

BANCO DE ESPAÑA

economic bulletin

April 2000

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## Conventions used

M1	Money supply = Notes and coins held by the public + sight deposits.
M2	M1 + savings deposits.
M3	M2 + time deposits.
ALP	Liquid assets held by the public = M3 + other liquid assets.
ALPF	ALP + fixed-income mutual funds.
H1/H2	First/second half
bn	Billions (10 <sup>9</sup> ).
m	Millions.
a	Projection.
p	After a date [January (p)], this means that all the related figures are provisional; after a figure, only said figure is provisional.
pp	Percentage points.
	Annual ( 1970 ) or quarterly data with this symbol are averages of the monthly data of the year or quarter; series of monthly, ten-day or weekly data are averages of the daily data for such periods.
...	Not available.
—	Nil, non-existence of the event considered or insignificance of changes when expressed as rates of growth.
»	Less than half of the last digit indicated in the series.
*	Series of seasonally adjusted data.

## Abbreviations

AIAF	Association of Securities Dealers
BE	Banco de España
BIS	Bank for International Settlements
CNE	Spanish National Accounts
CNMV	National Securities Market Commission
CPI	Consumer price index
DM	Deutsche mark
EAGGF	European Agricultural Guidance and Guarantee Fund
ECB	European Central Bank
ECOFIN	EU Council (Economic and Financial Affairs)

EDP	Excessive Deficit Procedure
EMU	Economic and Monetary Union
EPA	Official Labour Force Survey
ERM	Exchange Rate Mechanism
ERM II	New Exchange Rate Mechanism for currencies of EU Member States outside the euro area
ESA 79	European System of Integrated Economic Accounts (1979)
ESA 95	European System of National and Regional Accounts (1995)
ESCB	European System of Central Banks
ESP	Pesetas
EU	European Union
EU-15	The fifteen current EU Member States
EUR	Euro
EUROSTAT	Statistical Office of the European Community
FIAMMs	Money-market funds
FIMs	Securities funds
GDP	Gross Domestic Product
GDP cp	GDP at constant prices
GNP	Gross National Product
GVA	Gross Value Added
G7	Group of Seven
HICP	Harmonised index of consumer prices
HF	Households and firms
IMF	International Monetary Fund
INE	National Statistics Office
INVERCO	Association of Portfolio Investment Institutions and Pension Funds
IPI	Industrial Production Index
MEFF	Financial Futures and Options Market
MFIs	Monetary financial institutions
MINER	Ministry of Industry and Energy
MMFs	Money-market funds
NBER	National Bureau of Economic Research
OECD	Organisation for Economic Co-operation and Development
PPI	Producer price index
R + D	Research and development
RENFE	National railway company
SEPI	State industrial holding company
SGP	Stability and Growth Pact
SIB	Stock-exchange interconnection system
TARGET	Trans-European Automated Real-Time Gross Settlement Express Transfer system
ULCs	Unit labour costs
VAT	Value Added Tax
WB	World Bank

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# Quarterly report on the Spanish economy

## 1. Overview

Into the year 2000, the Spanish economy has been sustaining a high growth rate. The well-rooted expansion of foreign markets and the continuing buoyancy of domestic demand have, on Banco de España estimates, placed the year-on-year growth rate of real GDP at 4 % in the first quarter, slightly up on the initial rate released by INE (National Statistics Institute) for the final quarter of 1999. The climate of growth is likewise the case for the other euro-area economies, according to the indicators available for the opening months of the year. The 12-month growth rate of the harmonised index of consumer prices (HICP) for the area has continued accelerating. It stood at 2.1 % in March (3 % in the Spanish economy), due essentially in both cases to the rise in energy prices, the effect of which reached its height in the preceding months.

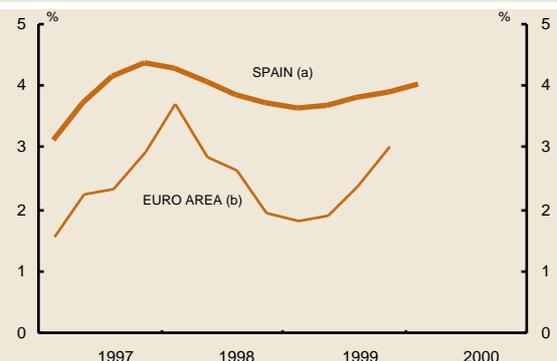
Charts 1 and 3 show that the gap between the growth rate of the Spanish economy and that of the euro area as a whole is narrowing, while the differences between the growth rates of consumer prices, measured via harmonised indices, have been cut slightly. Underpinning the notable pick-up in the euro-area economies is, on one hand, the expansionary impact of the external environment and, on the other, the increasingly firm recovery (albeit still of differing intensity from country to country) in domestic demand. Yet in the Spanish economy, despite the improvement in the contribution of net external demand being on a similar scale, what was already a high growth rate of domestic demand is moderating, after four years of notable vigour.

For 2000 Q1, it is estimated that real national demand in the Spanish economy may have posted a rate of around 4.5 % year-on-year, with a negative contribution of net external demand of approximately half a percentage point. Assessment of these data, on comparing them with 1999 Q4, requires caution as the INE figures could be altered once information not available at the time of their release is incorporated. The trend discernible in the indicators underpinning these estimates points to a stabilising or moderate loss of momentum of the year-on-year growth rate of domestic demand in the final months of the current year, and to an improvement in the negative contribution of the net external balance.

The continuation of the growth phase in the US economy has played a pivotal role in extending the expansionary climate to virtually all the main economic areas, with the notable exception of Japan. The macroeconomic and financial stability attained (or progress towards it) in many of these countries has been a fundamental factor in this favourable environment be-

CHART 1

Gross domestic product



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

(a) Non-centred annual rate of change calculated on the basis of the trend-cycle series.

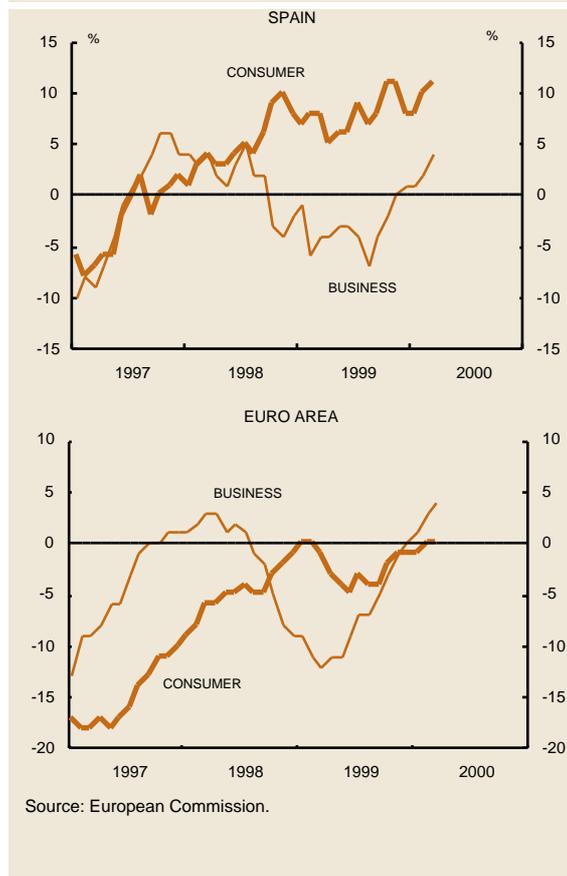
(b) Non-centred annual rate of change calculated on the basis of the seasonally adjusted series.

coming a generalised feature. And a further underlying factor has been the spread of significant technological advances taking place in key sectors of these economies. The surge in the prices of energy products since mid-1999 has posed a threat to the stability marking this process. Although the latest developments on the market for crude oil are tending to ease the pressures generated, the impact of the increases recorded has yet to run its full course and, in addition, regard must be had to the ongoing rise in the prices of other commodities and of certain manufactures. These effects are felt most sharply in the economies whose currencies have depreciated or which are ahead in the growth cycle.

As stated, the 12-month growth rate of the HICP for the euro-area countries was 2.1 % in March, approximately one percentage point up on the related rate in mid-1999. The strong increase in energy product prices on international markets, exacerbated by higher import prices further to the depreciation of the euro, was to a large extent the determining factor here. The change in the future price outlook, the firming of the recovery in economic activity across the area and the persisting high growth rates of monetary and credit aggregates (the assessment of which requires looking beyond the influence of the temporary factors in place during the monetary union's first year of life) all bore on euro-area monetary policy. The European Central Bank (ECB) decided to continue in February and March with the gradual pattern of rises first initiated in November last year, taking its benchmark interest rate to 3.5 %. These interest rate movements had already been dis-

CHART 2

Confidence indicators

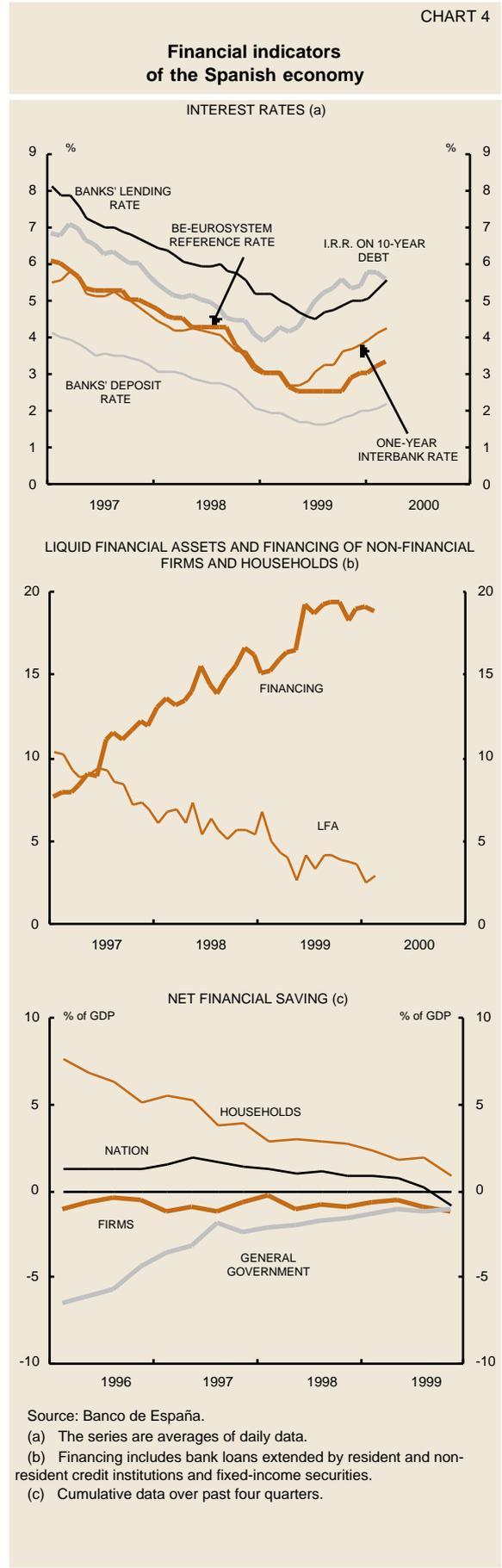
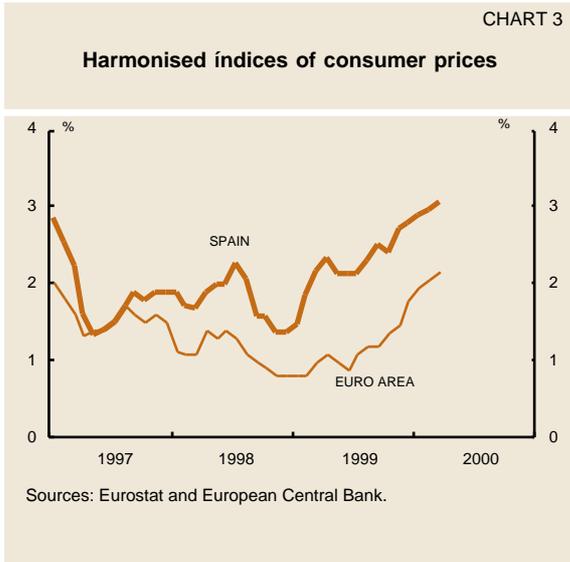


Source: European Commission.

counted by the money markets which, in turn, brought forward their expectations about future upward movements. Financial markets and, in particular, stock markets were also influenced by the volatility stemming from the US markets.

The fiscal policy stance of most of the euro-area economies enabled the overall general government deficit to be cut to 1.2 % of GDP in 1999. The fresh cuts envisaged for the current year should have a bearing, above all, on the effective control of spending. Wage negotiations for the year have not confirmed the fears that the high demands in Germany had aroused. And this, combined with favourable expectations about crude oil prices and with the response of the monetary authorities, is shaping an environment more conducive to an easing of pressure on consumer prices in the second half of the year.

The generous monetary and financial conditions that continue to prevail across the euro area are feeding through to the Spanish economy and affecting it due to its particular position ahead in the cycle. The narrow aggregates, those most directly related to spending deci-



sions, posted the highest rates of increase in the early months of the year, and the growth of financing to the private sector remained very high at around 19 %, far outstripping the rate for the area as a whole (see Chart 4). As regards fiscal policy, the end-1999 result was an overall general government deficit of 1.1 % of GDP, which was better than expected. The figures on the State budget outturn in 2000 Q1 also show a favourable trend. Notable on the revenue side is the continuing positive performance of indirect tax, which is closely linked to the buoyancy of economic activity. The strong increase in expenditure is due, in turn, to the concentration in these months of heavy interest payments. Indeed, if the period allocation of this expenditure is made in accordance with National Accounts criteria, the results are very positive, namely a slight deficit during Q1 similar to that of the same period a year earlier.

Against this background, in which greater export buoyancy has added to the factors driving domestic spending, final demand in the economy is estimated to have run at an annual rate of around 6 % in real terms during 2000 Q1, exceeding the related figure for 1999. The acceleration in output was, as earlier stated, less intense since approximately two percentage points of the growth of demand leaked out to the foreign sector, via the increase in imports.

Notable among the national demand components was the vigour of private consumption, as most of the indicators released show. The factors behind high growth rates in real consumption for the third year running remain essentially unchanged. They include the rise in real disposable income, low real interest rates, gains in wealth and favourable consumer expectations.

Of particular significance in these opening months of the year is the expansionary impact of wage- and pension-related inflation-adjustment mechanisms (which pass through to current-year revenue the differences between the previous year's forecast and actual consumer price growth) on household income. Such differences largely arose from the increase in the prices of energy products. Attempts to avoid the losses in real income deriving from external shocks prove unfruitful in the medium run and may have undesirable consequences for the inflation rate. The increase in consumer spending and the notable buoyancy of investment in housing (where only the initial signs of a slowdown can be seen) are reducing households' lending capacity. This is confirmed by the estimate of their net financial saving which, at the end of last year, was at historically low levels.

The slowdown in construction investment, which is less than expected some months back owing, perhaps, to the firmness of investment in housing, is therefore due to the course of public works, the growth rate of which began to fall in mid-1999. Capital investment, for its part, is running on similar lines to 1999 Q4, having gradually slowed over the course of last year. Robust final demand in the economy and the favourable corporate conditions prevailing are reflected in the positive expectations about the future course of investment shown by most surveys.

The pick-up in goods exports is, as commented, proving to be a key factor in the intensifying growth rate of the Spanish economy in the opening months of the year, as it is in the other euro-area economies. Adding to the impetus given by non-euro area markets and by the weakness of the euro is the boost provided by the growing buoyancy of intra-Community trade, as some of the more lagging economies in the area join the process. The persistence of high real growth rates for imports, accentuated by the surge in import prices, is further widening the current-account deficit, despite the fact that other associated components (particularly tourism and transfers) are contributing to its containment.

Employment developments in the early months of 2000 are corroborating the strength of economic activity, which is common to virtually all branches of industry. The moderate slowdown dating back to last year in the rate at which new net jobs are being created does not appear to have intensified, and is providing for a gradual recovery in apparent labour productivity. This, in turn, is preventing the rise in wages – the consequence, to date, of the effect of wage-adjustment mechanisms and of collective bargaining agreements spanning several years (the information on new agreements is as yet scant) – from passing through in full to unit labour costs. The growth rate of this latter variable, which is higher than that of most euro-area countries, is not substantially different from that posted last year.

Turning to price developments, the 12-month growth rate of the consumer price index (CPI) has stabilised at close to 3 % in Q1, owing essentially to the effect of higher energy prices. Food prices are generally trending favourably, while the rate of increase of non-energy industrial goods has turned considerably up, widening the gap (as measured by the HICP) with the euro-area countries. The service inflation differential, however, is narrowing slightly, as the related growth rate has accelerated across the area while holding stable in the Spanish economy.

The circumstances surrounding the Spanish economy's performance so far in the year 2000 are not substantially different from those prevailing at the end of 1999. First, the pick-up in the external environment is firming and growth expectations for the world economy are being revised upwards. Next, price pressures persist on certain commodities markets which, in the case of energy products, are tending to ease. Further, monetary and financial conditions are particularly generous, although there has been a change of tack in the euro area-wide monetary policy stance. And finally, the shortfall in public finances continues to abate, favoured by the increases in revenue that the buoyancy of economic activity entails.

