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1998

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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 date [January (p)], this means that all the related figures are provisional; after a figure, only said figure is provisional.
pp	Percentage points.
	Annual (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 of the last digit indicated in the series.
*	Series of seasonally adjusted data.

Abbreviations

AIAF	Association of Securities Dealers
BIS	Bank for International Settlements
CNE	Spanish National Accounts
CNMV	National Securities Market Commission
CPI	Consumer price index
DM	Deutsche mark
EAGGF	European Agricultural Guidance and Guarantee Fund
ECB	European Central Bank
ECOFIN	EU Council (Economic and Financial Affairs)
EDP	Excessive Deficit Procedure
EMU	Economic and Monetary Union
EPA	Official Labour Force Survey

ERM	Exchange Rate Mechanism
ERM II	New Exchange Rate Mechanism for currencies of EU Member States outside the euro area
ESA 79	European System of Integrated Economic Accounts (1979)
ESA 95	European System of National and Regional Accounts (1995)
ESCB	European System of Central Banks
ESP	Pesetas
EU	European Union
EU-15	The fifteen current EU Member States
EUR	Euro
EUROSTAT	Statistical Office of the European Community
FIAMMs	Money-market funds
FIMs	Securities funds
FUNCAS	Fundación de Cajas de Ahorros
GDP	Gross Domestic Product
GDP cp	GDP at constant prices
Gen. govt.	General government
GNP	Gross National Product
GVA	Gross Value Added
G7	Group of Seven
HICP	Harmonised index of consumer prices
HF	Households and firms
H1/H2	First/second half
IMF	International Monetary Fund
INE	National Statistics Office
INVERCO	Asociación de Instituciones de Inversión Colectiva y Fondos de Pensiones
IPI	Industrial Production Index
MEFF	Financial Futures and Options Market
MFIs	Monetary financial institutions
MINER	Ministry of Industry and Energy
MMFs	Money-market funds
NBER	National Bureau of Economic Research
OECD	Organisation for Economic Co-operation and Development
PPI	Producer price index
R + D	Research and development
RENFE	National railway company
SEPI	State industrial holding company
SGP	Stability and Growth Pact
SIB	Stock-exchange interconnection system
TARGET	Trans-European Automated Real-Time Gross Settlement Express Transfer system
ULCs	Unit labour costs
VAT	Value Added Tax
WB	World Bank

Contents

CHAPTER I

OVERVIEW

I.1. THE CULMINATION OF CONVERGENCE

The year 1998 was one of particular importance for the Spanish economy. In May, Spain's participation in Stage Three of Economic and Monetary Union (EMU) along with ten other European countries was approved. To be among the founders of EMU after having satisfactorily met the convergence criteria set was a most considerable success. Indeed, it broadens the possibility of drawing the Spanish standard of living closer to that in the more advanced EU economies. The degree of nominal convergence achieved is a step forward in this direction, and the benefits are already being seen. However, for progress in real convergence, fresh efforts will be required to further adaptation of the productive structure and economic institutions to this new setting.

The attainment of nominal convergence has also been accompanied by high growth in GDP and employment, balanced external accounts and a further cut in the budget deficit. These results were initially favoured by the climate of recovery prevailing in the European economies in the first half of 1998. As from the summer, however, the climate abroad began to turn increasingly adverse. The crisis in Russia broke and spread to other transition countries of the former Soviet Union and to certain emerging economies, especially in Latin America, generating great instability on international markets. Moreover, there was a further worsening of the Japanese economy, with the south-east Asian economies showing no clear signs of picking up. The accumulation of all these problems drastically changed the outlook for world growth and intensely impacted certain European economies via a decline in exports and a loss of business confidence.

In Spain, culminating nominal convergence with the EU countries, which has been progressively firmer from 1997 onwards, has entailed a long and complex process. Its attainment became more pressing with the launching of the monetary union project and the signing of the Treaty on European Union in 1992. Under the Treaty, specific requirements of macroeconomic equilibrium were stipulated (alignment of the inflation rate and interest rates with those of the core countries of the area, sustainability of public finances and exchange rate stability) for entry into the group of countries founding monetary union. The path followed to meet these requirements was initially strewn with obstacles; there was great uncertainty and considerable turbulence, and a change in the gearing of the economic policy mix was required to ensure coherence with the stability goals pursued. Correction of the disequilibria was slow at first but gained momentum in the following years as the credibility of the economic policies implemented progressively increased. This was the case both of monetary policy, particularly after autonomy was granted to the Banco de España and direct inflation targeting arrangements were set in place, and fiscal policy, via the introduction of mechanisms to cut public spending and improvements in its control and management.

Thanks to the economic discipline applied, Spain succeeded in meeting the criteria for EMU entry. The reduction of the inflation rate, accompanied by a parallel decline in the outlook for price growth, and the stability of the exchange rate made significant cuts in interest rates possible. Against the background of a fiscal policy aimed at reducing the budget deficit, all these developments favoured consolidation of a sustained growth process driven by private investment and exports. Having passed the convergence examination, which was conducted on the basis of 1997 figures, a new economic policy setting was established for 1998. With convergence attained, the objective was to sustain the stability achieved and smooth the transition to fully-fledged EMU membership, scheduled for 1999. Foreseeably, maintaining stability would be assisted, under the new conditions, by the adjustment of inflation expectations and by the stabilising elements built into public-sector policy as a result of the restructuring of public finances. Nonetheless, for these mechanisms to work it was vital that economic policies should continue to be consistent with the aforementioned objective.

Monetary policy design and execution in 1998 were essentially determined by the need to keep inflation rates low and, at the same time, to smooth the convergence of interest rates towards the level that was to mark the starting point of the single monetary policy. Despite the uncertainty for much of the year over the level of interest rates at which such convergence would be made, it was certain in Spain's case that this would involve a sizeable reduction. Accordingly, the Banco de España decided to administer the cuts in its rates with caution, so that they would be compatible with controlling inflation and with a stable peseta trading around its central ERM parity. True, the international financial crisis affected Spanish markets in the summer months, giving rise to fall in stock market indices and to a moderate widening of the long-term interest rate spread over Germany. But these effects proved transitory. The year ended with a situation of financial stability and a convergence level for short term interest rates of 3 %. This was lower than expected during the year owing to the decline in inflation in the euro zone and to the deterioration in growth expectations for the area as a whole, mainly as a result of the international crisis.

The control of inflation has been the cornerstone of the new framework of macroeconomic equilibrium. In Spain's case, inflation had been strongly entrenched in economic agents' behaviour and in the very institutional mechanisms underpinning the workings of the economy. To alter these constraints, an extensive effort was needed to make the stability-oriented stance of economic policy credible. Progress in recent years has been considerable: after the inflation rate, measured by the CPI, stood at 2 % in 1997, in 1998 it was reduced further, the year ending with average CPI growth of 1.8 % and a 12-month growth rate in December of 1.4 % (see Table I.1). Although these levels are historical lows and compatible with the quantitative definition of price stability adopted by the European Central Bank, the policies on which the low-inflation environment are based need to be strengthened so as to ensure the new situation lasts.

Among the factors that help explain the favourable performance of prices in 1998 is the moderation of wage increases. Nominal wages, which had already slowed substantially in 1997, saw their growth rate decline again in 1998. Behind this development was the abatement of inflation expectations, which have progressively been accommodating themselves to increasingly ambitious inflation targets. Even so, wage settlements pursuant to collective bargaining agreements (2.6 % on average) stood above forecast inflation (2.1 % under the 1998 budget), incorporating a purchasing power gain which was heightened by the fact that actual inflation was finally lower than forecast. In any event, the increase in real wages did not exceed that in labour productivity. The beneficial effect of wage moderation on prices was accompanied by other factors exerting great influence on consumer prices. Notable among these was the moderate behaviour of agricultural prices and, more significantly, the downward effect exerted by external prices, via the decline in commodity and oil prices and the general stability of tradeable goods prices. Nonetheless, despite the good results posted, there were also certain worrying aspects to the price performance in 1998. One such facet is the continuation of widely differing rates of change between different product groups and, in particular, between manufactures and services, prolonging the duality which has marked price formation in the Spanish economy over the past decade.

The ongoing reduction of the budget deficit was favoured by price stability and low interest rates against a background of high GDP growth. The general government deficit fell from 2.6 % in 1997 to 1.8 %, a result on which various factors had a bearing. The fall in interest rates and lower public indebtedness led to a reduction in interest payments. Adding to this was the moderate increase in those expenditure items indexed to inflation as forecast in the budget (lower than in the 1997 budget) and the ongoing control of other current expenditure items, such as government consumption. Finally, economic growth made for a further reduction in unemployment-related expenses. Overall, the weight of general government spending in GDP diminished by half a percentage point, despite the fact that public investment grew substantially above output, giving rise to a restructuring of spending conducive to bolstering the economy's growth potential. On the revenue side, there was a sharp increase in tax receipts, especially those more closely related to business activity. The restraint exerted on certain public spending items by the fall in inflation coupled with the cyclical effects derived from the situation of economic buoyancy, which tend to favour tax takings and to lessen the amount of certain transfer expenses, ease the task of reducing the budget deficit. The benefits resulting from this add to the saving generated by the fall in interest rates when the economy manages to

TABLE I.1

Main macroeconomic variables

	1991	1992	1993	1994	1995	1996	1997	1998
DEMAND AND OUTPUT AT CONSTANT PRICES (a):								
Private consumption	2.9	2.2	–2.2	0.9	1.6	2.0	3.1	3.8
Government consumption	5.6	4.0	2.4	–0.3	1.8	0.9	1.4	1.6
Gross capital formation	1.1	–3.9	–14.0	3.8	8.9	1.2	3.6	10.0
Exports of goods and services	7.9	7.4	8.5	16.7	10.0	10.6	14.8	7.8
Imports of goods and services	9.0	6.9	–5.2	11.3	11.0	7.4	12.2	10.6
Gross domestic product	2.3	0.7	–1.2	2.3	2.7	2.4	3.5	3.8
EMPLOYMENT, WAGES, COSTS AND PRICES (a):								
Total employment	1.0	–1.5	–2.9	–0.5	1.8	1.5	2.7	3.3
Compensation per employee	9.5	10.4	6.8	2.8	3.0	3.9	2.3	1.8
Unit labour costs	8.1	8.0	4.9	0.0	2.1	2.9	1.5	1.3
GDP deflator	7.1	6.9	4.3	4.0	4.8	3.2	2.0	2.2
Consumer price index (annual average)	5.9	5.9	4.6	4.7	4.7	3.6	2.0	1.8
Consumer price index (end-year twelve-month rate)	5.5	5.3	4.9	4.3	4.3	3.2	2.0	1.4
SAVING, INVESTMENT AND FINANCIAL BALANCE (b):								
Resident sectors: saving (c)	21.5	19.6	19.4	19.2	22.3	22.0	22.2	22.5
General Government (c)	*0.3*	*–0.1*	*–3.0*	*–2.5*	*–3.7*	*–1.6*	*0.4*	*1.5*
Resident sectors: investment	24.6	22.6	19.9	20.1	21.1	20.6	20.7	21.6
General government	*4.8*	*4.0*	*4.1*	*3.9*	*3.6*	*3.1*	*3.0*	*3.3*
Resident sectors: national net lending (+) or borrowing (–)	–3.1	–3.0	–0.5	–0.9	1.1	1.3	1.6	0.9
General government	*–4.5*	*–4.1*	*–7.0*	*–6.4*	*–7.3*	*–4.7*	*–2.6*	*–1.8*
Gross general government debt (d)	45.6	48.0	60.1	62.6	65.5	70.1	68.8	65.6
MONETARY AND CREDIT AGGREGATES (a):								
ALP	11.8	6.3	7.7	7.6	10.0	7.2	5.1	1.5
ALPF (e)	12.9	9.6	7.6	10.2	7.3	9.1	9.1	6.8
M2	15.3	5.6	0.1	8.2	4.0	4.9	10.8	11.1
Domestic credit to households and firms	11.1	8.1	4.6	2.9	6.9	7.9	11.2	14.1
Domestic credit to general government	5.5	3.6	10.8	10.4	22.8	7.1	2.2	–8.7
Total financing to general government (f)	13.9	15.1	15.4	16.8	15.9	12.1	9.6	4.1
INTEREST RATES AND EXCHANGE RATES (g):								
Banco de España intervention rate	13.2	12.8	11.3	7.7	8.8	7.5	5.4	4.2
Ten-year government bond yield	…	11.7	10.2	10.0	11.3	8.7	6.4	4.8
Synthetic bank lending rate	16.2	15.6	14.5	10.7	11.5	9.7	7.2	5.9
Peseta/D-Mark exchange rate	62.6	65.6	76.9	82.6	87.0	84.2	84.5	84.9
Nominal effective exchange rate (developed countries)	100.2	98.0	86.6	80.8	80.3	80.9	77.2	76.9
Real effective exchange rate (developed countries)	101.5	101.2	90.6	86.3	87.5	89.3	85.4	85.3

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.
(c) Includes net capital transfers received.
(d) As a percentage of GDP at market prices (GNP Directive).
(e) Includes all ALP – except those issued by general government – plus that portion of the net asset value of mutual funds not included in ALP.
(f) Includes domestic credit to general government, government debt placements with residents and non-residents and foreign direct financing.
(g) Levels.

sustain itself on an expansionary course with price stability.

Broadly speaking, fiscal policy in 1998 may be considered to have been moderately restrictive following the considerable consolidation drive in the two previous years. Combined with the increase in public saving and the reduction in the sector's financing requirements brought about by the very process of fiscal consolidation, this situation contributed to sustaining the climate of confidence in the Spanish economy; it smoothed the way for the additional cuts in interest rates during the year; and, in sum, it continued to make for an environment geared to the growth of private-sector productive investment.

The above-mentioned macroeconomic setting of low interest rates, price stability, balanced gearing of economic policy and heightened confidence owing to Spanish membership of the monetary union was propitious to the expansion of spending by households and firms. As a result, GDP growth in 1998 was 3.8 %, the highest figure this decade. Employment generation was also strong, running at a rate of 3.3 % and culminating a period of progressive recovery in the economy which had begun in 1994. Higher spending by the private sector was financed without problems by the resources generated by the various economic sectors and was compatible with continuing equilibrium on the external accounts.

Household spending on consumer goods and services and on housing strengthened in 1998, backed by the high growth of real disposable income (3.7 %) and by the increase in consumer confidence. The notable rise in household spending capacity was principally the result of job creation and the increase in real wages. Furthermore, interest rate cuts continued to exert an expansionary effect on consumption, especially that of durable goods, and of residential investment. Consumer confidence improved notably during the year, reflecting the increasingly firmer favourable outlook for the Spanish economy. Although this uptrend was checked by the financial turbulence of the summer months, the confidence indicator stabilised at maximum levels in the closing months of 1998 and the beginning of 1999. In any event, the stable growth profile of consumption during the year would suggest that the check on the improvement in confidence levels and a cooling of economic expectations, further to the worsening of the international crisis, moderated the momentum of consumption in the second half of the year, though it ended the year posting average growth of 3.8 %.

The prospect of increasing demand on the part of firms translated into substantial growth in private investment. The corporate sector has faced the current cyclical upturn attempting to square expenditure on expanding productive capacity with intense financial restructuring. The result has been an appreciable improvement in the sector's profitability. Not unrelated to this improvement has been the reduction, over a period of several years, of firms' financial expenses, assisted by interest rate cuts and by the reduced flow of debt. Under these conditions of corporate financial restructuring and of high saving levels in other sectors of the economy, the promotion of investment projects was driven by prospects of high demand at the outset of 1998, which accounts for the strong growth rate in capital investment in that period. As the year unfolded, there was clearly a progressive slowdown in firms' sales and value added (especially in manufacturing). This was linked to the crisis on foreign markets which, along with the stabilising – at high rates – of consumer spending and the worsening of demand prospects arising from the crisis, led to a fall in business expectations in industry and to a slowdown in productive investment. Nonetheless, in annual average terms, investment in capital goods increased by almost 13 % in 1998.

Demand by the households and firms sector was thus on an expansionary course last year, with national demand accelerating from 2.9 % in 1997 to 4.9 % in 1998. This contributed to changing, to some extent, the essentially investment- and export-driven pattern of growth seen in previous years. The change in the make-up of growth was also due to the slowdown in exports of goods and services (the growth rate dipped from 14.8 % in 1997 to 7.8 % in 1998). At the start of the year, sales abroad still retained considerable momentum, despite the fact that they had already begun to feel the effects of the financial crisis in the Asian economies in 1997. However, as 1998 unfolded, exports to the different geographical regions were progressively impacted as the crisis made itself felt, and in the fourth quarter even sales to the rest of the EU diminished. Exports may also have been influenced by the loss of competitiveness of Spanish products on third markets, given the devaluation in the currencies of some of the countries most affected by the crisis and which compete with Spain in certain product ranges.

From the domestic standpoint, manufacturing was the activity most affected by the weakening of the external environment. In addition to inducing a deceleration in activity and a fall in demand expectations in industry, the international crisis prompted a substantial slowdown in the prices of tradeable goods, obliging the Spanish manufacturing sector to moderate its price increases. Given this deceleration in final prices, manufacturing unit labour costs rose somewhat, despite lower wage settlements, and operating margins tended to slow. However, set against this movement in margins, financial charges again declined significantly in 1998 and the profitability of manufacturing firms continued to grow, reaching very high levels.

The expansion of the Spanish economy in recent years has been balanced in a way that has made for sustainability. However, the change in the composition of demand in 1998 (in favour of consumption and construction and at the expense of exports and investment), which became accentuated as from the autumn owing to the strong slowdown in exports, could, if prolonged, result in the medium run in a lesser expansion of productive capacity and greater pressure on prices. So far, the weakening of external demand and, to a lesser extent, of capital investment has translated into a slowdown in GDP; after running at 3.9 % year-on-year at the start of 1998, output growth at the end of the year stood at 3.6 % compared with four quarters earlier. The deterioration in exports has, moreover, given rise to a widening of the trade deficit, which has been influential in reducing the current-account surplus. Consumer prices, after closing 1998 at a 12-month rate of 1.4 %, have surged in the opening months of the year to 2.2 % in March, as a result of the rise in energy prices, the increase in certain food prices and the persistence of systematically higher inflation rates in services.

For 1999 as a whole, exports may be expected to begin to pick up in the course of the second half of the year, whereby their weight in GDP will cease to diminish, investment expectations should improve and the deterioration in the trade balance should be contained. Thus, although it may slow slightly, GDP growth in 1999 will again be above the European average, giving rise to a fresh increase in employment. Once the episodes of price increases affecting food (normally the most volatile component along with energy) are behind, the inflation rate should reflect more closely the behaviour of the more stable factors determining price formation, in particular wage deceleration and the moderation of external prices. That said, this would be conditional upon the rise in oil prices at the outset of 1999 not heightening further and on confirmation of the mild slowdown in consumption.

I.2. THE TRANSITION TO THE SINGLE MONETARY POLICY

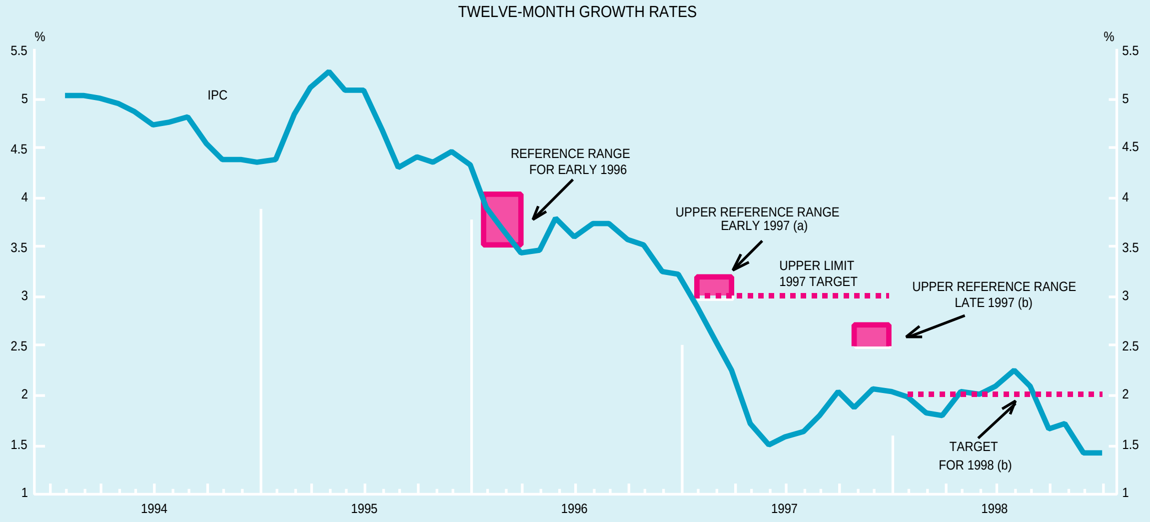
The year 1998 was also singular in that it saw a most important change in the monetary policy regime. 1998 marked the end of a four-year period in which monetary policy had been implemented under a regime of full autonomy, further to the related Statute granted to the Banco de España in June 1994. The end of this period gave way to a new phase involving the application across the euro area of a single monetary policy designed and executed by the European System of Central Banks (ESCB).

The monetary policy implemented over these last four years has, with the other economic policies, contributed to the slowdown in inflation prospects and, in sum, to the attainment of nominal convergence. The adoption from 1995 of a direct inflation targeting framework geared to securing price stability in the medium term has played a key role in bringing about these achievements. During this period the inflation reference values and targets successively set by the Banco de España were progressively met, whereby 1998 concluded with a situation of virtual price stability (see Chart I.1). The success of this strategy was largely due to its ability to influence economic agents' price expectations. That said, the contribution of other factors, such as a more appropriate economic policy mix or structural changes that have added flexibility to the Spanish economy, has also proven vital.

The formulation of monetary policy for 1998 was conditioned by Spain's foreseeable incorporation into EMU. Consequently, the design of targets for the year and their implementation were made taking into account two types of consideration. One was the requirement to keep inflation rates low, in step with the prevailing direct inflation targeting framework. And the second, the advisability of steering a smooth transition towards a single monetary policy that would enable the Spanish economy's monetary conditions to be aligned with those of the countries making up EMU. On the first issue it should be recalled that the entrenchment of low inflation rates had to be brought about in a setting in which, following the reduction of interest rates since 1995, there had been an easing of monetary and financial conditions, which had exerted an expansionary effect on aggregate demand. As for the second matter, the Banco de España intervention rate significantly stood, at end-1997, 1.5 percentage points above the official rates of the lowest-inflation EU members. As a result, the convergence of short-term interest rates in late 1998 meant that further substantial – although uncertain – cuts had to be made. From the spring onwards, the expected level of interest rates at the outset of the Union was successively pared, owing to the uncertainty generated by the spread of the crisis on international financial markets and to its pos-

CHART I.1

Year-on-year inflation
Targets and reference ranges



Source: Banco de España.

(a) The CPI growth rate was, in the opening months of 1997, to be close to 3%.
(b) The twelve-month inflation rate was, at end-1997, to be close to 2.5 %, and around 2 % during 1998.

sible contractionary effects on global economic growth.

Bearing these considerations in mind, the Banco de España set a target for 1998 which involved holding the 12-month growth rate of the CPI at close to 2 % over the course of the year. A goal of this nature was considered suitable for consolidating price stability in the Spanish economy and close, in all certainty, to the price stability target that the European System of Central Banks would have to set. The transition towards a single monetary policy was thus smoothed. It was sought to pursue this objective during the year by means of cautiously administering the leeway for lowering intervention interest rates, with the aim of entrenching lower inflation rates against the above-mentioned background of sustained output growth.

Nonetheless, the capacity of monetary policy to influence Spanish prices in the transition towards the single currency was clearly increasingly constrained. Indeed, any deviation by the Spanish inflation rate from the European average would have to be corrected via the contractionary effects of the resulting losses in competitiveness. Consequently, as the proximity of integration into the euro area gradually eroded the margin for autonomy of Spanish monetary policy, it became more important for the other economic policies to improve their contribution to attaining price stability. Specifically, policy had to adjust to the terms laid down in the Stability and Growth Pact and undertake the structural reforms needed to make the Spanish economy more flexible and competitive.

The Banco de España was, in 1998, also closely involved in the complex decision-making process behind the launching of the euro and the start-up of the ESCB's single monetary policy (see Box I.1). Further, the Bank continued working in co-operation with financial intermediaries to adapt the monetary implementation arrangements to the operational framework being designed for the future single monetary policy. Thus, throughout the year, the most suitable timing for the introduction of these instruments and of the related procedures was gradually defined so that financial institutions could familiarise themselves with the methods to be used later by the ESCB, as explained in chapter two.

The favourable inflation performance and price outlook were propitious to drawing Spanish monetary conditions closer to those that would prevail at the start of EMU. The Banco de España intervention rate was cut by 1.75 percentage points in 1998 to 3 %. The succession of cuts intensified as the year elapsed, reflecting the growing importance that external constraints were acquiring in the Banco de España's decisions. The last of these cuts, for a total of 50 basis points, was on 3rd December. It was the outcome of concerted action by the

BOX I.1

Main measures adopted in 1998 for the introduction of the single currency

Date		Measures	
Month	Day	Origin	Content
March	25	European Monetary Institute	Convergence Report
		European Commission	Convergence Report
April	**28**	**Spanish Parliament**	**Law 12/1998 on the amendment of the Law of the Autonomy of the Banco de España**
May	1-2	European Council	Decision on the Member States to adopt the euro
			Establishment of the irrevocable conversion rates for the euro
		ECOFIN	Recommendation on the designation of the members of the ECB Executive Board
	3	European Council	Regulation on the introduction of the euro
	11	European Parliament	Opinion on the appointment of the ECB Executive Board
June	1	European Council	Establishment of the ECB
July	7	European Central Bank	Decision on the denominations, specifications, reproduction, exchange and withdrawal of euro banknotes
September	1	ECB/NCBs of non-participating Member States	Agreement on the Exchange Rate Mechanism II for countries with a derogation (ERM II)
		European Central Bank	Statistical Requirements for Stage Three of Monetary Union (Implementation Package)
	18	European Central Bank	Release of the General Documentation on ESCB monetary policy instruments and procedures
	28	Informal ECOFIN	Announcement of ERM II fluctuation bands
October	13	European Central Bank	Agreement on the ESCB monetary policy strategy
			Definition of “price stability”
			Eligible assets for ESBC operations
	16	European Central Bank	Financial Institutions subject to minimum reserves
	30	**Banco de España**	**Circular 9/1998 on the amendment of the rules governing the National Electronic Clearing System**
Nobember	23	ECOFIN	Regulation concerning the application of minimum reserves
			Regulation concerning the powers of the ECB to impose sanctions
			Regulation concerning the collection of statistical information by the European Central Bank
December	1	European Central Bank	Regulation on the application of minimum reserves
			Regulation concerning the consolidated balance sheet of the Monetary Financial Institutions sector
			Announcement of the reference value for monetary growth
		ECB/NCBs	Agreement on TARGET
		Eurosistem	Guidelines on single monetgary policy instruments and procedures
	3	NCBs of the Eurosystem	Co-ordinated reduction of Member States’ interest rates
	11	**Banco de España**	**Resolution of the Executive Commission on the adoption of general clauses applicable to monetary policy operations**
	17	**Spanish Parliament**	**Law 46/1998 on the introduction of the euro**
	22	European Central Bank	Announcement of interest rates applicable to the monetary policy operations of the Eurosystem
	23	**Banco de España**	**Circular 11/1998 on the adaptation of the Money Market Telephone Service to TARGET**
		Ministry of Economy and Finance	**Royal Decree 2813/1998 on the redenomination of public debt in euros**
	31	European Council	Adoption of the irrevocable conversion rates for the euro
		European Central Bank Danmarks Nationalbank Bank of Greece	Fixing of central and compulsory intervention rates for the currencies participating in ERM II

Note: Measures adopted in Spain as opposed to at the European level are in **bold** print.

euro-area central banks, in response to conditions across the area, where inflation developments were not jeopardising price stability and the growth rate was tending to decelerate, mainly as a consequence of the conditions prevailing in the international environment. With this decision, the level of interest rates for the start of Monetary Union was set in advance, in accordance with the monetary policy strategy pre-announced by the European Central Bank (ECB). These conditions prevailed until 8th April 1999, when the ECB made a further cut of 50 basis points, in response to the firming of price stability and worsening growth prospects in the area.

The interest rates and exchange rates of the euro-area countries were scarcely affected by the growing instability of the international environment that became perceptible as from the spring of 1998. The cancellation of investment in emerging economies and the switching of funds towards dollar- and DM-denominated instruments (both traditionally considered as safe-haven currencies) and towards government bond purchases prompted a significant increase in volatility on international stock and currency markets. Such volatility abated only in the final quarter of the year, against a backdrop of more accommodating international monetary conditions accompanied by certain international pledges of financial aid to the restructuring programmes of the economies most affected. The bout of instability on financial markets was accompanied by a deterioration in the outlook for world economic growth which would last until the opening months of 1999.

In the countries that would finally make up the euro area, the crisis was mainly manifest in a downward revision of interest rate expectations, motivated by the worsening growth forecasts for the European economies, which accentuated the downward course of long-term interest rates and prompted successive cuts in the interest rates foreseen for the start of the third stage of EMU. Moreover, European stock markets were buffeted by short-lived but very intense bouts of volatility, and the fixed-income markets showed a certain misalignment of long-term interest rates. But these had no distorting effect on the convergence process that would culminate at the end of the year.

The exchange rates of the currencies to form the euro area were very stable throughout 1998. This can be linked to the successful culmination of the process of nominal convergence that had been set as a requirement for constituting EMU and to the credibility of the pre-announcement in May of the fixed exchange rates for the currencies that were to participate in the third stage of Monetary Union. Under these conditions, the euro-area currencies gradually moved closer to their central parities against the D-Mark as the start of Stage Three drew nearer and the spreads between short-term interest rates narrowed.

Interest rates on Spanish financial markets and the exchange rate of the peseta adjusted well to this general pattern of behaviour. The reduction in Banco de España intervention rates was accompanied by cuts in money market interest rates, which remained on the falling trend seen in previous years (see Chart I.2). The downtrend in long-term interest rates was determined by certainty about Spanish participation in EMU and by the expectations about the monetary policy stance at the start of Stage Three. Hence, after the narrowing early in the year of the long-term interest rate spread over the low-inflation European countries, the 10-year spread over the D-Mark fluctuated around 20 points, at which level it has held since the euro area came into being. The exchange rate of the peseta, for its part, moved smoothly closer to its pre-announced central parity.

In sum, the transition to the single monetary policy during 1998 unfolded smoothly. The convergence of short-term interest rates and the approximation to the fixed conversion rate both came about in a way that allowed the expansionary effect of progressively easier monetary conditions on aggregate demand to be moderated. The inflation rate was also maintained, standing at year-end slightly below the 2 % threshold set under the monetary programming exercise for 1998.

I.3. THE START OF SPANISH PARTICIPATION IN EMU

Participation by the Spanish economy in the euro area is the culmination of a process of international integration which began in the mid-eighties following accession to the European Community. The benefits of integration have been numerous and have had a bearing on the more competitive behaviour of the Spanish markets for goods and capital. Against this background, the conditions of nominal stability needed to ensure a sustained, non-inflationary growth path have been laid down, and Spanish per-capita income levels have drawn somewhat closer to those of the more prosperous EU countries. That said, in 1998 Spanish GDP per capita stood at 79 % of the related Community figure and a set of indicators measuring the growth potential of the economy continued to fall short in relation to those of the EU (see Box).

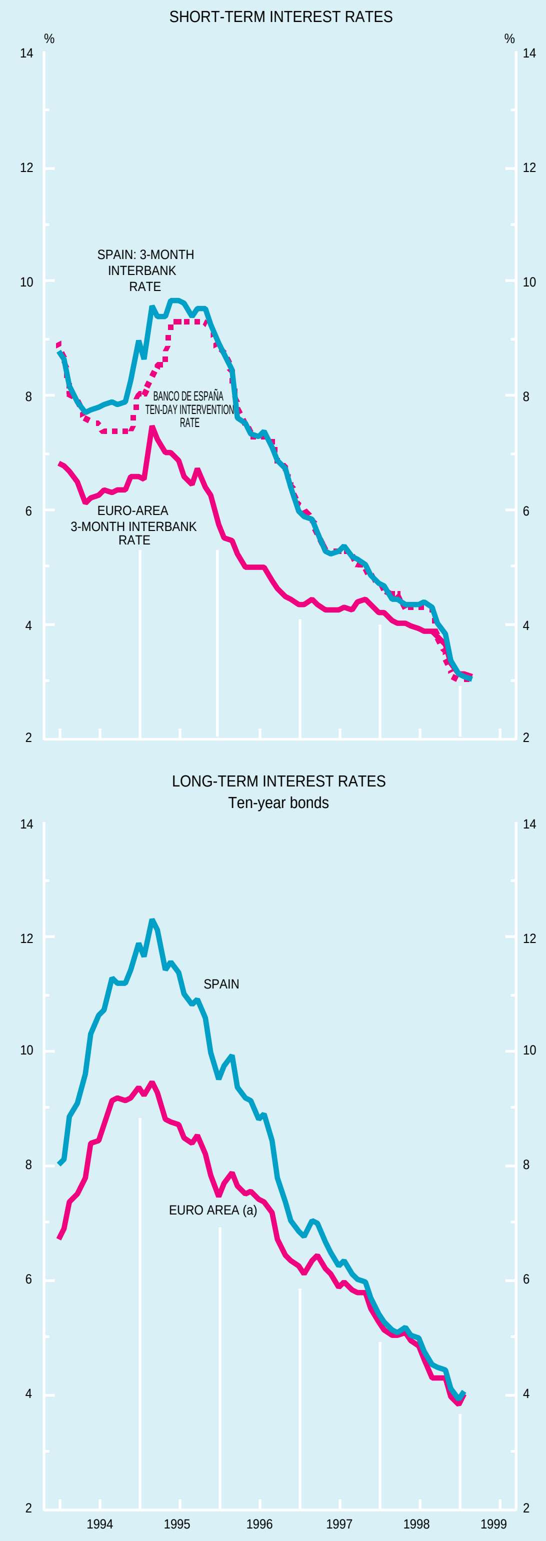
The starting position of the Spanish economy in EMU is, in principle, a suitable one for making progress in real convergence. As seen in previous section, convergence towards stability has made for output and employment growth at satisfactory rates. There are, however, certain downside risks on which economic policy efforts should focus in the immediate future.

The common monetary conditions arising from the monetary policy implemented by the Eurosystem with a view to the area as a whole may prove relatively loose for the Spanish economy's current economic circumstances. Real short- and long-term interest rates in Spain are standing at historically low levels of between 1 % and 2 %, and residents' liquid financial assets, along with the financing received by households and firms, have continued to post high growth rates. Such a situation might lead to excessive growth in domestic demand being financed and to the generation of upward pressures on prices. These risks arise not only from the more advanced position along the cycle of the Spanish economy compared with other euro-area countries, but also from the scale of the expansionary boost stemming from the interest rate cuts made over the last three years. As in other EU countries, the reduction of rates had to be sharper in Spain since it was departing from a less favourable inflation situation and from a higher level of nominal interest rates. Adding to this is the absence of a sufficiently entrenched culture of stability in agents' behaviour, owing to the recentness of the new low-inflation regime.

Such a setting has come about without the Spanish inflation rate, measured on the basis of the 12-month growth of the consumer price index, coming to be on a fully equal footing with that of the euro area, despite its having been substantially reduced in recent years. The inflation convergence criterion under the Maastricht Treaty stipulated a maximum difference of 1.5 percentage points in relation to the annual average inflation of the three best performing countries in 1997. The Spanish inflation rate met this requirement comfortably and has since held within this limit. However, during 1998, the growth rate of the harmonised index of consumer prices (HICP) for Spain ran systematically higher than that of its euro-area counterparts, and by March 1999 a difference of 1.1 percentage points in terms of respective 12-month rates had built up. The persistence of positive – even if limited – inflation differentials might, insofar as they reflect a worse relative performance by costs or rigidities in the workings of the market for goods, services and factors, ultimately have harmful repercussions for competi-

CHART I.2

Interest rates



Source: Banco de España.

(a) Interest rates calculated using GDP-weighted national interest rates.

tiveness in the context of the single currency in the euro area.

The inadequate alignment of the Spanish growth rate for prices with those of other countries in the area is essentially due to the limited adjustment of services prices. The growth rate in this sector is more than two points above the related 12-month rate for goods prices in Spain and two points above that for services in the euro area (see Box). The duality of Spanish inflation thus remains in place, although the latest information also points to a certain deterioration in the prices of industrial goods and in the related inflation differential.

There are several reasons for this behaviour, first among which is a higher growth trajectory in unit labour costs in the services sector, especially when commercial and financial activities are excluded. The relative rise in the cost of the labour factor in this sector stems from the combination of a situation of lower productivity gains than in the manufacturing sector and from centralised wage bargaining arrangements, which tend to unify wage increases across sectors and to weaken the link that should exist between wages and productivity (see Chart I.3). The prevalence of this model of behaviour has diminished in recent years. This has been due to the downward effects exerted on average wages by high employee turnover in the services sector, which has tended to offset the lack of adjustment of wage settlements to productivity, and to a narrowing of productivity differences across sectors. Nonetheless, the duality of Spanish inflation continues to evidence the persistence of the distortions derived from the current characteristics of the cost formation process.

It is difficult to identify with any certainty the determinants of productivity differences across sectors, given the diverse factors combining in these types of processes. In principle, the positive impact exerted by technological progress on labour productivity in the manufacturing sector, which arises because of its capital-intensive productive structure and as a result of the incentives to innovate in the face of exposure to competition, might explain the sector's higher relative growth of productivity. However, the Spanish case appears to be highly influenced too by the differential behaviour of employment; in manufacturing, employment has tended to react with greater intensity during cyclical downturns, determining more marked growth in actual labour productivity. This feature, which is largely due to the costs of employment adjustment in manufacturing, appears to have been of somewhat less significance than in the recent period.

A second reason for higher inflation rates in the services sector is the greater presence of markets sheltered from competition. This allows higher operating margins that are insensitive to market conditions to be sustained, leading to greater permissiveness in the face of cost increases and an inadequate feed-through of the ongoing advances in cost moderation. That contrasts with the pattern in the manufacturing sector. There, the need to align final price increases to those determined on international markets has limited the pass-through of cost increases, prompting significant adjustments in unit margins and, ultimately, more moderate price growth (see Chart I.4).

Such differing behaviour is further entrenched by the differences in the final destination of output in both sectors. The supply of services is, predominantly, for consumption on domestic markets relatively sheltered from foreign competition. That weakens the pressure exerted, in the manufacturing sector, by the need to compete with foreign products on domestic or international markets. The impact of this effect is heightened, moreover, by the very regulations governing the markets for certain services, where liberalisation is lagging compared with goods markets. In some cases, this relative lag is due to the very nature of certain services activities, which have had to be organised in a rather uncompetitive manner. In other cases, however, excessive regulations or more or less explicit barriers to entry are the cause of the lack of flexibility of services prices.

In this respect, mention should also be made of the high sensitivity of the prices of certain tertiary activities to the behaviour of the prices of property and of renting commercial and office premises. Here, price formation in services is affected by the insufficient regulation of the market for land use, which severely constrains supply and ultimately generates upward pressures on property and rental prices, especially when the cost of financing is low. Thus, the well-known adverse effects that the inefficiencies of the market for land use have on occupational mobility and wage-setting are exacerbated by the inflationary biases acting on the behaviour of services prices.

It should be borne in mind that the upward propensity of services prices may ultimately affect profitability in industry and feed through to the rest of the economy. It may do this either directly, via the rise in the price of the services used as production inputs in other sectors, or indirectly, through the influence exerted on the overall behaviour of wages, owing to the weight of services in consumer purchases.

BOX I.2

Spain vis-à-vis Europe: real convergence

The real convergence of the Spanish economy, understood as the approximation of its level of per-capita income to the levels prevailing in the more advanced European countries, has been one of the main objectives pursued by Spain: initially through integration into what is today called the EU, and subsequently through participation in EMU.

The relative position of the Spanish economy in 1986 (when it joined the European Community), in terms of a set of variables approximating its level of welfare and its growth potential vis-à-vis the EU, is summarised in Chart 1 below (starting position). In 1986, Spanish per-capita GDP stood at 69 % of EU GDP. This level was due both to the lower level of apparent labour productivity (95 % of that of the Community countries as a whole) and to the low proportion of the population employed in the Spanish economy (73 % of the related Community rate).

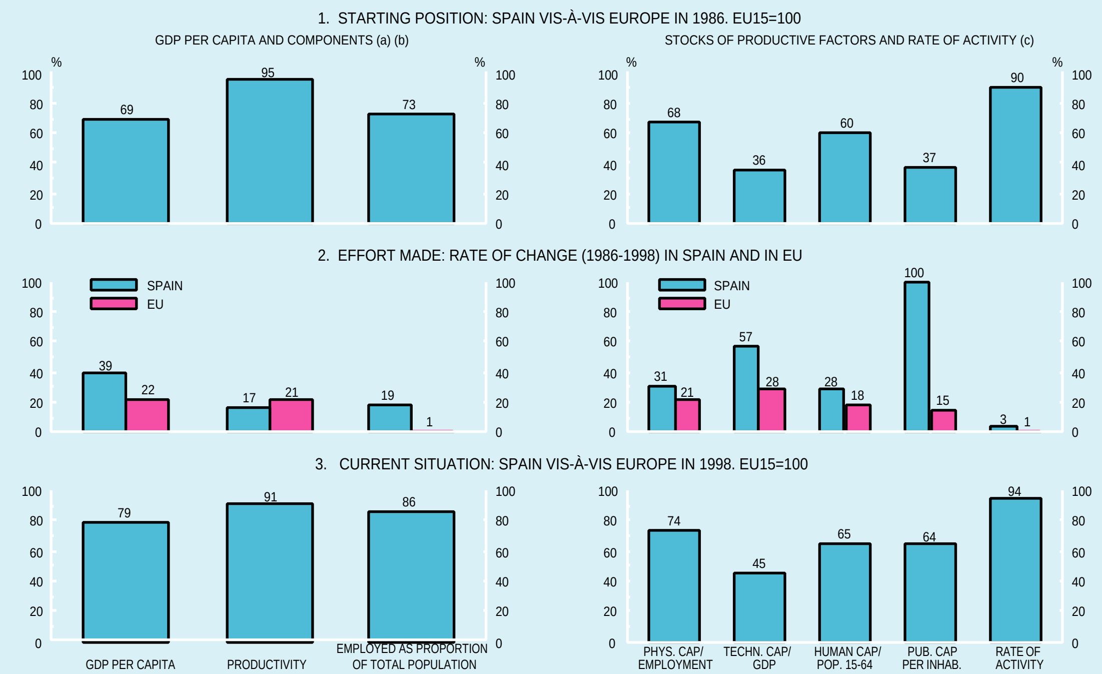
Chart 1 below also shows the comparative level, in 1986, of some of the indicators of the determinants of labour productivity, such as the stocks of physical, human, technological and infrastructure capital (the latter approximated via an indicator of the public capital stock). The relative position of each of these components was, as can be seen in the chart, at a considerable disadvantage to the EU-wide figure.

In the 1986-1998 period, the drive by the Spanish economy to reduce these differences was substantial. This is reflected below in Chart 2 (effort made), which shows the cumulative rates of change for Spain and the EU of the variables depicted in Chart 1. During this period, Spanish per-capita GDP grew 39 %, 17 percentage points above the related increase in Community per-capita GDP. This increase was due to similar growth in productivity and in the employment rate (17 % and 19 %, respectively), while in the EU the expansion of GDP was due almost exclusively to the growth of labour productivity.

The headway made in labour productivity has been the outcome of improvements in the endowment of the rest of the productive factors. This has been reflected in a build-up in the related stocks which was greater in this period than that of the EU as a whole. Of particular note has been the growth of the public capital stock, which has meant a most significant improvement in infrastructure. The increase in the stock of technological capital has been most notable, although the starting levels were extremely low, and investment in R+D remains very low in relation to the EU (0.8 % of GDP for Spain and 1.8 % of GDP for the EU).

It should be noted, however, that progress in employment creation by the Spanish economy during the period under review has, though substantial, not sufficed to reduce significantly the unemployment rate. Spanish unemployment is still eight percentage points above the European average, since there has been a sizeable growth in the labour force. This but partial improvement in the labour market situation not only reflects rigidities in this market, but also indicates still-inadequate productivity factor endowment, thereby preventing full harnessing of the possibilities provided by potential employment. Further, the growth of productivity has been less than in the EU as a whole, although the trend across sectors has differed greatly. Thus, while the increase in productivity in the services sector has been virtually zero, in the manufacturing branches it has been close to 30 %.

Nonetheless, and despite the efforts made, the distance separating the Spanish economy from the levels of welfare of the most advanced Community countries is still wide, as Chart 3 (current situation) shows. Thus, in 1998, Spanish per-capita GDP stood at a level of 79 % of Community GDP, the result of a worse relative position of labour productivity in relation to the 1986 situation. However, this has been offset by an increase in the proportion of the population in employment. Stocks of productive factors, which indicate the economy's growth potential, continued to show Spanish levels at a disadvantage to the EU.



Sources: Stocks of productive factors: Dep. Estudios Europeos, FUNCAS. Other: Eurostat.

(a) GDPcp and productivity at constant prices and in PPS, based in 1990. GDP not adjusted for exhaustiveness. On provisional data, Spanish GDPcp, adjusted for exhaustiveness, is at 80.4 % of the related Community figure.
(b) Rate of employment: employed as a proportion of total population.
(c) The latest year available for the stocks is 1997.

These cost- and price-formation problems become more pressing in the light of the relatively easy monetary and financial conditions marking the Spanish economy at the outset of EMU and given the change in the structure of final demand arising as a result of (i) the decline in exports, induced by the international economic crisis, and (ii) the buoyancy of private consumption and construction spending. The persistence of the inflation differentials with the euro area might jeopardise the economy's possibilities of non-inflationary growth and, therefore, of progress in real convergence.

So that the Spanish economy may draw closer to the average levels of income and well-being in the euro area, two things will be necessary. First, Spain must maintain persistently higher rates of growth than the area as a whole, without demand pressure eroding the competitiveness of national output. And further, growth in employment must be intensive enough to absorb progressively the greater level of unemployment still besetting the Spanish economy.

For these goals to be attained, the demand policies retained under national sovereignty should be geared to offsetting, in the short run, the expansionary effect of the monetary and financial conditions prevailing. Also, supply-side policies should be pursued with a view to promoting the growth potential of the Spanish economy and competitiveness, in keeping with the new setting arising from the creation of EMU. In this respect, the implementation of the single monetary policy virtually limits the range of demand policies available to national economic authorities to fiscal policy, and heightens the importance of the contribution that supply-side policies will have to make in adapting the Spanish economy to EMU.

Fiscal policy management will have to be geared to compliance with the commitments made under the Stability and Growth Pact. The Pact has been designed to reinforce the stabilising nature of fiscal policy in the euro area in the medium term and to define thereby the fiscal discipline framework in which the single monetary policy will have to be pursued. The EU countries have undertaken to bring their budgetary positions closer to equilibrium over the medium term so that fiscal deficit/GDP ratios throughout the cycle are always below the 3 % threshold. The Stability and Growth Pact thus provides some leeway for the built-in stabilisers to operate in periods of slowing activity.

