Quarterly report on the Spanish economy

1. Overview

The Spanish economy has moved into Economic and Monetary Union (EMU) under favourable conditions. For the third year running, the growth of output and employment in 1998 was notably higher than in most countries in the area. And the levels of stability attained (a low budget deficit, a low inflation rate and a current-account surplus) continued to provide an appropriate environment for the activity of private agents, underpinned by a sound financial position. However, the extension of the effects of the international financial crisis and their impact on merchandise exports began to weaken business confidence. Investment plans have duly been scaled back and the pace of industrial output is being adjusted, while consumers continue to show higher and more stable levels of confidence and expenditure. As a result, the economy's growth has slowed slightly, although it remains significantly higher than in the euro area as a whole, and the pattern of final demand has tended to swing towards domestic demand (and, herein, towards consumption and construction), to the detriment of exports.

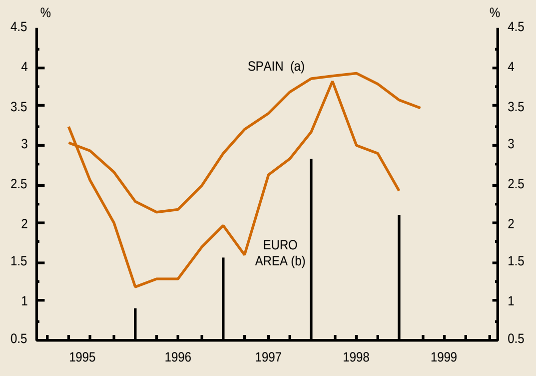
Against this background, there has been a rise in the 12-month growth rate of the consumer price index (CPI) in the early months of 1999. Although some transitory factors are involved here, the rise also reflects the persistence of high growth rates in the prices of certain sectors, especially services, and the differential with the euro area has widened. Sustaining a higher growth rate than that of the other euro-area members, under the common monetary conditions of EMU, requires preventing the rise in prices from translating into a worsening of the economy's competitiveness. In this connection, it is vital to tighten control of domestic costs and general government spending, while increasing flexibility in the markets for goods, services and productive factors.

The economic situation outside the euro area has improved slightly in the first quarter of 1999. This has been as a result of the upward revision of growth forecasts for the United States, the signs of recovery in certain emerging Asian economies and the lesser risk of the Brazilian financial crisis spreading. However, adverse factors persist. These include the consequences of the Brazilian crisis on real activity in Latin America and the absence of firm signs of recovery in Japan, along with the rise in the price of crude oil, which is beginning to bear on the industrialised countries' inflation rates.

In the euro area, real GDP growth was 2.9 % on average in 1998, a loss of buoyancy being confirmed in the fourth quarter of the year (see Chart 1). The dichotomy between the lev-

CHART 1

GDP



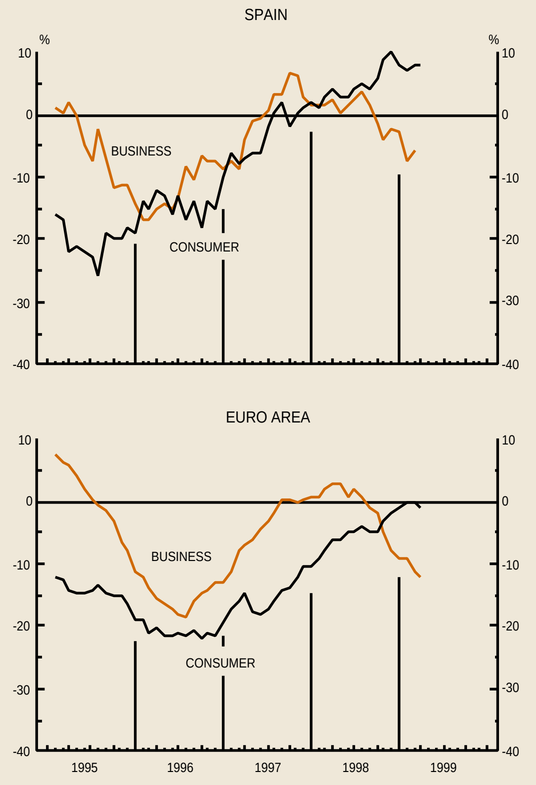
Sources: ECB, Instituto Nacional de Estadística and Banco de España.

(a) Non-centred annual rates of change calculated on the trend.

(b) Non-centred annual rates of change calculated on the seasonally adjusted series.

CHART 2

Confidence indicators



Sources: European Commission and Ministerio de Industria y Energía.

els of consumer and business confidence persists (see Chart 2), as does that between the contribution of domestic demand (essentially underpinned by private consumption) to growth and the negative contribution of net external demand. The rate of increase of the harmonised index of consumer prices (HICP) rose moderately in March (to 1 %) after having stabilised in the previous months. The upward impact of energy prices was primarily responsible here, since the prices of services and of non-energy industrial goods have recently slowed. Turning to the budget deficit, the 1998 outturn was better than expected (2.1 % of GDP), contributing to which was economic growth and the fall in interest rates.

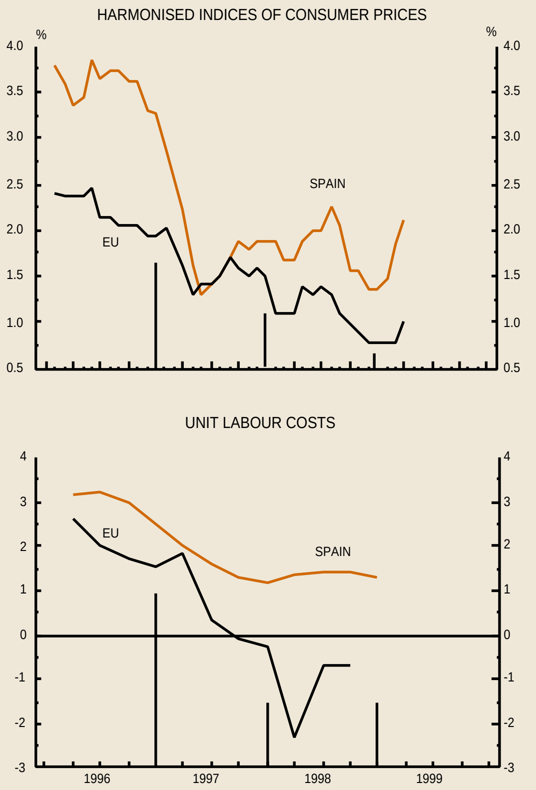
The monetary and financial conditions prevailing in the euro area in the first three months of the year were an extension of the trends seen in the main member countries during 1998. Real interest rates reached historically low levels, while both the narrow monetary aggregate (M1) and financing to households and firms posted high year-on-year increases. The M3 aggregate, which is the main monetary indicator for defining the Eurosystem's monetary policy strategy, stood slightly above its reference value of 4.5 % in February. This, along with the absence of significant inflationary risks and the downward revision of growth expectations for the area as a whole, led the Governing Council of the European Central Bank (ECB) to cut the rate on its main refinancing operations to 2.5 % on 7th April.

Against this international backdrop, not free from uncertainty and less conducive to growth, the Spanish economy has maintained a notable rate of expansion during the first quarter of 1999. It is estimated that real GDP will have achieved a growth rate of around 3.5 % year-on-year during this period, extending the mild slowdown recorded in the second half of 1998. National demand might once more be running at – or the odd tenth of a point below – the growth rate posted in the fourth quarter of 1998 (4.9 %), while the negative contribution of net external demand to GDP growth is expected to widen. From the standpoint of the productive branches, the keynote is the loss of momentum in industrial production, since the manufacturing branches are those most affected by the ongoing fall in merchandise exports. Services are holding up, however, thanks notably to tourism-related activities. Construction, for its part, is currently the economy's most buoyant sector.

Among the national demand components, the resilience of private consumption has already been highlighted. In the first quarter of 1999, it is estimated that its year-on-year rate of

CHART 3

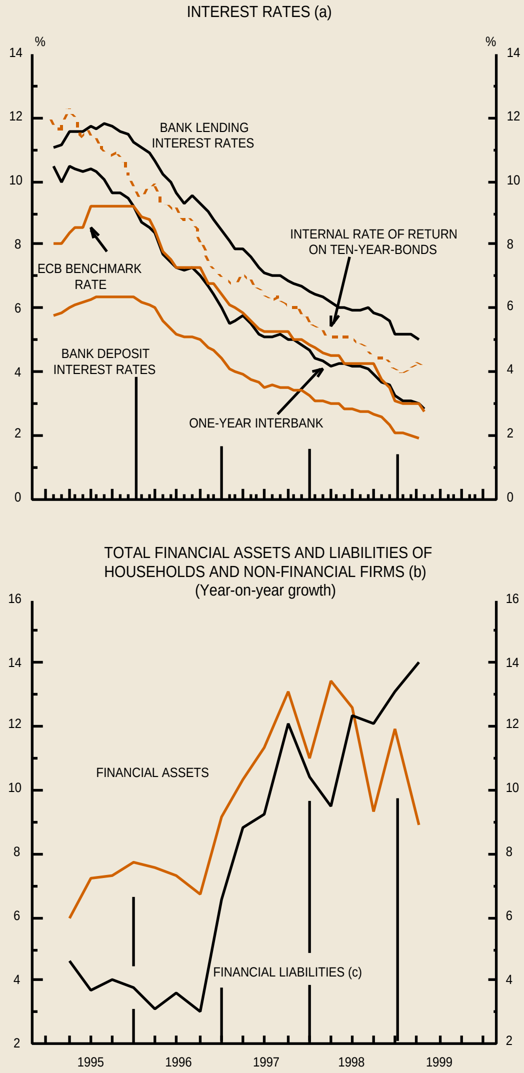
Harmonised indices of consumer prices and unit labour cots. Annual percentage change



Sources: Eurostat, European Central Bank and Instituto Nacional de Estadística.

CHART 4

Interest rates



Source: Banco de España.

(a) The series are averages of daily data.
(b) The data for the first quarter of 1999 are provisional estimates.
(c) Excluding shares.

change stabilised at around 3.5 %, quite similar to the previous quarter. Underpinning this growth in consumption has been an increase in real disposable income similar to that the previous year, it being difficult at present to assess the influence on this variable of the personal income tax reform. Although their saving ratio has stabilised, households' financing capacity has progressively been diminishing owing to a strong increase in investment in housing, in a setting in which the fall in interest rates and the gains in wealth of recent years have been conducive to taking on debt.

In connection with gross capital formation, mention has been made of the current expansion in investment in construction, in both the private and public-sector spheres. Capital investment has continued to decelerate, although its growth rates are still high. Contributing to this is the favourable financial position of firms, with their high cash flow and the highly favourable conditions for raising borrowed funds, along with the level of their domestic order books. Overall, the real increase in gross fixed capital formation in the first quarter of the year may have been around 9 %, to which a fresh positive contribution to GDP growth of the change in stockbuilding should be added.

With regard to external demand, the first two months of the year have, according to customs data, seen a considerable real decline in merchandise exports. Although the growth in revenue associated with tourism and other services remains very high, it seems unlikely that the trend rate of goods and services exports in real terms may, in keeping with the rates estimated on QNA terms, reach 5 % in the first quarter of 1999. The growth rate of imports, meantime, has fallen much more moderately. Imports continue to be driven by the – albeit diminishing – expansiveness of final demand in the economy, and by the notable decline seen in the prices of imported goods.

Against this background, the growth in employment has remained high, albeit on a slightly slowing trend, in keeping with the course of GDP. Wage negotiations, though rather unrepresentative, point to a moderate cut in wage growth compared with the previous year. This would provide for a lower growth rate of unit labour costs which, to date, has been above that posted in the euro-area countries (see Chart 3).

The rise in the 12-month growth rate of the CPI during the first quarter has been extensive to virtually all its components, with the exception of non-energy industrial goods. The sharpest acceleration has been in foodstuffs, while in the case of the energy component the rise in the price of crude oil on international markets has begun to become manifest, making its hitherto negative 12-month growth rate appreciably less so. Lastly, services prices ran at a rate (3.8 %) virtually double that in the euro area as a whole. As a result of these movements, the differential with the euro area, calculated with the harmonised indices, continues to widen.

The data on the State deficit in the first quarter of 1999 are affected by numerous factors hampering assessment: changes in the timing of refunds on certain taxes, extraordinary accumulation of interest payments etc., with very high increases being recorded in both revenue and expenditure. If the figures are analysed taking these factors into account, the budgetary performance proves compatible with the deficit-reduction target set under the Stability and Growth Programme.

Finally, the data on financing to households and firms in the first quarter continued to show high growth rates of around 14-15 %, far greater than the nominal growth of the economy. As regards the sector's financial assets, the cash, sight deposits and savings deposits in the hands of these agents continued increasing at rates above 14 % during the period. Conversely, a broader set of liquid financial assets including —in addition to cash and cash equivalents— time deposits, repos and shares in mutual funds, among others, ran at a moderate growth rate (of above 5 % during the quarter) similar to that observed in 1998. Overall, the total financial assets of households and firms grew at a rate of close to 7 % in the first quarter of 1999, signifying a moderate slowdown on the results for the last quarter of 1998 (see Chart 4).

2. The external environment of the euro area

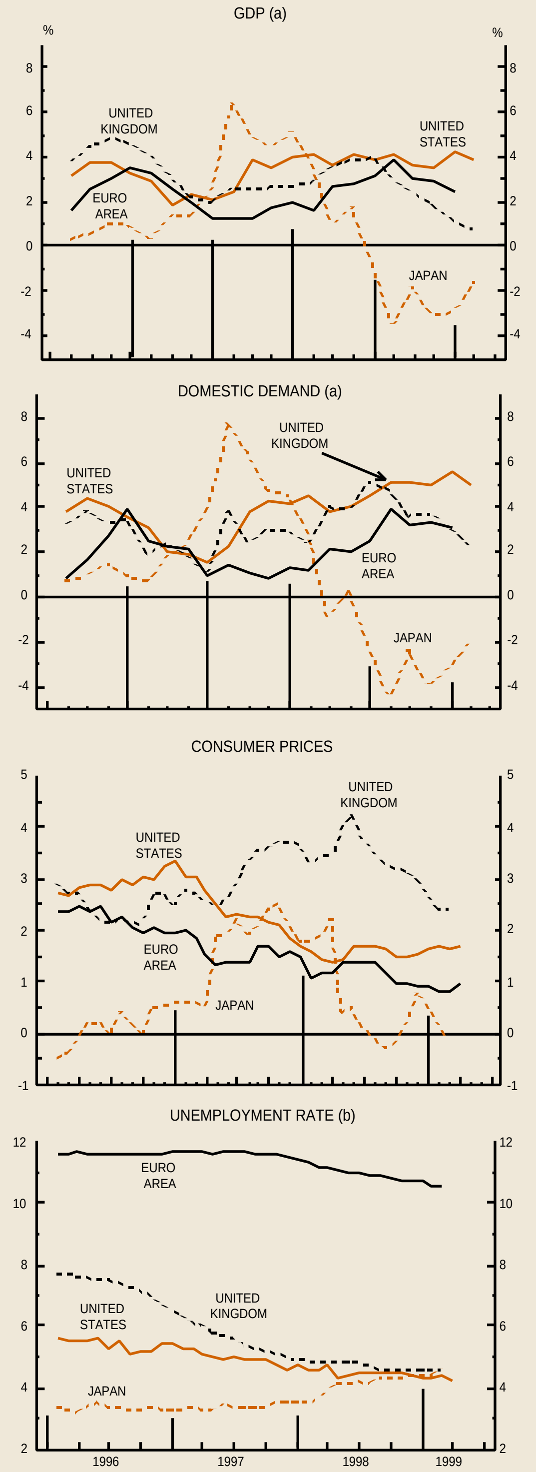
In 1999 to date there has been an improvement in expectations about the world economy as a whole compared with the greater pessimism prevailing in late 1998. Several circumstances have contributed to this. First, growth forecasts for the United States have been revised strongly upwards further to the buoyancy shown by this economy in the last quarter of 1998 and in the first three months of 1999. Second, there are increasingly firm signs that a good number of the south-east Asian economies might already be posting positive GDP growth rates, following the sharp contraction by some of them in 1997-98. Finally, the contagion of the Brazilian financial crisis has, so far, been limited, whereby one of the main sources of instability in late 1998 and early 1999 appears to have been defused.

Nonetheless, adverse elements continue to cloud the picture of the external environment of the euro area for 1999. Specifically, the consequences of the Brazilian crisis on real activity in the Latin-American countries as a whole are going to be significant; foreseeably, many of these countries will post negative growth rates in 1999. The forecasts for the two main countries, Brazil and Argentina, point to an expected contraction in GDP in 1999 of around 4 % in the former country and of 1.5 % in the latter. Other countries such as Mexico and Chile will probably show positive growth in output, albeit at a lower rate than in 1998. In Japan there are no unequivocal signs of the end of recession, despite the fact that the rise on the stock market and the improvement in business confidence might be interpreted as indicative that the end of the crisis is not far off. Lastly, it should be stressed that the prices of energy products, the reduction in which in previous quarters contributed decisively to the generalised decline in inflation in the industrialised countries, have begun to turn upwards (the dollar price of a barrel of oil has increased by more than 40 % since end-February). In the near future, this could prompt rises in other prices and costs.

The US economy has continued growing at a very high rate during the first quarter of 1999, albeit – probably – at a somewhat more moderate pace than in the fourth quarter of 1998 (see Chart 5). During this latter period GDP grew at an annualised quarter-on-quarter rate of 6 %, assisted to some extent by extraordinary factors such as the good weather, unexpected growth in exports and an end to labour unrest in the automobile industry. As reflected in the latest indicators, the disappearance of these factors in the period to date in 1999 has not significantly dampened the buoyancy of domestic demand. Thus, throughout the first quarter, retail sales increased strongly; the purchasing managers'

CHART 5

Main macroeconomic indicators
Annual percentage changes



Sources: Banco de España, national statistics and Eurostat.