## 2. The external environment of the euro area

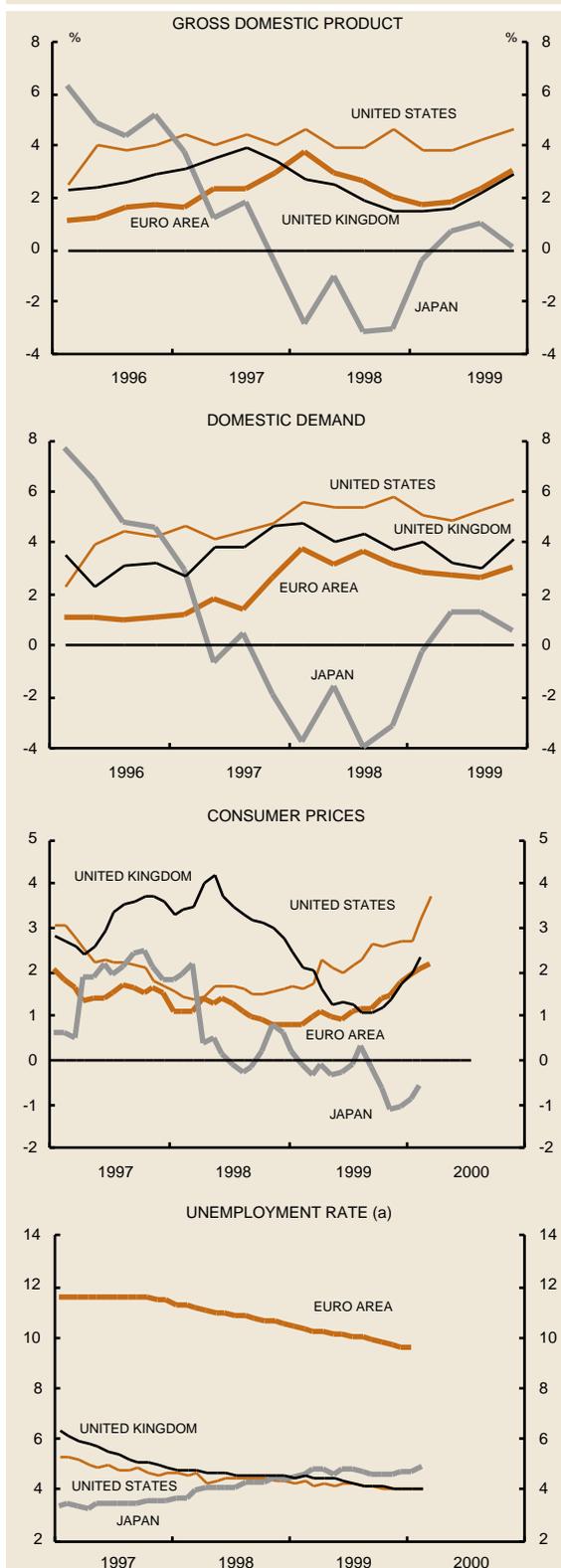
The trends observed in the final months of 1999 relating to the economic growth of the external environment of the euro area have firmed in 2000 Q1. The indicators available point to the prolongation of the robust expansion of growth in the United States, the acceleration of activity in the non-EMU EU countries and in the emerging south-east Asian economies, and the firming of the recovery in Latin America. Developments in Japan are less favourable, although there have been recent encouraging signs potentially heralding a return to positive growth rates. The generalised advance of economic activity worldwide coincides with the deterioration of the inflationary situation, essentially as a result of the rise in oil prices. Nonetheless, at the end of March, the Organisation of Petroleum Exporting Countries (OPEC) reached an agreement to increase crude oil production. That should contribute to stabilising oil prices in the coming months, although the lagged effects of past rises will continue to be felt.

According to final National Accounts data in the United States, GDP posted a growth rate of 4.6 % year-on-year in 1999 Q4 (7.3 % in annualised quarter-on-quarter terms), up three-tenths of a point on the rate for the previous quarter. This was the outcome of an additional rise in domestic demand, which offset the greater deterioration in net external demand. These figures place average growth for 1999 at 4.2 %, only one-tenth of a point below the related 1998 rate, this being the third year running in which GDP has exceeded 4 % (see Chart 5). The resilience of activity has proven compatible with the favourable trend of domestic costs, approximated by the GDP deflator, which grew by 1.5 % on average (1.2 % in 1998), despite a situation close to full employment having been attained owing to the favourable course of labour productivity. It seems increasingly difficult to attribute this pattern of growth solely to the interplay of a series of favourable economic factors and a policy mix geared to macroeconomic stability. The length of the non-inflationary growth period in the United States and the strong increase in labour productivity suggest the presence of structural changes in the economy that may be bearing favourably on its potential growth. On the evidence available, such changes might be connected with the incorporation of technical progress arising from the development of information technology and communications.

The economic indicators for 2000 Q1 point to the continuing buoyancy of demand and a further worsening of the current disequilibria. Indeed, for the first two months the consumption indicators show the continuing high growth of

CHART 5

**Main macroeconomic indicators**  
**Percentage change on previous year**



Sources: Banco de España, national statistics and Eurostat.  
 (a) As a percentage of the labour force.

spending, with the household saving rate at a new low (down to 0.8 % in February from an average of 1.9 % in 1999 Q4). The output indicators have also been on an expanding course, while employment has continued increasing in the first quarter of the year. The monthly wage indicators show no acceleration on recent months so unit labour costs, given the expected strong growth in productivity in 2000 Q1, remain contained. Nonetheless, consumer prices grew in March at a 12-month rate of 3.7 %, a strong acceleration on the figures for January (2.7 %) and February (3.2 %). With the fresh food and energy components stripped out, underlying inflation posted a rate of 2.4 %, also considerably up on the January and February rates of 1.8 % and 2.1 %, respectively. Lastly, the deterioration in the terms of trade continues to widen the trade deficit, which may further erode the current-account balance during the present year.

In Japan, GDP fell, for the second quarter running, in 1999 Q4 in relation to the preceding three months. This meant a year-on-year change of zero, whereby 1999 closed with average growth standing at 0.3 %, far below forecast, though clearly above the 1998 figure (-2.3 %). The economic deterioration in the second half of the year was further to the previous fiscal stimulus package having run its course, the slump in confidence (especially on the part of consumers) and the appreciation of the yen in effective terms. The only domestic demand component which trended favourably in 1999 Q4 was private investment, in line with the gradual improvement in business confidence and with the headway made in industrial restructuring. The slackness of private consumption in the last two quarters of 1999 appeared to exacerbate the adversely trending labour market in this period and the reduction of wages, though it was due above all to the persistence of deflationary expectations. The negative contribution of external demand, for its part, was largely the result of exchange rate developments.

The indicators available for 2000 Q1 appear to point to an improvement in the pace of activity. Accordingly, the economic deterioration in the second half of 1999 could prove to be a transitory phase in the irregular course of the Japanese economy. Among the domestic demand components, the advance release of the household spending indicator in February suggests a pick-up in private consumption. The rise in the composite index gauging the economic climate (the Tankan business survey) in April and in the industrial production index in the first two months of the year might augur a slight recovery in private investment, which would help reinforce the expansionary effects of the latest

The plan for restructuring Japanese banks

Throughout the nineties, the prolonged phase of low growth and, in the main, the sharp fall in real and financial asset prices led to a heavy deterioration in the quality of Japanese banks' lending portfolios and, in particular, to the enormous growth of the volume of defaults. The consequence of this was an ongoing decline in the profitability of Japanese banks (see accompanying chart). On official estimates, non-performing loans in the banking sector accounted at the beginning of 1999 for 11.7 % of total loans, or approximately 13 % of GDP. This situation, which was compounded as from late 1997 by worsening economic circumstances, forced the authorities to refrain in 1998 from applying partial measures (as would have occurred in previous years) and to implement a comprehensive restructuring plan for the sector.

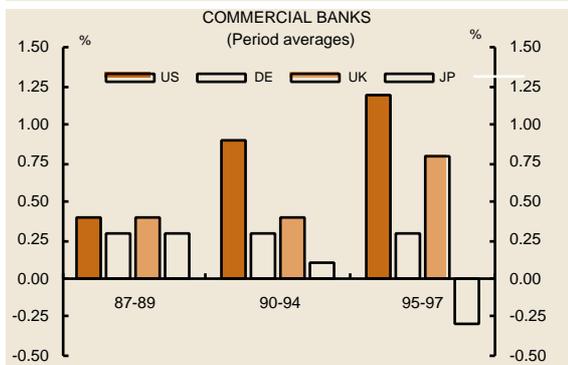
The aim of this plan, devised in connection with the principles of the "big bang" financial reforms officially announced in 1997, was twofold: to prevent forthwith the possibility of the sector collapsing, and to steer to a greater extent sectoral regulations and workings towards market criteria. This involved, on one hand, a substantial reduction in the short run of the enormous volume of non-performing loans by means of a programme of government subsidies to recapitalise banks. And, on the other, the adoption of a series of legislative measures and regulatory changes designed to promote, in the medium term, greater banking profitability and solvency.

To achieve the first aim, the economic authorities gave their approval in March 1999 to public funds supplementing those granted in March 1998. These funds were aimed initially at the biggest banks and were subsequently and gradually added to in the course of 1999 as other smaller banks were targeted. The government established that the amount of the funds should be determined by the applications made by the banks themselves, requiring in exchange the submission of adjustment plans spanning four years (i.e. up to March 2003). Thus, the 15 biggest banks (with the exception of the biggest bank of all) submitted applications for government aid for a total value of JPY 7.5 trillion (1.5% of GDP). Of this amount, which was paid out in late March 1999, JPY 6.2 trillion were channelled in the form of the acquisition by the State of preferred stock, and the remaining 1.3 trillion through the purchase of subordinated debt. Banks, for their part, made two commitments in their restructuring plans. First, to remove from their balance sheets non-performing loans for a total of JPY 9 trillion (1.8% of GDP) at the end of March 1999 (the end of the financial year). And further, to implement adjustment measures which, by the end of the four years the plan covered, would bring about an estimated increase in net income of 11.5% along with declines in overhead expenses and in staffing levels of 7.9% and 11.6 %, respectively. According to certain expert assessments, the government assistance plan may be positively viewed in that it has contributed to preventing several of the biggest banks from going to the wall. Nonetheless, there are continuing doubts about whether the plan is sufficient to fully resolve the problem within the time frame and under the terms considered.

Mention should be made of the two key regulatory changes defining the new operational framework for the banking sector. Firstly, the new system set in place in April 1998 for officially classifying the risk inherent to loans extended by banks, which is more in keeping with the criteria applied internationally. And secondly, the approval in October 1998 of legislation governing financial reconstruction (which authorises the government temporarily to nationalise failing banks and to step in at banks undergoing serious difficulties) and financial normalisation (which establishes the general outline for recapitalising banks via public funds). In all, total funds of JPY 60 trillion (equivalent to 12.1 % of GDP) were made available to the Deposit Guarantee Corporation to assist banks. These funds were to be earmarked for recapitalisation, the purchase of shares via nationalisation and liquidation, and the safeguarding of the depositors in failed institutions in respective amounts of 25, 18 and 17 trillion. In addition, the Financial Reconstruction Committee was instituted as the sole banking supervisor, with reinforced supervisory powers compared with the precursor institutions.

In addition to providing a way out of the crisis, the legal amendments made have set a substantial process of change in train, with an essentially liberalising orientation. It will be focused on a banking system hitherto characterised by a high degree of government intervention. In this respect, it should further be highlighted that the economic authorities have recently indicated that the general guarantee currently in force for safeguarding bank depositors will not be prolonged beyond the date initially agreed upon (March 2001).

Japanese bank profitability compared (a)

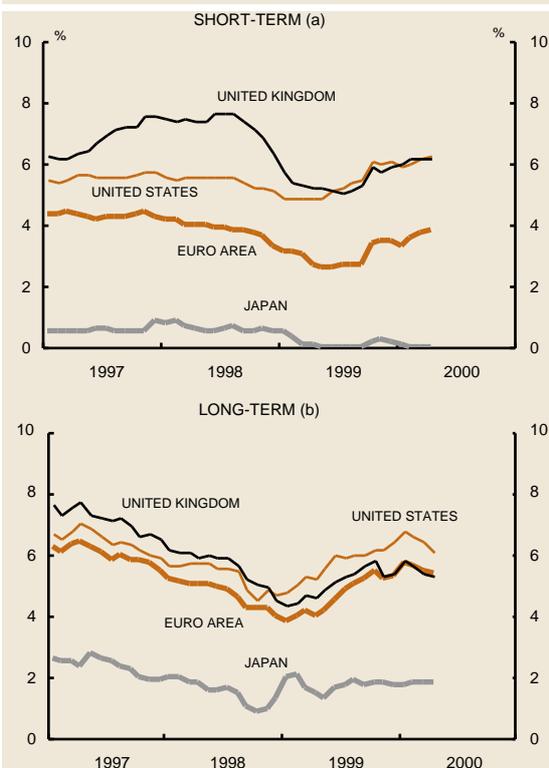


Source: OECD, *Bank profitability* (1999).

(a) Profit after tax as a percentage of total assets.

CHART 6

Interest rates



Source: Banco de España.  
 (a) Three-month interbank market interest rates. Euro area: until December 1998, weighted average of the eleven member countries; in 1999 and 2000, three-month EURIBOR.  
 (b) Ten-year government bond yields. Euro area: until December 1998, weighted average of the eleven member countries.

approved fiscal package on gross capital formation. Lastly, the decline in consumer prices in the early months of the year has slowed and, notably, wholesale prices in February have risen in year-on-year terms for the first time in over two years. Nonetheless, the limited leeway for expansionary demand policies and the accumulated losses in competitiveness will hinder the entrenchment of a growth path in the coming quarters. Only in the medium term, when the structural reforms undertaken begin to bear fruit, may a more sustained recovery in the Japanese economy be expected.

Turning to the non-EMU EU economies, the United Kingdom posted a GDP growth rate of 3 % year-on-year in 1999 Q4, up on the figure of 2.2 % for the preceding quarter. Average growth for the year was thus 2.1 % (2.2 % in 1998). The increase in GDP in Q4 is mainly due to the buoyancy of domestic demand, especially of private consumption, which grew by 4.5 % compared with the same period a year earlier.

This was because the contribution of the external sector slipped back after three successive quarters of improvement, owing to the strength of sterling and the thrust of final demand. The indicators available for 2000 Q1 point to the continuing resilience of domestic demand, although they appear to suggest the composition of growth in Q1 will be somewhat more balanced than in the previous quarter.

As regards inflation, the retail price index excluding mortgage interest payments (used by the Bank of England to set its targets) grew at a 12-month rate of 2.2 % in February. Inflation thus held at the levels recorded since mid-1999. Nonetheless, throughout this period the differential between services and goods prices has widened, with the former growing at rates close to 4 %, far outpacing the rates of increase (of close to zero) of goods more exposed to international trade. In addition, signs of inflationary pressures have heightened since the closing months of 1999 both in the labour market, as a result of lower unemployment, and in the residential property market.

GDP in the south-east Asian zone grew in 1999 by somewhat over 4.5 %, marking a notable acceleration on the previous year. Assisting growth was the climate of stability on financial and foreign exchange markets throughout the year. The data for 1999 Q4 confirmed, in the great majority of these countries, the acceleration in activity that had begun in previous months. Output growth was very high in South Korea and Malaysia and, to a lesser extent, in Hong Kong, Singapore and China. The rest of the economies in the area affected by the 1997 crisis – the Philippines, Indonesia and Thailand – grew at rates close to 5 %.

The first signs of economic recovery were discernible in South and Central America in 1999 Q4 following the crisis beleaguering this area since mid-1998. The pick-up was assisted by the improvement in activity in the rest of the world, against a background of stable financial markets, and by the rise in price of certain commodity exports. Average GDP growth in 1999 was 0.1 %, somewhat higher than forecast, although it is the lowest rate recorded in the entire decade. On the foreign exchange markets, most currencies appreciated significantly, while on the money and debt markets, interest rates fell substantially. Stock markets in the area, however, followed differing trends. The Mexican, Brazilian and Venezuelan indices rose strongly compared with stability or slight declines in Argentina, Colombia and Chile.

Country by country, Brazil grew 0.8 % in 1999 thanks to a strong rise in the rate of in-

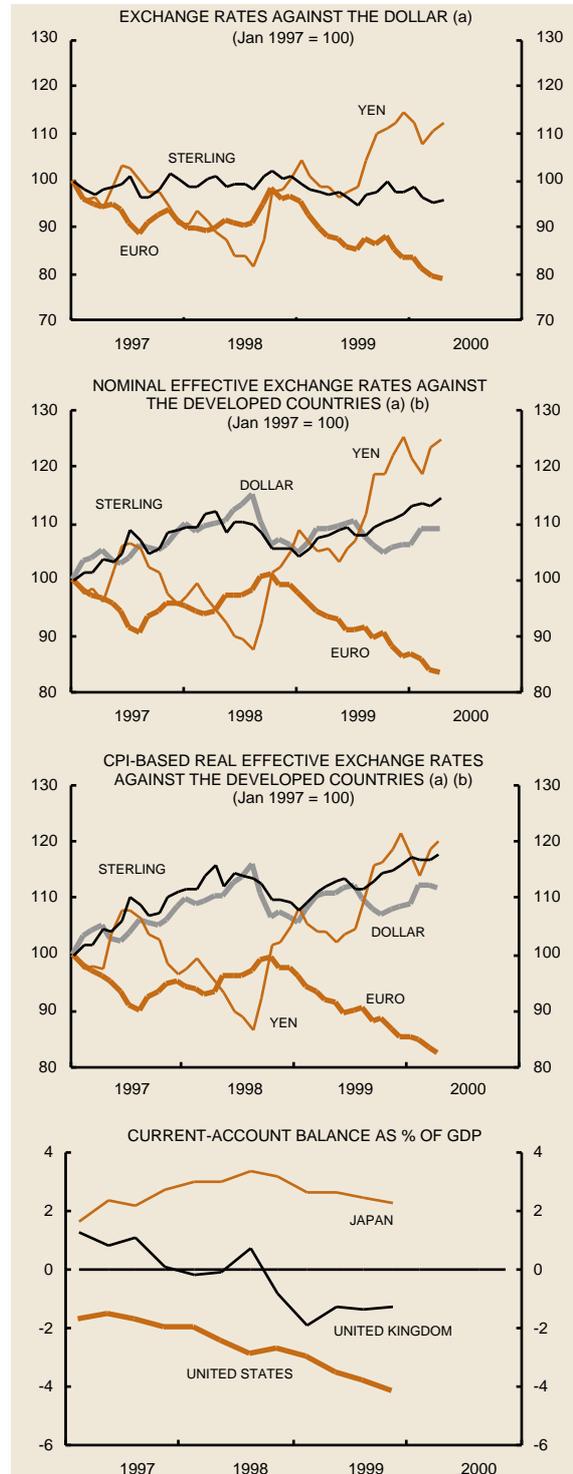
crease of GDP in Q4 (3.1 % year-on-year against -0.2 % the previous quarter). The inflation rate increased notably from July 1999 onwards, essentially as a result of the strong devaluation at the start of 1999, although this did not prevent the achievement of the target set by the Brazilian central bank for December. Nonetheless, a better inflationary outlook in the opening months of the year has allowed the monetary authority to cut its official interest rate in late March. Argentine GDP, for its part, posted a negative rate of -3 % in 1999, although it was on a clearly recovering path in the second half of the year. Mexico remained the economy in this area with the best macroeconomic results. In year-on-year terms, its GDP grew by 5.2 % in the final quarter. Despite the fact that its average inflation rate in 1999 was higher than that of the previous year, it made substantial headway in price moderation in the final months, and this has been sustained into the year 2000. The growing confidence of international investors in the Mexican economy became manifest, at the end of February, in the upgrading by credit rating agencies of Mexican government debt issues.