Under these constraints, Spanish fiscal policy should act in the short term to offset the expansionary effect derived from monetary and financial conditions and thus ease the pressure from demand on prices and competitiveness. The implementation of a tighter fiscal policy will ease adaptation to the new personal income tax arrangements, which will involve a significant reduction of the tax burden, on an as yet somewhat uncertain scale. And, at the same time, it will smooth transition towards the balanced budget position, the attainment of which is envisaged under the Stability and Growth Plan for the year 2002, allowing counter-cyclical room for manoeuvre to be had should its use be necessary in the medium term. Lastly, a stability-oriented fiscal stance focused on the tight control of spending will contribute to shaping a suitable economic policy mix from the standpoint of the composition of final demand. And it will also make for more efficient allocation of resources, given that the maintenance of low interest rates and of moderate growth rates in government consumption will have a favourable impact on investment, exports and prices. In the medium and long term, budgetary policy should continue to rationalise public spending and, in particular, to adjust those spending components which, for structural reasons, are more prone to overrun in the future.

Supply-side policies will have to play a key role in preventing the persistence over time of inflation differentials which, by eroding competitiveness, may hamper economic dynamism and employment generation. These policies should, firstly, promote the expansion of economic growth potential, through the development of infrastructure, human capital formation, incentives for innovation and greater technological investment. Further, they should push through the necessary changes in regulations and in the structure of the markets for goods, services and factors so as to break the inflexibility underlying the persistence and excessive duality of inflation.

It will be of particular importance in this connection to further and deepen the programme of liberalising reforms already under way, so as to eliminate the persisting distortions in cost and price formation. To date, this process has been based on structural reforms in the sectors and markets with the biggest working shortcomings, on a relatively extensive privatisation policy and on the bolstering of competition policy. Also under this heading are the measures adopted by the government in April, affecting a range of sectors and activities overly sheltered from competition. These measures are two-pronged: some are more structural, and mainly involve bringing forward the timetable for liberalisation previously set for certain sectors; others have a more short-term effect, with an immediate bearing on the inflation rate by directly reducing certain regulated prices.

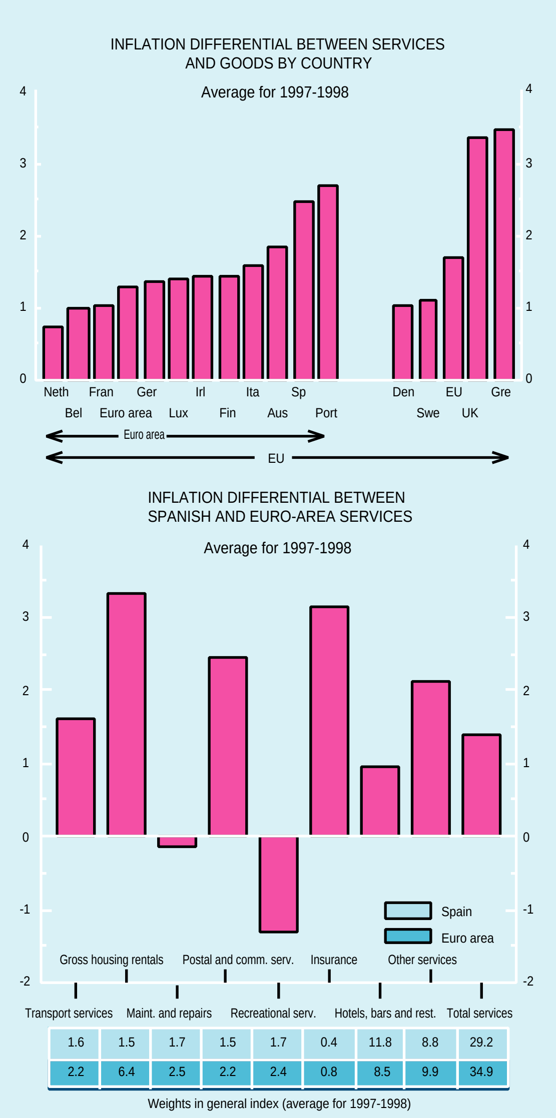
BOX I.3

Inflation differentials with the euro area in the services sector

The phenomenon of dual inflation, understood as the systematic tendency of inflation rates to be higher in non-tradeable goods sectors (largely those engaged in providing services) than in tradeables sectors (essentially those that produce goods), is a feature common to various developed economies. Theoretical models coincide in that a significant explanatory factor of this differential lies in the productivity differences between goods sectors respectively exposed to and sheltered from competition. Yet it is a much more complex task to detect the ultimate causes of the observed discrepancies (technological progress, a shift in economic agents' preferences towards the demand for non-tradeable goods, public-sector measures, inefficiencies in factor and product markets, etc.). Another key factor for explaining dual inflation is the different competitive environment of both sectors, which alters the capacity to adapt final prices to costs incurred. In this respect, the services sector, which is scarcely exposed to foreign competition, evidences high price-setting power.

In any event, the intensity of inflation duality differs from country to country, just as sectoral trends in productivity and the degree of competition in product and factor markets differ. The adjoining top chart shows the average inflation differential between goods and services in the various EU countries for the years 1997 and 1998. Since national consumer price indices have notable methodological differences, this box uses the harmonised indices of consumer prices. These, though not problem-free, are considerably more suitable for making international price comparisons. The chart shows that the growth rate of services prices is higher than that of goods for all the countries considered. The average differential in the euro area is 1.3 percentage points (pp), rising to 1.7 pp in the EU. Spain, with a differential of 2.5 pp, lies second to Portugal in the euro area in terms of the highest degree of inflation duality. In the EU it ranks fourth, additionally behind the United Kingdom and Greece. Greater inflation duality in Spain is basically the result of high rates of increase in services, which are out of kilter with price-formation patterns in other EU countries. Thus, the average growth of services prices in Spain amounted to 3.6 %, against 2.2 % in the euro area as a whole. Meantime, the average increase in goods prices in Spain was 1.1 %, only two-tenths of a point above euro-area prices.

Degree of inflation duality

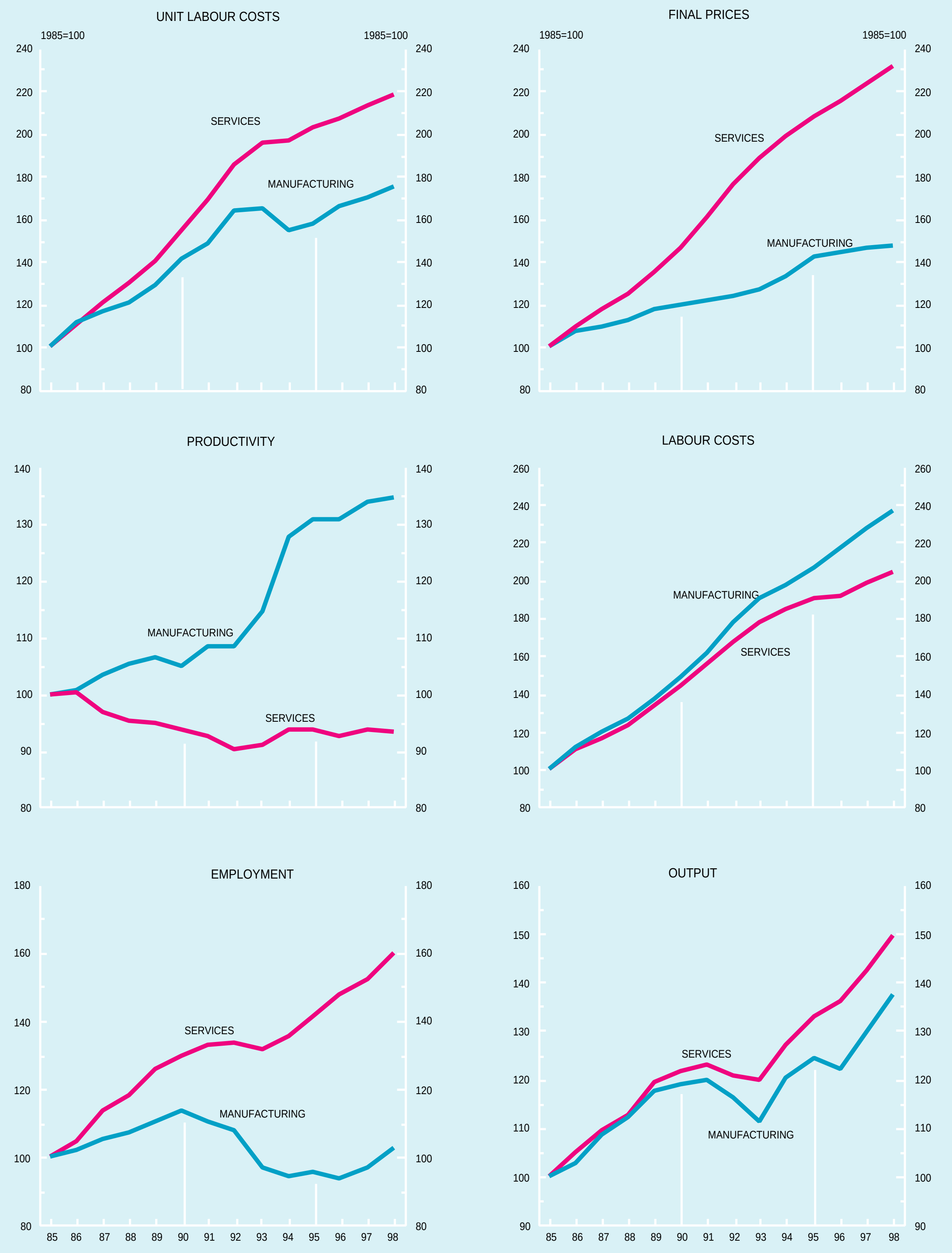


Source: Eurostat.

The higher growth rate of services prices in comparative terms does not, however, affect all its components to the same extent. The bottom chart duly gives average differentials in the period 1997-1998 between Spain and the euro area for certain specific groups of services. It should be borne in mind when interpreting the chart that the uniformity of the underlying information, despite harmonised indices being used, is not absolute. In any event, the chart highlights the heterogeneity existing between price growth rate differentials. Some activities, such as recreational services, hold at price-growth rates lower than in the euro area as a whole and others, such as hotels, bars and restaurants, maintain positive but moderate differentials. Of greater concern are the towering differentials in sectors where liberalising measures have as yet proven insufficient (postal services and communications, transport services), or in the case of rentals and insurance, although this assessment should be qualified by certain sectoral considerations. Hence, the difference in the growth rate of insurance prices relates, at least partially, to recent rises in indirect taxation. And in the case of telecommunications, differences may be due to the fact that price reductions as a result of greater competition between operators have not yet fed through, for methodological reasons, to consumer price indices.

CHART I.3

Prices and costs in manufacturing and services (a)

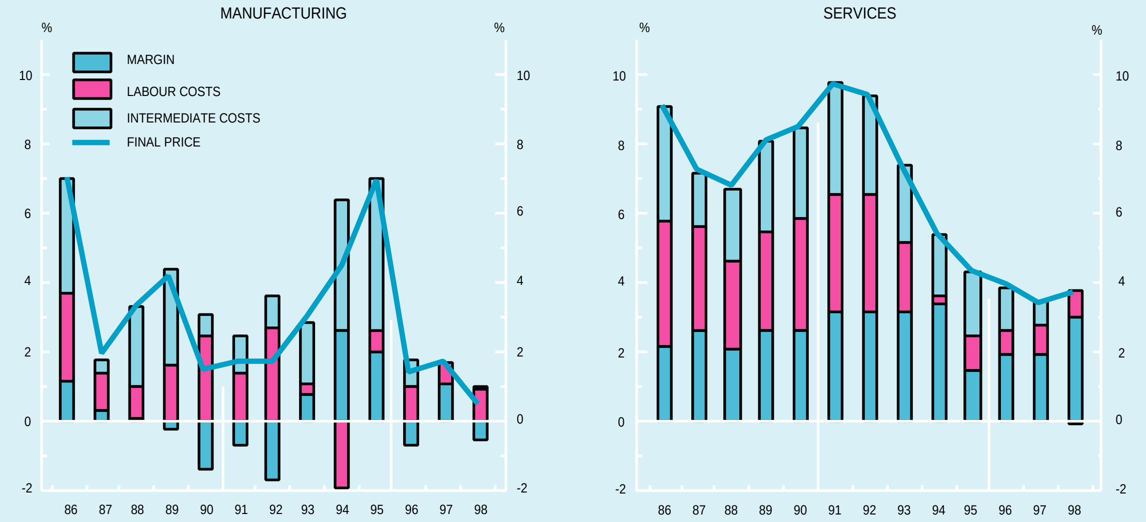


Sources: Instituto Nacional de Estadística and Banco de España.

(a) Calculated by the Banco de España on the basis of quarterly indicators. The services aggregate excludes, in addition to non-market services, financial services and distribution. There has been high productivity growth in this latter branch in recent years.

CHART I.4

Cost and margins in manufacturing and services (a)
Contributions to the growth of final prices



Sources: Instituto Nacional de Estadística and Banco de España.
(a) Calculated by the Banco de España on the basis of quarterly indicators.

The liberalisation policies have begun to bear fruit, especially in the public services sector, which was more regulated and subject to greater degrees of monopoly. Nonetheless, to bring about the necessary transformation, policy measures must be deepened and extended with a medium and long-term perspective. Thus, in the telecommunications and gas sectors, a definitive boost must be given to liberalisation to heighten the level of competition. Progress must also be made on the regulation of land use, retail trade and road haulage, where co-operation from regional and local government is pivotal. Lastly, it will be necessary to refine certain aspects of the legal system which have an adverse effect on economic activity through the uncertainty they cause in connection with the cost of certain legal processes, through hampering debt collection or through making the administrative charges levied on businesses excessively complex.

The labour market reforms of recent years have also been in the right direction. The Spanish economy's capacity to generate employment has perceptibly increased and, over the past year, stable employment has progressed in response to the regulatory amendments aimed at promoting this type of employment. Nonetheless, the unemployment rate and the proportion of temporary to permanent employees remain very high. The gap between the respective costs of permanent and temporary hiring is still significant, especially as regards their non-wage component. In this respect, a conclusive boost to permanent hiring and the success of the new hiring arrangements being pursued to this end will only be achieved when effective, lasting cuts are made to permanent hiring costs.

Lastly, the contribution of wages will be decisive for ensuring the Spanish economy's continuing competitiveness within the euro area. As indicated in the first section of this chapter, wage moderation has spread to all sectors of the economy and, in recent years, to services. The successive labour market reforms have had a particularly marked impact in services in bringing about a greater degree of labour turnover and lower wage settlements over the recent period. Nonetheless, containing labour costs in services may still be insufficient from the standpoint of the sector's productivity gains. Further, to prevent wage costs in Spain from compromising competitiveness, wages should desirably take inflation in the euro area as a whole as a reference, duly adapting to productivity differences across sectors or businesses.

In short, the Spanish economy has moved into EMU under favourable economic conditions for reducing the per capita income differences with the more prosperous member states. To ensure further progress, however, the risks of a loss of competitiveness derived from the persistence of duality in price formation must be eliminated, such duality being the main cause why Spain is running higher inflation rates than in the area as a whole.

Overcoming the risks that losses of competitiveness might entail for output and employment growth will require budgetary policy to accentuate its stabilising functions so as to lessen the accommodating character of the common monetary policy. Above all, however, the supply-side policies aimed at increasing growth potential and competitiveness must be reinforced, extending and completing the liberalising reform of the markets for goods, services and factors.

CHAPTER II

THE EURO AREA AND THE EXTERNAL ENVIRONMENT

II.1. INTRODUCTION

In 1998 the developed countries generally continued to post high growth rates, with the clear exception of Japan, which remained beset by a deep-seated recession. This performance was accompanied by a reduction in inflation virtually across the board, placing it at historical lows in many countries. Employment likewise responded favourably, as reflected by the fall in national unemployment rates. Among the developed countries the key features were the extension of the upturn in the United States, the slowdown in the UK economy and the ongoing recovery in the euro area. Nonetheless, the second half of the year saw something of an accentuation of the cyclical differences between the US economy on one hand, and the European economies on the other. This was the outcome of the greater contractionary effect exerted on Europe by the crisis in the emerging economies and, in particular, by its having spread to new regions from mid-1998 onwards.

For the developing countries and, in particular, the emerging economies, 1998 was strewn with difficulties. While the Asian economies affected by the mid-1997 crisis were making, with differing degrees of resolve, the necessary adjustment plans to correct disequilibria and overcome the economic downturn, other emerging economies with weak fundamentals were adversely affected by fresh bouts of international financial instability. Notable in this respect was the onset of the Russian crisis in the central months of the year, the scale and subsequent spread of which to various Latin American countries had serious repercussions for the stability of international financial markets. The crisis substantially worsened the external financing conditions these countries had until then enjoyed. The securities markets in the developed economies were affected to some degree by this turbulence, especially those in which foreign investment exposure to these areas was greater. Nonetheless, the subsequent measures by the monetary authorities who, in the absence of inflationary pressures, cut interest rates to alleviate the risks of activity slowing, contributed significantly to restoring calm to the markets.

In any event, the problems of both the south-east Asian economies and the Russian economy in 1998, coupled, in general, with the financial turbulence buffeting the emerging economies, have highlighted major shortcomings in the workings of the international financial system. In particular, weaknesses have been apparent in the mechanisms for preventing and containing the effects of international financial crises against a background of high capital mobility and the growing importance of international financial markets in crisis contagion (see Box II.1).

A salient feature of international economic developments in 1998 was the ongoing decline in energy and non-energy commodities prices, this being one of the main determinants of the low inflation rates worldwide. At the same time, the fall in commodities prices has exacerbated the problems of the emerging economies, substantially diminishing their export revenue from these goods, of which some of the countries in crisis are the leading world producers.

Closer to home, 1998 will go down in history as the year in which eleven EU countries met the economic conditions required to create a monetary union, the concrete expression of which was the birth of the single European currency, the euro, on 1st January 1999. Likewise, in July 1998, the European Central Bank commenced operating. The ECB is the supranational monetary authority for the eleven euro-area countries, and is entrusted with defining the single monetary policy, which will be executed mainly through the National Central Banks of the participating countries.

Developments on European financial markets during 1998 were governed by the decline across the eleven euro-area countries in the inflation rate and the convergence requirements for short-term interest rates. Likewise, on the foreign exchange markets, in a setting of growing stability, the behaviour of the eleven euro-zone countries' exchange rates was influenced by the prior announcement in May of the conversion parities for the euro. And this while the background was dominated by the greater volatility of the dollar against the main currencies.

The period to date in 1999 has been marked by a high degree of uncertainty over the world economic outlook. The US economy has remained notably buoyant. But growth in the European countries has generally held on a slowing trend, varying in intensity from country to country, and whose most general source is the contraction of exports. In any event, forecasts suggest that this decline in productive activity could be temporary, whereby the world economy as a whole would resume a more vigorous growth path in the year 2000.

The ECB's first monetary policy actions took the foregoing slowdown in the European economy and its low-inflation environment into account. After the co-ordinated reduction in the National Central Banks' intervention interest rates in December 1998, which set in advance the starting rate for EMU at 3 %, the ECB Governing Council decided in April to make a further cut of half a percentage point to the main interest rate, placing it at 2.5 %.

II.2. THE EXTERNAL ENVIRONMENT OF THE EURO AREA

II.2.1. The developed countries: United States, Japan and United Kingdom

In 1998, the US economy continued on the expansionary course it had followed since the second half of 1991. From then until the fourth quarter of 1998, US GDP increased 27 % in real terms, a performance that has proven compatible with a gradual decline in the inflation rate. Specifically, in 1998, GDP growth was 3.9 %, the unemployment rate was at an historical low (4.5 %) and consumer-price inflation stood at 1.6 %. The data for the opening months of 1999 confirm the sustained, non-inflationary vigour of the US economy, similar to that of the preceding months and years. The length of this upturn against a background of lower inflation has, however, been favoured by circumstantial factors such as the reduction in energy prices in recent years. At the same time, the firming of a stable macroeconomic environment, to which rapid technological developments and the economic policies implemented during these years have – along with the greater flexibility of goods and factor markets – contributed, has played a pivotal role in increasing the growth potential of the US economy. This is due to the increases in productivity generated and the gains in efficiency obtained in the allocation of available resources.

Nonetheless, though these results are very satisfactory overall, the breakdown of growth into its components reveals a deep-seated imbalance between the forceful buoyancy of domestic demand and the progressive deterioration in the trade balance. The thrust of domestic demand was driven essentially by private consumption growth, financed by a considerable increase in household debt. That led to a most significant reduction in the saving ratio, which even turned negative in certain months in 1998 (see Chart II.1). Set against the climate generated by the soundness of the economy and, in particular, by high job creation, the expansion of consumption largely responds to the effect of the strong rise in stock market prices seen in recent years. Taking the onset of the current cycle (late 1991) as a starting point, the average price of shares had increased by 200 % by March this year, placing stock market indices at historical highs.

Naturally, in these conditions, the sustainability of consumption growth over the medium term depends on the future course of stock market prices. Thus, the current high level of share prices in relation to customary corporate profit levels is an objective factor of risk. An abrupt correction of prices could increase the financial fragility of households, given their high debt, and alter their consumption plans, thereby checking economic activity. Nonetheless, it seems more likely at present that the maturity of the business cycle will, in the near future, be conducive to a mild, gradual moderation in the GDP growth rate.

As regards external sector developments, the US trade imbalance steepened in 1998, placing the current-account deficit at 2.7 % of GDP. A consequence of this was the increased contractionary effect of the contribution of net external demand to GDP growth (–1.6 percentage points). The vigour of domestic demand and the loss of competitiveness of the dollar combined with the fall in foreign demand for US products resulting from the slowdown in activity in the rest of the world.

On the prices front, buoyant domestic demand and labour market tightness (of which the

BOX II.1

Initiatives for reforming the international financial system

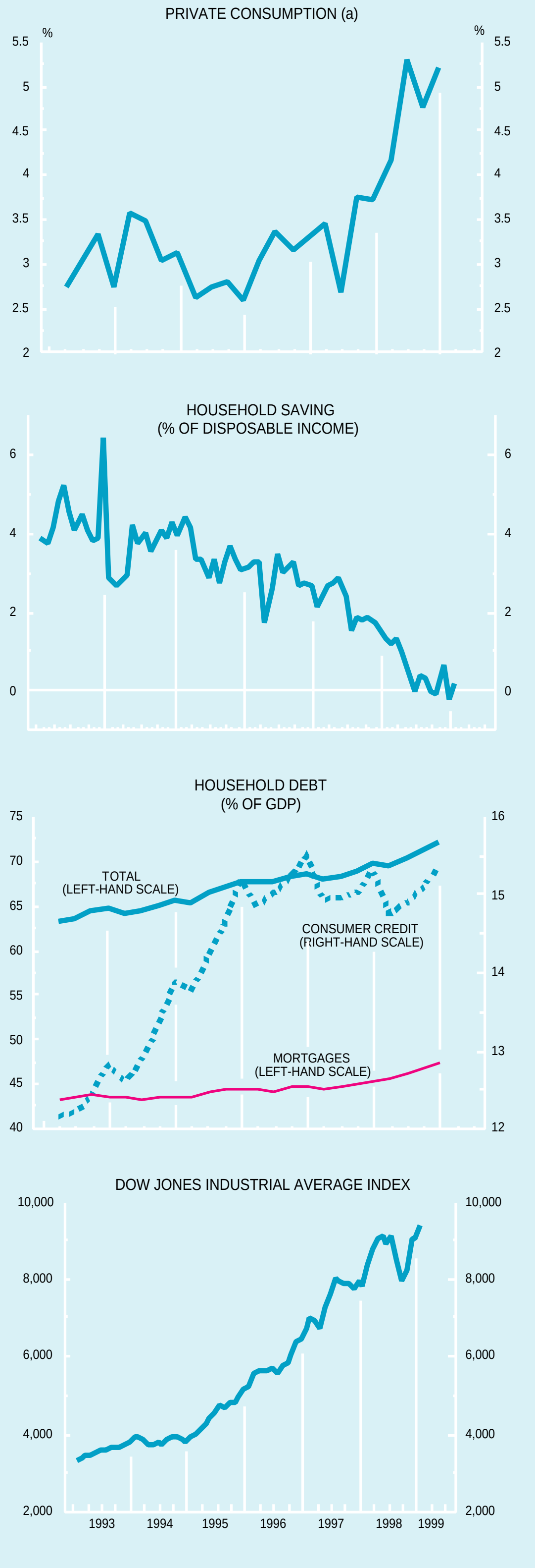
Since the Asian crisis broke in 1997, a number of proposals have been put forward by public and private agencies in both the national and international domain aimed at suggesting possible reforms of various aspects of the architecture of the international financial system. The aim is to limit the likelihood of fresh crises occurring and to ensure that the international community is better prepared to withstand anythat do occur. The discussion of this set of proposals in various international fora has led already to the adoption of some of them. In many cases, however, discussions are still at the preliminary stage. Yet, foreseeably, significant headway should be made in the near future in the specification and adoption of decisions in the appropriate fields.

The proposals designed to reform the international financial system in order to forestall financial crises or, at least, limit their consequences, are summarised in the following table.

	1. FINANCIAL SUPERVISION AND REGULATION
	Approved or approval under way: Adoption of standards relating to: — Banking supervision (by the Basle Committee on Banking Supervision) — Regulation of securities markets (International Organisation of Securities Commissions) — Supervision of insurance companies (International Association of Insurance Supervisors) — Disclosure of information for cross-border offerings of securities Creation, following a G7 initiative, of the Financial Stability Forum, aimed at improving the co-ordination of work geared to reinforcing financial regulation and supervision
	Under study: Creation of incentives for the application of standards already approved. These would include granting publicity for countries' adherence to standards and the establishment of a link between the capital requirements of a country's financial institutions and the quality of its supervisory mechanisms Reinforcement of the supervision of highly leveraged institutions (hedge funds) and of offshore centres
	2. IMPROVED TRANSPARENCY
2.1. Public sector	**Approved or approval under way:** Adoption by the IMF of a Code of Good Practices on Fiscal Transparency, the Special Data Dissemination Standards and (under preparation) a Code of Good Practices on Transparency of Monetary and Financial Policies
	Under study: Creation of incentives for countries to adhere to these codes and standards similar to those studied in the case of financial supervision and regulation standards
2.2. International financial institutions (IFIs)	**Approved or approval under way:** Adoption of a presumption in favour of information disclosure
	Under study Preparation of internal evaluation mechanisms in relation to policy effectiveness
2.3. Private sector	**Approved or approval under way:** Adoption by the International Accounting Standards Committee of International Accounting Standards Adoption by the OECD of a code of principles of sound corporate governance (under preparation)
	3. MACROECONOMIC ASPECTS
3.1. International capital flows	**Under study:** Amendment of the "Articles of Agreement" to allow greater involvement by the IMF in the definition of the sequence for the liberalisation of capital flows Desirability of establishing measures penalising short-term capital inflows under specific circumstances
3.2. Exchange-rate regimes	**Under study:** Study of the circumstances determining the suitability of alternative exchange-rate regimes in each specific case
	4. PREVENTION AND MANAGEMENT OF FINANCIAL CRISES
4.1. Private-sector involvement	**Under study:** Adoption of clauses in bond issuance contracts providing for co-ordinated action by creditors in the event of crisis Introduction of rollover options in all international debt contracts entiling borrowers to extend the maturity of the debt in the event of crisis for a specified period and at penal interest rates Obligation for bond-issue placement companies to underwrite a portion of such issue Arrangement of contingent credit facilities with the private sector Possible extension of loans by the IMF to debtors that have agreed with creditors to amend their debt financing terms
4.2. Other aspects	**Approved or approval under way:** Establishment of a contingent credit facility by the IMF to prevent and counter potential speculative attacks against a country whose macroeconomic and financial situation is sound
	5. SOCIAL EFFECTS OF CRISIS
	Approved or approval under way: Adoption by the World Bank (WB) of the Principles of Good Practice in Social Policy Regular examination of each developing country by WB to identify potential structural weaknesses that may exacerbate the consequences of the crisis
	Under study: Increased resources for the IMF Enhanced Structural Adjustment Facility and for the Highly Indebted Poor Countries initiative

CHART II.1

United States: private consumption and explanatory factors



Sources: National statistics and REUTERS.

(a) Year-on-year growth rate.

wage settlements in certain sectors and the annual growth in manufacturing unit labour costs are indicative) are, despite the low inflation posted in 1998, shaping a setting in which certain inflationary pressures should not be ruled out. But the highly favourable behaviour of commodities prices in 1998, the ongoing appreciation of the dollar (to a greater extent against the European currencies than against the yen [see Chart II.2]) and the flexibility of price formation mechanisms in the US economy are fundamental to explaining the relative stability of prices in 1998.

Regarding economic policies, the tight management of public finances in recent years is worthy of mention. According to IMF estimates, the structural balance, which was already positive in 1997, stood at 0.8 % of GDP in 1998. The fiscal consolidation drive undertaken and the favourable impact of economic growth on the cyclical component of the budget balance provided for a significant surplus (1.3 % of GDP in 1998) for the second year running.

Monetary policy had to be pursued in 1998 in a complex environment marked by the strong buoyancy of economic activity, by certain doubts about the soundness of the private sector's financial position and by the repercussions of the turbulence on international financial markets. Granted, the continuing pressure of spending on plant capacity appeared to call for contractionary demand-side policies. Yet high private-sector indebtedness, underpinned by a strong rise in stock market prices, and the exposure of the domestic financial sector to the crisis-ridden emerging economies were both a deterrent against adopting measures that might have prompted a sudden correction in share prices and increased the fragility of financial institutions.

Against this backdrop, the Russian crisis broke in August. Several developments ensued: a sizeable fall on the stock market; a substantial depreciation of the dollar against the D-Mark and the yen; a significant deterioration in the financial position of major investors in the countries affected by the crisis (primarily Russia, and then Latin America); and a notable increase in risk premia on private debt. Given the possibility of this instability heightening and spreading to the whole of the financial system, the Federal Reserve reduced its official interest rate on three occasions between September and November from 5.5 % to the current rate of 4.75 %. This decision was followed by a rally on stock markets, the resumption of relatively normal conditions on financial markets, a strengthening of the dollar against the euro-area currencies (it continued depreciating against the yen until January 1999) and renewed vigour in domestic demand. All of these factors have, moreover, persisted in the opening months of 1999.

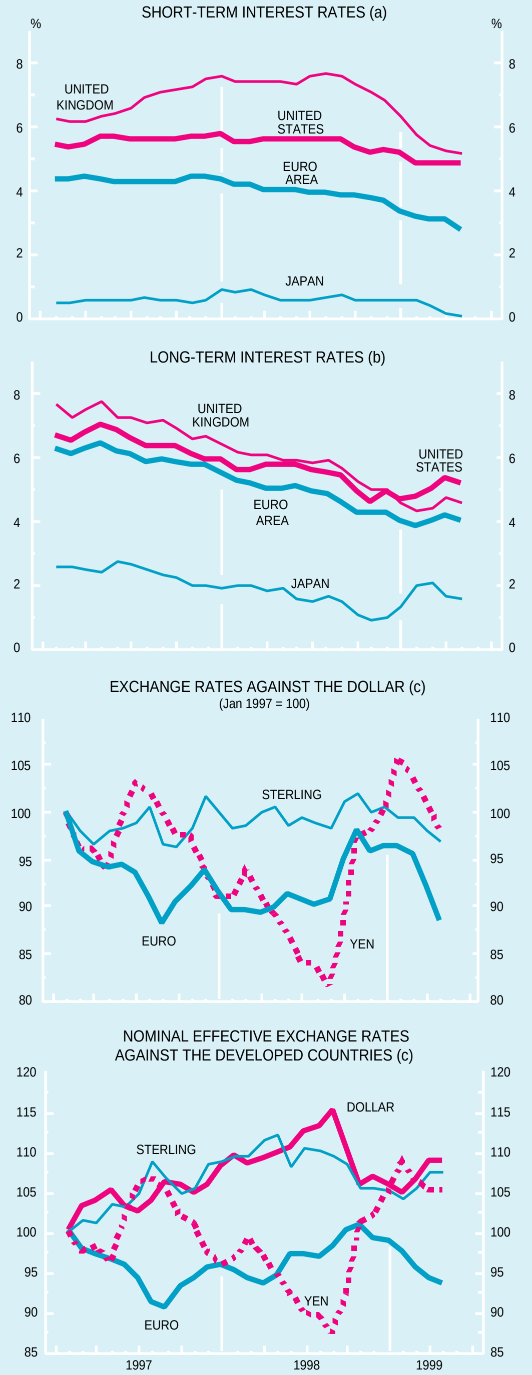
The economic situation described for the United States is in stark contrast to the recession beleaguering Japan since late 1997. In 1998, Japanese GDP declined by 2.9 % (see Table II.1), a contraction unprecedented since 1974 and which was the outcome of a 3.5 % fall in domestic demand, only partly offset by foreign demand. The heavy deterioration in the general economic climate, as evidenced by the historical lows in consumer and business confidence indices, and the rise in the unemployment rate to an unparalleled high (4.6 % in February 1999) prompted a drop in private consumption of 1.1 % and a fall of 9 % in gross fixed capital formation. As to the external sector, imports of goods and services plummeted by 7.7 %, led by the decline in domestic demand, while exports were 2.3 % down as a result of the fall in global demand. Consequently, the current-account surplus, which was 3.2 % of GDP in 1998, amply exceeded the related 1997 figure of 2.3 %.

Throughout 1998 and in the opening months of 1999, prices have followed a deflationary path. The consumer-price inflation rate is very low (0.4 % on average in 1998 and –0.1 % in the 12 months to February 1999). If fresh food is excluded from the general index, inflation has been negative since July. Producer prices, too, posted negative year-on-year rates during 1998, standing at between –4 % and –5 % in the first two months of 1999.

The macroeconomic situation can be set against the background of deep-seated fragility in the banking system and the serious structural shortcomings on Japanese markets. In response to the situation, the government set in train in 1998 a major bank restructuring plan which included the provision of sizeable public funds and the establishment of mechanisms to restructure the control and enhance the management of ailing banks. Further, macroeconomic and structural policies aimed at boosting activity and reinvigorating the workings of the economy began to be pursued. However, these bank restructuring plans have not yet made for an appreciable increase in the credit system's soundness. The successive fiscal packages have been applied with heavy delays and it is not certain how they will unfold in 1999. And the structural reform policies adopted, appropriately aimed at greater liberalisation in domestic markets and greater external openness, are making little impact in practice.

CHART II.2

Interest rates and exchange rates



Sources: Banco de España and BIS.

(a) Three-month interbank market interest rates. Euro area: to December 1998, GDP in PPS-weighted average of the eleven countries. In 1999: three-month EURIBOR.
(b) Ten-year government bond yields. Euro area: GDP in PPS-weighted average of the eleven countries.
(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.

TABLE II.1

Main macroeconomic indicators of the United States, Japan and the United Kingdom

	1993	1994	1995	1996	1997	1998
UNITED STATES:						
GDP (a)	2.3	3.5	2.3	3.4	3.9	3.9
Domestic demand	2.9	3.9	2.1	3.6	4.2	5.0
External demand (b)	–0.7	–0.5	0.1	–0.2	–0.4	–1.4
Public-sector balance (c)	–3.6	–2.3	–1.9	–0.8	0.5	1.3
CPI (a)	3.0	2.6	2.8	2.9	2.3	1.6
Current-account balance (c)	–1.3	–1.8	–1.6	–1.8	–1.9	–2.7
Unemployment rate	6.9	6.1	5.6	5.4	4.9	4.5
ULCs (a)	2.3	1.6	2.6	1.3	2.3	2.3
JAPAN:						
PIB (a)	0.3	0.6	1.5	5.0	1.4	–2.9
Domestic demand	0.1	1.0	2.3	5.7	0.1	–3.6
External demand (b)	0.2	–0.3	–0.8	–0.5	1.4	0.7
Public-sector balance (c)	–1.6	–2.3	–3.6	–4.2	–3.3	–6.1
CPI (a)	1.2	0.7	–0.1	0.1	1.7	0.4
Current-account balance (c)	3.1	2.8	2.2	1.4	2.2	3.2
Unemployment rate	2.5	2.9	3.1	3.3	3.4	4.2
ULCs (a)	2.0	1.8	0.2	–2.9	1.0	2.2
REINO UNIDO:						
PIB (a)	2.3	4.4	2.8	2.6	3.5	2.5
Domestic demand	1.8	3.2	1.8	3.1	3.8	3.4
External demand (b)	0.1	0.9	1.0	–0.5	–0.3	–1.3
Public-sector balance (c)	–7.8	–6.8	–5.5	–4.5	–1.9	0.6
CPI (a)	3.0	2.4	2.8	2.9	2.8	2.6
Current-account balance (c)	–1.6	–0.2	–0.5	–0.2	0.6	–0.4
Unemployment rate	10.3	9.3	8.0	7.3	5.5	4.7
ULCs (a)	0.4	–0.6	1.3	2.4	3.2	5.0

Sources: IMF and OECD.

(a) Rate of change.
(b) Contribution to GDP growth.
(c) As a percentage of GDP .

Against this backdrop, the scope of demand-side policies has diminished appreciably. On one hand, the expansionary budgetary measures (with a budget deficit of 6.1 % of GDP in 1998, which could be higher in 1999) have led the balance of public debt to levels exceeding 100 % of GDP in 1998. That has generated financing difficulties and, at certain times, it has been conducive to an increase in long-term interest rates, despite the deflationary environment (see Chart II.2). On the other, monetary policy, implemented via interest-rate cuts, has exhausted its room for manoeuvre (the official interest rate is currently at 0.15 %) and the monetary transmission mechanism has been weakened, owing to the fragility of the banking system and the scant demand for credit. The sustained appreciation (by over 25 %) of the yen against the dollar from August 1998 to January 1999 and the aforementioned rise in long-term interest rates restricted even further the effectiveness of the expansionary monetary policy. Despite signs during the first quarter of 1999 of a potential improvement in the economic situation over the following months, the difficulties of the demand for investment and private consumption picking up in the Japanese economy remain.

Lastly, among the EU countries not part of the euro area, the slowdown in activity in the United Kingdom during 1998 was notable. Its main source lies in the contraction in exports resulting from the Asian crisis and from the strength of sterling, which appreciated by 30 % in real terms from mid-1996 to end-1998. This deceleration in activity, which has proven particularly sharp in industry, was not enough (until well into the year) to reduce the upward pressure on wages in a labour market which continued to be very buoyant. Testifying to this was the fact that the unemployment rate has held stable at 4.6 % since August 1998, the lowest level for 18 years. Consumer-price growth, excluding mortgage interest payments, did not resume a path consistent with the official target of 2.5 % until the second half of the year.

UK economic policy has been clearly geared to nominal stability. Budgetary policy continued to be steered by fiscal consolidation, whereby the general government balance showed a surplus of 0.6 % of GDP in 1998 (–1.9 % of GDP in 1997), with a reduction in the structural deficit of 1.3 percentage points of GDP. The Bank of England altered its monetary policy stance after the summer, in line with the improvement in price prospects. In the period to June, it progressively raised the intervention rate to 7.5 %. From September, and in successive stages, it reduced the rate to the level of 5.25 % by April. Consequently, short and long-term interest rates have been on a virtually uninterrupted downward trajectory since mid-1998, while sterling has held stable against the dollar and appreciated against the euro on the foreign exchange markets.

II.2.2. The emerging economies

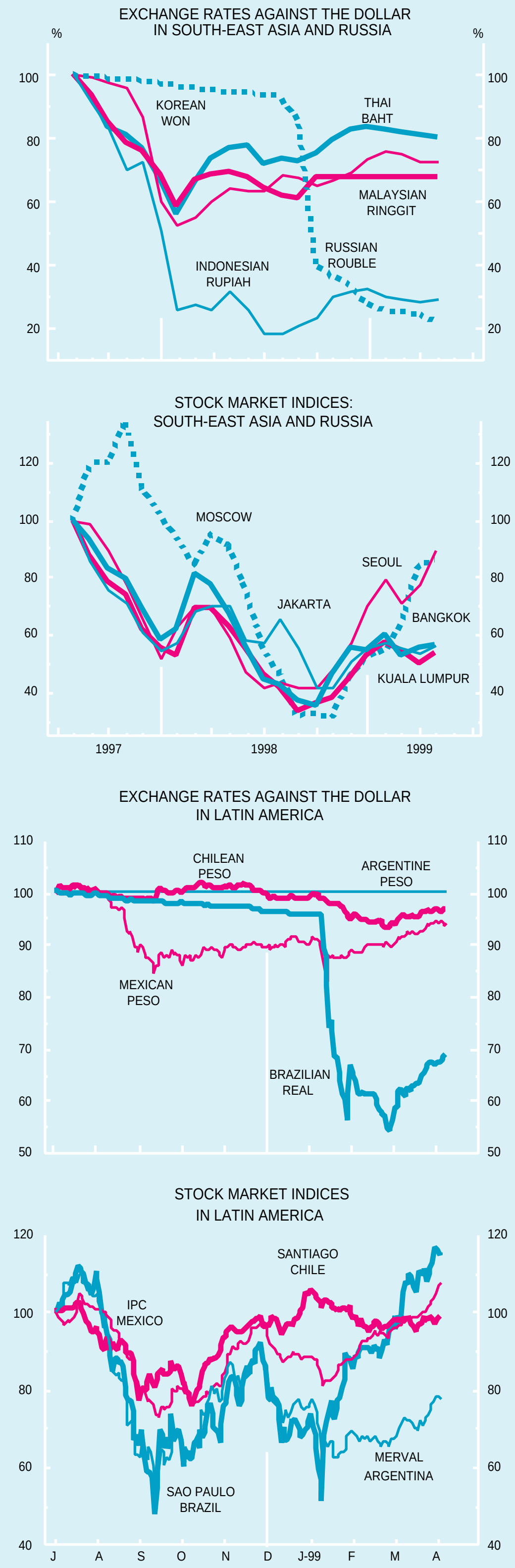
II.2.2.1. The emerging economies in Asia and Europe

Economic activity in the south-east Asian countries in 1998 was governed by developments in the wake of the crisis in the summer of 1997. Overall, the region's economy contracted strongly in 1998. Thus, GDP declined by 5.5 % in South Korea, 8 % in Thailand and Malaysia and 14 % in Indonesia (see Table II.2). Nonetheless, in the second half of last year there were initial signs that the summer 1997 crisis might have touched bottom so that, in the first two countries mentioned, economic activity might have rebounded.

In general, all the countries continued to pursue policies of macroeconomic adjustment and structural reform, in particular in the financial sector, albeit to highly differing degrees of intensity. The cumulative depreciation by these countries' exchange rates and the impact on imports of the contraction in domestic demand made for a turnaround in the current-account balance; at the end of 1998, significant surpluses were being run in many of the countries. From the summer onwards, an easing of financial conditions could be seen. Indeed, set against something of a recovery in investor confidence, it was possible to reduce interest rates substantially in most of these countries, with levels similar to those prevailing before the crisis in some. There was also an improvement on securities markets and the exchange rate of the countries in this region tended to stabilise (see Chart II.3). However, although most of these economies have begun to recover, elements of fragility remain. These are linked in particular to the position of their financial systems, which

CHART II.3

Exchange rates and stock market performance



Source: REUTERS.

TABLE II.2

Emerging-market economies: main macroeconomic indicators

	1993	1994	1995	1996	1997	1998
GDP (a):						
Asia						
South Korea	5.8	8.6	8.9	7.1	5.5	–5.5
Thailand	8.5	8.6	8.8	5.5	–0.4	–8.0
Indonesia	7.3	7.5	8.2	8.0	4.6	–13.7
Malaysia	8.3	9.3	9.4	8.6	7.7	–6.8
Russia	**–10.4**	**–11.6**	**–4.8**	**–3.5**	**0.8**	**–4.8**
Latin America	**3.9**	**5.2**	**1.3**	**3.6**	**5.2**	**2.3**
Argentina	6.3	8.5	–5.8	4.8	8.6	4.2
Brazil	4.9	5.9	4.2	2.8	3.2	0.2
Chile	7.0	5.7	10.6	7.4	7.1	3.3
Mexico	2.0	4.4	–6.2	5.2	7.0	4.9
INFLATION (a):						
Asia						
South Korea	4.8	6.2	4.5	4.4	4.4	7.5
Thailand	3.4	5.1	5.8	5.9	5.6	8.1
Indonesia	9.7	8.5	9.4	7.9	6.6	60.7
Malaysia	3.5	3.7	3.4	3.5	2.7	5.3
Russia	**895.9**	**302.0**	**190.1**	**47.8**	**15.0**	**28.0**
Latin America	**209.0**	**208.9**	**35.9**	**20.8**	**13.9**	**10.5**
Argentina	10.6	4.2	3.4	0.2	0.8	0.9
Brazil	2,103.3	2,123.7	59.6	11.1	7.9	3.5
Chile	12.7	11.4	8.2	7.4	6.1	5.1
Mexico	9.8	7.0	35.0	34.4	20.6	16.7
PUBLIC-SECTOR BALANCE (b):						
Asia						
South Korea (c)	1.7	1.4	1.4	1.4	1.4	–3.2
Thailand	2.1	2.0	2.6	1.6	–2.1	…
Indonesia	–0.7	0.0	0.8	1.4	…	…
Malaysia	–2.6	2.5	3.8	4.2	…	…
Russia	**–9.4**	**–10.4**	**–5.4**	**–7.9**	**–7.0**	**–6.0**
Latin America						
Argentina	–0.8	–2.3	–4.0	–3.7	–2.5	–2.1
Brazil	–58.1	–44.3	–7.0	–5.9	–6.1	–8.1
Chile	1.8	1.4	3.1	1.4	0.1	–1.2
Mexico	0.7	–0.1	0.0	0.0	–0.3	–1.2
CURRENT-ACCOUNT BALANCE (b):						
Asia						
South Korea (c)	0.1	–1.0	–1.9	–4.7	–1.8	13.1
Thailand	–5.0	–5.6	–8.0	–7.9	–1.9	12.2
Indonesia	–1.5	–1.7	–3.3	–3.3	–3.0	–0.1
Malaysia	–4.8	–7.8	–10.0	–4.9	–5.1	12.3
Russia	**3.4**	**3.8**	**1.3**	**0.5**	**–0.2**	**–0.5**
Latin America						
Argentina	–3.1	3.8	–1.7	–2.2	–3.7	–4.3
Brazil	–0.1	–0.3	–2.5	–3.0	–4.2	–4.5
Chile	–4.5	–1.2	–2.1	–5.4	–5.3	–6.6
Mexico	–5.8	–7.0	–0.6	–0.6	–2.0	–3.9

Sources: IMF AND Russian European Centre for Economic Policy.

(a) Rate of change.
(b) As a percentage of GDP.
(c) Includes certain Social Security transactions.

must be corrected so as to avoid vulnerability to disturbances on international markets.

