1
Financial institutions	1.0	1.2	0.8	1.2	0.5
Non-financial corporations and households	6.6	5.0	3.9	2.2	0.1
Households	*5.3*	*4.3*	*4.2*	*3.5*	*2.0*
Non-financial corporations	*1.4*	*0.7*	*–0.2*	*–1.3*	*–2.0*
6. Net financial saving (7 – 8)	**1.0**	**1.2**	**1.6**	**0.8**	**–0.6**
General government	–6.6	–5.0	–3.2	–2.6	–1.1
Financial institutions	1.0	1.2	0.8	1.2	0.5
Non-financial corporations and households	6.6	5.0	3.9	2.2	0.1
Households	*6.3*	*4.8*	*4.1*	*2.9*	*1.5*
Non-financial corporations	*0.3*	*0.2*	*–0.1*	*–0.7*	*–1.4*
7. Change in financial assets	**37.9**	**42.2**	**45.0**	**50.6**	**51.8**
General government	1.5	3.7	0.5	1.5	1.8
Financial institutions	17.6	19.9	21.9	24.1	22.2
Non-financial corporations and households	18.8	18.5	22.7	25.1	27.8
Households	*9.9*	*8.9*	*10.0*	*9.7*	*9.5*
Non-financial corporations	*9.0*	*9.7*	*12.7*	*15.3*	*18.3*
8. Change in financial liabilities	**36.9**	**41.0**	**43.5**	**49.8**	**52.4**
General government	8.1	8.6	3.7	4.1	2.9
Financial institutions	16.6	18.8	21.1	22.9	21.7
Non-financial corporations and households	12.2	13.6	18.7	22.9	27.7
Households	*3.6*	*4.1*	*5.9*	*6.8*	*8.0*
Non-financial corporations	*8.6*	*9.5*	*12.8*	*16.1*	*19.7*

Sources: Instituto Nacional de Estadística and Banco de España.

(a) Includes the change in stocks and net acquisitions of valuables and of non-financial non-produced assets.

CHART IV.5

Net financial saving



Source: Banco de España.

0.7 percentage points below the 1998 level (see the top panel of Table IV.6), but significantly less negative than in the previous upswing in the late eighties. The relatively favourable position indicated by the figures for firms' net financial saving may be a consequence of the relatively low buoyancy of gross capital formation and higher foreign direct investment; the latter flows, since they represent financial assets of firms, are not deducted when calculating the sector's net financial saving. However, the situation is also the result of the financial restructuring which has taken place in recent years, partly based on the lower financial cost of borrowed funds (see Box IV.4). In this respect, it should be pointed out that the process of gradual decline in interest rates came to an end in 1999, so that firms cannot expect the financial charges on their debt to continue to decline as they have in recent years.

Despite the increase in their borrowing, the net financial wealth (9) of firms continued to rise in 1999, primarily as a consequence of the revaluation of their share portfolios (see the top panel of Chart IV.7). This revaluation may have had two types of positive effect on investment. First, insofar as the ratio between the market value of firms and the cost of increasing installed capacity has risen, the revaluation will have boosted fixed-capital investment demand. Second, the increase in the value of the security available for obtaining financing will have helped to reduce the cost of borrowing and, as a result, the user cost of capital. It is also possible that the growth in firms' net financial wealth has affected the credit extended to the sector, by increasing firms' readiness to borrow and also by increasing the supply of bank credit, through raising the market value of collateral.

A breakdown by instrument of firms' financial investment (see Table IV.6) shows that the bulk corresponded to the acquisition of shares and other equity and the extension of inter-company credit. In the first case, a significant part of the securities acquired represents the takeover of foreign companies, under the strategy of international expansion pursued by large domestic firms, in their desire to attain a larger size and to exploit the business opportunities of less mature markets.

As for the liabilities of the firms, the most notable development in 1999 was the diversification of the sectors' sources of financing. As already mentioned in section IV.2, the healthy economic and stock market outlook encouraged IPOs and capital increases by certain firms. Issuance of fixed-income securities was small, but it should also be stressed that this market was revitalised by certain tax changes and the start of Stage Three of EMU. Loans from abroad also increased forcefully, and may to a certain extent have financed the acquisition of assets abroad. Finally, bank credit grew significantly, although the appeal to other sources of financing meant that its relative importance in the total flow of liabilities declined from 33 % in 1998 to 29 % in 1999.

One way of assessing a sector's financial position is to compare its debt with its financial assets. It can be seen, using this method, that despite the sharp increase in the liabilities of firms in recent years, as a proportion of total financial assets they were in decline (see Table IV.6), owing to the accumulation of assets and, above all, to the sharp revaluation of equities. However, if equities are deducted from total financial assets (given that their realisable value is less certain), the trend in firms' liabilities relative to their total financial assets was less favourable.

The gross saving of *households* in 1999, although higher than residential investment, continued to decline in relation to GDP (see the bottom panel of Chart IV.6). The sustained high volume of acquisition of financial assets and the increase in the purchase of real assets were financed, therefore, through higher borrowing (see Chart IV.8). The flows of financial assets and liabilities led to a significant reduction in net financial saving in 1999. The latter fell to 1.5 %

(9) Net financial wealth is the difference between the stocks of financial assets and of liabilities, and is equivalent to the concept of *net financial assets* defined in ESA 95.

BOX IV.4

Interest income flows in Spain between 1995 and 1999

Interest rate movements are immediately reflected in the composition of agents' portfolios of financial assets and liabilities, since they change both the relative attractiveness of one financial asset to another and the levels of debt assumed. The trend in interest rates affects the flows of income that periodically accrue on financial assets and liabilities directly and indirectly. The change in interest rates itself directly alters the income accruing on a given stock, and also induces an indirect effect on stocks and the composition of portfolios.

Expression (I) represents the change in income received (or paid) as a result of holding a financial asset (or liability) between time t=T (I_T) and a reference time t=0 (I_0). This change in income, $[I_T - I_0]$, breaks down, by means of a simple arithmetic manipulation, into two summands. The first can be interpreted as the change in income attributable to the change in interest rates between times 0 and T, $[S_0 * (i_T - i_0)]$, while the second reflects the change in the amount of income accruing as a result of the change in stocks during the same period $[(S_T - S_0) * i_T]$.

$$\Delta I_t = I_T - I_0 = S_T * i_T - S_0 * i_0 = S_0 * (i_T - i_0) + (S_T - S_0) * i_T \qquad \text{(I)}$$

This breakdown has been used to calculate the total changes in interest income on the portfolios of each group of agents, which has enabled the total income received and paid to be allocated between sectors(1). Taking as a basic reference the levels of interest rates and the structure of portfolios of financial assets and liabilities as of the final quarter of 1995 (t = 0), the cumulative changes in income have been calculated for each group of agents to the fourth quarter of 1999(2). This period was characterised by a continuous decline in interest rates that began in the final quarter of 1995 and continued until mid-1999.

The decline in interest rates means that the most indebted sectors, in net terms, have seen their income rise, basically as a consequence of the lower interest payments on their liabilities. Non-financial corporations and general government come into this category (see the chart below). The counterpart sectors, negatively affected by the decline in interest rates, in terms of interest income, were those that have traditionally maintained a net creditor position in instruments generating periodic flows of interest, such as credit institutions and households.

As regards *households,* their interest income fell by around 3.3 % of GDP during the reference period(3). Even if it is considered that households are the main shareholders of mutual funds, their interest income still does not increase if they are consolidated with that sector. However, it should be recalled that households' financial assets (in particular, shares in mutual funds and equities) have been significantly revalued in recent years, largely coinciding with the decline in interest rates. This revaluation can be estimated, in cumulative terms, as equivalent to 55 % of GDP. Although the effects on demand of the lower interest income and the large revaluation in financial assets may cancel each other out, assessing their total net effect on household spending decisions is complicated. In the case of households, the net amount of accrued income associated with the change in stocks was negative, due primarily to the fact that the lower level of interest rates stimulated an increase in the sector's indebtedness. Consequently, the liabilities generating interest payments grew to a greater extent than the financial assets on which periodic income accrues.

For *non-financial corporations,* the decline in interest rates had a very favourable impact, estimated at 2.9 % of GDP, although the effect of the change in stocks partly offset the income gains obtained through the fall in interest rates. As in the case of households, this was due to the significant increase in the net indebtedness of the sector in recent years, against a background of economic expansion, rising corporate profitability and reductions in the cost of borrowing. The case of general government was somewhat similar. Between 1996 and 1999 it recorded cumulative net saving equal to 5 % of GDP. This can be broken down into a reduction in payments, equal to 7.7 % of GDP, due to the change in interest rates, which far outweighed the increase in payments (estimated to have been 2.7 % of GDP) associated with the change in stocks (arising from the growing stock of outstanding public debt in the period). The change in interest rates also significantly affected credit institutions. During the period considered, these institutions suffered a decline in their cumulative net income equal to 3.4% of GDP. Despite this drastic reduction, credit institutions have adapted to the new low interest rate environment by restructuring their sources of income and reorienting their business towards new activities. For example, in recent years, their income from commissions on transactions and fees for services provided to customers has increased notably, enabling the effects of the narrowing of the net interest margin to be neutralised.

Finally, it should be stressed that interest rate developments have led to a fall in the payments of interest by the Spanish economy to *non-resident investors.* The total effect is the sum of two components: a saving of interest payments arising from the fall in interest rates, equal to 1.8 % of GDP; and an increase in interest payments owing to the rise in external indebtedness on the part of credit institutions and non-financial corporations, estimated to be equal to 0.6 % of GDP. The total interest paid thus declined by 1.2% of GDP.

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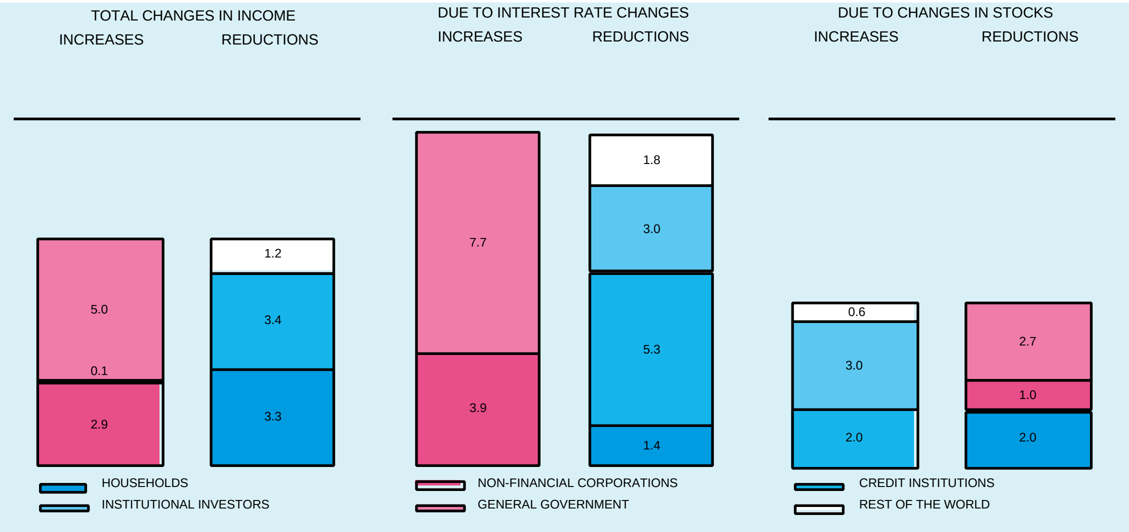
(1) In this exercise, the financial assets and liabilities on which periodic interest receipts and payments accrue are considered to be the following: transferable deposits, short-term securities, bonds and loans. Similarly the following sectoral groupings have been considered: households, non-financial corporations, credit institutions (including the Banco de España, other monetary institutions, the Official Credit Institute and specialised credit institutions), the so-called institutional investors (portfolio investment institutions, securities-dealer companies and securities agencies and insurance corporations), general government and, finally, the external sector.

(2) The criteria used to estimate the inter-sectoral changes in interest income are set out in greater detail in the February 2000 issue of the Banco de España *Boletín económico,* in an article entitled "Evolución de los flujos por intereses en España entre 1995 y 1999".

(3) This figure was obtained by accumulating the saving recorded, year by year, during the period 1996-1999 and dividing by the GDP of 1999.