With respect to the economic policies of the main countries, the United States and the United Kingdom both ran fiscal surpluses in 1999, accounting for 0.5 % and 1.2 %, respectively, of GDP. These figures will probably improve in the year 2000 in the case of the United States, and the surplus will be maintained, albeit at a lower level, in the United Kingdom. In Japan, the budget deficit amounted to 7 % of GDP in 1999 and, in 2000 Q1, the latest supplementary expansionary fiscal package (JPY 18 trillion in total), implemented in the last fiscal year, has come into effect. For the current year, the recently approved budget foresees a total deficit of between 7 % and 8 % of GDP. Monetary policy in the United States and the United Kingdom has adopted in recent months a decidedly restrictive stance to counter inflationary pressures. Since the start of the year, the Federal Reserve has twice increased its federal funds rate by one quarter of a point, taking it to 6 %. The Bank of England has also twice raised its official rate, which currently stands at 6 %. Lastly, Japan continued to pursue its "zero interest rates" strategy, although the Japanese central bank has announced the possibility of abandoning this practice if the improvement in activity takes root and deflationary signs disappear.

The financial markets in the developed countries have been marked in recent months by the reduction in long-term interest rates and high stock market volatility. The rapid response by the US and UK monetary authorities to tackle inflationary pressures was favourably

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) Before 1999 the euro is represented by an approximate indicator devised by the BIS on the basis of the effective exchange rates of the euro-area countries.

viewed on the markets, as reflected by the increase in short-term interest rates and the decline in long rates during the first quarter of the year (see Chart 6). In Japan, 10-year bond yields stabilised at around 1.8 % in February and March.

On the New York Stock Exchange, the rising trend of the technology stocks was curtailed. As a result, the NASDAQ index, which had risen from the start of the year until 9th March by 24 %, has dropped sharply since, all the more so on the release of the March inflation figures on 14th April. At the time of this bulletin going to press, the index was 34 % and 18 %, respectively, below its peak and its level at the start of the year. The more traditional securities includ-

ed in the Dow Jones index, which had been volatile in the opening months of the year, also fell heavily on 14th April, placing this index around 10 % below its end-1999 level. The strong decline in the New York equity market was also immediately reflected in the Tokyo Stock Exchange Nikkei index which, in trading on 17th April, lost the gains of approximately 8 % it had built up during the year. On the foreign exchange markets, the dollar appreciated by 5.4 % against the euro and by 2.5 % against the yen in the period from December 1999 to mid-April (see Chart 7). Over the same period, sterling has appreciated in nominal and real effective terms (by 2.5 % and 1.7 %, respectively), although it has depreciated against the dollar (by 1.5 %).

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

#### 3.1. Economic developments

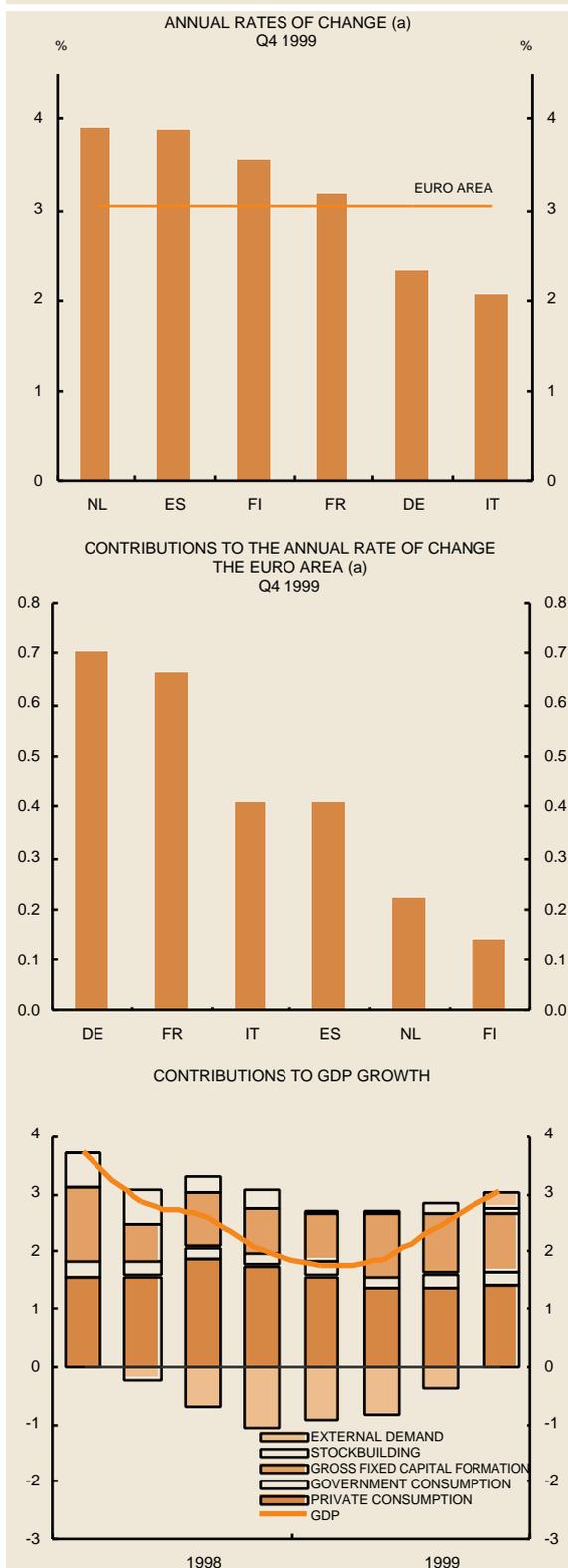
The latest data released on developments in the euro area depict a recovery led by the strengthening of net exports, the contractionary effects in recent years on the external sector of the crisis in the emerging economies having been put behind. In turn, relatively generous monetary and financial conditions and the improved climate of confidence are proving conducive to maintaining robust growth in domestic demand which, on the latest official forecasts, could be more pronounced in the coming months. Against this background, prices have continued to increase at moderate rates, albeit on a markedly quickening path as a result of the increase in the price of oil and the depreciation of the euro. Currently, the outlook for the price of crude oil and for wage costs is more favourable than it was in the previous quarter, although demand pressure and the potential emergence of second-round effects derived from the cumulative increase in the oil price pose risks to continuing price stability.

On the latest national accounts estimate for the euro area for 1999 Q4 (see Chart 8), GDP ran at a year-on-year rate of 3 %, six-tenths of a point up on the previous quarter, thereby prolonging the accelerating path dating back to 1999 Q2. The expansion of output in Q4 was underpinned by the greater contribution of net external demand (0.3 percentage points compared with -0.4 points the preceding quarter), reflecting the intense pick-up in exports. Domestic demand remained robust, increasing by 2.8 %. There was no substantial change in either its pace or its composition, since both private consumption and gross fixed capital formation trended at very similar rates to those of the two preceding quarters. Average growth for the year was 2.3 %, five-tenths of a point down on 1998 owing to the slowdown in domestic demand, since the contribution of net external demand to output was, at -0.5 percentage points, the same in both years.

Looking behind this overall pattern, the growth rates of the various economies in the area were relatively different. Countries such as Ireland and, to a lesser extent, Spain saw a higher-than-average increase in activity. This was the result of their greater potential growth, the lesser exposure of their trade to the south-east Asian economies and the greater effect of the adoption of the common monetary policy on their domestic monetary and financial conditions, as such a policy entailed nominal and real interest rates far lower than those prevailing in these countries in the period prior to the start of EMU. Germany and Italy, for their part, grew appreciably below the average owing to their

CHART 8

GDP in the euro area



Sources: Eurostat and national statistics.  
 (a) Excluding Belgium, Ireland, Luxembourg, Austria and Portugal, for which no quarterly national accounts data are available.

tighter trade links with the crisis-ridden economies. Further, whereas in Germany the expansionary impact of the single monetary policy has been relatively limited, Italy has borne the brunt of the forceful fiscal consolidation drive required to join EMU. Nonetheless, the course of GDP has been similar in virtually all the countries, exhibiting an upward trend throughout the year linked to the progressive recovery in exports.

The euro-area indicators for 2000 Q1 (see Chart 9) support the continuity of the trends observed in the preceding quarter, although they appear to point to a certain acceleration in domestic demand. The consumption indicators (consumer confidence, retail trade survey, new passenger vehicle registrations and retail sales) show notable signs of strength. Similarly, business surveys and indicators of activity, including most notably the industrial production index, are holding on a marked rising path.

Employment grew by 1.3 % in 1999 Q4, whereby the mild slowdown over the course of the year continued. Taking the 12 months as a whole, the average change in employment was 1.5 %, entailing a slowdown in the growth of labour productivity to 0.8 %, although in the second half of 1999 the path of recovery was patent. As regards the opening months of the current year, the unemployment rate stood at 9.5 % in February, at a similar level to the two preceding months. So far, the initial data on the outcome of collective bargaining in the year 2000 signal some restraint in wage settlements. Thus, insofar as the recovery in the growth of apparent productivity continues during 2000, following the cyclical depression in 1999, the trend of unit labour costs in the coming months could prove compatible with price stability.

On ECB estimates, the euro-area current-account balance ran a deficit of EUR 6.6 billion in January, 4.2 billion up on the same month in 1999. This was due to the sizeable decline in the merchandise surplus (EUR 0.9 billion compared with 4.8 billion in January 1999) and to an increase in the investment income account deficit, offset only partly by reductions in the deficit on services and current transfers. Underlying the increase in the merchandise deficit was the rise in the value of imports, which was greater than that in exports, owing to the forceful increase in import prices arising from higher oil prices and the weakening euro.

Euro-area inflation has continued to worsen in the opening months of 2000 as a result of dearer oil, the price of which grew a further 9.2 % between January and March, and the de-

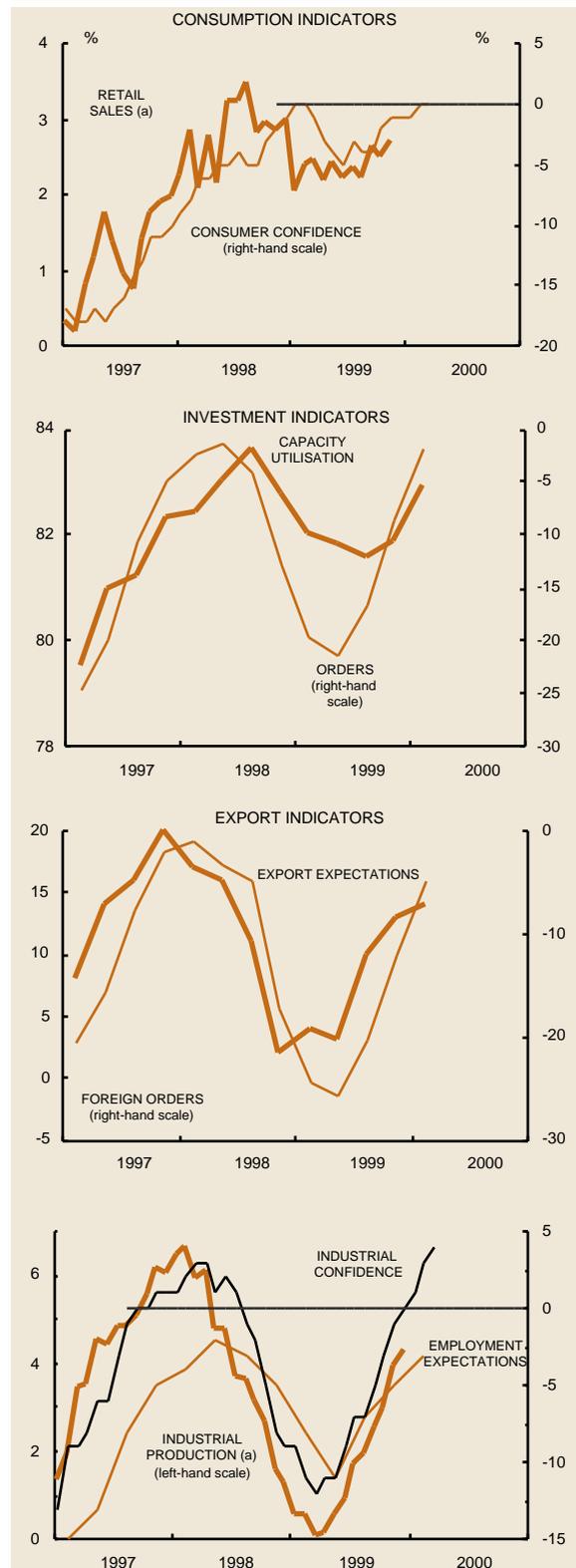
preciation of the euro (5 % against the dollar in Q1). In March, the 12-month growth rate of the HICP stood at 2.1 % (see Chart 10), four-tenths of a point up on the December 1999 figure. This reflected the strong increase in the energy component, since the index comprising non-energy goods and services grew by only 0.9 %, a similar figure to that for the final month of last year. The trend of service prices was very stable, despite the impact of the growth of fuel prices on transport costs, against a background of more buoyant activity. Across the different euro-area member states, March saw a widening of the range in which national inflation rates are situated owing to the trend of the processed food, energy and services components. With regard to industrial prices, these grew at a 12-month rate of 5.7 % in February, six-tenths of a point up on January, furthering the acceleration discernible since last year. Component by component, the prices of intermediate goods grew by 9.2 % year-on-year, compared with 8.1 % in January, and consumer and capital goods, though still growing at moderate rates, have been following the same trend for several months.

The course of inflation in the coming months will be highly conditional upon that of oil prices, and these will largely hinge on the degree of compliance with the new supply constraints recently adopted by the OPEC countries. The OPEC members decided at the end of March to raise output by 7 %, with the aim of stabilising the price of crude oil in a range of \$20-25 per barrel. Since then, oil prices have fallen by 15 % to around \$22 per barrel. The increase in production, set against the seasonal reduction in demand, may suffice to stabilise the price of crude at this new level during 2000 Q2. However, if the level of compliance with the cuts were maintained close to the figure reached in February (74 %, against 91 % in July 1999), the price could fall to around \$ 20 per barrel. As from Q3, the seasonal pick-up in demand could prompt a fresh increase in crude prices unless supply is once more revised upwards at the OPEC meeting scheduled for June.

With regard to budgetary policy, the decline in the overall budget deficit of the euro-area countries continued in 1999, falling to 1.2 % of GDP, eight-tenths of a point below the related 1998 figure. Nonetheless, the correction of budgetary disequilibria in 1999 was on a lesser scale than may be inferred from the course of the overall balance, since this improvement was substantially attributable to the reduction in interest payments. The primary surplus increased by only three-tenths of a point of GDP owing to the highly favourable behaviour of revenue, while current expenditure rose by 0.3 % of GDP.

CHART 9

**Euro area. Real indicators**

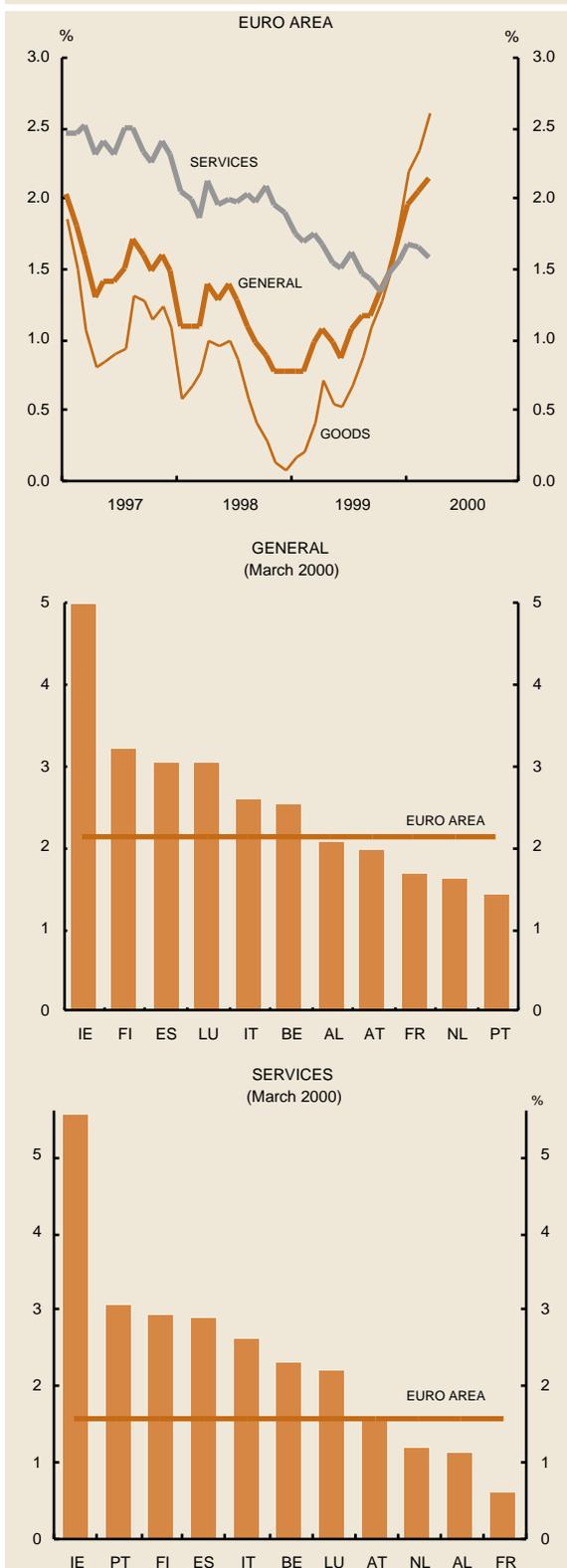


Sources: Eurostat and European Commission.

of the quarterly moving average of the seasonally adjusted series.