A clear example of the international transmission of bouts of instability was the financial crisis in Russia in the summer of 1998. Russia was particularly vulnerable to the changes in the perception of the risk inherent to investment in emerging economies brought on by the Asian crisis, given the state of heavy deterioration marking its economy. Between 1992 and 1998, Russian GDP had undergone a cumulative decline of almost 50 % in real terms, investment had fallen by 70 % and social conditions had seriously worsened. Budgetary problems, largely of a structural nature, were evident mainly in Russia's scant tax-raising capacity (the result of its relatively stunted tax base, of high tax evasion and of the effects of lower sales and a lower oil price), in the difficulties encountered in privatisation and in the expenses incurred in keeping inviable or inefficiently managed public-sector companies afloat. The high general government borrowing requirement (the budget deficit exceeded 6 % of GDP in 1997 and 1998) meant, in turn, a notable increase in the outstanding balance of public debt which, from 1995, had very short maturities and, to a large extent, was held by foreigners (over 30 % in May 1998).

In these conditions, the mid-1997 Asian crisis considerably exacerbated the financial situation in Russia. It induced a generalised reduction in the propensity of international investors to purchase assets issued in countries with emerging economies and a subsequent rise in the interest rates demanded on debt issued by such countries. The tightening of debt financing conditions, set against a chronic shortage of fiscal resources and a growing current-account deficit, generated selling pressure on the rouble and heavy foreign reserve losses. The signing of the agreement between the Russian government and the IMF in July, involving an extraordinary financing arrangement, was unable to contain these losses. On 17th August, the Russian authorities announced a drastic set of measures. These included the devaluation of the rouble (which was subsequently floated on 3rd September), a unilateral 90-day moratorium on the servicing of private banks' external debt, the obligatory conversion of rouble-denominated short-term public debt into new long-term instruments and the suspension of the servicing and trading of such instruments.

Since then the economic situation has progressively worsened. It is estimated that GDP fell by almost 5 % in 1998, inflation has quickened to a rate of 103 % in February 1999 compared with a year earlier, the rouble has depreciated by more than 75 % between August and March 1999 (see Chart II.3) and the banking system is deep in crisis. Nonetheless, foreign debt may once more be refinanced thanks to the financial support Russia is to receive from international financial institutions, from Japan, from the Paris Club and from international banks in respect of the so-called "Soviet debt" (debt incurred by the former USSR prior to 1.1.1992).

To date, the direct impact of the Russian crisis on the euro area has been limited. The link is tighter on the financial side (especially in Germany's case) than on the trade side. At the end of 1997, bank loans from the euro area to Russia accounted for 10 % of international loans and exports for 2.7 % of the total. Yet the overall scale of the impact also depends on its consequences for the rest of the central and eastern European economies. In this respect, the influence of the Russian crisis has been substantial only in the countries belonging to the former Soviet Union. In the main economies of the area (Poland, Czech Republic and Hungary), with which the euro area has very close trade ties, the repercussions have been limited owing to the relative soundness of these countries' situation and economic policies.

Nonetheless, the recent military conflict in Kosovo appreciably heightens the uncertainty over the region's immediate economic future.

II.2.2.2. The Latin-American economies

In 1998 the Latin-American economies were adversely affected by the reduction in global demand for commodities induced by the south-east Asian economic crisis. In the second half of the year, the situation worsened considerably as a result of the instability generated on international markets by Russia's financial problems and by certain countries' domestic difficulties, particularly Brazil, in making headway in reducing macroeconomic disequilibria. These developments were accompanied by a reduction in capital flows to the Latin-American economies, since international investors preferred to place funds in higher quality assets.

Since 1994, Brazil had been successfully applying a structural adjustment programme. This had enabled it to curb the hyperinflation dynamics besetting it since the previous decade, to correct to a large extent its swollen budget deficit and to attract stable and very sizeable foreign capital flows. However, signs that this programme had run its course became progressively manifest during 1998. International investors' confidence was weakened, giving rise to selling pressures on the Brazilian currency, the real, which maintained a crawling peg to the dollar. In the first half of 1998, the budget deficit exceeded 7 % of GDP, as a result of a growing interest burden not offset on the revenue side and of profligate spending in the run-up to the elections. The current-account deficit, meantime, amounted to 4.5 % of GDP. Against this backdrop, the moratorium on Russian debt in August led international investors' confidence in Latin America and, especially, in Brazil's ability to meet its financial commitments, to plummet. Capital flight ensued along with strong selling pressures on the real, generating sizeable losses in reserves and most significant rises in short-term interest rates, which climbed to 42 % in November.

In this situation the Brazilian authorities obtained a financial aid package from the IMF tied to their implementing a stringent budgetary adjustment plan. In January 1999, in the light of the difficulty of putting the required budgetary reforms into practice, capital outflows accelerated and the interest rate spreads required of Brazilian issuers widened, whereby the authorities ended up abandoning the peg to the dollar. After a sharp depreciation (close to 40 %) against the dollar in the first two months the real floated freely, it has since tended to stabilise. As from early March, it has appreciated slightly, in a setting of still-high interest rates and an incipient renewal of capital inflows following the introduction of certain fiscal reforms. In any event, the flatness of Brazilian output, which has given rise to a recession in 1999, means that the forecast exit from the crisis has currently been postponed until the year 2000.

The Brazilian crisis and the general movement in search of quality saw the reappearance of doubts on the markets about the soundness of the economic adjustment applied in other Latin-American countries. The risk associated with investment in emerging markets was similarly re-assessed, translating into a tightening of the financial conditions prevailing in the area as a whole.

The financial crisis assailing the Latin-American region led to a collapse in stock market prices, heavy selling pressures on exchange rates requiring the intervention of central banks on the foreign exchange markets, sizeable rises in interest rates and, in certain cases, the downgrading of debt issues (see Chart II.3). Finally, countries such as Colombia and Ecuador had to alter their crawling band to the dollar (see Box II.3). The tightening of financial conditions, set against the holding or falling commodity export prices of these countries, affected the area's GDP growth rate, which declined notably in the second half of the year to 2.3 % on average in 1998 compared with 5.2 % in 1997. Likewise, the fall in demand and in export unit value meant a notable deterioration in the current-account deficit for the area as a whole, which was estimated to have reached $90 billion (almost 40 % up on 1997).

The crisis has affected some countries more than others, depending on their macroeconomic situation, their relative indebtedness and the degree of concentration of their exports. Unlike in other similar situations, Mexico, Argentina and Chile managed, once the critical moments of the speculative bouts were behind, gradually to restore normality to their monetary and financial conditions. That reflects the markets' confidence in their reforms, the healthy state of their public finances and, above all in Argentina's case, the soundness of their monetary policy regime. That said, the economic outlook for the area as a whole hinges on how successful Brazil proves in its process of adjustment and in its economic recovery. Significantly, Brazil accounts for around 40 % of the Latin-American region's GDP and has close trade ties with the main countries in the area, most especially with Argentina.

II.3. THE EURO AREA

II.3.1. Economic conditions in the euro area

In the euro area, the high growth recorded in 1998 was accompanied by the absence of inflationary pressures. As a result, the economic conditions prevailing at the outset of EMU were, generally, suitable for the launching of the euro. Nonetheless, the expansion in activity during 1998 as a whole was accompanied by a notable slowdown in growth in the second half of the year. And the decline in inflation benefited from the positive contribution of certain traditionally somewhat erratic prices, which masked the downward stickiness of other components of the general price index. Finally, the correction of fiscal imbalances and the structural reforms under way made relatively limited progress in 1998.

Economic growth last year, running at 2.9 %, saw the extension of the recovery that began in 1997 (see Table II.3), following the mediocre results obtained between 1995 and 1996. As a result, the GDP growth rate in 1998 was the highest since the start of the decade. However, after the first half of the year when the peak of the current upturn was reached, the buoyancy of activity moved onto a declining trend, since domestic demand was unable to counter what

BOX II.2

Exchange-rate regimes in emerging countries

A good number of the emerging-market countries recently – and particularly as from the start of the nineties – adopted economic policy strategies aimed at achieving a sufficient degree of macroeconomic stability that would enable them to attain full integration into the international financial community. These stabilisation plans generally included measures aimed at ensuring full trade openness, furthering market deregulation and liberalising cross-border capital flows. The liberalising measures were accompanied by the adoption of exchange-rate regimes involving, to a greater or lesser extent, the nominal anchoring of the economy to exchange-rate developments.

As the adjoining table shows, before the 1997 and 1998 foreign exchange crises most of the emerging economies had fixed or semi-fixed exchange rate systems in place. The extreme expression of this was the currency board (where the monetary base in circulation must be fully backed by the foreign reserves available) adopted by Argentina and Hong Kong. In general, the south-east Asian countries opted for a fixed exchange rate in relation to the dollar, while the Latin-American countries opted for crawling rate regimes, according to pre-announced rules (crawling pegs or crawling bands). From 1993 to 1996, the proportion of IMF member countries with this type of exchange-rate regime rose from 68 % to 73 %. Such an exchange-rate policy strategy was adopted mainly for three reasons:

- An attempt to reduce exchange-rate risk or the associated hedging costs for foreign investors.
- To progress towards price stability, so that the discipline imposed by international competition and the exchange-rate regime on the sectors most exposed to international competition might extend to the economy as a whole.
- To reduce the degree of domestic monetary policy discretionarity so as to achieve a sufficient degree of credibility conducive to the attainment of price stability targets and reduce counter-inflationary policy costs. This strategy seemed the logical response to the failure of counter-inflationary strategies based on prices and incomes policies and to the growing dollarisation of means of payment in these economies.

Despite the initial success of strategies based on maintaining exchange-rate stability, several countries have undergone foreign exchange crises in recent years. Such crises have generally been unleashed against a background of heightening imbalances in the economies affected. Thus, for example, the crises affecting the Mexican peso (December 1994), the Russian rouble (August 1998) and the Brazilian real (January 1999) were preceded by a notorious worsening of fiscal imbalances. The Czech koruna crisis (May 1997) was brought on by a growing current-account deficit which placed foreign debt at barely sustainable levels. Finally, in the case of the crisis of the south-east Asian currencies, high private-sector foreign debt associated with the surplus of domestic private investment and the channelling of foreign capital flows via fragile and inadequately supervised domestic financial systems played a prominent role.

Nonetheless, notably influential at least in the outbreak and deepening of the most recent crises (Russia and Brazil) – apart from the economic disequilibria of the affected countries – have been not strictly domestic aspects such as the generalised scaling back of investment in emerging markets induced by the south-east Asian crisis. Moreover, the strongly leveraged position of a significant portion of international investment has, in many cases, exacerbated portfolio restructuring and price movements on financial markets.

In any event, the collapse of an exchange-rate regime normally implies the unwinding of the economic policy strategy in the face of the change in economic setting. In this respect, the technological and regulatory changes recently enacted in the international domain, and the low return on domestic investment in the developed countries, have driven the transformation of these countries' domestic savings into international capital flows. Thus, the economic policy strategies based on exchange-rate stability that were adopted by the emerging economies had to be pursued under conditions of heavy and in many cases speculative capital inflows. This heightened their vulnerability to the international financial environment and made the economic conditions required for the maintenance of the exchange-rate regime more demanding.

Against this backdrop, the crises in recent years have reopened the debate about the conditions that make policies with explicit exchange-rate targets viable. They have also tended to polarise the debate on which exchange-rate systems are most suitable for the emerging economies. In this respect, given that virtually all the countries that have been obliged recently to modify their exchange-rate regime had either traditional fixed exchange-rate systems or crawling pegs, and that both Argentina and Hong Kong have managed to maintain their exchange-rate regimes, some analysts have suggested currency boards or even complete dollarisation as the only viable alternatives to a free-float system in the current circumstances. However, setting general rules in this field is enormously complex in view of the interplay between a country's exchange-rate regime and its economic situation and outlook, and of the great diversity which, in this respect, the so-called "emerging economies" currently display.

Exchange-rate arrangements in certain emerging and developing economies since 1993

	Former exchange-rate arrangement	Changed in	Current arrangement
Asia:			
Thailand	Pegged to the dollar (a)	July 1997	Float
Indonesia	Pegged to the dollar (a)	August 1997	Float
Philippines	Pegged to the dollar (a)	August 1997	Float
South Korea	Pegged to the dollar (a)	November 1997	Float
Malaysia (b)	Pegged to the dollar (a)	August 1997 / September 1998	Float/Pegged to the dollar
Hong-Kong	Fixed to the dollar under a currency board arrangement	—	Fixed to the dollar under a currency board arrangement
Latin America:			
Mexico	Crawling peg to the dollar	December 1994	Dirty float
Brazil	Crawling peg to the dollar	January 1999	Dirty float
Ecuador (c)	Crawling band in relation to the dollar	February 1999	Float
Peru	Dirty float	—	Dirty float
Columbia (d)	Crawling band in relation to the dollar	August 1998	Crawling band in relation to the dollar
Venezuela	Crawling band in relation to the dollar	—	Crawling band in relation to the dollar
Argentina	Fixed to the dollar under a currency board arrangement	—	Fixed to the dollar under a currency board arrangement
Chile	Band around currency basket (80 % dólar)	—	Band around currency basket (80 % dollar)
Central and Eastern Europe:			
Russia	Bands in relation to the dollar	August 1998	Float
Poland	Crawling band in relation to basket	—	Crawling band in relation to basket
Hungary	Crawling band in relation to basket	—	Crawling band in relation to basket
Czech Republic	Crawling band in relation to basket	May 1997	Dirty float in relation to the DM
Slovakia	Band around basket	October 1998	Float
Bulgaria	Float	June 1997	Fixed to the DM under a currency board arrangement
Romania	Fixed	May 1997	Float

(a) Formally, they followed a basket of currencies in which the predominant currency was the dollar.
(b) Controls on capital outflows were introduced in Septermber 1998.
(c) Devaluation of the central parity (August 1998).
(d) Devaluation of the central parity.
Currency Board: fixed exchange rate where the monetary base is backed, by law, by foreign exchange.
Crawling peg: the exchange rate depreciates at an officially pre-announced rate.
Crawling band: *crawling peg* where bands that depreciate at the same pre-announced rate are imposed.

TABLE II.3

Euro area. Main macroeconomic indicators

	1993	1994	1995	1996	1997	1998
DEMAND AND OUTPUT (a):						
Gross domestic product	–1.1	2.7	2.2	1.6	2.5	2.9
Domestic demand	–2.6	2.3	1.9	1.2	1.9	3.4
Private consumption	–0.9	1.4	1.9	1.9	1.4	3.0
Government consumption	1.0	0.5	0.1	1.7	0.3	0.4
Gross fixed-capital formation	–7.9	2.1	3.4	0.4	2.1	4.2
Exports	1.1	8.7	8.1	4.4	10.3	6.0
Imports	–4.1	7.6	7.4	3.3	9.0	7.3
Contributions to GDP growth (b):						
Domestic demand	*–2.6*	*2.3*	*1.9*	*1.1*	*1.9*	*3.3*
External demand	*1.5*	*0.4*	*0.4*	*0.4*	*0.7*	*–0.3*
PRICES AND COSTS (a):						
Consumer prices (annual average)	3.7	3.0	2.7	2.2	1.6	1.1
Consumer prices (end-year 12-month rate)	3.6	2.8	2.8	1.9	1.5	0.8
Unit labour costs	…	…	1.7	1.8	0.6	…
Compensation per employee	…	…	3.5	3.4	2.6	…
GENERAL GOVERNMENT ACCOUNTS (c):						
Current expenditure	51.0	50.1	49.7	49.7	48.6	47.4
Interest charges	*5.7*	*5.4*	*5.7*	*5.5*	*5.0*	*4.5*
Current revenue	49.4	48.6	48.5	48.8	49.0	48.6
Public investment	2.9	2.7	2.6	2.4	2.3	2.3
Primary deficit (–)/surplus (+)	0.2	0.3	0.7	1.3	2.5	2.4
Deficit (–)/surplus (+)	–5.5	–5.1	–5.0	–4.1	–2.5	–2.1
LABOUR MARKET:						
Total employment (a)	…	…	0.4	0.2	0.3	1.3
Unemployment (d)	10.9	11.7	11.4	11.6	11.6	11.0

Sources: ECB and European Commission.

(a) Rate of change.
(b) Rate of change of GDP in percentage points.
(c) As a percentage of GDP.
(d) As a percentage of labour force.

was a progressively more adverse external environment. Hence, the negative contribution of external demand to GDP growth increased considerably in the second half of the year in most countries (see Chart II.4).

Initially, the financial turbulence that first began to affect the emerging economies in the summer of 1997 contributed to the fall in long-term interest rates in the euro area (and in other industrialised countries). Likewise, lower demand for oil and for other commodities by these countries led to the decline in the prices of such products on international markets and, by extension, to the containment of inflationary pressures.

However, during 1998, with the spread of the crisis to other countries, its adverse effects on the euro area became increasingly manifest. First, its negative influence was reflected in the diminished buoyancy of external demand as a result of the deterioration in activity in the countries affected. Subsequently, the prolongation of the crisis began to impair business confidence and, as a consequence, to heighten doubts about sustained growth being maintained in the area as a whole.

Domestic demand remained notably resilient throughout 1998, albeit on a mildly declining path in the second half of the year. Component by component, the buoyancy of consumption, which tended to heighten in the second half of the year, was driven by the increase in real household disposable income stemming from job creation and from the modest increase in real wages derived from the improved inflation outlook. This was further magnified by the improvement in households' confidence, which increased their propensity to consume. Against this background, the effect arising from the stock market upturn played a relevant role, albeit a less significant one than in the United States in view of the lower share of equity holdings in the wealth of households resident in the euro area.

Lower inflation, the continuing downtrend of interest rates and exchange rate stability in the euro area all shaped a macroeconomic climate propitious to the expansion of investment. Yet the conjunction of these elements proved insufficient to avoid the gradual slowdown in some of its components at the end of the year. Logically, the gradual deterioration in the outlook for the external sector may have prompted greater precaution in corporate investment plans and, thus, have accounted for the deceleration in gross capital formation between the first and final quarter of the year. Nonetheless, two-thirds of the reduction in the contribution of investment to growth were due to the behaviour of stocks. The trend in stocks cannot be readily interpreted owing to the relative inaccuracy with which they are estimated and to the difficulty of identifying the voluntary or involuntary nature of actual stock adjustment.

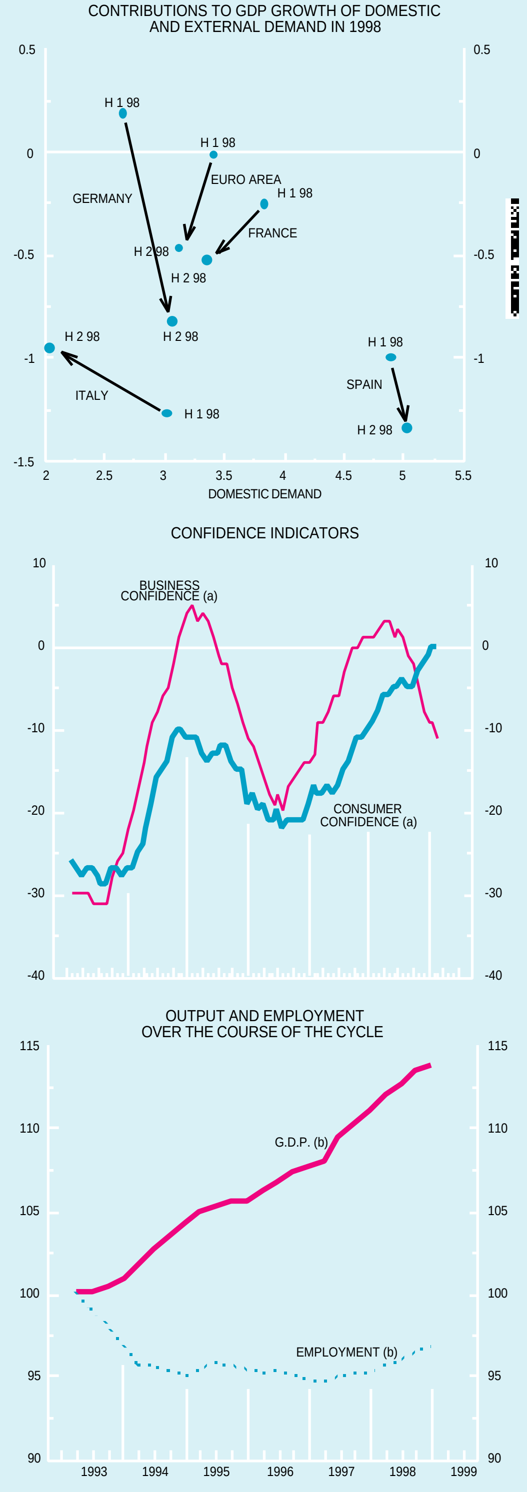
The performance of exports was the biggest check on the expansion of activity in 1998. Trade flows underwent a sustained and pronounced deceleration, which was sharper in the case of exports than in that of imports. As a result, the contribution of external demand to GDP growth turned negative in 1998 after having been positive since 1993. The export performance can largely be explained by the deterioration in growth in countries with emerging markets and by the appreciation of the real effective exchange rate of the euro area over most of the year.

The latest indicators for the opening months of 1999 point to an extension of the moderate slowdown in activity. The deterioration in business expectations is confirmed by the decline in the business confidence index. In contrast to the strong positive correlation it has historically shown, this index has, since mid-1998, trended contrary to the consumer confidence indicator, which has held at its highest levels since the series first began to be calculated in 1985 (see Chart II.4). The differing pattern of behaviour between both types of indicators largely reflects a differentiated trend of activity in the various productive branches; while services output is running at a sustained level, weakness is concentrating in industry, which is more directly affected by the deterioration of the foreign sector.

In the main, the ranking of the euro-area countries on the basis of GDP growth rates remained unchanged in 1998 in relation to the

CHART II.4

Euro area: composition of growth, confidence indicators and employment over the course of the cycle



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

(a) Balance of replies.
(b) Index of the level of the variable: first quarter of 1993 = 100.

TABLE II.4

Euro-area countries: annual GDP growth

	1993	1994	1995	1996	1997	1998
Belgium	–1.5	2.4	2.1	1.5	2.9	2.9
Germany	–1.2	2.8	1.3	1.3	2.3	2.5
Spain	–1.2	2.3	2.7	2.4	3.5	3.8
France	–1.3	2.8	2.1	1.6	2.3	3.2
Ireland	3.7	8.1	11.8	8.3	10.7	11.9
Italy	–1.2	2.2	2.8	0.9	1.5	1.4
Luxembourg	8.7	4.2	3.8	3.0	3.7	5.7
Netherlands	0.8	3.2	2.3	3.1	3.6	3.7
Austria	0.4	3.1	1.8	1.6	2.5	3.3
Portugal	–1.4	2.4	2.9	3.2	3.5	4.0
Finland	–1.2	4.6	5.1	3.6	6.0	5.3
Euro area	–1.1	2.7	2.2	1.6	2.5	2.9

Sources: Eurostat, European Commission and national statistics.

preceding year (see Table II.4). The most notable exception is France. Having grown below the average in 1997, it was two-tenths of a point above it in 1998. Germany and Italy continued growing at a slower rate than the other members and, along with Belgium, they were the only countries with growth rates lower than the average for the area. This classification of countries according to their respective output growth rates cannot be transferred mechanically to their relative position in the business cycle, since potential growth rates differ from one country to another. However, the countries with higher potential growth rates tended to coincide in 1998 (as was the case in 1997) with those further along the cycle in terms of the difference between actual and potential GDP growth rates. Accordingly, the degree of cyclical diachrony among the euro-area economies did not change significantly in 1998 in relation to 1997.

During 1998, euro-area inflation, measured by the average rate of change of the harmonised index of consumer prices (HICP), continued on the progressively slowing path of recent years. The HICP, which grew 1.6 % in 1997, moderated further in 1998 to 1.1 %.

However, the performance of the general index masks diverging trends regarding both the behaviour of the various components and of the different countries. Product groups whose prices ran, on average, at a lower growth rate than a year earlier included services and energy goods (see Chart II.5). In the case of services, however, the muted improvement compared with 1997, which was concentrated at the start of the year, did not prevent the traditional reluctance of price growth in this component to converge towards the general level. More significant was the slowdown in the rate of increase of energy goods prices. The oil price fell on international markets, partly as a result of the drop in demand brought on by the crisis of the emerging economies and the absence of agreement among the oil exporting countries to adjust their output to the new demand conditions. This prompted a fall in the price of the energy goods included in the HICP of 2.6 % for the year as a whole, compared with an increase of 2.7 % the previous year, a fall which intensified notably in the second half of the year. The considerable scale of the decline in this component accounted for a substantial part of the slowdown in the general index, despite its relatively limited weight in the index (see Chart II.5).

As to the remaining components, processed food prices increased in 1998 at the same rate as in 1997, while the pace of prices of unprocessed food and non-energy industrial goods increased. The upward momentum was more pronounced in the case of unprocessed food. But it was also less significant since this is a volatile component whose prices slowed strongly in the final course of the year after a temporary surge in the spring, owing to the impact of bad weather during these months and to the effect on 12-month growth rates of the favourable performance the previous year. Unprocessed food was, along with services, the most inflationary component in 1998.

Thus was the trajectory of the prices of energy goods and fresh food, two markedly erratic general index components. That aside, the slight moderation in services inflation and the somewhat more expansionary pattern of non-energy industrial goods led, in 1998, to a narrowing of the spread between the price growth rates of the products most exposed to international competition (processed food and non-energy industrial goods) and those more sheltered from it (services). However, the narrowing of the gap for the area as a whole coincided with it widening for some countries.

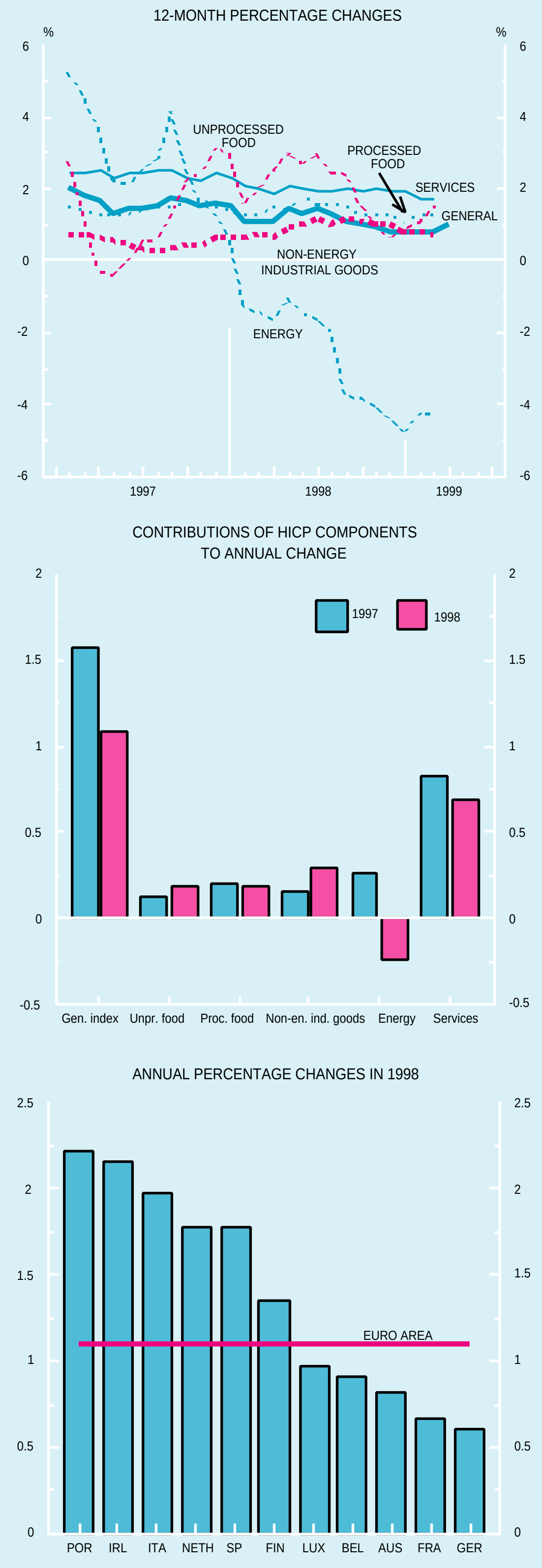
The bigger productivity gains normally recorded in the tradeable goods sector can be explained, in principle, by the persistence of a certain inflation differential between the two product groups, the scale of which is difficult to pinpoint. Generally, however, this gap tends to be greater in countries where demand pressure is more intense. This causes inflationary pressures in the services sector, whose prices, unlike in the goods sector, are less influenced by international competition. In practice, a very high correlation could in fact be seen in 1998 between the business cycle position of the various countries and their inflation differentials between both groups of products. The reason for this is that much of the dual inflation phenomenon is due to the existence of barriers to free competition and inflexibilities in price formation mechanisms in the sectors sheltered from international competition.

The ongoing strengthening of the rate of job creation that began in the spring of 1997 continued on labour markets during 1998. Over the year as a whole, job creation grew at a rate slightly higher than 1 %. It was assisted by the firm trend of economic activity, the moderation of wages (which grew below productivity) and the favourable effects of the reforms that have begun to be introduced into certain domestic markets for labour and for goods and services. The slowdown in activity in the final course of the year had a limited effect which, moreover, was confined to the manufacturing sector without, so far, having affected services.

The growth of the labour force (attributable largely, perhaps, to the favourable trend of the euro-area labour market) prevented job creation from expressing itself as a sharper reduction in the unemployment rate. Nonetheless, after peaking in the central months of 1997, the unemployment rate fell progressively to 10.5 % in the first two months of 1999, its lowest level for the past five years. Notwithstanding, from a medium and long-term perspective, the labour market situation is far from satisfactory in view of the structural nature of most of the remaining unemployment. The divergence between the results obtained by the various countries, which are more favourable in those which have more resolutely tackled this unemployment compo-

CHART II.5

Euro area. Harmonised indices of consumer prices



Sources: Eurostat and in-house.

TABLE II.5

Deficit targets in the stability programmes
(as a percentage of GDP)

	1999	2000	2001	2002
Belgium	–1.3	–1.0	–0.7	–0.3
Germany	–2.0	–2.0	–1.5	–1.0
Spain	–1.6	–1.0	–0.4	0.1
France (a)	–2.3	–2.0	–1.6	–1.2
Ireland	1.7	1.4	1.6	—
Italy	–2.0	–1.5	–1.0	—
Luxembourg	1.1	1.2	1.3	1.7
Netherlands (a)	–1.3	—	—	–1.1
Austria	–2.0	–1.7	–1.5	–1.4
Portugal	–2.0	–1.5	–1.2	–0.8
Finland	2.4	2.2	2.1	2.3
MEMORANDUM ITEM:				
Euro area	–1.8	–1.6	–1.2	–0.8

Source: National stability programmes.
(a) Lower economic growth scenario.

nent via structural reforms, are particularly illustrative.

II.3.2. Economic policies in the euro area

In the euro-area countries, there was something of a pause in 1998 in the fiscal consolidation process that began in 1994. Although the overall budget deficit fell to 2.1 % of GDP (compared with 2.5 % in 1997), this reduction was underpinned by the lower cost of debt refinancing (because of the downward course of interest rates) and by the favourable impact of activity on the cyclical components of revenue and expenditure. As a result, the primary surplus worsened for the first time since 1994, moving from 2.5 % to 2.4 % of GDP, while the structural budget deficit, i.e. that calculated under neutral cyclical conditions, underwent a slight increase according to various estimates.

Among the main countries in the area, the far-greater-than-expected scale of the improvement in the German budget deficit was particularly significant: it ran a deficit of 2 % of GDP. This result may be attributed, in part, to the generalised containment of spending at all levels of general government, but above all to the cyclical recovery in tax receipts. In France, the deficit underwent a marginal reduction of 0.1 % of GDP to 2.9 %. The improvement, which is no greater owing to the introduction in 1997 of reversible budgetary consolidation measures (of the order of 0.5 % of GDP), is due in particular to the performance of revenue, compared with the difficulties experienced in controlling expenditure. Finally, in Italy, the reduction in interest payments exceeded forecasts, helping counter the weakness of tax receipts.

The aims of budgetary plans for 1999 are, in some cases, not ambitious enough. This is because the improvements envisaged in results tend to reside to a greater extent on the favourable effects of the exogenous factors described above continuing (in particular, the reduction in debt service costs) rather than on a genuine fiscal consolidation drive. In the medium run, the Stability Programmes, the presentation of which by the euro-area countries concluded last January, outline the goals that each member expects to achieve in the coming years (see Table II.5). In certain cases, the rate at which it is planned to draw closer to the goal of achieving a balanced budget by the year 2002 (which some countries have already achieved) seems appropriate. In other cases it would probably have been desirable for the projected consolidation path to have been more resolute. Among the second group are the three biggest countries in the area; given their current fiscal position, they are all among those which tend to show less flexible leeway, in budgetary terms, to withstand, via the built-in stabilisers, a hypothetical slowdown in activity.

In any event, fiscal policy faces very important challenges which advise benefiting, as far as possible, from any opportunity to accelerate progress towards attaining structural balances in equilibrium. Likewise, overcoming the shortcomings on the various product and factor markets should be a priority in all the member states. In this respect, the recent initiatives of the European Council are promising. Under the "Luxembourg and Cardiff processes", it is planned to create an institutional framework which, on one hand, encourages co-ordinated moves to reform national markets and, on the other, promotes the monitoring of the progress made under the multilateral surveillance exercises.

II.3.3. Monetary and financial conditions in the euro area

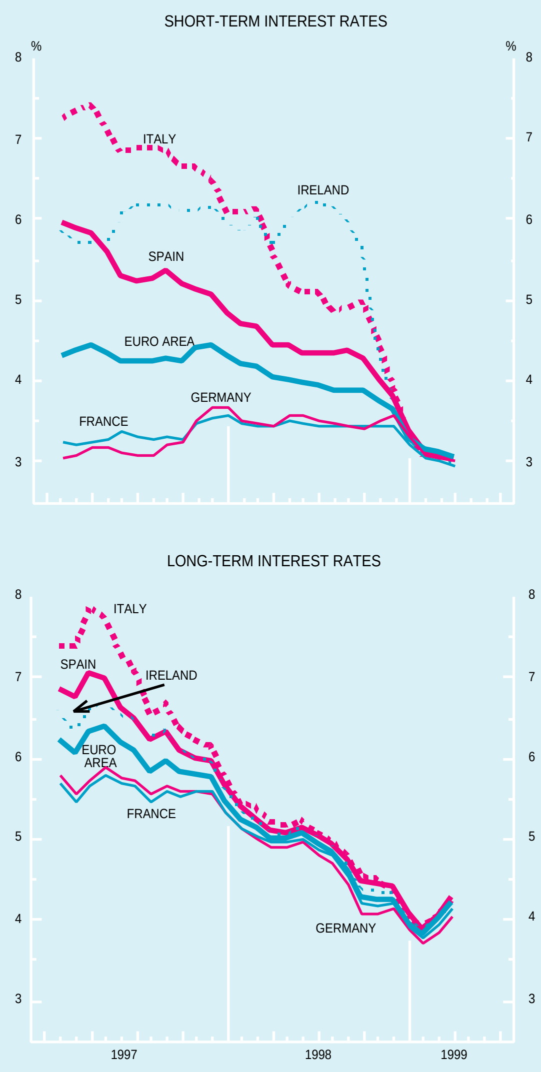
During 1998, monetary and financial conditions in the countries that would make up the euro area drew progressively closer, as reflected in the high stability of bilateral exchange rates and the narrowing of interest rate spreads at all maturities. This process was a consequence of the nominal convergence attained by the economies concerned which, in turn, strengthened the markets' confidence about the culmination of Monetary Union on schedule.

Broadly, monetary conditions across the euro area in 1998 could be considered as accommodating: real interest rates were at historical lows, below 3 %, and the growth of the narrow monetary aggregates and of credit variables was high, especially in the countries with higher growth rates. From May, the exchange rates between the currencies of the countries that would make up the euro area generally remained very stable, at levels close to the ERM central parities. The exception here was the Irish pound, whose strength, tied to that of sterling at that time, made a 3 % revaluation of its central parity necessary in March. The convergence of exchange rates towards their central parities quickened further to the announcement on 3rd May that the conversion rates of each currency against the euro would observe the ERM central bilateral parities. The Irish pound, despite its revaluation in March, held significantly above its central parity until the end of the year, owing to the lesser speed with which the Irish central bank cut its intervention interest rates to align them with those prevailing in the core countries of the area.

National monetary policies in 1998 were strongly influenced by the ongoing convergence of interest rates and by the need to take into account, to an increasingly greater extent, considerations relative to the euro area as a whole. Indeed, the central banks of Germany, France, Belgium, the Netherlands and Finland kept their intervention rates similar for virtually the entire year, and they did not change until December. The other central banks, with higher interest rates, could have regard only to the specific conditions of each economy in administering over time the existing leeway for reducing their intervention rates.

CHART II.6

Interest rates

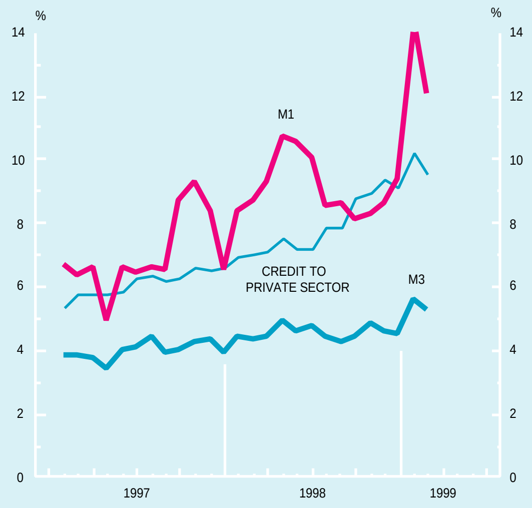


Source: Banco de España.

In this respect, the economies with higher interest rates in relative terms were, with the exception of Italy, those running higher growth rates and, therefore, those potentially vulnerable to greater inflationary risks. Hence, the respective national central banks modulated the reduction of their intervention interest rates in an attempt to soften the potential expansionary effects of these cuts on aggregate demand. Such potential effects were pertinent in view of the low level of real interest rates and of the strong rise in the public's financial wealth that had gen-

CHART II.7

Monetary and credit aggregates in the euro area



Source: Banco de España.

erally resulted from the reduction in interest rates and the favourable performance of equity markets on the international stage. The national central banks of these economies thus tended to assign the biggest portion of the cut in their interest rates to the second half of the year, once the decision had been adopted to begin Stage Three of EMU in 1999 and their position in terms of price stability was more entrenched. Notably, moreover, in view of the widespread uncertainty over how the international financial crisis would unfold, the level at which the ECB's intervention rates were to be set at the outset of Stage Three was not decided until December. It was on 3rd December that the national central banks, in concert, reduced their intervention rates to 3 %. The exception was the Bank of Italy, which followed suit on 22nd December. On that date, the ECB announced that the interest rate on its first main refinancing operation would be 3 % (see Chart II.6).

The trend of shorter-dated interest rates at the national level, especially in the countries where reductions were greatest in 1998, did not have a significant bearing on the rates expected over longer horizons. Indeed, long rates were largely influenced by common factors linked to conditions in the euro area as a whole and to agents' expectations about the monetary conditions that would prevail beyond the start of Stage Three of EMU. Such developments were the outcome of the credibility accorded by economic agents to EMU months before it came into being.

Long-term interest rates in the euro-area countries continued in 1998 on the downward trend observed throughout the nineties. It was interrupted only by certain temporary episodes which also affected the other industrialised countries (see Chart II.6). This trajectory was connected with a notable and generalised decline in inflation expectations and the ongoing reduction in real interest rates and inflationary risk premia. Events on international capital markets did, however, have an effect, especially in the second half of 1998. Then, as a result of the crisis affecting Japan, Russia and certain other emerging markets, there was an ensuing increase in the volatility of public debt prices. In fact, the heightening mid-year of the uncertainty over the scale of the effects of the crisis on the industrialised countries, coupled with the volatility shown by financial markets, altered agents' perception of the risk involved and prompted changes in their portfolio selection decisions.

Investors duly opted for the financial assets considered to be most liquid and safe. This gave rise to switching from equities to fixed-income instruments, from debt issued in emerging markets to instruments issued in the more stable developed countries, and, among the latter, to short-dated debt. These movements, along with the earlier mentioned scaling back of growth and inflation expectations in the industrialised countries in the closing months of 1998, prompted further cuts in long-term interest rates in the euro-area countries.

During 1998, the average yield on ten-year bonds in the area fell by 150 basis points to 3.95 % at year-end. Movements across the different countries were very uniform and, as a consequence, long-term interest rate spreads generally remained fairly stable, after having significantly narrowed in previous years. Nonetheless, after the summer crisis, the "flight to quality" witnessed on the financial markets temporarily affected rate spreads, which widened slightly. But, in the closing months of the year, this phenomenon was fully corrected. The levels of average long-term spreads over Germany in the euro area stood, at year-end, in a range from almost zero in France's case to 30 basis points in the case of Portugal.

The long-term interest rate spread of the euro area over the United States increased somewhat. This was due to the bigger reduction in interest rates in Europe and to the perceptible divergence between the cyclical positions of the United States and the euro-area economies. The spread stood at around 70 basis points at the end of the year.

Turning to the euro-zone stock markets, these generally performed similarly to their US counterpart, albeit with a variable degree of synchrony. In any event, market volatility increased significantly during 1998 as a result of worldwide financial instability. Thus, in the first half of the year, there were sizeable increases on European markets, as reflected in the 45 % rise from end-1997 to mid-July in the share prices of the Dow Jones EURO STOXX general index. However, further to the turbulence caused by the Russian financial crisis in the summer, to the increase in uncertainty and to the emergence of doubts about the sustainability of the marked uptrend on international stock markets, the associated indexes fell. The reflection of this in Europe was a 35 % decline in the EURO STOXX index from July to October. Finally, as from October, there was a rally on securities markets which offset the previous falls.

In this financial setting, the monetary and credit aggregates of the various euro-area countries behaved in a relatively homogeneous way in 1998, similar to 1997. The fall in the opportunity cost of holding liquid financial assets contributed to increasing the rate of expansion of the narrow monetary aggregates, especially in those European countries experiencing higher economic growth. In turn, the lower cost of debt financing prompted a quickening in credit extended to non-financial firms and households, this acceleration proving sharper in the more buoyant economies. The financing of general government continued to diminish significantly, in line with the improvement in budget deficits. As a result of all these movements, the narrow monetary aggregates held at considerably higher growth rates than the broad aggregates, and high rates of expansion were posted for financing obtained by the resident sectors. According to the definition used for the euro area, the M3 aggregate ran at a year-on-year rate of between 4 % and 5 % during 1998, while the M1 aggregate grew at between 8 % and 11 %. Finally, financing to the resident sectors increased in December at an annual rate of 9.8 % (see Chart II.7).

II.4. THE ECONOMIC SITUATION AND MONETARY POLICY AT THE OUTSET OF EMU

At the start of Stage Three of EMU, inflation in the euro area as a whole stood at a 12-month growth rate below 1 %, which was consistent with the price stability target as defined by the ECB (see section II.5). The favourable performance of prices was accompanied by satisfactory economic growth. This was the outcome of the cyclical conditions prevailing in the euro area and of the favourable outlook generated by the introduction of the single currency following the culmination of nominal convergence among the founder members and the attainment of a high degree of macroeconomic stability.

Yet although monetary policy did not have to contend with situations of immediate risk for price stability, the ECB had to adopt its first decisions in a complex setting. Constraints included, on one hand, the technical difficulties of implementing a monetary policy derived from the introduction of the single currency and, on the other, the prevailing uncertainty over the future course of the key economic variables.

Conducting the single monetary policy would require the preparation of new statistics for the euro area and the availability of aggregate time series for a large number of variables, whose properties it had not been possible to study comprehensively beforehand. In turn, the very introduction of the single currency entailed changes in agents' behaviour, thereby hindering the use of models estimated with historical data for the definition of targets and the preparation of projections for monetary policy ends.

The euro-area economy was, moreover, subjected to opposing forces arising from the external sector and from domestic demand. In the case of the external sector, the sluggishness of exports, associated with the international economic instability, exerted a considerable check. Nonetheless, domestic demand remained relatively buoyant, underpinned by the strength of consumption, although the deterioration in fixed capital investment in the closing months of the year contributed to moderating its growth rate.

In the opening months of the year, domestic demand expanded on the basis of relatively easy monetary and financial conditions. Real short- and long-term interest rates thus stood at 2 % and 3 %, respectively. The exchange rate of the euro stood, at the end of March, 6 % down in nominal effective terms compared with the beginning of the year. In turn, stock market prices were at very high levels, once the effects of the Russian crisis were behind. Finally, the monetary and credit aggregates (the narrow ones in particular in the case of the former) were expanding vigorously. Specifically, the growth of M3 in the first half of the year stood above the reference value set by the ECB (4.5 % in annual year-on-year growth terms), although this behaviour was partly the outcome of temporary factors associated with the transition to the single currency.

The price outlook in April 1999 was therefore governed by a slowdown in demand (the result of the behaviour of the external sector and of investment) and by uncertainty as to the continuity of the supply-side factors that had contributed favourably to the low inflation rate recorded in 1999. The main risks for sustaining low inflation rates were associated with the behaviour of commodity prices. In particular, the oil price had risen appreciably in March and April. Likewise, wage settlements in certain countries could have a negative bearing on the inflation rate, especially if they were to be emulated in other countries.

Nonetheless, economic activity in the euro area was showing signs of evident deterioration which, against a background of very low inflation, made a rise in prices that were to place the inflation rate permanently above 2 % in the short and medium run unlikely. In this respect, the weakening in foreign trade in recent months, the slowdown in investment and the progressive deterioration in business confidence augured diminished buoyancy in the economy's final demand. Moreover, were the instability on international financial markets to extend over time, the resulting uncertainty over the prospects of certain economies and their ability to meet their commitments to the rest of the world could prompt a further shrinkage in international trade and inhibit productive investment to a greater than expected degree. All these factors had triggered the generalised downward revision of the latest growth forecasts for the euro area and contributed to the low level of long-term interest rates.

Under these conditions, and in the light of the monetary policy strategy adopted (see section II.5), the ECB decided on 8th April to cut its main intervention rate (that on the weekly tender) from 3 %, at which it had stood since the start of the year, to 2.5 %. It also placed the marginal lending facility rate at 3.5 % and the deposit facility rate at 1.5 %. Given the absence of significant risks for price stability, the ECB sought through this measure to contribute to strengthening economic growth and restoring confidence in the economy.

The measure adopted by the ECB is admittedly tailored to the needs of the area as a whole. But it is likely that its influence will differ according to each economy's situation, and this may have a bearing on price growth differentials, so that the competitiveness of those economies where inflation is higher will be affected. In this respect, it should be borne in mind that price prospects differ as a result, among other factors, of the limited cyclical synchrony still shown by the various countries, linked to their different degree of exposure to the rise in the imported oil price and to the disparate results of wage bargaining to date in 1999. Further, although monetary and financial conditions have eased in all countries of the area, such easing has been appreciably more intense in those economies in which interest rate convergence during 1998 meant a greater reduction in their central banks' intervention interest rates.