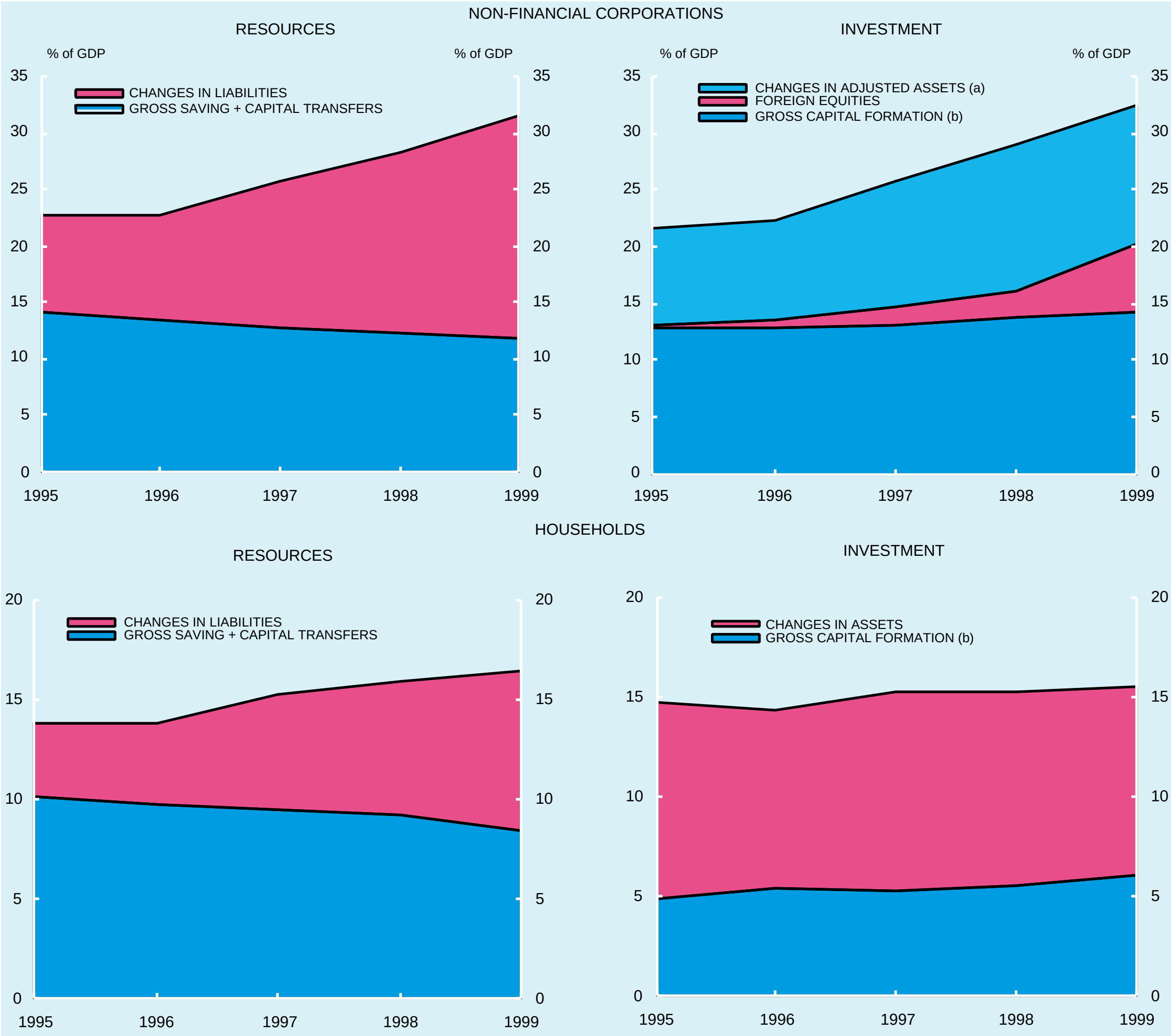
Cumulative changes in interest income between 1996 and 1999
As a % of 1999 GDP



Source: Banco de España.

CHART IV.6

Saving, investment and financing of households and non-financial corporations



Source: Banco de España.

(a) Calculated by subtracting foreign equities from the change in assets.

(b) Gross capital formation includes changes in stocks and purchases of valuables and of non-financial assets.

of GDP (from 2.9 % in 1998), representing the smallest flow of household saving in the past decade.

Despite this increase in liabilities, the net financial wealth of households continued to increase in 1999. As in the case of firms, this was partly the result of the net acquisition of new financial assets, but mainly it was a consequence of the revaluation of assets. The strong growth in the financial wealth of households in recent years, together with the increase in the wealth of the sector held in real assets, as a consequence of rising house prices and the growth in residential investment, has been a factor that has tended to expand aggregate demand. First, it has encouraged households to spend a higher proportion of their disposable income (thereby helping to reduce the saving ratio) and second it has made it easier for households to borrow.

In recent years, within households' acquisition of financial assets there was a major switching of funds from traditional bank instruments towards other assets capable of being revalued in a low interest rate environment, such as mutual fund shares and equities. This pattern changed in 1999. First, as analysed in section IV.3, the bringing of the tax treatment of bank deposits into line with that of mutual funds led to a significant increase in the demand for

TABLE IV.6

Non-financial corporations and households. Financial transactions

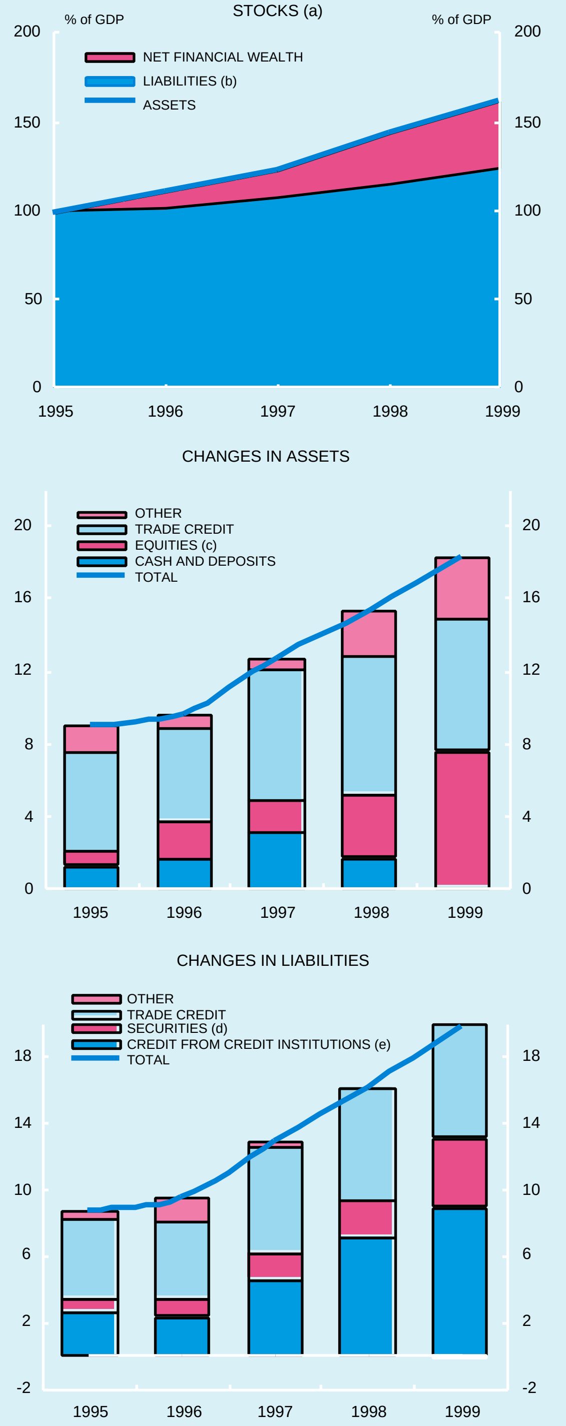
% of GDP

	1997	1998	1999
	NON-FINANCIAL CORPORATIONS		
Net financial saving	**–0.1**	**–0.7**	**–1.4**
Net change in financial assets	**12.7**	**15.3**	**18.3**
Cash and transferable deposits	1.5	1.6	1.0
Other deposits	1.6	0.1	–0.9
Of which: rest of the world	*1.1*	*1.5*	*–1.1*
Short-term securities and bonds	0.1	0.1	1.1
Shares and other equity	1.7	3.5	7.5
Of which: shares in mutual funds	*0.7*	*0.6*	*0.2*
Insurance technical reserves	0.2	0.1	0.1
Credit and other	7.6	9.9	9.5
Net change in liabilities	**12.8**	**16.1**	**19.7**
Short-term securities and bonds	–0.1	0.0	0.4
Shares and other equity	1.7	2.3	3.8
Credit	10.9	13.8	15.7
Of which:			
Credit institutions	*4.5*	*5.3*	*5.8*
Trade credit	*6.3*	*6.7*	*6.8*
Rest of the world	*0.1*	*1.7*	*2.9*
Insurance technical reserves and other	0.3	0.0	–0.1
MEMORANDUM ITEM (%):			
Stock of liabilities (a)/stock of financial assets	87.4	79.8	76.8
Stock of liabilities (a)/stock of financial assets (a)	128.0	126.3	130.0
	HOUSEHOLDS		
Net financial saving	**4.1**	**2.9**	**1.5**
Net change in financial assets	**10.0**	**9.7**	**9.5**
Cash and transferable deposits	1.0	1.2	2.1
Other deposits	–1.7	0.6	4.4
Of which: rest of the world	*0.8*	*0.8*	*0.6*
Short-term securities and bonds	0.0	–0.4	0.4
Shares and other equity	9.4	5.0	–1.8
Of which: shares in mutual funds	*8.2*	*5.4*	*–1.7*
Insurance technical reserves	2.6	2.4	2.8
Credit and other	–1.4	1.0	1.7
Net change in liabilities	**5.9**	**6.8**	**8.0**
Credit	6.0	7.0	8.3
Of which:			
Credit institutions	*4.5*	*5.9*	*6.5*
Trade credit	*1.2*	*0.6*	*1.2*
Rest of the world	*0.4*	*0.4*	*0.5*
Insurance technical reserves and other	–0.1	–0.2	–0.4
MEMORANDUM ITEM (%):			
Stock of liabilities (a)/stock of financial assets	30.6	29.1	29.4
Stock of liabilities (a)/stock of financial assets (a)	41.6	43.1	45.7

Source: Banco de España.
(a) Shares not included.

CHART IV.7

Financial wealth of non-financial corporations



Source: Banco de España.

(a) Stocks include the changes in assets (or in liabilities), along with changes in value having arisen during the period.

(b) Excludes shares.

(c) Includes shares, shares in mutual funds and other holdings.

(d) Includes fixed-income securities, shares and other holdings.

(e) Includes resident and non-resident institutions.

bank deposits and, in particular, time deposits. Second, households disposed of part of their securities portfolio in 1999. However, this was the result of a reduction in equities and in shares in money market and fixed income funds (made less attractive by the low short-term interest rates and the higher long-term rates), while investment in equity funds increased. That said, the stock of households' equity holdings grew considerably last year, to represent around one third of the financial assets of the sector by end-1999, equivalent to nearly 70 % of GDP. Finally, the continued investment in financial insurance products was notable. For several years now these have channelled a relatively stable flow of household saving equal to nearly 3 % of GDP. As a result, the stock of such products exceeded 20 % of GDP by end-1999.

The financing obtained by households sustained the upward trend of previous years (see Chart IV.8). Most of this financing came from bank credit, which rose by 6.5 % of GDP, the largest flow of the past decade. Among other factors, the low level of interest rates and the strategies of banks, continued to boost credit for the acquisition of housing, which grew by nearly 20 % over the year as a whole. By contrast, the stock of loans to finance the acquisition of consumer durables slowed during the year, although its growth held at high rates.

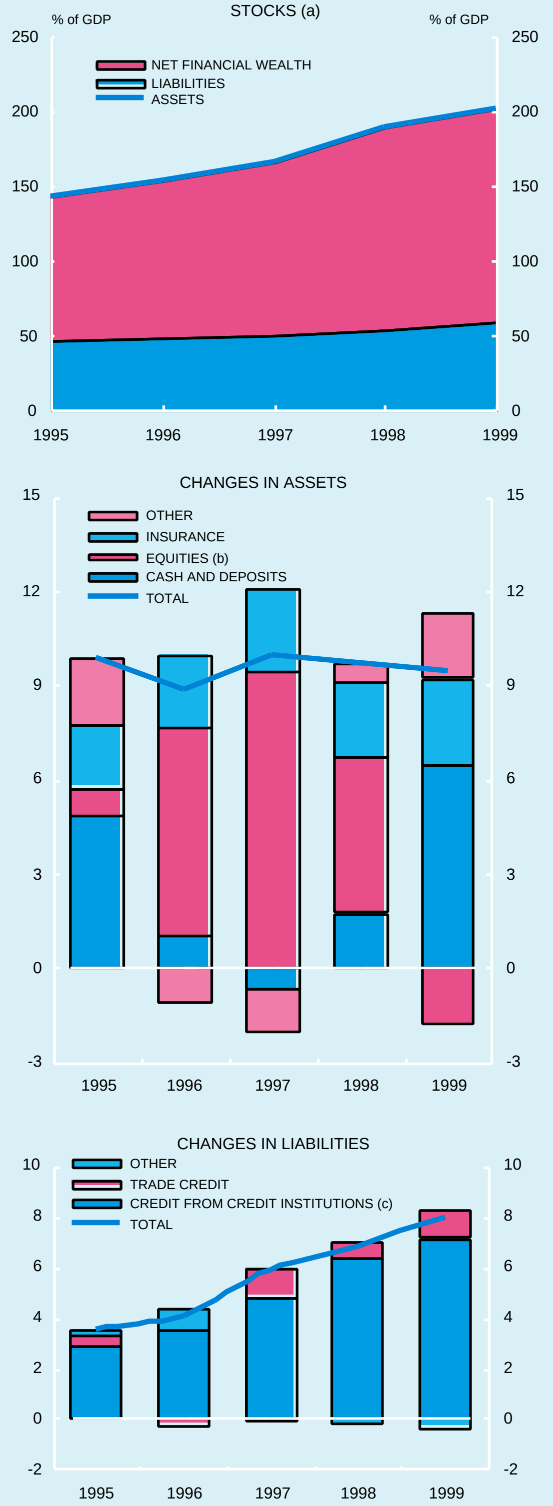
Households' liabilities as a proportion of their total financial assets fell slightly in 1999 to 30 %. As in the case of firms, this was primarily due to the revaluation of shares. Deducting shares from financial assets reverses this trend, with a small acceleration in recent years (see Table IV.6), although even in this case, the stock of financial assets held by households is still more than double the sector's liabilities.