CHART 10

**Harmonised indices of consumer prices  
Twelve-month percentage change**



Source: Eurostat.

Taking results country by country, none recorded a deficit in 1999 of more than 2 % of GDP and all improved their 1998 results except Ireland and Luxembourg which, nonetheless, are running comfortable surpluses. The biggest changes in the budgetary balance took place in Spain, France, Italy, the Netherlands and Finland (see Table 1).

All the euro-area countries have now submitted revised versions of their stability programmes, according to which both the deficit of the area as a whole and of each of the member states should be close to balance towards the year 2003. Among the fiscal measures unveiled in recent months are those of the French government following the upward revision, in step with the improved outlook for economic growth, of its forecast revenue for the current year. The surplus revenue will be applied only in part to reducing the deficit. The rest will be earmarked for higher expenditure on education and health (around 0.1 %) and for easing the fiscal burden, by means of a one-point cut in the main VAT rate and the lowering of income tax rates on households in the lower and middle income brackets.

**3.2. Monetary and financial conditions in the euro area and in Spain**

During 2000 Q1, relatively generous monetary and financial conditions have held in the euro area. In the light of the signals from other activity and price indicators, the situation has prompted growing expectations of interest-rate rises throughout the period. Indeed, the firming of more favourable growth prospects and the expansionary nature of the key monetary and financial indicators have pointed to a potential risk of inflation deteriorating in the medium term. The euro has thus continued to weaken against the dollar, compounding its significant depreciation over the course of 1999 and placing its real effective exchange rate index against the developed countries below its average level in recent years. In turn, real short-term interest rates have held at very low levels, below 2 %. Finally, the growth rates of the monetary and credit aggregates have remained high, and the latest data have shown that the most liquid components of M3 have continued to expand significantly. The combination of the foregoing factors led the ECB to raise its intervention rates on two occasions relatively close in time, on 3rd February and on 16th March. In both cases the increase was 25 basis points, whereby at the end of the period under analysis the rate on the main refinancing operations of the Eurosystem stood at 3.5 % and the rates on the marginal lending facility and the deposit fa-

TABLE 1

**General government financial balance of euro-area countries (a)  
(as % of GDP)**

	1996	1997	1998	1999	2000 (b)
Belgium	-3.7	-2.0	-1.0	-0.9	-0.5
Germany	-3.4	-2.6	-1.7	-1.1	-1.0
Spain	-5.0	-3.2	-2.6	-1.1	-0.7
France	-4.2	-3.0	-2.7	-1.8	-1.5
Ireland	-0.6	0.8	2.1	2.0	1.7
Italy	-7.1	-2.7	-2.8	-1.9	-1.5
Luxembourg	2.7	3.6	3.2	2.4	2.6
Netherlands	-1.8	-1.2	-0.8	0.5	1.0
Austria	-3.8	-1.9	-2.5	-2.0	-1.7
Portugal	-3.8	-2.6	-2.1	-2.0	-1.5
Finland	-3.2	-1.5	1.3	2.3	4.1
<b>MEMORANDUM ITEM:</b>					
Euro area					
Primary balance	1.4	2.7	2.8	3.1	3.1
Total balance	-4.2	-2.6	-2.0	-1.2	-0.9
Public debt	74.7	74.5	73.1	72.3	70.5

Source: European Commission.  
 (a) Deficit (-) / surplus (+).  
 (b) Forecast.

cility at 4.5% and 2.5 %, respectively (see Chart 11).

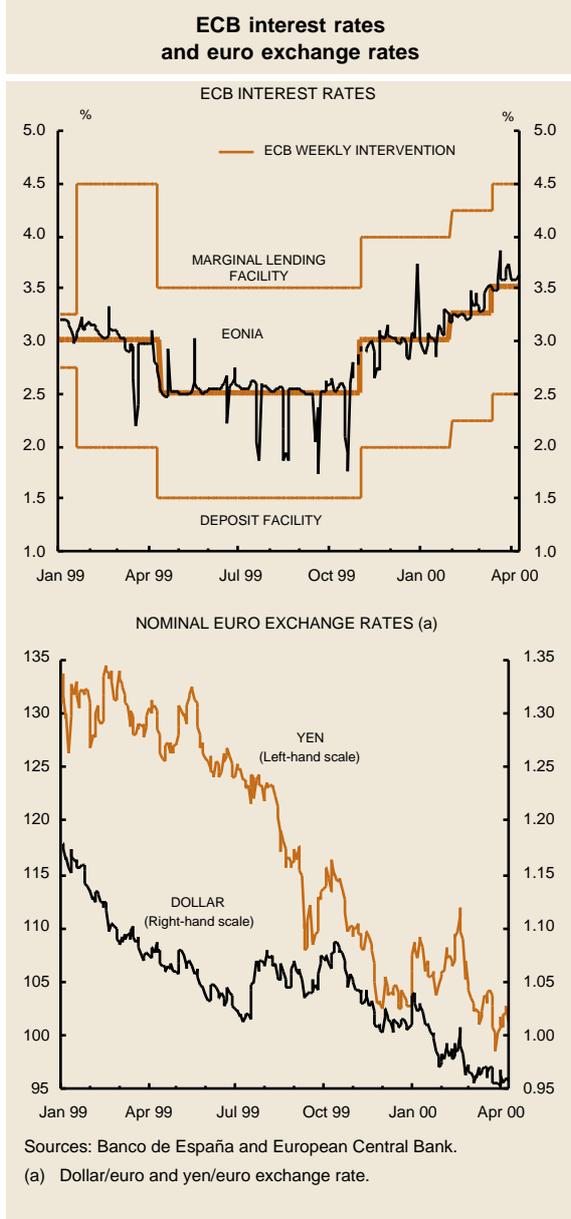
The monetary and financial situation in Spain has been more expansionary than in the euro area as a whole, and this was especially so before the ECB decided to adopt a less accommodating monetary policy stance. In particular, the most liquid financial assets and private-sector credit have been sustaining high growth rates, while the inflation differential vis-à-vis the EMU member states has meant that real short-term interest rates are lower in Spain than real rates in the euro area.

Money market interest rates in the area have trended in keeping with the hitherto prevailing expectations of an increase in the Eurosystem's intervention rates. Thus, the overnight interest rate, measured by the EONIA (European Overnight Index Average), has held above the interest rate on the main refinancing operations for much of the period and, in the run-up to tenders in which it was assumed that official rates could be raised, it stood at levels largely anticipating such movements. The rates on interbank deposits were on a similar rising trend. Indeed, by the end of the period under analysis, they stood at between 3.8 % and 4.3 % in the range from the one-month to the twelve-month maturity, respectively, between 30 and 50 basis points up on their average levels in December. In turn, rates on the futures market and implicit rates on

the spot market have evidenced in this period an upward revision of the levels of short-term interest rates expected over the course of the current year. In particular, the one-month forward rate showed at the end of the period under analysis that, following the interest-rate rises by the Eurosystem, market expectations about fresh intervention-rate movements in the coming months have been sustained (see lower part of Chart 12).

In the period to date this year, the virtually continuous uptrend of interest rates on euro-area debt markets since early 1999 has been curtailed. This has been the outcome of the cushioning effect exerted by the behaviour of US markets during this period (marked by increased volatility along with a reduction in interest rates), which has checked the upward trend driven by the favourable economic growth expectations in the euro area. At the end of the period under analysis, ten-year bond yields in the euro area stood at around 5.4 %, somewhat down on the level as at end-December last year. As a result of recent developments, there has been a slight reduction in the slope of the yield curve, and the long-term yield spread over the United States has narrowed, standing in April at around 70 basis points in monthly average terms. As regards the Spanish debt markets, the behaviour of prices has run parallel to that of the main euro-area domestic markets, and the ten-year yield spread over German

CHART 11



bunds has held at around 20 basis points (see Table 2).

Despite the reduction during this period in short- and long-term interest rate differentials between the United States and the euro area, the euro has once more depreciated against the dollar, following the trend observed since the start of 1999. In the year to date, the cumulative depreciation has been almost 5 % in monthly average terms, meaning that the nominal effective exchange rate index against the developed countries has come to stand in mid-April at more than 2 % below the average monthly level attained in December (see Chart 11).

The transmission of the movements in market interest rates to the rates applied by banks

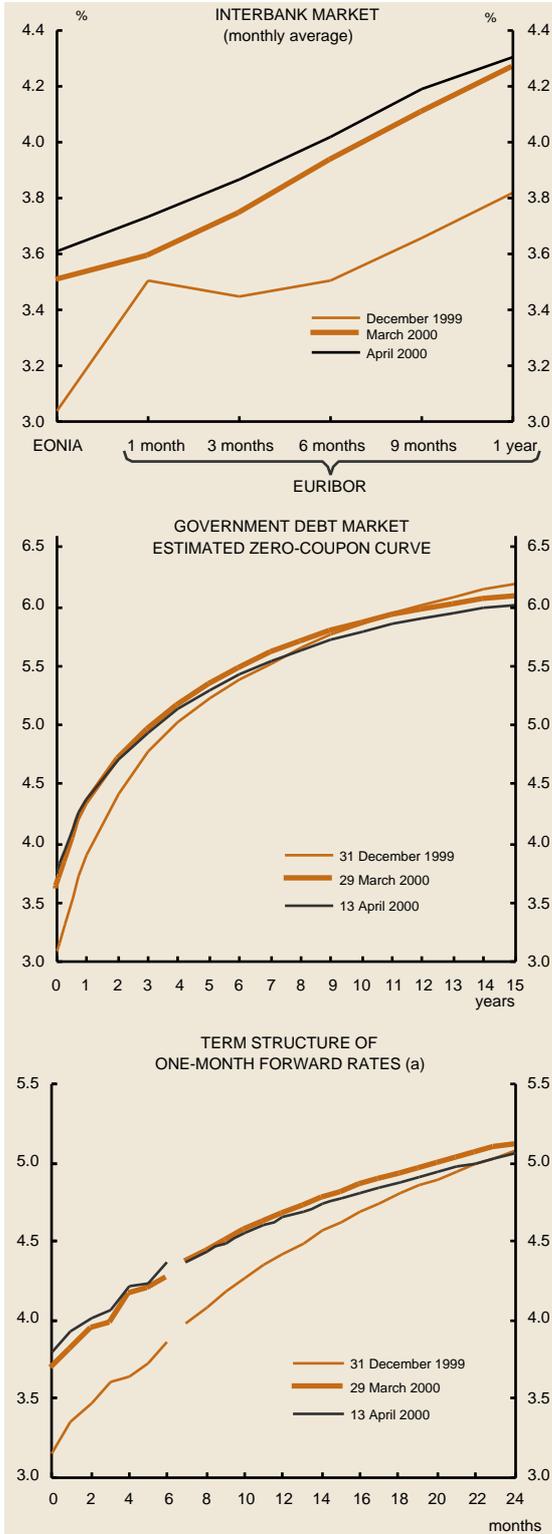
in their lending and deposit operations, on an upward course since mid-1999, has continued in the first two months of the current year for which information is available. Fresh rises have thus been seen in the most representative bank rates, more significantly so in longer-term lending to firms and in mortgage loans than in shorter-dated lending (see Chart 13). As regards Spanish banks, the rates on their operations have trended similarly to those of the euro area during these two months, although the cumulative increase in lending rates since July last year has been lower than in the area as a whole, where such rates depend to a greater extent on long-term market rates.

Equity markets in the euro area have been more volatile in 2000 Q1 than in the three previous months, and the uptrend that commenced with notable force in October last year has been checked. Prices on these markets have moved against a backdrop of interest-rate increases in the euro area and high volatility on the US equity markets, where prices tended to fall. Predominant in February and in the first half of March was the influence of growing corporate profit expectations, set against the firming of the economic recovery and the restructuring of certain sectors in the euro area, especially in the telecommunications field. In mid-April, however, expectations that the Federal Reserve would tighten monetary policy prompted a sharp fall in US stock market prices, which spread rapidly to the European stock markets. That has considerably reduced the gains this year seen on the broad Dow Jones Euro Stoxx index, which includes the main European equities. In Spain, where stock markets have been more volatile than in the previous quarter and appreciated less than was the case in European markets as a whole, the fall in share prices led the Madrid General Index to slip to its end-1999 level, although it subsequently picked up to some degree.

The behaviour of the monetary and credit aggregates in the euro area was uneven in the opening months of the year, whereby the deceleration observed in January has not subsequently firmed. The latest data for February have shown high rates of expansion in the M3 monetary aggregate (its latest three-month moving average growth rate in relation to a year earlier was close to 6 %), while the buoyancy of overnight deposits has continued, with the M1 aggregate growing at a year-on-year rate above 10 %. Assessment of the figures in these opening months of the year should be made bearing in mind that the year-on-year growth of M3 was continuously above its reference rate throughout 1999, and that there was great uncertainty over the factors behind this deviation. Some of

CHART 12

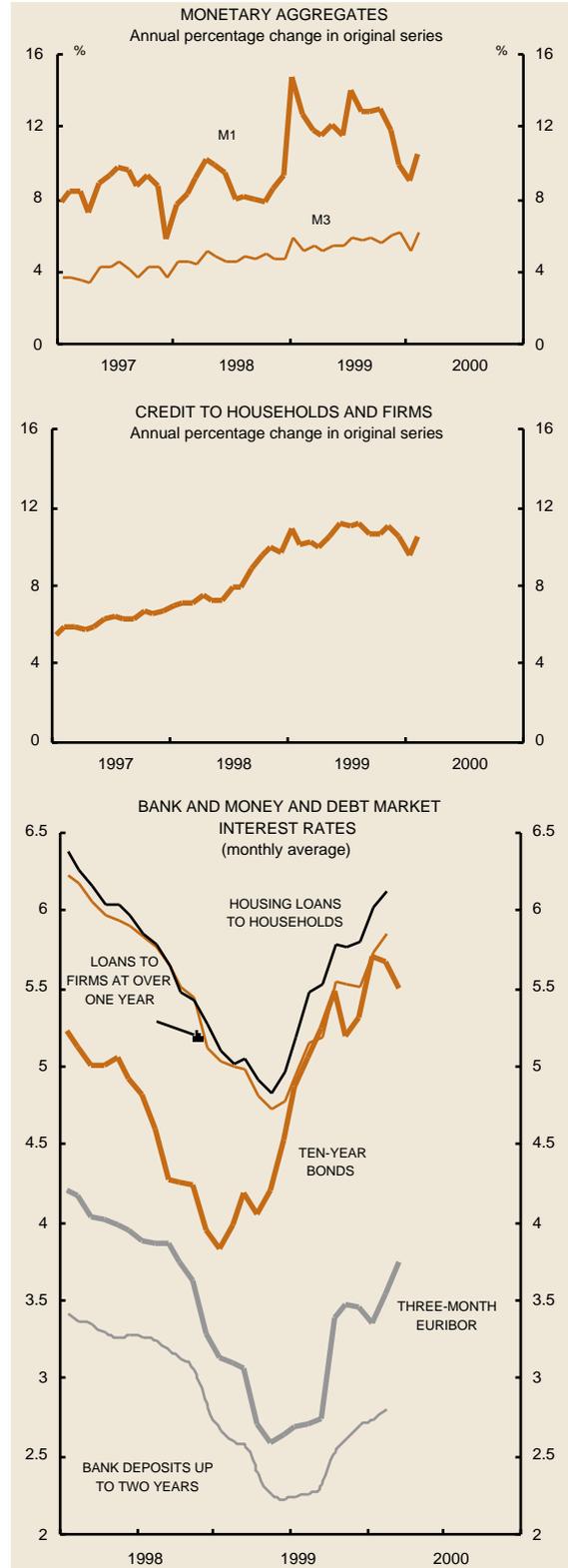
**Euro area yield curves**



Sources: Banco de España and European Central Bank.  
(a) Implicit up to six months.

CHART 13

**Monetary and credit aggregates and interest rates in the euro area**



Sources: Banco de España and European Central Bank.

TABLE 2

**Monetary and financial situation in the euro area and in Spain**

	1999				2000			
	MAR	JUN	SEP	DEC	JAN	FEB	MAR	APR (c)
MONETARY MAGNITUDES (a):								
<b>EURO AREA</b>								
M3	5.4	5.5	5.9	6.2	5.2	6.2		
M1	11.7	11.5	12.8	9.8	9.0	10.4		
Credit to private sector	10.1	11.1	10.6	10.4	9.5	10.5		
<b>SPAIN</b>								
Liquid financial assets	4.3	4.1	4.2	3.6	2.5	2.9		
Cash and cash equivalents	15.0	17.5	17.4	11.9	10.5	12.2		
Lending to private sector	15.9	19.2	19.3	19.0	19.0	18.8		
FINANCIAL MARKETS (b):								
EONIA	2.93	2.56	2.43	3.04	3.04	3.28 %	3.51 %	3.61 %
Three-month EURIBOR	3.05	2.63	2.73	3.45	3.34	3.54 %	3.75 %	3.87 %
Government debt								
<i>Euro-area ten-year government bond yields</i>	4.18	4.53	5.24	5.30	5.70	5.66 %	5.49 %	5.34 %
<i>US/euro area ten-year bond spread</i>	1.12	1.44	0.76	1.06	1.08	0.97	0.88	0.66
<i>Spain/Germany ten-year bond spread</i>	0.22	0.24	0.27	0.22	0.22	0.22	0.22	0.23
Bank interest rates in Spain								
<i>Synthetic deposit rate</i>	1.90 %	1.66 %	1.69 %	1.98 %	1.98 %	2.06 %	2.17 %	
<i>Synthetic lending rate</i>	5.02 %	4.54 %	4.71 %	5.02 %	5.10 %	5.33 %	5.55 %	
Dollar/euro exchange rate	1.088	1.038	1.050	1.011	1.014	0.983	0.964	0.958
Equity market (d)								
<i>Broad Dow Jones EURO STOXX index</i>	3.4	8.9	6.8	39.5	-4.1	6.8	6.0	3.5
<i>Madrid Stock Exchange General Index</i>	-0.1	4.2	-1.2	16.2	-3.4	11.4	7.5	2.9

Sources: European Central Bank and Banco de España.