II.5. THE STRATEGIC AND OPERATIONAL FRAMEWORK OF THE EUROSYSTEM'S MONETARY POLICY

The year 1998 saw the completion of the preparatory work for the start-up on 1st January 1999 of the Eurosystem's single monetary policy. The task was a very complex one. Lengthy planning periods were needed to harmonise major areas of the national central banks' operational procedures, monetary policy instruments and payment systems, adapting them to a common model. Accordingly, the process was set in train many years in advance, as far back as 1990, in the former Committee of Governors of the European Union Central Banks. With the creation in 1994 of the European Monetary Institute, which took over co-ordination of the bulk of the preparatory work for Monetary Union, significant impetus was given to the process.

During the second half of 1998, the European Central Bank, established further to the European Council decision last May, approved the preparations and finalised certain unresolved matters regarding the definition of the operational framework of the single monetary policy. Regarding the monetary policy strategy, where the European Monetary Institute had left options more open, the Governing Council of the ECB ratified a set of general principles that were to govern the framework of monetary policy objectives (effectiveness, accountability, transparency, medium-term orientation and continuity in respect of the experience built up at the respective national central banks). An all-encompassing strategy pragmatically combining features of different monetary policy models was selected. In adopting this decision, the Council examined in particular the relative merits of strategies based on intermediate money supply targets and on direct inflation targets. Regard was had to the particularities of the euro area and the uncertainty as to how specific aspects of the monetary policy transmission mechanism would work in the area as a whole. Such uncertainty arose especially from the possible change in economic agents' conduct as a result of the structural change inherent to the start of Monetary Union.

BOX II.3

Changes in the implementation of monetary policy

	Previous situation in Spain	Situation in EMU
1. MONETARY POLICY INSTRUMENTS		
Open market operations	• Ten-day tenders with ten-day maturities, through which more than 90% of liquidity was provided. American-type variable-rate auctions. • Very frequent fine-tuning operations (on more than 80 % of market days) with 13 market-makers. Conducted with a one-day maturity and accounted for less than 10 % of the liquidity provided.	• Main refinancing operations: weekly tenders with a maturity of two weeks, which provide around 70 % of the total amount allotted. Fixed-rate tenders with strong rationing (in 60 % of tenders the allotment ratio has been lower than 10%). • Longer-term refinancing operations: monthly tenders with a maturity of three months accounting, approximately, for 30 % of the total amount provided. American-type variable-rate auctions. • Fine-tuning and structural operations may be carried out, but as yet not used.
Marginal lending and deposit facilities	• None.	• Marginal lending facility and credit facility with interest rates set at 3.5% and 1.5 %, respectively. Relatively insignificant and, after initial phase, sporadic use.
Minimum reserves	• Reserve ratio of 2%. • Broad reserve base • Ten-day and concurrent calculation and maintenance periods, with a two-day lag at the beginning. • Non-remunerated.	• Reserve ratio of 2%. • The reserve base has undergone changes which, in the Spanish case, have meant a net increase of approximately 20%. • Calculation of reserve requirements on last day of month and lagged maintenance period, starting on 24th calendar day of following month. • Remunerated at the ESCB rate for main refinancing operations. • Allowance of EUR 100,000 to be deducted.
2. ELIGIBLE ASSETS		
Assets eligible as collateral	• Certificates of the Banco de España (CBE) and book-entry government debt.	• Tier “one” of the Banco de España, including, basically, government and regional and local government debt, matador bonds and mortgage bonds. • Tier “two” of the Banco de España, including other debt instruments with limited credit risk, Ibex-35 non-banking securities and non-mortgage loans. • Tier “one” and “two” assets of the other National Central Banks of the Eurosystem.
Risk control measures	• Unnecessary.	• Valuation “haircuts” depending on the type of asset and maturity, and initial margin for all monetary operations depending on maturity.
Eligibility mechanism	• Repo operations.	• Repo operations. • Pledged assets.
3. COUNTERPARTIES		
	• Banks, savings-banks and credit co-operatives (around 250).	• All credit institutions (around 400).
4. LARGE-VALUE PAYMENT SETTLEMENT SYSTEMS		
	• Domestic payments through the Money Market Telephone Service, which operated as an end-of-day gross settlement system. • Cross-border large-value payments through SEPI (Spanish interbank payment service) (around EUR 35 billion daily). • Correspondent accounts. • Cross-border payments through the ECU Clearing System of the EBA (around EUR 120 billion daily for the euro area as a whole.	• Domestic payments through the Banco de España Settlement Service, as the Spanish component of TARGET, converted into a real-time gross settlement system. • Cross-border payments mainly through TARGET (around EUR 400 billion daily for the euro area as a whole), and, to a lesser extent, through the Euro Clearing System (formerly ECU Clearing System) of the EBA and other net multilateral systems. In addition, correspondent accounts.

TABLE II.6

Definitions of monetary aggregates in the euro area

	Spain before EMU			Euro area		
ISSUING SECTORS	Spanish credit system			Euro-area credit system Euro-area money market funds		
HOLDING SECTORS	**Residents in Spain:** • Non-financial firms and households • Private non-profit institutions • Insurance companies • Pension funds • Mutual funds • Securities dealer companies and agencies • Administrative agencies			**Residents in euro area:** • Non-financial firms and households • Private non-profit institutions • Insurance companies • Pension funds • Mutual funds (except FIAMMs) • Securities dealer companies and agencies • General government, except central government		
FINANCIAL ASSETS	**M1**	**M2**	**M3**	**M1**	**M2**	**M3**
Cash in circulation	✓	✓	✓	✓	✓	✓
Sight deposits	✓	✓	✓	✓	✓	✓
Time deposits						
Up to two years			✓		✓	✓
Over two years			✓			
Deposits redeemable at up to three months' notice		✓	✓		✓	✓
Repurchase agreements			✓			✓
Shares in Money Market Funds (MMFs) and money market instruments						✓
Securities other than shares up to two years			✓			✓

Note: "✓" denotes items included in the respective definition.

The first element of the Eurosystem's monetary policy strategy agreed on by the Governing Council of the ECB is the definition of the price stability objective laid down in article 105 of the Treaty on European Union. This objective has been defined as maintaining a 12-month growth rate for the euro-area Harmonised Index of Consumer Prices of below 2 % over the medium term. This definition is notable in several respects. First, by implicitly excluding deflation as compatible with price stability, the latter is effectively defined in terms of an inflation corridor between 0 % and 2 %. Second, the definition adopted is in line with those applied prior to the start of Monetary Union by many euro-area central banks, including the Banco de España. Third, in placing the objective in the medium term, it is stressed that the Eurosystem monetary policy stance shall be considered over this horizon. In that way, deviations from the target deemed as temporary may be tolerated and, in the face of sharp short-run variations in the level of prices, an immediate return to the target will not be pursued, since that would require abrupt changes in the monetary policy stance that might generate excessive cyclical volatility in the economy. Finally, the definition is a reminder that the price performance of relevance for monetary policy decisions refers to the euro area as a whole; accordingly, the single policy will not react to specific national or regional situations.

The Eurosystem pursues the above-defined price stability objective through an assessment of the inflation outlook in the euro zone drawing on a systematic analysis and overall evaluation of a broad set of area-wide economic, monetary and financial indicators. However, a leading role is given to the trend of the money stock, in recognition of the essentially monetary nature of inflation in the medium and long term. Thus, using the terms coined by the ECB, the money stock is the "first pillar" and the set of economic and financial indicators the “second pillar” of the monetary policy strategy adopted.

The importance of the monetary aggregates in the Eurosystem’s strategy could be seen in the fact that the ECB Governing Council set a reference value for the growth of the M3 aggregate. This aggregate was selected after a comparative analysis of the stability of the demand for different definitions of the money stock and their properties as leading indicators of price developments. A comparison between the money stock definitions adopted by the Eurosystem and those previously existing in Spain is given in Table II.6. The year-on-year growth of this aggregate, which was considered compatible with the definition of price stability, was set at a level of 4.5 %. To underscore the Eurosystem’s intent to avoid mechanistic responses to temporary deviations by monetary growth from the reference value set, and, therefore, without too much informative content on medium-term price prospects, it was decided that such deviations would be evaluated in terms of the moving average of the year-on-year growth of M3 over the previous three months.

The definition of the monetary policy strategy and the adoption of the associated key decisions were thus necessarily centralised in the Governing Council of the ECB. But for the implementation of such policy the Eurosystem opted for an essentially decentralised model. That allows harnessing of the technical and personal skills, the experience and the comparative advantage of the national central banks in respect of their knowledge of national markets and their relationship with the banking industry in their respective countries. Box II.3 details the specific characteristics of the instruments available to the Eurosystem, the general features of which are discussed below.

Monetary policy is essentially implemented through open market operations. As a general rule, the operations are conducted by means of weekly tenders, where loans at two weeks are extended, and monthly tenders, where three-month loans are granted. In addition, the possibility of conducting specific operations of a more structural nature has been envisaged when, in the opinion of the ECB, conditions so require it in order to affect the structural position of banks’ liquidity.

The weekly and monthly tenders are the main sources of liquidity for banks, although the bulk of liquidity is supplied by the weekly tenders, whose interest rates are the valid reference of the Eurosystem’s monetary policy stance. Financial and monetary institutions can adjust their daily liquidity requirements by resorting to the Eurosystem’s lending and deposit facilities. The interest rates on these standing facilities form a corridor which bounds overnight interest rate fluctuations. Under the Treaty, all liquidity injection operations require that sufficient collateral be provided by the recipient institutions.

The ECB decided to impose a minimum reserve requirement, whose level it set at 2 %. This reserve ratio is calculated on the basis of credit institutions’ average reserve holdings over a maintenance period of one month, which should contribute to reducing the volatility of very short-term interest rates. The reserve holdings are remunerated at the weekly tender rate, whereby the reserve requirement arrangements entail no cost for the institutions affected.

The adoption of this common operational framework for the implementation of the Eurosystem’s monetary policy has required significant changes in the national central banks’ intervention procedures and instruments. As mentioned, Box II.3 provides some extra details on the features of the new operational framework, comparing it with the previous situation in Spain. Although there were a series of changes in Spanish monetary policy implementation during 1998 aimed at smoothing the transition to the new framework, these changes are not taken into consideration in the box so as to highlight the differences between the new and former framework. Notably, too, the data offered in relation to the new operational framework refer to the first four months of 1999.

To date, the Eurosystem’s monetary policy has been implemented without particular difficulty, despite the scale of the changes involved for national central banks and for market operators. Contributing significantly to this has been the sound working of the interbank market, thanks, among other factors, to the effective coming on stream of the TARGET interbank operations settlement system. TARGET enables institutions to transfer to or receive funds from institutions resident in euro-area countries with the same security and speed with which these operations were previously made between institutions in a single country. TARGET is a real-time gross-settlement system, which requires payer institutions to have sufficient funds in their accounts at the related central bank or sufficient collateral so that the central bank in question may extend it the necessary credit.

Generally, monetary policy implementation and liquidity management by credit institutions have been conducted without significant frictions. That said, some of the features of the weekly tenders initially entailed adaptation costs for institutions, especially those in certain countries not accustomed to obtaining financing at fixed-rate tenders with strong rationing of the amounts allotted. This situation created liquidity redistribution problems. But these gradually eased as the Eurosystem adopted a more flexible liquidity-supply policy, enabling the overnight interbank interest rate to oscillate around the weekly tender rate, and as the integration of the various national segments of the euro money market was gradually completed.

CHAPTER III

THE SPANISH ECONOMY

III.1. INTRODUCTION

In 1998, as mentioned in Chapter I of this report, the Spanish economy took full advantage of the climate of stability achieved, which was conducive to higher rates of growth and job creation. On initial National Accounts (CNE) data, GDP at constant prices grew by 3.8 %. This was higher than the rate achieved in 1997 (3.5 %) and also higher than the EU average. Meanwhile employment grew by 3.3 %, giving rise to a significant reduction in the rate of unemployment. A balanced economic policy mix enabled this high growth to be accompanied by a further reduction in the rate of inflation, against a backdrop of heavy falls in commodity prices on international markets and containment of wage settlements.

The rate of growth of national demand quickened notably over the year as a whole to 4.9 %, assisted by the improvement in agents' expectations regarding the economic situation and by the gradual loosening of monetary conditions, which took real interest rates to historically low levels. For its part, net external demand made a negative contribution of 1.2 percentage points to output growth, which increased as the year elapsed.

In the first half of 1998, the advanced stage of the cyclical expansion entailed a significant increase in imports. However, the continued strength of exports prevented an excessive fall in the contribution of external demand to GDP growth, in a setting of recovery in the European economies, albeit with certain differences in their cyclical positions (see Box III.1). Nonetheless, the spreading of the effects of the international financial crisis led to a drastic slowdown in manufacturing exports in the second half of the year, which strengthened the negative contribution of net external demand. Although the deterioration in the external environment prompted a decline in firms' demand expectations, which ultimately fed through to their investment plans, domestic demand continued to grow at high rates. It was driven by the strength of construction spending (the aggregate least sensitive to external events), the strength of private consumption and the thrust that continued to emanate from capital investment despite its slowdown. Hence, the pattern of growth changed as the year unfolded. From being underpinned largely by the buoyancy of exports and private productive investment, growth came to depend on household spending and construction.

From the viewpoint of the productive branches, the most notable feature in 1998 was the gradual slowdown in value added in manufacturing, affected by the weakness of external sales. Meanwhile, market services displayed a more sustained rate of growth during the year, construction activity recovered strongly, in line with spending, and primary activities emerged from the recession that affected them in 1997.

III.2. DEMAND

The expansionary thrust experienced, to a greater or lesser degree, by all the components of national demand in 1998 is evident in Table III.1, which shows aggregate demand and GDP. Government consumption was the most moderate component. Both exports and imports slowed during the year, especially the former. Nonetheless, their rates of growth remained well above those of domestic spending, so that the degree of openness of the economy – i.e. the sum of exports and imports as a percentage of GDP at constant prices – rose to 76.2 %. The following sections analyse these results in terms of the spending decisions taken by the various economic agents.

III.2.1. National demand

Table III.2 provides an estimate – provisional in the case of the most recent years – of the

TABLE III.1

Main macroeconomic aggregates

Real rate of change

	% GDP 1998	1995	1996	1997	1998	1998 (a)			
						Q 1	Q 2	Q 3	Q 4
National private consumption	62.3	1.6	2.0	3.1	3.8	3.9	3.9	3.8	3.7
Government consumption	16.0	1.8	0.9	1.4	1.6	1.8	1.8	1.6	1.2
Gross fixed capital formation	24.2	8.2	1.3	5.1	9.0	8.4	9.1	9.3	9.4
Construction	*14.0*	*6.6*	*–2.0*	*1.3*	*6.5*	*5.0*	*6.2*	*7.1*	*7.8*
Capital goods and other	*10.2*	*11.2*	*7.1*	*11.0*	*12.7*	*13.6*	*13.3*	*12.5*	*11.6*
Change in stocks (b)	0.3	0.2	0.0	–0.3	0.2	0.1	0.2	0.2	0.3
National demand	**102.8**	**3.2**	**1.6**	**2.9**	**4.9**	**4.7**	**5.0**	**4.9**	**4.9**
Exports of goods and services	36.7	10.0	10.6	14.8	7.8	10.6	8.5	6.5	5.9
Final demand	**139.5**	**4.6**	**3.6**	**5.7**	**5.6**	**6.2**	**5.9**	**5.4**	**5.2**
Imports of goods and services	39.5	11.0	7.4	12.2	10.6	12.5	11.3	9.5	9.4
Gross domestic product	**100.0**	**2.7**	**2.4**	**3.5**	**3.8**	**3.9**	**3.9**	**3.8**	**3.6**
MEMORANDUM ITEM:									
Net external demand (b)	–2.8	–0.6	0.7	0.5	–1.2	–0.8	–1.1	–1.2	–1.4

Source: Instituto Nacional de Estadística.

(a) Annual percentage change.

(b) Contribution to GDP growth.

breakdown of the most significant components of national demand, in terms of the spending decisions of the various economic sectors and agents: households, firms and general government. From this viewpoint, the strength of domestic demand in 1998 was a consequence of a substantial acceleration in the spending of households on private consumption and housing. Business investment also grew at very high rates, increasing its weight among the components of demand, so that capital investment was, for the second year running, the component of domestic demand with the highest rate of growth, despite having slowed in the second half. General government demand accelerated slightly over the year as a consequence of the larger impulse from investment.

Private consumption grew at an average real rate of 3.8 % in 1998, as against 3.1 % the previous year. This aggregate was more dynamic in the first part of the year, subsequently tending to stabilise at high, though slightly declining, rates of growth. The main factor driving consumption in 1998 was the increase in the spending capacity of households. However, the improvement in consumer confidence and, in general, the trends in financial variables also contributed. The latter included the continued decline in interest rates, the further revaluation of wealth and the strong growth of credit.

In fact, real household disposable income grew by 3.4 % in 1998, as against the estimate of 1.7 % for 1997. This acceleration was basically a result of the performance of wage income, a consequence, in turn, of the high rate of job creation and a certain increase in real wages, due to wage settlements under collective agreements (2.6 %) and the fact that annual inflation was lower than initially expected. Non-wage income also accelerated considerably. Particularly notable was the increase in income relating to business activities carried out by households for their own account. By contrast, income relating to the remuneration of savings made a negative contribution, albeit somewhat smaller than in 1997. The successive cuts in interest rates led to a decline in the returns from holding financial assets, and an increase in the volume of indebtedness, with a consequent rise in interest payments. Finally, the contribution of general government to the increase in household income – through the combined effect of taxes and social security contributions and benefits – was small, and of a similar magnitude to previous years. The increase in disposable income helped to finance the larger increase in consumption, in real terms, although there was also a reduction in the savings ratio, which stood at 10.1 % of disposable income.

Apart from the contractionary effect on household disposable income, the decline in interest rates had important expansionary effects on consumption through other channels. First, the financial wealth of households has been substantially revalued in recent years, boosted

The relationship between the Spanish and European business cycles

The growing synchrony in the cyclical fluctuations of the economies of the developed countries is particularly important for economies involved in integration processes, like EMU. To assess to what extent these economies display similar and synchronised responses to disturbances, or whether their business cycles differ in intensity and duration, or are out of phase, are crucial questions. The purpose of this box is to present certain indicators of the degree of synchrony between the cyclical fluctuations of the main Spanish economic aggregates and those of the other main European economies.

The adjoining chart shows the cyclical component (1) of Spanish real GDP superimposed on that of the aggregate euro-3, which summarises the performance of the other main euro area economies: France, Germany and Italy. These economies are also Spain's main trading partners and those potentially having the greatest influence on Spanish aggregate cyclical fluctuations. The series for the euro-3 aggregate are a weighted average of the related French, German and Italian series, in which the weights reflect the weight of each country in Spain's total trade with these three countries. Although the cycle of Spanish real GDP lags somewhat behind that of the euro-3 in the first half of the sample period, the lag shortens thereafter until almost complete synchrony is attained by the end of the period. The high degree of synchrony between the cyclical components of the French and German series is also notable in the period studied (except around the time of German reunification), as seen in the adjoining chart.

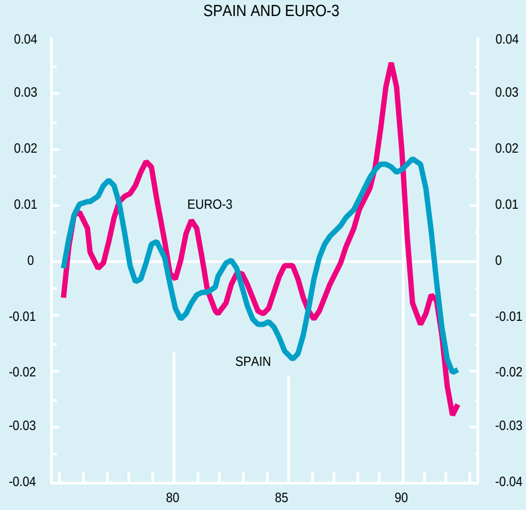
The adjoining table summarises the results of a more detailed analysis of the degree of joint fluctuation, based on the calculation of cross correlations between the cyclical components of the Spanish series and those of the series of the other main European economies (2). The series studied are GDP and some of the main components of aggregate demand, at constant prices and per capita, as well as employment as a percentage of the labour force and total hours worked per capita. The data are quarterly, running from 1970 Q1 to 1996 Q4. The main result of the analysis is confirmation of the strong synchrony between the Spanish and European business cycles, with a coinciding joint fluctuation of GDP, private investment, imports and net exports. However, the cyclical fluctuation of private consumption in Europe is more than one year ahead of that observed in Spain, as is that of employment. The least correlated cyclical components are those of government consumption (probably due to the different national fiscal policies) and exports (due to the different destinations of those of each country). The strong relationship found with the euro-3 aggregate is basically due to the high degree of correlation and synchrony between the Spanish business cycle and the French one, and to a lesser extent the Italian one too, while the interdependence with the German cycle is characterised by a high degree of correlation, but with the German cycle about one year ahead of the Spanish cycle.

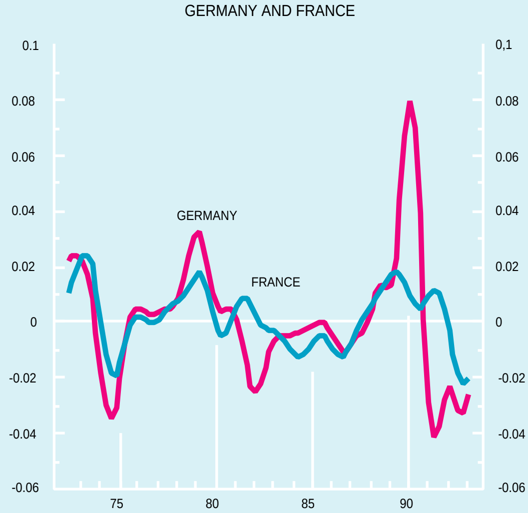
In sum – with the exception of the existence of a certain lag in the cyclical fluctuations of certain Spanish variables – evidence is found of similarity and synchrony between the cycles of Spain and of the other main euro area economies. Moreover, the similarity has become more pronounced as the degree of integration between these economies has increased.

(1) Obtained by applying to the original series a linear band filter proposed in Baxter, M. and R. King (1995), *Measuring Business Cycles: Approximate Band-Pass Filters for Economic Time Series,* NBER Working Paper no. 5022.

(2) See Ortega, E. (1998), *The Spanish Business Cycle and its Relationship to Europe,* Banco de España, Working Paper no.9819.

Cyclical fluctuations of GDP





Source: Banco de España.

Maximum correlation between the cyclical components of the Spanish series at t and that of the aggregate euro-3 at t + k, k being the number of quarters' difference in brackets

GDP	0.59 (a)	(0)
Private consumption	0.72 (a)	(–5)
Government consumption	0.12	(–1)
Private investment	0.72 (a)	(0)
Exports	–0.28	(–4)
Imports	0.63 (a)	(0)
Net exports	0.61 (a)	(0)
Employed	0.78 (a)	(–5)
Total hours	0.67 (a)	(–2)

Source: Banco de España.
(a) Correlation coefficients significantly different from zero.

TABLE III.2

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

Real rate of change

	% GDP 1998	1995	1996	1997	1998
Households					
Private consumption	62.3	1.6	2.0	3.1	3.8
Gross fixed capital formation (b)	4.5	7.1	9.1	–0.7	8.0
Firms					
Gross fixed capital formation (c)	15.9	12.8	2.4	8.0	8.0
Construction	*7.0*	*8.0*	*–1.7*	*4.2*	*3.2*
Equipment	*9.0*	*18.0*	*6.5*	*11.5*	*12.0*
General government					
Government consumption	16.0	1.8	0.9	1.4	1.6
Gross fixed capital formation	3.7	–4.9	–11.1	–0.1	15.4
Of which:					
Construction	*2.5*	*3.0*	*–18.0*	*–3.0*	*14.0*
MEMORANDUM ITEM:					
Gross fixed capital formation	24.2	8.2	1.3	5.1	9.0
Construction	*14.0*	*6.6*	*–2.0*	*1.3*	*6.5*
Equipment	*10.2*	*11.2*	*7.1*	*11.0*	*12.7*

Sources: Instituto Nacional de Estadística and Banco de España.

(a) Some figures are provisional Banco de España estimates.
(b) Domestic residential investment.
(c) Private productive investment; includes investment by individual entrepreneurs.

by the extensive shift in savings from more traditional investments – such as time deposits – towards other higher yield instruments, such as mutual funds. The latter have been revalued more than other assets in recent years, largely due to the path of interest rates. However, it should be noted that it is difficult to estimate the size of the effect that this increase in wealth may have had on consumption demand. Second, the expansionary effect of interest rate cuts on consumption through the substitution effect – by lowering the relative cost of deciding to spend earlier in time – has been significant, especially in the case of consumer durables, the acquisition of which is linked to the availability of financing (see Chart III.1).

In any event, the increase in household disposable income was rapidly passed through to their spending decisions, against a backdrop of growing optimism regarding the general economic situation and, in particular, employment. The consumer confidence index improved substantially as the year elapsed, financial market turmoil in the second half hardly impeding its upward path in the final quarter, and it ended the year at levels comparable to the peaks reached in the last cyclical expansion. The improvement in consumer confidence was boosted by the changes in the composition of the employment generated during the year; the weight of permanent contracts grew, reducing the uncertainty in the future income expectations of employed persons.

Of the main spending categories of consumption, the continued buoyancy of the acquisition of durable goods is notable. It was underpinned not only by the extraordinary growth in the demand for motor vehicles, but also by the expansion of spending on those categories of goods closely related to the acquisition of new houses, such as electrical appliances and other household equipment. The consumption of services accelerated slightly over the year, while spending on food rose moderately.

The recovery in housing investment, after its hesitancy in 1997, linked to the temporary stagnation in housing start indicators, was fully consolidated in 1998, when residential investment sustained very high rates of growth (see Chart III.2). The increase in household disposable income and the significant decline in mortgage rates in recent years gave rise to a considerable improvement in the terms of household access to the acquisition of housing, although its relative price rose considerably. Over the last four years an unsatisfied demand has emerged, accumulated from previous cycles, when high house prices, high interest rates and uncertainty regarding job stability curbed the acquisition of housing, although those sections of the population with the greatest tendency to form new households had increased substantially. The buoyancy of residential investment was also boosted in 1998 by factors relating to the purchase of houses as an alternative asset in which to hold wealth, due to the decline in the returns on financial assets subject to risk. In addition, foreign investment in property has increased very considerably in the last two years, helping to explain the growth in the demand for housing and the pressures on prices in coastal areas.

Although the household saving ratio held more or less stable in 1998, the expansion of residential investment entailed a reduction in the financing capacity of the sector which, on provisional estimates, stood at 2.7 % of GDP. This rate was still higher than that achieved in the most advanced stages of the previous cyclical expansion.

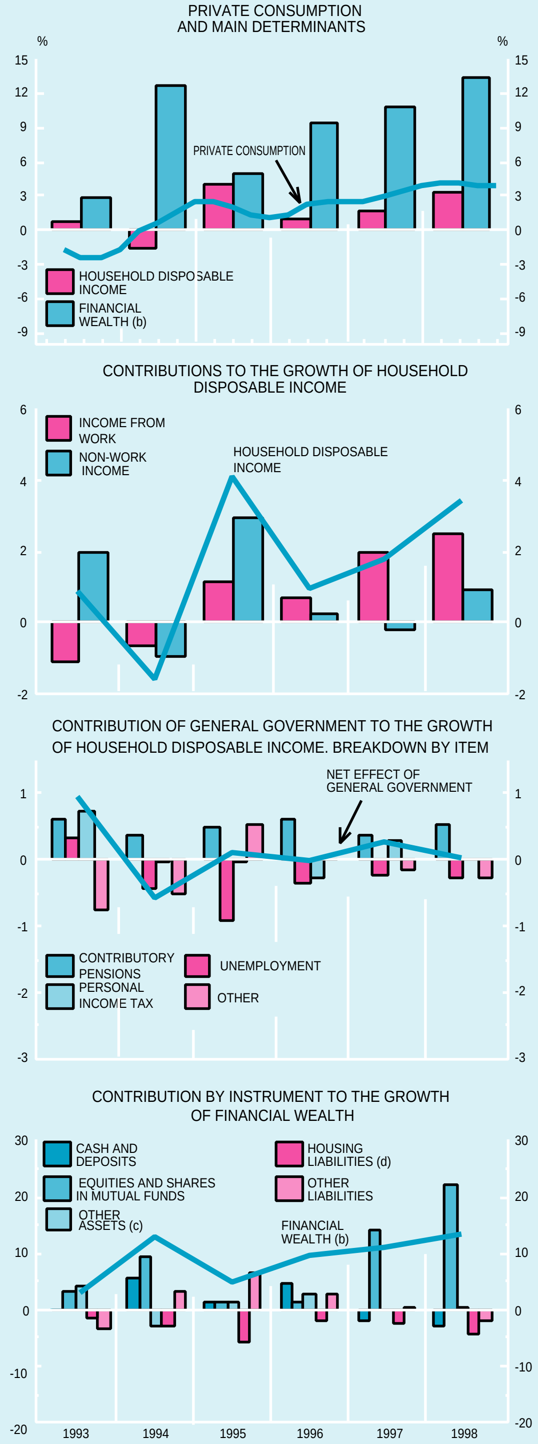
In 1998, general government demand continued to be governed by the authorities' commitments to contain public spending and correct the budgetary imbalance, although its composition was orientated, to a greater extent than in previous years, to improving the economy's productivity. The adjustment drive was thus concentrated on government consumption, which sustained the moderate tempo that had characterised it in previous years, while investment increased considerably. According to figures published by the National Statistics Office (INE), real government consumption grew at a rate of 1.6 % in 1998, very similar to the rate in 1997, while in nominal terms it grew by 3.5 %, with each of its components behaving differently. Compensation of wage-earners accelerated slightly, as a consequence of the increase in the remuneration of public sector employees in line with expected inflation, compared with the freeze of the previous year, while the growth in the number of wage-earners was once again very modest. The rate of growth of net purchases of goods and services edged downwards, although there was an upward deviation in those made by the State in relation to the total budgeted. Finally, fixed capital consumption also decelerated slightly, increasing moderately, in step with the contraction in the stock of public capital in recent years, as a consequence of the cut in investment spending.

After five consecutive years of sizeable real decreases, public investment commenced a timid recovery in 1997, which strengthened substantially in 1998, when its real rate of growth stood at around 15 %. The recovery was particularly significant in the case of Territorial Government, while Central Government spending remained very moderate. As to the type of investment, the expansion of investment in construction (the largest component), which had fallen considerably in the two preceding years, was notable. Moreover, the scant information available on public investment in capital goods indicates that this item was also very buoyant in 1998.

Productive investment – in capital goods and in private non-residential construction – by the business sector has been the most expansionary component of domestic demand since 1996. As a percentage of GDP, having fallen significantly in the first few years of the Nineties, it has subsequently increased considerably, to stand at levels similar to those attained in the previous expansion of the economy. In fact, in 1998 as a whole the rate of growth of private productive investment strengthened slightly.

CHART III.1

Private consumption (a)

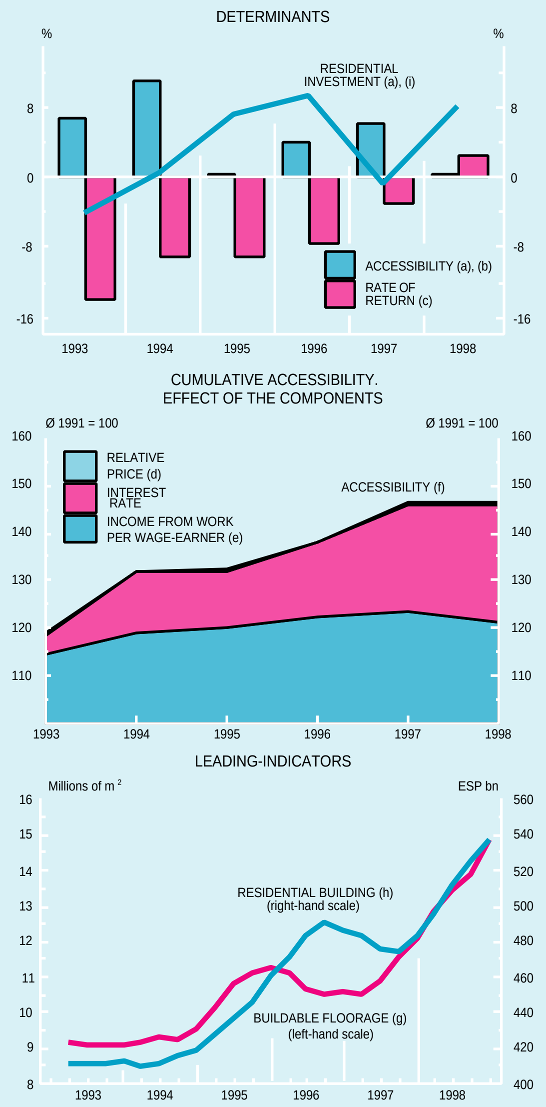


Sources: Instituto Nacional de Estadística and Banco de España.

(a) Year-on-year real rate of change.
(b) Wealth calculated at the begining of the period.
(c) Includes, inter alia, short-term securities, technical insurance reserves and bonds.
(d) Credit to individuals for purchase of own dwelling.

CHART III.2

Residential investment



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

(a) Real rate of change.
(b) This indicator attempts to approximate some of the factors determining the capacity of a family to purchase a dwelling. It has been constructed on the basis of the relative price of housing, the mortgage interest rate and household income, approximated by income from work per wage-earner.
(c) Estimated as the difference between the rate of change in the price of a new home and the nominal interest rate on alternative assets, approximated here as the yield on ten-year government bonds.
(d) In relation to the private consumption deflator.
(e) Net of contributions and expressed in real terms.
(f) 1991 = 100.
(g) Uncentred 12-term moving average of the buildable floorage (expressed in square metres) for residential use, according to the official "Edificación y Vivienda" (Building and Housing) statistics.
(h) Annual National Accounts figures converted to a quarterly basis. 1986 constant pesetas.
(i) Banco de España estimate for 1998.

As seen in Chart III.3, in which the profile of productive investment has been approximated by capital goods investment, this impulse was especially significant in the first half of the year, in a context of strong growth in final demand. The latter led to an increase in the level of capacity utilisation, and expectations that demand would remain expansionary, generating a need to increase productive equipment. The restraint in the rate of growth of final demand in the second half of the year, caused by the weakness of exports and the deterioration of demand expectations, linked to the climate of uncertainty then prevailing, prompted a downward adjustment of firms' investment plans. In any event, investment remained considerably buoyant, a result that the favourable terms of borrowing and the high levels of profitability of Spanish firms help to explain.

On Central Balance Sheet Office data, the favourable trend in activity during the current recovery, together with the gradual decline in interest rates and the moderate growth in operating costs, as a consequence of the slowdown in wages and salaries, have given rise to successive increases in the profitability of non-financial firms, which reached very high levels in 1998. The growth of self-financing, due to the healthy profits earned, has enabled firms to undertake restructuring, in the form of an ongoing reduction in levels of borrowing. However, in 1998, the combination of low interest rates and high returns on assets led firms, for the first time since 1993, to increase their recourse to external funds to undertake new investment projects. Also, a certain slowdown was discernible in funds generated in 1998, which particularly affected manufacturing activity, although without preventing its profitability rate from improving.

In the specific case of industrial firms, information is available on the purpose of the investment undertaken in 1998, based on the results of the half-yearly survey of investment carried out by the Ministry of Industry and Energy. According to this survey, the main purpose of investment was to increase capital, although the rationalisation of productive processes – a concept which includes labour substitution, as well as the introduction of new technologies and the saving of raw materials – continued to be a very significant reason for firms' investment plans. The survey has also captured the negative impact of the international crisis on investment plans for 1999. Of the factors determining the scheduling of investment, a reduction has been detected in the importance of the expansion of productive capacity, while the introduction of improvements in performance has acquired greater prominence.

Information is also available on business investment in construction by productive activity. Within this component, the building of premises for industrial uses was seen to be highly buoyant, in line with the expansion of this activity. Likewise, the construction of offices and commercial premises grew significantly, somewhat relieving the scarcity of this type of building. In contrast, there was a slowdown in investment in buildings for agricultural use, closely linked to the moderate advance of activity in the primary sectors.

Finally, stockbuilding made a positive contribution of two percentage points to GDP growth in 1998, in contrast to the 0.3 points it deducted the previous year. The successive cuts in interest rates and the fall in commodity prices on international markets led to a significant reduction in the cost of holding stocks, which firms exploited by voluntarily increasing their levels of stocks. The increase in the desired levels of stocks must have been particularly significant in the first half of the year, when very favourable expectations prevailed regarding the path of final demand in the economy. However, with the growing weakness in sales on external markets as the year elapsed, business surveys revealed an increase in the number of employers reporting higher-than-desired levels of stocks, indicating an increase in the involuntary component of stock building. This undesired increase in levels of stocks was greatest among the producers of inputs, while producers of capital goods held stocks closer to the desired level, due to the strength of the demand for such goods both on external markets and at home.

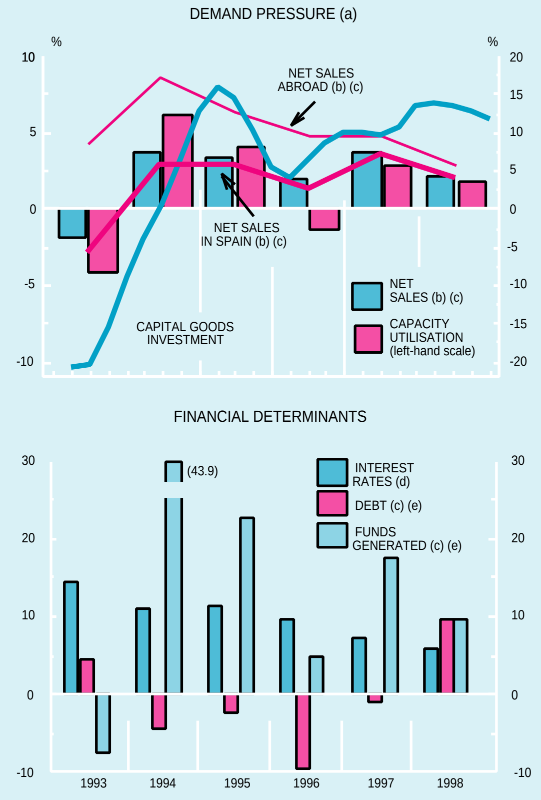
III.2.2. External demand

In 1998, the contribution of net external demand to output growth was –1.2 percentage points, in contrast to the positive contribution of 0.5 points in 1997. The contractionary effect was mainly a consequence of the sharp slowdown in exports of goods and services, with average real growth of 7.8 % in 1998, well below the 14.6 % growth in the previous year. Imports also contributed to the contractionary impulse in the first few months of the year, when they attained a high rate of growth, which subsequently stabilised, although at a slightly lower level. The real rate of growth of imports in the year as a whole was 10.6 %, somewhat below that of the previous year.

As seen in Chart III.4, goods exports continued to grow at very high real rates at the beginning of 1998, despite the fall in demand from Asian countries, which were in deep recession from mid-1997. The small share of Asian countries in Spanish exports and, above all, the strength of sales to euro area markets, against a background of progressive strengthening of these economies, were instrumental here. However, the situation changed considerably in the second half of the year, with the international crisis spreading to other emerging economies, including notably the Latin American countries, with which Spain has closer trade links. Sales to these markets began to display great weakness, aggravated by the petering out of the positive effects of the previous year's improvement in competitiveness vis-à-vis the dollar-area

CHART III.3

Private productive investment



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

(a) Year-on-year real rate of change and differences for capacity utilisation.

(b) Net turnover deflated by the final demand deflator. The domestic-demand deflator and the exports deflator have been used for its domestic and external components, respectively.

(c) Data to 1997 obtained from the annual figures released by the Central Balance Sheet Office and for 1998 from the quarterly figures.

(d) Nominal interest rate on one- to three-year bank loans.

(e) Nominal rate of change of the level of both variables.

countries. Furthermore, some of these countries introduced protectionist measures to reduce imports and so relieve the effects of the fall in commodity prices on their trade balances. Finally, the International crisis eventually affected the euro area countries, curbing the recovery apparent in the first half of the year and prompting a further slowdown in external sales. The latter ended the year with a real rate of growth of 2.6 %, in contrast to the 10.4 % increase in the first quarter (see Box III.2).

On average in 1998, exports to the euro area grew by 9.2 %, in nominal terms, as against almost 15 % in the first half of the year. Within this area, sales to France rose by 14.1 %, well above the rate of the previous year, despite slowing sharply as the year elapsed. By contrast those to Italy and Germany advanced very moderately. Outside the euro area, sales to the UK grew at a similar rate to 1997, driven by the appreciation of sterling in the first half of the year, while those to the US slowed drastically. The latter are strongly dominated by consumer manufactures, the competitiveness of which was negatively affected by the devaluations of the Asian countries' currencies. Finally sales to Japan and Asian countries fell heavily, while those to Latin America and Central and Eastern European countries grew slightly on average during the year. Nonetheless, within the latter group of countries, exports to those which have signed trade agreements with the EU were very expansionary.

In contrast to the weakness of goods exports, tourism receipts accelerated further in 1998, growing at a real rate of 11 % in the year as a whole. The buoyancy of this component of external demand is related to the improvement in the factors determining consumption in the main European economies, which translated into a larger influx of tourists from France and Germany. Tourism from the UK remained notably strong, bolstered by the appreciation of sterling to mid-1998. In addition, the promotional campaigns of recent years, aimed at reducing the pronounced seasonality which has traditionally characterised tourism, by promoting alternative tourist destinations and products to those offered by the coastal regions, seem to be bearing fruit, having stimulated a larger influx of visitors outside the summer months.

Goods exports grew by 8.3 % in 1998, somewhat below the 10.3 % rate of 1997, in line with the slight slowdown in final demand. By contrast it is not possible to attach much importance to changes in the competitiveness of imported products, since import prices moved very much in line with the prices of domestically produced goods. Analysing the composition of imports by product group, it can be seen that purchases of non-energy intermediate goods were the most hesitant, owing to the slowdown in certain industrial activities that make intensive use of imported inputs. On the other hand, imports of capital and consumer goods quickened, in step with the strength of these components of aggregate demand. Of consumer goods, the growth of car purchases was particularly strong, possibly driven by a shift in demand from cars towards a range of vehicles not produced domestically. Energy imports also rose significantly, reflecting the recovery in the refining industry over the last two years associated with the low oil price.

As for other external demand transactions, tourism payments grew by 10.1 % in 1998, underpinned by the improvement in the confidence of Spanish consumers and by the peseta's stability against the dollar during the year, following the depreciation of 1997. Finally, receipts and payments for services other than tourism sustained very high real rates of growth as a consequence of the increase in freight and passenger transport operations, and the expansion of certain services items provided to firms, which have been boosted in recent years by the liberalisation measures adopted by the World Trade Organisation.

III.3. OUTPUT AND EMPLOYMENT

In 1998 as a whole, the acceleration in national demand offset the slowdown in exports, with the result that final demand rose by 5.6 %, very close to the rate estimated for 1997. Despite this stable growth in final demand, the rates of change of the flows of products to satisfy it – imports and GDP – changed, with a certain weakness in external purchases and a recovery in domestic output. This somewhat uneven behaviour may have been related to the greater moderation in those components of demand most closely linked to imports (such as exports), while domestic activity was stimulated by the considerable recovery in construction. In fact, the acceleration in output in 1998 was not common to all the productive branches; while construction and agriculture were expansionary, industry – affected by the performance of exports – decelerated, and the services branches also slowed somewhat.

On QNA estimates, the rate of job creation, boosted by the recovery in GDP, rose to 3.3 %, six tenths of a percentage point higher than in 1997. Consequently, for the third year running, apparent labour productivity grew at a low rate. During the year, output and employment followed different paths. GDP sustained rates of

BOX III.2

An approximation to the effects of the international financial crisis on Spanish economic activity: the foreign trade channel

In 1998, foreign trade flows were strongly influenced by the development of the international financial crisis. The financial and exchange instability afflicting the emerging Asian economies from 1997 intensified as the year elapsed and ended up affecting other areas, in particular Russia and the Latin American countries. The slump in the economic activity of these countries and the devaluations, in certain cases, of their currencies have led to a significant deterioration in Spanish trade with these markets.

This box presents a quantitative approximation of the effects of the emerging market crisis on Spanish net exports and national output using various econometrics models estimated at the Banco de España. It should be borne in mind that these estimates are subject to numerous caveats. In particular, the crisis has had repercussions of a very general nature, given its impact on financial markets, on prices and on agents' confidence, which go beyond the direct impact arising from trade flows and which are not addressed in this analysis. Hence, the results obtained should be considered as the lower limit to the overall impact.

Before analysing the results, it should be pointed out that the magnitude of the bilateral trade relations between Spain and the economies stricken by the crisis is relatively small. In fact, as a whole, these countries (including Japan) account for slightly less than 13 % of all external sales and 14 % of imports. These percentages are slightly lower than the EU averages and well below those of the US, which has closer trade links with these economies. Accordingly, the direct impact of the crisis will have been limited. However, to the extent that the crisis has resulted in a slowdown of demand in the industrialised countries, which are Spain's main trading partners, the effects will be greater.

The adjoining table presents, first, the estimates of the effect on the national and external demand aggregates and on GDP of the fall in demand from the countries directly affected by the crisis. To evaluate these effects, first of all the possible impact on external sales is analysed, comparing the results obtained by simulating the exports function under two alternative scenarios: the first uses the actual values of the basic determinants of exports (export markets and competitiveness) for 1997 and 1998 and the forecasts for 1999; while the second is what might have happened if the emerging, economies had sustained over these three years similar rates of growth to those in the period prior to the crisis and if their real exchange rates had remained unchanged.

According to the results obtained, the effect of the crisis on exports in 1997 is practically nil. By contrast, in 1998 it is estimated that export growth may have been reduced by 2.4 percentage points, a very similar figure to that estimated for 1999. Furthermore, the greater slackness of external sales has repercussions on the behaviour of capital investment, since final demand – i.e. the sum of national demand and exports – is one of the basic determinants of this macro-economic aggregate. However, the total impact on national output would have been moderated as a consequence of the slower growth of imports caused by the slowdown in final demand, which would more than offset the fall in their relative prices. Hence, the direct impact of the crisis in the emerging economies may have involved a reduction in GDP growth of 0.1 percentage points in 1997, rising to 0.2 percentage points in 1998 and 1999.

In addition, an approximation has been made of the indirect effects that may have stemmed from the slower growth in the industrialised countries. The same calculation has been repeated, taking into account the differences between the growth forecasts for this area of various international agencies immediately before the crisis and the estimates made today. As can be seen in the adjoining table, the slower growth in the industrialised countries would translate into a 0.1 percentage point reduction in the growth of activity in 1998 and 1999.

In sum, the impact of the crisis in the emerging economies through foreign trade flows, considering the direct and indirect effects, may have reduced GDP growth by 0.1 percentage points in 1997 and by 0.3 percentage points in 1998 and 1999.