IV.4.2. General government

General government saving continued to increase in 1999, to stand at 3 % of GDP. This, together with the moderate rate of growth of gross capital formation, led to a reduction in the sector's borrowing requirement, to 1.1 % of GDP (see Chart IV.9). The reduction in the public deficit in recent years has enabled the outstanding stock of debt to decline from its 1996 peak by 4.5 percentage points of GDP. According to Government data submitted under the Excessive Deficit Procedure in March, the consolidated nominal gross debt of general government was 63.5 % of GDP in 1999 (Box III.4 contains a detailed analysis of the impact on the general government sector of the introduction of the new system of accounts known as ESA 95)

CHART IV.8

Household financial wealth



Source: Banco de España.

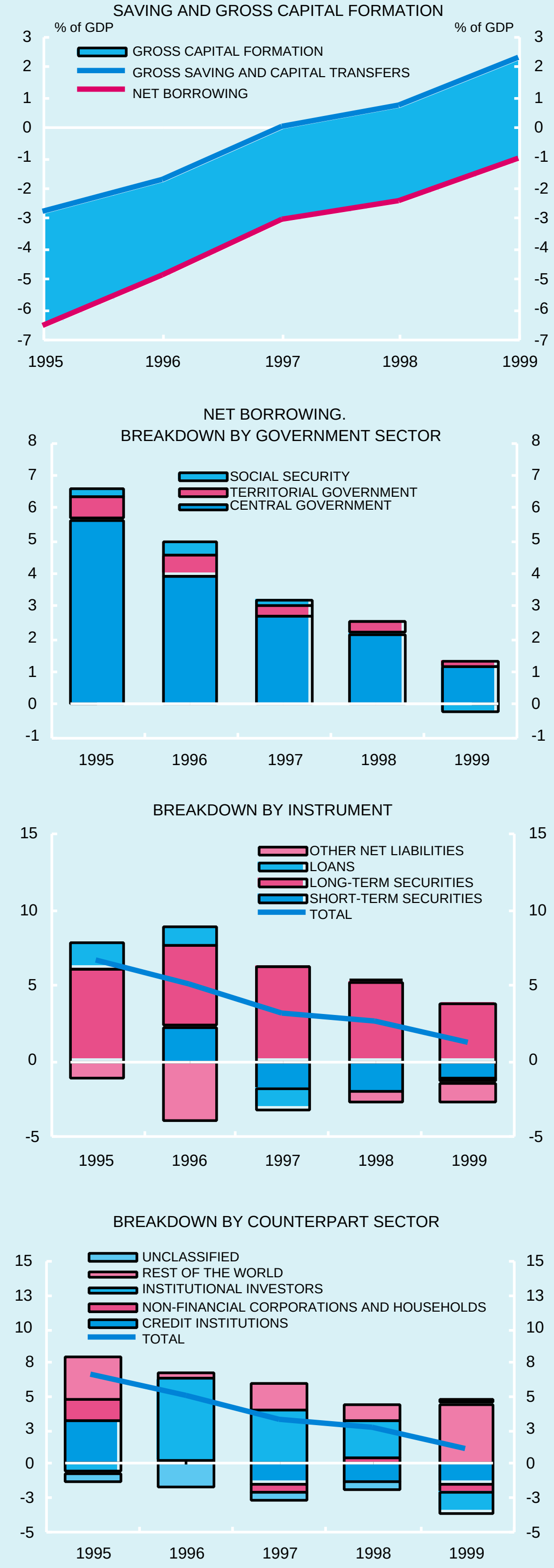
(a) Stocks include the changes in assets (or in liabilities), along with the changes in value having arisen during the period.

(b) Includes, shares, shares in mutual funds and other holdings.

(c) Includes resident and non-resident institutions.

CHART IV.9

General government saving, investment and financing



Source: Banco de España.

The decline in the general government deficit was the result of lower borrowing requirements on the part of all the bodies making up the sector. The decline in the general government borrowing requirement in 1999 was reflected in a smaller increase in its liabilities than in previous years, while the increase in assets, relative to GDP, was sustained. Net issuance of short-term securities remained negative, although less so than in 1998. The outstanding stock of medium and long-term securities continued to rise, although the volume of net issuance extended the downward path of the last four years (see Chart IV.9). This strategy of adjusting financing maturities was accompanied in 1999 by operations to exchange State securities issued in the past at higher interest rates, for new securities paying interest at a lower rate. The purpose of these exchanges (which totalled EUR 5.6 billion in 1999) was to reduce the financial expenses on outstanding debt in coming years. However, there was an increase in the financial charge last year, owing to the redemption of liabilities paying higher interest rates than those issued in the same period. The pattern of securities issuance at the various maturities, together with these exchanges, enabled the average life of state debt to continue to lengthen. It stood at more than five years at the beginning of 2000.

Among the sectors that financed general government in 1999, non-residents were the main purchasers of instruments issued by general government. The institutional investors (which had absorbed the bulk of the public securities issued in the three previous years) reduced their portfolio of public debt, insofar as they sold money market and fixed income mutual fund shares (see the bottom panel of Chart IV.9).

IV.4.3. Saving, investment and financing of the economy

As indicated in the introduction to this section, following a four-year period of positive net lending, in 1999 the Spanish economy once again required financing from the rest of the world (see Table IV.5). The existence of this net borrowing (which amounted to 0.6 % of GDP) shows that national saving was not high enough to finance the strong growth in gross capital formation last year. However, in balance of payments terms, this net borrowing was covered by a debtor position on the financial account of 2 % of GDP, the discrepancy being explained by the existence of an errors and omissions item and the use of different valuation criteria. In terms of assets and liabilities, external liabilities rose by 16.3 % of GDP, while assets vis-à-vis the rest of the world increased by 14.3 % of GDP.

External assets and liabilities have grown strongly in recent years. This has been a consequence of, among other factors, the complete liberalisation of capital movements, the internationalisation of financial markets and the macroeconomic-stability policy pursued in Spain, which gave rise to expectations (subsequently confirmed) that the Spanish economy would join the euro area. The total stock of external assets and liabilities reached more than 176 % of GDP in 1999, compared with 109 % of GDP in 1995. Despite the notable increase in external debt, the rate of acquisition of assets was even faster, so that by end-1999 external assets represented 80 % of liabilities, ten percentage points up on the 1995 level.

The accumulation of external assets basically took the form of direct and portfolio investment, which represented 13.8 % of GDP. In 1999, direct investment stood at twice the already high level recorded the previous year, primarily as a result of the acquisition of holdings in Latin American companies. Portfolio investment also expanded strongly, through purchases of equities, shares in foreign mutual funds and fixed income securities. As already mentioned in sections IV.2 and IV.3, this reflects both the growing interest of institutional investors and the banking system in diversifying their securities portfolios internationally, and a certain scarcity of securities on the domestic market.

Other Spanish investment abroad (which includes loans and deposits) saw a significant decline in the deposits of the non-credit private-sector in non-resident credit institutions (including the foreign branches of Spanish banks), which meant a departure from the trend displayed by these capital flows in recent years (see Table IV.7). The reasons for this may be connected with changes in the post-tax financial return on foreign deposits relative to other financial instruments. Also, resident credit institutions reduced their external assets slightly. The assets of the credit system as a whole rose, however, due to the assets held by the Banco de España in the Eurosystem, which were driven by the transfers of funds between Spanish credit institutions and the rest of the euro area. As regards reserve assets, the fall in 1999 reflected the transfer of reserves from the Banco de España to the ECB at the beginning of the year, and the expiry of currency swaps entered into in the past.

In relation to capital inflows, unlike in 1998 when more than half of the increase in liabilities was due to loans obtained and deposits taken

TABLE IV.7

Financial account of the Balance of Payments

As a % of GDP

	1995	1996	1997	1998	1999
FINANCIAL-ACCOUNT BALANCE	**–0.3**	**–0.7**	**–0.6**	**0.0**	**2.0**
Change in external liabilities	**5.8**	**4.6**	**7.0**	**12.8**	**16.3**
Foreign investment in Spain	4.7	1.6	3.4	5.0	9.3
Direct investment	1.1	1.1	1.1	2.0	1.6
Portfolio investment	3.6	0.5	2.3	2.9	7.8
General government	*3.0*	*0.3*	*2.0*	*0.8*	*4.5*
Other resident sectors	*0.6*	*–0.1*	*0.2*	*1.6*	*1.8*
Credit system	*0.1*	*0.3*	*0.0*	*0.5*	*1.4*
Other foreign investment in Spain	1.1	2.9	3.6	7.9	6.9
General government	*0.3*	*0.0*	*0.0*	*0.2*	*0.0*
Other resident sectors	*0.1*	*–0.2*	*0.1*	*0.8*	*2.7*
Credit system	*0.7*	*3.1*	*3.5*	*6.8*	*4.3*
Change in external assets	**6.0**	**5.2**	**7.6**	**12.8**	**14.3**
Spanish investment abroad	0.9	1.7	5.2	11.2	13.8
Direct investment	0.7	0.9	2.2	3.3	5.9
Portfolio investment	0.2	0.7	2.9	7.9	7.8
Other resident sectors	*0.1*	*0.4*	*2.1*	*6.0*	*5.4*
Credit system	*0.1*	*0.4*	*0.9*	*2.0*	*2.4*
Other Spanish investment abroad	6.3	–0.4	0.3	4.0	4.2
General government	0.1	0.1	0.1	0.1	0.0
Other resident sectors	1.6	1.1	2.5	3.3	–1.6
Credit system	4.6	–1.6	–2.3	0.6	5.8
Of which: BE: intra-system assets	*…*	*…*	*…*	*…*	*5.9*
Reserve assets	–1.2	4.0	2.1	–2.3	–3.7
MEMORANDUM ITEM: BREAKDOWN OF FLOWS BY SECTOR (CHANGE IN LIABILITIES – CHANGE IN ASSETS)::					
Credit system (without BE)	–4.1	4.7	4.7	4.5	3.5
Banco de España (a)	1.2	–4.0	–2.1	2.3	–2.1
General government	3.2	0.2	2.0	0.9	4.4
Other resident sectors	–0.5	–1.6	–5.1	–7.8	–3.8

Source: Banco de España.

(a) Includes reserve assets and intra-system assets.

by the credit system, in 1999 it was notable that other resident sectors (i.e. general government and the non-credit private-sector) resorted significantly to external financing. In particular, the non-credit private sector obtained a similar volume of funds from the rest of the world (through direct investment, the sale of securities and loans) to that raised by the credit system. This shows the growing capacity of Spanish firms to tap international markets directly in order to cover their borrowing requirement.

Finally, as already mentioned in section IV.3, the credit system continued to resort to external financing in 1999, although at a more moderate rate and with greater diversification than in previous years. While in 1996 and 1997 more than 80 % of capital inflows destined for the credit system were in the form of short-term loans and deposits, in 1999 this percentage was only 33 %, the rest being distributed among long-term loans and deposits and the placement of securities. Moreover, credit institutions reduced their borrowing requirement by selling external assets.

The capital flows seen in recent years show that the Spanish economy has reached a certain level of maturity. From being an economy which had to finance its domestic growth through inflows of foreign capital, it has become a more open economy more integrated into the international economy, with a very significant foreign investment outflow. Moreover, this process is permanent in nature, being bound up in the medium-term expansion strategies of large Spanish firms. Such a situation certainly involves risks, but these are inseparable from the higher rates of return that Spanish firms can obtain in third countries. The firms concerned, the supervisory authorities and the investor community should make a prudent assessment of such risks, each promoting control mechanisms and good governance in the firms, so that incentives exist for the right decisions to be reached.