- (a) Percentage change on a year earlier.  
 (b) Monthly averages.  
 (c) Average for the month up to the latest information available.  
 (d) Month-end data. Latest data available: 14 April 2000.

the momentum of this growth might have been associated in the opening months of 1999 with certain special effects arising from the introduction of the euro and the start-up of Monetary Union, which might have increased the demand for overnight deposits. However, the persistently high growth rate of M3 in subsequent months and the recent downward stickiness of its growth rates suggest that the pattern of behaviour of this monetary aggregate has been due not so much to special factors but, above all, to a genuine process of liquidity expansion.

In Spain, analysis of the variables allowing an assessment of the liquidity conditions of the Spanish economy reveals, as in the case of the European monetary aggregate, the considerable buoyancy of the more liquid assets. Cash and cash equivalents (which include cash in circulation, overnight deposits and savings deposits), having trended downwards since 1999

Q4, have expanded significantly in February at a year-on-year growth rate of around 12 %. Deposits with an agreed maturity have also shown increasingly marked vigour. However, the sharp fall in shares in securities funds during these first two months of the year has meant that the growth rate of liquid financial assets as a whole has decelerated to below 3 % year-on-year in February (see Table 2).

Turning to the credit aggregates, finance extended by Monetary Financial Institutions to euro-area residents expanded in February at a rate similar to that observed over the course of 1999, at around 8% in year-on-year terms. This overall figure was a result of differing performances across the various sectors. Compared with the restraint of lending to general government, which grew by 1 % year-on-year in February, finance to the private sector, after having slowed in January, once more proved as

vigorous as it had in 1999, running at a growth rate of over 10%. The net external position of MFIs continued to diminish over the first two months as a result of a bigger increase in liabilities vis-à-vis the external sector than in foreign assets; it was EUR 123 billion lower in February than in the same month a year earlier. As indicated in previous reports, this gap is providing for a faster growth rate of credit than of liabilities vis-à-vis euro-area residents.

The growth rates of the representative credit aggregates in Spain have remained high, against a backdrop of economic expansion and favourable finance conditions. The latest data

on finance to the resident private sector (non-financial corporations and households) show its growth rate to be holding at around 19 %, unchanged since mid-1999. This is the result of something of an acceleration in the finance raised by a companies, which is growing at over 20 %, and of mild restraint in credit to households. The growth rate of finance to general government has grown slightly at the start of this year, although a partial influence here has been the specific course of the State deficit in the early months of the year 2000. In any event, the following section of this "Quarterly Report" offers a more detailed analysis of financial flows in the main sectors of the Spanish economy.

## 4. The Spanish economy

The Spanish economy benefited last year from the general global economic upturn and, in particular, from the expansionary effect it had on euro-area activity in the second half of the year. The rate of growth of activity in Spain, which had been adversely affected by the international economic crisis in late 1998 and early 1999, was back on an upward trend, reaching 3.9 % year-on-year in Q4. Throughout the period, domestic demand sustained high growth rates (albeit with a moderate downward trend), based on loose monetary and financial conditions (as described in the preceding section), and on a fiscal stance that combined a strong increase in tax receipts with measures encouraging spending by other sectors. From the information available on activity and demand in the first quarter of 2000 it appears that the recovery in output continued, led by a further improvement in net external demand, while domestic demand grew at a real year-on-year rate of around 4.5 %, close to its end-1999 level.

As in other European economies, the Spanish inflation rate ended 1999 on a rising trend, owing to the increase in energy prices. In the first quarter of the year 2000 prices continued to grow at high rates, which can be expected to dip as the oil price returns to more moderate levels. The inflation differential with the euro area, having remained at around one percentage point in 1999, fell by a few tenths of a point at the beginning of 2000. In any event, wages continued to help moderate prices, ensuring not only that the inflation rate did not accelerate further, but also that employment creation was high in 1999 and, on the available information, is still high now.

### 4.1. Demand

On Quarterly National Accounts (QNA) estimates, national demand grew in 1999 Q4 at the high real year-on-year rate of 4.2 % (1). This was, nonetheless, below the rates of close to 5 % estimated in preceding quarters (see Chart 14) as a consequence of a levelling off in the rates of growth of all the spending components. In the final quarter of the year, the growth rates of household and general government final consumption spending and of gross fixed capital formation in relation to capital goods and construction appear to have slowed. Despite the loss of momentum of national demand, GDP accelerated slightly, to reach a real year-on-year rate of 3.9 %, since the negative

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(1) The QNA figures referred to in this chapter are defined in trend-cycle terms, in accordance with the terminology used by the National Statistics Institute.

contribution of net external demand to output growth fell significantly, to stand at  $-0.4$  percentage points, down from  $-1.1$  points in Q3. This outcome was due to the greater buoyancy of exports, which rose by  $10.7\%$  in Q4, two percentage points more than in Q3, and to lower import growth, although the latter was still running at a rate of  $11.7\%$ .

Following the release of the INE estimates discussed above, further information on end-1999 has been received. Overall, this seems to indicate that the slowdown in national demand in Q4 may have been less pronounced than originally estimated, while the contribution of net external demand would have been somewhat more contractionary. The short-term indicators for the first quarter of 2000 – based on very incomplete data – suggest that domestic demand continued to grow at high rates of close to  $4.5\%$ . Household final consumption spending would have grown in the first quarter at similar rates to those in the preceding quarter, investment in capital goods would have gained momentum and the slowdown in construction spending, dating back to 1999 Q1, may have diminished. As regards foreign trade flows, goods exports continued to recover while imports stabilised at a high rate of growth, indicating a less contractionary contribution from net external demand than in 1999. Overall, GDP may have risen in the first quarter of the year at a year-on-year rate of  $4\%$ , slightly up on the previous quarter.

On QNA data, household final consumption expenditure grew in 1999 Q4 by  $4.2\%$  year-on-year, in real terms, three-tenths of a percentage point less than in the preceding quarter. This slowdown has been captured by some indicators, such as apparent consumption of goods and new car registrations, while other indicators, such as the retail sales index and total household spending, estimated by the Spanish Household Expenditure Survey, show more sustained growth, more in line with the recovery in the consumer confidence index in that period (see Chart 15). In fact, the scant information available on consumption in 2000 Q1 would indicate that the slowdown in its growth came to a halt, a fact that would also be consistent with the high levels of consumer confidence in the first quarter. The retail sales indicator, deflated by consumer prices, grew by  $9.5\%$  year-on-year in January and February, well above the Q4 rate of  $4.5\%$ . New car registrations grew strongly in the same months, and although they were weak in March this may have been linked to the timing of Easter. In any event, the growth rates of consumption of consumer durables, according to the relevant apparent-consumption index, would have levelled off. Finally, although

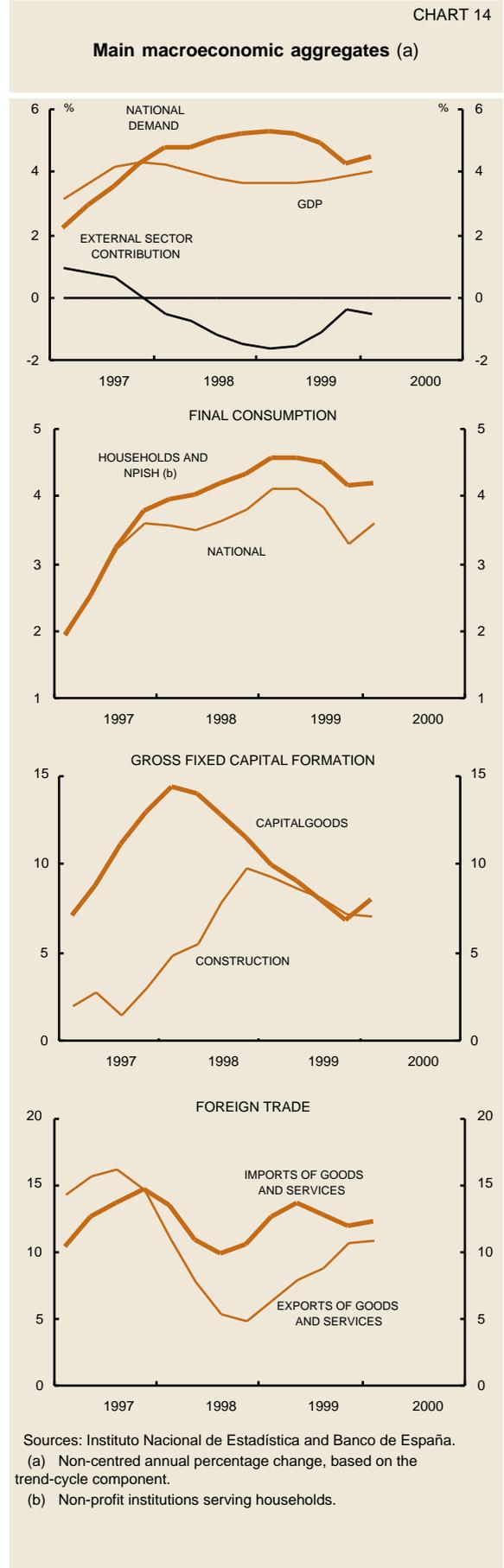
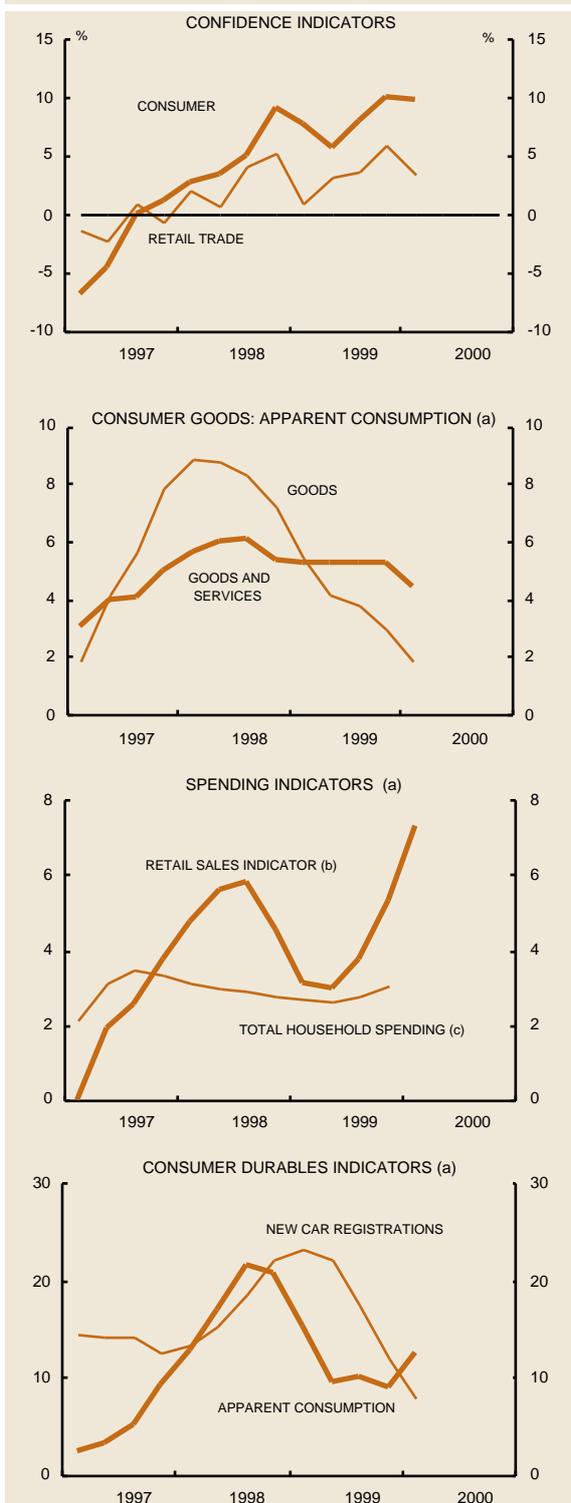


CHART 15

Private consumption indicators



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

- (a) Non-centred annual percentage change, based on the trend of the indicator.
- (b) Deflated by the CPI.
- (c) Household expenditure survey, deflated by the CPI.

on the basis of incomplete information for the first quarter the ongoing slowdown in the aggregate indicator of apparent consumption of consumer goods seems to have continued, this was due to the poor performance of the food component, since other consumer goods grew at similar rates to those in the fourth quarter.

The strength of household consumption in 2000 Q1 is based on the positive performance of its main determinants. Indeed, it is estimated that household disposable income will rise in the year as a whole at a rate similar to that in 1999. As regards the compensation of wage earners, the slight slowdown in employment will be offset by the higher growth in average compensation. The payments arising from the triggering of inflation-adjustment clauses in 1999 settlements received in the first quarter of the current year will have contributed to this higher growth. Net transfers from the public sector will also help to sustain disposable income. The social benefits received by households have been boosted by the increases in pensions stemming from the rise in the minimum pension and from the compensation for the inflation overshooting in 1999, partly replacing the expansionary impulse provided by the reform of personal income tax last year. The relatively expansionary performance of disposable income is supplemented by the improvement in household expectations and the rise in property values, factors conducive to consumption rising faster than income. As already mentioned, the consumer confidence index improved significantly in February and March, regaining levels close to its all-time high, helped by the rapid reduction in the rate of unemployment. In addition, financial conditions remain favourable for the expansion of household expenditure.

In 1999, on QNA data, general government final consumption spending grew by 1.8 %, in real terms, with a profile of progressive slowdown over the year. The information available for the first quarter of 2000, relating exclusively to the State, is distorted by the transfers of responsibilities to the regional (autonomous) governments. However, it is estimated on the basis of the budget plans for the current year that the trend slowdown in general government final consumption expenditure will come to a halt, so that the rise in this expenditure will be similar to that in 1999 as a whole.

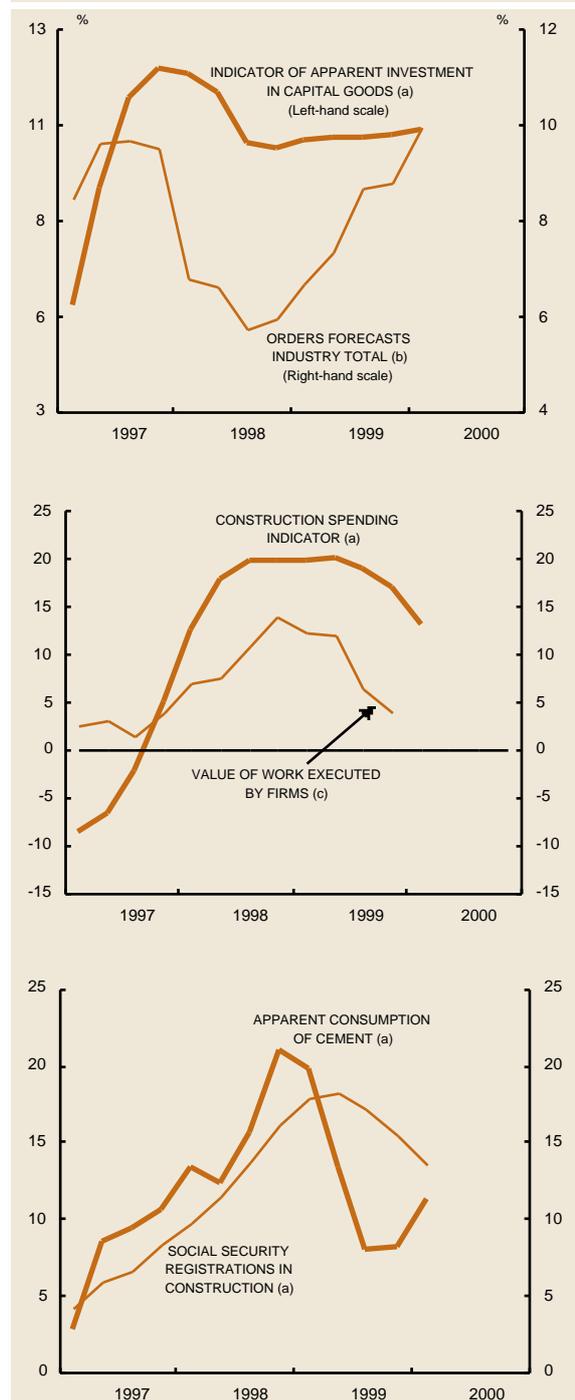
In 1999 Q4, on QNA estimates, the slowdown in gross fixed capital formation that commenced in preceding quarters accelerated, reducing the real year-on-year growth rate to 7 %, one percentage point less than in Q3. The diminished buoyancy of investment was a result of weakness in both construction spending and

in investment in capital goods. Investment in capital goods grew, on QNA estimates, at 6.8 % year-on-year, in real terms, somewhat more than one percentage point less than in the third quarter and significantly below the 10 % rate of the first quarter of the year. It should be noted though that the information available for end-1999, in particular that provided by the apparent investment indicator, based on full information for the year in question, seems to suggest that the slowdown in this spending component last year may have been less sharp (see Chart 16). This has given rise to an estimate for year-on-year growth of close to 8 % for investment in capital goods in 2000 Q1, in line with the growth signalled by the apparent investment indicator for this period (albeit based on incomplete data). It should be noted that the latest figures for the industrial production of capital goods, relating to February, show a recovery, although the business survey run by the Ministry of Industry and Energy, on data to February, has tended to indicate a somewhat less optimistic situation in investment goods industries. Meanwhile, the autumn results of the weekly investment survey of industrial firms signal, besides an upward revision to investment in 1999, investment growth in the year 2000 at very close to the 1999 rate, in nominal terms.

In general, the buoyancy of spending on capital goods forecast for the beginning of 2000 is in line with the expansionary behaviour of final demand and with the expectation that this strength will be sustained in the coming quarters. In fact, industrial orders, a variable approximating expected demand, have been markedly expansionary since end-1998, as seen in Chart 16. Moreover, the financial position of firms, reflected in the results of the Central Balance Sheet Office quarterly survey (CBQ) available to 1999 Q4, remains very comfortable, with low levels of indebtedness and a very high return on assets. Given that the cost of borrowing continued to fall to the end of 1999, the differential between this cost and profitability continues to widen, which is in principle conducive to new investment.