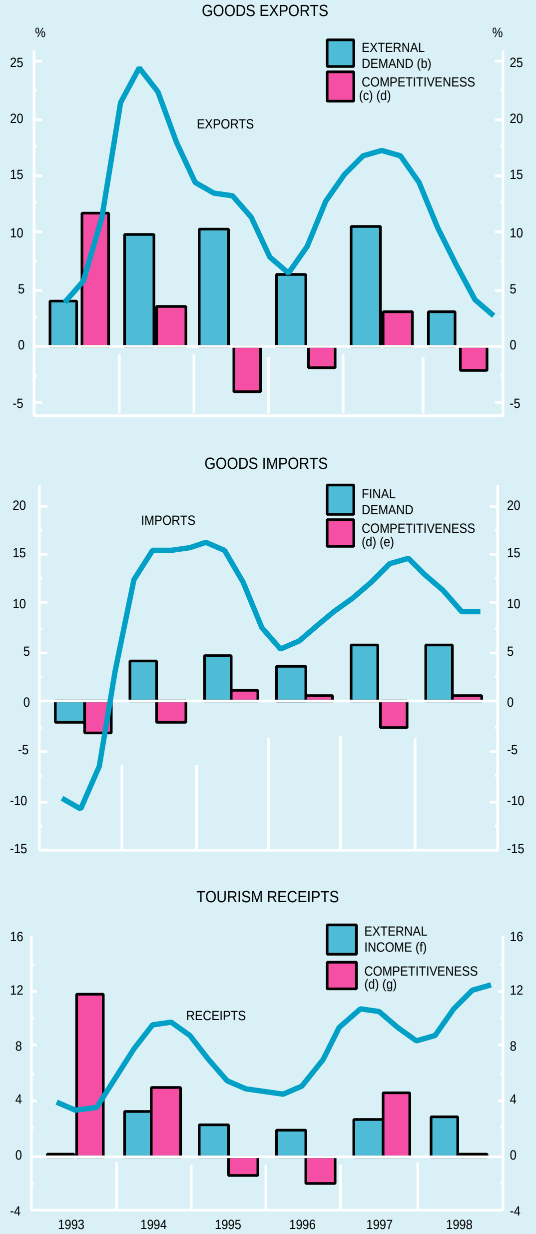
Effects of the internacional economic crisis on the Spanish economy: the foreign trade channel

Percentage points

	1997	1998	1999
DIRECT EFFECTS:			
Net external demand	—	–0.1	–0.1
Exports	*–0.4*	*–2.4*	*–2.3*
Imports	*–0.3*	*–1.8*	*–1.3*
National demand	–0.1	–0.1	–0.1
Gross domestic product	–0.1	–0.2	–0.2
INDIRECT EFFECTS:			
Exports	—	–0.2	–1.1
Gross domestic product	—	–0.1	–0.1
TOTAL EFFECT:			
Exports	–0.4	–2.6	–3.4
Gross domestic product	–0.1	–0.3	–0.3

CHART III.4

Net external demand
and its main determinants (a)



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

(a) Year-on-year real rate of change.
(b) Growth of world trade in goods (IMF).
(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 effective exchange rate against the OECD countries..

growth close to 4 % in the first half of the year, and slowed gradually in the second half, while employment gathered momentum until the summer months, its acceleration being curbed thereafter (see Chart III.5). These output and employment paths led to a reduction in the rate of growth of productivity as the year unfolded.

III.3.1. Output and employment in the different productive branches

The recovery in activity in the primary branches in 1998 enabled the negative rates of change of the preceding year to turn positive. In 1998, gross value-added in the primary branches grew by 0.8 %, in real terms, compared with a fall of 1.3 % in 1997. Analysis of the quarter-on-quarter growth rates shows that the recovery in activity in these branches basically occurred in the first half of the year, while in the second half there was a considerable slowdown, primarily caused by the scant rainfall during that period in a large part of Spain. In consequence, there were significant increases in the growth rates of products harvested in the first half of the year, such as grains, citrus fruits and olives, while serious reductions were recorded in the output of those products harvested in the second half of the year, such as fruit and wine grapes. Employment in agriculture, having fallen in 1997, declined further, which explains the recovery in productivity.

In 1998 as a whole, industrial activity remained highly buoyant. Its value added grew on average by 5.1 %, three tenths of a percentage point less than in 1997. This strength enabled the industrial branches to continue to make a significant contribution to GDP growth (1.4 percentage points) (see Chart III.6). However, their performance over the course of the year was not even. In the first half of 1998 year-on-year rates of growth of close to 6 % were recorded. The international financial crisis and its subsequent impact on the EU countries led to a gradual reduction in industrial goods exports, so that activity slowly moderated in the second half, and in the fourth quarter the GVA of the industrial branches grew at a year-on-year rate of around 4 %. Employment in industry rose by 5.3 %, since it began to slow with a certain lag on activity, giving rise to a significant deceleration in productivity from the already low rate of growth of 1997.

Of the different branches of industrial activity, the metal processing industry and the extractive and chemicals industries behaved in the same way as the aggregate of the industrial sector. Both branches grew on average in 1998 at similar rates to the previous year, despite a gradual slowdown. In the metal processing industry the vitality of car manufacturing was notable. According to the industrial production index (IPI) its annual growth was 12.1 %, 1.5 percentage points higher than in 1997. Among the basic industries, the extraction of non-metallic minerals was the sector with the highest growth rate, at 9.1 % according to the IPI. Finally, among the set of activities which make up other manufacturing industry the recovery of food production in the second half of 1998, in contrast to the slowdown predominant in other industrial activities, should be emphasised.

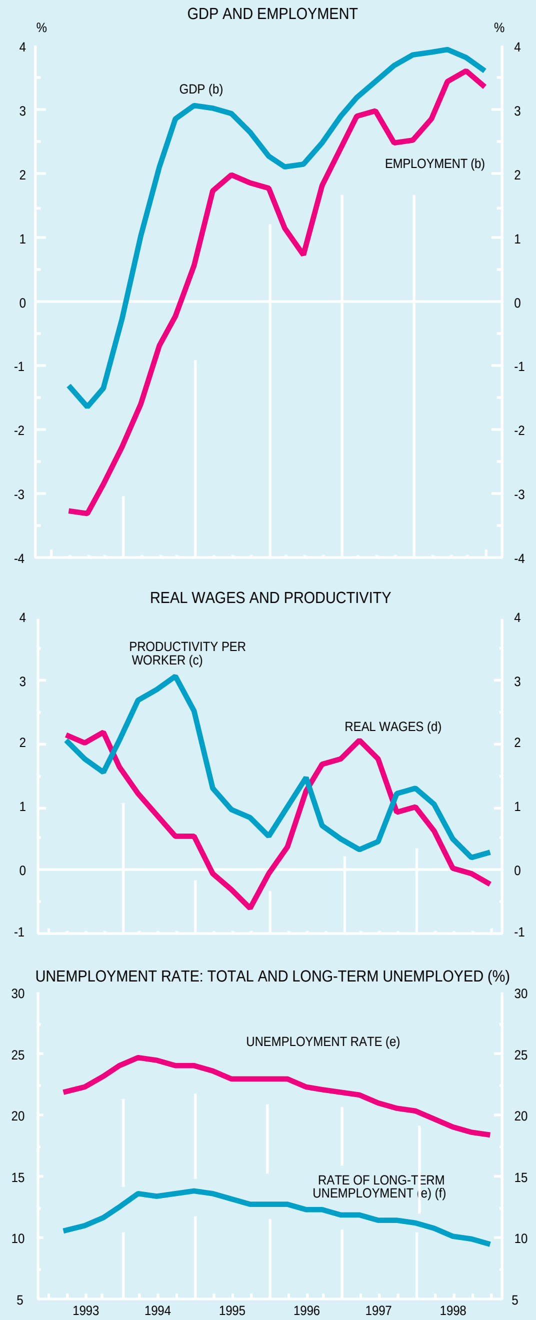
In 1998 construction expanded sharply, consolidating the recovery that dated back to mid-1996. The average annual growth of its value-added was 6 %, notably higher than in the rest of the branches of activity and well above the 1 % growth in construction activity the previous year. In consequence, its contribution to GDP growth was 0.4 percentage points, three tenths of a point higher than in 1997. Over the course of the year, this branch was characterised by continuous expansion, reaching a rate of growth of 6.8 % at year-end. Similarly, employment rose by 5.2 % in the year as a whole, its year-on-year rate standing at 10.1 % in the fourth quarter.

The various components of construction followed different paths. Thus, while the growing profile of construction activity was underpinned, to a large extent, by the buoyancy of residential building – where the strength of demand played an important role – the profile of housing refurbishment and non-residential building was one of continuous deceleration. Civil engineering, for its part, recovered significantly, driven by the greater demand from general government.

As a whole, services activities grew by 2.7 % in 1998, five tenths of a percentage point below the rate of change of the previous year, which resulted in a contribution to GDP growth of 1.5 percentage points. This slowdown affected the two main components of the branch, although with differing intensity over the year. The loss of vigour in market services basically occurred in the first quarter of 1998, after which the situation was stable. In year-on-year terms, the rate of growth of these activities fell from 3.5 % at end-1997 to 3 % in the final quarter of 1998. Employment, however, recovered, growing more briskly than value-added in the year as a whole. Activity in non-market services rose to a lesser extent (a result of the drive to control government consumption), its rate of growth falling from 1.9 % at end-1997 to 0.9 % in the final quarter of 1998.

CHART III.5

Real growth, employment, wages, productivity and unemployment rate (a)



Source: Instituto Nacional de Estadística.

(a) Year-on-year rate of change, except in the case of the unemployment rate.
(b) Quarterly National Accounts. GDP in constant pesetas.
(c) GDP/employed person [as per note (b)].
(d) Ratio of average earnings per worker per month, in terms of total payments, to the GDP deflator.
(e) EPA (Labour Force Survey). Number of unemployed as a percentage of the labour force.
(f) Persons unemployed for more than one year as a percentage of the labour force.

The vigour of private consumption fed through to the distributive trade which, together with hotels and catering and telecommunications, were the only branches of the tertiary sector to show a recovery in 1998. The distributive trade expanded throughout the year, as shown by the sales and employment indicators, which were consistent with the improvement in the climate of confidence in the retail trade. According to the indicators of visits and overnight stays, there was growing buoyancy in hotels and catering. However, this did not lead to a greater increase in employment. Telecommunications was the other expanding branch, as shown by the acceleration in its employment. Finally, the value-added of the rest of the activities of the tertiary sector decelerated.

III.3.2. The labour market

The high rate of growth of employment in 1998, at 3.3 %, involved the net creation of around 450,000 jobs during the year, according to National Accounts figures. This increase was primarily a result of the greater vigour of productive activity, the effect of which was reinforced by the moderation of labour costs. The latter stemmed from lower wage settlements under collective agreements, the lower weight of inertial factors (such as length of service) in the determination of wages and the effect of social security contribution reductions aimed at fostering permanent contracts. These factors are analysed in the following section.

The expansion of employment and the smooth slowdown in the labour force were conducive to a fall in unemployment. The result was that the rate of unemployment stood on average in 1998 at 18.8 %, two percentage points below the rate of the preceding year, and at 18.2 % at year-end. The rate of long-term unemployment (see Chart III.5) continued to decline, although it should be noted that the proportion of long-term unemployment still exceeds 50 % of the total. Strong resistance to a reduction in this proportion is seen among the over-40s, so that its decline is concentrated in the younger age groups.

The generation of new jobs was greatest among wage-earners, while numbers of self-employed rose by only 10,000 in 1998. Among wage-earners, the new type of permanent contract, introduced after the Employment Stability Agreement between the employers' associations and trade unions in May 1997, and which incorporates a lower cost of dismissal and a reduction in the social security contributions payable by employers, continued to bear fruit in 1998. On Labour Force Survey (EPA) data, the number of wage-earners with permanent contracts rose by 5.4 %, while those on temporary contracts rose by 3 %. The proportion of temporary employment thus fell by five tenths of a percentage point to stand at 33 %. Despite the positive trend in permanent employment, the proportion of temporary employment remained very high and its rate of decline slow. Moreover, 1998 saw a further cut in the average duration of temporary contracts and, therefore, an increase in the rate of turnover.

Numbers of part-time wage-earners grew by 5.3 %, well below the rate of the preceding year. The slowdown can be explained by various factors, including the wait-and-see situation created by the negotiations between the government and trade unions to amend this type of contract, which were not completed until the end of the year. Also, failure to apply the reductions for permanent contracts to part-time contracts until January 1999, and the abolition, as from March 1998, of certain reductions in the contributions associated with some of these contracts may have had a negative impact on part-time hiring. In any event, the proportion of part-time wage-earners remained practically unchanged at around 80 %, still well below the EU average of 16 %. In 19th December 98, this type of contract was finally amended by Royal Legislative Decree 15/1998. Part-time employment was more precisely defined and access to the mechanisms of the Social Protection System facilitated. In addition, temporary part-time contracts were penalised, while incentives were provided for permanent part-time contracts, as in the case of other permanent contracts.

As regards the broad lines of more medium and long-term employment policies, it should be recalled that it was decided at the extraordinary summit in Luxembourg in November 1997 to co-ordinate EU member countries' employment policies, with the establishment of a set of guidelines which all of them adopted in 1998. In the case of Spain, these guidelines were set out in the National Employment Plan, which the government approved and presented to the European Commission in spring 1998. In 1999 the Commission assessed the progress made in applying the employment guidelines, identifying the main obstacles which remain. These will be taken into consideration in the 1999 National Employment Plans.

III.4. PRICES AND COSTS

As already mentioned, price developments in 1998 were very favourable. Practically all the inflation indicators reached very low levels, which was especially significant as they proved to be compatible with highly buoyant activity and employment and a reduction of two percentage points in the unemployment rate. Undoubtedly, low inflation expectations and their consequence in terms of low wage settlements was essential to achieve these results, but the slowdown in prices in the international sphere also played a very prominent role.

In fact, the largest contribution to the reduction in the rate of growth of the final demand deflator came from the costs of imported products, while domestic costs trended less favourably. Of the latter, unit labour costs decelerated slightly, but less than in the previous year, as the moderation in labour costs per worker was partly offset by the slowdown in apparent labour productivity. Unit business margins grew by more than in the previous year, although this buoyancy did not affect all branches of activity. While in the majority of manufacturing activities there was a small reduction in the gross margin per unit of output, in market services the increase was across the board.

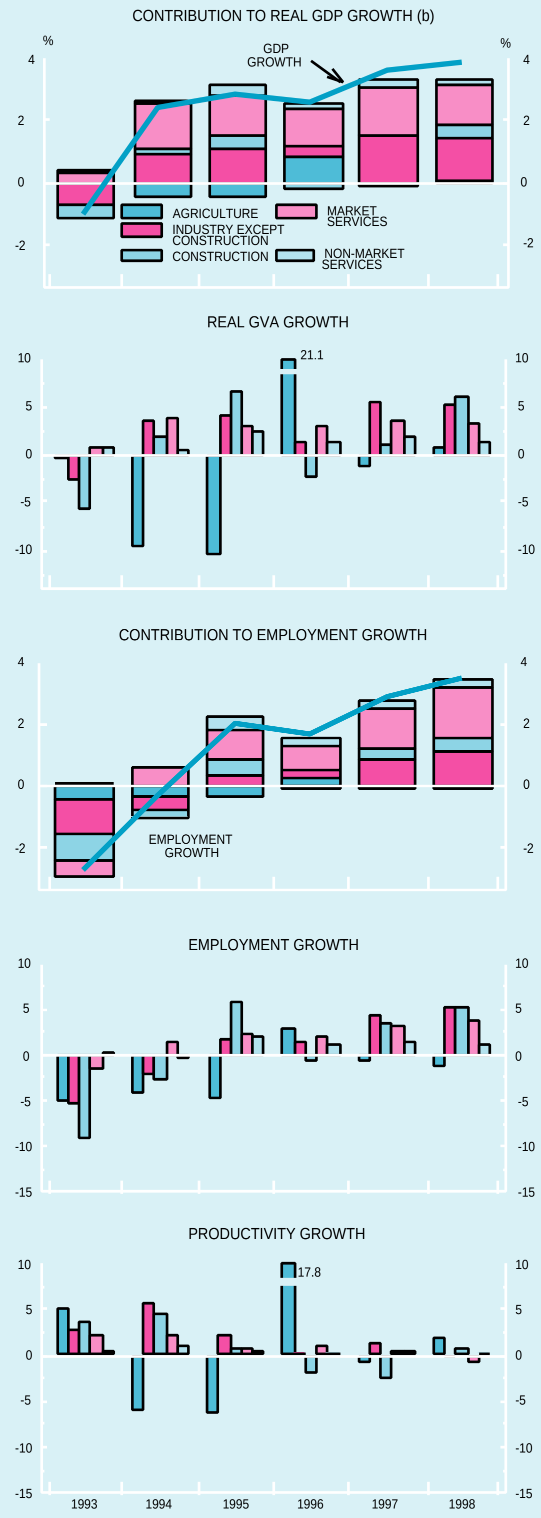
III.4.1. Costs and price formation

In 1998, the economy's final demand deflator grew by 1.2 %, seven tenths of a percentage point less than in the previous year. As seen in Chart III.7 and in Table III.3, the slowdown, very marked up until the summer, was a consequence of the reduction in import costs, since domestic costs (taking the GDP deflator as a first approximation) grew at a moderately higher rate of 2.2 % on average during the year. The favourable performance of import prices, with a decline of 0.6 % in the related deflator, was the result of several factors, including notably: the fall in commodity prices (in US dollars, the price of crude oil fell by 30 %, that of food commodities by 16 % and that of industrial commodities by 20 %), the consequent moderation in the prices of industrial products sold on international markets and the significant devaluations in the currencies of certain emerging economies. The latter predominated over the slight depreciation in the peseta against the currencies of the developed countries, which was in any event less than in the previous year.

As regards the domestic component of costs, as already mentioned, unit labour costs, measured in terms of compensation per employed person, increased by 1.7 %, two tenths of a percentage point less than in the previous year. The slowdown in unit labour costs was a consequence of the trend in compensation per employed person. Its rate of growth in 1998

CHART III.6

Gross value added, employment and productivity (a)



Source: Instituto Nacional de Estadística.

(a) Annual percentage change.
(b) The contribution of taxes to GDP growth is not depicted.

(2.2 %) was down five tenths of a percentage point on 1997. Meanwhile, apparent labour productivity made very little headway (0.5 %). As in recent years, the growth in compensation per employee (which excludes wage growth attributable to the self-employed) was less than that of compensation per employed person, although there was a minimal acceleration with respect to the previous year (2.1 % in 1998, against 2 % in 1997). The differences between compensation per employee and compensation attributed to the self-employed stem from the fact that the social security contributions of self-employed workers continued to increase at a brisk rate in 1998, while those of wage-earners moderated notably. This is because the reductions associated with the new forms of stable hiring more than offset the effect of progressive abolition of the ceilings existing for the different occupational categories.

The slight acceleration in compensation per employee in the economy as a whole was due to the behaviour of wages in general government. After the 1997 wage freeze, the remuneration of public-sector employees rose in line with the inflation forecast included in the 1998 budget (2.1 %). In the rest of the sectors, collective bargaining produced an average wage settlement of 2.6 %, four tenths of a percentage point less than in 1997, in line with the reduction in inflation forecast in the budget. Average hourly earnings according to the wages survey (a statistic which covers industry and services) slowed by more than wages under collective agreements, with an increase of 2.9 % against 4.1 % in 1997. The difference compared with wage settlements reflects lower wage drift, a consequence of the hiring of new workers on lower wages, the disappearance of remuneration for length of service in certain branches of activity and less recourse to overtime than in 1998. Average monthly wages, also according to the wages survey, increased by 2.4 %, less than hourly earnings, as in the previous two years. This difference is explained by the cut in the average working hours of the workers represented in the survey.

The above-inflation wage growth did not result in an increase in the price of the labour factor for employers. The moderating effect, mentioned above, of social security contributions per worker meant that compensation per employee (an approximate measure of the per capita cost of labour to firms) rose by 1.8 % in the economy as a whole, and by 1.5 % if public sector employees are excluded. These rates are very close to those of final prices. Moreover labour productivity increased moderately, helping to reduce the cost of labour per unit of output.

By branch of activity, the largest increases in hourly pay per person, according to the wages survey, were in industry and construction (3.3 %). However, in industry there was a continuous slowdown over the year and in construction a gradual acceleration. In services the increase in hourly pay per person was 2.8 %, with a marked slowdown over the year. It was in this branch that wage drift was lowest (it was in fact negative), being that which is most benefiting from the greater flexibility being introduced into the labour market. Moreover, it is in services that the largest differences are seen between hourly and monthly wages, since it is here that most part-time employment is to be found.

Indirect taxes net of subsidies, another component of final prices, grew at a high rate in 1998 (7.8 %), increasing their contribution to the growth of the GDP deflator. This was a consequence of the large increase in receipts from indirect taxes (around 10 %), which offset the rise in subsidies (23 %). The increase in receipts is explained partly by the rise in certain tax rates, although it reflects, above all, the recovery in consumption and, in particular, in those components of consumption which attract the highest rates of VAT.

Finally, the gross operating surplus per unit of output (corrected for the compensation attributed to self-employed workers) grew by 1.7 % in 1998, four tenths of a percentage point higher than in 1997, but below the increase in the GDP deflator. As a result, the share of the surplus in GDP fell. As will be seen in the following section, the moderate advance in the unit surplus in the economy as a whole masks certain differences in the paths of margins in the various branches of activity. These lie at the root of the duality which characterises inflation in Spain, since the paths of the costs borne by the various branches run more closely than do those of their selling prices.

III.4.2. Price formation in the productive branches

This section offers a view of the process of price formation in the main productive branches, excluding non-market and financial services. The indicators used cover, inter alia, information on final prices net of taxes (both on the domestic and external markets) for the different productive branches, variable costs (which combine inputs and labour costs), the prices of equivalent products on external markets and indicators of demand pressure. The comparison of final prices with variable costs enables an approximation to be obtained, as a residual, of the path of the gross operating surplus.

In agriculture, final prices are estimated to have fallen by 0.4 % in 1998, a much smaller fall than in 1997 (4.6 %). This further decline in prices was a consequence of the slowdown in variable costs, the path of external food prices and subdued demand (see Chart III.8). Among the variable costs, the reduction in the cost of intermediate goods, both domestic and imported, and the moderation in unit labour costs, due to the greater vigour of apparent labour productivity, were notable. The overall result was that the gross operating margin as a percentage of output rose to levels similar to those of 1996.

In the energy branch, production prices fell considerably in 1998 due to the sharp fall in the price of crude oil on international markets. In addition, moderating effects arose from the various reforms being introduced in these markets. Electricity utilities reduced their prices under the schedule of cuts agreed with the government, as a step towards greater liberalisation of the sector (see Box III.3). It is estimated that the gross operating margin per unit of output remained unchanged at the levels reached in previous years.

In the manufacturing branches, final prices are estimated to have grown on average by 0.3 %, almost one-and-a-half percentage points less than in 1997. Moreover, the increase in prices on the domestic market was lower than that of export prices. The smaller increase in prices was the result of two counteracting factors: on the one hand, the high pressure of demand faced by these branches and, on the other, external competition, given that the peseta prices of competing products slowed considerably. By contrast, the growth of variable costs was similar to that of the preceding year, the slowdown in intermediate costs being offset by the acceleration in unit labour costs, due to the paltry rise in apparent labour productivity. In consequence, the gross operating surplus tended to contract, with certain exceptions, such as transport materials, where demand was very high, not only domestically but also abroad, and the textile industry, which made a significant adjustment to its employment.

The retail branch is that which enables the production (and import) prices of goods to be linked to consumer prices. The difference between these two sets of prices broadly approximates the retail margin. During 1998, retail selling prices net of taxes slowed markedly, with growth of 0.6 %. This more subdued behaviour was a result of the sharp moderation in the buying prices of products, partially offset by the

TABLE III.3

Composition of GDP and final demand deflators

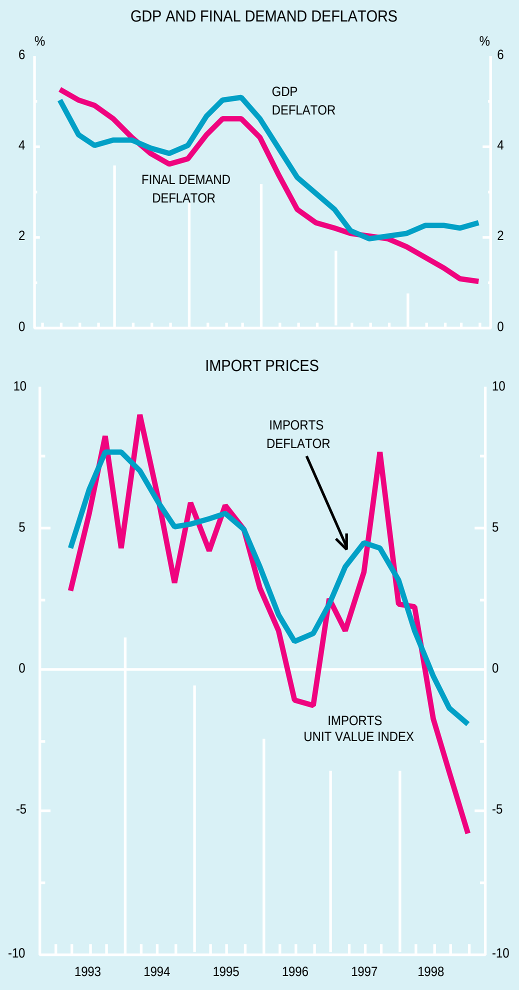
Rate of change

	1993	1994	1995	1996	1997	1998
Unit labour costs	**4.7**	**0.8**	**2.4**	**2.7**	**1.9**	**1.7**
Compensation per employee	6.6	3.6	3.3	3.6	2.8	2.2
Output per employee	1.8	2.8	0.9	0.9	0.8	0.5
Real GDP	*–1.2*	*2.3*	*2.7*	*2.4*	*3.5*	*3.8*
Total employment	*–2.9*	*–0.5*	*1.8*	*1.5*	*2.7*	*3.3*
Net indirect taxes (a)	**–12.2**	**10.6**	**2.5**	**8.1**	**7.2**	**7.9**
Gross operating surplus (a)	**8.4**	**8.7**	**9.7**	**2.9**	**1.0**	**1.7**
GDP deflator	**4.3**	**4.0**	**4.8**	**3.2**	**2.0**	**2.2**
Domestic costs	**5.3**	**2.0**	**2.9**	**2.0**	**–0.1**	**0.4**
GDP per unit of final demand	0.9	–1.9	–1.8	–1.2	–2.1	–1.8
GDP deflator	4.3	4.0	4.8	3.2	2.0	2.2
Import costs	**3.1**	**12.9**	**11.1**	**5.2**	**10.2**	**4.1**
Imports per unit of final demand	–3.2	6.8	6.1	3.6	6.1	4.7
Imports deflator	6.5	5.7	4.7	1.6	3.9	–0.6
Final demand deflator	**4.9**	**3.8**	**4.4**	**2.6**	**1.9**	**1.2**
MEMORANDUM ITEM:						
ULCs (b)	4.9	0.0	2.1	2.9	1.5	1.3

Sources: Instituto Nacional de Estadística and Banco de España.
(a) Per unit of output.
(b) ULCs calculated using compensation per employee.

CHART III.7

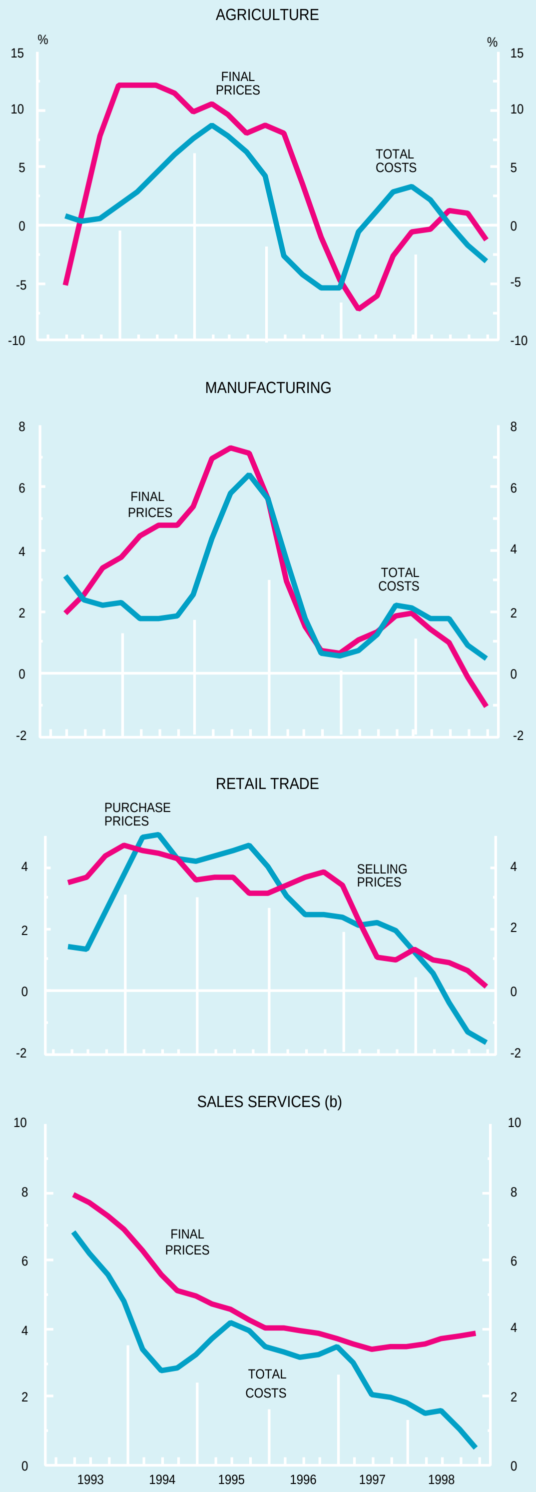
GDP, final demand and imports deflators (a)



Sources: Instituto Nacional de Estadística and Ministerio de Economía y Hacienda.
(a) Annual percentage change.

CHART III.8

Price formation (a)



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

(a) Annual percentage change based on trend.
(b) Excluding the distributive trade.

high pressure of demand associated with the strength of private consumption. In consequence the gross retail margin rose slightly, and this rise was passed through to the operating margin, since variable costs, especially labour costs, were very restrained, due to the strong gain in productivity and wage moderation.

The construction branch recorded one of the smallest slowdowns in final prices, which grew by 2 %, only two tenths of a percentage point below the 1997 rate. This was due to the strength of demand, already referred to in the preceding sections. In addition, variable costs decelerated to a lesser extent than in the rest of the branches, since the composition of its intermediate inputs benefited less from conditions in the international environment. By contrast, unit labour costs slowed considerably, because apparent labour productivity recovered its usual rate of growth and wages also moderated somewhat. As a result, operating margins held stable.

Finally, the prices of market non-financial services rose by 3.7 %, as against 3.4 % in 1997. This strong inflationary bias is due to the behaviour of margins. The path of variable costs is much more in line with that of the rest of the branches, or even more positive, since this branch is one of those which most benefits from the reforms introduced into the labour market, and wages thus rose more moderately here. This phenomenon is a consequence of the limited pass-through to final prices of the permanent gains in costs, which are only reflected in them after a number of years, due to the insufficiency of domestic competition and the small moderating effect exerted by the external sector. In any case, in certain branches in which domestic competition is somewhat greater, such as hotels and catering, the strong demand pushed up their selling prices. In consequence, the increase in margins was common to all services branches. Transport, however, should be highlighted. Its prices continued to grow at a healthy rate, despite its fundamental input, energy, becoming drastically cheaper. Only in communications and professional services have margins tended to moderate in recent years, these branches being precisely those in which the introduction of competition has progressed furthest.

III.4.3. Final demand deflators

With the sole exception of the government consumption deflator, all the final demand deflators displayed markedly decelerating profiles in 1998. Notable for the size of their decelerations were, first, the exports deflator and, second, the capital goods investment deflator.

BOX III.3

Regulation, competition and inflation

Lack of competition affects price formation in goods and services markets. This box analyses the reforms recently undertaken in three sectors: the electricity sector, which is following a process of gradual liberalisation; and petrol and diesel oil distribution and telecommunications, in which the liberalisation is at a more advanced stage.

The rules for liberalisation of the electricity sector were established in the Electricity Protocol, signed on December 11th 1996, between the electricity utilities and the Ministry of Industry and Energy (MINER). This agreement granted major consumers the opportunity to choose their suppliers, and a timetable was agreed for step-by-step liberalisation. Also a series of minimum reductions in the average tariff was agreed: 3 % for 1997, 2 % for 1998 and 1 % for the period between 1999 and 2001. However the reduction in electricity tariffs agreed for 1999 (1.9 %) was the result of a new agreement between the MINER and the electricity utilities. This agreement set the tariff reductions for 2000 and 2001 at 1 %, abolished the cases which, under the Protocol, enabled larger reductions to be implemented and regulated certain other aspects of the sector: the timetable for choosing suppliers was brought forward; access tariffs and capacity payments were reduced; and a large part of the costs of transition to competition was securitised. Subsequently, in May of this year, following the entry into force of Royal Legislative Decree 6/1999, on urgent measures for liberalisation and increasing competition, the tariff for domestic consumers was cut by a further 1.5 %. As a result, the average tariff for all consumers has finally been reduced by 2.5% in 1999.

In sum, the negotiated opening up of the sector has been accompanied by a reduction of 8.9 % in the average tariff for consumers who cannot choose their supplier between 1997 and 1999, inclusive. For households the reduction has been somewhat less (7.1 %), although in 1999, unlike in the previous two years, the average reduction applied (3.5 %) has been greater than that for businesses.

The introduction of competition into petrol and diesel oil distribution was conceived as a step-by-step process, to ensure that liberalisation was accompanied by adequate consumer protection. For this purpose, it was decided to apply in the initial stages of liberalisation a system of automatically determined maximum prices, based on the price of crude in international markets, the US dollar exchange rate and the average pre-tax price applied by the six largest European countries. The system of maximum prices for petrol and diesel oil was introduced on July 10th 1990, with diesel oil prices finally liberalised in June 1996 and petrol prices in October 1998. One way of seeing the impact of liberalisation on competition is to compare final pre-tax prices in Spain with the price of crude on international markets. This comparison shows that the pass-through of price movements on international markets was incomplete, both at times of falling prices and rising prices, although it tended to be more rapid when prices were rising. Nonetheless, the system of maximum prices and certain aspects of the way in which these are determined, prevent definitive conclusions being drawn from this comparison. An alternative method is to assess the degree of competition by comparing the prices actually charged for the various products with their maximum prices. As seen in Chart 1, the divergences between the maximum prices and those actually charged for diesel oil during the period such maximum prices were in force were of some significance. This is explained by the fact that the supply to this market was channelled through direct sales to major consumers. In the case of petrol, however, except in specific periods, the differences between these two sets of prices were small, which indicates scant competition.

CHART 1

Weekly price of petrol and diesel oil

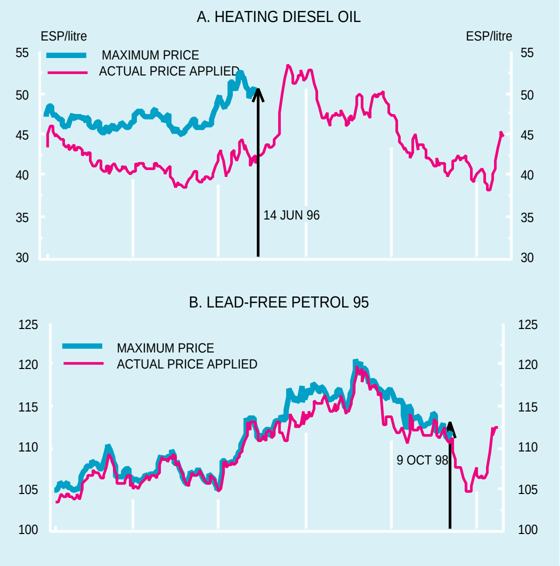
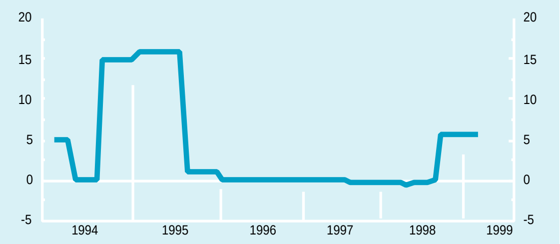


CHART 2

CPI: telephony and telegraphy
Annual percentage change



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

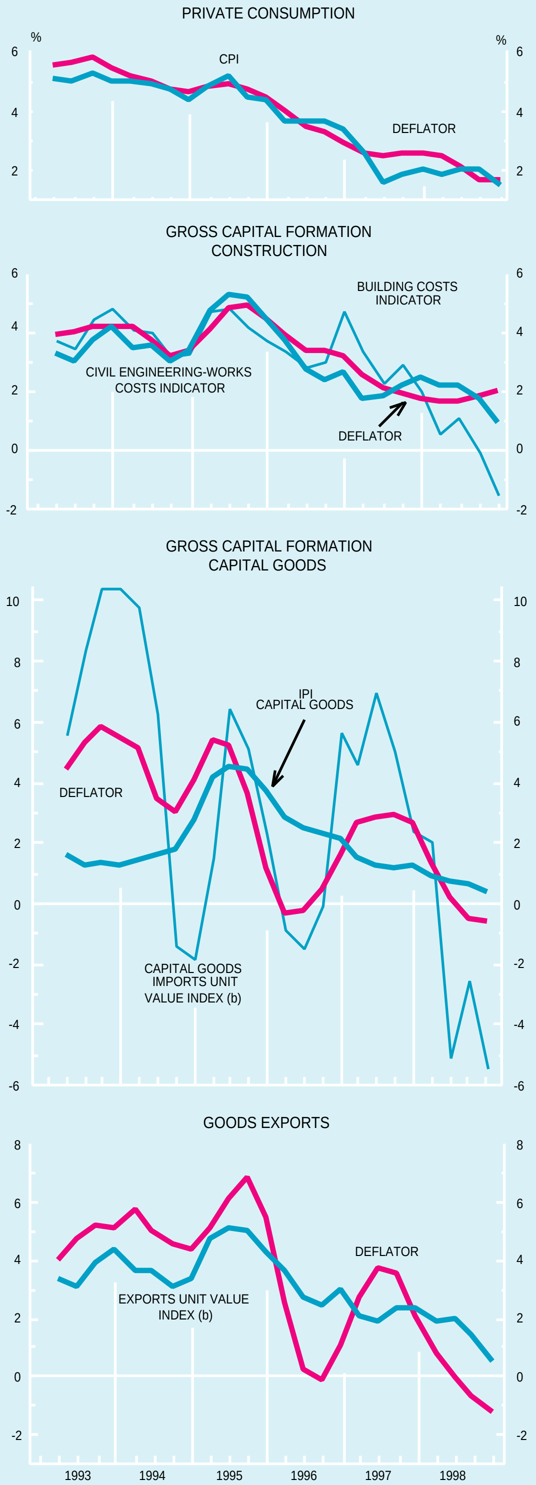
The telecommunications market has also been opened up through a step-by-step process, ending on December 1st 1998, when the supply of all services was fully liberalised. New operators may now set their rates freely, while the Telecommunications Market Commission is responsible for, temporarily, establishing the price-setting criteria for the sector's leading operator and mechanisms for controlling it. Charges for interconnection to the main operator's network must be in line with the costs of the services. Following liberalisation there are three national operators in basic telephony. This has created the conditions for the appearance of new arrangements, involving billing innovations and, in the final analysis, cheaper phone calls. The consumer price index (CPI) only reflects general offers maintained for at least several months and the rates of new suppliers are only taken into account after a year on the market. For these reasons, telephone and telegraph prices in the CPI may overestimate the prices actually charged. Even with the appropriate caveats, as shown by Chart2, which represents this CPI sub-class, the opening-up of the sector has involved a fall in the price of telephone calls. The size of the fall has, however, been affected by the partial adjustment of rates in August 1998 to eliminate cross subsidies(1). This raised the 12-month rate of the telephone and telegraph sub-class of the CPI by 5.3 % (2). Nonetheless, it is expected that after the entry into force of Royal Legislative Decree 6/1999, the growth of this sub-class will return to negative rates in 1999.

(1) Traditionally, rates for local calls have not reflected their actual cost, but have been subsidised by provincial, interprovincial and international rates.

(2) In particular, rates for local calls rose, but only for those exceeding 160 seconds, as did connection charges (by ESP 200), but provincial rates were reduced by 5 %, interprovincial rates by 15 % and international rates by 12 %.

CHART III.9

Final demand deflators (a)



Sources: Instituto Nacional de Estadística, Ministerio de Fomento and Subdirección General de Previsión y Coyuntura.

(a) Annual percentage change.
(b) 1995 = 100.

The private consumption deflator grew by 2 % year-on-year, five tenths of a percentage point less than in 1997. This growth was once again higher than that of the CPI, its main short-term indicator, which grew on average by 1.8 % (see Chart III.9). The difference between these two indices was less than in 1997, since the prices of home-consumed food behaved less satisfactorily. This is the component with the greatest discrepancy between its weight in the private consumption deflator and in the CPI (the component which offsets this difference in weight is food consumed outside the home, which is classified in the services category). According to the CPI, food prices grew by 1.7 % in 1998, more than one percentage point above the rate in 1997, in line with the path of agricultural prices, but in clear contrast to the deceleration in the producer price index (PPI) for food products and in the imports unit value index for food products. The prices of the energy goods included in the CPI fell by 3.8 % in 1998, as a consequence of reductions in the prices of these products at prior stages of production: the PPI for energy products fell by 7.7 % and the imports unit value index by 29.5 % (1). The consumer prices of non-energy industrial goods grew by 1.5 %, two tenths of a percentage point less than in 1997 and in line with their main determinants, since the PPI for this type of good rose by 1.1 % and the import unit value index by 3.5 %. By contrast, service prices accelerated slightly on average over the year to a rate of 3.6 %.

The government consumption deflator grew by 1.9 % in 1998, as against 1.3 % in 1997. This acceleration was concentrated in the first half of the year and was the result of the increase in the remuneration of public-sector employees, which was not revised upwards in 1997. The deflators of the other two components of government consumption - fixed capital consumption and net purchases of goods and services – decelerated slightly during the year, in line with the path of the prices of these goods for the economy as a whole.

In 1998 the gross fixed capital formation deflator decelerated considerably, with growth of 0.9 %, as against 1.9 % in 1997. Both the construction deflator and the capital goods investment deflator contributed to the slowdown,

(1) To understand these differences it should be taken into account that the weight of the oil products component in the PPI is much greater than in the CPI, and in the unit value index practically the only relevant item is the price of crude oil. Moreover, both in the PPI and in the CPI what is calculated is the price of oil products, which includes other costs in their refining and, more significantly, excise duties, which represent a hign proportion of the retail selling price.

which was concentrated in the first quarter, the deflator remaining fairly stable thereafter. At a disaggregated level, while the growth of the construction deflator reached a floor in the second quarter of 1998, and subsequently accelerated, the capital goods investment deflator ended the year with a decline of 0.7 %, reflecting the path of the domestic producer prices of this type of good, which in the year as a whole rose by 1.1 %, and of imports, which fell by 2.8 %.

Finally, the goods and services exports deflator moderated considerably in 1998, with growth of 0.4 %, more than two percentage points less than in 1997. Although tourism prices continued to grow at a higher rate than goods exports prices, both slowed significantly, the latter falling by 1.2 %. This decline was a consequence of the significant moderation in prices on external markets, against a background of exchange rate stability.

CHAPTER IV

MACROECONOMIC POLICIES AND ECONOMIC AND FINANCIAL FLOWS

IV.1. INTRODUCTION

Throughout this *Annual report* it has been described how, in 1998, headway continued to be made in applying a more balanced macroeconomic policy mix. As regards fiscal policy, the fiscal deficit was reduced for the third year running, to stand at 1.8 % of GDP, the lowest level for the past 20 years. Moreover, this reduction, which stemmed both from a fall in spending and an increase in revenue (both as percentages of GDP), was compatible with a significant increase in capital spending. Monetary policy was loosened progressively during 1997, in the context of relatively comfortable compliance with the objective programmed by the Banco de España (namely, to keep the 12-month rate of growth of the CPI close to 2 %), and of gradual convergence of the monetary conditions of the countries that would initiate Stage Three of EMU in January 1999. The Banco de España used the available leeway to distribute the cuts in its intervention rates over the year, preserving in so far as possible the contribution of monetary policy to the regulation of aggregate demand. The marginal interest rate at regular auctions fell in 1998 by 1.75 percentage points (a large part of the fall being concentrated in the final quarter), to stand at 3 % at year-end.

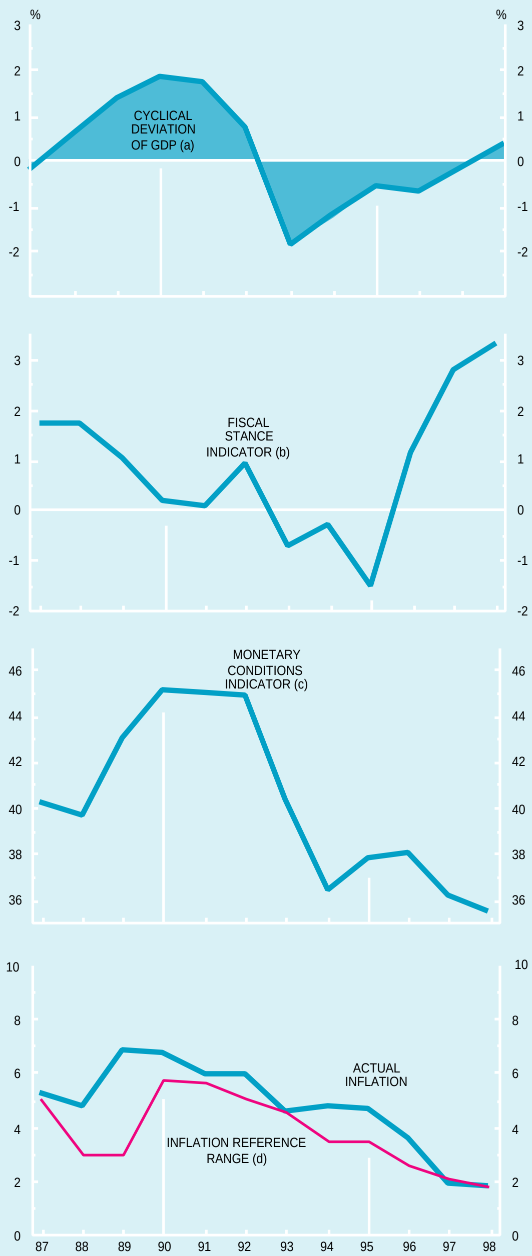
The benefits of this more balanced macroeconomic policy mix for the Spanish economy are particularly evident when a longer time frame is considered. As seen in Chart IV.1, throughout the expansionary phase of the last business cycle, which commenced around 1987, fiscal policy was pro-cyclical, leaving monetary policy with the task of addressing macroeconomic imbalances. As a result, the latter had to be very restrictive. The difficulty of regulating the rate of expansion of aggregate demand with an unbalanced combination of economic policy instruments, led to significant overshooting of the annual references for inflation in the budget and a pattern of economic growth biased against private investment and the export sector. This meant that, after the expansionary stage of the cycle, the recession in the early nineties was particularly severe. In this period, the large structural component of the budget deficit and the high level of public debt, accumulated in the boom years, considerably limited the capacity of fiscal policy to stimulate the economy, so that once again monetary conditions had a more countercyclical profile (see Chart IV.1). However, in these years, despite the weakness of the economy, there continued to be significant overshooting of the inflation goals laid down in the budgets.