ANNUAL ACCOUNTS OF THE BANCO DE ESPAÑA (*)

1999

(*) Subject to the provisions of Article 4.2 of Law 13/1994 of 1 June 1994 of Autonomy of the Banco de España.

INTRODUCTION

The annual accounts of the Banco de España ("the Bank"), as established by Article 29.1 of its internal rules, comprise the balance sheet, the profit and loss account and the notes to the accounts. The accounts, pursuant to the provisions of the same article, have been prepared in accordance with the Bank's internal accounting rules. These rules follow generally accepted accounting principles, adapted to the special characteristics of the operations and functions of a central bank. They also comply, in all applicable aspects, with the accounting criteria and valuation rules established for the European System of Central Banks (ESCB), as required by Article 26.4 of the Statute of the ESCB, relating to standardisation of accounting principles and practices in the Eurosystem.

The annual accounts of the Banco de España have been submitted, in accordance with the provisions of Articles 29 and 32 of its internal rules, to internal audit by the In- house Audit Department and to review by the Accounts Review Committee, appointed for the purpose by a resolution of the Governing Council of the Banco de España of 21 December 1999, whose report is included below. The accounts have also been audited by independent external auditors, as stipulated by Article 27 of the Statute of the ESCB, whose report is also included below.

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 Economy and Finance Minister, to approve the balance sheet and accounts of the Bank, which will be sent to Parliament for informational purposes. The Governing Council of the Bank, under the provisions of Article 21.1 (g) of said Law, is responsible for formulating the Bank's accounts.

Unless otherwise indicated, the figures refer to millions of euro. For ease of comparability, 1998 figures are given on the same basis, i.e. using the same unit of account (converting pesetas into euro at the irrevocable exchange rate of PTA 166.386 per euro) and the new structure of the balance sheet, profit and loss account and accounting standards established by the ESCB. It should be pointed out that the discrepancies that may, on occasions, be observed between the breakdowns in the notes and the figures in the balance sheet and profit and loss account arise from the rounding of the former.

This document presents the accounts for the year 1999. Section I includes the reports of the external auditors and of the Banco de España Accounts Review Committee; Section II, the balance sheet and profit and loss account; Section III, the notes to the accounts, with the valuation criteria used and explanatory notes on the most important aspects of the balance sheet and profit and loss account. Finally, Section IV, in compliance with Article 4.2 of the Law of Autonomy, details the contributions made to the Deposit Insurance Funds and the loans and transactions not conducted on an arm's-length basis or which in any other way entail a loss of profit or losses for the Bank, giving estimates of the amount of such loss of profit or losses.

I. REPORTS OF THE EXTERNAL AUDITORS AND OF THE BANCO DE ESPAÑA ACCOUNTS REVIEW COMMITTEE

I.1. LETTER FROM THE EXTERNAL AUDITORS

The Governor and Governing Council of the Banco de España

We have audited the annual accounts of the Banco de España, comprising the balance sheet as of 31 December 1999, the profit and loss account and the notes to the accounts for the year then ended. The Governing Council is responsible for the preparation of the accounts. It is our responsibility to express an opinion on the annual accounts taken as a whole based on our audit.

We conducted our audit in accordance with International Standards of Auditing, which require us to plan and conduct the audit in such a way that we can be reasonably certain that the annual accounts do not contain any material errors. An audit includes examination, by means of selective tests, of the documentation supporting the annual accounts and evaluation of their presentation. It also includes an evaluation of the estimates made and of whether the accounting principles applied are appropriate to the Banco de España's circumstances and adequately disclosed. We consider that our work provides an adequate basis for our opinion.

For purposes of comparison, the attached annual accounts present, in addition to the 1999 figures, those for the previous year for each balance sheet and profit and loss account item. Our opinion refers solely to the 1999 annual accounts.

In our opinion, the annual accounts referred to above present a true and fair view, in all material respects, of the net worth and financial position of the Banco de España as of 31 December 1999, and of the net profit from its operations in the year then ended, and contain the sufficient necessary information for their proper interpretation and comprehension, in conformity with the accounting principles and standards referred to in Section III.1 of the notes to the accounts, based on the accounting rules established for the member central banks of the European System of Central Banks, which are consistent with those applied the previous year.

Pricewaterhouse Coopers Auditores, S.L.

[signed]

Juan José Hierro

Partner – Auditor

1 June 2000

I.2. REPORT OF THE ACCOUNTS REVIEW COMMITTEE

We the undersigned, José Manuel González-Páramo, Eduardo Bueno and Jaime Requeijo, members of the Governing Council of the Banco de España and of the Accounts Review Committee appointed by the Governing Council, were given the task of reviewing the accounts of the institution for the year 1999.

By virtue of this mandate, the Accounts Review 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 1999, prepared by the Control and Accounting Department of the Banco de España; 2) studying the internal audit of the balance sheet and profit and loss account of the Banco de España for 1999, conducted by the In-house Audit Department; 3) studying the documentation requested by the members of this Committee from the independent external auditors; 4) interviewing the senior managers of the Control and Accounting Department and of the In-house Audit Department of the Banco de España; 5) interviewing the senior managers of the independent external audit firm; and 6) making proposals for the modification, correction or clarification of various matters, all of which have been satisfactorily incorporated in the Annual Accounts by the Control and Accounting Department.

The basic conclusion of our report is that from the analysis carried out of the examination and accounting procedures, of the accounting records and of the internal controls carried out, it can be inferred that the Annual Accounts for the year 1999 present a true and fair view of the net worth and financial position of the Banco de España.

31 May 2000.

D. José Manuel González-Páramo Martínez-Murillo	D. Eduardo Bueno Campos	D. Jaime Requeijo González

II. BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

Balance sheet of the Banco de España as at 31 December 1999

(EUR millions)

		Note number	1999	1998
	ASSETS			
1.	**Gold and gold receivables**	**1**	**4,872.62**	**4,813.79**
2.	**Claims on non-euro area residents denominated in foreign currency**		**32,655.83**	**47,453.50**
	2.1. Receivables from the IMF	2	1,933.49	2,555.49
	2.2. Balances with banks and security investments, external loans and other external assets	3	30,722.34	44,898.01
3.	**Claims on euro area residents denominated in foreign currency**		**0.03**	**0.00**
4.	**Claims on non-euro area residents denominated in euro**	**4**	**4,118.98**	**43.02**
	4.1. Balances with banks, security investments and loans		4,118.98	43.02
	4.2. Claims arising from the credit facility under ERM II		0.00	0.00
5.	**Lending to financial sector counterparties of euro area denominated in euro**	**5**	**24,184.30**	**26,876.67**
	5.1. Main refinancing operations		20,347.70	23,134.89
	5.2. Long-term refinancing operations		3,379.30	0.00
	5.3. Fine-tuning reverse operations		0.00	0.00
	5.4. Structural reverse operations		0.00	0.00
	5.5. Marginal lending facility		453.00	3,711.26
	5.6. Credits related to margin calls		1.55	25.88
	5.7. Other claims		2.75	4.64
6.	**Securities of euro area residents denominated in euro**		**0.00**	**0.00**
7.	**General government debt denominated in euro**		**11,632.68**	**12,181.61**
	7.1. State	6	9,842.54	10,341.28
	7.2. Social Security	7	1,790.14	1,840.33
8.	**Intra-Eurosystem claims**	**8**	**32,821.83**	**444.68**
	8.1. Participating interest in ECB		444.68	444.68
	8.2. Claims equivalent to the transfer of foreign reserves		4,446.75	0.00
	8.4. Other claims within the Eurosystem (net)		27,930.40	0.00
9.	**Items in course of settlement**	**9**	**4.81**	**303.09**
10.	**Other assets**		**6,563.92**	**7,684.91**
	10.2. Tangible and intangible fixed assets	10	223.50	229.51
	10.3. Other financial assets	11	3,534.83	3,687.56
	10.4. Off-balance-sheet instruments revaluation differences	12	0.00	767.12
	10.5. Accruals and deferred expenditure	13	738.97	597.31
	10.6. Sundry	14	2,066.62	2,403.41
	TOTAL ASSETS		**116,854.99**	**99,801.27**

Balance sheet of the Banco de España as at 31 December 1999 (continued)

(EUR millions)

		Note number	1999	1998
	LIABILITIES			
1.	**Banknotes in circulation**	**15**	**58,911.16**	**52,731.24**
2.	**Liabilities to euro area financial sector counterparties denominated in euro**	**16**	**12,490.92**	**7,410.69**
	2.1. Current accounts (covering the minimum reserve system)		12,462.00	6,431.34
	2.2. Deposit facility		28.00	967.46
	2.3. Fixed-term deposits		0.00	0.00
	2.4. Fine-tuning reverse operations		0.00	0.00
	2.5. Deposits related to margin calls		0.92	11.89
	2.6. Other liabilities		0.00	0.00
3.	**Debt certificates issued**	**17**	**3,301.82**	**6,345.81**
4.	**Liabilities to other euro area residents denominated in euro**		**22,082.66**	**13,874.80**
	4.1. General government	18	20,947.66	12,846.14
	4.2. Other liabilities	19	1,135.00	1,028.66
5.	**Liabilities to non-euro area residents denominated in euro**	**20**	**451.07**	**48.99**
6.	**Liabilities to euro area residents denominated in euro**		**2.66**	**1.21**
7.	**Liabilities to non-euro area residents denominated in foreign currency**		**548.38**	**0.53**
	7.1. Deposits, balances and other liabilities	21	548.38	0.53
	7.2. Liabilities arising from the credit facility under ERM II		0.00	0.00
8.	**Counterpart of special drawing rights allocated by the IMF**	**22**	**407.86**	**359.90**
9.	**Intro-Eurosystem liabilities**		**0.00**	**0.08**
	9.2. Liabilities related to promissory notes backing the issuance of ECB debt certificates	0.00	0.00	
	9.3. Other liabilities within the Eurosystem (net)		0.00	0.08
10.	**Items in course of settlement**	**23**	**260.81**	**509.10**
11.	**Other liabilities**		**891.10**	**1,267.65**
	11.1. Off-balance-sheet instruments revaluation differences	24	1.22	0.00
	11.2. Accruals and deferred income	25	125.25	151.21
	11.3. Sundry	26	764.63	1,116.44
12.	**Provisions**	**27**	**3,796.81**	**3,790.06**
13.	**Revaluation accounts**	**28**	**9,641.37**	**6,988.21**
14.	**Capital and reserves**		**4.54**	**4.54**
	14.1. Capital	29	1.37	1.37
	14.2. Reserves	30	3.17	3.17
15.	**Profit for the year**	**31**	**4,063.83**	**6,468.46**
	TOTAL LIABILITIES		**116,854.99**	**99,801.27**

Profit and loss account of the Banco de España for the year ending 31 December 1999

(EUR millions)

	Note number	1999	1998
Interest income	1	3,091.84	4,471.79
Interest expense	2	–699.74	–936.76
Net interest income		**2,392.10**	**3,535.03**
Realised gains/losses arising from financial operations	3	2,304.78	745.54
Write-downs on financial assets and positions	4	–398.21	–13.52
Transfer to/from provisions for foreign exchange rate and price risks		0.00	0.00
Net result of financial operations, write-downs and risk provisions		**1,906.57**	**732.02**
Fees and commissions income		35.94	24.18
Fees and commissions expense		–1.33	–1.58
Net income from fees and commissions	**5**	**34.61**	**22.60**
Income from equity shares and participating interests	**6**	**1.60**	**1.45**
Net result of pooling of monetary income	**7**	**–22.61**	**0.00**
Other income	**8**	**139.17**	**2,527.06**
TOTAL NET INCOME		**4,451.44**	**6,818.16**
Staff cost	9	–170.35	–164.15
Other administrative expenses	10	–54.08	–45.66
Depreciation of (in)tangible fixed assets	11	–16.22	–15.53
Banknote production services	12	–56.41	–43.95
Other expenses	13	–0.85	–0.76
TOTAL OPERATING EXPENSES		**–297.91**	**–270.05**
Transfers and additions to other funds and provisions	**14**	**–89.70**	**–79.65**
PROFIT FOT THE YEAR	**15**	**4,063.83**	**6,468.46**

III. NOTES TO THE ACCOUNTS

III.1. VALUATION CRITERIA

1. Basic principles

The following accounting principles have been applied:

- economic reality and transparency;
- prudence;
- recognition of post-balance-sheet events;
- materiality;
- the accruals principle;
- consistency and comparability.

2. Basis of accounting

The accounts have been prepared on a historical cost basis, modified to include market valuation of marketable securities, gold and the foreign currency position. Transactions in financial assets and liabilities are reflected in the accounts on the basis of the date on which they are settled.