(a) The data for the first quarter of 1999 are forecasts, except for UK GDP, which is an estimate.
(b) Percentage of labour force.

index grew continuously, at a rate consistent with an increase in manufacturing output of between 4 % and 5 % per annum; and the number of authorised housing starts continued to grow. Nonetheless, other indicators have pointed to a potential moderation in activity. This has been the case of new orders for durable goods, which fell in February for the first time since October 1998, and of non-farm employment, which increased by 46,000 in March compared with the increase of 297,000 recorded in February. All told, the unemployment rate stood at 4.2 % in March against 4.4 % in February.

Despite the ongoing momentum of domestic demand, the fresh decline in unemployment and the increase in the price of oil, there are still no signs of inflationary pressures. Consumer prices have continued to trend very moderately, as seen in the 12-month growth rate for the month of 1.7 % (2.1 % if energy and fresh food are excluded). Wage growth declined in March (3.6 % year-on-year, against 4.1 % in February).

The resilience of domestic demand, along with the contractionary effect of the fall in world demand on exports, has continued to contribute to widening the current-account deficit which, in 1998, amounted to 2.7 % of GDP. The trade deficit in February stood at a new high of USD 19,400 million. The growing external deficit is, likewise, a reflection of the increase in the private sector's financing requirements, the main source of which is the ongoing decline in the household saving ratio. In late 1998 and early 1999, this ratio stood at levels close to zero or was even negative. Box 1 analyses the increase in the US external deficit in relation to the increases in the EU and Japanese surpluses.

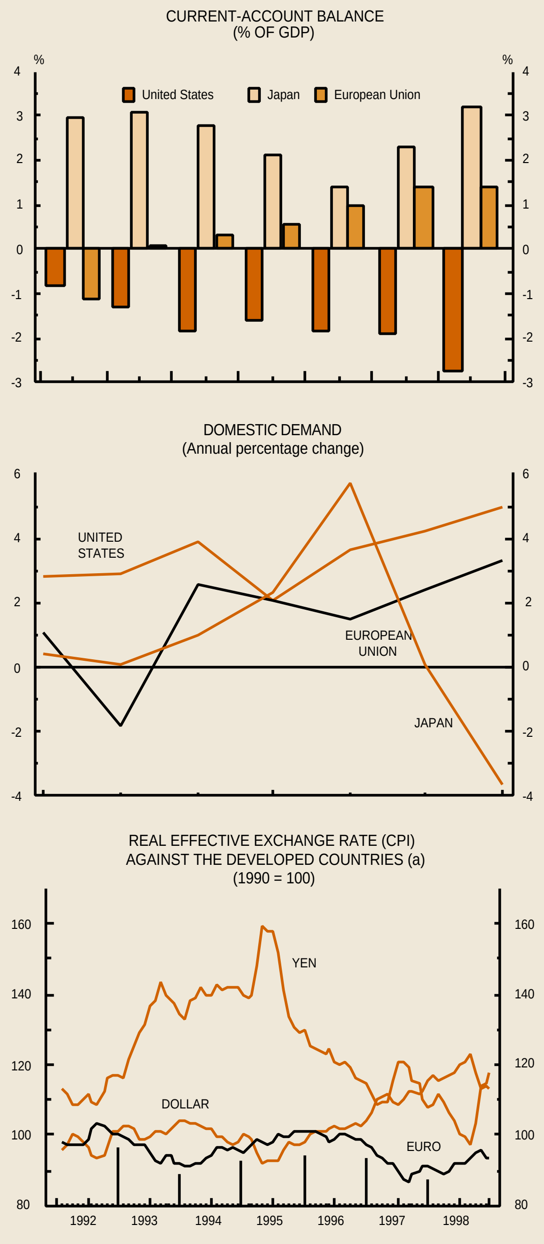
The positive performance of the US economy in 1999 to date has led to a substantial upward revision of growth forecasts for the year as a whole which, generally, point to a rate slightly above 3 %. However, there are two factors in the current US situation that may entail some risk of instability. The first is the above-mentioned low household saving ratio and the increasingly intense resort by households to debt to finance the expansion in consumption. The second, closely linked to the first, is the high level of stock market prices. This has generated a wealth effect which has contributed to the growth of consumption and to private-sector indebtedness. Given this situation, a sharp correction in stock market prices, were it to occur, could undoubtedly prompt a far-reaching change in consumption decisions and cause a sharp contraction in demand. Nonetheless, although this scenario cannot be ruled out, the al-

BOX 1

Growth of external imbalances between the main economies

A salient feature of international economic developments in recent years has undoubtedly been the notable increase in differences between the current-account balances of the main areas, and in particular between the United States, Japan and the European Union (EU). Whereas in the United States the current-account balance moved from –0.8 % of GDP in 1992 to –2.7 % in 1998, that of the EU, which was –1.1 % of GDP in 1992, stood at 1.1 % last year. Japan has run surpluses in recent years, its balance standing at 3.2 % of GDP in 1998. The progressive growth of the US current-account deficit in the period 1992-1998 ran in parallel to the gradual increase in the overall EU surplus and, above all, to the sustained high current-account surplus in Japan (see adjoining chart).

From the standpoint of national economies, it should be pointed out that the US external deficit is in response to the specific features of this economy's current growth cycle (the longest witnessed in recent decades), driven by strong, sustained domestic demand, and to the US economy's extraordinary external financing capacity. As to the gradual increase in the EU external surplus, this is attributable to the composition of growth in recent years, which has been based more on external than on domestic demand. It cannot be ruled out that the EU may also have a relatively low structural propensity to import, as a result of lower potential output constrained by insufficient flexibility of the productive structure. Finally, the deep-seated economic recession besetting Japan in recent years has translated into a substantial widening of its traditional current-account surplus, by means of the slowdown and subsequent decline in imports rather than because of a strong expansion in its exports.



Sources: IMF, OECD and Banco de España.
(a) A decline in the index denotes a gain in the competitiveness of the currency against the group of countries indicated.

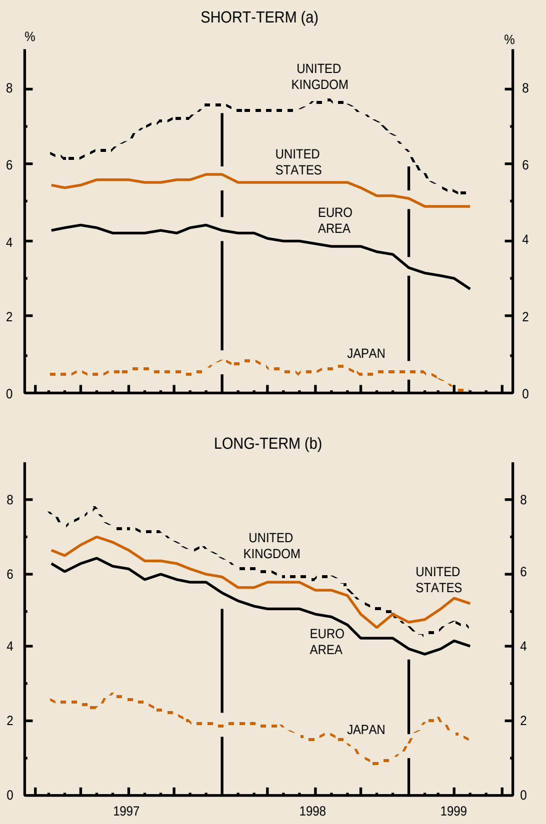
Several factors may be a cause for some concern given the level reached by the aforementioned external balances. First, the strongly predominant role played by the United States as a net purchaser from the rest of the world and, in particular, from the Asian countries in crisis. That has led the US authorities to call for a greater contribution from the rest of the industrialised countries, most especially from the EU, in overcoming the crisis assailing the emerging economies. However, analysis of Asian imports from the United States and from the EU reveals that although the former economy buys a greater quantity of Asian products, the EU has increased its Asian imports in 1998 to a greater extent than the United States. Moreover, the cyclical position of the United States accounts for its greater volume of imports. And, finally, it should not be forgotten that the current foreign sector data of the EU, obtained through aggregating national balance of payments statistics, are not sufficiently reliable and tend to overestimate the European surplus.

A second cause for concern might be the effect on the stability of the dollar exchange rate of a growing US foreign deficit. However, after the widespread liberalisation of international capital flows in recent years, the significance of trade flows for exchange rate developments has diminished considerably. The size and volatility of financial flows appear increasingly to be the determining factors of price changes on foreign exchange markets.

Generally, given the flexible exchange rates and free capital movements in today's world, it is difficult to arrive at direct normative conclusions on the basis of a specific external balance. The current-account balance reflects the discrepancy between national saving and investment and, therefore, it responds to intertemporal decisions taken by agents in response to existing incentives. A further point is that the external position, in conjunction with other indicators, contains information on the economy's situation and prospects, and on the financial position of households and firms, that may prove relevant for economic policy.

CHART 6

Interest rates



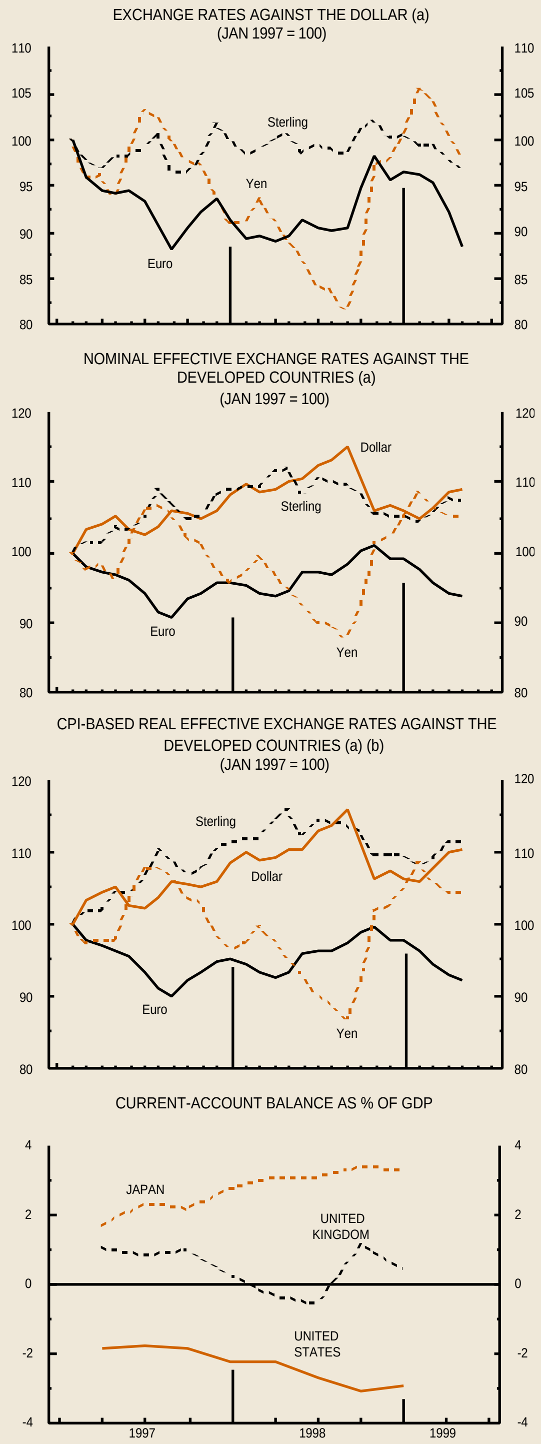
Source: Banco de España.

(a) Three-month interbank market interest rates. Euro area: to December 1998, weighted average of the eleven countries.

(b) Ten-year government bond yields. Euro area: average of the eleven countries.

CHART 7

Exchange rates and current-account balances



Sources: Banco de España, BIS and national statistics.

(a) 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.

(b) Up to 1999 the euro curve is an approximate indicator devised by the BIS on the basis of the effective exchange rates of the euro-area countries.

ternative scenario of a mild slowdown, associated with the maturity of the business cycle, is more likely.

In Japan, unequivocal signs that the recession has touched bottom have yet to be perceived, despite the improvement in certain indicators. GDP in the last quarter of 1998 fell by 0.8 % in relation to the preceding quarter (–2.8 % year-on-year). And this despite the strong increase in public investment, which was not capable of countering the heavy declines in private consumption and investment. In the opening months of 1999, the main indicators have confirmed that the economy remains in recession (fresh falls in industrial production, housing construction and household consumption). That said, some indicators have improved partially, as is the case with business confidence, where less pessimism is apparent. Also of note is the recent climb of the stock market, although this might be connected with the new industrial restructuring and merger plans. These plans, though they may contribute in the medium term to improving the financial health of firms and profit expectations, might lead in the short run to labour shedding. That would involve an increase in unemployment, which, in February, amounted to 4.6 % of the labour force. Consumption indicators for the first quarter continue to be negative: wholesale sales fell once again in February at a rate of 2.2 % in year-on-year terms (–3.9 % in January). Flagging consumption continues to be accompanied by flat or negative price growth rates. In February, the 12-month growth rate of the CPI was –0.4 % and producer prices have continued falling by between 4 and 5 % in year-on-year terms in the first two months of 1999.

As to the EU countries that have not joined EMU, the performance of the British economy is worthy of mention. It ended 1998 with a strong deceleration, the main source of which is a contraction of exports as a result of the crisis in the emerging economies and of the forceful appreciation of sterling. The economic indicators for the opening months of 1999 show a similar position to that of the last quarter of 1998, although the business and consumer confidence indices have improved slightly, the latter standing above its historical average. The effects of the slowdown in activity on prices did not become manifest until well into 1998, since nominal wages had showed considerable buoyancy up to that point in a labour market characterised by an unemployment rate holding stable at its lowest level for 18 years (4.6 %). As from September, wages decelerated and consumer prices moved progressively towards growth rates close to the inflation target (2.5 %). In February 1999, the 12-month increase in the CPI, excluding mortgage interest payments, was 2.4 %, although in March it edged up once more to 2.7 %.

Turning to economic policies, the Anglo-Saxon countries have continued pursuing their fiscal consolidation programmes. The United States duly posted a relatively high surplus (of 1.3 % of GDP) in 1998, which will probably be sustained in the coming years. Likewise, in the United Kingdom, the overall general government balance at the end of the year was positive (0.6 % of GDP). In Japan, public finances reflected the effects of the successive fiscal programmes to boost the economy and restructure the banking sector: the 1998 budget deficit totalled 5.4 % of GDP and is expected to exceed 8 % of GDP in 1999 (if the Social Security surplus were excluded, these figures would be 7.7 % and 10.3 % of GDP, respectively).

With regard to monetary policy, the US Federal Reserve held its federal funds rate unchanged at 4.75 % against the background of accelerating monetary and credit variables accompanying the robust growth rate in output. The Bank of Japan, for its part, cut its discount rate again on 12th February from 0.25 % to 0.15 %. Finally, given the slowdown in the British economy and the easing of inflationary pressures, the Bank of England cut its base rate on two occasions, in February and in April, to 5.25 %.

In the United States, the changes in growth expectations and the perception of greater financial stability have been mirrored on the money and financial markets. First, while short-term interest rates have held stable, long rates have increased by 0.5 percentage points between December and mid-April, with the subsequent increase in the slope of the yield curve, reflecting market expectations about the potential tightening of medium and long-term interest rates. Conversely, in the United Kingdom, and despite the successive cuts in official and short-term rates, more marked cuts in long rates have been seen, giving rise to a yield curve with a slightly negative slope. In Japan, although the market has partly corrected the rise in long-term government bond yields which had led to associated financing difficulties for the Treasury, the yield curve continues to evidence a positive slope, with a spread between the 10-year bond and the three-month rate of over one percentage point (see Chart 6).

Notable on the foreign exchange markets (see Chart 7) is the strength of the dollar against the other currencies, due largely to the buoyancy of the US economy. Notwithstanding, the strong appreciation of the yen against the dollar, which began in August 1998, has been corrected only partially: between August and January, the yen had appreciated by close to 20 % against the dollar, and thereafter to mid-April it depreciated by 6 %. The course of sterling has been marked in part by interest-rate movements; since the Bank of England began, in October 1998, to reduce its intervention rate, sterling has depreciated in the period to April 1999 by 5 % against the dollar.

3. The euro area and the monetary policy of the European Central Bank

3.1. Economic developments

In 1999 to date, economic activity in the euro area has followed a similar pattern to that seen in the last quarter of 1998. The slackness of the industrial sector, linked to the generalised fall in exports, has persisted. Meanwhile, in the services sector, the level of activity remains very high, underpinned by the continuing buoyancy of consumption. Inflation remains low, although in March the increase in the price of oil has prompted a rise of two-tenths of a point in the 12-month growth rate of the HICP to 1 %. In the labour market, the unemployment rate has held stable at its January level (10.5 % of the labour force).

The latest revision by Eurostat of the national accounts of the euro area has confirmed that, in the fourth quarter of 1998, the loss of buoyancy in output seen in the preceding quarter stepped up. This was due to an additional slowdown in the external sector and in certain investment components (namely stockbuilding, though also fixed capital investment to a lesser extent). However, private consumption performed very positively, as reflected in progressively higher growth rates. Thus, the resulting strength of domestic demand meant GDP growth rose to 2.9 % for the year as a whole, higher than the preceding seven years (see Chart 5).

As regards the opening months of the year, the confidence surveys available to March reflected the persisting dichotomy since the second half of 1998 between business and consumer confidence. The former underwent a further deterioration during the first quarter of 1999, placing it clearly below the average for the past ten years, while the latter held at its highest level since this indicator first began to be compiled in 1985 (see Table 1).

The adverse performance of business confidence has been largely due to the additional deterioration in orders and, in particular, in foreign orders. It should nonetheless be clarified that the decline in the business confidence index and in orders between the first quarter of 1999 and the last quarter of 1998 has been on a lesser scale than the fall in these indicators between the third and fourth quarters of 1998. For its part, the indicator tracking the assessment of stock levels has stabilised. These signs, along with the muted recovery in industrial production (which grew 1.7 % year-on-year) in January and the improvement in the international environment, point to the possibility that the slowdown in the industrial sector will be cushioned in the coming months.