The situation has changed significantly in the new expansionary phase that commenced in 1994. Fiscal policy has been gradually assuming a more active role in the regulation of macroeconomic conditions, which has given monetary policy, once inflation was set on a course towards price stability, greater leeway to be more accommodating, as can be seen in the chart.

The healthy performance of the Spanish economy in recent years is reflected both in the markets and financial intermediaries and in agent's economic and financial flows. In 1998 there was again a significant revaluation of the assets traded on *financial markets,* which was particularly large in the case of equities, and turnover rose significantly. This strong expansion was compatible with the volume of funds channelled through f*inancial intermediaries* continuing to grow in 1998 at a higher rate than GDP. The strong increase in credit demand and the need to obtain funds to finance it are some of the factors which, as in previous years, govern the behaviour of deposit money institutions. As for mutual funds, they continued to raise funds from the private sector, albeit at a more moderate rate than in previous years, basically as a result of the smaller net investment in money market funds. By contrast, the information available on pension funds and insurance companies indicates that their absorption of

CHART IV.1

Business cycle, inflation and macroeconomic policies



Source: Banco de España.

(a) Percentage deviation from the GDP trend, estimated on the basis of the Hodrick-Prescott procedure.
(b) Cumulative fiscal impulses estimated following the IMF methodology. Fiscal impulses measure the fiscal stance in any year, taking the previous year as a reference and subtracting from the change in the deficit the part attributable to cyclical factors. An increase (decrease) in the indicator corresponds to a loose (tight) fiscal stance.
(c) Calculated as a weighted average of the variations in the real exchange rate and in the real short-term interest rate since a given base year. An increase (decrease) in the indicator corresponds to a loose (tight) monetary stance.
(d) Established in the State Budget.

funds from the non-financial sector of the economy continued to grow very strongly.

Analysis of the recent financial saving of the economic sectors, especially when it is compared with previous patterns of behaviour, also enables elements to be identified which confirm the healthy pattern of growth of the Spanish economy. Chart IV.2 and Table IV.1 help this comparison to be made, by simultaneously depicting net financial saving as a percentage of GDP in the current and preceding cyclical recoveries. In terms of the nation as a whole, it is notable that during the last four years a positive financing capacity has been sustained. This contrasts with the sharp deterioration in the external balance during the economy's previous cyclical recovery.

This marked difference in the path of the nation's financial saving is a reflection, in turn, of important changes in the behaviour of the various sectors of the economy. As mentioned above and as seen in Chart IV.2, the general government borrowing requirement has been progressively declining, to stand at below 2 % of GDP, while in the previous cyclical expansion it stood systematically at around 4 % of GDP. As regards the financial situation of firms, throughout the five years of the current cyclical recovery they have maintained gross saving and gross capital formation at very similar levels, so that higher indebtedness has been accompanied by higher rates of acquisition of financial assets, increasingly channelled towards foreign direct investment. As can be seen in Chart IV.2, the previous cyclical expansion was characterised by a rapid deterioration in the gross saving and net financial saving of firms, prompted, among other factors, by the strong increase in labour and financial costs. By contrast, in the current cyclical recovery both factors have tended to operate in the opposite direction, putting firms in a much more favourable position to invest.

Finally, as regards households, although they started the current cyclical recovery with savings ratios and a financing capacity significantly higher than in the previous period, these variables have followed a markedly countercyclical path, in clear contrast to what happened in the previous cycle. Nonetheless, the decline in household saving over the last few years reflects the higher degree of confidence in the country's economic situation and the increase in the net financial wealth of this sector.

The composition of economic agents' financial assets and liabilities evidences the significant changes occurring in their financial behaviour as a consequence of the new environ-

TABLE IV.1

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

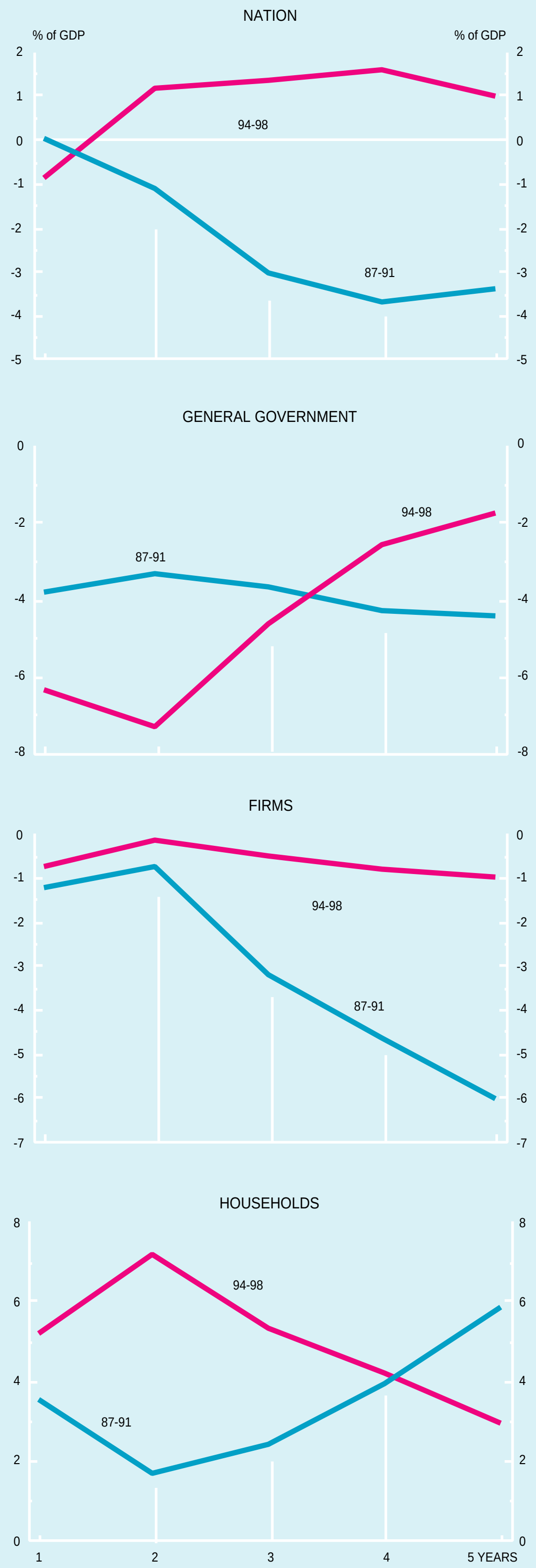
	Average 84-91 (b)	Average 84-86 (c)	Average 87-91 (d)	Average 92-98 (e)	Average 92-93 (c)	Average 94-98 (d)	1996	1997	1998
1. Gross disposable income	**99.6**	**99.3**	**99.8**	**99.3**	**99.4**	**99.2**	**99.4**	**99.2**	**99.1**
General government	15.9	14.1	17.0	16.3	16.8	16.1	15.7	17.2	18.0
Financial institutions	2.6	2.3	2.8	1.9	2.1	1.8	1.8	1.5	1.3
Non-financial firms and households	81.1	82.9	80.0	81.1	80.5	81.3	81.8	80.5	79.8
Households	*70.4*	*71.8*	*69.5*	*70.3*	*71.3*	*69.9*	*70.1*	*69.3*	*69.1*
Non-financial firms	*10.7*	*11.1*	*10.5*	*10.8*	*9.2*	*11.4*	*11.7*	*11.3*	*10.8*
2. Consumption	**78.3**	**78.5**	**78.1**	**79.1**	**80.4**	**78.6**	**78.5**	**78.1**	**77.6**
General government	15.0	14.4	15.4	16.7	17.3	16.4	16.6	16.2	15.8
Households	63.3	64.2	62.7	62.4	63.1	62.1	61.9	62.0	61.8
3. Gross national saving (1 – 2)	**21.4**	**20.8**	**21.7**	**20.2**	**18.9**	**20.7**	**20.9**	**21.0**	**21.5**
General government	0.9	–0.2	1.6	–0.4	–0.5	–0.3	–0.9	1.0	2.2
Financial institutions	2.1	2.1	2.2	1.7	1.8	1.6	1.7	1.3	1.1
Non-financial firms and households	18.3	18.9	17.9	18.9	17.7	19.4	20.0	18.7	18.2
Households	*7.6*	*7.9*	*7.4*	*8.1*	*8.5*	*8.0*	*8.3*	*7.5*	*7.4*
Non-financial firms	*10.7*	*11.1*	*10.5*	*10.8*	*9.2*	*11.4*	*11.7*	*11.3*	*10.8*
4. Gross capital formation (a)	**22.2**	**19.4**	**23.9**	**20.1**	**20.7**	**19.8**	**19.5**	**19.5**	**20.5**
General government	5.5	5.5	5.4	4.3	4.9	4.1	3.7	3.5	3.9
Financial institutions	0.6	0.4	0.7	0.6	0.7	0.5	0.5	0.4	0.2
Non-financial firms and households	16.1	13.4	17.8	15.2	15.0	15.3	15.4	15.7	16.3
Households	*5.1*	*4.7*	*5.3*	*4.7*	*4.6*	*4.7*	*4.9*	*4.8*	*4.9*
Non-financial firms	*11.1*	*8.7*	*12.5*	*10.5*	*10.4*	*10.5*	*10.4*	*10.9*	*11.4*
5. Net lending (+) or borrowing (–) of the nation (3 – 4)	**–0.8**	**1.4**	**–2.1**	**0.1**	**–1.7**	**0.8**	**1.3**	**1.6**	**1.0**
General government	–4.7	–5.9	–3.9	–4.9	–5.6	–4.6	–4.7	–2.6	–1.8
Financial institutions	1.6	1.6	1.5	1.1	1.0	1.1	1.2	0.9	0.9
Non-financial firms and households	2.3	5.7	0.3	3.8	2.8	4.3	4.8	3.3	2.0
Households	*2.8*	*3.3*	*2.4*	*3.7*	*4.1*	*3.6*	*3.6*	*3.0*	*2.7*
Non-financial firms	*–0.4*	*2.3*	*–2.1*	*0.1*	*–1.3*	*0.7*	*1.1*	*0.3*	*–0.7*
6. Net financial saving (7 – 8)	**–0.9**	**1.4**	**–2.3**	**0.1**	**–1.7**	**0.8**	**1.3**	**1.6**	**0.9**
General government	–4.7	–5.9	–4.0	–4.9	–5.6	–4.6	–4.7	–2.6	–1.8
Financial institutions	1.5	1.6	1.4	1.1	1.0	1.1	1.3	0.8	0.9
Non-financial firms and households	2.3	5.7	0.3	3.9	2.9	4.3	4.7	3.4	1.9
Households	*4.9*	*7.3*	*3.5*	*5.4*	*6.5*	*4.9*	*5.3*	*4.2*	*2.9*
Non-financial firms	*–2.6*	*–1.7*	*–3.2*	*–1.5*	*–3.7*	*–0.7*	*–0.6*	*–0.8*	*–1.0*
7. Change in financial assets	**44.3**	**42.8**	**45.2**	**39.7**	**45.0**	**37.5**	**38.2**	**42.0**	**48.3**
General government	2.2	3.5	1.4	2.3	4.1	1.6	3.8	0.7	1.2
Financial institutions	23.2	22.2	23.9	21.5	27.2	19.3	21.0	23.6	24.9
Non-financial firms and households	18.9	17.2	19.9	15.8	13.8	16.6	13.5	17.7	22.2
Households	*11.7*	*12.7*	*11.0*	*10.1*	*11.3*	*9.6*	*8.5*	*10.3*	*11.1*
Non-financial firms	*7.2*	*4.5*	*8.9*	*5.8*	*2.5*	*7.1*	*4.9*	*7.4*	*11.1*
8. Change in financial liabilities	**45.2**	**41.4**	**47.5**	**39.6**	**46.7**	**36.7**	**36.9**	**40.4**	**47.4**
General government	6.8	9.3	5.4	7.2	9.7	6.2	8.5	3.3	3.1
Financial institutions	21.7	20.5	22.5	20.4	26.2	18.2	19.7	22.8	24.0
Non-financial firms and households	16.6	11.5	19.7	12.0	10.9	12.4	8.7	14.4	20.3
Households	*6.8*	*5.4*	*7.6*	*4.7*	*4.8*	*4.6*	*3.2*	*6.1*	*8.2*
Non-financial firms	*9.9*	*6.1*	*12.1*	*7.3*	*6.1*	*7.8*	*5.5*	*8.3*	*12.1*

Sources: Instituto Nacional de Estadística and Banco de España.

(a) Includes net capital transfers.
(b) Covers a complete cycle of the economy defined as the period between two cyclical troughs of GDP.
(c) Cyclical downturn.
(d) Cyclical upturn.
(e) Covers the elapsed period of the economy's current cycle.

CHART IV.2

Net financial saving in cyclical upturns



Source: Banco de España.

ment of macroeconomic stability. The most notable changes are those relating to the internationalisation and disintermediation of financial flows and the restoration of financial health undertaken, principally by firms and general government. In recent years there has been a significant increase in financial transactions with the external sector, closely related to the complete liberalisation of Spanish capital movements – with a view to the creation of EMU – and to the possibilities of obtaining high yields on markets that are less mature than the Spanish one. The process of financial disintermediation has also intensified. Economic agents, and particularly households, have increasingly invested their savings in non-bank financial instruments, such as shares in mutual funds, insurance products or, directly in equities, to the detriment of bank deposits which have traditionally attracted the bulk of private sector saving. This has led to a considerable expansion in the external activity of credit institutions, which have had to replace domestic financing with external funds in order to finance the strong growth in lending to the private sector.

IV.2. MACROECONOMIC POLICIES

IV.2.1. Fiscal policy

Fiscal policy in 1998 remained geared, as in the preceding two years, to reducing budgetary imbalances. This permitted a general government deficit of 1.8 % of fiscal GDP, eight tenths of a percentage point less than in the previous year (Box IV.1 describes the changes in the measurement of GDP and the effects on the deficit and public debt data). This result was an improvement on the initial forecasts (the budget had set a deficit target of 2.4 %) and the figure included in the April 1997 Convergence Programme, against a background of higher-than-expected economic growth. This fiscal policy stance was set in the framework of the commitment to comply with the Stability and Growth Pact, which requires that public finances be close to balance in the medium term and that budget deficits should not exceed 3 % of GDP in normal cyclical situations.

To examine the fiscal policy implemented last year, it is useful to analyse first how this policy was *designed* in the budget. The target set was to reduce the general government deficit by six tenths of a percentage point of GDP, exclusively through a deceleration of consolidated expenditure, for which an increase of 3.8 % was budgeted. Consolidated revenue was forecast to grow at a similar rate to GDP (6 %).

The scheduled reduction in expenditure as a proportion of GDP was based on interest payments (estimated to fall by 7.7 % as a consequence of the effects of the decline in interest rates since 1995 and lower public indebtedness) and on unemployment benefits (down 2.7 % owing to the expected reduction in unemployment). At the same time, significant growth in capital spending (actual investment and capital transfers) was planned, to reverse the downward trend of previous years. As regards the forecast for revenue, first, indirect taxes were expected to grow strongly (10.2 %), as a result of buoyant consumption and imports, as well as the expected revenue impact of the creation of the duty on electricity, and the increase in the rate at which the Insurance Premium Tax is levied. Second, it was estimated that direct taxes and social security contributions would grow more moderately (5.6 %), in line with the forecasts for growth of employment and wages and with the effect of certain legislative amendments (the speeding up of personal income tax and corporate income tax rebates, among others), as well as the reduction in investment income owing to the reduction in interest rates. Finally, under other revenue, the fall in profits and dividends was notable, due to the lower profits than in 1997 from the disposal of public-sector firms, and lower receipts obtained under the heading of rates and other income, as a consequence of the decline in revenue from public debt issuance premiums.

The new agreement on the financing of health for the period 1998-2001, approved by the Fiscal and Financial Policy Board in November 1997, entered into force in 1998, setting an annual increase in health spending in terms of nominal GDP. In 1998, the Board made certain changes to the model for financing regional government in force for the period 1997-2001. These changes involved strengthening the system of financial guarantees to avoid losses of revenue by the regional governments as a result of the reform of personal income tax. Finally, the government reached an agreement with practically all the regional governments to achieve a balanced budget in 2001.

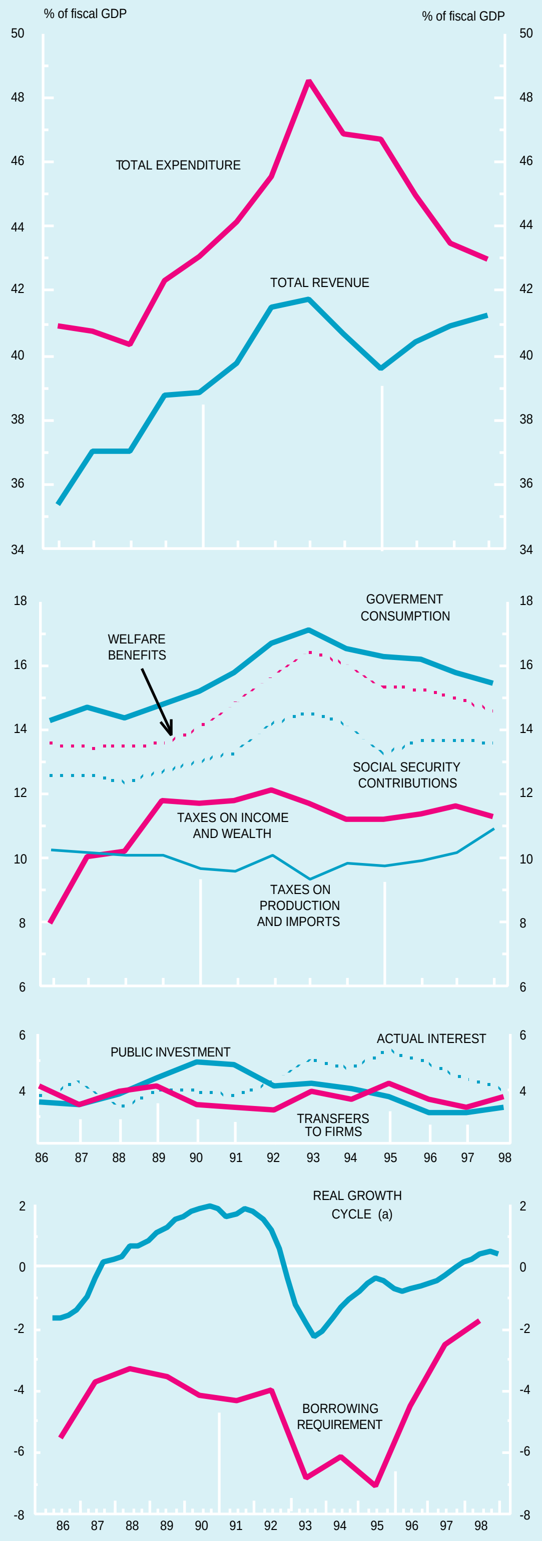
The fiscal policy *implemented* in 1998 enabled the fiscal deficit to be reduced. This reduction was the result of two factors. First, an increase in revenue, largely driven by the expansion in economic activity and, second, a reduction in total expenditure as a proportion of GDP, stemming basically from interest payments, unemployment benefits and government consumption, with similar contributions from each of these items (see Chart IV.3). The healthy behaviour of revenue and the moderation of expenditure enabled a primary surplus to be sustained for the third year running, which rose to 2.2 % of GDP in 1998. The drive to reduce the deficit was centred on the State, whose deficit fell to 1.5 % of GDP (2.1 % in 1997), while the deficits of territorial government and the social security system stood at 0.2 % and 0.1 % of GDP, respectively (0.3 % and 0.2 % in 1997).

As regards *revenue,* the contrast between direct and indirect taxes is notable. The former fell by three tenths of a percentage point of GDP as a consequence of the moderation in the growth of personal income tax receipts. This moderation is basically explained by the reduction in withholdings on investment income and by rebates being made earlier than in 1997. Corporate income tax receipts, however, grew at a high rate, as result of the performance of corporate profits, which neutralised the negative effect on revenue of other factors. These included, notably, the falls in withholdings on investment income, the levy on balance sheet restatement and the increase in payments on account, which affected the figures in 1997. Indirect taxes, for their part, rose as a proportion of GDP by seven tenths of a percentage point, driven by the healthy behaviour of consumption and influenced by the increase in the tax rate payable on insurance premiums and by the creation of the new tax on electricity. Social security contributions rose at a similar rate to that of the previous year, despite the acceleration in the number of contributors. Finally, other revenue and transfers grew slightly faster than in 1997, while capital receipts rose moderately, after the fall in 1997, as a result of the high inheritance tax receipts and the increase in the transfers of funds from the EU.

With regard to public *expenditure,* its decline with respect to GDP is explained by a number of factors: first, the low growth of social benefits, which fell by four tenths of a percentage point of GDP mainly as a consequence of the reduction in unemployment benefits and sick pay; second, lower interest payments, which also fell by four tenths of a percentage point of GDP, owing to lower interest rates and the reduction in the weight of public debt in GDP over the last two years; and, finally, government consumption, which fell by four tenths of a percentage point of GDP, as a result of the moderate growth in compensation of wage earners and, to a lesser extent, net purchases of goods and services. By contrast, public investment grew significantly, to stand at 3.3 % of GDP. Operating subsidies also rose (by three tenths of a percentage point of GDP), particularly those received by RENFE, those used to finance coal utilities and the reductions and rebates of employers' social security contributions, as did

CHART IV.3

General government: Main variables



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

(a) Cyclical deviation of GDP: sign reversed.

capital transfers, which rose by one tenth of a percentage point of GDP.

The fiscal consolidation drive was part of a medium and long-term strategy. Pursuant to the Stability and Growth Pact, the Spanish government presented its first Stability Programme at the beginning of 1999. This laid down as public finance objectives the achievement of a balanced budget and a reduction in the public-debt-to-GDP ratio to below 60 % in 2002. In addition, it has been announced that these objectives must be compatible with a reduction in the tax burden, so that the burden of the adjustment must fall on public expenditure and, within the latter, current expenditure, since it is planned to increase public investment. The Program incorporates in its forecasts the effects of the reform of personal income tax, already approved, which will entail an average reduction of 11.1 % in the tax burden on households and a reduction in the number of rate bands and deductions. It is also planned to amend the General Budget Law, in order to improve the control of the budget outturn and the effectiveness of public expenditure, and furthermore it is acknowledged that progress must be made in rationalising the social security system in order to ensure its financial sustainability.

IV.2.2. Monetary policy

1998 marked the end of a four-year period in which monetary policy was implemented under a regime of independence, pursuant to the provisions of the Law of Autonomy of the Banco de España of June 1994, within a framework based on the establishment of direct inflation targets aimed at achieving price stability in the medium term. Although the objectives of monetary policy in 1998 were, once more, set within this framework, they were formulated taking into account the singularity of 1998. If, – as was considered likely – Spain joined the Monetary Union, the transition to a new monetary policy regime had to be carried out that year. This required the Banco de España to respond to domestic factors, but at the same time to modulate interest rate movements to ensure that by year-end the monetary conditions of the Spanish economy were in line with those of the group of countries adopting the euro.

Mindful of these considerations, the Banco de España set a target for 1998 consisting of keeping the 12-month growth rate of the CPI over the course of the year close to 2 %. Such a goal was considered sufficient to consolidate price stability in the Spanish economy. Moreover, it was in line with the objectives that the ESCB might have been expected to establish,

BOX IV.1

Changes in the measurement of macroeconomic aggregates: ESA 95 implementation timetable and its repercussions on the Stability and Growth Pact deficit and public debt data

This box explains the recent changes in EU countries' macroeconomic statistics and those scheduled for the near future. The aim is to reduce, as far as possible, the confusion that these types of changes cause among analysts. These statistics are a part of certain EU legal texts, such as those relating to the Excessive Deficit Procedure/Stability and Growth Pact (EDP/SGP), the Community Budget and Own Resources, etc. Accordingly, any revision of, or conceptual change in, these series affects very sensitive areas. This largely accounts for the graduality with which it is planned to introduce ESA 95.

The revisions in question, indicating the period, scope and context in which they have arisen, with particular reference to the case of Spain, may be listed as follows:

1. *Gross domestic product (GDP): Spanish National Accounts (CNE) GDP versus "fiscal" GDP.* The Spanish GDP referred to, unless otherwise indicated, both in this Annual Report and in Chapter I of the complementary publication Financial Accounts of the Spanish Economy (FASE), is that published by INE (National Statistics Institute) in *Contabilidad Nacional de España. Base 1986 (CNE),* which has been prepared in accordance with ESA 79. However, for the purposes of calculating the deficit and public debt ratios under the EDP/SGP framework, and the contribution to the Community budget, the so-called "fiscal" GDP or "GNP Directive" GDP is used. In principle, CNE GDP and "fiscal" GDP, also calculated by INE, should be identical (both are based on ESA 79). But for various reasons INE has not considered it appropriate to incorporate the result of the harmonisation undertaken by Eurostat, for the aforementioned "fiscal" ends, into the official CNE series. In Spain's case, this harmonisation has taken the specific form of: a) treatment alternative to that in the CNE relative to lotteries, education subsidies and certain means of transport, insurance services and income vis-à-vis the rest of the world, and b) the result of the exercise on exhaustiveness, concluded in March 1999. As a result, current "fiscal" GDP is higher than CNE GDP (1998 data) by 2.7 %, 2.2 percentage points of which relate to the exhaustiveness exercise (see the CNE GDP and "fiscal" GDP amounts in Table I.1.1 of FASE). There is every indication that, once INE draws up the CNE in terms of ESA 95 (see below), this GDP duplicity will end.

2. *Introducing* ESA 95. This will be done in stages, as established in the related regulations (EC Regulation No. 2223/96). Specifically, in May or June 1999, INE will publish the series 1995-1998, relating to the macroeconomic aggregates, with specific additions but without including the non-financial accounts of the institutional sectors, among which those of the General Government sector which, evidently, will include measurements of the deficit and – to some extent – of public debt. The non-financial accounts of the institutional sectors will, like the financial accounts prepared by the Banco de España, be published in September or October 1999, and likewise for the period 1995-1998, although the series will subsequently be extended for previous years.

3. *SGP (formerly EDP) Notifications.* The next Notifications are those for September 1999 and March 2000. Under Article 8.2 of the ESA 95 Regulation, the September 1999 Notification will still be within the ESA 79 framework. Accordingly, when the GDP data are being released, and deficit and debt data are on the point of being published within the ESA 95 framework, this Notification will use deficit, debt and GDP data within the ESA 79 framework, which may cause some confusion. The reason for this apparent inconsistency is of a fiscal nature. Certain net-contributor countries to the Community did not endorse approval of the ESA 95 Regulation (which came into force in November 1996) while it was not stipulated that, until the financing arrangements for the European Community were amended (scheduled for the year 2000), the GDP actually to be used for determining countries' contribution to the Community budget was that of the GNP Directive, i.e. ESA 79, and not that inferred by the application of ESA 95. As from the Notification for the year 2000, the deficit, debt and GDP data will be calculated in terms of the ESA 95 framework.

so that it facilitated the transition to the single monetary policy.

In the design of monetary policy in 1998, the Banco de España weighed up the favourable contribution of macroeconomic conditions to the shaping of a low inflation environment. As for the international setting, prices on international markets were expected to continue to display moderation and the tempo of economic activity was expected to be favourable to price stability. In the domestic arena, the maintenance of a balanced pattern of growth was considered likely, with national demand, stimulated by the expansion in investment and by the recovery of private consumption, gathering momentum, while the contribution from the external sector diminished owing to the strength of imports. This scenario, subject to some uncertainty regarding the impact of the south-east Asian crisis, was considered consistent with the inflation targets and rigorous implementation of the budgetary policy, with a further cut in the general government deficit, as described in the previous section. Finally, the Banco de España reaffirmed the framework of analysis for taking monetary policy decisions of previous years, based on the monitoring of a broad range of economic, monetary and financial indicators. Among these, the money stock and the fulfilment of commitments arising from membership of the ERM continued to be very important. As for presentation to the public of the assessment of the inflationary situation and monetary policy actions, the Banco de España continued, throughout 1998, to use the regular channels available to it, notably the half-yearly *Inflation Report,* the final edition of which was released in September.

The encouraging inflation figures and favourable prospects for prices in the medium term facilitated the convergence of Spanish *monetary conditions* on those set at the outset of Stage Three of EMU. The intervention rate of the Banco de España was cut by a total of 1.75 percentage points in 1998, to 3 % (see Chart IV.4). However, the cuts were unevenly distributed over the year, reflecting the growing weight of external factors in monetary policy decisions. Thus, by October, the intervention rate had been cut by 0.50 percentage points, as a result of two cuts of 0.25 percentage points each in February and May, the latter when Spain’s participation in Stage Three of EMU had been confirmed. The bulk of the adjustment was therefore made in the final quarter of the year, when the Banco de España reduced its 10-day intervention rate on three occasions (October 6th, November 3rd and December 3rd) by a total of 1.25 percentage points (see Chart IV.4). The reduction of 0.50 percentage points on December 3rd was the result of the concerted action of the central banks that were going to participate in Stage Three of EMU and was based on considerations relating to the area as a whole. This action sought, moreover, to dispel the uncertainty regarding the monetary conditions at the outset of Stage Three of EMU and so smooth its opening.

This latter decision was influenced by the crisis in international financial markets, which was at a height between August and October, and by the downward revision to economic growth prospects within Europe. The easing of monetary policy led to significant reductions in short-term interest rates in most Western countries and enabled the stock market recovery to be consolidated, following the sharp falls in prices in August and September. Long-term interest rates also fell in the last few months of 1998, to stand below the already low levels they had reached in the industrialised countries. 1998 therefore ended with monetary and financial conditions in Spain practically in line with those of the countries which were going to make up the euro area and with very low real interest rates. In the first quarter of 1999, the ECB, after analysing the different factors affecting its basic objective of maintaining price stability, decided to leave the initial level of the main monetary policy interest rate unchanged at 3 %. However, on April 8th, the Governing Council of the ECB decided to cut this rate of interest by half a percentage point to 2.5 % for the reasons already set out in Chapter II.

As regards the path of *monetary aggregates* in Spain in 1998, liquid assets held by the public (ALP) continued to follow the decelerating path that commenced in 1995, to reach a very low growth rate (1 %) by the end of the year (see Chart IV.2). By contrast, as seen in Chart IV.5, ALPF (which includes shares in money-market and fixed-income mutual funds, to which a large amount of funds invested in bank deposits were moved) grew at a year-on-year rate closer to that of nominal GDP (around 6 %), which was nonetheless below the 1997 rate of almost 8 %. The low level of interest rates and the buoyancy of domestic demand led to strong growth in the narrowest monetary aggregates, so that the rate of expansion of M2, for example, which includes cash and sight and savings deposits, was close to 14 % at the end of the year.

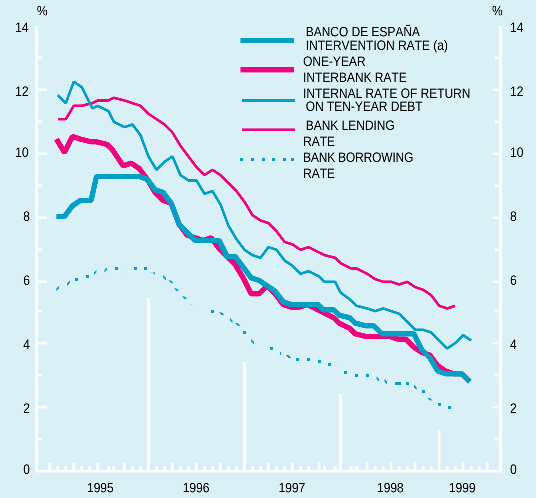
In 1998, the rate of growth of financing to firms and households continued to accelerate, to reach a year-on-year rate of 16.6 % by year-end, as against 12 % the preceding year. This increase was explained by financial conditions that were very favourable for borrowing and by the encouraging economic prospects, particularly in the case of households, as reflected by consumer confidence indicators. Other factors that may have influenced the private-sector demand for credit are analysed in more detail in Box IV.2. This expansion of private-sector credit was almost totally offset by the lower general government borrowing requirement, which grew at a rate of only 2 %, as against 7 % in 1997. Total financing to non-financial resident sectors thus increased at a rate of 11.2 %, slightly above the 10 % rate of 1997.

The process whereby credit institutions resident in Spain raise net financial liabilities abroad, which had commenced in previous years, intensified in 1998, with the result that the net debtor position vis-à-vis the external sector increased notably. At the same time there was a reduction in the external assets held by the Banco de España, so that the total debtor position of the credit system increased.

Turning to the *implementation* of monetary policy, the Banco de España progressively adapted the operating framework of Spanish monetary policy to the new framework for the single monetary policy, especially when, during the last few months of 1998, the ECB finalised decisions on the questions remaining open in this area. Specifically, measures were introduced in 1998 to control the risks involved in accepting collateral, similar to those which were going to be established by the ESCB. In July 1998 a deposit facility was introduced, alongside the already existing credit facility, in order for the institutions to familiarise themselves with the instruments which were going to be available to them from 1999. Likewise, in November, the Banco de España began to hold weekly liquidity-providing tenders with 14-day maturity, at the same time as it modified the computation period for reserve requirements to one month, and proposed reducing the frequency of fine-tuning operations, in anticipation of the expected model for Stage Three, in which these operations were likely to be very sporadic. Finally, both for calculating the monetary aggregates, which play an important role in the monetary policy strategy of the Eurosystem, and for the compliance with reserve requirements, the relevant information obligations were established for Monetary Financial Institutions (MFIs), consisting basically of credit institutions and money-market funds. In order to ease the changeover to the single monetary policy, these obligations were brought into effect early and Spanish MFIs began to send information on their balance sheets to the Banco de España monthly from June1998.

CHART IV.4

Interest rates



Source: Banco de España.

(a) Interest rate on the main ECB financing operations since January 1999

IV.3. THE FINANCIAL MARKETS

Developments on the Spanish financial markets in 1998 were characterised by the continuation of some of the trends observed in 1997, although they were also influenced by the international financial crisis which occurred during the summer months. Thus, interest rates continued to decline and equity prices rose over the year as a whole. On primary markets the supply of fixed-income securities continued to decelerate, since private-sector securities, despite their expansion, failed to completely offset the smaller volume of public issuance. All these issues are set out and analysed below in greater detail, starting with prices and then continuing with the behaviour of turnover on primary and secondary markets.

On the *interbank deposit market,* interest rates adjusted to the successive movements in the Banco de España intervention rates – which, as indicated in the preceding section, were reduced by 1.75 percentage points over the year – and the expectations regarding future changes. Consequently, the reductions ranged from 1.9 percentage points for overnight deposits to 1.4 percentage points for the one-year maturity. Overall, the yield curve had a negative slope for most of the year (see Chart IV.6), reflecting expectations of cuts in intervention rates. Nonetheless, during the final quarter the curve tended to flatten out, as the leeway

TABLE IV.2

Monetary and credit aggregates.
End-year twelve-month growth rates

	1995	1996	1997	1998
MONETARY AGGREGATES:				
M1	2.3	7.5	12.4	15.3
M2	2.6	7.5	11.0	14.2
M3	10.8	4.2	3.5	1.7
ALP	9.2	6.5	3.7	1.1
ALPF	8.0	9.8	7.9	6.4
CREDIT AGGREGATES:				
HF (a) + Gen. gvt. (b)	9.7	9.4	10.1	11.2
HF (a)	7.1	7.7	12.1	16.6
Gen. gvt. (b)	14.3	12.4	6.9	2.2

Source: Banco de España.

(a) Domestic credit to households and firms plus commercial paper and foreign direct credit.
(b) Domestic credit to general government plus outright debt held by the public and foreign direct financing.

for cutting intervention rates to the forecast level of the EMU convergence rate was exhausted.

The *public debt market* yield curve also shifted continuously downwards (see Chart IV.6). The decline in yields was smaller the longer the maturity, ranging from two percentage points at the short end of the curve to 1.3 percentage points at the longer end. Consequently, the positive slope of the yield curve increased until the spread between the long and short maturities reached 1.9 percentage points. In 1999 to date, the spread has continued to widen due to the reductions in short-term rates and the increase in long-term rates. The positive slope of the curve is also reflected by the term structure of one-year forward rates, under which the latter increase with the time horizon.

As in the rest of the industrialised economies, continuation in 1998 of the downward path of previous years has taken long-term public debt yields to very low levels (see Chart IV.6). The size of the decline in Spanish long-term interest rates in 1998 was very similar to that in rates on the sovereign debt of the rest of the countries which have adopted the euro. The backdrop to this decline was increasing certainty as to completion of the monetary integration project on schedule and convergence of inflation rates and short-term interest rates. The downward movement of long-term interest rates was also helped by the flight to quality securities of the more stable industrialised countries, in particular fixed-income securities, and by the easing of monetary policy in the United States and in Europe.

Prices on Spanish *equity* markets, as on the majority of international markets, were characterised by their high level of volatility (see Chart. IV.7). Thus, to mid-July there was a marked upward trend in prices, which resulted in a 51 % rise in the Spanish Ibex 35 stock exchange index. However, as mentioned in Chapter II, after the financial crisis in Russia market sentiment deteriorated sharply. These circumstances, together with the fact that prices were at very high levels, led to large price falls in August and September. As a result, by the beginning of October, the Ibex 35 index had lost all the ground gained to mid-July and even stood slightly below its end-1997 level. In October, however, coinciding with the easing of US monetary policy and the revision of some of the more pessimistic scenarios contemplated at the beginning of the crisis, there commenced a recovery in prices which enabled 1998 to close with significant gains. Thus, the Ibex 35 rose by 35.6 % in the year as a whole, which was larger than the rise in the Euro Stoxx (29.8 %) and in the S&P 500 (26.9 %).

In 1999 to date, stock market prices have continued to display high levels of volatility. During the first few days of the year, coinciding with the commencement of trading in euro, there were large price rises in the markets of the countries forming the common currency area. However, in mid-January, coinciding with the devaluation of the Brazilian real, the previous rises were wiped out by falls. Since then, the Ibex 35 has been fluctuating without any clear direction. At the beginning of May its level was slightly higher than at an end-1998.

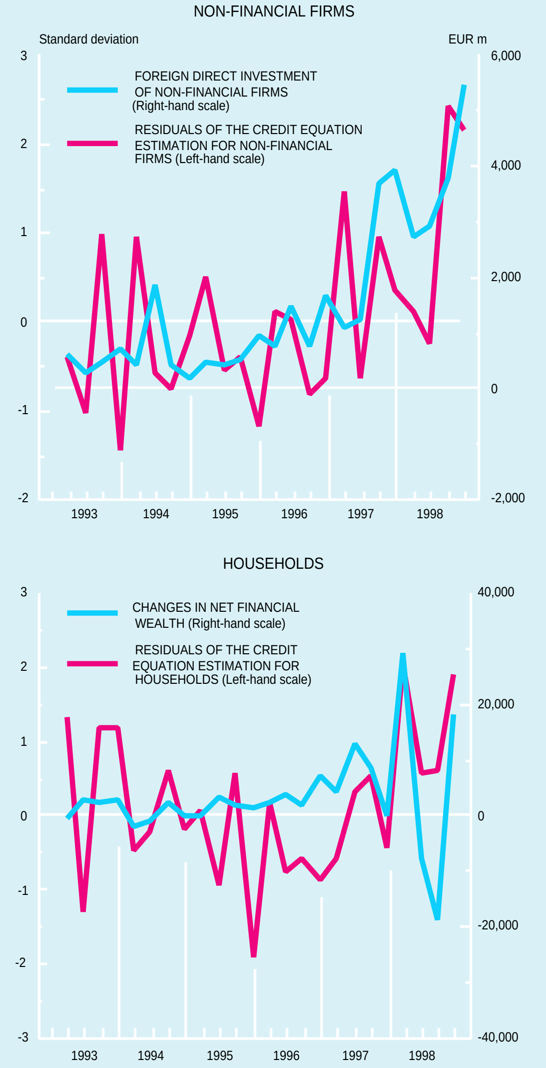
BOX IV.2

The expansion of bank credit in Spain

The high growth rates in 1998 of the demand by households and non-financial firms for credit are the continuation of a process which began in late 1995 and which is largely based on the downward trend of interest rates and on the pick-up in economic activity since mid-1996.

In the period from 1996 to 1998, households increasingly resorted to the various financing sources available: the resident credit sector, non-resident credit institutions and the corporate sector (via trade credit), as highlighted in the main body of this chapter. The factors traditionally accounting for the behaviour of households' credit financing have essentially been related to their spending decisions: consumption and housing demand. The lower cost of financing, arising both from interest rate cuts and from the generalisation of floating-rate loans, mainly on mortgage loans, have further boosted the demand for credit. As regards non-financial firms, all their forms of financing have also expanded since late 1996. In this case, private productive investment (the main indicator of firms' typical activity) is the variable which has accounted for the course of corporate credit financing.

However, there has been an increase in credit financing in both sectors since 1997 which is significantly greater than what would be consistent with historical patterns. The usual demand factors (private consumption, residential investment, private productive investment and cost of financing) have ceased to be the driving force behind the behaviour of credit. Evidence of this is the fact that currently available econometric estimates of equations of the demand for credit by non-financial firms and households have shown significant prediction errors throughout 1998, as can be seen in the adjoining chart.



Source: Banco de España.

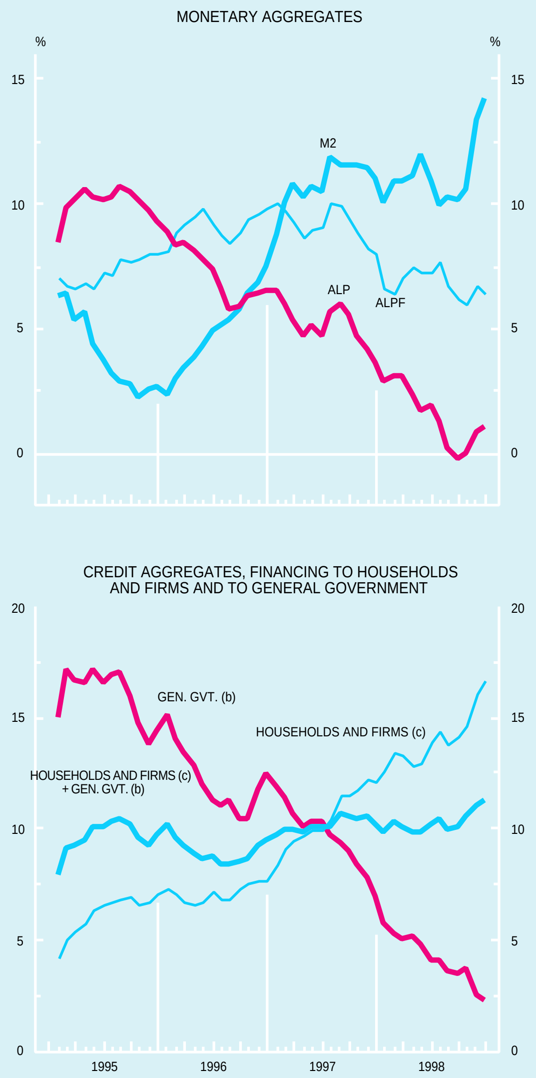
The explanatory factors of this growth of financing to households, factors of a different nature to those underlying previous situations of strong credit growth, may be related both to the demand for and supply of credit. Among the demand factors is a considerable improvement in the capacity of households to meet the payment commitments arising from their debt, the result of the decline in actual interest paid as a proportion of gross disposable income. In 1990, this proportion was approximately 6.2 %, dipping to 4.4 % in 1994 and, finally, to 3.5 % in 1998. Hence, households might be prepared to incur debt in a greater proportion than previously to satisfy the same spending requirements, having to make a lesser relative effort in terms of their disposable income. Among the supply factors, the degree of rationing normally applied by banks in extending credit has been eased, against a background of heightened competition for banking business. In this connection, one influential factor combining both supply and demand-related considerations is the ongoing rise in the value of households' financial wealth since 1996, due principally to the increased value of equity holdings and shares in mutual funds. The chart shows the estimation errors of the equation compared with an estimation of the rise in the value of households' net financial wealth, derived exclusively from the rise in the price of financial assets. The possibility of households having used financial assets whose price has risen sizeably as collateral for their credit may have given rise to a shift in the demand for credit. In turn, the supply of credit by financial institutions might also be shifting, given their greater proclivity to lend to a sector with a healthier financial position.

Particularly relevant among the factors accounting for much of the growth seen in credit to non-financial firms is the strong growth of investment abroad by Spanish firms, mainly through equity acquisitions. The figures of the Balance of Payments financial account show that foreign direct investment by agents included under *other resident sectors* was around 3 % of GDP in 1998, compared with 2.1 % and 1% in 1997 and 1996, respectively. In the chart relating to firms, the credit equation estimation errors are shown for the sector set against their foreign direct investment, with a certain correspondence discernible since mid-1997. It may be assumed that a significant portion of the resources needed to finance such foreign investment will have been obtained through bank credit.

Data from the Banco de España Central Balance Sheet Office suggest there are additional factors that may also be encouraging greater resort to bank credit by firms. Specifically, firms are obtaining a far higher return than what borrowed funds are costing them, whereby they are more interested in taking on debt than in resorting to equity financing. Thus, the greater leverage on borrowed resources results in higher returns for shareholders. Further, the extensive creation of firms witnessed in recent years, the establishment of which entails sizeable financing needs, may also explain a part of credit growth. This latter factor may likewise be affecting the growth of credit to households, since there has been a strong increase in the number of individual entrepreneurs, who are classified under the household sector.

CHART IV.5

Monetary and credit aggregates (a)



Source: Banco de España.

(a) 12-month rate on original series.
(b) Domestic credit to general government plus outright debt held by the public and direct financing.
(c) Domestic credit to households and firms plus commercial paper and foreign direct credit.

As for *turnover* on the financial markets, the slowdown in the growth in the total supply of marketable fixed-income securities on the *primary markets* already seen in 1997 continued in 1998. This slowdown is attributable to the trend in assets issued by the State and, to a lesser extent, by territorial government (see Table IV.3). In fact, the lower Treasury borrowing requirement helped to reduce its volume of net issuance from EUR 15.5 billion (ESP 2.6 trillion) in 1997 to EUR 5.5 billion (ESP 0.9 trillion) in 1998. As issuance was concentrated at the medium and long terms, while the net issuance of Treasury bills was negative, there was a significant shift in the composition of outstanding debt towards the longer dates. By year-end the average life of the debt had risen from 3.5 to 5 years. The net issuance of territorial government also slowed in relation to previous years, this being mainly attributable to the assets issued by the Regional (Autonomous) Governments. As in previous years, issuance was concentrated on the medium and long terms, although it was also here that the volume of net issuance fell.

On the *primary markets for the fixed-income* securities of other resident sectors, the volume of net issuance, at EUR 4.8 billion (ESP 0.8 trillion), was at a significantly higher level than in previous years. This enabled the size of these markets, until now little developed in Spain, to grow considerably. The greater dynamism of these markets in 1998 is explained principally by the large issues of securitisation bonds in the fourth quarter, which were stimulated (as mentioned in Box IV.3) by the approval of a new legal regulation. The favourable trend in the commercial paper market was also notable. The volume of net issuance was positive again, after several years of decline in the stock of outstanding paper.