As an exception to the application of the general historical cost criterion it should be pointed out that, on 31 December 1998, in application of the harmonised accounting standards established for the European System of Central Banks, gold, domestic and foreign securities and foreign currencies were valued at their market prices and exchange rates, without recognition of profits, in the event of unrealised gains, and with a charge to the profit and loss account in the case of unrealised losses.

The specific valuation criteria applied to each of the assets and liabilities specified were the following:

Gold

Purchases are recorded at their purchase price, including the expenses inherent to the transaction. The cost of sales is determined by applying the daily LIFO method. In the event that the cash to be paid or received is specified in a foreign currency, it is translated into euro at the mid-market exchange rate two business days before the settlement date.

On the last day of each calendar quarter stocks are valued at the market price per troy ounce of fine gold supplied by the European Central Bank, with the appropriate accounting adjustments, without changing the average book price

Unrealised losses existing at the end of the year are taken to the profit and loss account and the average book price is changed. Such losses are considered irreversible.

Sales of gold for foreign currency under repurchase agreements are recorded as off-balance-sheet items, with no effect on the balance sheet. Possible differences arising between gold delivered spot and that received forward are recorded as if there had been an independent outright sale or purchase.

Special drawing rights

SDRs and the net IMF position are valued at the year-end SDR market exchange rate.

Foreign securities

Foreign securities are recorded at the purchase price, which is determined by the cash amount paid, after deducting any accrued gross coupon.

The cost of foreign securities sold or redeemed is determined by the average book price of the security in question.

Foreign securities are revalued quarterly, in line with market price. This revaluation is carried out without any netting of unrealised gains and losses on different security codes. Gains and losses (with the exception of losses at year-end are reflected in adjustment accounts and credited or debited, respectively, to revaluation and expense accounts, with both cancelled at the end of the following quarter.

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 implicit rate of return - of the security code concerned is changed. Such losses are considered irreversible, not being cancelled at the end of the following quarter.

Any premiums, discounts and coupons that have accrued but are not due are recorded in accruals accounts, using the implicit rate of return of each security code for their calculation.

The above references to purchase and market prices shall be understood to refer to the relevant currency, these amounts being translated into euro, as stipulated below.

Convertible currencies

Purchases and sales of foreign currencies against euro are valued at the exchange rate agreed in the transaction. Where foreign currencies are bought and sold against other foreign currencies the euro valuation is at the mid-market exchange rate of the currency sold on the contract date.

The cost in euro of foreign currency sold is calculated using the daily LIFO method.

On the last day of each calendar quarter stocks are valued at the mid-market exchange rate, with the relevant adjustments, without changing the average book price. Losses existing at the end of the year, for each currency, are taken to the profit and loss account, and the average book exchange rate changed. Such losses are considered irreversible.

Repurchase agreements involving securities

Securities acquired under reverse repurchase agreements are recorded on the assets side of the balance sheet as collateralised loans for the value of the loan. The securities acquired purchased under this type of agreement are not revalued nor included in the securities portfolio.

Securities sold under repurchase agreements are recorded on the liabilities side of the balance sheet as a deposit collateralised by securities. The balance sheet shows the deposits and the value of the items that have been given as collateral. Securities that have been sold under this type of agreement remain on the balance sheet of the Banco de España and are treated as if they 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.

Doubtful debtors

Where there is any reasonable doubt over the recovery of an asset it is recorded separately and the relevant provision set aside.

Special loans to the State and the Social Security System

Special loans granted to the State that are referred to in transitional provision seven of Law 21/1993 on the State budget for 1994, and those granted to the Social Security System that are envisaged in transitional provision six of Law 41/1994 on the State budget for 1995, are valued at their nominal amount, in accordance with the ESCB's harmonised rules for recording loans.

Intra-Eurosystem balances

The net positions of Intra-Eurosystem balances (except for the participating interest in the ECB and positions resulting from the transfer of reserve assets to the ECB) are shown on the assets or liabilities side of the balance sheet, as appropriate.

Domestic securities

The criteria used to record and value domestic securities are the same as those indicated above for foreign securities.

Participating interests in institutions and other entities

Participating interests in the ECB and in the Bank for International Settlements are valued at their purchase price.

Tangible and intangible fixed assets

In general, fixed assets are valued at the purchase price, which includes any non-recoverable VAT paid and all additional expenses that may arise to bring them into operation.

Annual charges for the depreciation of depreciable assets are calculated on the basis of the estimated economic life of the various assets using the straight-line method. Land and items forming part of the Bank's art collection are not considered to be depreciable assets.

Depreciation is carried out on a monthly basis, starting from the month following that of the date the asset concerned is recorded in the accounts or put into operation.

Assets paid for out of the Beneficent-Social Fund *(Fondo de Atenciones Benéfico-Sociales)* are valued at their purchase price and considered automatically depreciated.

Expenses relating to projects due to be in effect for several years may be capitalised, in which case they are depreciated over a maximum period of four years.

Purchases of silver are recorded at the purchase price. At year-end the stocks are revalued at the US dollar London market price per troy ounce, translated into euro at the prevailing exchange rate. This revaluation is carried out only in the event that the amount so obtained is less than the book value.

In 1999, the depreciation percentages applied to the various fixed assets were the same as those applied in 1998, and were as follows:

	%
• Buildings for own use	2
• Facilities	6
• Furniture and office equipment	
— Libraries	10
— Furniture	10
— Office machines other than computer equipment	20
— Machines for the treatment of banknotes and coins	20
— Computer equipment	25
— Otrher machines and equipment	20
• Transport equipment	20
• Computer applications	33
• Art collection	0

Fixed assets whose cost is less than EUR 120 are recorded as expenses in the year in which they are acquired.

Banknotes

Banknotes in circulation are recorded on the liabilities side of the balance sheet at their face value.

Their issuance costs are not capitalised. The production costs of those acquired from the *Fábrica Nacional de Moneda y Timbre* (National Mint) are recorded each year in the expense account.

Recognition of income and expenses

Income and expenses are recognised in the period in which they are earned or incurred.

Realised gains and realised and unrealised losses are taken to the profit and loss account. An average cost method is used to calculate the purchase price of individual items sold. In the case of unrealised losses on any item at the year-end, its average cost is reduced in line with 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 arising on issued and purchased securities are calculated and shown as interest income or expenses and amortised over the remaining life of the securities concerned, according to the implicit rate of return method.

Pension scheme

Contributions to an external pension fund by employees who, having joined the Bank after 1.1.1986, are entitled to and form part of the Pension Scheme, are established at 6.5 % of the so-called “regulating salary”, consisting of the salary items determined in the Scheme Rules. The amounts contributed by the Bank are recognised as current expenses in the year to which they relate.

Off-balance-sheet positions (1)

Foreign exchange forward transactions, forward legs of foreign exchange swaps and other currency instruments involving an exchange of one currency for another at a future date, have been included in the net foreign currency positions for calculating foreign exchange gains and losses. Interest rate instruments are revalued on an item-by-item basis and treated in a similar manner to securities. Profits and losses arising from off-balance-sheet instruments are recognised and treated in a similar manner to on-balance-sheet instruments.

Post-balance-sheet events

Assets and liabilities are adjusted for events that occur between the annual balance sheet date and the date on which the Governing Council formulates the financial statements if such events materially affect the condition of assets and liabilities at the balance sheet date.

III.2. NOTES ON THE BALANCE SHEET

1 Gold and gold receivables

The Banco de España’s gold holdings amount to EUR 4,872.62 million, consisting of 16,830 million troy ounces of fine gold, valued at

(1) The net position under foreign exchange forward transactions and swaps, and the foreign-exchange gains and losses generated by such position are shown in the balance sheet under items 10.4 on the assets side and 11.1 on the liabilities side, depending on their sign.

EUR 289.518 per ounce. (2) As a consequence of the rise in the market price of gold during the year, the value of the Bank's holdings is EUR 58.8 million higher than at end-1998, despite a decline in stocks from the level at the end of the previous year (19,539 million ounces). The reduction is almost entirely accounted for by the transfer of 2,707 million ounces, to the value of EUR 667.01 million, on 5 January 1999, as part of the Banco de España's contribution to the reserves of the ECB, pursuant to Article 30 of the Statute of the ESCB/ECB.

2. Receivables from the IMF

These include: a) drawing rights within the reserve tranche (EUR 1,516.73 million) which include the net IMF position (EUR 1,516.73 million) and the euro tranche position and its balancing account (EUR 2,639.43 million, with a positive and negative sign); b) special drawing rights (EUR 259.04 million), and c) other claims (EUR 157.72 million). In total, receivables from the IMF fell by EUR 622 million with respect to end-1998, due to various factors. Notable among them were operations carried out through the IMF, basically aid to other countries, loan repayments and the subscription and payment of the increase in the IMF quota, involving a net reduction of EUR 852.95 million, while stocks of SDRs rose by EUR 216.79 million owing to their revaluation at year-end,

3. Balances with banks and security investments, external loans and other external assets

This item includes balances with banks, loans and other claims on non-euro area residents denominated in foreign currency. Their total amount is EUR 30,722.34 million, with the following breakdown:

(EUR millions)

Type of asset	1999	1998
Balances with banks	253.60	233.48
Security investments	30,238.30	44,355.19
External loans and other external assets	243.24	338.47
Loan provisions	*–14.86*	*–30.81*
Non-euro area banknotes	2.06	1.68
TOTAL	**30,722.34**	**44,898.01**

At end-1999, 96.25 % of the balances with foreign banks, loans denominated in foreign currency and security investments were denominated in US dollars.

The significant decline in this item (EUR 14,175.67 million) was basically due to the net effect of the following factors: a) the transfers, to the value of EUR 143,401.76 million (in US dollars) and EUR 377.97 million (in Japanese yen), as part of the Banco de España's contribution to the ECB's reserves; b) the net effect of foreign exchange swaps to the value of EUR 9,971.88 million, entered into to adjust the Bank's foreign-currency portfolio; c) net sales of foreign currency during the year, which in the case of US dollars amounted to EUR 4,433.20 million; d) revaluations due to exchange rate movements, involving an increase of EUR 4,287.99 million; e) the fall in the value of the portfolio as a consequence of the decline in the price of securities and their subsequent revaluation at year-end, to the value of EUR 681.96 million; and f) finally, the increase in stocks of US dollars as a consequence of gold/dollar swaps, to the value of EUR 471.10 million. The remaining difference was basically due to changes arising in currencies other than the US dollar.

Under "external loans and other external assets" are included certain assets, to the value of EUR 44.23 million, considered to be of doubtful recovery. Country-risk provisions of EUR 14.86 million have been set aside in respect of these assets. Of the aforesaid EUR 44.23 million, EUR 18.52 million will be written off in 2000, relating to the outstanding balance as at 31.12.1999 of loans granted to the Dominican Republic (EUR 14.34 million) and to the central bank of Equatorial Guinea (EUR 4.18 million), which will be assumed by the State, pursuant to additional provision eighteen of Law 54/1999 on the State budget for the year 2000. The provisions relating to these loans were cancelled, and their amount credited to the profit and loss account, at end-1999.

4. Claims on non-euro area residents denominated in euro

This item, totalling EUR 4,118.98 million at end-1999, includes the debtor position vis-à-vis the Banco de España with non-participating NCBs, arising from cross-border payments made by the banking system through TARGET (3) (EUR 4,080.55 million), the net amount of bilateral agreements denominated in euro

(2) One troy ounce is equal to 31.1035 grams.

(3) Trans-European Automated Real-time Gross settlement Express Transfer system.

(EUR 38.43 million) and the balance on correspondent accounts in euro held with non-participating NCBs, which was nil at year-end. Almost the whole of the change in this group of accounts (EUR 4,075.96 million) was due to the balances arising from payments made through the TARGET payment system, which was not operational in 1998.

5 Lending to financial sector counterparties of euro area denominated in euro

This includes euro-denominated lending to euro area counterparty financial institutions, for the conduct of monetary policy. Most of this lending is in the form of main refinancing operations.

Although the year-end data show a decline of 10 % with respect to those for 1998 (EUR 24,184.30 million in 1999, compared with EUR 26,876.67 at end-1998), it should be pointed out that the average daily flow of financing during the year was down 42 %, from EUR 23,510.53 million in 1998 to EUR 13,644.20 in 1999. This decline was basically connected with the workings of the tender system for providing liquidity to the financial sector and the high levels of available collateral required, as well as the lower borrowing requirement of foreign banks in Spain, which were able to obtain financing in euro from their parent institutions.

In compliance with the provisions of Article 4.2 of the Law of Autonomy of the Banco de España of 1 June 1994, it is hereby stated that no loans were granted to financial institutions other than on an arm's-length basis.

6 General government debt denominated in euro. State

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. Transitional provision seven of this Law states that the terms and maturities originally established in such loans shall be maintained, and in the absence thereof they shall be repaid on a straight-line basis within twenty-five years, by means of annual payments as from 1999.