TABLE 1

Euro area: qualitative indicators

	1989-1998	1998	1998				1999	1998			1999		
			Q 1	Q 2	Q 3	Q 4	Q 1	OCT	NOV	DEC	JAN	FEB	MAR (p)
MONTHLY SURVEY (PERCENTAGE BALANCES):													
Industrial confidence	–8	–1	2	2	–1	–7	–11	–5	–8	–9	–9	–11	–12
Order books	*–18*	*–5*	*–2*	*–1*	*–4*	*–13*	*–20*	*–10*	*–14*	*–15*	*–16*	*–20*	*–23*
External orders	*–20*	*–7*	*–1*	*–3*	*–5*	*–17*	*–24*	*–13*	*–18*	*–21*	*–20*	*–25*	*–28*
Stocks	*11*	*9*	*7*	*7*	*8*	*11*	*14*	*10*	*11*	*13*	*14*	*15*	*14*
Costruction confidence	–24	–19	–25	–22	–13	–15	–9	–17	–14	–14	–9	–9	–9
Orders	*–32*	*–25*	*–33*	*–28*	*–19*	*–21*	*–17*	*–23*	*–21*	*–20*	*–19*	*–18*	*–15*
Retailer confidence	–7	–2	–2	–4	–1	–3	–3	–1	–4	–4	0	–4	–6
Consumer confidence	–15	–5	–8	–5	–5	–2	0	–3	–2	–1	0	0	–1
Economic sentiment index (1985 = 100)	101.2	104.0	103.8	104.9	104.4	103.6	104.2	103.3	103.8	103.8	104.5	104.2	104.0
QUARTERLY SURVEY:													
Capacity utilisation (%)	81.7	83.2	82.8	83.4	83.7	82.8	81.9						

Source: European Commission.

Turning to construction, the related confidence index is holding stable at high levels, above those of the seven preceding years and comparable to those achieved in 1991. The recent performance of new construction orders is particularly positive in this sector. These results, which are not yet reflected in the sector's output data (which, across the euro area, are running at negative year-on-year rates), might presage something of a recovery in residential investment in the near future.

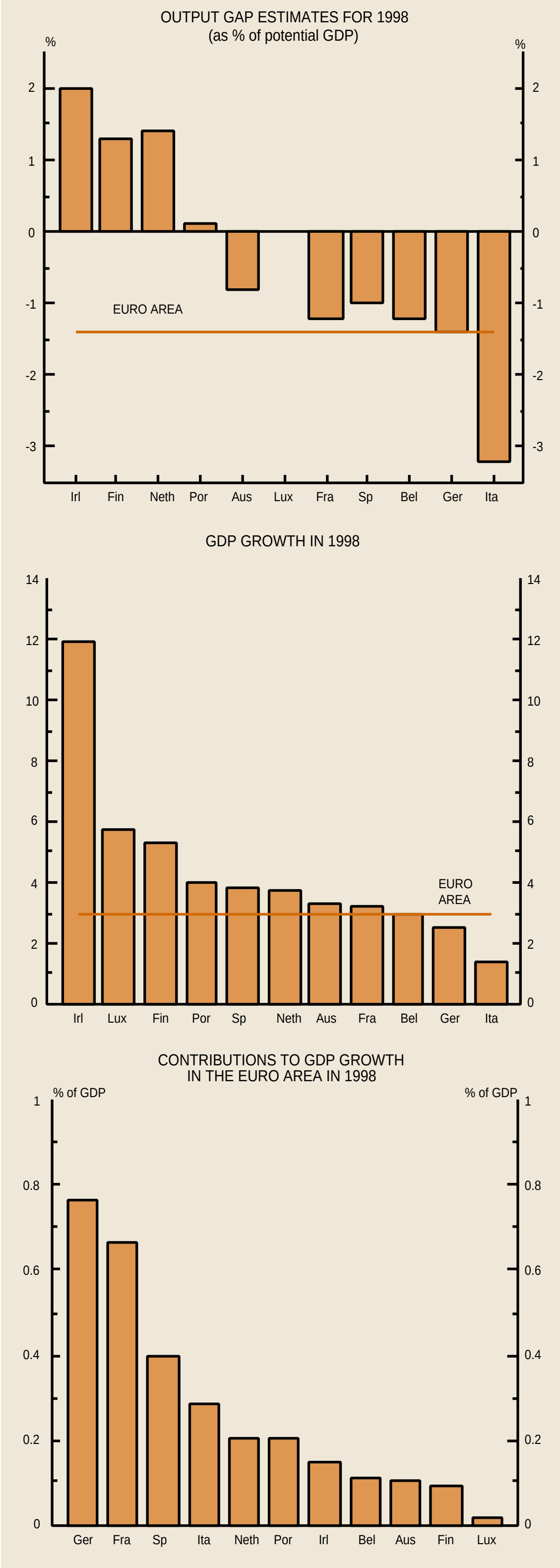
The available consumption indicators (retail sales and new passenger car registrations) reflect, to some degree, the continuing resilience of consumption, in line with the sustained high level of confidence. In January, retail sales slowed slightly, while new passenger car registrations grew at a year-on-year rate of 5.6 % in February (5.1 % in January). In any event, registrations across the area as a whole mask widely differing developments in the various countries. For example, whereas in Austria registrations fell in February by 7.3 % compared with twelve months earlier, in Portugal they increased by 42.8 %. Nonetheless, retail traders' confidence has worsened significantly during the quarter, although still above the average for the past ten years, a development in contrast to the information furnished by the indicators of national consumption.

Data on the foreign sector are currently confined to the trade balance for the euro area to December, when the slowdown in exports seen in the preceding quarters steepened. The cumulative trade surplus in 1998 (1.4 % of GDP) was 7 % less than in 1997. That said, the gain in competitiveness accumulated by the euro since the start of the year, along with the improvement in conditions outside the area, might contribute in the coming months to a recovery in the contribution of the external sector to growth (see Chart 7). Indeed, during the first quarter of 1999 the euro was somewhat weak against the main currencies, particularly the dollar, whose value was bolstered by the soundness of the US economy and by the effects of the Balkans crisis. The nominal effective exchange rate of the euro against the currencies of the European Monetary Union's main trading partners depreciated by 5 % between December 1998 and the first half of April, which meant a gain in competitiveness of around 6 % over the same period.

With regard to the cyclical synchrony of the euro-area countries, actual GDP – according to the OECD output gap estimates for 1998 – in most of the countries in the area would have increased by less than potential GDP. Only those countries that showed appreciably higher growth in previous years than the average for the area (the case of Ireland, the Netherlands, Finland and Portugal) grew above their potential in 1998 (see Chart 8). Conversely, Italy and Germany were the countries that grew least in

CHART 8

Output gaps and GDP in the euro area



Sources: OECD («Economic Outlook» December 1998) and national statistics.

1998, clearly below their potential, owing to the strong contraction in their exports.

In the first two months of 1999, inflation in the euro area, measured by the 12-month rate of change of the Harmonised Index of Consumer Prices (HICP), was stable. In both months the HICP grew 0.8 % year-on-year, unchanged on November and December 1998 (see Chart 9). In March, however, the HICP climbed to 1 %, chiefly as a result of the recent sharp increase in energy prices, whose year-on-year rate thus came to stand at –2.8 % that month (as opposed to –4.2 % in February).

Thanks to a moderate but continuous employment creation process being sustained throughout 1998 and in the opening months of 1999, there has been a significant reduction in the average unemployment rate in the euro area. Thus, despite the recent economic slowdown, the fall in business confidence and the worrying outcome of wage bargaining in certain countries, the euro-area unemployment rate measured in harmonised terms fell by three-tenths of a point in January to 10.5 % of the labour force and held at this level in February (see Chart 5).

With regard to the fiscal policies of the EMU member states, the overall results for the area for 1998 were significantly better than expected. It is estimated that the budget deficit amounted to 2.1 % of GDP, signifying an improvement on the previous year (see Table 2). However, it should be recalled that this improvement has been largely due to circumstantial factors such as the favourable contribution of the fall in interest rates to reducing debt service costs and the robust economic growth during the year. Significantly, then, between 1997 and 1998 there was a slight reduction in the primary surplus from 2.5 % to 2.4 % of GDP.

The general government balance of the euro-area countries has fallen more as a result of a favourable economic situation than of actual progress in terms of fiscal consolidation. And this highlights once more the need further to reduce structural budgetary imbalances, so that all countries in the area may comply with the Stability and Growth Pact. The adverse effects that the economic slowdown may have on budget deficit forecasts for this year in certain countries are indicative of the relative ease with which room for manoeuvre may be lost in fiscal policy when the economic situation turns unfavourable. It brings to light the need to attain structural balances which, even in adverse circumstances, ensure compliance with the budget deficit ceilings agreed on by the member states.

3.2. Monetary and financial developments

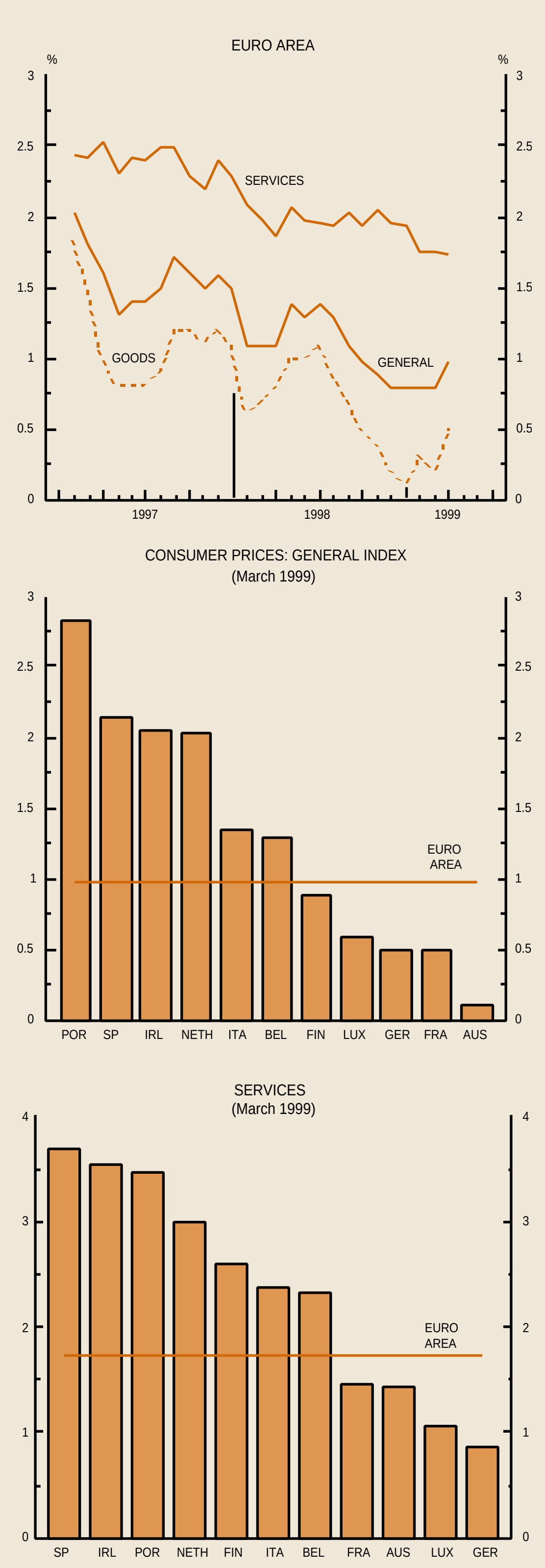
The basic elements of the Eurosystem's monetary policy strategy were defined in the second half of 1998. The objective of maintaining price stability was targeted specifying a 12-month increase in the harmonised index of consumer prices (HICP) in the area as a whole of less than 2 %. It was also announced that monetary policy decisions would be taken on the basis of the overall assessment of a broad set of variables with properties as leading indicators of price developments. Among such variables, a predominant role was to be assigned to the monetary aggregates. It was further decided that implementation of this monetary policy strategy would be pursued in a decentralised manner via the national central banks and that it would be based essentially on open market operations. These would be conducted via the weekly main refinancing operations and the monthly longer-term refinancing operations. Further, standing facilities would be set in place at the permanent disposal of the financial sector counterparties, with their interest rates limiting fluctuations in short-term interest rates. This framework was complemented with a reserve requirement of 2 %, remunerated at market interest rates.

At end-1998 and for the start of Monetary Union, the Governing Council of the ECB set the interest rates on the lending and deposit facilities at 4.5 % and 2 %, respectively, and that on the main refinancing operations at 3 %. However, it was agreed temporarily to narrow the standing facilities corridor during the first three weeks of January to between 2.75 % and 3.25 %. The aim was to smooth adaptation by the counterparties to the changes entailed by the start of the Third Stage, such as the coming on stream of the new interbank payment system, TARGET, and the conversion into euros of a large number of financial transactions.

In 1999 to date, the Governing Council of the ECB has analysed the economic situation of the euro area at its meetings, assessing whether a change in the single monetary policy stance was advisable and taking into account at all times the indicators available on monetary, financial and real-sector developments in the economy. During the first quarter, the rate on the main refinancing operations remained at its initial level of 3 % and, with the exception of the first three weeks, the rates on the lending and deposit facilities held at 4.5 % and 2 %, respectively. At the first meeting of the ECB Governing Council in April (April 8th) it was decided to cut the interest rate on the main refinancing operations by 50 basis points to 2.5 %, and the rates on the lending and deposit facilities were also

CHART 9

Harmonised Indices of Consumer Prices
Annual percentage changes



Source: Eurostat.

TABLE 2

General government balance in the euro-area countries
(as % of GDP)

	1994	1995	1996	1997	1998 (e)
Belgium	–4.9	–4.0	–3.1	–1.9	–1.3
Germany	–2.6	–3.3	–3.4	–2.7	–2.1
Spain	–6.2	–7.1	–4.5	–2.6	–1.8
France	–5.8	–4.9	–4.1	–3.0	–2.9
Ireland	–1.5	–2.1	–0.3	1.1	2.3
Italy	–9.2	–7.7	–6.6	–2.7	–2.7
Luxembourg	2.7	1.8	2.8	2.9	2.1
Netherlands	–3.8	–4.0	–2.0	–0.9	–0.9
Austria	–5.0	–5.1	–3.7	–1.9	–2.1
Portugal	–6.0	–5.7	–3.3	–2.5	–2.3
Finland	–6.6	–4.6	–3.1	–1.2	1.0
MEMORANDUM ITEM:					
Euro area					
Primary balance (a)	0.3	0.7	1.3	2.5	2.4
Total balance (a)	–5.1	–5.0	–4.1	–2.5	–2.1
Public debt	70.8	74.8	76.1	75.4	73.6

Source: ECB.
(a) Deficit (–) / surplus (+).
(e) Estimate.

cut to 3.5 % and 1.5 %, respectively (see Chart 10). The decision was based on an assessment of the economic situation; activity across the area was slowing and the inflation rate was very low, and there were no perceptible signs of risks that might endanger the Eurosystem's price stability target. As discussed elsewhere in this report, the real-sector indicators have, in recent months, been slowly deteriorating and this has led to a downward correction of growth prospects in the euro area and to more pessimistic business expectations. Although the monetary and financial data did not offer such an adverse picture of the economic situation, nor did they appear to signal the existence of inflationary risks. Finally, the Governing Council of the ECB concluded that price stability was firmly rooted in the current and foreseeable economic and financial context and that a reduction in interest rates was appropriate for the situation of the euro area as a whole and consistent with the strategy adopted. The reduction in the rates on the standing facilities has, moreover, meant a narrowing of the interest rate corridor and has made its bounds symmetrical to the rates on the main refinancing operations.

As foreseen, in the opening months of 1999 the Eurosystem has provided the bulk of the liquidity applied for by the financial sector counterparties via the main refinancing operations. By means of these weekly operations it has injected around 70 % of the liquidity granted to counterparties, which accounts, in the maintenance period ending 23rd April, for around EUR 130 billion, settled via fixed rate tenders announced beforehand to the counterparties. The remaining 30 % were injected via monthly longer-term refinancing operations, settled by means of variable rate tenders and, up to March, with a single rate tender. On 4th March, the Governing Council of the ECB decided that these long-term tenders, the interest rates on which convey no monetary policy signal, would be settled under the multiple rate method of allotment so that each bid accepted would involve payment at the bid as opposed to the marginal interest rate. In addition, counterparties have had access to the lending and deposit facilities to obtain additional financing or to place surplus reserves at the end of the day. A significant penalising component is built into the interest rates on these facilities and their use has been substantially confined to specific times, especially at the end of the minimum reserve maintenance periods, which is when the averaging provision of the requirement loses its stabilising potential. In the maintenance period ending 23rd April, the average daily use of both facilities accounted for only 1 % of the liquidity granted via regular open market operations.

The use of fixed rate tenders for the main refinancing operations has enabled the monetary policy stance to be clearly signalled. Yet, at the same time, it has given rise to certain difficulties in liquidity distribution. As the Eurosystem wishes to inject a specific volume of funds via these tenders, the announcement of a fixed rate has led counterparties to bid for more liquidity than necessary, since they anticipate that the rest of the sector will behave similarly. Thus, ultimately, the ECB has had to strongly ration the amounts allotted. This posed certain problems for counterparties not accustomed to rationing in the operations previously undertaken with their respective national central banks. To satisfy their liquidity requirements they had to resort to the interbank market, where the cost of liquidity was generally higher than the related tender cost. To ease the situation, the Eurosystem gave greater flexibility to the volumes of liquidity injected via the weekly tenders, so that the pressures on interbank interest rates abated. Thus, for example, the overnight interest rate (EONIA), which had stood until the end of February above the main operations rate (3 %), tended to hold thereafter at around this level.