Growth in the supply of new marketable securities was highest in the *equity markets,* where turnover exceeded EUR 18 billion (ESP 3 trillion). This is attributable both to the high volume of public offerings for the second year running (primarily due to the privatisation of state-owned firms) and to capital increases (which were much higher than in previous years). According to the information available on the distribution of placements, households and to a lesser extent non-residents continued to absorb a significant proportion of the new supply of shares.

Developments on the primary markets as a whole during 1998 significantly changed the distribution of the supply of marketable securities: the relative weight of instruments issued by general government fell, while that of instruments issued by private firms rose, and there was a significant increase, in absolute and relative terms, in equities. This was the result of a number of factors of various kinds, which have affected both the supply and the demand for marketable securities. On the supply side, privatisation policy and the reduction in the fiscal deficit have led to a strong increase in the supply of equities and a slowdown in State issuance, while the new regulation on securitisation has extended the range of instruments capable of being securitised and introduced greater flexibility into such operations. On the demand side, the greater stability of the Spanish economy and the lower nominal return on low-risk assets have stimulated a shift from assets issued by the State to others with a higher expected return and, consequently, greater risk, such as equities and fixed income securities issued by private firms. Moreover, the inclusion of some securities issued by private firms in the lists of collateral eligible for the monetary policy operations of the Eurosystem has boosted credit institutions' demand for these securities.

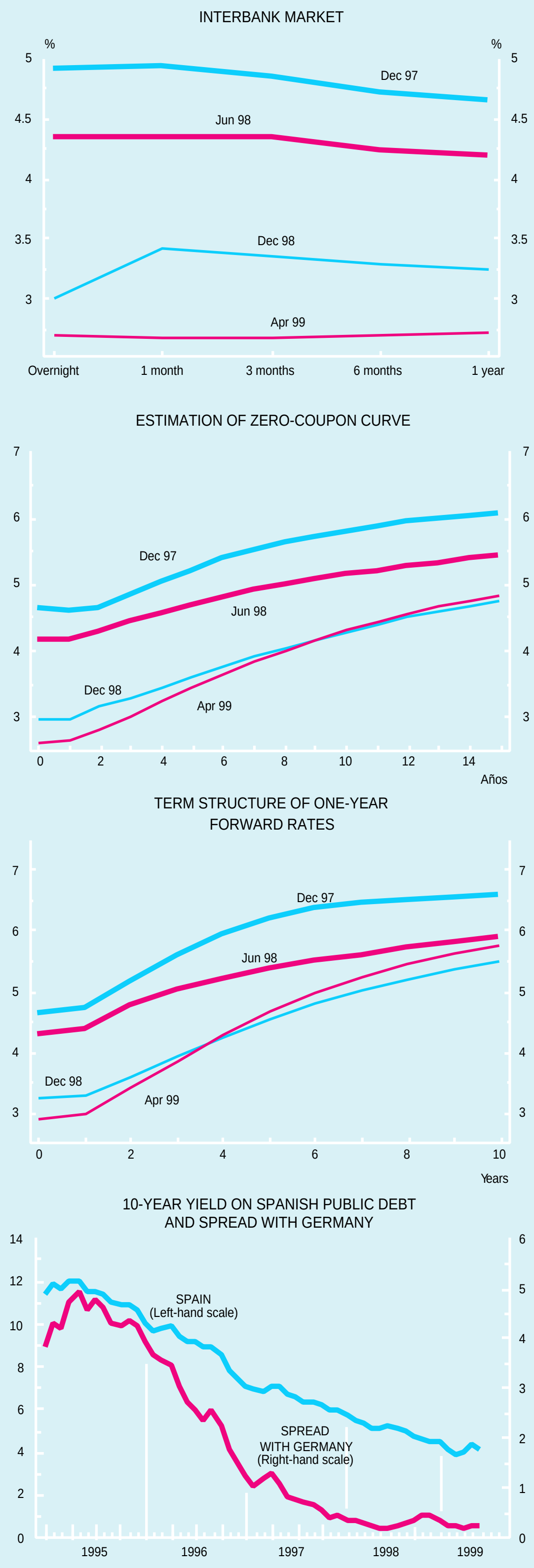
On the *secondary markets,* the behaviour of turnover differed according to instruments and markets (See Table IV.4). Thus, in the book-entry public debt market volumes continued to grow in almost all types of trading, although at a lower rate than in previous years. In the AIAF fixed-income market, turnover reached EUR 43.1 billion (ESP 7.2 trillion), double the figure for the preceding year. On the stock market, turnover in fixed-income fell to EUR 53.1 billion (ESP 8.8 trillion). By contrast, turnover in equities rose again significantly for the third year running, reaching EUR 261.3 billion (ESP 43.5 trillion), 60 % higher than in the preceding year. The upward trend in turnover on this market is a consequence of investors' growing interest in this type of securities, although, as mentioned above, it has also been helped by the strong increase in the supply of marketable instruments.

On the *derivatives markets* the behaviour of turnover varied with the nature of the underlying asset. Thus, activity with contracts based on fixed-income contracted significantly. This contraction, which was particularly intense in the final quarter of 1998 and has continued in the first few months of 1999, is explained by the fact that the high correlation between interest rates in the different euro area countries means that fixed-income derivatives trading is tending to shift to the larger markets. By contrast, activity with contracts based on equities continued to grow, following a very similar profile to the spot market. The behaviour of turnover in the two segments mentioned resulted in a fall in the overall turnover on MEFF markets to EUR 2.7 trillion (ESP 442.8 trillion).

Finally, it should be noted that, since the beginning of 1999, cash and securities accounts in all money and securities markets have been re-denominated in euro as regards contracts, pricing and settlement. This process has coincided with the entry into force of the reform of the Securities Market Law (Law 37/1998), which adapts Spanish law to various Community directives and opens up Spanish markets to

CHART IV.6

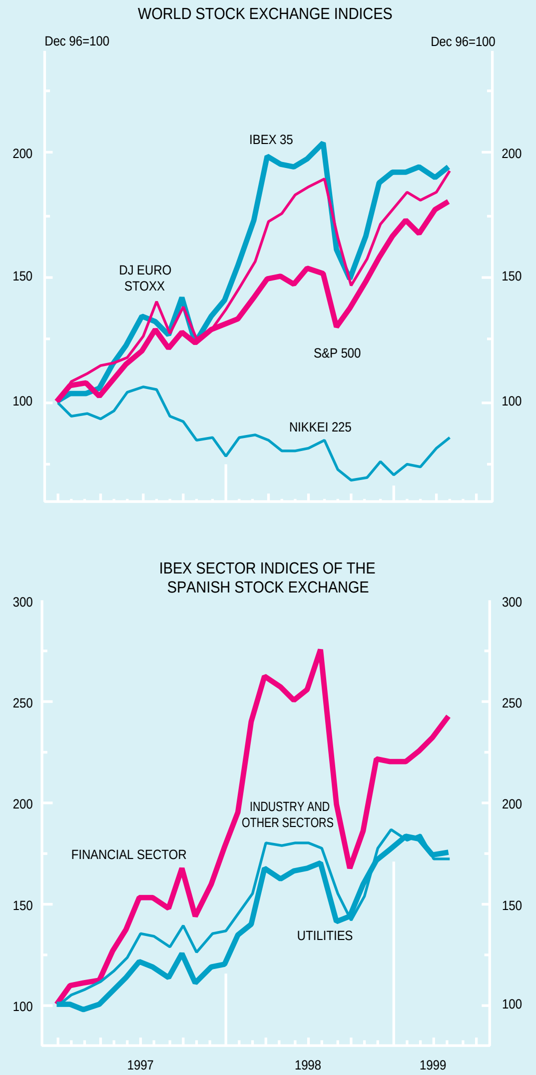
Interest rates and spreads



Source: Banco de España.

CHART IV.7

Stock exchange indices



Sources: BIS and Banco de España.

foreign competition, by establishing the principle of freedom of establishment and provision of investment services within the EU.

IV.4. FINANCIAL INTERMEDIARIES

Although there has been a notable expansion of organised financial markets in recent years, the nature and characteristics of the monetary policy transmission mechanism continue to depend largely on the behaviour and decisions of the financial intermediaries. The prominent role they play in the channelling of flows of savings and financing means that they have a significant impact upon agents' spending decisions, at the same time as their activity is very directly influenced by monetary policy decisions. For both reasons, the behaviour of the sector will be analysed below. In addition to deposit money institutions, the sector includes other intermediaries, such as mutual funds, pension funds and insurance companies. This section describes the changes in the main items of the structure of their balance sheets and, in the case of deposit money institutions, attention is also given to their pricing policy and their profit and loss accounts are briefly analysed.

The volume of funds channelled through financial intermediaries (the credit system, portfolio investment institutions, securities-dealer companies and securities agencies, insurance companies and pension funds) grew again in 1998, to reach the equivalent of 49 % of GDP, if we consider the acquisition of assets and liabilities together, the financial saving of all the financial intermediaries being 0.9 % of GDP. Deposit money institutions and portfolio investment institutions were the intermediaries that contributed most to the growth in the financial transactions of the sector (somewhat more than 80 %). Of the other financial intermediaries, securities-dealer companies and securities agencies recorded the largest increase in the volume of transactions.

IV.4.1. Deposit money institutions

The progress of deposit money institutions is reflected in their balance sheet and profit and loss account. As regards the former, the *activity* of the deposit money institutions in 1998 was characterised, once again, by the strong growth of lending and by the need to raise funds to finance this growth, given the slower growth in deposits as a result of the greater attractiveness of mutual funds. In consequence, foreign currency borrowing, mainly through loans granted by non-resident credit institutions, continued to be one of the main sources of funds for these institutions, although its increase was mitigated by the recovery in financing from the domestic market and the Banco de España, the rate of expansion of which was in line with the growth of average total assets.

Considering the different items of the *assets,* it was normal lending activity, net of doubtful debts, that grew most in 1998. At an average rate of 14.9 % in 1998 its growth was well above the 8 % growth in average total assets. As a result the share of lending in the average total assets of the deposit money institutions rose by 2.4 percentage points (see Table IV.5).

TABLE IV.3

Issues and public offerings of marketable securities

EUR millions

	1995	1996	1997	1998
Net issues	**28,151**	**32,827**	**19,707**	**20,530**
Fixed income	23,722	30,700	18,716	11,401
State	*22.832*	*28.897*	*15.530*	*5.493*
Territorial governments	*2,013*	*1,977*	*2,194*	*1,064*
Credit institutions (a)	*1,046*	*793*	*2,572*	*1,370*
Other resident sectors (b)	*–2,170*	*–968*	*–1,581*	*3,474*
Equities	4,429	2,128	992	9,129
Credit institutions	*577*	*204*	*210*	*4,868*
Other resident sectors	*3,852*	*1,923*	*781*	*4,261*
Public offerings and underwritings (c)	**1,575**	**1,376**	**8,271**	**9,236**
Public offerings	1,575	1,376	8,099	8,852
Privatisations	*1,260*	*1,224*	*7,316*	*8,138*
Other	*315*	*151*	*784*	*714*
Public underwritings	0	0	171	385

Sources: CNMV and Banco de España.

(a) The short-term issues are the notes registered by the CNMV.
(b) The short-term issues are the notes placed via banks and savings banks.
(c) Includes only the domestic tranche.

The component which contributed most to this buoyancy was lending to the private sector (“other resident sectors”), which increased its weight in average total assets by somewhat more than three percentage points, with average annual growth of 17.6 %. Lending to non-residents also rose notably in 1998, although its contribution to the growth of total lending was much smaller. Lending to general government, in contrast, grew at negative rates, continuing the decline that began in 1997.

Another notable fact is that, during 1998, there was a change in the relative importance of lending in pesetas and in foreign currencies, since the decline in interest rates on domestic markets and the prospects for exchange-rate stability boosted the demand for financing in pesetas. In 1998, all forms of lending grew strongly, with the exception of discounting, which nonetheless grew faster than in 1997. The most buoyant component continue to be lending to the resident private sector with security on property, which grew at a rate of 20.3 % on average during the year.

Unlike in the case of lending, the weight of portfolio investment in average total assets of deposit money institutions fell again in 1998. This was basically a result of the decline in the stock of State debt, whose weight in the balance sheet fell by 1.2 percentage points (see Table IV.5). By contrast, the equity portfolio grew significantly, as a consequence of the rise in holdings in group companies and other holdings.

Among the other asset items, the most significant change was in interbank market positions, which include forward accounts and repos vis-à-vis other resident and non-resident credit institutions, both in pesetas and foreign currencies. The growth in these positions was well below the average expansion of total assets, due to the reduction in the stock of forward accounts, basically vis-à-vis non-resident institutions. The recovery in 1998 in repos only partially offset this decline, so that interbank market positions as a percentage of average total assets fell by 1.3 percentage points (see Table IV.5). The other asset items grew at a similar rate to average total assets so that there was hardly any change in their weight in the latter.

As regards the *liabilities* of deposit money institutions, some of the most characteristic features of the previous year were sustained in 1998, although they were less pronounced. Thus, the growth in foreign-currency denominated interbank loans (mostly granted by non-resident credit institutions) continued, their weight in the balance sheet rising by 0.6 percentage points, as compared with a rise of 1.8 percentage points in 1997. At the same time, the financing obtained on the domestic market, from the Banco de España and other credit institutions was practically unchanged as a per-

TABLE IV.4

Turnover on money and financial markets

EUR millions

	1995	1996	1997	1998
Interbank deposit market	**2,277,264**	**2,777,335**	**2,920,397**	**3,020,575**
Government debt book-entry market (a) (b)	**6,108,092**	**8,439,412**	**11,684,348**	**14,034,492**
Spot	1,151,070	1,608,200	2,110,190	2,311,156
Repos	4,922,620	6,800,843	9,544,535	11,700,053
Forward	34,402	30,369	29,624	23,283
AIAF fixed-income market (a)	**15,662**	**14,929**	**21,174**	**43,117**
Commercial paper	5,103	3,474	4,447	7,933
Ordinary and securitisation bonds, long-term bonds and mortgage-backed notes	8,877	8,823	10,950	28,758
Matador bonds	1,683	2,632	5,776	6,425
Fixed-income stock market (a)	**31,824**	**78,071**	**54,217**	**53,141**
Government debt	21,264	53,226	21,889	601
Territorial government debt	6,870	21,047	30,045	51,789
Other	3,690	3,798	2,284	751
Equities stock market	**48,303**	**77,140**	**163,265**	**261,278**
SIB	46,428	75,932	160,939	257,846
Ring trading	1,875	1,208	2,326	3,432
MEFF derivatives market (c)	**1,353,045**	**2,284,027**	**3,283,376**	**2,661,316**
Fixed income	1,288,570	2,194,385	3,012,657	2,111,987
Short-term	*413,190*	*904,866*	*1,631,754*	*1,125,443*
Medium and long-term	*875,380*	*1,289,520*	*1,380,903*	*986,543*
Equities (d)	64,475	89,642	270,719	549,329

Source: Banco de España.

(a) Nominal volumes.
(b) Only includes transactions with government securities.
(c) Volumes are expressed in monetary units and have been obtained by multiplying the number of contracts traded by their size.
(d) Does not include contracts involving on individual securities.

centage of average total assets, in contrast to 1997, when it fell by 1.6 percentage points.

One aspect which distinguishes the financing of the deposit money institutions in the last two years is the change in the structure of funds raised from clients. While to 1997, the weight in average total assets of repos with the resident private sector increased considerably, in 1998 there was a moderation in their rate of growth, which stood at 4.1 % on average during the year. This development is closely related to the decline in money market funds (FIAMMs) – discussed below – as well as to the low volume of government securities held by deposit money institutions that are available to be assigned under repos. Private sector funds in the form of deposits showed signs, by contrast, of a notable recovery, increasing by almost 7 % on average during the year, well above the 2.7 % rate of the previous year. This acceleration, which was nonetheless clearly insufficient to cover the growth in lending, stemmed primarily from the behaviour of the banks, since savings bank deposits grew by only 5.4 %. Foreign branches played an important role in this process, since they raised more than 40 % of the increase in the bank deposits of the resident private sector. A significant part of these funds seems to come from Spanish insurance companies and non-financial firms. As in previous years, the various types of deposits behaved differently: while current and savings accounts grew strongly, time deposits, denominated in pesetas and in foreign currencies, hardly changed.

As regards the institutions' *pricing policy,* a basic determinant of the profit and loss account, the interest rates set by the banks continued to decline during 1998, in line with the reductions on money markets and public-debt rates. Nonetheless, the reductions in the synthetic lending and borrowing rates were more moderate than in 1997. Unlike in that year, both rates fell by a similar amount in 1998, so that the spread between the synthetic lending and borrowing rates tended to stabilise (see

BOX IV.3

The growth of securitisation in 1998

Asset securitisation involves the conversion of assets on a specific entity's balance sheet into securities that may be transferred, assigned or sold. This process, which has attained a high level of expansion on the main financial markets, has developed belatedly and fairly slowly in Spain. The year 1998 might, however, mark a turning point in this respect. This box summarises the main reasons potentially behind this change, indicating and putting into perspective the recent growth of this market.

In 1998 Royal Decree 926/1998, of May 14th, was approved. This legislation included two new aspects which, at least potentially, could significantly boost this market. First, the range of assets qualifying for securitisation was considerably broadened. Second, the foundations were laid to improve the solvency of securitisation funds; along with securitisation bonds, loans from credit institutions and institutional investors (which are subsidiary to the former) were allowed to be included in the liabilities of these funds.

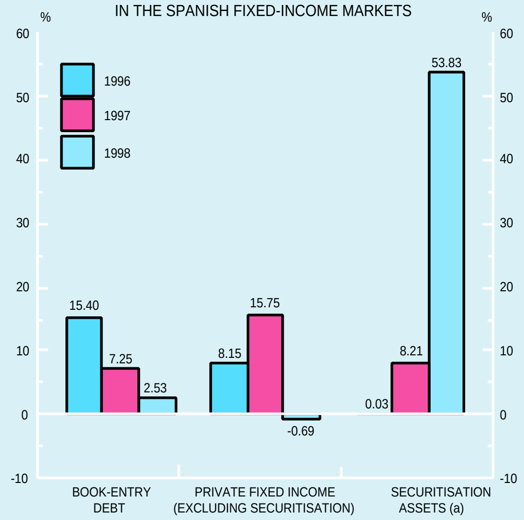
Furthermore, these legal changes came about in a context in which a series of factors were shaping a framework conducive to the growth of this market in Spain. Thus, on the demand side, the growing "institutionalisation" of savings was considerably fuelling the demand for marketable securities in Spain while, at the same time, the application of the Stability and Growth Pact was laying the bases so that the relative weight of public debt on Spanish financial markets might be progressively reduced. Likewise, the growing stability of the Spanish economy and the subsequent reduction in the nominal return on lower-risk assets was beginning to encourage a switch towards higher-risk investment strategies. Although all these factors point to greater demand for private fixed-income securities, in general, securitisation bonds could benefit particularly in view of the scant issues traditionally made by Spanish small and medium-sized non-financial firms.

On the supply side, the main attraction of securitisation for financial firms (which are the driving force behind the process) lies in the opportunities provided to them to add flexibility to the structure of their balance sheet. This greater flexibility is particularly attractive in a setting of heightened competition such as that perceptible in the euro area. Also, asset securitisation enables them to increase their holdings of eligible assets as collateral for monetary policy loans.

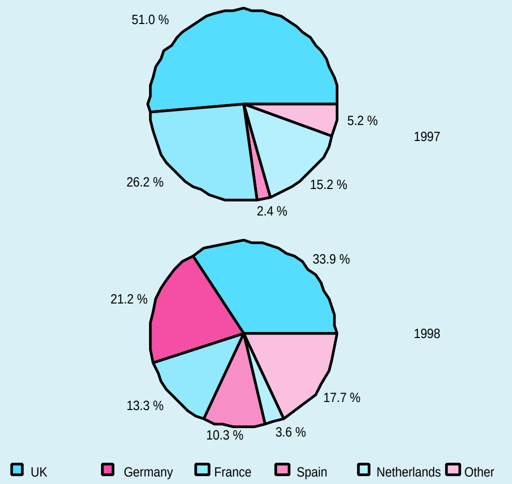
In sum, the expansion of the Spanish market for securitised assets began to become discernible in mid-1998. The initial data available on its growth in 1998 and in the first quarter of the current year confirm this trend. At end-1998, the total outstanding balance amounted to EUR 13.4 billion, 12.8 billion of which related to the securitisation of assets from financial intermediaries. These figures signify a growth rate of 45% on the previous year. The contrast with prior-year growth is even more marked for the assets from financial intermediaries (54 % growth in 1998) and, hereunder, for securitisation bonds, the outstanding balance of which has increased by 3.5 times. The forecasts for the first quarter of 1999 show higher growth still.

In order to put this strong growth into perspective, the adjoining chart respectively offers comparisons with the growth of the other domestic fixed-income markets and with the growth of securitisation in European countries. As the top half of the chart shows, the growth of securitisation assets in 1998 was greater not only than the growth of other private fixed-income assets but also than that of securities traded on the market for book-entry debt. The chart also shows the first signs of the loss of relative weight of the market for book-entry debt, and the scant growth of private fixed income other than that arising from securitisation. The lower half of the chart shows that new issues on the Spanish market in 1998 accounted for somewhat more than 10 % of the total issues on European markets (which amounted to almost $ 47 billion), compared with a share of only 2.4 % the previous year.

ANNUAL GROWTH RATE OF OUTSTANDING BALANCES
IN THE SPANISH FIXED-INCOME MARKETS



BREAKDOWN OF EUROPEAN
SECURITISATION ASSET ISSUES



Sources: Moody's and Banco de España.
(a) Excluding securities corresponding to the nuclear moratorium.

In short, 1998 appears to mark a turning point in the hitherto slow development of securitisation in Spain. Given the scant issuance tradition of Spanish firms, the growth of this market is particularly significant set against the current foreseeable growth in the demand for private fixed-income securities, although the distance separating it from the main Spanish financial markets remains great. Thus, the end-1998 outstanding balance is still far off the EUR 46 billion relating to the rest of the private fixed-income market (matador bonds included), and much more so from the almost 238 billion for book-entry debt or the over 286 billion corresponding to market capitalisation.

Securitisation assets in Spain. Outstanding balances

EUR millions

Year	Mortgage-backed notes (1)	Securitisation bonds (a) (2)	Total fin. inst. (3)=(1)+(2)	Nuclear moratorium (4)	Total (3)+(4)
1995	6,495	1,203	7,698	0	7,698
1996	6,704	996	7,700	1,208	8,908
1997	6,910	1,422	8,332	926	9,258
1998	7,783	5,035	12,818	595	13,413
1999H1 (p)	7,777	7,140	14,917	505	15,422

Source: Banco de España.
(a) Includes short-term assets.

Chart IV.8), after several years in which it had been gradually narrowing.

Analysis of the *profit and loss account* in 1998 shows a moderation in the rate of decline of net interest income in relation to total assets, although interest expenses continued to fall less than interest income. Nonetheless, significant differences were observed between banks and savings banks, with the deterioration in net interest income being much greater in the case of the latter.

The fall in total net interest income was almost completely passed through to gross income, since the favourable performance of commissions was offset by the decline in profits on financial operations. The commissions which grew most continued to be those obtained from the marketing of non-banking products, such as mutual funds, pension funds and insurance.

In 1998, the total combined net income of banks and savings banks declined further in relation to average total assets. However, in the case of banks it held steady, while in that of savings banks it declined notably. Overall, the reduction in the net income of deposit money institutions in relation to total assets was somewhat more moderate than in the previous year. One factor which provides a partial explanation is the slower growth of operating expenses in 1998 (4.4 %, against 5.2 % in 1997), although the rate is still higher than in previous years. In recent years, the increase in operating expenses has been governed by the behaviour of staff costs. In 1998, however, staff costs slowed by more than operating expenses as a whole, with overheads accelerating in relation to recent years. Investment carried out to ensure that computer systems can deal with the introduction of the euro and are year 2000 compliant – apparent in the strong growth in the “computing” and “communications” items in 1998 – almost completely explains this acceleration. The result of these developments has been a slight decline in operating expenses in relation to gross income, a return to the pattern of recent years which had been departed from in 1997.

The magnitude of provisions for write-downs and special funds per unit of assets in 1998 entailed a reduction in the rate of decline that had prevailed over the previous five years. This was a result both of the increase in provisions to securities fluctuation funds and the lower rate of decline of provisions for bad and doubtful debts. However, despite the increase in write-offs and provisions, their weight in the balance sheet fell again last year. This, together with the growth of other income, basically due to sales of securities held as investments, enabled pre-tax profits to rise by more than average total assets.

Analysis of the profit and loss account of the deposit-money institutions in 1998 confirms, once again, a phenomenon that has prevailed for several years. Despite the reduction in margins in relation to the size of the balance sheet, pre-tax profits per unit of assets continue to increase; while in 1994 they represented 0.75 %, in 1998 they were equivalent to 0.93 %. A decisive factor in explaining this behaviour is the decline in provisions for write-downs in relation to average total assets, stemming from the significant reduction in default indices (see Chart IV.9). It seems unlikely that this trend can be sustained for much longer, however, given the very low levels these indices have reached. Nonetheless, there are other factors making for moderately optimistic expectations of future profitability. First, the gross return on capital sustained, in 1998, the upward path of recent years, to stand at 16.23 %. Second, the improvement in the profitability ratios of the consolidated statements reflects the significant contribution to the profits of banking groups from their subsidiaries, among which mutual fund management companies and the financial institutions acquired in Latin America are notable. Box IV.4 provides specific information on the process of internationalisation of the activity of Spanish credit institutions and on the way in which they are addressing the risks arising from such activity.

IV.4.2. Other financial intermediaries

In recent years non-bank financial intermediaries have developed significantly. These include: portfolio investments institutions, which manage professionally the portfolios of a large number of investors (e.g. securities funds); capitalisation and savings institutions, whose returns are used to cover retirement (pension funds); and institutions which offer products to cover certain contingencies or risks. This set of institutions constitutes an important alternative for the investment of the savings of economic agents and their decisions are influential in the financial markets, given the volume of funds they manage. For these reasons, this section analyses the recent trends in the net asset value and investments of this set of intermediaries, also known as *institutional investors.*

The net asset value of *mutual funds* grew strongly in 1998, increasing by EUR 41.3 billion (ESP 6,876 billion), to reach EUR 203.8 billion (ESP 33,905 billion) at the end of the year. This increase was less than in 1997, although similar to that which took place in 1996. The divergent

TABLE IV.5

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

% of average total assets

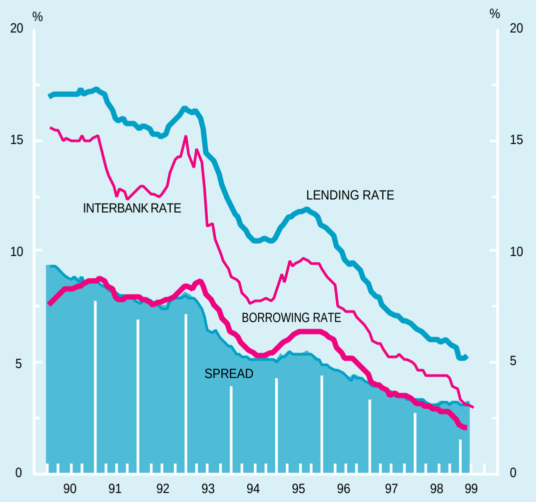
	Total (a)		Banks		Savings banks	
	1997	1998	1997	1998	1997	1998
ASSETS:						
Cash and banks (b)	2.2	2.2	1.7	1.8	2.3	2.2
Interbank market assets (c)	26.5	25.2	32.0	31.0	16.7	15.2
Lending	44.8	47.2	41.2	42.9	51.1	54.2
General government	*4.3*	*3.4*	*3.9*	*3.2*	*5.3*	*3.9*
Other resident sectors	*36.1*	*39.3*	*31.6*	*33.7*	*43.6*	*48.3*
Non-residents	*3.1*	*3.6*	*4.6*	*5.3*	*0.5*	*0.8*
Doubtful assets	*1.3*	*0.9*	*1.1*	*0.7*	*1.7*	*1.2*
Securities portfolio	20.6	19.6	19.3	18.5	23.8	22.3
Of which:						
Government debt	*12.9*	*11.7*	*11.5*	*10.6*	*16.0*	*14.1*
Equities	*3.8*	*4.1*	*3.9*	*4.1*	*3.7*	*4.3*
Other assets (d)	5.9	5.8	5.8	5.8	6.1	6.0
LIABILITIES:						
Credit and savings institutions and Banco de España (e)	30.4	31.0	41.7	41.7	10.7	12.8
Peseta borrowing	*19.1*	*9.0*	*25.3*	*25.0*	*8.2*	*8.8*
Foreign-currency borrowing	*11.3*	*11.9*	*16.4*	*16.7*	*2.5*	*4.0*
Asset repo sales to other resident sectors	11.2	10.8	9.5	9.1	15.2	14.6
Other customer funds	45.5	45.3	35.9	36.0	61.7	60.1
Accounts payable: general government	*2.3*	*2.3*	*2.3*	*2.2*	*2.4*	*2.4*
Accounts payable: other resident sectors	*36.7*	*36.3*	*25.5*	*25.7*	*55.3*	*53.3*
Accounts payable: non-residents	*4.8*	*4.9*	*6.5*	*6.7*	*1.9*	*1.9*
Borrowing	*1.7*	*1.7*	*1.6*	*1.4*	*2.1*	*2.5*
Own funds, special reserves and other accounts	12.8	12.9	13.0	13.2	12.4	12.5
Of which:						
Subordinated financing	*1.5*	*1.6*	*2.0*	*2.1*	*0.6*	*0.8*
(+) Interest income	6.67	5.70	6.50	5.62	6.94	5.82
(–) Interest expenses	4.25	3.39	4.56	3.70	3.74	2.88
Net interest income	**2.42**	**2.31**	**1.94**	**1.91**	**3.20**	**2.94**
(+) Commissions	0.60	0.67	0.62	0.68	0.58	0.64
(+) Profits on financial operations	0.20	0.14	0.24	0.13	0.13	0.15
Gross income	**3.22**	**3.12**	**2.80**	**2.73**	**3.91**	**3.73**
(–) Operating expenses	2.08	2.01	1.85	1.78	2.45	2.38
Net income	**1.14**	**1.11**	**0.94**	**0.95**	**1.46**	**1.35**
(–) Write-downs and provisions	0.42	0.40	0.34	0.38	0.55	0.46
(+) Other income	0.17	0.22	0.14	0.19	0.25	0.30
Pre-tax profit	**0.90**	**0.93**	**0.74**	**0.76**	**1.16**	**1.19**
MEMORANDUM ITEM:						
Pre-tax profit (as a % of own funds)	15.58	16.23	13.74	14.75	18.45	18.52
Average total assets (EUR millions)	831,897	898,838	533,771	572,224	271,507	297,243

Source: Banco de España.

(a) Banks, savings banks, and credit co-operatives. Total turnover figures, including foreign branches of banks.
(b) Includes cash and central banks (except repos) and credit and savings institutions (except forward accounts, repos and securities lending).
(c) Includes credit and savings institutions (except forward accounts, repos and securities lending).
(d) Includes premises and equipment, and other asset accounts.
(e) Includes all financing from credit and savings institutions and Banco de España.

CHART IV.8

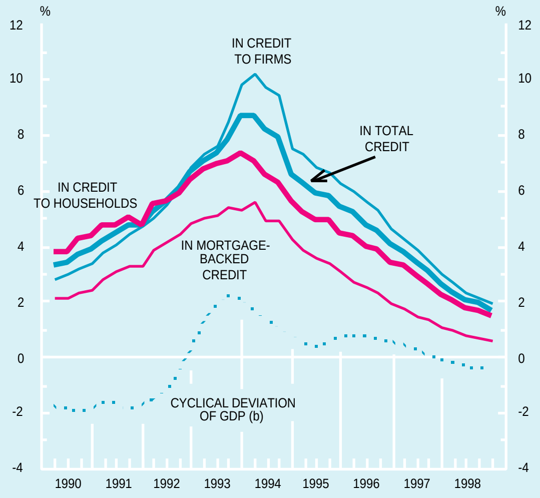
Interest rates: banks and savings banks



Source: Banco de España.

CHART IV.9

Non-performing assets and the economic cycle (a)
Banks and savings banks



Source: Banco de España.

(a) Ratio of non-performing assets to credit in pesetas.
(b) Sign reversed.

behaviour in 1998 of the net asset value of money market funds (FIAMMs) and other securities funds (FIMs) (see Chart IV.10) was notable. The net asset value of the former fell by EUR 10,5 billion, while that of the latter increased by EUR 51.8 billion. Two very different factors underlie this result: the revaluation of FIMs as a result of the decline in interest rates; and, above all, very different volumes of net investment (negative in the case of FIAMMs and positive in that of FIMs (see Table IV.6)). The declining returns offered by FIAMMs in recent years (see Chart IV.10) and the expectations that FIMs will continue to provide higher returns in future were, probably, the main reasons explaining the difference in the funds invested in these two types of mutual funds.

A second aspect characterising the behaviour of FIMs in 1998 was the expansion of equity funds and international funds. At the end of 1998, they represented 12 % and 10 %, respectively, of the total net asset value managed by mutual funds, having represented only 9 % and 3 % at end-1997. The weight of guaranteed funds also increased during the year.

In 1998, there were also important changes in the composition of the portfolios of mutual funds. Both FIMs and FIAMMs reduced the share of repos in their portfolios (see Chart IV.10) and increased the weight of investments in foreign-issued assets. This adjustment in the investments of the funds was due, among other factors, to the shortage of public-debt securities held by deposit-money institutions available to be assigned, and the general insufficiency of a wide range of domestic marketable securities with which to meet the growing demand for this type of asset from Spanish institutional investors. Moreover, the international financial crisis led fund managers to moderate the growth of the equity portfolio and, given the above-mentioned shortage of securities in the domestic market, there was a strong increase in holdings of foreign fixed-income securities.

As for *pension funds,* their net asset value continued to grow at high rates in 1998. On information provided by the Directorate General for Insurance and INVERCO, the net asset value of pension funds rose by almost 25 % last year, an increase of about EUR 5.3 billion (ESP 900 billion) (see Table IV.6). Although this figure represents a relatively small volume of funds, in comparison with the amount raised by other financial intermediaries such as mutual funds, it is nonetheless a significant amount in absolute terms and comparable in magnitude to the changes in the mathematical reserves of insurance companies in previous years (see Table IV.6).

According to the latest data on the balance sheet of the *insurance companies,* corresponding to 1997, the mathematical reserves of the sector sustained steady growth of close to 22 % in the last three years for which information is available. The estimates available for 1998 indicate a rather more moderate increase. This may be explained by certain investors waiting to take out single premium insurance in order to take advantage of the more favourable tax treatment which the latest reform of personal income tax grants to this type of transaction.

According to the *Annual financial accounts,* the structure of the financial assets of pension funds and insurance companies is characterised by the large weight of fixed-income investments. However, their importance has been declining in the last three years for which full information is available (see Chart IV.10). By contrast, the importance of bank deposits and equities has been growing. Likewise, the information available for 1998 on the investments of pension funds suggests that there has been a certain shift towards external assets in the fixed-income and equity portfolio of the sector as a whole, with the external portfolio of pension funds reaching 18 % in 1998. At the same time, the share of equities in the total investments of these intermediaries rose from 8.6 % in 1996 to 23 % in 1998.

The information available for 1998 shows a significant shift towards external assets and equities in the investments of this set of financial intermediaries. This indicates the commencement of a process of greater international diversification of their portfolios and a search for higher returns than those offered by the markets for fixed-income securities, traditionally the mainstay of their investments. When explaining this change in the investment policy of insurance companies and pension funds, the slowdown in the supply of domestic fixed-income securities referred to above needs to be taken into account. In this respect, general government has been significantly moderating the rate of net issuance of public debt, and placements of private fixed-income securities by national issuers are still at very modest levels.

IV.5. SAVING AND ECONOMIC AND FINANCIAL FLOWS

In 1998, the financing capacity of the Spanish economy vis-à-vis the rest of the world was positive for the fourth consecutive year, although at 0.9 % of GDP it was less than in previous years. In terms of financial saving by sector, this outcome was the result of a decline in the saving of households and firms, owing to the buoyancy of consumption and investment, which was only partially offset by the greater saving of general government (see Chart IV.11), stemming from the drive to contain the fiscal deficit. A detailed analysis is set out below of the contribution of each sector, as well as of the economic and financial flows with the rest of the world through the balance of payments.

IV.5.1 Households and firms

In 1998, the financing capacity of the non-financial private sector fell to 2 % of GDP, from 3.3 % in 1997. It thus continued along the downward path that commenced in 1995, when this variable stood at 7 % of GDP. In the case of *firms,* their financing capacity fell from 0.3 % in 1997 to –0.7 % in 1998, the first time since 1992 that it had been negative. This reduction in financing capacity was due both to a reduction in firms' gross saving and to an increase in gross capital formation. If the flows of firms' financial assets and liabilities are analysed together with these variables, it can be seen that in recent years there has been an increase in the liabilities contracted by firms, which, along with gross saving, have financed not only gross fixed capital formation, but also growing acquisition of financial assets. As analysed in more detail below, a significant part of these assets represents foreign direct investment by firms, so that their investment activity, taking into account this external dimension, would be more dynamic in recent years than the figures for gross fixed capital formation suggest (see Chart IV.12).

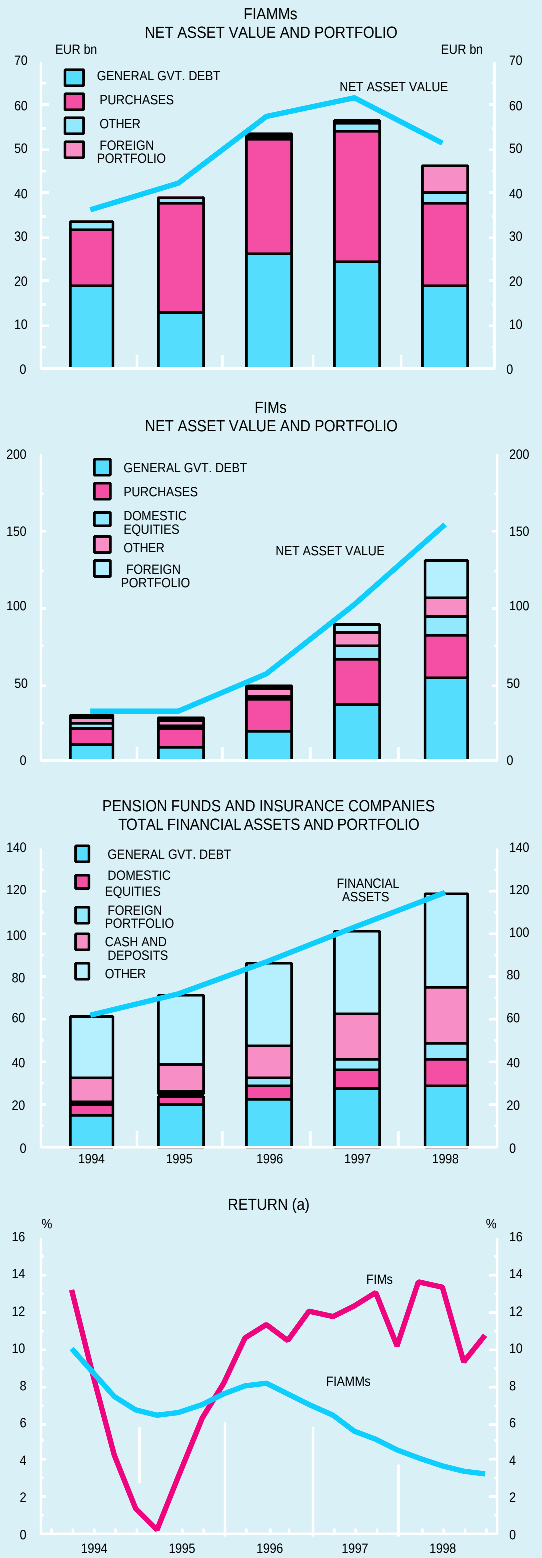
In terms of net financial saving (which is obtained from the financial assets and liabilities of the sectors and which, therefore, may not exactly coincide with the figures for financing capacity, which come from the use of income and capital accounts), that of non-financial firms fell slightly, in comparison with previous years, to –1 % of GDP (1).

Although firms' net financial saving was negative, the increase in the value of their equity

(1) In theory, the balance of the financial transactions account, i.e. the net financial saving of any sector, should match the balance of the capital account, i.e. the financing capacity or requirements of the sector in question. In practice discrepancies arise between these two measurements, basically with respect to the balances of "Non-financial firms" and "Households". The reasons for the discrepancy between the balances of the non-financial and financial accounts are of a statistical nature: different preparation timetables, different sources for the base statistics, different compilers and, even, different institutional definitions of the two sectors between one approximation and the other (See Scheme 1 of the Methodological notes at the beginning of the *Financial Accounts of the Spanish Economy 1989-1998).* The size of these discrepancies is expected to be reduced with the forthcoming introduction of ESA 95. In any case, it should be taken into account that the profiles of the historic series of both balances in the two sectors mentioned are similar.

CHART IV.10

Institutional inverstors



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

holdings has led to a continuous increase in their *net financial wealth,* defined as the difference between the balances of financial assets and liabilities (see Chart IV.13). The increase has been very significant in recent years, particularly in 1998, and stems from the rise in the prices of equities, which represent about 28 % of all the financial assets of the sector. In addition to the increase in the financial wealth of the sector, interest payments as a percentage of gross operating profit, which may give an indication of the risks associated with the level of indebtedness, fell from 42 % in 1992 to 22 % in 1998.

By instrument, it is seen that a portion of the new financial *assets* of firms does indeed correspond to equities (see Table IV.7). It is also established that the acquisition of equities issued by foreign firms exceeds the total acquisition of this type of instrument, which suggests that Spanish firms have reduced their holdings in domestic firms. Part of the explanation for this may lie in the privatisations carried out in 1998, which have entailed a fall in the balance of the equities held by certain companies (such as the State Industrial Holdings Company (SEPI)), in whose accounts the shares of the privatised public-sector companies were recorded. In turn, the boom in direct investment since 1997, concentrated on Latin America, may be interpreted as a response by non-financial firms to the new environment of macroeconomic stability, to the completion of the single European market, to growing international economic integration and to the possibilities of obtaining higher returns in less mature markets than the Spanish one. This behaviour has also been stimulated by the favourable credit conditions prevailing in Spain, with historically low and foreseeably stable interest rates. At the same time, the favourable treasury position of firms has been reflected in the growth of their deposits, which rose by 4.4 percentage points of GDP, as against increases of around 2.5 percentage points of GDP in the previous two years.

On the *liabilities* side, bank lending by domestic credit institutions to firms was around 40 % of GDP, slightly below the level prevailing a decade ago (46 % in 1989). In any event, it should be noted that lending from the rest of the world expanded strongly in 1998, increasing by 1.7 % relative to GDP. This suggests that Spanish firms' strategy of direct investment abroad may partly have been financed by foreign borrowing.

It should also be noted that the gross issuance of securities, which represented 0.5 % of GDP in 1996 and 1997, rose to 2.5 % of GDP in 1998. Admittedly, this is still a moderate

BOX IV.4

The internationalisation of Spanish banks

In recent years, the progressive liberalisation of capital movements, the growing globalisation of economic and financial activity and the ongoing consolidation of the single market for financial services in Europe have prompted a general tendency towards a greater degree of internationalisation of banking activity. This has been reflected in an increase in the relative weight of activity with non-residents and/or in foreign currency on bank balance sheets.

The Spanish banking system has also been party to this tendency. As the adjoining table shows, the relative weight of Spanish banks' activity with non-residents and/or in foreign currency under the most significant captions of their balance sheets has increased. Nonetheless, if activity through subsidiaries is not considered, the increase in international activity has been limited and has focused particularly on two areas: interbank financing and, to a lesser extent, lending and deposit activity. Moreover, the growth of both has been more influenced by factors specific to the Spanish banking system than by the factors that have driven the internationalisation process.

However, if activity through the foreign subsidiaries of Spanish banking groups is taken into consideration, the degree of internationalisation rises significantly, with increases of almost six percentage points in assets and almost nine points in resources obtained between 1995 and 1998. The increase in international activity has been much sharper in the case of banks and, hereunder, it has been the biggest institutions behind most of the increase, concentrating almost 70 % of the Spanish banking system's international activity.

These figures highlight the fact that the internationalisation of the Spanish banking system has come about mainly through the acquisition of subsidiaries abroad, and not through direct action by Spanish banking institutions. Indeed, the principal factor behind the increase in the international activity of the main Spanish banking groups has been the process of expansion in Latin-American financial markets via the acquisition of majority stakes in the financial institutions established in these countries. The heightened presence of Spanish banks in the area responds to a strategy geared to consolidating long-term investments in (mainly) majority holdings enabling them to control the management of the investee entities. Moreover, the goodwill arising on these purchases is subject to accelerated amortisation and the exchange rate risk and country risk associated with these investments is being covered. Lastly, the financial position of the investee entities is generally sound, since investments have mainly targeted the entities best positioned in their respective sectors. As a result of the foregoing, the risks associated with these investments have been limited.

In the future, the Spanish banking system's degree of internationalisation is expected to continue increasing, since it is still at low levels compared with other European countries (approximately half that of France or Germany). The main reason for these differences lies in the scant significance of the smallest banking institutions' activity abroad. Along with investment in emerging countries, it is also highly likely that, as the degree of integration of European financial markets progressively increases, Spanish banking institutions will increase their business with institutions and customers established in other euro-area countries.

Admittedly, the increase in international activity makes the control of risks associated with banking business more difficult as it spreads to countries and markets with widely differing regulations and practices. Moreover, the knowledge of such new markets is comparatively less, foreign exchange risks increase in the case of markets outside the euro area and, in many cases, operations are undertaken in economies with higher country-risk levels. Accordingly, this process requires that both banks and the supervisory authorities should reinforce risk control mechanisms. However, the process will also enable banks to diversify their sources of finance and their investment to a greater extent.