The outstanding balance at 31 December 1999 of the loans granted to the State amounted to EUR 9,842.54 million, broken down as follows:

(EUR millions)

Type of asset	31.12.1999	Repayment	31.12.1998
Treasury. Law 3/1983 special account	2,440.64	97.63	2,538.27
Treasury. Law 4/1990 special account	6,600.58	347.39	6,947.97
Subrogation under loans to Tabacalera, S.A. (Law 31/1991)	25.80	12.90	38.70
Credits arising from subscription for participating interests, contributions and quotas in international agencies	775.52	40.82	816.34
TOTAL	**9,842.54**	**498.74**	**10,341.28**

The change was solely due to repayments made during the year, as specified in the above table.

7 General government debt denominated in euro. Social Security System

This item corresponds to the outstanding amount of two loans granted to the Social Security System under Law 41/1994 of 30 December 1994 on the State budget for 1995. The first includes the principal of another loan granted to this institution, which was not paid on its maturity, of EUR 1,539.19 million, and the second includes the interest due but not paid on the previous loan to 31.12.1994, amounting to EUR 501.90 million. The repayment of this loan, which shall begin on 31.12.2000, is treated in the same way as established for the repayment of special loans granted to the Sate, referred to in the previous note. The loan for interest due to 31 December 1994 will be repaid on a straight-line basis over ten years, the first repayment having been made on 31 December 1995.

The change of EUR 50.19 million corresponds to the receipt of the fifth repayment under the loan of EUR 501.90 million, which took the year-end balance to EUR 250.95 million. The amount of the said repayment was recovered by means of set-off against amounts due to the Social Security System in respect of interest payable on its interest-bearing accounts with the Banco de España.

8. Intra-Eurosystem claims

a Participating interest in ECB

The fully paid-up subscription of the Banco de España to the capital of the ECB amounts to EUR 444.68 million, which is equal to a share of 8.8935 % in such capital. This is the percentage corresponding to the Banco de España, according to the capital keys established by the European Commission. The key for Spain was set in accordance with its population and GNP, and remained unchanged during the year.

b) Claims equivalent to the transfer of foreign reserves

Pursuant to Article 30 of the Statute of the ESCB/ECB, the Banco de España transferred to the ECB at the beginning of 1999 foreign reserve assets to the value of EUR 4,446.75 million. The division of the amounts transferred into gold, US dollars and Japanese yen has been given in notes 1 and 3 above. These claims are equivalent to this transfer. They are subject to a possible reduction of up to 20 % in their initial value, in the event that the European Central Bank incurs unrealised losses caused by falls in the exchange rates relating to the reserve assets and the ECB is unable to cover them either with its reserves or through appropriation of the monetary income for the year pooled by the participating NCBs. In 1999, it was not necessary to use this means to cover unrealised losses of the ECB.

c) Other claims with the Eurosystem (net)

This reflects the net position vis-à-vis the Eurosystem, with the breakdown shown in the table below, in respect of the transfers issued/received through TARGET, as well as the balances held with the national central banks that belong to the Eurosystem through correspondent accounts, the latter constituting an insignificant part of the total.

Position of the Banco de España vis-à-vis the Eurosystem national central banks and the ECB at end-1999 (a)

(EUR millions)

Eurosystem members	Claims with the Eurosystem	Liabilities with the Eurosystem	Net asset position
Belgium		2,096.80	
Germany	853.32		
France	14,686.73		
Ireland	1,284.79		
Italy		1,351.62	
Luxembourg	1,445.66		
Netherlands	2,596.63		
Austria	3,761.58		
Portugal	2,957.00		
Finland	2,160.42		
Total NCBs	**29,746.13**	**3,448.42**	
ECB	1,632.69		
TOTAL	**31,378.82**	**3,448.42**	**27,930.40**

(a) The Eurosystem came into existence on 1.1.1999, so that no comparative data are shown for the previous year. However it should be noted that the position vis-à-vis the Eurosystem NCBs in correspondent accounts at end-1998 was insignificant.

In this first year since the start of Stage Three of EMU, the net balance at end-1999 of the intra-Eurosystem accounts (excluding those mentioned in (a) and (b) above) totalled EUR 27,930.40 million. This increase, the result of the processing of cross-border payments of the national banking systems and, marginally, of the payments made between the member central banks of the Eurosystem, was significantly influenced by the following factors: *a)* the recourse of Spanish credit institutions to external financing in euro, due to the working of the tender system used for providing liquidity to the financial sector and the high level of available collateral required; *b)* a lower recourse to borrowing from the Banco de España on the part of many foreign institutions which in 1998 had borrowed funds in pesetas on the domestic market and in 1999 were financed instead in euro by their parent institutions, and *c)* the maturation in 1999 of swap transactions by means of which a significant part of the foreign-currency sales of the Banco de España in 1998 were executed. All the factors mentioned involved transfers from abroad to the Spanish banking system, which were reflected in an increase in the position of the Banco de España vis-à-vis the other members of the Eurosystem, on whose accounts it credited the funds paid in euro to the national banking system.

9. Items in course of settlement

Totalling EUR 4.81 million, they correspond basically to bills and documents in the process of being cleared.

10. Tangible and intangible fixed assets

Totalling EUR 223.50 million at end-1999, of which EUR 388.05 million corresponded to their cost and EUR 164.55 to accumulated depreciation.

The two tables below show this item broken down into its components, together with their cost or valuation and accumulated depreciation.

(EUR millions)

Cost or valuation	Property and facilities	Furniture and equipment	Fixed assets under construction	Other fixed assets	Total
1 January 1999	231.49	73.66	1.74	76.50	383.39
Change during the year	0.17	-0.49	2.70	2.28	4.66
31 December 1999	231.66	73.17	4.44	78.78	388.05

(EUR millions)

Acumulated depreciation	Property and facilities	Furniture and equipment	Fixed assets under construction	Other fixed assets	Total
1 January 1999	82.09	58.96	—	12.84	153.89
Change during the year	8.74	0.79	—	1.13	10.66
31 December 1999	90.83	59.75	—	13.97	164.55

The Bank's holdings of silver, valued at EUR 28.3 million, are included under «Other fixed assets» and were unchanged from end-1998.

11. Other financial assets

Of the total amount of this item, 99 % corresponds to the portfolio of book-entry debt, in which the Banco de España has EUR 3,534.50 million invested, EUR 152.7 million less than a year earlier. This decline is basically due to the unrealised losses arising from rising interest rates.

12. Off-balance-sheet instruments revaluation differences

See note 24.

13. Accruals and deferred expenditure

Of the total balance of this group of accounts (EUR 738.97 million), the main components are interest accrued but not yet received on securities denominated in foreign currency (EUR 325.67 million), interest accrued but not yet received on State book-entry debt (EUR 167.89 million) and interest accrued on the claims equivalent to the transfer of foreign reserves (EUR 102.87 million).

14. Sundry

The most significant component of this item, representing 92.3 % of the total, is the transfer made to the Treasury on 29.11.1999, in respect of the Bank's recorded profits accrued to 30 September 1999, which totalled EUR 1,905.85 million.

15. Banknotes in circulation

The breakdown of banknotes in circulation by denomination at 31.12.1999 is shown in the table below:

(EUR millions)

Denomination	1999	1998
1,000 PTA	1,574.21	1,481.39
2,000 PTA	3,164.23	2,608.19
5,000 PTA	20,734.52	19,269.57
10,000 PTA	33,471.71	29,372.10
Held by other ESCB banks	–33.51	0.00
TOTAL	**58,911.16**	**52,731.25**

The stock of banknotes in circulation was 11.7 % up on end-1998. However, if average daily stock data are compared for 1999 and 1998, the increase is reduced to 4.2 %. This is because a significant part of the rise at end-1999 was temporary in nature, being related to the so-called «year-2000 problem», as a result of which the public held more banknotes than usual at end-1999.

16. Lliabilities to euro area financial sector counterparties denominated in euro

The overall balance of the different types of deposit held by credit institutions with the Banco de España totalled EUR 12,490.92 million at end-1999. The large increase with respect the previous year was concentrated in current accounts (covering the minimum reserve system), which rose from EUR 6,431.34 million at 31.12.1998 to 12,462.00 million at 31.12.999. Like the increase in the public's demand for banknotes mentioned above, this increase was basically related to the decision of the credit institutions to cover themselves for possible risks arising from the so-called «year-2000 problem». This explains why, although the increase over 1998 in the average daily balance on these accounts was 26 %, the increase resulting from a comparison of the end-year data rises to almost 94 %. For its part, the increase in the average daily balance (EUR 8,174.54 million in 1999, against EUR 6,474.90 million in 1998) was a consequence of the increase in the eligible liabilities of the institutions subject to minimum reserve requirements.

17. Debt certificates issued

This item, totalling EUR 3,301.82 million, includes fixed-term certificates issued by the Banco de España to absorb liquidity from the financial system, pursuant to the Ministerial Order of 21 February 1990, whereby the reserve requirements for financial intermediaries were altered. Such certificates have specified repayment schedules, which are due to be completed in September 2000.

In 1999, the balance of this item fell by EUR 3,043.99 million, as a result of the repayments made during the year.

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. These deposits are remunerated on the terms specified in Note 2 on the profit and loss account. The outstanding balance at year-and was EUR 20,947.66 million, which breaks down as follows:

(EUR millions)

	1999	1998
Central government (State)	16,866.33	11,669.87
Treasury–current account	*14,869.97*	*10,295.98*
Other central government agencies and similar bodies	*1,996.36*	*1,373.89*
Territorial government	165.82	74.41
Regional (autonomous) governments, administrative agencies and similar bodies	*162.54*	*72.22*
Local government	*3.28*	*2.19*
Social security funds	3,915.51	1,101.87
TOTAL	**20,947.66**	**12,846.15**

The large increase in the balance of this subitem (EUR 20,947.66 million at end-1999, compared with EUR 12,846.15 million at end-1998) was basically due to the increase in the current account of the Treasury, which rose from EUR 10,295.98 million to EUR 14,869.97 million, and to the increase in the balance of the accounts of the Social Security System, which rose from EUR 1,101.87 million to EUR 3,915.51 million.

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 Insurance Funds, other financial intermediaries associated with securities markets settlement, other intermediaries in the debt book-entry market, etc., as well as the current accounts of employees and pensioners and other accounts of legal persons classified in the other resident non-financial sectors. The balance at end-1999 was EUR 1,135 million, an increase of EUR 106.33 million on end-1998, basically due to the increase in the balance of the current accounts of the agents included in this item.

20. Liabilities to non-euro area residents denominated in euro

The main component of this item is the credit balance with the EU national central banks that do not belong to the Eurosystem, arising from transactions carried out through TARGET (EUR 429.75 million of the total of EUR 451.07 million). The change on a year earlier (EUR 402.70 million) was due to the transfers of funds made through the aforementioned payment system.

21. Liabilities to non-euro area residents denominated in foreign currency. Deposits, balances and other liabilities

These liabilities, totalling EUR 548.38 million, basically correspond to debts arising under repurchase agreements relating to the management of the foreign-currency reserves of the Banco de España (87 % of the total). The balance of this group of accounts increased by EUR 547.85 million, of which EUR 475.50 million corresponded to such repurchase agreements.

22. Counterpart of special drawing rights allocated by the IMF

This item, totalling EUR 407.86 million, includes the counterpart of the special drawing rights allocated to Spain in proportion to its IMF quota. Of the EUR 47.96 million change, 45.73 million correspond to the revaluation of this liability owing to exchange rate movements.

23. Items in course of settlement

From the total balance of this group of accounts (EUR 260.81 million), EUR 258.92 corresponds to transfers ordered by credit institutions pending payment at year-end, which also account for almost the whole of the change with respect to 1998 (EUR 248.28 million).

24. Other liabilities. Off-balance-sheet instruments revaluation differences

Included here is the amount of the net position under foreign-exchange forward transactions and swaps, as well as their related exchange rate adjustment accounts. The end-1999 balance was EUR 1.22 million, while the end-1998 balance was a debit amount of 767.12 million.

25. Other liabilities. Accruals and deferred income

The most significant components of this sub-group of accounts, the total amount of which was EUR 125.25 million, correspond to interest accrued but not yet due on certificates of deposit issued (EUR 50.34 million) and interest accrued on remunerated current accounts. Among the latter, those of the Social Security System (EUR 50.65 million) and the Treasury (EUR 10.22 million) were notable.

26. Other liabilities. Sundry

The most important components of this sub-group of accounts are those relating to contributions payable to the Banco de España employee social welfare scheme *(Mutualidad de empleados),* which amounted to EUR 396.03 million, representing the current value of the debt acknowledged by the Banco de España in favour of the scheme arising from commitments made thereto, this amount being reduced by EUR 14.90 million during the year, and to settled credit interest pending allocation – suspense accounts (corresponding to a loan to the Social Security System, referred to in note 7), the balance of which at year-end amounted to EUR 250.95 million, down 50.19 million on the previous year. The sum of the balances on these two accounts represents 85 % of the total amount of this sub-group of accounts.