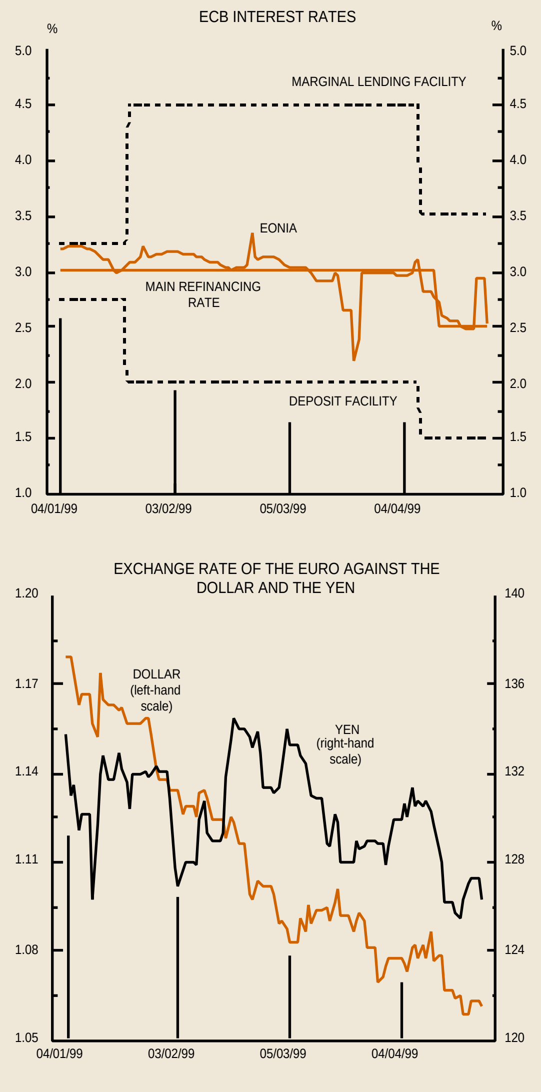
As mentioned, the course of the monetary aggregates is an essential factor in the analysis of the Eurosystem. Broadly, in the first two months of 1999, they showed the same pattern of behaviour as in 1998 in the euro area as a whole (see Chart 11). The benchmark monetary aggregate for the area, M3, posted 12-month growth rates of 5.6 % and 5.2 % in January and February, respectively. The latest available three-month moving average of this aggregate's year-on-year growth was 5.1 %, slightly above the reference value set by the Governing Council of the ECB (4.5 %). The acceleration in M3 was basically due to the strong rate of expansion of the most liquid financial assets. Specifically, the narrow monetary aggregate (M1) showed a much higher growth rate, running at 12 % year-on-year in February. This strong growth, which in any event was lower than in January, may have been influenced not only by the low level of interest rates but by special factors relating to the birth of the single currency and to the portfolio shifts arising as a result.

Turning to the credit aggregates, total credit to euro-area residents (including the extension of loans and purchases of fixed-income and equity securities by Monetary and Financial Institutions [MFIs]) continued to show high growth rates. In the twelve months to February, this aggregate expanded by 7.4 %. As in the recent past, this performance was the outcome of a very small increase in financing to general government, which stood in February at 2.2 % in year-on-year terms, and of a strong rise in lending to the other resident sectors (principally households and firms), which was 9.5 % that same month (see Chart 11).

The liabilities of MFIs not included in M3 showed moderate growth in the first two months

CHART 10

ECB interest rates and euro exchange rates



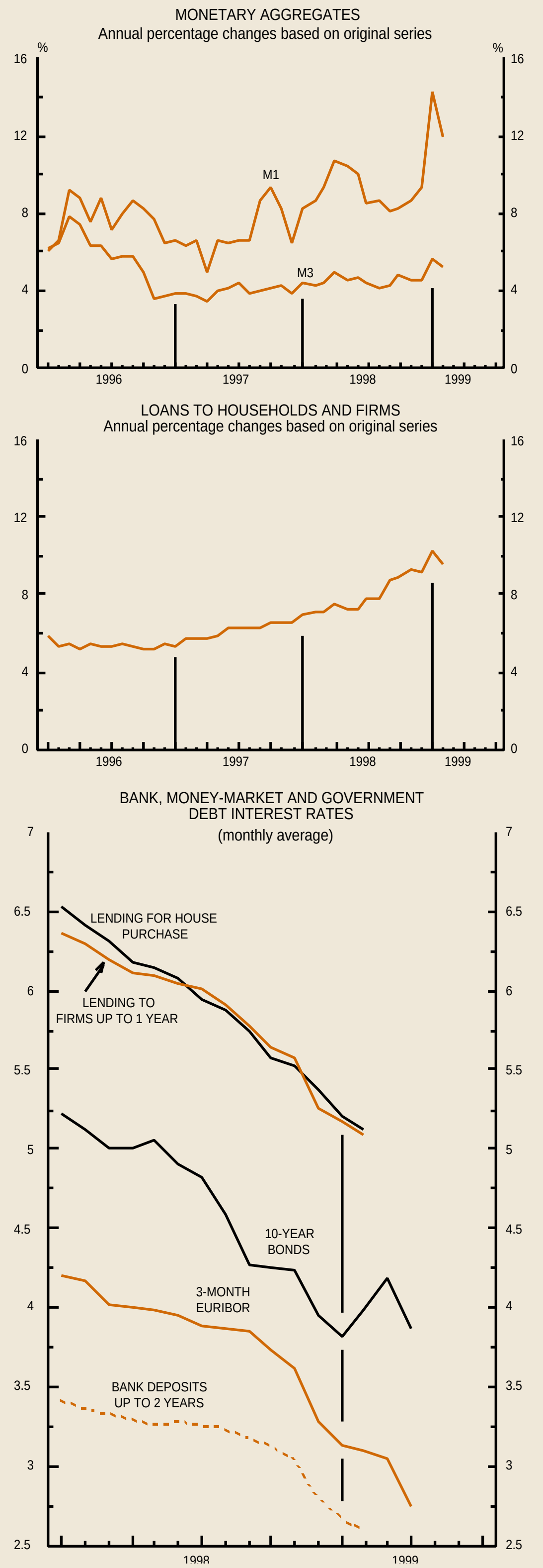
Sources: Banco de España and ECB.

of the year, the result of their uneven behaviour. Whereas fixed-income securities at over two years ran at relatively high rates (6.8 % year-on-year in February), long-term deposits held at rather negligible rates. MFIs' foreign assets and liabilities remained very volatile, although the decline in the net external position of these institutions initiated in 1998 continued.

EURIBOR rates (interest rates on the European interbank market) were marked by the gradual downward revision of interest-rate expectations attributable to the deterioration in growth prospects for the euro-area as a whole and to the favourable trend of prices. This

CHART 11

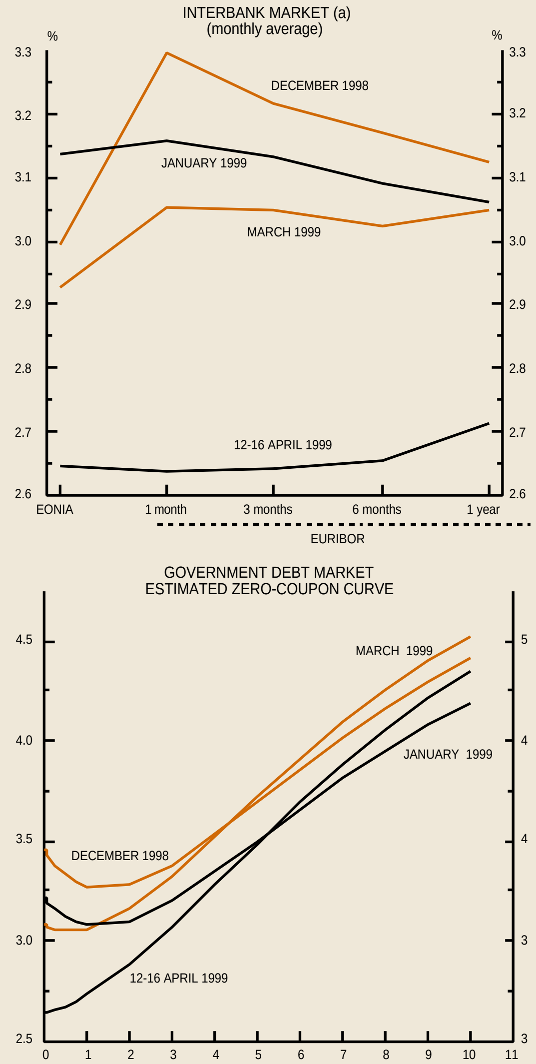
Monetary and credit aggregates and interest rates in the euro area



Sources: Banco de España and ECB.

CHART 12

Euro area yield curves



Sources: Banco de España and ECB.

(a) In December 1998, average of the interbank interest rates of the euro area countries.

downward revision of expected interest rates was reflected in shifts in the yield curve (see Chart 12), especially in the shortest-dated maturities, and in interest rates on futures. Three-month rates on euro futures maturing in June and September declined by around 25 basis points between late February and early April.

Although there was the odd upward-moving bout in longer-dated interest rates during the first quarter, they generally held fairly stable around the levels reached at end-1998 (see Chart 11). These increases were basically associated with external factors, linked to the upward revision of growth expectations in the US economy and to rises in Japanese bond rates. In this respect, the cut of 50 basis points to the Eurosystem intervention rate on 7th April was, due to its probably being greater than expected by the markets, reflected in a downward movement in long-term rates of about 10 basis points. As a result of the foregoing movements, 10-year bond rates stabilised in mid-April at around 4 %.

Bank lending rates, which are of particular relevance for spending and borrowing decisions by non-financial firms and households, continued on a downward course in the early months of 1999 (see Chart 11). In February, the latest month for which information is available, the average euro-area interest rate on loans extended to firms at over one year and on credit to households for house purchases stood at 5.1 %, 1.2 percentage points less than a year earlier. Movements in interest rates in the euro area were reflected in an increase in the short-and long-term spreads over the United States, although this would not appear fully to explain the progressive appreciation of the dollar against the euro (by 10 % from January to mid-April – see Chart 10). This process seems to be related more to the different growth prospects of the US and European economies and, probably, to developments in the Balkans conflict.

Equity markets in the euro area were generally affected by the increase in volatility on international markets. In early January, widespread rises were recorded on markets across the area, though they were subsequently corrected in part. Meantime, as from March, prices generally began to resume a slightly upward trend. In any event, throughout the first quarter of the year there was no sign of a clear trend on European stock markets. In this connection, the 4 % rise in the EURO STOXX general index from end-February to early April is in contrast to the clearly upward trend seen on the US and Japanese markets, probably as a consequence of the differing growth prospects for the economies involved.

4. The Spanish economy

4.1. Demand

On provisional INE estimates, the expansion in Spanish national demand accelerated in 1998. Real growth was 4.9 % on average during the year, well above the 2.9 % rate recorded in 1997. The rates of growth of all the components of demand increased. Construction spending and private consumption accelerated notably, as did capital investment. However, while construction spending gained momentum over the year, private consumption and capital investment slowed slightly in the second half, as did general government consumption. The result was that the rate of growth of aggregate national demand tended to stabilise. The contribution of net external demand, which had turned negative in the final quarter of 1997, became more broadly contractionary over the course of 1998, reducing output growth by 1.2 percentage points on average during the year. This result reflects the sharp slowdown in exports, as a consequence of the weakness of international (including European) markets, while imports remained notably buoyant, with only a slight moderation in the final months of the year.

The short-term information available for the first few months of 1999 tends to show a firming of the patterns of behaviour displayed by the main components of demand at the end of 1998, with the year-on-year growth rate of national demand estimated to have slipped by the odd percentage point. Specifically, it is estimated that private consumption and capital investment again recorded high real rates of growth, although they are still tending to slow moderately. By contrast, the rate of growth of construction spending accelerated further. The negative contribution of external demand to real output growth may have risen in this period as a consequence of the weakness of exports, while imports were sustained by the stronger final demand of the economy.

Most of the available private consumption indicators were expansionary in the first quarter of 1999, although no more so than in the previous quarter. Chart 13 shows, on the basis of very partial information, that the growth in the index of apparent consumption of consumer goods and services tended to moderate. This was a result of a loss of momentum in the food and consumer durable components, in the latter case despite the extraordinary surge in new passenger car registrations, which reached a year-on-year growth rate of 23.3 %, slightly higher than in the final quarter of 1998. The general retail sales index also slowed in the first two months of the year, in line with the deterioration in confidence apparent from the business surveys conducted in this branch. There has also been a further deterioration in recent months in the perceptions of the producers of such goods regarding the current course of demand, although they are more optimistic regarding the future.

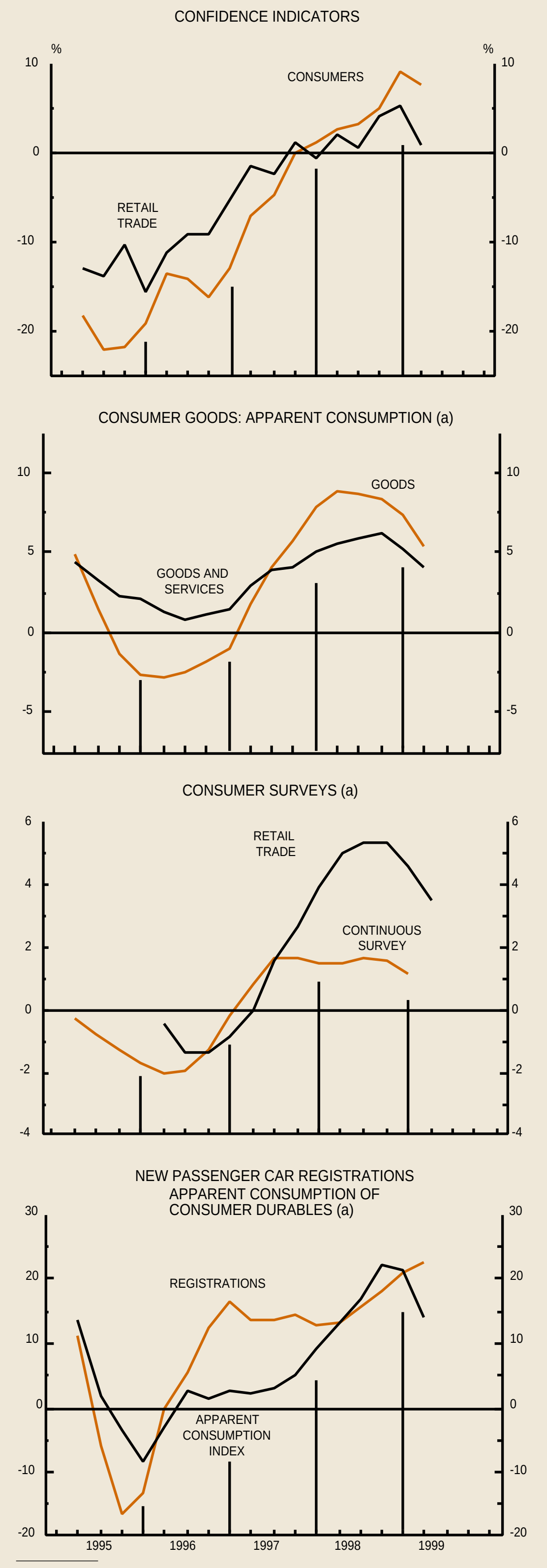
The growth in private consumption at rates slightly above 3.5 % is justified by the contribution of its main determinants and does not involve appreciable changes in the household saving ratio. However, as will be seen below, the strong increase in housing investment, in response to the decline in interest rates and cumulative wealth gains, is significantly reducing the private sector's financing capacity and increasing its borrowing. The rate of growth of household disposable income remains high, since lower growth in employee compensation – the result of a gradual decline in wage rates, against a background of a slight decrease in employment growth – has been offset by a reduction in withholdings on earned income. This reduction is a result of the tax reform introduced at the beginning of the year, which has led to an increase in spending capacity that is still difficult to quantify. At the same time, the cumulative decline in interest rates continues to drive the demand for certain consumer durables and, in particular, for new passenger cars, by making their financing significantly cheaper. Finally, according to consumer surveys consumers are highly optimistic.

On QNA estimates, government consumption increased by 1.2 % year-on-year in real terms during the fourth quarter of 1998, continuing the slowdown commenced at the beginning of the year. This rate of growth was sustained in the first quarter of 1999, owing to the moderation in the compensation, in real terms, of general government employees, as a consequence of the lower increase in public-sector employment. In nominal terms, employee compensation slowed somewhat from the previous quarter. The real rate of growth of net purchases of goods and services fell slightly, while fixed capital consumption accelerated, in step with the greater buoyancy of public investment in 1998.

The acceleration of gross fixed capital formation, which began at the end of 1996, seems to have halted in the first quarter of 1999. Unlike last year, the greater strength of investment in construction does not seem to have fully offset the further moderation in the capital goods component, as shown by most of the available indicators (see Chart 14). These include the indicator of apparent investment in capital goods, which has continued its downward path in the first few months of the year as a consequence of the lower buoyancy in the domestic output of

CHART 13

Private consumption indicators



Sources: Instituto Nacional de Estadística, European Commission, Dirección General de Trabajo and Banco de España.

(a) Non-centred percentage change on same quarter a year earlier, based on the trend of the indicator.

CHART 14

Gross fixed capital formation indicators

Sources: Ministerio de Fomento, Oficemen and Banco de España.

(a) Non-centred percentage change on same quarter a year earlier, based on the trend of the indicator.
(b) Level, trend.
(c) Obtained from the quarterly construction industry survey and deflated by the construction costs indicator. Four-quarter rate of change based on original series.

such goods, since imports continue to grow at high rates. The confidence indicator of the capital goods production industry also declined further in the first two months of the year, compared with the final quarter of 1998. Finally, investment plans for 1999 for industry as a whole have been revised significantly downwards, according to the Ministry of Industry and Energy's half-yearly investment survey carried out in autumn 1998. This produced a forecast of 4 % investment growth in 1999 as a whole, in real terms, against the 8 % estimated for 1998.

In any event, the buoyancy still being displayed by capital investment (with year-on-year increases of more than 10 %) is justified by two factors: the favourable financial position of Spanish firms – a result of both their high fund generating capacity and of successive cuts in interest rates, which have substantially reduced the cost of borrowing – and the strength of domestic demand, despite the strong deceleration in external sales. This situation is reflected in the Central Balance-Sheet Office data for the fourth quarter of 1998, a period in which the profitability ratios of the firms were at very high levels, similar to those of the preceding quarters.