Construction investment remained highly buoyant in 1999 Q4, growing by 7.1 % year-on-year, although the slowdown to which it had been subject during the year became more pronounced. In any case, in 1999 as a whole, the growth of construction investment was notable, due to the healthy performance of building, while civil engineering works began to show signs of stagnation as from the second half of the year. Within building, the growth in residential investment, against a background of growth in employment and disposable income and low interest rates, which boosted the demand for

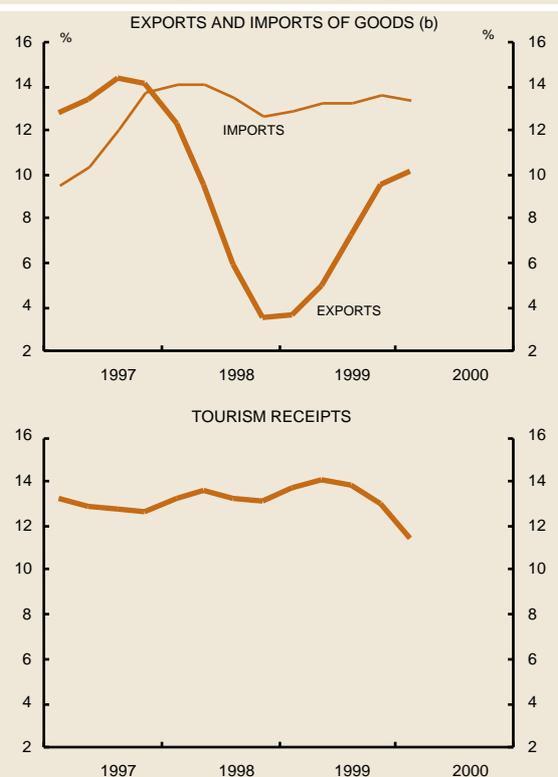
CHART 16  
Gross fixed capital formation indicators



Sources: Instituto Nacional de Estadística, Ministerio de Industria y Energía, Ministerio de Fomento, OFICEMEN, Instituto Nacional de Empleo and Banco de España.  
 (a) Non-centred percentage change on same quarter a year earlier, based on the trend of the indicator.  
 (b) Trend level.  
 (c) Obtained from the quarterly construction industry survey and deflated by the construction costs indicator. Four-quarter rate of change based on original series.

CHART 17

Foreign trade (a)



Sources: Ministerio de Economía y Hacienda, and Banco de España.  
 (a) Non centred percentage change on same quarter a year earlier, based on the trend of the indicator.  
 (b) Series deflated by the related unit value indices.

dwellings, was notable. Also, the healthy financial position of firms helped to boost spending on non-residential building.

The most recent short-term information, relating to the first quarter of the current year, seems to indicate that the slowdown in construction was tending to be curbed in this period. Input indicators, such as the index of industrial production of construction materials and apparent consumption of cement, have signalled greater buoyancy in the most recent months, which could be related to the onset of a period of greater buoyancy in civil engineering, which uses such materials very intensively in the early stages of work (see Chart 16). However, the indicators of employment in the sector show a continuation in the first quarter of the year of the slowdown displayed since the second half of the previous year. From a medium-term viewpoint, the recent behaviour of the leading indicators implies a further slowdown in this component of investment in the coming

quarters. The rate of growth of indicators of new building starts in the private sector fell in the second half of 1999 and the volume of work tendered by general government dropped in 1999 as a whole, although the decline was less pronounced in the last few months of the year.

To finish off the components of gross capital formation, it should be noted that, as in the two preceding quarters, stockbuilding added one-tenth of a point to the year-on-year growth rate of GDP in 1999 Q4. The scant information available for 2000 Q1 comes from the business survey and seems to indicate a certain rise in the level of stocks in industry.

As mentioned at the beginning of this section, provisional QNA estimates indicate that the negative contribution of net external demand to output growth fell significantly in 1999 Q4, to stand at -0.4 percentage points, down from -1.1 points in Q3 and -1.5 points in the first half of 1999. This smaller deterioration in the external imbalance was a consequence of the strong recovery in exports in the final quarter and the slight slowdown in imports, which nonetheless continued to grow at high rates. The figures for December goods trade, which were not known at the time the QNA estimates were released, confirm that net external demand made a smaller negative contribution to GDP growth in Q4. However, they seem to indicate that the correction was less significant than initially estimated by INE. These figures show that exports accelerated significantly in the final quarter of 1999, driven by the strong improvement in the global economy and by the euro's depreciation against the US dollar, but they also show that imports were highly buoyant too, growing at even higher rates than in Q3. The still very scant information on the first quarter of 2000 indicates that the recovery in world trade and the ongoing depreciation of the euro against the US dollar continued to strengthen exports, while imports sustained a high rate of growth, driven by the growth in final demand and the pick-up in industrial production.

Goods exports were on an upswing throughout 1999. This firmed in Q3, with the improvement in the European economies and the recovery in Asian markets, and strengthened in Q4, with the upturn spreading to all Spanish export markets. In the latter period, exports reached a real year-on-year growth rate of 10.3%. January 2000 customs figures show that the upswing extended into the beginning of the current year, as a result of the expansionary behaviour of sales to the EU and the strong growth in those to other markets (see Chart 17). As regards product types, the ongoing robust growth in capital goods, against a background

of heavy price falls is notable, as is the buoyancy of sales of non-energy intermediate goods, driven by the recovery in global activity. Sales of non-food consumer goods gained new momentum, owing to the growth in semi-manufactures and cars, while exports of food consumer goods grew more moderately. As regards the performance of service exports, tourism receipts displayed considerable strength in 1999, surpassing the excellent results of the previous year. The progressive improvement in the European economies, where most of the tourists visiting Spain come from, and the recovery in the countries afflicted by the international crisis, together with the euro's depreciation against the US dollar and against sterling, were responsible for this very positive performance by tourism. The only data available for the year 2000, referring to January, shows a slowdown in tourism receipts from the very high end-1999 rates. Finally, non-tourism services were very buoyant during 1999, the receipts associated with financial services, insurance and information technology services being particularly dynamic.

Goods imports grew at notably high real rates – well above those for exports – during 1999, as a consequence of the firm growth in final demand. However, a mild slowdown began in Q3 and, on QNA estimates, continued in Q4, with the year-on-year growth rate down to 11.7 % in the latter period. As mentioned above, complete customs data for 1999 Q4 would seem to indicate a strengthening of imports, in line with the recovery in final demand. The information available on January suggests that the high real growth rates of foreign purchases levelled off, against a background of sharp rises in prices. That said, given the volatility of these flows, further data will be required to corroborate this development. As regards groups of products, energy imports were particularly vigorous in January, while the rate of growth of non-energy components slowed, especially imports of capital goods and non-food consumer goods. Finally, service imports grew at a high rate in 1999. Tourism payments accelerated significantly in the second half of the year, to reach a real growth rate well up on that of the previous year, reflecting the high level of consumer confidence. This strong rate of growth moderated in January 2000. Non-tourism payments were also buoyant in 1999, especially those relating to financial services, in tune with the strong foreign investment activity generated during the year.

#### 4.2. Output and employment

From the viewpoint of the productive branches, the slight acceleration of GDP in 1999 Q4 -

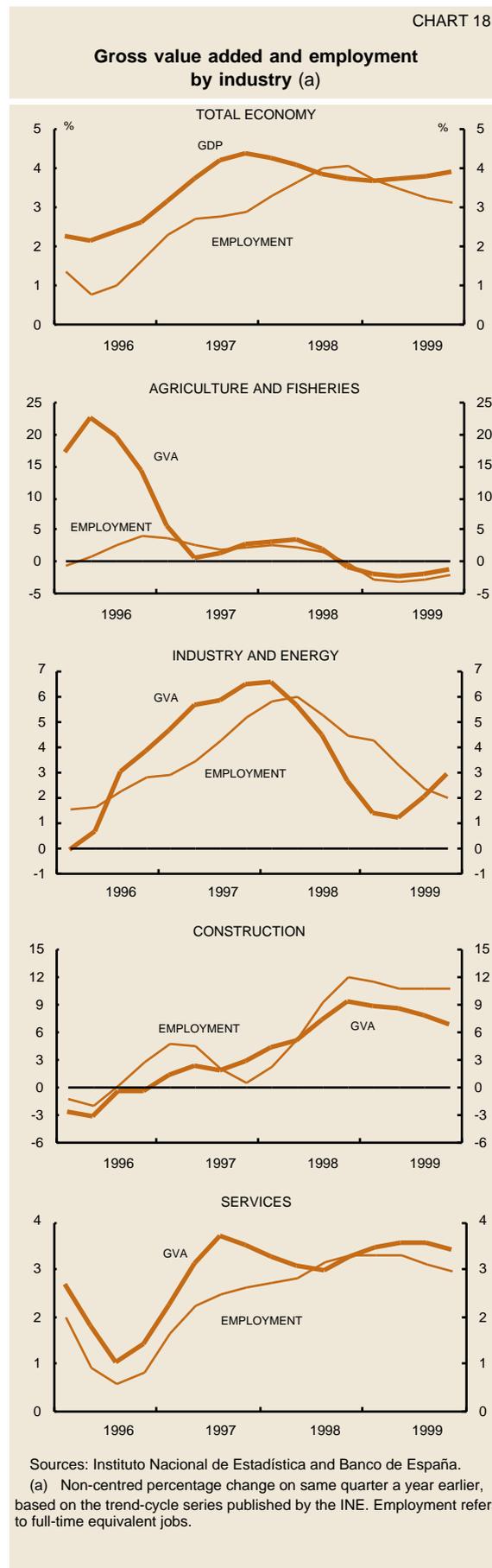
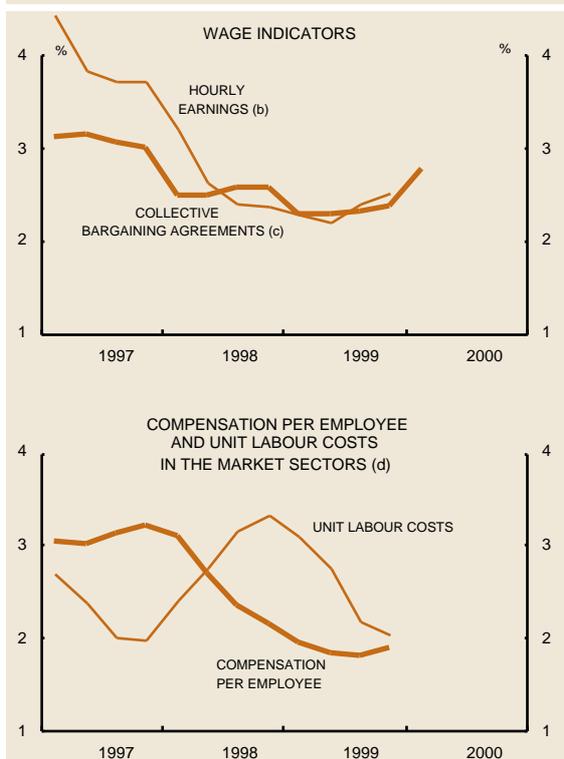


CHART 19

Wages and labour costs (a)



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

- (a) Percentage change on same quarter a year earlier.
- (b) Basic pay.
- (c) Average settlement for the year to date, without taking into account inflation-adjustment clauses.
- (d) Rates based on QNA trend-cycle series.

from 3.8 % to 3.9 %, year-on-year – stemmed from increased buoyancy of the industrial branches and a smaller negative contribution by agriculture to output growth. At the same time market services grew at a higher rate, while construction saw moderation in its growth rate, while continuing to be the most expansionary activity (see Chart 18). These trends continued in the first quarter of the current year, according to the short-term information available, with a further acceleration in GDP estimated. Against this background, employment generation continued to display notable strength. The number of full-time equivalent jobs rose by 3.2 % in 1999 Q4, with respect to the same period a year earlier, similar to the rate estimated for Q3. This stable employment growth enabled apparent labour productivity to continue to recover, to reach a year-on-year rate of 0.7 %, which is nonetheless still somewhat low compared to the average for the last decade. The recovery in productivity was especially notable in industry, where employment growth slowed. In the first

few months or 2000, the employment indicators have continued to display notable strength, although it is estimated that the rate of growth has been slightly below that in the second half of 1999, enabling apparent labour productivity to recover further.

In 1999 Q4, real gross value added in agriculture fell by 1.3 % year-on-year, almost one percentage point less than in the preceding quarter. The decline in arable production was a result of the low rainfall in Spain last year, although the fact that the unfavourable weather conditions did not affect all regions equally explains why the output of some crops, such as vegetables and especially fruit, increased. The growth in the output of animal products partly offset the sharp fall in arable output; the production of meat, milk and eggs showed greater vigour. The lack of rain in the first quarter of 2000 gave rise to a potentially unfavourable scenario for agricultural production this year, which seems to have changed in recent weeks.

In the last few months of 1999, industrial activity received the stimulus arising from the progressive recovery of the European, South American and Asian economies, as well as from the prolonged expansion of the US economy, against a backdrop of depreciation of the euro. Industrial gross value added rose by 2.9 % in Q4, with respect to the same period a year earlier, nine-tenths of a percentage point more than in Q3. The most recent economic information is unanimous in signalling a continuation of accelerated growth in industrial value added. In February, as in previous months, the index of industrial production was expansionary, reaching a year-on-year growth rate of 10.2 %, which took its trend growth rate close to 5 %. Also, industrial social security registrations recovered significantly in 2000 Q1, increasing by 3.8 % year-on-year, as against 3.1 % in 1999 Q4. The results of the surveys of industrial employers' confidence have moved in the same direction; the business confidence indicator was three percentage points higher in March than in December, with an improvement in expectations regarding output and orders. At the level of the individual industries, it can be seen that the expansion of industrial activity was fairly broad based in the most recent period, although the slowdown in other manufacturing industries sounds a discordant note.

As was implicit when analysing investment in construction, activity in this industry continued to be highly buoyant in 1999 Q4, although it slowed from the previous quarter to a real year-on-year growth rate of 6.9 %. According to the preliminary results of the quarterly construction industry survey, the reduced momentum of ac-

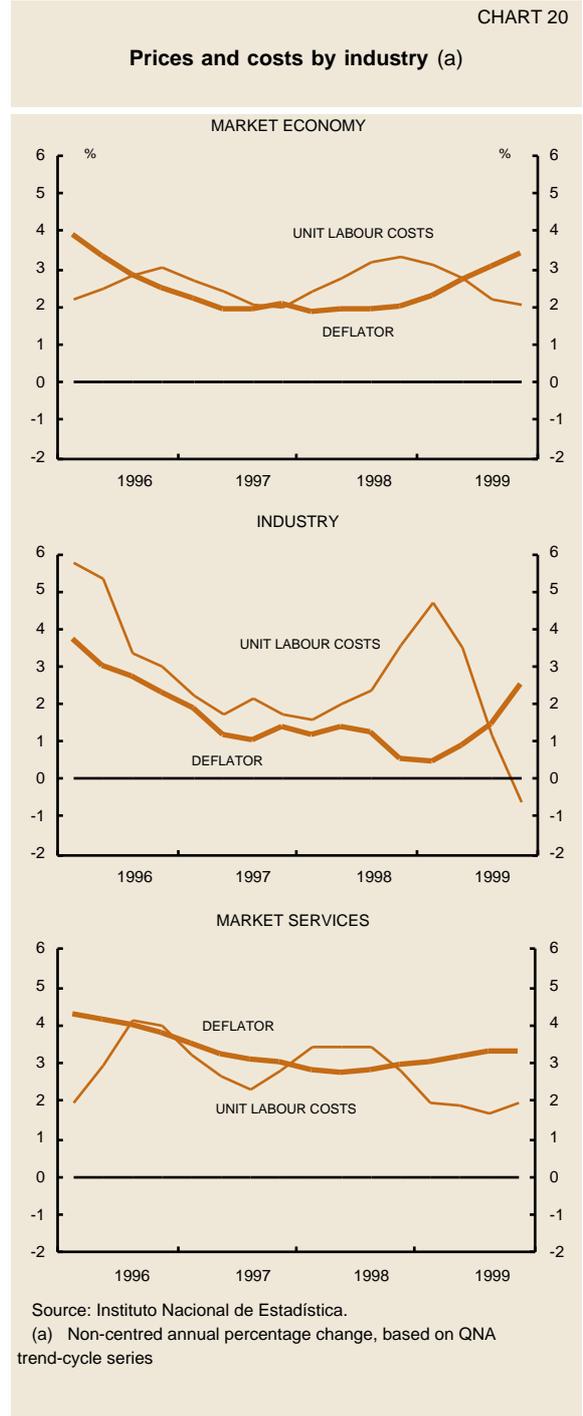
tivity in Q4 was apparent in both civil engineering and building, although the loss of vigour in the former was much greater. Some of the coincident indicators for construction activity, mainly relating to trends in inputs, have tended to show a levelling off of their deceleration in 2000 Q1.

Value added in services decelerated slightly in 1999 Q4. Its year-on-year growth rate fell to 3.4 %, one-tenth of a point lower than in Q3. This loss of momentum stemmed from non-market services, which decelerated by eight-tenths of a percentage point, while market services sustained their trend of mild acceleration, to reach a growth rate of 4.4 %. This expansion was not across-the-board, but was concentrated in telecommunications and, to a lesser extent, in corporate, personal and air-transport services. The scant economic information available on the first quarter of the current year shows a recovery in the distributive trade, accompanied by a loss of momentum in hotels and restaurants.

As mentioned above, the QNA data confirm that the Spanish economy continued to generate employment at a very brisk rate in 1999 Q4. In terms of full-time equivalent jobs, a variable which measures employment in terms of standardised working hours, employment grew by 3.2 % on the same period a year earlier, enabling apparent labour productivity to recover (see Chart 18). Those indicators offering information on the first few months of the year 2000 show that the rate of employment growth – albeit still vigorous – was slightly down on end-1999, and the recovery in productivity will have continued in this period. Specifically, the number of social security registrations rose by 5.4 % in 2000 Q1, entailing a moderate slowdown from 1999 Q 4.