Also appearing in this subgroup are the taxes pending payment, to the value of EUR 4.97 million, of which EUR 4.91 correspond to withholdings on the wages and salaries paid to employees.

27. Provisions

With the exception of country-risk provisions, which are presented in the balance sheet in the form of adjustments to the values of the assets concerned, provisions are recorded under this item, with the breakdown shown in the table above.

(EUR millions)

	1999	1998
For liabilities and charges	4.18	22.18
For exchange rate risks– Pre-system account	3,767.58	3,767.58
For ECB losses covered by monetary income	3.94	N/A (a)
For ECB losses covered by additional contributions	20.81	N/A (a)
For other risks	0.30	0.30
TOTAL	**3,796.81**	**3,790.06**

(a) Not applicable.

The most important provision, unchanged during the year, relates to pre-system exchange rate risks. It was created by a resolution of the Executive Commission of 26 January 1999 to cover future exchange rate risks affecting the external reserves of the Banco de España and possible contingencies in respect of unrealised losses on reserves transferred to the European Central Bank.

The changes in this item are due to the creation of new provisions to cover the losses of the ECB in 1999, as detailed in note 7 on the profit and loss account, and to the fact that those relating to the collective agreement with employees, which was applied in 1999, were no longer needed.

28. Revaluation accounts

These accounts represent revaluation reserves arising from unrealised gains on assets and liabilities. Their breakdown is as follows:

(EUR millions)

Type of account	1999	1998
Pre-system revaluation accounts	**4,763.33**	**6.988.17**
For exchange rate differences	1,729.83	2,591.52
For price differences	3,033.50	4,396.65
Gold	*2,565.79*	*2,978.78*
Securities denominated in foreign currencies	*96.09*	*877.71*
Book-entry public debt	*371.62*	*540.16*
Ordinary revaluation accounts	**4,878.04**	**N/A**
For exchange rate differences	4,151.58	N/A
For price differences	726.46	N/A
Gold	*726.22*	*N/A*
Securities denominated in foreing currencies	*0.24*	*N/A*
Book-entry public debt	*0.00*	*N/A*
TOTAL	**9,641.37**	**6,988.17**

The balances, in respect of unrealised gains, on revaluation accounts at end-1998, before the start of Stage Three of EMU, are called pre-system revaluation accounts. These balances declined in 1999 for two reasons: a) due to the realisation of unrealised capital gains, as a consequence of sale and redemption of the assets concerned, and b) due to netting against unrealised losses in the end-1999 revaluation of those securities that remained in the Bank's portfolio throughout the year. The amount of the decline was EUR 2,224.84 million, with the following breakdown:

(EUR millions)

Pre-system revaluation accounts	Reasons for the change in 1999: Due to the realisation of capital gains in sales and redemptions	Due to netting against unrealised capital losses	Total
For exchange rate differences	861.69	—	861.69
For price differences	800.69	562.46	1,363.15
Gold	*412.98*	—	*412.98*
Securities denominated in foreign currencies	*373.13*	*408.50*	*781.63*
Book-entry public debt	*14.58*	*153.96*	*168.54*
TOTAL	**1,662.38**	**562.46**	**2,224.84**

Of the unrealised capital gains due to exchange rate movements that were realised during the year (EUR 861.69 million), EUR 251.48 million arose from the transfer of foreign reserve assets in the form of US dollars and Japanese yen to the ECB at the beginning of the year and the rest from ordinary transactions carried out during the year.

As regards the realisation of pre-system unrealised gains due to price movements (EUR 800.69 million), almost all those relating to gold (EUR 412.7 5 million) were a consequence of the transfer of this asset to the ECB, as were EUR 69.35 million of the EUR 373.13 million obtained from the sale of securities. Finally, from the sale and redemption of State book-entry debt, pre-system unrealised gains of EUR 14.58 million were realised.

With respect to the reduction in the pre-system revaluation accounts by netting against unrealised losses at 31.12.1999 (EUR 562.46 million), the majority (EUR 408.50 million) corresponded to foreign securities, and the rest (153.96 million) to book-entry debt, as a consequence of the rise in euro and dollar interest rates during this period.

Finally, it should be pointed out that the large revaluation of the US dollar entailed an increase in the so-called «ordinary» revaluation accounts (to distinguish them from the pre-system ones) of EUR 4,151.58 million due to exchange rate movements and of EUR 726.22 million due to the higher price of gold with respect to end-1998.

29. Capital

The capital of the Banco de España, constituted in accordance with the provisions of Royal Legislative Decree 18/1962 of 7 June 1962, totalled EUR 1.38 million and remained unchanged during the year.

30. Reserves

Included in this item, which remained unchanged during the year, is the amount of capital, reserves and profits arising from membership in 1973 of the former Spanish Foreign Currency Institute in the Banco de España.

31. Profit for the year

The net profit for the year, having deducted the transfer to the Beneficent-Social Fund (EUR 8.14 million), totalled EUR 4,063.83 million, 37.2 % down on 1998. Of this amount, EUR 1,905.85 million, as indicated in note 14 above, was paid to the Treasury on 29.11.1999, in accordance with Royal Decree 1746/1999 of 19 November 1999.

The following amounts corresponding to 1998 profits were also paid to the Treasury during the year.

a) On 1.2.1999, EUR 3,564.8 million, equivalent to 90 % of the profit for 1998 (EUR 6,468.46 million).

b) On 31.8.1999, the balance sheet and profit loss account for the year 1998 having been approved by the Council of Ministers, EUR 646.85 million, representing the rest of the profit for 1998.

The details of the various components of the profit for 1999 are given in the following notes on the profit and loss account.

III.3. NOTES ON THE PROFIT AND LOSS ACCOUNT

1 Interest income

This item includes income from interest accrued on the main assets of the Banco de España.

It was made up, in 1998 and 1999, as follows:

(EUR millions)

	Foreign currency		Euro		Total	
	1999	1998	1999	1998	1999	1998
Securities	1,737.74	3,044.15	138.19	285.07	1,875.93	3,329.22
Other assets	65.76	158.09	1,150.15	984.48	1,215.91	1,142.57
TOTAL	**1,803.50**	**3,202.24**	**1,288.34**	**1,269.55**	**3,091.84**	**4,471.79**

Of the total of EUR 1,803.50 million, corresponding to interest on foreign-currency denominated investments in 1999, the interest on US-dollar-denominated fixed-income security investments totalled EUR 1,698.70 million (94.2 %), with much lower amounts corresponding to the interest on SDRs, Canadian dollars, gold, etc.

The average level of such US-dollar investments was EUR 35,481 million, with an average yield of 4.9 %.

The interest on euro-denominated investments (EUR 1,288.34 million) arose, in short, from the following assets:

(EUR millions and %)

Assets	Average investment	Amount	Average yield in 1999
Loans to institutions under monetary policy operations	13,644.20	382.82	2.77 %
Net position with European Union central banks	24,171.62	658.66	2.68 %
Claims equivalent to the transfer of foreign reserves	4,405.27	102.87	2.30 % (a)
Book-entry debt portfolio and other	3,833.82	143.99	3.70 %
TOTAL	**46,054.91**	**1,288.34**	**2.76 %**

(a) The claims equivalent to the transfer of foreign reserves are remunerated at 85 % of the marginal rate in main refinancing operations.

A comparative analysis with the previous year shows the notable reduction in total interest obtained (EUR 4,471.79 million in 1998, as against EUR 3,091.84 million in 1999), basically due to the divestment of external assets with yields of around 5 % (the average level of US-dollar investments fell by USD 16,339.67 million), and a corresponding increase in euro-denominated assets (the average level of these investments increased by EUR 19,670.38 million), with yields of around 2.7 %. Another reason for this reduction was the lower average yield obtained in 1999, both on foreign-currency-denominated assets (down from 5.9 % in 1998, to 4.9 %) and on euro-denominated assets (down from 4.2 % to 2.7 %).

2. Interest expense

This item includes expenditure on the interest accruing on liabilities, which breaks down as follows:

(EUR millions and %)

	Average financing	Interest expense 1999	Interest expense 1998	Average cost in 1999
Certificates issued by the Banco de España	4,822.20	289.05	464.59	6.00 %
Remuneration of minimum reserves	8,174.54	223.24	—	2.69 %
Deposits of general government	5,409.93	149.15	436.04	2.76 %
Oher euro-denominated liabilities	268.38	7.74	14.69	2.84 %
Liabilities denominated in foreign currencies	744.55	30.56	21.44	4.10 %
TOTAL	**19,419.60**	**699.74**	**936.76**	**3.60 %**

The reduction in the expense compared with the previous year was primarily due to the decline in the balance of the accounts of the Treasury and in the stock of outstanding debt certificates. This decline was partly offset by the deposits of institutions to cover their reserve requirements, which began to be remunerated in 1999.

In addition, it should be noted that as regards the balance in favour of the Treasury, only that part which exceeds the amount of the special loans granted to the Treasury (assets of the Bank) is remunerated.

3. Realised gains/and losses arising from financial operations

This item includes the profits and losses arising from the sale and purchase of financial assets. In 1999, there was a net realised gain of EUR 2,304.78 million, which basically arose from the following sources:

— Foreign exchange gains upon the sale of foreign currency totalling EUR 1,728.68 million, of which EUR 861.69 million corresponded to the realisation of unrealised gains already existing at 31.12.1998 and the rest, EUR 866.99 million, to the realisation of those arising in 1999.

Of the total of EUR 1,728.68 million, EUR 1,558.01 million (90.1 %) arose from the net daily sale (daily LIFO) of US dollars which, including the transfer of reserves to the ECB, totalled USD 12,800 million in 1999. The other gains related to the net sale of Japanese yen (EUR 19.40 million), SDRs (EUR 139.20 million) and other foreign currencies.

— Gains from the sale of gold, almost all of which arose from the transfer of reserves to the ECB, amounted to EUR 413.04 million, of which EUR 412.98 million corresponded to the realisation upon such transfer of unrealised gains already existing at 31.12.1998.

— The net gains arising from price movements, on the sale of foreign securities, amounted to EUR 160.59 million, basically corresponding to the sale and transfer to the ECB of US-dollar denominated securities, to the value of USD 54,890 million.

Two countervailing factors were present in the results of these sales of securities. While there was a profit of EUR 373.13 million from the realisation of unrealised gains existing at 31.12.1998, at the same time there were current losses of EUR 212.54 million during the year, as a consequence of the rise in interest rates.

4. Write-downs on financial assets and positions

This item includes that part of the loss arising from exchange rate depreciation in the foreign currency position at end-1999, as well as from the fall in the price of gold and of securities denominated in foreign currency, that cannot be netted against unrealised gains arising from previous years.

The loss recorded in 1999 basically corresponds to the fall in value of securities denominated in foreign currency. The resulting unrealised losses charged to the profit and loss account at the end of the year were EUR 806.7 million. These were partially netted against unrealised gains recorded at 31.12.1998 to the value of EUR 408.5 million (see note 28 on the balance sheet), so that the net effect on the profit and loss account was a loss of EUR 398.21 million.

5. Net income from fees and commissions

This basically includes income and expenses arising from fees for banking services and the like (transfers, negotiation of cheques, custody and administration of securities, telephone service for securities transactions, etc.).

It may be broken down as follows:

(EUR millions)

	Income		Expenses	
	1999	1998	1999	1998
External operations	23.93	1.45	–1.15	–1.57
Domestic operations	12.01	22.73	–0.17	–0.01
TOTAL	**35.94**	**24.18**	**–1.32**	**–1.58**

The increase in income in 1999 from commissions on external operations is notable, the Banco de España having secured a loan granted by the Bank for International Settlements to Brazil.

The reduction in income from domestic operations is also notable, owing to the lower commissions received in relation to the Telephone Service.

6. Income from equity shares and participating interests

This includes the dividends paid on the participating interest of the Banco de España in the capital of the Bank for International Settlements.

7. Net result of pooling of monetary income

According to Article 32.5 of the Statute of the ESCB/ECB, the monetary income of the national central banks, accruing in the performance of the ESCB's monetary policy function, shall be allocated to such banks in proportion to their paid-up shares in the capital of the ECB. The Governing Council of the ECB, in its meeting of 3 November 1998, decided to calculate monetary income by the application of a reference rate to the liability base, defined for this purpose as all the central bank's deposit liabilities to credit institutions, without including banknotes. The reference rate used is the latest available two-week repo rate and is applied on a daily basis to the liability base of each national central bank.