On QNA data, investment in construction was stronger in the fourth quarter of 1998, growing by 7.8 % year-on-year. The most recent indicators, referring to the first quarter of 1999, show that this aggregate was very expansionary. Although certain signs of moderation are apparent in the acceleration that has continued uninterrupted since end-1996, its growth has possibly reached rates of well over 8 %. Specifically the concurrent input and employment indicators for this branch show very high rates of growth in the first few months of the year, similar to those seen in the preceding quarter. Thus, apparent cement consumption grew by 18.9 % in January and February, against 19.8 % in the fourth quarter of 1998, while social security registrations and registered unemployment trended very favourably. In the same vein, sentiment in the construction sector regarding current levels of output continued to rise in the first two months of the year, although a slight decline is noted in surveys of order-book levels and future output.

The continuing buoyancy shown by investment in construction is endorsed by the trend estimated on the basis of leading indicators. Information on private-sector building – permits granted by local authorities and architects' associations' approvals – was very expansionary in 1998. The improvement in the spending capacity of households and the healthy financial situation of firms, together with the fall in the cost of financing for house purchases, justify the vigour of this segment of spending. Public works also acquired notable strength, according to figures for government tenders, which rose by 49.6 % in 1998 (against 2.1 % in 1997), in step with the increase in budget appropriations for the enlargement and improvement of infrastructure.

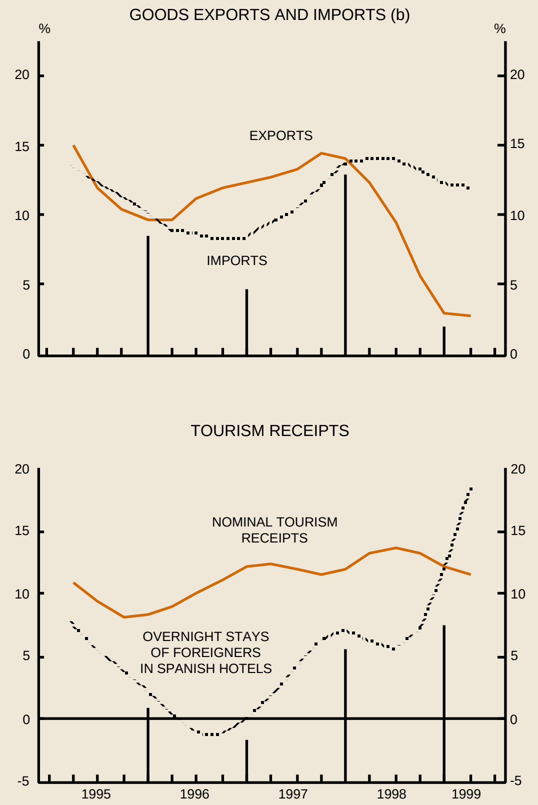
The level of stocks increased progressively during 1998 to account for three-tenths of a percentage point of real output growth in the final quarter. The decline in commodity prices and interest rates has led to a fall in the cost of holding stocks which has clearly raised the desired levels of stocks. This trend may have continued in the first quarter of 1999, as no significant changes in their determinants are appreciated. In addition, the results of the monthly business survey for the first two months of the year indicate that the percentage of firms holding stocks at a higher level than desired held steady at levels similar to those seen at the end of 1998. Thus, the contribution of this aggregate to output growth may have been sustained in the first quarter of the year.

On QNA estimates, the negative contribution of net external demand to GDP growth strengthened in the fourth quarter of 1998, as a consequence of the sharp slowdown in exports, while imports sustained high – albeit decreasing – real rates of growth (see Chart 15). The information available for the first quarter of 1999 suggests that the negative impact of real net external demand on output growth may have increased (exceeding the 1.4 percentage points estimated by the INE for the preceding quarter), due to the pronounced weakness of external sales and the buoyancy of imports, underpinned by the strength of domestic demand and the fall in the prices of foreign goods.

According to Customs data, goods exports grew at a negative real year-on-year rate in the final quarter of 1998, for the first time since 1986. The latest information suggests that exports remain very depressed and declined at a year-on-year rate of –0.3 % in January and February. This is a consequence of the weakness of sales to EU countries, in line with the slowdown in their economic activity in recent months, as well as the sizeable decreases in those to the emerging economies of south-east Asia and Latin America and the transitional economies of Eastern Europe. By group of product, all components grew at negative real rates in January, except for exports of capital goods, which show notable growth. In contrast to the progressive weakening of goods exports, tourism receipts remained highly buoyant in the first few months of the year. According to the balance of payments figures they rose by 16.1 % in the first two months of 1999, while the number of tourist visits and foreign visitors staying in hotels grew considerably to March. This is explained by the depreciation of the euro in the first few months of the year and the high levels of confidence of European consumers.

CHART 15

Foreign trade (a)



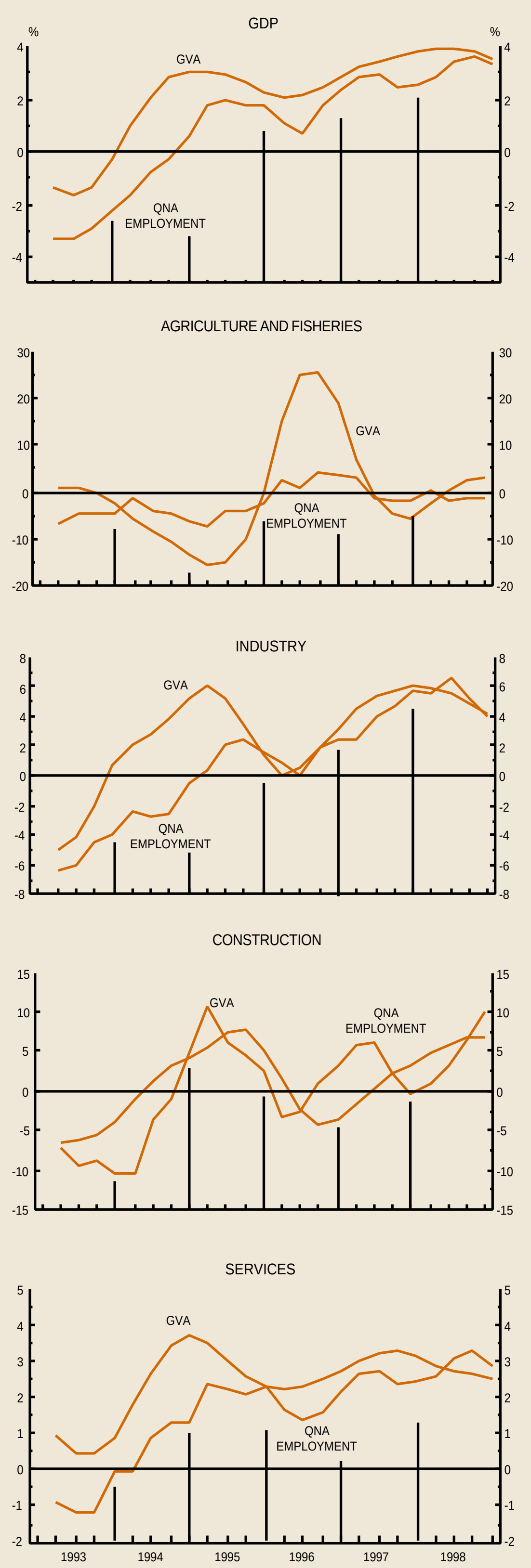
Sources: Ministerio de Economía y Hacienda, Instituto Nacional de Estadística and Banco de España.

(a) Non-centred percentage change on same quarter a year earlier, based on the trend of the indicator.
(b) These series are deflated by their related unit value indices.

As for imports, their real rate of growth stood at 8.3 % in January and February, exactly the same rate as in the preceding quarter. Purchases of capital goods and non-food consumer goods grew steadily, while those of non-energy intermediate goods held at a very moderate tempo, in step with the weakness of industrial activity. Imports of energy intermediate goods sustained high real rates of growth, driven by the fall in their prices in the first few months of the year. Finally tourism payments continued to increase strongly.

CHART 16

Gross value added and employment by branch of activity
Rate of change



Source: Instituto Nacional de Estadística.

4.2. Output and employment

On provisional INE estimates, the modest slowdown in real GDP in the second half of 1998 continued during the first quarter of 1999. Accordingly, year-on-year real GDP growth will have been around 3.5 % in this period, one-tenth of a percentage point lower than in the preceding quarter and three-tenths of a point below the average rate in 1998. From the viewpoint of productive branches, the slight loss of momentum is basically due to the behaviour of industrial activity, linked in turn to the effects of the international crisis on the export sector. As mentioned above, construction has not strayed from its accelerating path and services are displaying greater stability, albeit with a trend of slight deceleration. In this context, employment growth continues to be notable, having ended 1998 at a rate of growth of 3.3 %, according to the QNA estimate, somewhat below the level recorded at the beginning of the year (see Chart 16). This picture of smooth deceleration in the rate of growth of jobs, similar to that seen in real output, seems to be confirmed by the indicators available for the first few months of 1999.

In the fourth quarter of 1998 primary activity extended the headway observed since the beginning of the year. However, the low rainfall in the second half meant that the advances became smaller, and in the final quarter of 1998 the year-on-year rate of growth of gross value added stood at 3.1 %, in accordance with the QNA estimate. Agricultural output was hit particularly hard by the unfavourable weather, especially those crops which ripen in the second half of the year, such as fruit and wine grapes. These trends seem to have remained broadly the same at the beginning of 1999, although the impact of the adverse weather on the activity of the sector has become stronger.

As mentioned above, the fall in exports of industrial products has primarily affected industrial activity, excluding construction. As a result, the rate of growth of the gross value added generated by this branch dipped slightly during 1998, although it remained buoyant. According to the data for the first few months of 1999 the slowdown continued. The cumulative growth in the industrial production index (IPI) in January and February was 2.2 %, compared with the increase of 4.8 % in the final quarter of 1998, both rates being adjusted to take into account the different number and distribution of working days. Also, the business climate indicator reached one of its lowest values for two years in February 1999, largely as a result of the deterioration in order books.

The loss of buoyancy apparent in the IPI data extends to all their components, although to a varying degree. The reduction in the year-on-year rate of growth of the index of production of consumer goods (cumulative growth of 0.3 % to the month of February, against 5.6 %, on homogenous terms, in the fourth quarter of 1998) is notable, especially in the food aggregate, although this decline also affects the rest of its components, including consumer durables. The slowdown in the production of capital goods is less severe, and that of intermediate goods is practically imperceptible. In the latter case it is cushioned by the upturn in energy production. By the branches of origin of the products, the metal industry has remained most buoyant.

As seen from the viewpoint of demand, construction activity intensified during 1998. This vigour stemmed from the growth in civil engineering projects and house building and, given the further headway indicated by the available first-quarter data on the apparent consumption of cement and the numbers of persons registered for Social Security, it can be expected to be sustained.

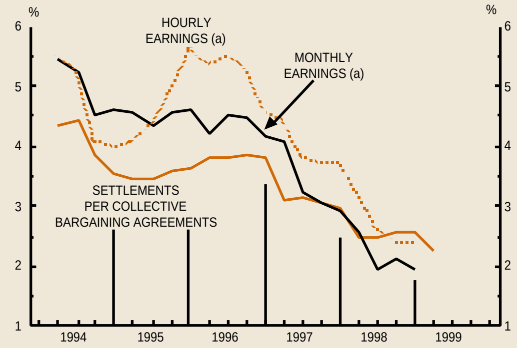
The rate of growth of value added in the services branch is displaying greater stability: the smooth slowdown seen since end-1997 in both its components (market and non-market services) is not so large. The information available for the first quarter of 1999 – albeit very scant – shows no significant change. The moderate slowdown seen in certain branches can be expected to be mitigated by the strength of others – inferred from the available employment data – such as hotel and catering and telecommunications.

The boost to the generation of employment in 1998, consistent with the strength of productive activity and the moderation in the growth of average labour costs, weakened in the fourth quarter of the year. On QNA data, the number of persons employed rose by 3.3 % year-on-year in the fourth quarter, three-tenths of a percentage point below the rate in the third quarter. This more subdued performance was preceded by the slowdown in employees in employment in the third quarter. However, this aggregate continued to grow at a high rate (4.3 % at the end of 1998), and there was a slight increase in the second half of the year in the rest of the employed labour force in relation to the same period of 1997, after a year and a half of declines.

The available data on social security registrations and registered unemployment for the first quarter of 1999 suggest that the moderate slowdown in the number of jobs created during this period will continue, in step with economic activity and its distribution between the main productive branches. Thus, on March data the number of Social Security registrations seems to have dipped. Although the detailed information only goes up to February, registrations in construction and in services were notably buoyant, while in industry the slowdown which began last summer firmed. As for registered unemployment, the rate of decline of the first quarter (13.8 %) was similar to that at end-1998. This decline was at its strongest in agriculture and services and more moderate in industry, while in construction the sharp decline in unemployment of 1988 was sustained.

CHART 17

Wages
Annual percentage changes



Sources: Instituto Nacional de Estadística and Ministerio de Trabajo y Asuntos Sociales.

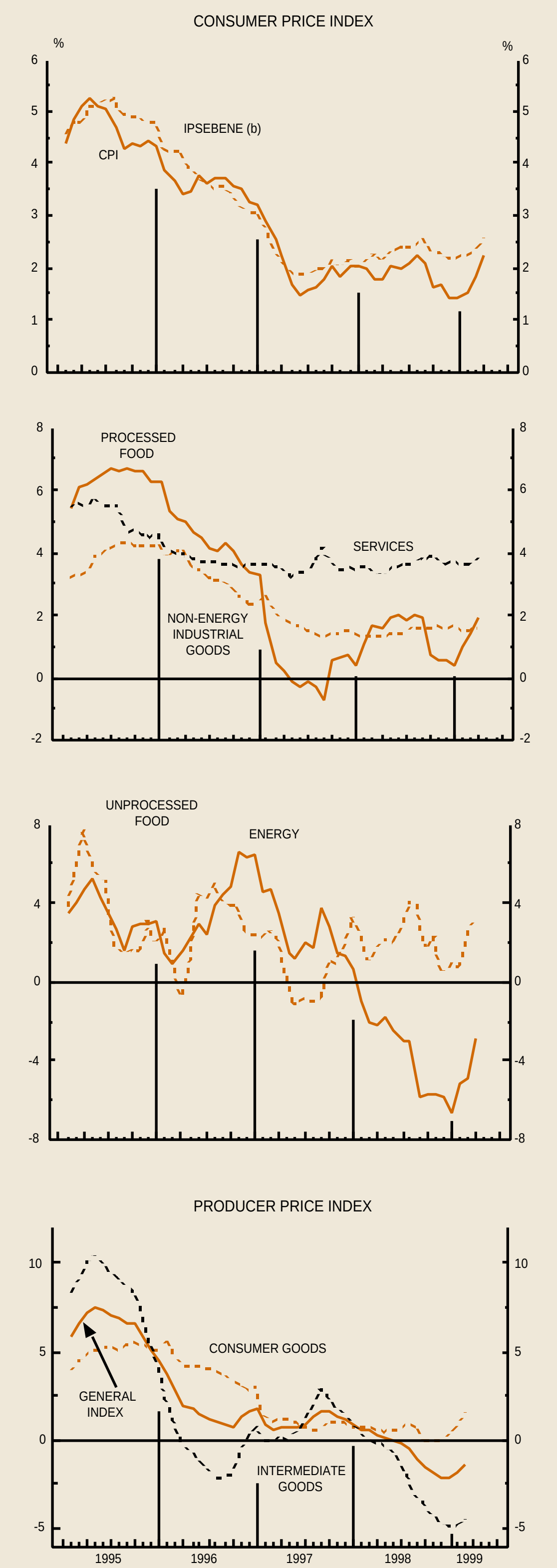
(a) Basic pay.

4.3. Costs and prices

According to the wage survey, average hourly earnings (in terms of basic pay) rose by 2.4 % in the fourth quarter of 1998 in relation to the same period a year earlier. In the year as a whole, such earnings grew on average by 2.6 %, more than one percentage point less than in the previous year (3.9 %). As has become usual, the increase in average monthly earnings was somewhat lower (1.9 % in the fourth quarter and 2.1 % on average during the year), as a consequence of the hiring of workers on shorter hours. By branch of activity, the largest increase in average hourly earnings in the fourth quarter was in construction (3.5 %) – which also saw the emergence of a slightly accelerating profile during the year – followed by services (2.9 %) and industry (2 %). The latter sector saw a marked containment of wages in 1998. There was also a general reduction in wage drift in 1998. This phenomenon is affect-

CHART 18

Price indicators (a)
Spain



Source: Instituto Nacional de Estadística.

(a) 12-month percentage change based on original series.
(b) Index of non-energy processed goods and services prices.

CHART 19

Price indicators (a)
Euro area

Sources: Banco de España, national statistics and Eurostat.

(a) The first quarter data for 1999 are a forecast, except for UK GDP, which is an estimate.
(b) Percentage of labour force.

ed by various factors, among which the hiring of new workers on low wages, the elimination in some branches of seniority pay and the lower growth in the number of hours of overtime worked stand out.

The average increase in wage rates in the collective bargaining agreements registered to 31 March – which gives an indication of how wages will behave in the year as a whole – was 2.3 %, three-tenths of a percentage point below the average growth in 1998 (see Chart 17). This further headway in the process of wage deceleration would, if confirmed, mean a slight increase in real wages, albeit lower than the forecast growth of apparent labour productivity. To date, 95 % of the agreements registered correspond to revisions of agreements spanning several years signed in previous years, with an average settlement of 2.3 %; newly signed agreements, scarcely significant so far, showed more moderate growth (2 %). By branch of activity, only in services was a representative number of agreements signed, with an average recorded settlement of 2.4 %, several tenths of a percentage point higher than that in industry and construction.