Internationalisation of the Spanish banking system (a)

	1995	1996	1997	1998
EXCLUDING SUBSIDIARIES. AS A PERCENTAGE OF TOTAL ACTIVITY:				
Activity with non-residents				
Lending(b)	7.27	7.75	9.20	9.88
Deposits(b)	8.41	8.68	8.80	9.58
Credit institutions: asset-side accounts	46.24	44.84	40.42	39.06
Credit institutions: liabilities-side accounts	28.39	35.23	40.45	41.94
Total activity with non-residents (c)	19.34	19.23	19.78	19.94
Activity in foreign currency				
Lending(b)	7.65	8.43	9.88	10.52
Deposits(b)	5.47	5.41	6.12	7.66
Activity with credit institutions (d)	31.24	32.37	35.74	34.17
Total assets	15.31	15.52	16.62	16.09
INCLUDING SUBSIDIARIES. AS A PERCENTAGE OF TOTAL ASSETS:				
Activity with non-residents				
Total assets(e)	21.58	22.36	26.78	27.22
Subsidiaries	*3.35*	*4.72*	*9.97*	*10.63*
Direct	*18.91*	*18.45*	*17.80*	*17.44*
Total funds(e)	16.24	19.46	24.09	25.14
Subsidiaries	*2.57*	*3.03*	*5.62*	*5.65*
Direct	*13.66*	*16.43*	*18.47*	*19.49*
MEMORANDUM ITEM. AS A PERCENTAGE OF TOTAL ASSETS:				
Banks				
Total assets(e)	27.59	29.62	36.66	37.52
Total funds(e)	21.99	27.29	33.88	35.57
Savings banks				
Total assets(e)	9.33	8.21	7.45	8.67
Total funds(e)	4.53	4.21	4.91	6.36

(a) Banks and savings banks.
(b) Operations with credit institutions are excluded.
(c) The total is calculated for all those captions in which there is breakdown of activity with non-residents.
(d) Sum of asset- and liabilities-side accounts with credit institutions.
(e) Also includes activity with credit institutions.

TABLE IV.6

Funds raised by other financial intermediaries

EUR millions

	1995	1996	1997	1998	1998 Balances
Total	**8,003**	**41,390**	**52,692**	**—**	**—**
Pension funds (change in net asset value)	2,682	4,270	4,500	5,253	27,147
Insurance companies (change in mathematical provisions)	5,351	6,343	7,905	—	—
Securities funds (net subscriptions) (a)	–30	30,777	40,287	28,166	203,774
FIAMMs	*3,237*	*11,668*	*1,532*	*–12,267*	*50,643*
FIMs	*–3,267*	*19,109*	*38,755*	*40,433*	*153,131*
MEMORANDUM ITEM:					
Deposit money institutions (change in customer funds) (b)	45,286	24,491	32,160	24,858	519,250
Deposit money institutions (change in other resident sectors' funds) (c)	43,399	21,084	25,339	15,795	434,922

Sources: Banco de España *(Cuentas financieras anuales),* Dirección General de Seguros, INVERCO and CNMV.

(a) In the "Balances" column is the net asset value.
(b) Includes the total of the items accounts payable and borrowings.
(c) Includes accounts payable of other resident sectors.

level, but it does involve an increased presence on the part of Spanish firms on the securities markets and it is consistent with the process of disintermediation taking place in Spain. In this respect, the positive net issuance of fixed-income securities – short-term securities and bonds – is especially significant, as already explained in this chapter, given that the outstanding stock of such securities has been falling continuously since 1990. As regards equities, as seen in Section IV.3, the favourable stock market situation in the first half of 1998 and the positive economic outlook significantly boosted issuance and increases in capital.

As in the case of firms, the decline in the financing capacity of *households* (from 3 % in 1997 to 2.7 % in 1998) stemmed from both a reduction in their gross saving and a slight increase in investment. Joint consideration of financial flows, gross saving and residential investment shows that, in recent years, the increasing incurrence of financial liabilities by households has been reflected in greater accumulation of assets, as seen in Chart IV.12. As in the case of non-financial firms, the *net financial wealth* of households has risen continuously since 1992, to reach a current level of 91 % of GDP (see Chart IV.14). The revaluation of equities (shares and mutual funds) has played a prominent role in this increase during the last two years. The revaluation effect also appears to have been progressively stronger, since households have been channelling their investments towards equities, long-term fixed-income securities and foreign securities, all of which are assets whose prices are most sensitive to changes in interest rates and exchange rates.

As regards the breakdown of households' financial assets by instrument, there has been a certain polarisation of demand (see Table IV.7). On one hand, the reduction in the inflation rate and interest rates to very low levels and confidence in the stability of these trends have led to a reduction in the opportunity cost of holding very liquid assets, such as cash and sight deposits. At the same time, the decline in the interest rates paid on bank deposits and fixed-income securities (particularly public debt), which have traditionally represented the bulk of the sector's investments, has prompted households to seek alternative investments, offering higher expected returns, but possibly with greater risk. Accordingly, there has been a very notable increase in the acquisition of shares, both directly and through mutual funds. As a result, households' holdings of shares now represent 29 % of GDP and 18 % of their total financial assets. Adding households' indirect holdings through mutual funds gives a total figure for shares held by households of 32 % of GDP, which is equivalent to one fifth of all the financial assets of this sector.

The search for higher returns, together with the greater facilities for and attractions of investing abroad, deriving from the growing financial integration and exchange rate stability within Europe, have also led to a significant expansion in the acquisition of assets issued by non-residents. In 1998 the stock of such assets held by households rose to 13 % of GDP. Most of this foreign investment has been channelled through institutional investors.

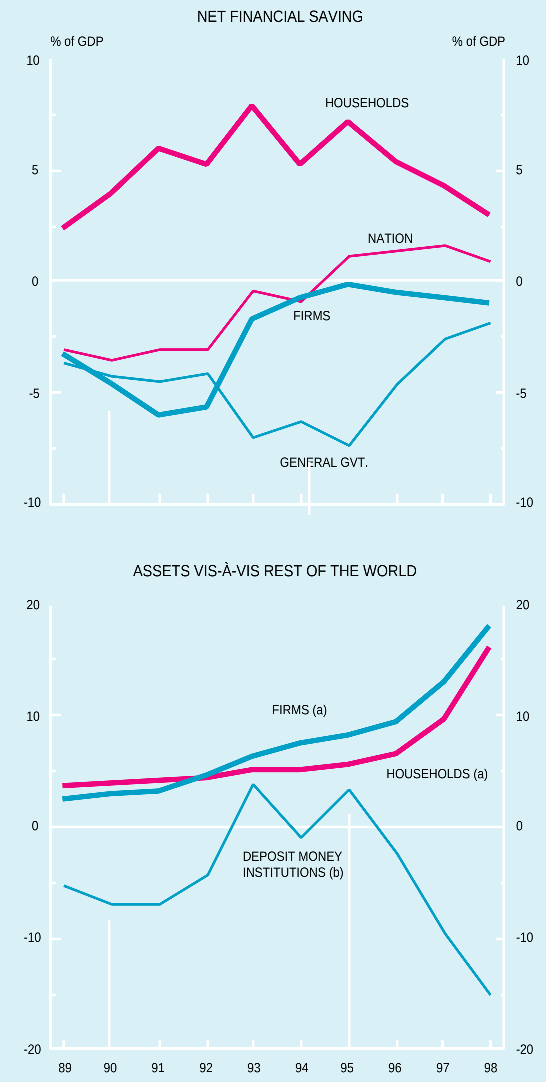
This polarisation of households' demand for financial assets towards, on one hand, very liquid assets and, on the other, shares and foreign securities, may have repercussions on the spending capacity of agents and on the workings of the financial system. As regards the former, the larger holdings of very liquid assets are, by their very nature, capable of financing households' spending decisions with ease. As regards the latter, the increase in the holdings of financial instruments which are very sensitive to changes in interest rates and in economic prospects introduces a novel element into the financial position of households. This may help to strengthen the transmission of monetary policy, but also to increase its sensitivity in periods of uncertainty or in the event of unfavourable developments in the economic or financial environment. Finally, the greater demand for instruments not intermediated by the credit system has led credit institutions to resort to foreign borrowing to cover the gap between their deposits and lending, as mentioned in Section IV.4. In any event, the approximation of the tax treatment of medium and long-term deposits to that of mutual funds may help to halt this trend and stimulate the demand for bank time deposits.

Among the other financial assets of households, their continuous investment in financial insurance products over the past decade is notable. It is true that the aim of these products, which is to cover, through constant saving, the uncertainty of retirement, among other risks, makes it difficult for them to absorb a high percentage of the gross saving of the sector. Yet their very nature generates a flow of constant saving, which in recent years has represented almost 3 % of GDP per annum. Probably, the fact that these assets have not increased more strongly is also due to the financial and tax advantages which mutual funds have enjoyed in recent years, making them the preferred instrument, even over insurance, to cover certain risks. However, at the end of 1998 the financial insurance products of households stood at 20 % of GDP, which is equal to 13 % of the total assets held by households.

As regards households' *liabilities,* the sustained increase in bank credit, which represented at end-1998 45 % of GDP, as against 35 % ten years previously, is notable. In 1998, in addition to the strong growth in recent years of financing for house purchases, there was a strong expansion in credit to finance consumer durables and other purposes, which may be related to pleasure, education or, even, the acquisition of other financial assets. However, if the risk associated with this level of indebtedness is assessed in terms of the capacity of agents to pay the interest accruing, as was done in the

CHART IV.11

Net financial saving and the internationalisation of the economy



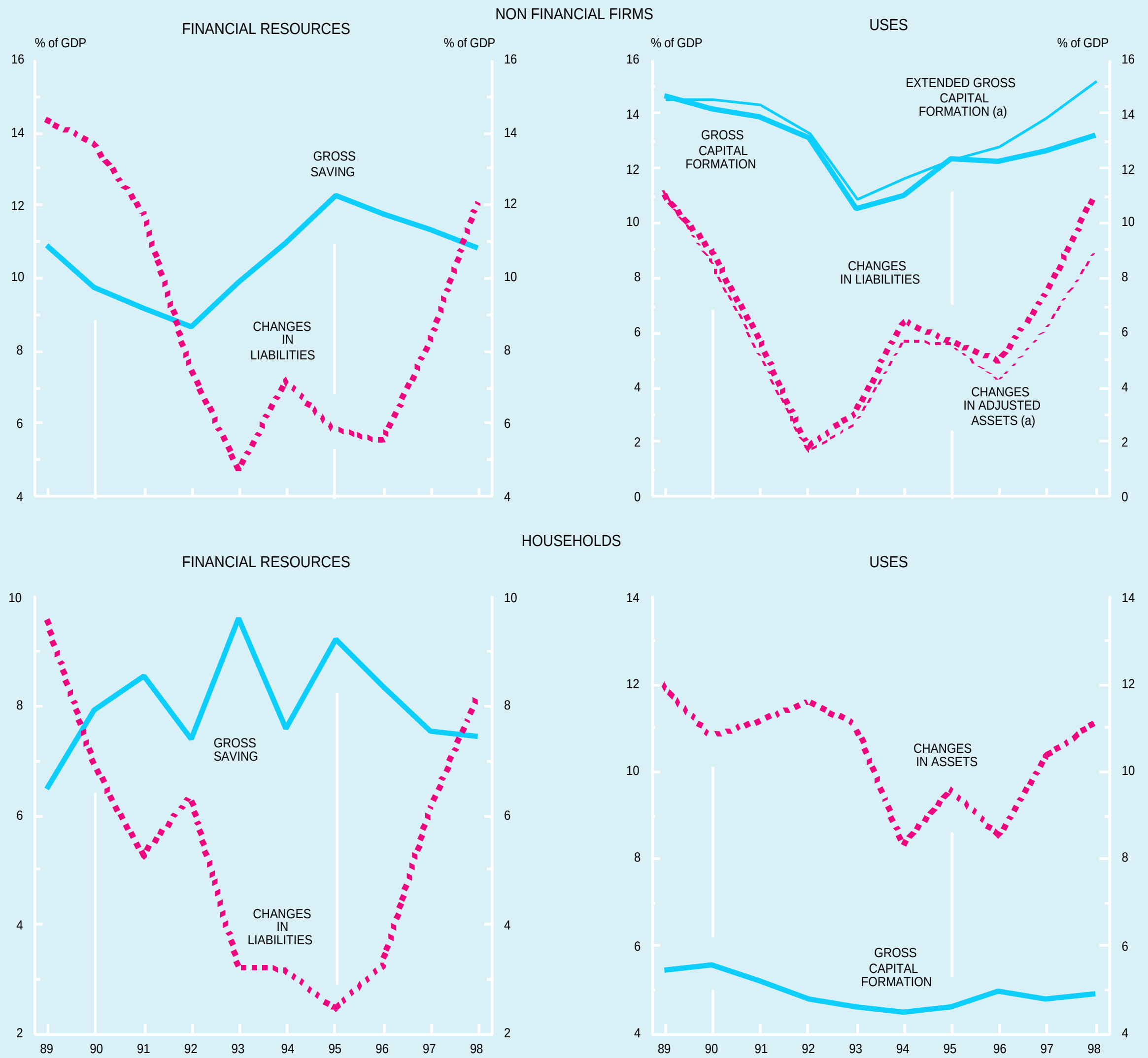
Source: Banco de España.

(a) Including assets vis-à-vis rest of the world indirectly held by households and firms through mutual funds and insurance companies.

(b) Assets less liabilities of deposit money institutions vis-à-vis rest of the world.

CHART IV.12

Use of financial resources by non-financial firms and households



Source: Banco de España.

(a) Extended gross capital formation is calculated as the sum of gross capital formation plus foreign equities. This item is subtracted from assets to give the adjusted assets.

case of firms, the situation of households has improved as a consequence of the increase in disposable income and the reduction in interest rates. Thus, while in 1991 6 % of the disposable income of households had to be allocated to interest payments, that percentage had fallen to 3.5 % in 1998.

As to the composition of the intersectoral flows of households, the reduction in their net financial saving, which fell from 6 % of GDP on average in 1996 and 1997 to 2.9 % in 1998, did not give rise to a reduction in their acquisition of assets. On the contrary, the latter grew at a higher rate than GDP and consequently households had to increase their net liabilities vis-à-vis credit institutions significantly. Compared to the balance maintained on average in recent years they rose by an amount equivalent to 5.5 % of GDP at end-1998. At the same time, households have increased their asset position vis-à-vis institutional investors (mutual funds and insurance companies) by 8.5 % of GDP in 1998. This has supplied funds to such investors to acquire financial instruments issued by non-residents. Finally, households have also directly increased their asset position vis-à-vis the external sector, principally through the delocation of deposits.

IV.5.2. General government

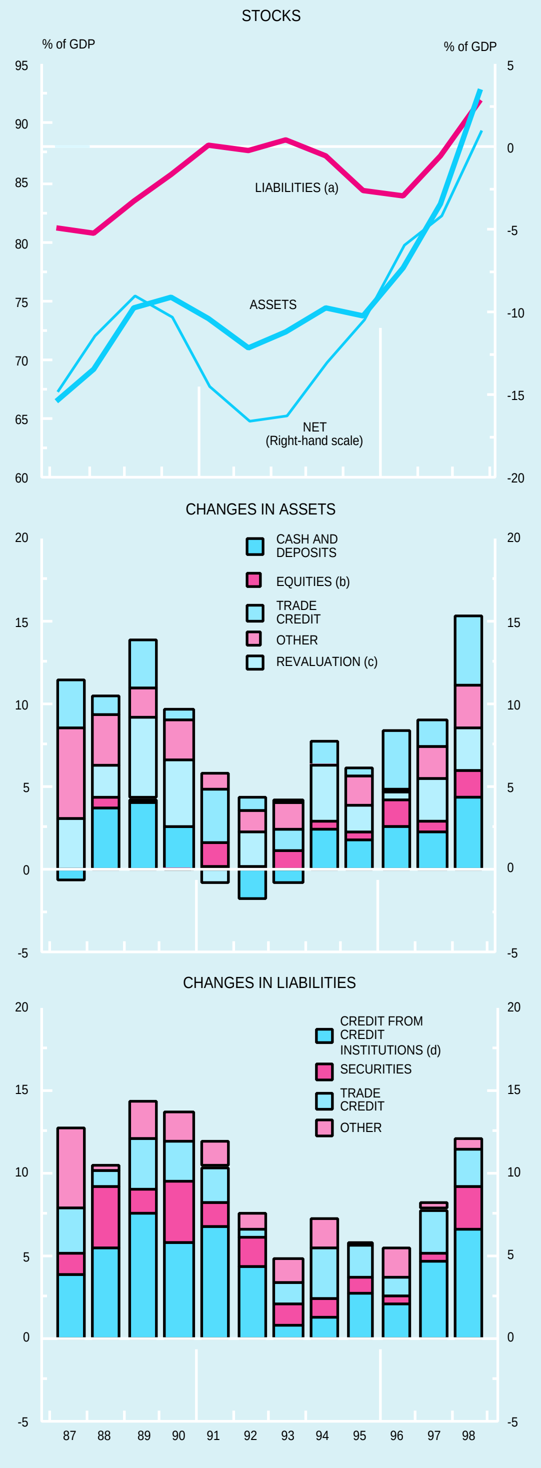
In 1998 there was an increase in the gross saving of general government. The relatively stable public investment ratio enabled this increase to be translated into a reduction in the borrowing requirement of the sector, as already discussed in detail in Section IV.2.1. In terms of balances, in 1998, as in 1997, there was a reduction in the net debtor position of general government. In terms of the Excessive Deficit Protocol, general government debt as a percentage of GDP fell, from the high reached in 1996 (70.4 %), to 69.3 % in 1997 and 67.4 % in 1998.

By instrument, it should be noted that the more stable economic and financial conditions prevailing also had a bearing on the financial behaviour of general government, accentuating the trends of recent years (see Chart IV.15). Specifically, the existence of low medium and long-term interest rates and more liquid and deeper debt markets have been conducive, as mentioned in Section IV.3, to the progressive lengthening of the maturity at issue of public debt since the beginning of the nineties. Moreover, the introduction of strippable debt in July 1997, which abolishes withholdings on coupons for investors who are legal persons, has further boosted the demand for medium and long-term public debt. As a result, short-term securities now only represent 16 % of the liabilities of general government, as against 50 % ten years ago.

With regard to State financing, specific mention should be made of the use by the Treasury of its deposit with the Banco de España as a mechanism to cushion fluctuations in the timing of the State's receipts and expenses. The prohibition, since 1994, on the Banco de España's financing general government has required the Treasury to establish a relatively high balance on its current account with the Banco de España to enable it to cope with possible cash flow shortages, without needing to raise short-term funds on the market. In the last two years, for example, the balance on this current account hardly fell below EUR 6 billion (somewhat less than ESP 1 trillion). Moreover, the Treasury has attempted to stabilise the rate of issuance of securities, especially in the medium and long-term segments, so that the market always has an adequate stock of public securities. As a result, since 1996, the Treasury has set issuance targets for its bond auctions. To the extent that these targets have not been fully

CHART IV.13

Financial wealth of non-financial firms



Source: Banco de España.

(a) Excludes shares.
(b) Includes both resident and non-resident shares, contributions to mutual funds, and other equity.
(c) Calculated as assets revaluation less liabilities revaluation (excluding shares).
(d) Includes resident and non-resident institutions.

TABLE IV.7

Financial transactions

EUR millions and %

	1996	1997	1998
	NON-FINANCIAL FIRMS		
Net financial saving	**–0.6**	**–0.8**	**–1.0**
Net change in financial assets	**4.9**	**7.4**	**11.1**
Net change in financial liabilities	**5.5**	**8.3**	**12.1**
Net financial saving	**–2,497**	**–3,952**	**–5,137**
As a % of GDP	–0.6	–0.8	–1.0
Net change in financial assets	**21,857**	**34,709**	**54,946**
As a % of GDP	4.9	7.4	11.1
Cash and transferable deposits	0.6	2.4	3.3
Other deposits	2.0	0.0	1.1
Of which: rest of the world	*0.8*	*1.5*	*2.3*
Short-term securities and bonds	–0.1	0.4	0.3
Equities	1.6	0.5	1.5
Of which: rest of the world	*0.7*	*1.2*	*2.0*
Credit	0.6	2.9	3.4
Insurance technical reserves and other	0.1	1.3	1.5
Net change in financial liabilities	**24,354**	**38,660**	**60,082**
As a % of GDP	5.5	8.3	12.1
Short-term scurities and bonds	–0.4	–0.3	0.9
Equities	1.0	0.8	1.7
Credit	2.9	7.2	9.0
Of which:			
Credit institutions	*1.9*	*4.5*	*4.9*
Trade credit	*1.0*	*2.6*	*2.4*
Rest of the world	*0.0*	*0.1*	*1.7*
Insurance technical reserves and other	1.9	0.5	0.5
	HOUSEHOLDS		
Net financial saving	**5.3**	**4.2**	**2.9**
Net change in financial assets	**8.5**	**10.3**	**11.1**
Net change in financial liabilities	**3.2**	**6.1**	**8.2**
Net financial saving	**23,540**	**19,702**	**14,474**
As a % of GDP	5.3	4.2	2.9
Net change in financial assets	**37,870**	**48,259**	**55,106**
As a % of GDP	8.5	10.3	11.1
Cash and transferable deposits	0.9	1.0	0.9
Other deposits	–0.4	–1.8	–0.2
Of which: rest of the world	*0.0*	*0.2*	*0.2*
Short-term scurities and bonds	–0.6	–0.2	–0.7
Equities	7.1	10.0	7.5
Of which: shares in mutual funds	*7.3*	*8.6*	*5.9*
Insurance technical reserves	2.7	2.9	2.8
Credit and other	–1.2	–1.5	0.7
Net change in financial liabilities	**14,330**	**28,556**	**40,632**
As a % of GDP	3.2	6.1	8.2
Credit	1.8	5.2	7.4
Of which			
Credit institutions	*3.5*	*4.8*	*6.8*
Trade credit	*–1.9*	*0.0*	*0.1*
Rest of the world	*0.3*	*0.4*	*0.4*
Other	1.4	0.9	0.8
MEMORANDUM ITEM: ASSETS, INCLUDING THOSE HELD THROUGH FUNDS:			
Shares	–0.1	2.8	3.0
Cumulative balance	*14.2*	*23.5*	*32.2*
Assets vis-à-vis the rest of the world	0.8	2.3	6.1
Cumulative balance	*5.2*	*7.4*	*13.1*

Source: Banco de España.

adjusted to the timing of receipts and expenses of the State, the Treasury's deposit at the Banco de España has been used more intensively, both to cover the lack of funds to finance public spending and to take up the excess financing obtained by the Treasury on the market. The latter has been rather common in recent years and, in particular, in 1998, when the balance of the Treasury's deposit exceeded EUR 18 billion (approximately, ESP 3 trillion) for a large part of the second half.

As for general government, its net financial borrowing as a percentage of GDP fell again in 1998, to stand at 0.2 %. With respect to the composition of the financial liabilities of the sector, the decrease in funds obtained from the securities markets and, in particular, from the issuance of bonds, which was less than half the annual net issuance in the period 1993-1997, was notable. By contrast, bank credit rose moderately in 1998. As to its composition, the balance of credit from domestic credit institutions fell, while foreign currency credit from non-resident institutions rose significantly. In terms of stocks, credit in pesetas from credit institutions continues to make up the bulk of the financial liabilities of the sector, with a share of 47 %, while credit financing from the rest of the world is only 8 %. Issued securities, primarily medium and long-dated, constitute 30 % of all general government liabilities.

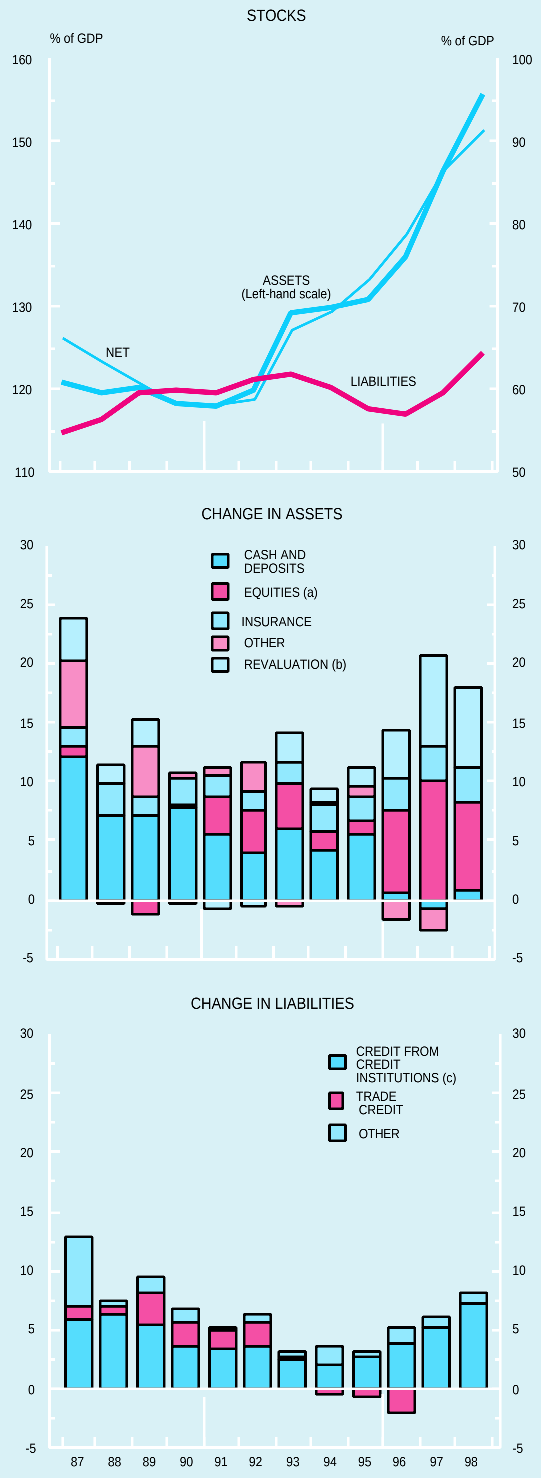
Breaking down the stocks of general government liabilities by holder shows that the activity of institutional investors continued to boom. These investors were the only ones, other than non-resident investors, to have acquired public-sector liabilities, in net terms, in recent years (see Chart IV.15). By contrast, credit institutions and firms and households have reduced their holdings of public-sector assets, in net terms.

IV.5.3. The balance of payments: saving and net borrowing of the economy

The surplus on *current and capital account* deteriorated significantly in 1998, to stand at EUR 4,355 million (ESP 725 billion), as against EUR 7,653 million (ESP 1,273 billion) in 1997 (see Table IV. 8). In terms of GDP, the combined balance on the two accounts stood at 0.9 %, as against 1.6 % in 1997. This outturn reflects the deterioration in the current transactions balance as the year elapsed, which was translated into a deficit of EUR 1,269 million (ESP 211 billion), which contrasts with the surplus accumulated in the preceding three years. This worsening arose, in turn, from the progressive increase in the trade deficit, which was not offset by the excellent tourism results.

CHART IV.14

Household financial wealth

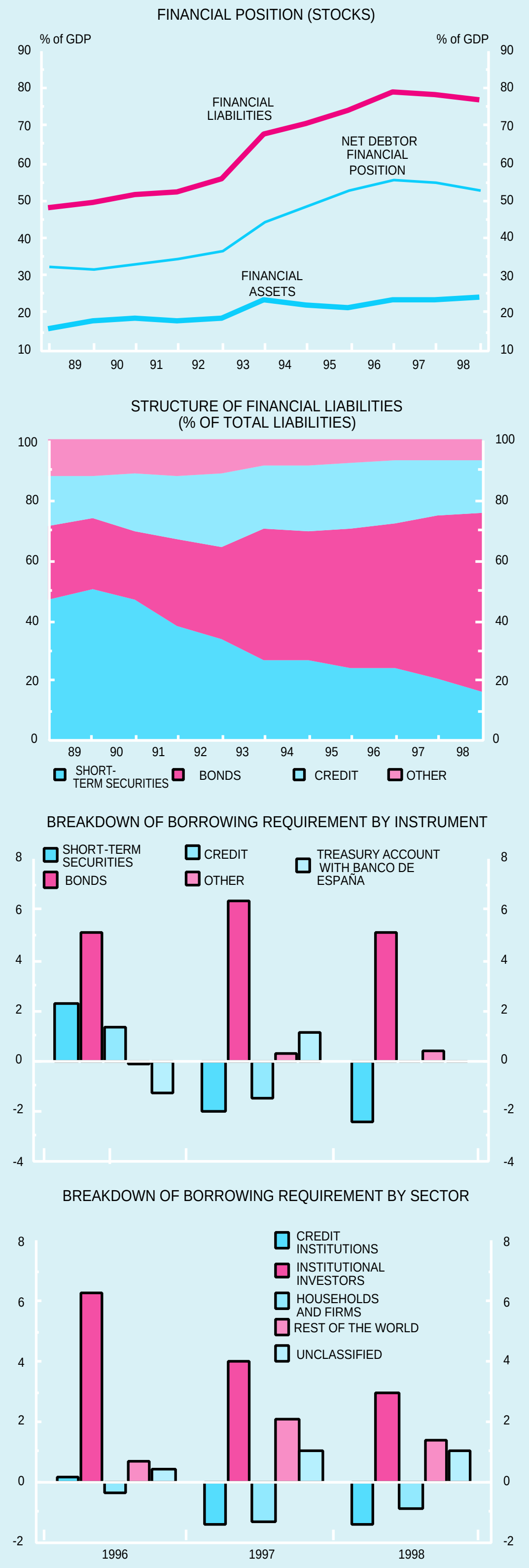


Source: Banco de España.

(a) Includes both resident and non-resident shares, and shares in mutual funds.
(b) Calculated as assets revaluation less liabilities revaluation.
(c) Includes resident and non-resident institutions.

CHART IV.15

General government



Source: Banco de España.

As mentioned in Chapter III of this report, the persistence of the crisis on Asian markets, the collapse of the Russian economy and the difficulties besetting certain Latin American countries led to a gradual slowdown in exports over the course of 1998. This slowdown gained considerable momentum in the final quarter, when a certain weakness in the demand of the European countries was also apparent. Imports, in contrast, grew at high rates over the year as a whole, driven by the strength of domestic demand. Consequently, the trade gap widened considerably, despite the improvement in the terms of trade. As regards the services balance, tourism receipts were very expansionary, as a result of the larger influx of tourists from Germany and France. Tourism payments also grew at very high rates. As for other services, freight transactions slowed, while corporate and computer services expanded notably, in line with the progress made in recent years in the liberalisation of trade in these services.

The investment income deficit worsened again in 1998, with very high rates of growth of both receipts and payments, reflecting the notable increase in cross-border capital movements in recent years. On the receipts side, the buoyancy of those of the non-financial private sector was noteworthy. This was linked to the increase in this sector's external assets (in the form of both direct investment and mutual funds and short-term loans and deposits), prompted by the search for higher returns than in the domestic market. The receipts of the credit system, by contrast, increased more moderately. As for payments, their buoyancy primarily reflects the intense growth of those made by the resident credit system, in line with the rise in its short-term external liabilities. The payments of the non-financial private sector also increased due to the rise in foreign holdings in mutual funds and short and long-term loans received from abroad.

As regards cross-border transfers, the current transfers surplus improved again as a consequence of the increase in flows from the EU under EAGGF-Guarantee, since those received from the European Social Fund declined. The balance on capital transfers stabilised at the same level as in 1997, as the notable increase in Community structural funds was offset by the decline in capital transfers received by the private sector, which had reached a very high level in 1997.

The *financial account* of the balance of payments continued to record a net outflow of capital in 1998, although there was a slight reduction with respect to the previous year (see Table IV. 8). In fact, the increase in the external

TABLE IV.8

Balance of payments

EUR millions

	1997			1998		
	Receipts	Payments	Balance	Receipts	Payments	Balance
Current account	**154,416**	**152,369**	**2,047**	**167,024**	**168,293**	**–1,269**
Merchandise	93,700	105,287	–11,587	98,485	115,160	–16,676
Services	38,876	21,902	16,974	43,973	24,982	18,991
Tourism	*23,668*	*3,973*	*19,694*	*26,793*	*4,491*	*22,302*
Other services	*15,208*	*17,929*	*–2,721*	*17,179*	*20,491*	*–3,312*
Factor income	11,554	17,464	–5,910	13,027	19,774	–6,746
Current transers	10,286	7,716	2,570	11,540	8,377	3,163
Capital account	**6,341**	**735**	**5,606**	**6,363**	**739**	**5,624**
	Net change in liabilities	Net change in in assets	Balance	Net change in liabilities	Net change in in assets	Balance
Financial account	**34,479**	**37,236**	**–2,757**	**65,681**	**66,671**	**–990**
Spanish investment abroad	—	25,328	–25,328	—	57,293	–57,293
Foreign investment in Spain	16,689	—	16,689	25,506	—	25,506
Spanish loans and deposits abroad	—	1,555	–1,555	—	21,625	–21,625
Foreign loans and deposits in Spain	17,790	—	17,790	40,176	—	40,176
Reserves	—	10,352	–10,352	—	–12,248	12,248
Unclassified items, errors and omissions	**—**	**—**	**–4,897**	**—**	**—**	**–3,365**
	FINANCIAL ACCOUNT BREAKDOWN					
FINANCIAL-ACCOUNT BALANCE		**–2,757**			**–990**	
Change in external liabilities		**34,479**			**65,681**	
Investment		16,689			25,506	
Excluding marketable securities		5,621			10,152	
Marketable securities		11,068			15,353	
General government		*9,952*			*4,125*	
Other resident sectors		*1,183*			*8,469*	
Credit system		*–67*			*2,760*	
Other investment		17,790			40,176	
General government		21			866	
Other resident sectors		544			4,319	
Credit system		17,226			34,991	
Of which:						
Loans and long-term deposits		*3,090*			*11,462*	
Short-term deposits and repos		*14,135*			*23,529*	
Change in external assets		**37,236**			**66,671**	
Investment		25,328			57,293	
Other resident sectors		19,890			44,627	
Credit system		5,454			12,863	
Other investment		1,555			21,625	
General government		331			388	
Other resident sectors		12,392			17,668	
Credit system		–11,168			3,569	
Of which						
Loans and short-term deposits and repos		*–13,113*			*2,452*	
Reserves		10,352			–12,248	
BREAKDOWN BY SECTOR:						
1. Net flows (change in liabilities – ch. in assets)		**7,596**			**–13,237**	
General government		9,658			4,800	
Other resident sectors		–25,042			–39,563	
Credit system		23,022			21,527	
2. Reserves		**10,352**			**–12,248**	
3. Financial account balance (1 – 2)		**–2,757**			**–990**	

Source: Banco de España.

assets held by resident investors was much greater than the change in liabilities, and this difference was financed, in part, by the fall in the reserve assets held by Banco de España. In addition, the significant increase in the volume of cross-border financial transactions in 1998, to approximately double the previous year's total, was notable. This expansion was related, among other factors, to the behaviour of households and firms, as analysed in the previous section. Over the last decade the external assets and liabilities of residents have almost tripled as a proportion of GDP: assets rose from 24 % of GDP in 1989 to 69 % in 1998, while liabilities increased from 34 % in 1989 to 89 % in 1998.

The most important feature identified by a sectoral analysis of these flows is the high level of foreign direct investment, more than half of which went to Latin America. Meanwhile the increase in households' net external assets has largely been channelled through institutional investors. It stems from the search for higher returns, and also from the relative shortage of securities in Spanish financial markets. Unlike the case of direct investment, the purchase of foreign securities has primarily been orientated towards the OECD developed countries. Also, a significant portion of the external assets of resident sectors is made up of bank deposits (included in Table IV.8 under the heading "other investment"), which again increased significantly in 1998.

In contrast, capital inflows have been concentrated under the heading of loans to the credit system. The cross-border financial flows of these institutions have been strongly governed by the behaviour of the other two sectors. Specifically, the increase in bank credit to households and firms, together with the disintermediation of the savings of these agents, has forced credit institutions to cover the gap with foreign financing (see Section IV.4.2). Finally, general government has continued to raise funds abroad, albeit less than in 1997.

In short, certain processes that were first apparent in 1996 intensified in 1998. These represent a notable change in the structure of capital movements between Spain and the rest of the world. First, there was an increase in the rate of acquisition of external assets, especially by non-financial firms and institutional investors, which contrasts with the traditional dependence on foreign investment. Second, although the current account surplus enabled part of these capital outflows to be financed, the most significant portion has been financed through the incurrence of a large amount of net liabilities by credit institutions. This has meant that the net external position of credit institutions moved into debit in 1997, and increased further in 1998.

BANCO DE ESPAÑA BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

1. BANCO DE ESPAÑA BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

The balance sheet and profit and loss account are provisional as they are pending government approval under the terms provided for by article 4.2 of the Law of Autonomy of the Banco de España (Law 13 dated June 1st 1994).

The main captions of this balance sheet, or those that have changed most markedly in 1998, are discussed below.

1.1. Balance sheet

Balance sheet of the Banco de España

ESP bn

	Balances as of 31.12.1998	Change on 31.12.1997
Assets		
Foreign assets	8,677	–1,956
State	1,721	–39
Other public-sector accounts	306	–9
Credit to financial institutions	4,471	2,205
Investment securities	688	123
Premises and equipment	38	–1
Bills and other accounts receivable	73	—
Sundry accounts	129	57
Accrual accounts	128	–34
TOTAL ASSETS	**16,231**	**346**
Liabilities		
Banco de España nationalisation capital	—	—
Reserve funds	1,794	–191
Notes in circulation	8,774	136
Special drawing rights assigned	60	–1
Foreign liabilities	9	1
State	1,709	74
Independent government agencies	447	132
Other public-sector accounts	148	5
Accounts payable to financial institutions	2,359	–195
Accounts payable to other agents	3	—
Bills and other accounts payable	98	28
Sundry accounts	103	3
Income pending payment to the Treasury	701	359
Accrual accounts	26	–5
TOTAL LIABILITIES	**16,231**	**346**

1.1.1. Foreign assets

This balance sheet caption details the equivalent peseta value of the foreign reserves position, the basic components of which are gold (ESP 801 billion), convertible currency (ESP 7.5 trillion), and the net IMF position (ESP 300 billion).

1.1.2. State

The State asset-side balance, totalling ESP 1,721 billion, breaks down as follows:

State. Accounts

ESP bn

Specific credit	1,721
Special account, Law 3/1983	*422*
Special account, Law 4/1990	*1,156*
Credit for payment of participations in, contributions to, and membership dues for international organisations	*136*
Subrogation for Tabacalera, S.A., Law 31/1991	*7*

1.1.3. Other public-sector accounts

Credit to Social Security Funds under the sixth transitory provision of Law 41/1994 of December 30th 1994 (1995 State Budget Law).

Other public-sector accounts

ESP bn

Social Security Funds, Law 41/1994	
Principal	256
Interest	50
Balance	**306**

1.1.4. Securities portfolio

Investment securities. Type of security

ESP bn

	Amount	
	Nominal Pesetas	Effective Pesetas
Book-entry government debt	**522.7**	**613.7**
Medium- and long-term bonds	522.7	613.7
Share of the capital of the European Central Bank	**74.0**	**74.0**
Balance	**596.7**	**687.7**

2. Profit and loss account

Profit and loss account (a)

ESP bn

	1997	1998
GROSS INCOME	**909.2**	**1,291.7**
Return on domestic operations	**253.5**	**255.1**
Interest	185.7	163.3
Investment securities	51.0	51.6
Other	16.8	40.2
Return on external operations	**559.3**	**1,000.0**
Interest and yields	541.4	619.1
Other	17.9	380.9
Profit/loss on foreign-exchange dealing	**96.4**	**36.6**
TOTAL EXPENSES	**207.8**	**215.4**
Administrative expenses	**40.1**	**42.2**
Personnel	26.2	27.2
Wages and salaries	*19.4*	*20.0*
Social Security contributions	*4.3*	*4.7*
Welfare schemes	*2.5*	*2.5*
Issuance and distribution of notes	6.9	7.4
Overheads	7.0	7.6
Debt repayment	**2.6**	**2.6**
Financial expenses	**145.2**	**155.1**
Domestic operations	142.3	152.3
Banco de España certificates	*103.8*	*77.3*
Interest on Treasury accounts	*23.0*	*56.0*
Interest on Regional (Autonomous) Government accounts	*2.1*	*1.9*
Interest on Social Security accounts	*8.1*	*14.7*
Repos	*5.3*	*0.3*
Monetary policy operations	*—*	*2.1*
External operations	2.9	2.8
Provisions to special reserve	**18.5**	**13.3**
Art. 3º. Law 192/64	**1.4**	**2.2**
PROFIT	**701.4**	**1,076.3**

(a) The 1997 data have been adjusted to make them comparable with the 1998 data, which follow the ESCB's accounting criteria.

2. ISSUE AND CIRCULATION OF NOTES AND COINS

Breakdown of notes in circulation

Annual change

	Circulation				% share			
	In millions of notes		ESP bn		Of the number of notes		Of the value in circulation	
	31.12.1998	31.12.1997	31.12.1998	31.12.1997	31.12.1998	31.12.1997	31.12.1998	31.12.1997
DENOMINATION:								
10,000	488.7	468.4	4,887.1	4,684.0	30.7	29.6	55.7	54.2
5,000	641.2	659.3	3,206.2	3,296.5	40.2	41.6	36.5	38.2
2,000	217.0	203.5	434.0	407.0	13.6	12.8	4.9	4.7
1,000	246.5	246.2	246.5	246.2	15.5	15.5	2.8	2.9
Subtotal	**1,593.4**	**1,577.4**	**8,773.7**	**8,633.7**	**100.0**	**99.5**	**100.0**	**100.0**
500 (a)		7.7		3.8		0.5		0.0
TOTAL	**1,593.4**	**1,585.1**	**8,773.7**	**8,637.5**	**100.0**	**100.0**	**100.0**	**100.0**

(a) Notes being phased out (exchange period ends: 22.6.1998).

Breakdown of coins in circulation

Annual change

	Circulation				% share			
	In millions of coins		ESP bn		Of the number of coins		Of the value in circulation	
	31.12.1998	31.12.1997	31.12.1998	31.12.1997	31.12.1998	31.12.1997	31.12.1998	31.12.1997
DENOMINATION:								
2,000	19.6	18.4	39.1	36.7	0.2	0.2	10.2	10.4
500	211.9	202.8	105.9	101.4	2.2	2.4	27.7	28.6
200	80.1	69.5	16.0	13.9	0.8	0.8	4.2	3.9
100	1,349.8	1,238.5	135.0	123.8	13.9	14.6	35.4	35.0
50	118.0	113.5	5.9	5.7	1.2	1.3	1.5	1.6
25	1,704.8	1,557.2	42.6	38.9	17.6	18.3	11.2	11.0
10	372.0	372.7	3.7	3.7	3.8	4.4	1.0	1.1
5	3,839.2	3,215.2	19.2	16.1	39.5	37.9	5.0	4.5
1	2,015.5	1,703.2	2.0	1.7	20.7	20.1	0.5	0.5
Commemorative issues	3.2	3.1	12.3	12.0	0.0	0.0	3.2	3.4
TOTAL	**9,713.9**	**8,494.0**	**381.8**	**354.0**	**100.0**	**100.0**	**100.0**	**100.0**

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COMPOSITION OF THE GOVERNING BODIES OF THE BANCO DE ESPAÑA

Governing Council

GOVERNOR	Luis Ángel Rojo
DEPUTY-GOVERNOR	Miguel Martín
COUNCIL MEMBERS	Eduardo Bueno José M. González-Páramo Jesús Leguina Joaquín Muns Jaime Requeijo Julio Segura
DIRECTOR-GENERAL OF THE TREASURY AND FINANCIAL POLICY (No vote on monetary policy issues)	Jaime Caruana
VICE-PRESIDENT OF THE NATIONAL SECURITIES MARKET COMMISSION (No vote on monetary policy issues)	Luis Ramallo
DIRECTORS-GENERAL OF THE BANK (Without a right to vote)	Luis M. Linde Gonzalo Gil José L. Malo de Molina Raimundo Poveda Manuel Zamanillo
SECRETARY (Without a right to vote)	Joaquín Fanjul
REPRESENTATIVE OF THE BANK'S PERSONNEL (Without a right to vote)	José Mª Penela

Executive Commission

GOVERNOR	Luis Ángel Rojo
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COUNCIL MEMBERS	José M. González-Páramo Julio Segura
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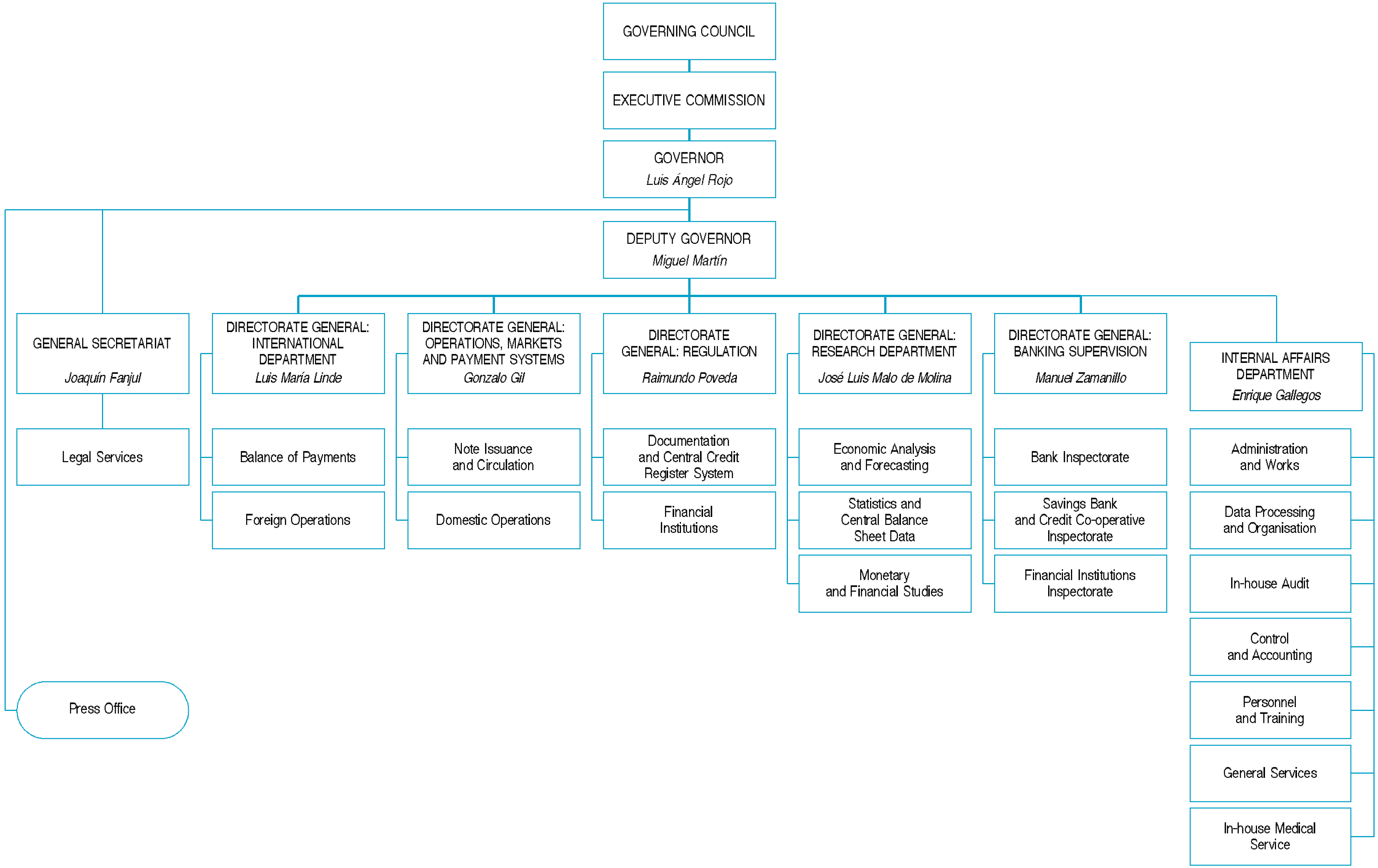

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