At the same time, pursuant to Article 33.2 of the Statute of the ESCB and to the decision of the Governing Council of the ECB of 15 December 1999, a loss incurred by the ECB during the years 1999 to 2001 shall be transferred in the following order:

a) The shortfall may be offset against the general reserve fund of the ECB;

b) Following a decision by the Governing Council, any remaining loss may be offset against the monetary income for the relevant financial year in proportion to and up to the amounts allocated to the NCBs in accordance with Article 32.5 of the Statute of the ESCB;

c) Provided that such shortfall cannot be offset in accordance with Article 33.2 of the Statute, then:

1) Any remaining loss will be offset in the first instance, by waiving a part of the original value of the ECB's liabilities equivalent to the transfer of foreign reserves in the balance sheet of the ECB. The maximum waiver may not exceed:

—the amount of unrealised losses which arise on the foreign currency and gold positions;

—an amount that would reduce the aforesaid claims to below 80 % of their original value;

2) Any remaining shortfall will be offset against a direct charge on income, apportioned in accordance with the ECB's capital key, accruing to participating NCBs from national banknotes in circulation, subject to the limitation that such a direct charge on any one NCB shall not exceed its own income on national banknotes.

The table below shows the breakdown of the net result for the Banco de España of the pooling of monetary income and the coverage of ECB losses for 1999.

(EUR millions)

Items	December 1999
Contributions of monetary income to the Eurosystem	–1.80
Reallocation of monetary income to the Banco de España	3.94
Contribution by the Banco de España to the ECB's losses	–24.75
Using monetary income	*–3.94*
Additional contributions	*–20.81*
Net result of pooling of monetary income	**–22.61**

As there were no unrealised losses in the foreign reserves of the ECB, neither the procedure envisaged in paragraph (c) (1) above nor the provision made by the Banco de España to cover this risk were used.

8. Other income

This includes the profits arising on book-entry public debt, as well as other diverse income of an exceptional nature.

It may be broken down as in the table below.

Under the extraordinary profit, of particular note were the tax rebate (EUR 47.57 million), the interest withheld from the Social Security System to pay its debt (EUR 50.19 million) and the recovery of provisions and other amounts as a result of the State's assumption of debts of

(EUR millions)

Description	1999	1998
Profit on the sale of book-entry public debt	–0.95	23.22
Profit on pre-system book-entry public debt	14.58	0.00
Extraordinary profit	124.66	2,502.85
Sundry	0.88	0.99
TOTAL	**139.17**	**2,527.06**

the Dominican Republic and Equatorial Guinea (EUR 25.7 million). The sharp decline with respect to 1998 was due to the fact that net profits of EUR 2,273 million were credited to the profit and loss account that year, in respect of already realised gains; EUR 141 million, due to the payment to the Bank of withholdings made on the returns on its book-entry portfolio and others of smaller amounts.

9 Staff cost

This item, which amounts to EUR 170.35 million, includes the salaries and other emoluments of the Bank's staff (EUR 124.01 million), which were 3 % higher than in 1998; Social Security contributions (EUR 29.49 million), 3.9 % higher; expenses of a social nature (EUR 14.74 million) and contributions to the pension scheme (EUR 2.11 million).

On 31 December 1999 the Bank employed 3,148 staff. 69 additional staff were employed during the period and 93 members of staff left the service of the Bank.

10. Other administrative expenses (4)

This item includes expenditure arising from the purchase of current assets, as well as diverse services received during the year. The most important were office expenses (including IT costs), which amounted to EUR 24.72 million, and costs relating to premises (especially maintenance), which amounted to EUR 12 million.

It breaks down as follows:

(EUR millions)

Description	1999	1998
Office expenses	–24.72	–16.64
Property expenses	–12.00	–12.47
Transport and communications	–4.42	–4.19
Security	–4.83	–4.92
Training and grants	–1.14	–0.87
Sundry operating expenses	–6.22	–5.83
Taxes	–0.75	–0.74
TOTAL	**–54.08**	**–45.66**

(4) Given that there is no explicit provision for taxes in the harmonised ESCB profit and loss account format, these are included in this item.

11. Depreciation of fixed assets

Included here is the cost of the estimated depreciation of the Bank's fixed assets, which breaks down as follows:

(EUR millions)

Description	1999	1998
Depreciation of property	–9.05	–9.13
Depreciation of transport equipment	–0.08	–0.06
Depreciation of furniture and office equipment	–5.88	–5.72
Depreciation of computer applications	–0.98	–0.62
Other depreciable expenses	–0.23	0.0
TOTAL	**–16.22**	**–15.53**

12. Banknote production services

This amount (EUR 56.41 million) corresponds to payments made by the Banco de España to purchase banknotes from the National Mint. The increase (EUR 12.46 million; 28.4 %) was basically attributable to the increase in the unit price of banknotes and to the increase in the production and storage of peseta banknotes, so that the Mint can devote more resources in the coming years to the production of euro bank notes.

13. Other expenses

These were as follows:

(EUR millions)

Description	1999	1998
Fund conveyance expenses	–0.63	–0.55
Coin and banknote packaging material expenses	–0.22	–0.21
TOTAL	**–0.85**	**–0.76**

14. Transfers and additions to other funds and provisions

These totalled EUR 89.70 million and included that part of the unrealised losses in the book-entry public debt portfolio at year-end that was not netted against unrealised gains existing at 31.12.1998 (EUR -39.48 million), expenses arising from payment commitments to the Banco de España employee social welfare scheme (EUR -45.20 million), the transfer to the Beneficent-Social Fund (EUR –8.14 million) and the partial recovery of provisions made in previous years to cover country risk (EUR 3.24 million).

15. Profit for the year

As detailed and explained in the preceding notes, the net profit for 1999 amounted to EUR 4,063.83 million, 37.2 % down on the previous year.

As detailed in the table below, of this amount, pursuant to Royal Decree 1746/99, EUR 1,751.60 million was paid to the Treasury on 1.2.2000. This was the amount necessary, taking into account the advance payment made on 29.11.1999 of EUR 1,905.85 million, to make a total payment of 90 % of the Bank's profit for the period ending 31.12.1999.

(EUR millions)

1. Profit fot the year 1999		4,063.83
2. Payments to the Treasury:		
— on 29.11.1999, 70 % of profit for the year ending 30.9.1999	1,905.85	
— on 1.2.2000, the difference between the above amount and 90 % of the profit for the year ending 31.12.1999	1,751.60	3,657.45
3. Profit pending payment to the Treasury (5)		406.38
TOTAL (2 + 3)		**4,063.83**

IV. SPECIFIC INFORMATION REQUIRED BY ARTICLE 4 OF THE LAW OF AUTONOMY OF THE BANCO DE ESPAÑA

1. Contributions made by the Bank to the Deposit Insurance Funds (Article 4.2 of the Law of Autonomy of the Banco de España of 1 June 1994)

The contribution of the Banco de España to the Deposit Insurance Funds for 1999 is regulated by Article 3 of Royal Decree 18/1982, according to the wording established by additional provision seven of Royal Legislative Decree 12/1995 of 28 December 1995 and Royal Decree 2606/1996 of 20 December 1996, which implemented the legal regime for such funds.

The latter Royal Decree established that the Deposit Insurance Funds may only exceptionally be supplemented by contributions from the Banco de España, the amount of which shall be fixed by Law. In 1999 the Banco de España

5 The remaining amount due shall be paid to the Treasury when the annual accounts for 1999 have been approved by the Government.

made no contributions whatsoever to the Deposit Insurance Funds.

2. Loss of profit

The table below shows the loans outstanding in 1999 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 millions and %)

Average balances on loans outstanding in 1999 with interest rates below the reference rates

Title	Estimated average balance in 1999	Interest rate received	Reference interest rate	Estimated loss of profit
Net State debt	1,083.93	0.00 %	2.71 %	29.37
Loans to the Social Security System	1,840.06	0.00 %	2.71 %	49.87
Housing loans and repayable advances to employees	127.32	1.97 %	2.71 %	0.95
Housing loans	*109.35*	*2.29 %*	*2.71 %*	*0.46*
Repayable advances	*17.97*	*0.00 %*	*2.71 %*	*0.49*
TOTALS	**3,051.31**			**80.19**

Included under the heading «net State debt» is the average balance during the year, on a daily basis, of the special loans granted to the State before 1994 and the deposits held by the Treasury with the Banco de España, when there is a net balance in favour of the latter. The fact that the amount shown under this heading is larger than in 1998, despite the fact that the average balance of the deposits of the Treasury was higher in 1999 as a whole, is a consequence of the greater variability of the latter in 1999, which means that they were below the outstanding balance of the aforementioned special loans granted to the State on more occasions and by a larger amount.

As regards the loans to the Social Security System, transitional provision six of Law 41/99 of 30 December 1994 on the 1995 State budget, when establishing the conditions for repayment of certain loans to the Social Security System, provided that no interest shall accrue on such loans as from 1 January 1995.

Finally, housing loans and advances to employees correspond to those granted under the collective agreement signed by the Banco de España with them.

The reference rate used to estimate the loss of profit is the monthly average of the interest rate on main refinancing operations during the year, the same as used to calculate the monthly interest accruing to the Treasury on the net balance of its account, on the terms established in the agreement with the Banco de España.

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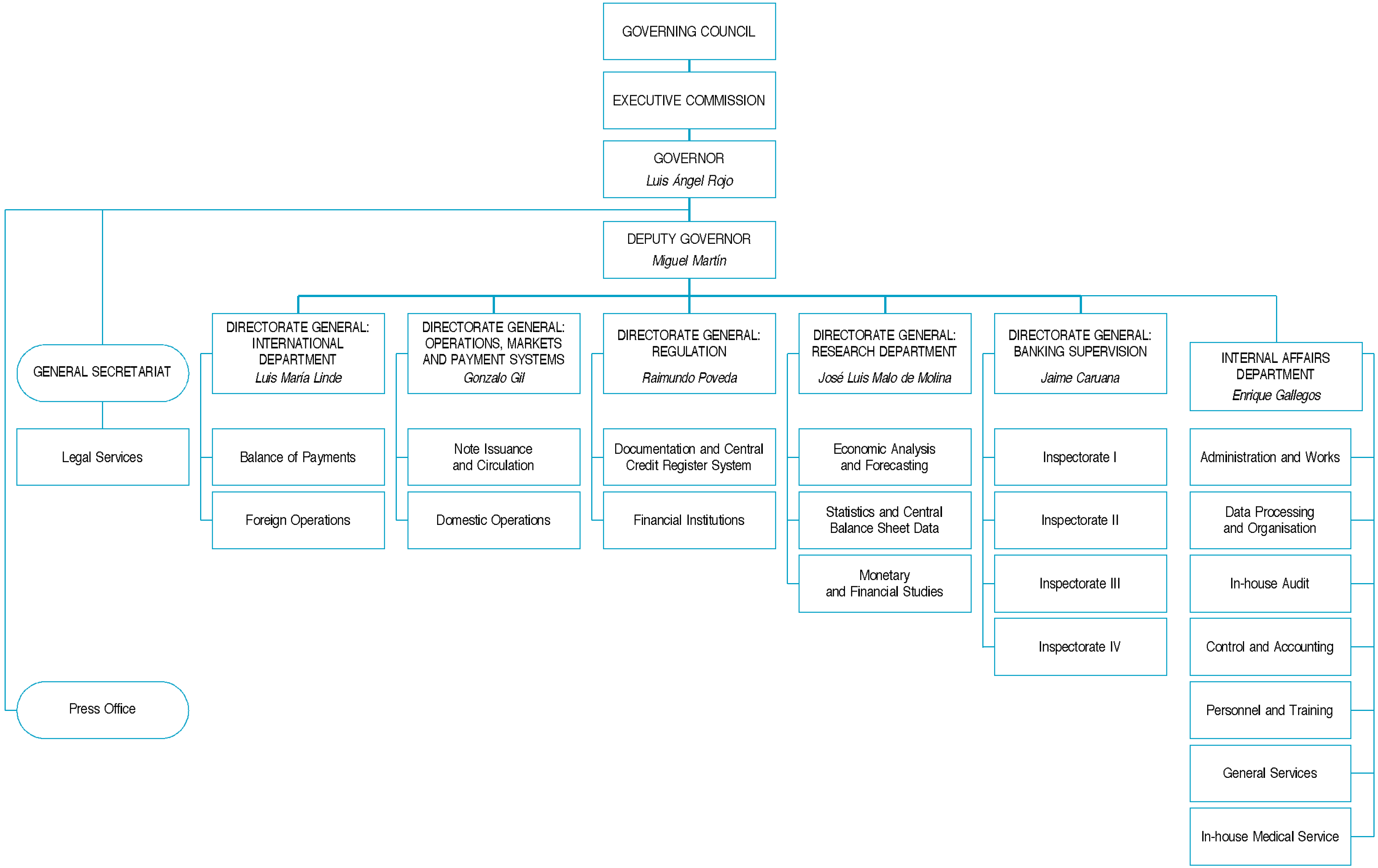

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