Most indicators of prices in the Spanish economy deteriorated during the first few months of 1999 (see Chart 18). Thus, in March, the year-on-year rate of change of the CPI stood at 2.2 %, eight-tenths of a percentage point higher than in December. This unfavourable outturn fed through to the most stable component of the CPI, the IPSEBENE (index of non-energy processed goods and service prices), which was already recording higher rates than the general index. In March it rose year-on-year by 2.5 %, three-tenths of a point above the growth in December. The harmonised index of consumer prices (HICP) grew by 2.1 % in March with respect to the same month of 1998. As the rates in the countries which make up the euro area increased to only 1 %, the differential continued to widen. The gap recorded in the service component is especially significant, although that of non-energy industrial goods is also tending to widen (see Chart 19).

Since December 1998, the rates of growth of all the components of the CPI, with the sole exception of non-energy industrial goods (whose inflation stabilised at 1.6 %) rose, the more erratic ones to a greater extent. Unprocessed food prices grew by 3.2 % year-on-year in March, as against 0.9 % at end-December and, with the oil price on international markets beginning to pick up and electricity tariffs being reduced in the first few months of 1999 by less than in the preceding year, the growth rate of the prices of energy goods rose from –6.6 % to –2.9 % over the same period. The rate of growth of processed food prices rose from 0.4 % to 1.9 %, due in part to the increase in tobacco and olive oil prices. Finally, services prices increased by 3.8 %, as has become usual well above the increases in the prices of other products, and above the rise recorded in December (3.7 %). Product by product, the largest differentials with respect to the euro area in February continued to be found in services inflation (approximately 2 %), although the gap was also significant for non-energy industrial goods (1 %).

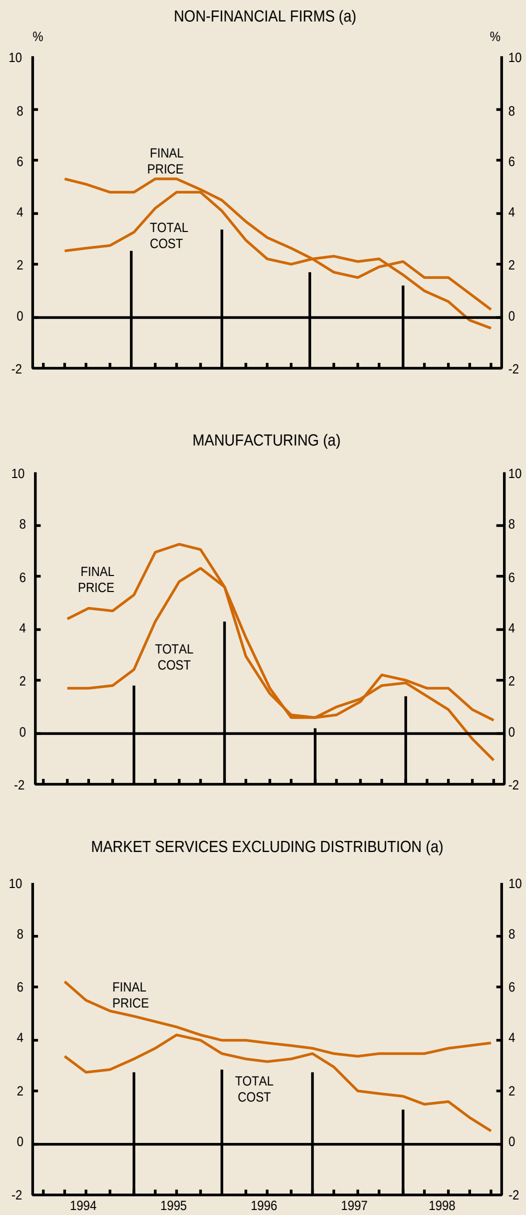
The year-on-year rate of change of the producer price index was still negative in February (–1.4 %), although less so than at the end of 1998 (in December the year-on-year rate was –2.1 %). This profile basically matches that of food consumer goods, which rose by 1.7 % in February after falling at a rate of 1.1 % in December, due above all to the behaviour of tobacco and olive oil prices. The price of intermediate goods also followed a somewhat less favourable path, with a reduction of 4.6 %, against 4.9 % in December. By contrast, inflation of non-food consumer goods fell by two tenths of a percentage point to stand at 1.2 %, while that of capital goods held steady at 0.3 %. The trend in prices received by farmers for agricultural products was less favourable in the fourth quarter of 1998, the upward profile of vegetable prices being notable.

Import unit value indices slowed again in January 1999, falling by 6.6 % with respect to the same month of 1998. The sharp fall in import prices was, above all, a consequence of energy prices, which have still not reflected the rise in the price of crude oil on international markets.

Combining the information furnished by these price and cost indices in the accounting framework of input-output tables for the Spanish economy, indicators can be obtained for the process of price formation and, residually, the behaviour of operating margins (see Chart 20). In the fourth quarter of 1998, the latest for which complete information is available, there was a significant slowdown in the final prices of non-financial firms (most pronounced in the case of goods sold on export markets), which was also accompanied by lower growth in variable costs, so that the unit operating margin was practically unchanged. As for costs, the trend in unit labour costs was somewhat less favourable. This was connected with the slowdown in apparent productivity caused by the lower buoyancy of activity. Nonetheless, this behaviour was offset by the decline in interme-

CHART 20

Price and cost indicators



Sources: Instituto Nacional de Estadística and Banco de España.

(a) Non-centred percentage change on same quarter a year earlier, based on the trend of the indicator.

diate costs, linked to the sharp reduction in import prices.

By branch of activity, prices and margins continued to behave differently in manufacturing and services. In manufacturing, final prices fell by 1.3 %, as a result of the reduction in the international prices of competing products and the pressure of demand which, although high, was lower than in the preceding quarters. Unit variable costs also slowed, although by a smaller amount, since the greater vigour of unit labour costs offset the reduction in the cost of intermediate goods. This led to a squeezing of operating margins as a percentage of output. Service prices grew at high rates, well above those of their variable costs, which behaved more like those in the other branches of activity. In consequence, the gross operating margin per unit of output continued to widen.

4.4. The State budget

In the first quarter of 1999, the State cash-basis deficit fell by 3.1 % in relation to the same period of 1998. This decline was the result of revenue (up 23 %) rising by more than expenditure (up 19.2 %) (see Table 3), in contrast to the budget forecast of a small reduction in revenue (0.5 %) and a slight increase in expenditure (1.2 %). In order to assess the budget outturn during this period it is necessary to take into account the impact of certain extraordinary factors. As regards revenue, the high year-on-year growth in the first quarter was, above all, a consequence of the reduction in the volume of rebates in respect of the main taxes, since the Treasury, to adapt to the new shorter rebate periods (generally six months), speeded up their processing during the final months of 1998, with the result that rebates pending at the beginning of 1999 were much lower than a year earlier. Moreover, there was extraordinary revenue of ESP 340 billion corresponding to capital gains recorded by the Banco de España, which exceeded the ESP 224 billion raised in 1998 from the privatisation of Argentaria. As for expenditure, the concentration of interest payments in the first few months of 1999 should be mentioned. In any event, if these effects are eliminated, the improvement in the cash-basis deficit in relation to the budget would be maintained and its reduction with respect of the first quarter of 1998 could be even greater.

The data released in the National Accounts framework, however, show that the cumulative State deficit in the first quarter of 1999 stood at ESP 912 billion, 29.3 % higher than in the same period of 1998. Expenditure rose by 19.2 %, in line with the increase according to the cash-basis criterion, while revenue grew by 17.4 per cent, which was less than in cash terms. This difference was primarily due to the revenue in respect of capital gains and privatisation proceeds mentioned above, which is not recorded as current revenue when the National Accounts methodological criteria are applied. In any case, when the discrepancies in the schedule of revenues and expenditure mentioned above are

TABLE 3

Budget: outturn

ESP billions and %

	Outturn 1998 1	Initial projection 1999 2	Percentage change 3=2/1	Outturn 1998 JAN-MAR 4	Outturn 1999 JAN-MAR 5	Percentage change 6=5/4
1. Revenue	**17,534**	**17,445**	**–0.5**	**4,064**	**5,001**	**23.0**
Direct taxes	7,457	7,431	–0.3	1,370	1,861	35.8
Personal income tax	*4,992*	*5,201*	*4.2*	*1,344*	*1,678*	*24.9*
Corporate income tax	*2,324*	*2,082*	*–10.4*	*5*	*158*	—
Other	*140*	*149*	*5.7*	*22*	*25*	*11.1*
Indirect taxes	7,015	7,524	7.3	1,885	2,161	14.7
VAT	*4,373*	*4,807*	*9.9*	*1,268*	*1,494*	*17.8*
Excise duties	*2,391*	*2,463*	*3.0*	*563*	*603*	*7.0*
Tariffs	*132*	*133*	*0.8*	*29*	*33*	*16.6*
Other	*120*	*120*	*0.7*	*25*	*31*	*26.8*
Other net revenue	3,063	2,490	–18.7	809	979	20.9
2. Expenditure	**18,649**	**18,867**	**1.2**	**4,759**	**5,674**	**19.2**
Wages and salaries	3,053	3,132	2.6	654	656	0.4
Goods and services	388	340	–12.4	116	133	14.7
Interest payments	3,334	3,042	–8.8	1,051	1,593	51.6
Current transfers	9,906	10,411	5.1	2,411	2,665	10.5
Investment	898	945	5.3	300	409	36.3
Capital transfers	1,071	997	–6.9	228	218	–4.3
3. Deficit (3 = 1 – 2) (a)	**–1,114**	**–1,422**	**27.6**	**–695**	**–673**	**–3.1**
MEMORANDUM ITEM: NATIONAL ACCOUNTS (b):						
Revenue	17,316	—	—	–3,855	–4,524	17.4
Expenditure	18,550	—	—	4,560	5,436	19.2
Financing capacity (+) or borrowing requirement (–)	**–1,234**	**–1,164**	**–5.6**	**–705**	**–912**	**29.3**

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

(a) This is the cash-basis deficit as defined by IGAE (National Audit Office).
(b) The budget figure is for Central Government. according to the reply of the Ministerio de Economía y Hacienda to the Excessive Deficit Procedure questionnaire.

taken into account, the result of the first quarter does not depart from the budget deficit target envisaged in the Stability and Growth Programme for 1999. The breakdown of the data hereafter will be in cash terms, this being the information available (see Table 3).

With regard to revenue, the high growth of direct taxes is notable, due, as mentioned above, to the lower volume of rebates made in respect of both personal income tax and corporate income tax. Moreover, in relation to the IRPF, it should be taken into account that part of the revenue from withholdings on earned income relates to December pay. This revenue was not affected by the reduction in the withholding percentages under the new system of calculation which came into force in January 1999. Consequently, the receipts from this tax are expected to decelerate over the coming months. Meanwhile, receipts from corporate income tax will not be significant until April, when the first advance payment becomes due. In the first quarter, therefore, they were governed by the change in the timetable for rebates. Note that the projected reduction in the receipts from this tax for the year as a whole is a consequence of the receipts in 1998 in respect of capital gains which arose in the privatisation of state-owned firms.

As in the case of direct taxes, in the period January-March receipts from all the indirect taxes grew at rates well above those foreseen in the budget. VAT, the most important indirect tax, was also affected by the reduction in the volume of rebates, while receipts from excise duties include one month more revenue than in 1998 from the electricity tax (which was charged for the first time in February last year). Among the other indirect taxes, that on insurance premiums was charged in January 1998 at a lower rate. Nonetheless, and especially in the case of excise duties and taxes on external trade, the buoyancy

TABLE 4

Balance of payments: summary table (a)

EUR millions

	JAN-FEB 1998	JAN-FEB 1999
	Receipts	Receipts
Current account	**26,954**	**26,608**
Merchandise	15,357	14,727
Services	5,687	6,356
Tourism	*3,172*	*3,683*
Other services	*2,515*	*2,673*
Income	2,011	2,030
Current transfers	3,899	3,494
Capital account	**1,835**	**1,675**
	Payments	Payments
Current account	**25,778**	**26,789**
Merchandise	17,195	17,540
Services	3,726	3,997
Tourism	*552*	*622*
Other services	*3,174*	*3,375*
Income	2,756	3,177
Current transfers	2,100	2,074
Capital account	**110**	**106**
	Balance	Balance
Current account	**1,176**	**–181**
Merchandise	–1,838	–2,813
Services	1,961	2,359
Tourism	*2,620*	*3,061*
Other services	*–659*	*–702*
Income	–745	–1,147
Current transfers	1,798	1,420
Capital account	**1,725**	**1,569**

Source: Banco de España.
(a) Provisional.

of consumption and imports are the factors which best explain the favourable trend in receipts in the first quarter of the year.

Finally, the budget headings which include the other net revenue of the state, excluding current transfers (which mostly originate from other general government bodies), also recorded rates of change in the first quarter notably higher than those budgeted. The growth in profits and dividends, due to the extraordinary revenue obtained from the Banco de España mentioned above, and in rates and other income, which was affected by much more favourable positive issuance premiums than foreseen in the budget, stood out. All the same, this set of revenues is also expected to slow over the coming months as the revenue from the sale of state-owned firms and from the royalty paid by the mobile telephony firms in 1998 becomes incorporated into the basis of comparison.

As for expenditure, all the headings, except wages and salaries, grew in the first quarter of 1999 at rates higher than those budgeted for the whole of the year. In the case of interest payments, their high growth, at above 50 %, is, as already mentioned, linked to the different maturity schedule of government securities. This schedule is always announced at the beginning of the year and, therefore, this heading is budgeted with some accuracy. Over the coming months, therefore, it will tend to converge with the budget forecast for a reduction of 8.8 % in this heading. In addition to the effects of larger payments in 1988 due to the early repayment of debt, this forecast also takes into account the effects of the reduction in interest rates since end-1995 and of the primary surpluses achieved in recent years. Current transfers (up 10.5 %) also increased by significantly more than forecast in the budget (5.1 %). Here, it is the growth in transfers to social security, due to the assumption by the State of the full cost of the health service (previously partly financed by social security contributions), and to the Regional (Autonomous) Governments, due to the transfer of powers in relation to non-university education to the governments of Aragón, Baleares and La Rioja, which should be taken into account.

Wages and salaries grew by 0.4 % in the first quarter, less than the 2.6 % growth forecast in the budget. The increase in both public-sector wages and pensions has been set at 1.8 % for 1999. Taking into account the increase in the number of pensioners and the normal level of wage drift, expenditure under this heading could accelerate. The growth in expenditure commitments in the first quarter, which stood at 1.9 %, seems to indicate this will be the case.

Finally, there have been significant deviations from budget under the headings of goods and services and investment, since around 40 % of the appropriations budgeted have already been used up. Accordingly, compared with forecasts for 1999 of a decline of 12.4 % in goods and services and of growth of 5.3 % in investment, increases of 14.7 % and 36.3 %, respectively, were recorded in the first quarter. In both cases the deviations are the result of obligations outstanding from previous years, which account for most of those acknowledged in the first quarter.

4.5. The balance of payments and the capital account of the economy

The current- and capital-account balance amounted to EUR 1,388 million in the first two months of 1999, which was a considerable deterioration on the EUR 2,901 million recorded in the same period a year earlier (see Table 4). The weakness of goods exports is causing a notable widening of the trade gap, which the excellent tourism results have not been able to offset. As for other external transactions, the decline in the current transfer surplus is notable. This is a consequence of the fall in income received under the European Social Fund, stemming from a certain delay in the receipt of the funds assigned in the EU budget. The investment income deficit deteriorated, due to the notable increase in payments by the credit system, although the receipts of this sector and the private sector showed notable buoyancy, associated with the expansion in their external assets.

From the viewpoint of the flows of saving and investment of resident sectors, patterns of behaviour have been similar to those seen in 1998. Thus, the deterioration in the financing capacity of the economy as a percentage of nominal GDP, inferred from the balance of payments figures mentioned above, is explained by the decline in the financing capacity of households and firms, which is not offset by the downward path of the net borrowing of general government. The decline in the financing capacity of the private sector is, in turn, a consequence of the strong expansion of housing investment and of private productive investment, since the saving ratios of households and firms tended to stabilise, after last year’s fall (as a percentage of GDP, when capital transfers received are taken into account).

5. The markets and financial flows of the Spanish economy

As already mentioned in the February 1999 Boletín económico, the new framework created by the start of Stage Three of EMU has required changes in the information traditionally used for the analysis of domestic financial conditions. The changes introduced are explained in Box 2.

5.1. Interest rates and the financial markets

In recent months, the financial decisions of economic agents have been made against an economic background (analysed in previous sections of this quarterly report) marked by relatively high growth of economic activity compared with the rest of the European Union economies. This growth has been driven by more buoyant consumption and investment demand. As regards monetary conditions in the euro area there have been no significant changes in the stance of monetary policy, although it has become more accommodating, as a consequence of the reduction in the ECB's reference interest rates at the beginning of April and the depreciation of the euro against the dollar. In any event, as highlighted in section 3.2 of this report, nominal and real interest rates in the euro area currently stand at historically low levels. In Spain, the convergence towards the interest rates of the start of the single monetary policy has involved significant reductions with respect to the levels prevailing in previous years.

In the first quarter of 1999, developments in Spanish financial markets were very similar to those in the other euro area countries. As seen in Table 5, interest rates on the primary and secondary markets for short-term debt held practically unchanged with respect to the final quarter of 1998, at levels below 3 %. Although the yield on 10-year bonds increased slightly in the first quarter, the spread over German debt with the same maturity, at around 20 basis points, was at a similar level to end-1998.

Bank rates, however, were revised slightly downwards. The synthetic deposit rate was reduced by 22 basis points with respect to the previous quarter, to stand at 1.9 %, while the synthetic lending rate was lowered by a similar amount (14 basis points), to 5 %, despite the strong demand for credit. In March 1999, the decrease in synthetic lending and deposit rates with respect to the same month of the previous year amounted to 1.1 percentage points. In consequence, the spread between the two rates, an indicator of the net interest margin, has held at slightly above 3 percentage points.