Industry by industry, employment growth in 1999 Q4 was, in relative terms, in line with the differences in output buoyancy. In construction and services the year-on-year rates of growth were higher (11 % and 3 %, respectively, on QNA data) than in industry (1.9 %), while employment continued to decline in agriculture. As a result, with the exception of non-market services, apparent labour productivity recovered in all industries. According to the information on social security registrations, employment in 2000 Q1 continued to grow at high rates in construction and in market services, albeit with a mild slowdown, while it recovered in industry.

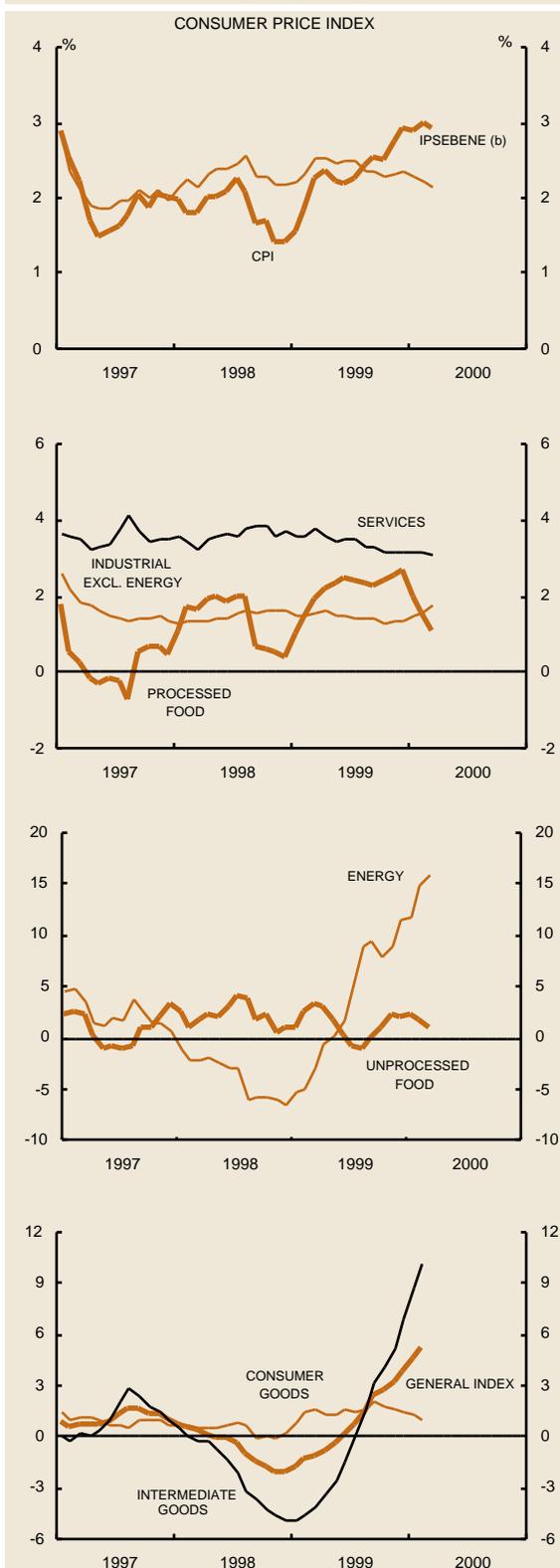
Net job creation was concentrated among wage-earners, as self-employment tended to decline. This feature is common to the QNA and the Labour Force Survey (EPA) data. As mentioned in previous reports, the information



provided by the EPA for 1999 must be interpreted with caution, as the statistics have been subject to certain modifications within the framework of harmonisation of European labour statistics. These have led to more precise estimation of the level of employment in the Spanish economy, but they have also affected the comparability with past data. This may explain why employment growth at end-1999 was 5.2 % according to the EPA, two percentage points higher than the National Accounts estimate. On EPA data, as regards the length of

CHART 21

**Price indicators (a)  
Spain**



Source: Instituto Nacional de Estadística.  
 (a) Twelve-month percentage change based on the original series.  
 (b) Index of non-energy processed goods and service prices.

contracts, the year-on-year growth rate of wage-earners with permanent contracts rose in 1999 Q4. However, that of temporary employment recovered to a greater extent, so that the ratio of temporary to permanent employment was slightly up on 1998 Q4, standing at 32.6%. Both in Q4 and during the year as a whole, part-time employment rose faster than full-time employment, although the results of the new regulations and the establishment of incentives for permanent part-time employment may be considered modest.

According to the EPA, the labour force accelerated in 1999 Q4, rising by 1.8 % year-on-year, twice the rate in Q3. This was due to a significant increase in the participation rate, which stood at 64.1 % for the population between 16 and 64 years of age. The increase in participation cancelled out the rise in employment, leaving the rate of unemployment unchanged from Q3 at 15.4 %. In fact, the rate of decline in the number of persons unemployed fell again, as did that of INEM-registered unemployment in the same period. In 2000 Q1, the rate of decline in registered unemployment was again lower than in the previous quarter, although there were signs of a levelling off. The acceleration in the labour force in 1999 Q4 was greater among women. However, the increase of 8.8 % in female employment meant that female unemployment rates fell, while the male unemployment rate rose slightly.

**4.3. Prices and costs**

On QNA estimates, in 1999 Q4 the implicit GDP deflator grew by 3.5 % year-on-year, sustaining the upward trend it had displayed throughout the year, to make an average increase of 3.1 % in 1999. As unit labour costs slowed slightly in Q4, and despite the increase in net indirect taxes per unit of output, the acceleration in the deflator was compatible with a significant increase in the gross operating surplus per unit of output and with a widening of margins.

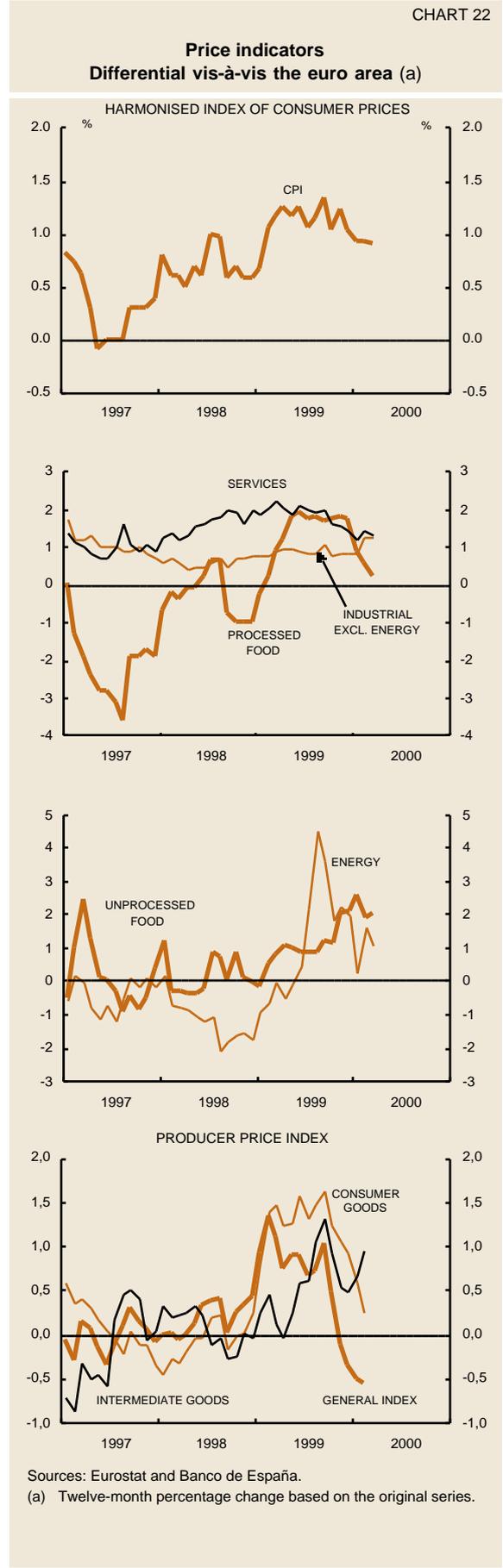
Unit labour costs rose year-on-year by 1.7 % in Q4, one-tenth of a percentage point less than in the previous quarter (see Chart 19), since the recovery in apparent labour productivity made up for the weak acceleration in average remuneration, which increased to 2.4 % from 2.3 % in the previous quarter. According to the Wages Survey, average hourly earnings in 1999 Q4, in terms of total pay, rose by 2.6 % on the same period a year earlier, one-tenth of a percentage point up on the Q3 rate. In terms of average monthly earnings, the increase was slightly smaller (2.5 %), although the acceleration was

somewhat greater. Industry by industry, the largest increase in average hourly earnings was in construction (4 %), while in industry (2.6 %) and in services (2.3 %) the increases were considerably more moderate. If these results are compared with those of collective bargaining, an estimate may be obtained for wage drift which, as in recent years, was not significant in 1999. In fact, the average increase in wage rates agreed in 1999 was 2.4 %, without including the effect of inflation-adjustment clauses, which were activated subsequently by the overshooting of the inflation target used as a reference in the settlements.

The average increase in wage rates agreed for the year 2000 in the settlements registered to March 31st was 2.8 %, which was higher than in 1999. As usual in the first quarter, most of the registered settlements were under existing agreements. The increase in wage rates under existing agreements to March was 2.7 %. The increase agreed in newly signed agreements was 4.5 %, but this was not a representative figure as very few newly signed agreements had been registered by that date. Industry by industry, the average rise in agriculture was 3.5 %, which was higher than in services (2.8 %), industry (2.7 %) and construction (2.5 %).

Chart 20 shows the behaviour of value-added deflators and unit labour costs in the market economy (excluding non-market services), in industry and in market services. In industry, the value-added deflator accelerated considerably in 1999 Q 4, while unit labour costs moderated, as a consequence of the buoyancy of productivity and the favourable trend in average compensation. As a result, the gross unit operating margin recovered somewhat in the final quarter of 1999. The market services deflator grew at the same rate as in the previous quarter, while unit labour costs rose by two-tenths of a percentage point more than in the Q3. There was thus a narrowing of the gap between these two growth rates, although the unit margin continued to widen.

The upward path of the GDP deflator in 1999 was accompanied by an acceleration in the imports deflator, so that the final demand deflator increased year-on-year by 3.7 % in Q4, eight-tenths of a percentage point more than in Q3. The deflator for goods and services imports rose to a year-on-year rate of 4.6 % in the same period, with an increase in the acceleration that had been taking place over the year. According to the information on import unit value indices, this acceleration continued to increase in January 2000. The growth in import prices was strongly influenced by the prices of



energy imports, which rose by more than 150 % year-on-year in 1999 Q4, driven by the upward path of oil prices on international markets and, to a lesser extent, by the euro-US dollar exchange rate. The positive growth of non-energy import prices in 1999 Q4 increased in January, in contrast to the declines of the preceding quarters.

Developments in the main price indicators during the first few months of 2000 have continued to be determined largely by the upward path of the price of crude oil on international markets, together with the depreciation of the euro against the US dollar. The 12-month growth rate of the CPI (the main indicator of final prices) stood at 2.9 % in March, close to the end-1999 rate (see Chart 21), despite the decline in the 12-month growth rate of the index of service and non-energy processed goods prices (IPSEBENE) to 2.1 % that month, from 2.4 % in December. The main components of the CPI behaved dissimilarly in the first few months of this year. The strong increase in energy prices and the growth in those of non-energy industrial goods were partly offset by the favourable course of food prices, while service prices held roughly steady.

The 12-month growth rate of the energy component rose from 11.5 % in December to 15.9 % in March. Among energy products, there were significant increases in the prices of both those whose prices are freely determined, such as diesel oil and fuels, and in the case of natural gas, the regulated price of which was increased in February. The decision of OPEC to increase oil production from April will doubtless entail a decline in the oil price on international markets, which will relieve the inflationary pressures stemming from the energy component in the coming months. That said, the reductions in the price per barrel of oil will not be passed through immediately to consumer prices, which will continue to hold at high rates of growth in year-on-year terms. The 12-month growth rate of prices of non-energy industrial goods rose by five-tenths of a percentage point during the first three months of the year, to reach 1.8 % in March. During the same period food prices trended favourably. The 12-month growth rate of the prices of unprocessed food fell by one percentage point to stand at 1 % in March, while that of processed food prices fell from 2.6 % in December to 1.1 % in March. This significant decline is basically a reflection of the fact that the prices of oils increased significantly in the first few months of last year, the period of comparison for the 12-month rate. Finally, service prices rose by 3.1 % in March, with price falls in telecommunications.

The HICP followed a similar path in Spain and in the euro area during the first quarter (see Chart 22). In both cases there was a slight increase in the 12-month rate, which was greater in the case of the euro area. The inflation differential thus narrowed by one-tenth of a percentage point to stand at 0.9 points in March. Component by component, the differential narrowed in the case of food and energy, since the rise in energy prices was stronger in the euro area than in Spain. In the case of services, the differential held steady, while in that of non-energy industrial goods it widened, since the upward path of these prices in Spain was accompanied by a slowdown in the euro area.

The producer price index continued to accelerate during the first two months of the year 2000, to reach a 12-month growth rate of 5.1 % in February, as against 3.8 % in December. The highest growth rates were recorded for energy intermediate goods, although there was also a certain deterioration in the prices of other intermediate goods, as well as capital goods. By contrast, the prices of consumer goods, and food consumer goods in particular, slowed, largely as a result of the high growth rates of olive oil prices in the first few months of 1999, the period of comparison for the 12-month rate. Farm gate prices continued to fall in 1999 Q4, and the information available for the first quarter of the year 2000 on wholesale markets generally indicates that these prices trended favourably.

#### 4.4. State budget

The updated stability programme set a target for the general government deficit for the year 2000 of 0.8 % of GDP, 0.5 percentage points below the deficit then estimated for 1999 (1.3 % of GDP). The year 1999 finally closed with a public deficit of 1.1 % of GDP. The target deficit for general government as a whole in the year 2000 is based on a projected deficit of 0.8 % of GDP for the State and 0.1 % for territorial government, and a surplus of 0.1 % of GDP for the Social Security System.

The first data for the year 2000 in the National Accounts framework, available to March, are consistent with the achievement of this target. In the first three months of the year the State deficit reached approximately PTA 57 billion (0.1 % of GDP), which was very similar to the deficit recorded in the same period of 1999 (see Table 3). Revenue grew by 8 %, basically due to the strength of taxes on consumption, production and imports. As in 1999, the increase in VAT receipts was notable and larger than that explained by its determinants. By con-

TABLE 3

## State Budget outturn

PTA bn and %

	Outturn		Budget		Outturn		
	1998	Percentage change 1999/1998	2000	Percentage change	1999 JAN-MAR	2000 JAN-MAR	Percentage change
	1	2	3		5	6	
<b>1. Revenue</b>	<b>18,364</b>	<b>4.8</b>	<b>18,742</b>	<b>2.1</b>	<b>5,001</b>	<b>4,866</b>	<b>-2.7</b>
Direct taxes	7,817	4.8	8,008	2.4	1,861	1,738	-6.6
<i>Personal income tax</i>	5,098	2.1	5,149	1.0	1,678	1,589	-5.3
<i>Corporate income tax</i>	2,558	10.0	2,688	5.1	130	43	-66.9
<i>Other (a)</i>	161	14.9	171	5.8	53	106	100.9
Indirect taxes	7,951	13.3	8,558	7.6	2,161	2,505	15.9
VAT	5,114	17.0	5,655	10.6	1,494	1,777	19.0
<i>Excise duties</i>	2,567	7.4	2,630	2.5	603	657	9.0
<i>Tariffs</i>	144	9.2	143	-0.9	33	38	12.9
<i>Other</i>	126	5.3	130	3.3	31	34	7.6
Other revenue	2,597	-14.8	2,176	-16.2	979	622	-36.4
<b>2. Expenditure (b)</b>	<b>19,421</b>	<b>4.2</b>	<b>19,769</b>	<b>1.8</b>	<b>5,674</b>	<b>5,866</b>	<b>3.4</b>
Wages and salaries	2,979	-2.4	2,888	-3.0	656	628	-4.3
Goods and services	436	12.3	340	-22.0	133	133	0.2
Interest payments	3,178	-4.7	2,806	-11.7	1,593	1,564	-1.8
Current transfers	10,809	9.1	11,664	7.9	2,665	2,930	9.9
Investment	957	2.6	1,012	5.8	409	373	-8.8
Capital transfers	1,063	6.6	1,059	-0.3	218	238	9.2
<b>3. Cash-basis deficit (3 = 1 - 2)</b>	<b>-1,057</b>	<b>-5.1</b>	<b>-1,028</b>	<b>-2.8</b>	<b>-673</b>	<b>-1,000</b>	<b>48.6</b>
MEMORANDUM ITEM: NATIONAL ACCOUNTS:							
Revenue	18,796	8.7	—	—	4,573	4,937	8.0
Expenditure	19,882	3.5	—	—	4,623	4,994	8.0
<b>Net borrowing (-) or lending (+) (c)</b>	<b>-1,087</b>	<b>-43.4</b>	<b>-788</b>	<b>-27.5</b>	<b>-51</b>	<b>-57</b>	<b>12.1</b>

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

(a) Including revenue from the tax on the income of non-residents.

(b) Including unclassified expenditure.

(c) The annual figures (columns 1 and 3) are drawn from the Spanish Finance Ministry's response to the Excessive Deficit Procedure questionnaire (ESA 95 methodology).

trast, direct tax receipts grew weakly, and other revenue fell significantly, as a consequence of lower revenue in respect of Banco de España ordinary profits. As for expenditure, it grew by 8 % in March, which was higher than the rate for 1999 as a whole. The decline in final consumption expenditure, associated with the transfer of responsibilities for non-university education to the regional (autonomous) governments, and the related increase in current transfers, as well as the reduction in accrued interest, were notable.

On the available cash-basis information, the State deficit to March 2000 was PTA 1 trillion, as against PTA 673 billion for the same period of 1999. The increase in the cash-basis deficit in 2000 Q1 was due to the reduction in revenue (2.7 %), in contrast to the moderate growth projected in the Budget, and to the 3.4 % increase in expenditure in the first quarter, which was somewhat higher than budgeted. The various

items of revenue and expenditure will be discussed below, using cash-basis information.