BOX 2

Presentation of the financial flows analysis method

Monitoring the national components of monetary and credit aggregates in the euro area is not an appropriate method of analysis under the new circumstances, since such components have certain shortcomings regarding their use in the case of a national economy. By contrast, analysis of the financial flows of the Spanish economy, in terms both of instruments and sectors, provides a more comprehensive framework for assessing, from the financial standpoint, the spending and saving decisions of the various economic agents, especially non-financial firms, households and general government. The very nature of the exercise and the information-availability limitations mean that the core of this analysis must be of a quarterly frequency and based on the information from the quarterly financial accounts of the Spanish economy compiled by the Banco de España Research Department.

The Banco de España publishes and assesses each month the course of a set of financial indicators, among which are liquid financial assets and the financing of the most relevant economic sectors which, owing to their characteristics, are available monthly drawing on euro-area bank statements. It is true that these aggregates make up a large portion of total financial assets and liabilities, and probably that portion most linked to economic agents' spending decisions. But there are other instruments such as shares and insurance products, on the assets side, and inter-company credit, on the liabilities side, which are relevant for the more comprehensive analysis proper to quarterly economic reports. Nonetheless, when it comes to using the information relating to monitoring markets and financial flows that is included in quarterly reports on the Spanish economy, in line with the description in the preceding paragraphs, certain clarifications relating to the time horizon of the analysis, the basic groupings used and the criteria for valuing financial instruments should all be considered:

— Time horizon of the analysis. The period in which financial conditions are monitored is limited by the availability of the information. The quarterly financial accounts are available with a lag of more than one quarter. Thus, for example, the latest data from the quarterly financial accounts currently refer to the fourth quarter of 1998. In this way, to assess developments in the first quarter of 1999, an estimation must be made based on the various sources of information available: euro-area monthly banking statements, Banco de España Book-Entry Government Debt System, CNMV (National Securities Market Commission), etc. On this basis, the flows and stocks of the various financial instruments of non-financial firms, of households and of general government have been projected. In any event, these projections are highly provisional insofar as they are a mere approximation to quarterly financial flows, which, moreover, are usually subject to a high degree of revision, especially at the close of the year. In this first report, therefore, a more detailed assessment is made of the information available on the fourth quarter of 1998, cautiously uncovering the trends that may be derived for the first quarter of 1999 on the basis of the data available.

— For the analysis of the economy's financial flows, it is appropriate to group economic agents in sectors responding to similar patterns of economic behaviour. In this respect, the financial assets and liabilities-holding sectors used in this report are non-financial firms and households and general government. Moreover, to examine who are the issuers of these financial assets and liabilities, a further two groupings have been established, namely credit institutions, among which the Banco de España is included, and institutional investors, encompassing insurance companies, portfolio investment institutions, agency brokers and broker-dealers.

— To make monetary analysis of the sector of households and non-financial firms easier, a regrouping based on instruments and sectors has been made so as to obtain a set of liquid assets similar to that prevalent in traditional monetary analysis.

— Regarding the valuation criteria for financial instruments, a harmonised treatment of all assets and liabilities has been sought. That has meant making estimates to obtain a valuation at market prices, as opposed to the current criterion prevailing in quarterly financial accounts where instruments are generally valued at book price. The instruments where the change in valuation criterion is most relevant are shares in mutual funds and shares held by households and firms. In this way, the monetary analysis of quarterly financial accounts is enhanced, since valuation at market prices allows for assessment of the relative significance of changes in actual financial transactions and of portfolio revaluations in determining the financial position of the sectors.

TABLE 5

Interest rates and domestic financial markets (a)

	1997 Q 4	1988 Q 1	1988 Q 2	1988 Q 3	1988 Q 4	1999 Q 1
BANK RATES:						
Synthetic deposit rate	3.22	3.02	2.79	2.67	2.06	1.92
Synthetic lending rate	6.54	6.20	5.93	5.80	5.15	5.01
TREASURY:						
Auction of twelve-month Treasury bills (b)	4.47	4.01	4.05	3.67	2.95	2.94
Auction of three-year bonds	4.90	4.32	4.35	3.96	3.54	3.51
Auction of ten-year bonds	5.78	5.14	5.05	4.75	4.32	4.40
SECONDARY MARKETS:						
Six-twelve month Treasury bills	4.50	4.05	4.06	3.64	2.88	2.91
Ten-year public debt	5.64	5.09	5.02	4.47	4.08	4.25
Spread over German bond	0.31	0.18	0.22	0.43	0.20	0.22
Commercial paper	4.80	4.41	4.02	4.16	3.26	...
Private-sector bonds	5.48	5.06	4.96	4.35	4.29	3.93
Madrid Stock Exchange General Index (c)	42.22	40.49	39.66	8.72	37.19	–0.12

Source: Banco de España.
(a) Average daily data for the last month of the quarter.
(b) Marginal interest rate.
(c) Cumulative percentage change in the index since the start of the year.

The Spanish Stock Exchange, like other European markets, was highly volatile, strongly influenced by developments on international markets, and primarily those in the US. Accordingly, at the end of the first quarter, prices were at a level very close to that of end-1998.

5.2. Financial flows in the economy as a whole

Net national financial saving fell during 1998, as a result of a rapid decline in private saving that was not completely offset by the increase in general government financial saving (see Table 6). On information to the fourth quarter of 1998, net national financial saving in the year as a whole amounted to 0.9 % of GDP, as against 1.6 % in 1997. All the same, it should be noted that, considering a longer period, the Spanish economy has, in recent years, recorded positive levels of net financial saving instead of the traditional negative levels.

By sector, the largest decline in net financial saving was recorded by households, primarily due to the rapid relative growth in their financial liabilities. The net financial saving of non-financial firms fell more slowly, to reach –1.7 % of GDP. In the case of general government, budgetary consolidation has led to a progressive recovery in its saving.

Unlike financial saving, which represents flows (i.e. new lending and borrowing), wealth or financial position measures the stocks of financial assets and liabilities. The latter concept therefore also includes other flows, principally associated with capital gains and losses stemming from the revaluation of the securities portfolios held by economic agents. Table 6 shows that the net financial wealth of the nation has remained stable, at a liability position of around 20 % of GDP. The net financial wealth of households has grown significantly in recent years, representing 93 % of GDP at end-1998. Also, non-financial firms have been improving their net financial position in recent years, attaining a liability position of 2 % of GDP in 1998.

An analysis of inter-sectoral financial flows is also very important for understanding the economic and financial activity of economic agents. In recent years, there has been a fundamental change in the relations of the Spanish economy with the rest of the world with the increasing internationalisation of the financial decisions of agents. This has led firms to invest abroad and institutional investors to channel a significant part of the savings of households into foreign assets. As a result credit institutions have had to resort heavily to foreign credit to cover the gap between the increase in demand for financing from firms and households and the expansion in bank deposits. In sum, these circumstances show that the slight increase in net

TABLE 6

Saving and financial position

	FINANCIAL SAVING AS % OF GDP (CUMULATIVE DATA TO THE FOURTH QUARTER)						
	Average 1988-1992	Average 1993-1997	1997	1998			
				Q 1	Q 2	Q 3	Q 4
National financial saving	–3.0	0.5	1.6	1.4	1.0	1.2	0.9
Non-financial firms and households	–0.4	5.1	3.4	2.9	1.9	1.6	1.9
Non-financial firms	*–4.2*	*0.9*	*1.2*	*–1.4*	*–2.5*	*–2.0*	*–1.7*
Households	*3.8*	*6.0*	*4.6*	*4.3*	*4.4*	*3.7*	*3.6*
Credit institutions (a)	1.6	0.9	0.6	0.7	0.9	0.7	0.7
Institutional investors (b)	–0.1	0.2	0.2	0.1	0.1	0.1	0.2
General government	–4.0	–5.6	–2.6	–2.3	–1.9	–1.3	–1.8
	FINANCIAL POSITION AS % OF GDP (FOURTH QUARTER DATA)						
	1992	1993	1994	1995	1996	1997	1998
Spain's financial position	–17.4	–20.0	–20.2	–18.9	–18.5	–19.0	–20.5
Non-financial firms and households	41.5	50.2	55.4	61.7	71.6	81.0	90.5
Non-financial firms (c)	*–17.9*	*–17.7*	*–14.7*	*–12.1*	*–7.7*	*–5.9*	*–2.1*
Households	*59.4*	*67.9*	*70.1*	*73.9*	*79.2*	*86.9*	*92.6*
Credit institutions (a) (c)	13.0	14.7	13.5	12.6	13.4	14.9	15.0
Institutional investors (b)	–1.2	–1.2	–1.0	–0.9	–0.6	–0.5	–0.6
General government	–36.7	–44.1	–48.4	–52.6	–55.0	–54.7	–52.4

Source: Banco de España.
(a) Defined according to the 1st Banking Directive.
(b) Insurance enterprises, collective investment undertakings and securities-dealer companies and securities agencies.
(c) Shares are excluded from their liabilities.

national financial saving, from an average of 0.5 % of GDP in the period 1993-1997 to 0.9 % of GDP in 1998, has been insufficient to cover the large increase in the external assets of the Spanish economy.

The incomplete balance of payments data available for January 1999 confirm the trend in flows mentioned above. However, unlike in 1998, there was a net inflow of capital in January (see Table 7). Capital outflows in the form of direct investment and portfolio investment continued to run at high levels, while the majority of capital inflows were again in the form of financing obtained by Spanish credit institutions abroad. In any event, it should be noted that the changes consequent upon Spain's membership of the single currency mean that the balance of payments data must be analysed with caution. Thus, it should be noted that the interbank financing raised by Spanish institutions through the TARGET system, recorded as a capital inflow, is completely offset by the external assets recorded by the Banco de España in respect of these transfers, which constitute a capital outflow of the same amount. Consequently, the figures for capital inflows and outflows may be inflated to some extent by the operation of this payment system. Likewise, the fall in the balance of reserve assets at the Banco de España in January 1999, of somewhat more than EUR 5 billion, is largely explained by the transfer of reserves to the ECB. As a counterpart to this transfer the Banco de España has recorded an asset of the same value.

5.3. Financial flows of households and non-financial firms

In 1998 and in 1999 to date, the financial assets and liabilities of households and non-financial firms have followed diverging paths, with a slowdown in the growth rates of assets and a progressively faster expansion in the liabilities of these agents, as seen in Chart 21. Financial assets grew by 9 % in the first quarter of 1999 with a certain polarisation in demand, which is primarily directed towards assets with less risk and lower yields, and towards those with the highest risk, which are also the most profitable. The aggregates which grew most were cash

TABLE 7

Balance of payments on financial account

EUR millions

	1997	1998	1998 JAN	1999 JAN
BALANCE ON FINANCIAL ACCOUNT	**–2,756**	**–990**	**–620**	**287**
CHANGE IN LIABILITIES VIS-À-VIS EXTERNAL SECTOR	**34,479**	**65,681**	**21,394**	**28,172**
Investment	**16,689**	**25,506**	**2,420**	**372**
Excluding marketable securities	5,621	10,152	1,326	69
Marketable securities	11,068	15,353	1,094	303
General government	*9,952*	*4,125*	*396*	*–343*
Other resident sectors	*1,183*	*8,469*	*845*	*295*
Credit system	*–67*	*2,760*	*–147*	*351*
Other investment	**17,790**	**40,176**	**18,974**	**27,801**
General government	21	866	–74	–319
Other resident sectors	544	4,319	579	1,863
Credit system	17,226	34,991	18,469	26,257
Of which:				
Long-term loans and deposits	*3,090*	*11,462*	*1,263*	*303*
Short-term deposits and repos	*14,135*	*23,529*	*17,207*	*25,953*
CHANGE IN ASSETS VIS-À-VIS EXTERNAL SECTOR	**37,236**	**66,671**	**22,014**	**27,886**
Investment	**25,328**	**57,293**	**3,343**	**4,214**
Other resident sectors	19,890	44,627	3,339	3,142
Credit system	5,454	12,863	4	1,072
Other investment	**1,555**	**21,625**	**19,083**	**28,817**
General government	331	388	92	57
Other resident sectors	12,392	17,668	12,892	3,635
Credit system	–11,168	3,569	6,099	25,126
Of which:				
Short-term loans and deposits and repos	*–13,113*	*2,452*	*6,091*	*20,492*
Reserves	**10,352**	**–12,248**	**–413**	**–5,146**

Source: Balance of Payments, Banco de España.

and cash equivalents, at rates of close to 15 %, and total financial assets. Meanwhile, so-called liquid assets, which group together, along with cash and cash equivalents, liquid assets, such as time deposits, repurchase agreements and shares in fixed-income mutual funds, have been slowing down to very moderate rates of growth, of around 5 % (see also Table 8)

In the same period, financial liabilities expanded sharply. However, in the case of credit financing, which includes bank credit and funds raised through the issuance of securities, the acceleration, which began at the end of 1996, halted in the first quarter of 1999 at rates close to 15 %.

In any case, the recent behaviour of the financial assets and liabilities aggregates of the private sector mentioned above shows that monetary and financial conditions in the Spanish economy remain relatively loose.

5.3.1. Financial flows of households

Lately, the financial flows of the household sector have been marked by a progressive decline in the rate of growth of its investments and a notable increase in financial liabilities, based on very high growth in credit granted by credit institutions. However, in 1998 this lower financial saving was offset by the cumulative net revaluation of equities and shares in mutual funds, which reached around 4 % of GDP. The effect of the revaluation of portfolios has been a dominant factor in the determination of the profile of the net financial position of households in 1998 (see Chart 22). In fact, the upward trend in stock markets that prevailed throughout 1997 and in the first quarter of 1998 (taking prices on the Madrid Stock Exchange to double their end-1996 level) came to a sudden halt in the third quarter, with a sharp fall in prices due to the crisis in international financial markets. This caused a significant change in the value of households' portfolios. In the third quarter, for example, the value of the equity portfolio of households fell by around 15 %. In the final quarter of the year there was a certain recovery, but it did not continue in the first quarter of 1999.

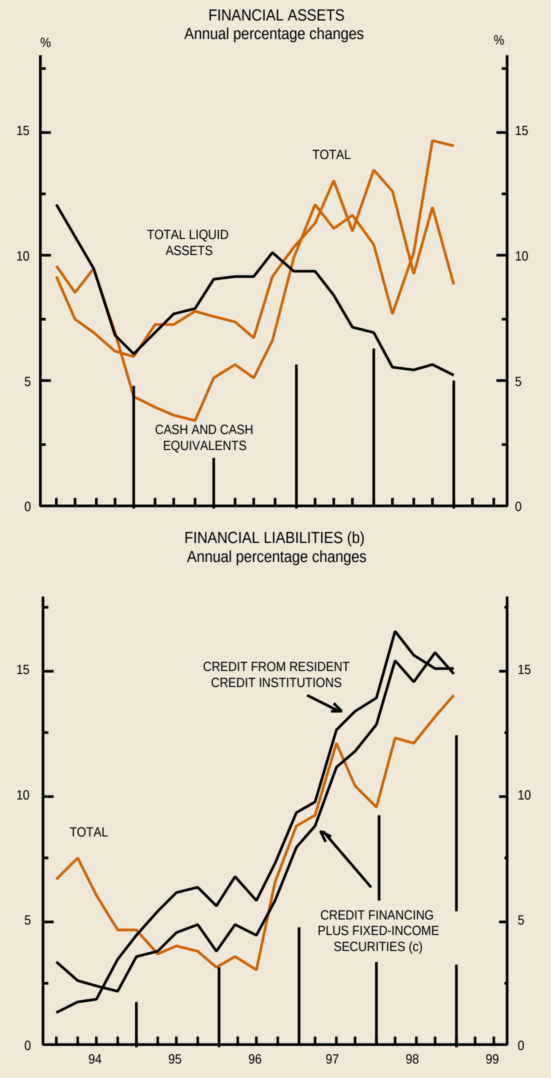
As regards households' financial assets, Chart 22 shows that in the first quarter of 1999 the progressive slowdown in their growth seems to have become more pronounced. The year-on-year expansion in that period was 6.4 %, as against average growth of 11 % in 1998. The most liquid instruments (cash and deposits) are the only ones to have accelerated moderately in the first quarter, in terms of their contribution to the growth of financial assets. Cash and cash equivalents, which include cash and sight and saving deposits have grown by around 9 % in the last two quarters. Component by component, households' sight deposits have grown most strongly, while cash continues, as in the last few quarters, to display practically zero growth. As regards other deposits there has been a recovery in time deposits, as a result of the more favourable tax treatment of those of over two years. In any event, the financial flows generated by this set of more liquid instruments make a modest contribution to the growth of all financial assets. In fact, the component made up of so-called liquid financial assets has continued to record moderate and declining rates, of around 3.5 %, in the first quarter of 1999.

In terms of their contribution, mutual fund shares and equities have made the largest contribution to the growth of the financial assets of households over the last two years, although the growth rates of both instruments have moderated in recent quarters. In fact, the total value of the portfolio of mutual funds grew in the fourth quarter of 1998 by 25 % year-on-year, a rate which may fall to 11 % in the first quarter of 1999. The factors behind this slowdown are, on one hand, connected with the poorer performance of stock markets, both domestic and international, which has reduced the accumulated capital gains in these instruments. On the other hand, stock market uncertainty, together with the low level of current interest rates, has discouraged agents from investing in these instruments. Furthermore, the changes made in January 1999 to the tax treatment of mutual funds, which have made them less attractive to investors, especially in comparison with bank deposits, may also have played a part in the shift in the demand for assets away from mutual fund shares and towards deposits. The available evidence suggests that net subscriptions for shares in mutual funds, which amounted to EUR 7.5 billion in the final quarter of 1998, have fallen significantly in the first few months of 1999.

Another instrument making a larger contribution to growth of the portfolio of households' financial assets in recent quarters has been equities. After the disturbances in stock markets over the summer months private investors and, in particular, households have shown caution in their acquisitions of new securities, with moderately positive flows in the final quarter of 1998. In any event, the increase in stock market levels in the fourth quarter relieved the financial position of households, enabling them to recover a large part of their third quarter losses and to close the year with a significant revaluation of their portfolios. Developments in the markets during the first three months of 1999 were characterised by stagnation at end-1998 levels, with an increase in volatility, which may have dis-

CHART 21

Non-financial firms and households (a)



Source: Banco de España.

(a) The data for the first quarter of 1999 are provisional estimates.
(b) Excluding shares.
(c) Excluding trade credit.

TABLE 8

Financial assets and liabilities of households and non-financial firms

	Latest quarter level (a) (b)	4-quarter % change					
		1997	1998				1999 (b)
		Q 4	Q 1	Q 2	Q 3	Q 4	Q 1
HOUSEHOLDS AND NON-FINANCIAL FIRMS:							
Total financial assets	**1,197.0**	**11.0**	**13.4**	**12.6**	**9.3**	**11.9**	**8.9**
Liquid financial assets	542.0	7.1	6.9	5.6	5.5	5.7	5.3
Cash and cash equivalents	*240.6*	*11.6*	*10.5*	*7.7*	*10.2*	*14.6*	*14.4*
Other liquid financial assets	*301.4*	*4.2*	*4.6*	*4.1*	*2.3*	*–0.6*	*–1.0*
Other financial assets	655.0	15.0	19.8	19.4	13.0	17.9	12.0
Total financial liabilities	**803.0**	**10.4**	**9.5**	**12.3**	**12.1**	**13.1**	**14.0**
Bank financing plus fixed-income securities	509.9	11.8	12.9	15.3	14.5	15.7	14.8
Credit from resident credit institutions	*413.3*	*13.3*	*13.8*	*16.6*	*15.6*	*15.1*	*15.0*
Other financial liabilities	293.1	8.2	4.2	7.4	8.1	8.9	12.6
HOUSEHOLDS:							
Total financial assets	**782.7**	**11.7**	**14.8**	**11.9**	**7.4**	**10.8**	**6.4**
Liquid financial assets	453.2	6.6	6.7	4.7	5.1	4.2	3.5
Cash and cash equivalents	*180.1*	*7.2*	*7.8*	*5.2*	*6.8*	*9.3*	*9.2*
Other liquid financial assets	*273.0*	*6.3*	*6.0*	*4.4*	*4.0*	*1.1*	*0.0*
Other financial assets	329.5	21.1	29.4	24.3	11.3	21.8	10.7
Total financial liabilities	**326.4**	**10.6**	**9.5**	**10.8**	**11.4**	**13.7**	**13.2**
Bank financing plus fixed-income securities	228.6	13.9	16.8	17.4	16.5	18.3	15.2
Credit from resident credit institutions	*206.2*	*14.5*	*17.6*	*18.2*	*17.2*	*19.1*	*15.9*
Other financial liabilties	97.7	4.3	–3.7	–1.6	1.4	4.3	8.8
NON-FINANCIAL FIRMS:							
Total financial assets	**414.3**	**9.7**	**10.7**	**13.9**	**13.1**	**14.1**	**13.8**
Liquid financial assets	88.8	9.9	8.3	10.5	7.8	14.1	15.3
Cash and cash equivalents	*60.5*	*31.5*	*21.3*	*16.9*	*23.6*	*34.4*	*33.2*
Other liquid financial assets	*28.4*	*–10.6*	*–6.2*	*2.3*	*–10.4*	*–14.1*	*–10.3*
Other financial assets	325.5	9.7	11.3	14.9	14.6	14.1	13.4
Total financial liabilities	**476.7**	**10.3**	**9.5**	**13.4**	**12.5**	**12.8**	**14.6**
Bank financing plus fixed-income securities	281.3	10.2	9.8	13.8	13.0	13.7	14.5
Credit from resident credit institutions	*207.1*	*12.3*	*10.4*	*15.1*	*14.1*	*11.4*	*14.1*
Other financial liabilities	195.4	10.4	9.0	12.8	11.8	11.5	14.6

Source: Banco de España,

(a) EUR billions.
(b) The data for the first quarter of 1999 are provisional estimates.

couraged the taking of new positions in this market.

Households' financial liabilities have grown considerably in the last two years, at higher rates than assets, especially in 1998. In the first quarter of 1999 this rapid expansion continued, with a year-on-year growth rate of 13 %. The dominant component is credit granted by resident credit institutions (see Chart 22). Here, there has been a certain moderation in the rate of growth: as against the year-on-year rate of 19 % attained in the final quarter of 1998, in the first quarter of 1999 the rate of expansion slowed to 16 %.

The notable expansion in bank credit in recent quarters may be a consequence of a number of supplementary factors to the basic determinants of households' demand for credit, these being the growth of disposable income and interest rates. In fact, the notable increase in financial liabilities may be linked to the similarly high growth of the financial wealth of the sector in the last two years, which has largely been a result of the favourable trend in stock markets. First, it may be supposed that households have financed part of their acquisitions of financial assets, for example those arising from some of the privatisations carried out in the past, by means of bank credit. Second, the greater accumulation of financial assets due to the revaluation of portfolios may have relaxed the financial restrictions on households and encouraged them to increase their levels of indebtedness to finance consumer goods or house purchases.

Quarterly bank balance sheet information on the use of credit granted by banks and savings banks, for the fourth quarter of 1998, shows that the financing granted to individuals (which does not precisely coincide with the definition of households used in this section) is primarily credit for house purchases. Although this appears to have slowed in relation to prior quarters, it is still recording rates of around at 17 %. Credit for the purchase of consumer durables although only accounting for 5 % of all financing granted by credit institutions, has continued to grow at very high rates in recent quarters. Credit for other purposes (including the purchase of financial assets, leisure, education, etc) has also grown at very high rates.

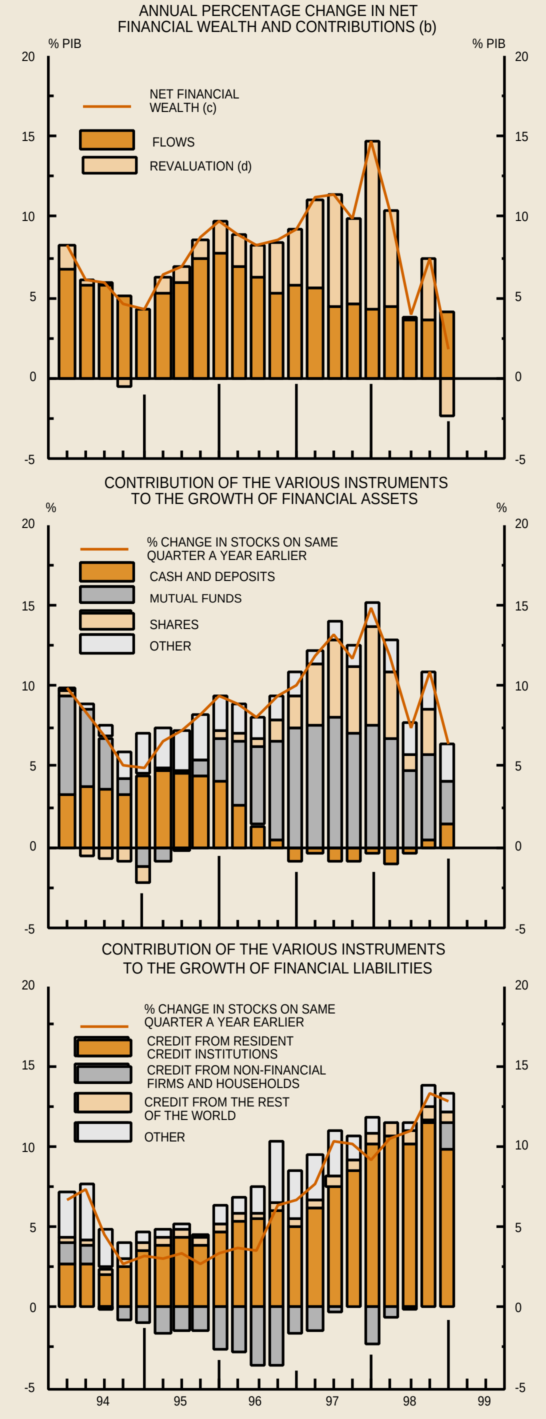
5.3.2. Financial flows of non-financial firms

The recent course of the financial flows of non-financial firms shows that, set against households, the revaluation effect has had a lesser bearing on the course of the sector's financial position in recent years when compared with that of financial flows arising from transactions. Furthering the comparison with the household sector, it should also be indicated that firms' demand for assets responds to different reasons than those of households, meaning that their balances are much more variable. Thus, firms' demand for liquid financial instruments is more associated with their treasury management than with their spending decisions. Moreover, their volume of liquid assets is only one-fifth of that of households, which contributes to their rate of change being more volatile.

Bearing in mind these caveats, it should be highlighted that non-financial firms' financial assets have sustained the brisk growth rate with which they ended 1998, running at 14.6 % in the first quarter of 1999. Liquid assets have made up a growing share of the total of financial assets and, hereunder, it is cash and cash equivalents which have shown the biggest growth rates (see Chart 23). Among the instruments that have most contributed to the growth of financial assets are assets vis-à-vis households and firms and claims on the rest of the world, which have mainly taken the form of an increase in foreign direct investment flows. Indeed, as earlier mentioned, Spanish firms have been stepping up their foreign investment notably, especially in Latin America. One aspect

CHART 22

Households (a)



Source: Banco de España.

(a) The data for the first quarter of 1999 are provisional estimates.

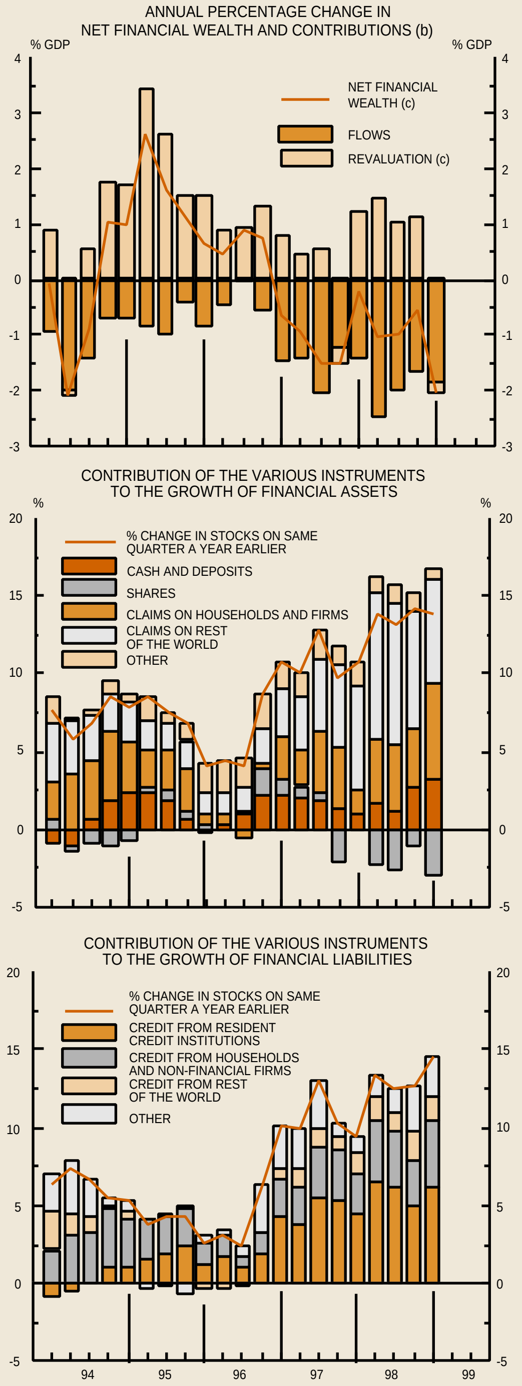
(b) Cumulative flows and revaluation data to the fourth quarter.

(c) Calculated using an estimate of the assets valued at market prices.

(d) Difference between the change in the stock and the flow.

CHART 23

Non-financial firms (a)



Source: Banco de España.

(a) The data for the first quarter of 1999 are provisional estimates.
(b) Cumulative flow and revaluation data to fourth quarter.
(c) Shares are not included in liabilities. Calculated using an estimate of the results valued at market prices.
(d) Difference beween the change in the stock and the flow.

worth mentioning is the change recorded in recent quarters in firms' equity holdings; as can be seen in Chart 23, since end-1997 these have contributed negatively to the growth of assets. This partly reflects the privatisation during 1998 of public-sector firms under the SEPI (State Industrial Holding Company) umbrella, which means that shares previously recorded in the firms sector (to which SEPI belongs) are now considered as part of the sector which acquired them, such as households or credit institutions.

The financial liabilities of firms continue to run at a high and rising growth rate. Compared with a year earlier, they stood at close to 15 % in the first quarter of 1999 (see Chart 23). Apart from financing obtained through credit institutions, the average growth of which held at around 13 % in 1998 and 14 % in the first quarter of 1999, mention should be made of the significant contribution by the other channels of financing during recent quarters. Specifically, the resort to foreign financing and to corporate credit made up almost half the total growth in financial liabilities in the sector. One of the explanatory factors behind the high growth rates of credit may be associated with the sizeable taking of positions abroad via direct investment, since such positions might be being financed through bank credit, whether from resident or non-resident credit institutions. Indeed, Spanish firms purchased shares and other equity issued by foreign firms worth almost EUR 10 billion in 1998, which approximates to foreign direct investment to some extent, accounting for 2 % of GDP. Meantime, the flow of credit for the rest of the world rose in 1998 to over EUR 8 billion.

As regards the information classifying financing to firms in terms of productive activities, the latest quarterly data from bank balance sheets (for end-1998) show that credit from banks and savings banks to the construction and services sectors is running at close to 20 % year-on-year, up on the rate in the third quarter. Financing extended to the industrial sector continues to post a year-on-year rate of 11 %.

5.4. General government financial flows

In 1998 the overall general government deficit stood at 1.8 % of GDP, eight-tenths of a point below the previous year's level. The downward course of the cumulative quarterly data on net financial saving appears to be in line with the target set in the Stability Pact, which involves attaining a budgetary position close to equilibrium over a not-too-distant time horizon. The deficit is expected to improve by around a further two-tenths of a point of GDP in

1999. The general government net financial position (assets - liabilities) is a debtor one, standing at 52 % of GDP at end-1998.

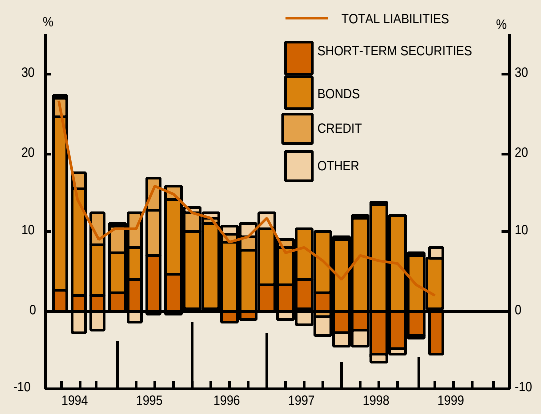
Throughout the period to date in 1999, the deficit-financing framework in place for most of 1998 has been maintained. As a result, long-term instruments have remained the main fund-raising source (see Chart 24). Specifically, net bond issues have exceeded the borrowing requirement for the period, whereby the reduction of the stock of short term instruments and the lengthening of the average life of outstanding balances have continued. Despite some instability on financial markets, which pushed yields on the secondary market for debt up in February and March, there was significant demand for government securities, which enabled the Treasury to lower its issuance rates once more.

As regards Treasury bills, there was a negative net issue of EUR 7.5 billion, despite the fact the gross issue amounted to 14.4 billion. Redemptions were concentrated in the 18-month bill segment, while there was a positive net issue of 12-month bills. The background of declining money market interest rates has been conducive to a fall in the financing cost of short-term instruments. In the period as a whole, the downward movement of marginal rates at issue meant a decline of about 30 basis points in the 12- and 18-month segments in relation to those prevailing at end-1998; they came to stand at around 2.6 % for both maturities. Meantime, there was a decline of about 20 basis points in the six-month maturity, to 2.5 %. Regarding the periodicity of Treasury bill tenders in 1999, the Treasury has altered the frequency of six-month deal tenders; these will now be every four weeks (previously there were fortnightly), alternating with the 12- and18-month bill tenders, which will be held every two weeks.

Turning to bond issues, the volume of funds raised in the first four monthly tenders in 1999 amounted to EUR 13,432 million, although this strong issue will be partly lessened by redemptions totalling 6,188 million on 30th April. The high demand for this type of instrument enabled the Treasury to cut its marginal rates: compared with last December, 45 basis points were shaved off three- and five-year bonds, and about 20 basis points off ten- and fifteen-year bonds. Thus, at the April tender, marginal rates were set at 3.10 %, 3.38 %, 4.12 % and 4.55 % for the three-, five-, ten- and fifteen-year bonds, respectively. The Treasury's comfortable financial position was likewise manifest in the successive reductions in issuance targets, the amounts of which for the April tender stood at minimum levels for this year.

CHART 24

Growth of general government liabilities
% change on same quarter a year earlier and contributions



Source: Banco de España.

The funds obtained on the securities markets have allowed financial requirements for the first quarter of 1999 (about EUR 5.1 billion) to be comfortably covered. As a result, a small portion of the Treasury's financial requirements has had to be covered through resort to its current account at the Banco de España, drawing down EUR 62 million. Consequently, the balance on this account at the end of March stood at around EUR 10 billion.

These financing arrangements have meant that the proportion of bonds in relation to total liabilities in circulation has grown continuously in recent quarters from 54 % at end-1997 to 59 % in the fourth quarter of 1998. Conversely, the share of short-term instruments has progressively declined, moving over the same period from 20 % to 16 %. Likewise, the credit component, which is of particular importance in financing the Territorial Government sub-sector, has seen its share in total liabilities fall during 1998 by one percentage point; it accounted for 16 % in the fourth quarter of 1998. As a result of this financing structure, the average life of outstanding liabilities has been extended during 1998. According to data on book-entry government debt, average life has increased from 3.5 years at end-1997 to around five years at present.

26.4.1999.