On the revenue side, total tax receipts grew in line with the budget forecast. However, this aggregate behaviour conceals contrary trends in the various components. While indirect taxes were highly buoyant, direct tax receipts fell significantly in the first quarter. The reduction in personal income tax revenue was largely due to the decline in receipts from the withholdings of regional (autonomous) governments and of social security relating to previous years. Moreover, it should be noted that the withholding tax revenue corresponding to the first two months of 1999 was raised by applying the previous tax regime, with higher withholding rates, and that the rate of withholding tax on dividends has also been reduced in the year 2000. As for corporate income tax, receipts in the first quarter are hardly indicative of their path in the year as a whole, as they were significantly affected by an in-

TABLE 4  
**Balance of payments: summary table (a)**

	EUR m	
	JAN 1999	JAN 2000
	Receipts	Receipts
<b>Current account</b>	<b>11,907</b>	<b>14,292</b>
Merchandise	6,894	8,383
Services	3,008	3,431
<i>Tourism</i>	1,660	1,807
<i>Other services</i>	1,348	1,625
Income	879	1,116
Current transfers	1,125	1,361
<b>Capital account</b>	<b>1,559</b>	<b>726</b>
	Payments	Payments
<b>Current account</b>	<b>13,579</b>	<b>16,116</b>
Merchandise	8,373	10,649
Services	1,988	2,367
<i>Tourism</i>	316	352
<i>Other services</i>	1,672	2,014
Income	1,780	1,766
Current transfers	1,438	1,334
<b>Capital account</b>	<b>61</b>	<b>79</b>
	Balance	Balance
<b>Current account</b>	<b>-1,671</b>	<b>-1,823</b>
Merchandise	-1,479	-2,265
Services	1,021	1,065
<i>Tourism</i>	1,344	1,454
<i>Other services</i>	-324	-389
Income	-900	-650
Current transfers	-313	27
<b>Capital account</b>	<b>1,498</b>	<b>646</b>

Source: Banco de España.

(a) First provisional results.

crease in rebates and by the change in the tax treatment of non-residents in March 1999 (2).

In the first quarter, the receipts from all the indirect taxes grew at much higher rates than were forecast in the Budget and recorded in 1999 as a whole. As already mentioned, the strength of VAT was notable, with a 19 % rise in receipts in the first quarter. This increase in their growth rate was, to some extent, a consequence of higher energy prices. Among excise duties, the increase in those on tobacco and electricity were notable, as was the tax on certain means of transport, reflecting the significant increase in vehicle registrations.

(2) Revenue from withholdings on interest paid on public debt held by non-residents to February 1999 was included in corporate income tax receipts. Since that date it has been included under the tax on non-residents.

The budget headings covering all other revenue, with the exception of capital transfers (which mostly arise from transactions with the EU), posted lower growth rates than budgeted in the first quarter. The reduction in revenue obtained from the Banco de España, in respect of both capital gains and ordinary profits, was notable, as was the decline in receipts from debt-issuance premiums.

As for expenditure, the growth to March of current expenditure was higher than budgeted, albeit in line with the increase during 1999 as a whole. This overshooting of the Budget projection was basically due to the concentration of interest payments and to the increase in current transfers to territorial government corresponding to their share in State revenue. Within the latter, those to the regional (autonomous) governments grew by almost 40 % to March, as a consequence of the above-mentioned transfers of responsibilities for non-university education in 1999, and of the transfer this year to the Castile and León regional (autonomous) government. By contrast, the contribution to the Social Security System to finance the current transactions of INSALUD (the national health service) rose by 6.4 %, in line with the budget projection, while the contributions to the Community budget declined. As regards capital transactions, investment declined in 2000 Q1, owing to the smaller volume of payments under obligations assumed in previous years, which offset the increase in capital transfers.

Finally, the first data on the budget outturn for the Social Security System in 2000 are briefly discussed. Receipts from social-security contributions (excluding surcharges and penalties) rose by 9.5 % in January, well above the 7.9 % rate projected in the Budget and the 7.2 % increase in 1999 as a whole. The growth in this revenue continued to be driven by the buoyancy of the total number of registered workers, which rose by 5.4 % in 2000 Q1, in line with the increase for 1999 as a whole. On the expenditure side, spending on contributory pensions grew by 4.7 % in January, much more slowly than budgeted. However, this item is expected to accelerate during the year as a result of the increase in minimum pensions and the payment in February 2000 of the compensation for the inflation overshoot in 1999. The number of contributory pensions grew by 1.2 % to March, in line with the budget projection and the increase in 1999. The total number of recipients of unemployment benefits fell by 5 % in February, as against an average reduction of 9.4 % in 1999, reflecting the slower rate of decline of registered unemployment (7 % to February, as against 12.6 % in 1999 as a whole). In line with developments in 1999, the fall in the number of

recipients of unemployment benefit was smaller in February than the number of registered unemployed persons hired, so that the eligibility ratio rose (to 65 %, up from 64.5 % in February 1999).

#### **4.5. The Spanish balance of payments and capital account**

In January 2000, the current and capital accounts ran an overall deficit of EUR 1,177 million, an increase of EUR 1,003 million on the deficit in the same month of 1999. This outcome reflects the further strong rise (53.2 %) in the trade deficit in the first month of the current year. This was because, although the strong recovery in exports of recent months firmed in January, and imports slowed slightly, there was a further deterioration in the terms of trade, basically due to the notable increase in the prices of imported energy products. The other current-account items, by contrast, trended favourably.

The tourism surplus continued to rise and the income deficit narrowed by EUR 251 million, reflecting the improvement in the credit system's income and the reduction in payments made by general government. The balance of current transfers also improved by EUR 340 million, as a consequence of the increase in flows from the EU under EAGGF-Guarantee and the European Social Fund. Finally, the surplus on capital account deteriorated by EUR 851 million in relation to January 1999, due to the lesser buoyancy of structural funds from the EU, although these tend to be subject to delays during the first few months of the year.

The nation's borrowing requirement reflected by these data would indicate a weakening of the sectoral balances of households and firms as a result of the buoyancy of residential investment and the strength of private productive investment, against a background of favourable growth prospects and progress in reducing the budget deficit.

## 5. Financial flows in the Spanish economy

### 5.1. Financial flows in the economy as a whole

The information for 1999 Q4 from the financial accounts of the Spanish economy highlights the firming of the trends indicated in previous reports. As can be seen in Table 5, the decline in the nation's net financial saving continued. Taking cumulative data over four quarters, growth stood at  $-0.9$  % of GDP, meaning that the nation's saving was negative for the first time in recent years. This performance was essentially determined by the sharp slowdown in household saving, while the net financial saving of firms diminished only slightly and general government continued to reduce its net borrowing.

In terms of the net financial position, measured as the difference between the stock of financial assets and liabilities, the data for 1999 Q4 confirm the increase in the credit balance of the non-financial corporations and households sector, as has been the case since the early nineties. The increase in the net financial position of firms basically reflects the significant restructuring undertaken in recent years, thanks to more favourable financial conditions and better corporate results. The net financial position of households has been reinforced by the notable rise in the value of their financial wealth and by the change in the composition of their saving in favour of financial instruments offering greater capital-gains generating capacity, rather than by an increase in assets purchased.

Turning to the financial account of the balance of payments, net capital outflows were recorded in 1999, as in the previous year. In other words, the Spanish economy invested more financial resources abroad than those it obtained from non-residents, whereby net assets vis-à-vis the external sector (excluding reserves) increased by EUR 12 billion (see Table 6). The significant rise in net capital outflows is mainly due to the strong buoyancy of Spanish direct and portfolio investment abroad, which amounted to EUR 76 billion, equivalent to 14 % of GDP. The salient event during the year was undoubtedly the exceptional expansion of direct investment abroad which, at EUR 33 billion, was double the previous year's figure.

As regards other investment, 1999 saw a change in the composition of foreign assets, with a notable reduction in non-financial private-sector deposits in non-resident banks. That suggests that agents, given unified payment systems in the euro area, have opted to cancel a portion of their previous positions. In turn, the foreign assets of the credit system increased forcefully, this being mainly the outcome of the increase in the intra-system assets held by the

TABLE 5

## Saving and financial position

	FINANCIAL SAVING AS % OF GDP (Cumulative data over four quarters)										
	Average 1988- 1992	Average 1993- 1997	1997	1998				1999			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Financial saving of the nation	-2.7	0.5	1.5	1.3	1.0	1.1	0.9	0.9	0.7	0.2	-0.9
Non-financial corporations and households	-0.2	4.9	3.1	2.6	2.0	2.1	1.7	1.6	1.2	0.9	-0.3
<i>Non-financial corporations</i>	-4.0	-0.7	-0.8	-0.3	-1.0	-0.9	-1.0	-0.8	-0.6	-1.0	-1.2
<i>Households</i>	3.8	5.6	3.9	2.9	3.0	2.9	2.7	2.4	1.8	1.9	0.9
Credit institutions (a)	1.4	0.7	0.6	0.7	0.8	0.6	0.6	0.5	0.4	0.4	0.4
Institutional investors (b)	-0.2	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
General government	-3.8	-5.4	-2.4	-2.2	-2.0	-1.7	-1.7	-1.4	-1.1	-1.2	-1.1

	FINANCIAL POSITION AS % OF GDP (c) (Fourth-quarter data)							
	1992	1993	1994	1995	1996	1997	1998	1999
Financial position of the nation	-16.7	-19.2	-19.4	-18.0	-17.7	-18.1	-19.2	-20.4
Non-financial corporations and households	39.8	48.1	53.2	59.2	68.5	77.2	86.2	95.9
<i>Non-financial corporations (d)</i>	-17.3	-16.4	-13.6	-10.9	-6.7	-4.8	-0.3	5.4
<i>Households</i>	57.1	64.5	66.8	70.1	75.2	82.0	86.5	90.6
Credit institutions (a) (d)	12.5	14.1	13.0	12.1	12.8	14.2	14.2	14.2
Institutional investors (b)	-1.1	-1.2	-1.0	-0.9	-0.6	-0.5	-0.6	-0.6
General government	-35.2	-42.3	-46.5	-50.3	-52.6	-52.0	-49.7	-47.5

Source: Banco de España.

(a) Defined according to the 1st Banking Directive.

(b) Insurance companies, portfolio investment institutions and securities-dealer companies and securities agencies.

(c) Calculated as the difference between outstanding financial assets and liabilities.

(d) Liabilities do not include shares.

Banco de España, and whose origin is linked to the interbank operations transacted via the TARGET system. The decline witnessed in reserve assets is in response to the transfer of reserves from the Banco de España to the ECB at the beginning of the year and to the maturity of foreign exchange swaps previously entered into.

Concerning purchases of external liabilities (capital inflows), the most notable development is the appreciable increase in non-resident portfolio investment, which amounted to EUR 41 billion. Unlike the previous year, in which over half the total of portfolio investment took the form of equity purchases, the slackness of national stock markets for much of 1999 shifted investors' attention towards government debt securities. With respect to other foreign liabilities included under the heading of other investment, there were two notable aspects. On one hand, the high foreign indebtedness of the non-financial private sector (which, in part, has been instrumental in financing Spanish firms' direct investment transactions abroad). And on the other, the increase once again in credit institutions' foreign liabilities, although the rate of their indebtedness was less than in 1998.

With regard to the sectoral structure of financial flows, the net capital outflows recorded during 1999 were mostly determined by the net acquisition of foreign assets by the non-financial private sector. This was financed via the indebtedness of the credit system (excluding the Banco de España) and the acquisition of government debt by non-resident investors.

Into the year 2000, there is only balance of payments information for January, which may not prove very relevant as regards the potential patterns to be expected this year. In any event, the main development for this month is that there was a net capital inflow, part of which was due to a direct investment flow from abroad into Spain. The flow was relatively high and exceeded that of Spanish direct investment in other countries.

## 5.2. Financial flows of households and non-financial corporations

As discussed in the previous section, the net financial saving of the non-financial private sector fell notably in 1999 Q4 to -0.3 % of GDP (on

TABLE 6

Balance of payments on financial account

EUR m

	1997	JAN-DEC	
		1998	1999
<b>BALANCE ON FINANCIAL ACCOUNT</b>	<b>-2.775</b>	<b>-991</b>	<b>9.098</b>
<b>CHANGE IN LIABILITIES VIS-À-VIS EXTERNAL SECTOR</b>	<b>34.479</b>	<b>65.678</b>	<b>88.157</b>
<b>Direct investment (a)</b>	<b>5.621</b>	<b>10.151</b>	<b>8.819</b>
<b>Portfolio investment (b)</b>	<b>11.068</b>	<b>15.353</b>	<b>41.419</b>
General government	9.952	4.125	23.812
Other resident sectors	1.183	8.469	9.348
Credit system	-67	2.759	8.259
<b>Other investment</b>	<b>17.790</b>	<b>40.174</b>	<b>37.919</b>
General government	21	866	-356
Other resident sectors	544	4.318	13.846
Credit system	17.226	34.990	24.429
<b>CHANGE IN ASSETS VIS-À-VIS EXTERNAL SECTOR</b>	<b>37.255</b>	<b>66.669</b>	<b>79.059</b>
<b>Direct investment</b>	<b>10.970</b>	<b>16.507</b>	<b>32.658</b>
Other resident sectors	9.844	14.756	33.199
Credit system	1.126	1.751	-541
<b>Portfolio investment</b>	<b>14.377</b>	<b>40.787</b>	<b>43.170</b>
Other resident sectors	10.049	29.873	29.302
Credit system	4.328	10.914	13.868
<b>Other investment</b>	<b>1.555</b>	<b>21.623</b>	<b>24.202</b>
General government	331	388	213
Other resident sectors	12.392	17.668	-8.853
Credit system	-11.168	3.567	32.842
<b>Reserves</b>	<b>10.352</b>	<b>-12.248</b>	<b>-20.971</b>

Source: Balance of Payments. Banco de España.

(a) Includes portfolio investment in unlisted shares.

(b) Includes direct investment in listed shares.

cumulative data over four quarters). This was particularly due to the heavy fall in household saving, the result of the growth of liabilities outpacing that of financial assets. According to the estimates based on the provisional information available for certain financial asset and liability items, this trend might hold in 2000 Q1.

Turning to financial assets, Table 7 and Chart 23 show how, from January to March 2000, private-sector financial investment may have sustained a stable growth rate of around 14 % compared with a year earlier, virtually unchanged on the second half of 1999. Conversely, it is estimated that liquid financial assets (comprising cash, bank deposits, repos, bank securities and shares in fixed-income mutual funds) have continued to grow at a much more moderate rate than total financial assets, running at a stable year-on-year rate of around 3%. The rate of expansion of cash and cash equivalents moderated appreciably in 1999 Q4. As a result, its annual growth rate stood at 12 % at end-1999, compared with 17 % in previous

quarters. Foreseeably, it will have continued on this trend in the January-March period in 2000. The relative restraint of cash and cash equivalents (which is most likely associated with the higher opportunity cost of holding such assets given rising interest rates) might be interpreted as a sign of agents' lesser willingness to adopt immediate spending decisions. However, the related rates of expansion remain very high and, moreover, the biggest slowdown appears to be for firms whereas it is less significant for households, where the relationship between cash and cash equivalents and spending decisions may be more direct.

As regards private-sector financial liabilities, the expansionary trend of previous quarters, with growth running at around 16 %, has been sustained. This figure reflects the firming of high rates of increase in finance extended to the private sector. Indeed, the indebtedness aggregate made up of bank credit and fixed-income securities is estimated to have grown at a rate of 20% in 2000 Q1 compared with a year earlier.

TABLE 7

**Financial assets and liabilities of households and non-financial firms**

	Latest quarter balance (a) (b)	Four-quarter % change					
		1998		1999			2000 (b)
		Q4	Q1	Q2	Q3	Q4	Q1
<b>HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS:</b>							
<b>Total financial assets</b>	<b>1.423.6</b>	<b>14.3</b>	<b>10.9</b>	<b>12.0</b>	<b>14.2</b>	<b>14.2</b>	<b>14.6</b>
Liquid financial assets	549.5	5.4	4.3	4.2	4.3	2.8	2.5
<i>Cash and cash equivalents</i>	271.8	14.6	14.9	17.5	17.5	11.9	12.5
<i>Other liquid financial assets</i>	277.6	-1.1	-3.1	-5.5	-5.4	-4.7	-5.7
Other financial assets	874.2	22.6	16.6	18.5	22.4	23.3	23.8
<b>Total liabilities</b>	<b>938.0</b>	<b>13.2</b>	<b>14.4</b>	<b>16.3</b>	<b>16.4</b>	<b>15.8</b>	<b>16.2</b>
Bank financing plus fixed-income securities	618.4	16.2	15.9	19.2	19.3	19.0	20.0
<i>Credit from resident credit institutions</i>	481.8	15.7	14.8	16.6	15.9	15.6	16.5
Other financial liabilities	319.6	8.3	12.0	11.4	11.4	10.2	9.4
<b>HOUSEHOLDS:</b>							
<b>Total financial assets</b>	<b>905.2</b>	<b>12.8</b>	<b>8.5</b>	<b>8.9</b>	<b>11.3</b>	<b>11.6</b>	<b>12.0</b>
Liquid financial assets	446.8	3.6	2.2	1.6	1.1	0.7	0.3
<i>Cash and cash equivalents</i>	204.9	8.9	10.6	14.2	15.4	13.9	12.7
<i>Other liquid financial assets</i>	241.9	0.4	-2.8	-6.3	-7.9	-8.2	-8.3
Other financial assets	458.4	27.4	17.2	18.8	26.2	25.8	26.3
<b>Total liabilities</b>	<b>380.0</b>	<b>13.2</b>	<b>15.4</b>	<b>15.1</b>	<b>15.3</b>	<b>14.6</b>	<b>12.7</b>
Bank financing plus fixed-income securities	272.7	18.3	18.5	18.3	18.3	17.7	16.0
<i>Credit from resident credit institutions</i>	246.9	19.1	19.3	19.0	18.9	18.2	16.3
Other financial liabilities	107.3	3.0	8.8	8.2	8.8	7.4	5.2
<b>NON-FINANCIAL CORPORATIONS:</b>							
<b>Total financial assets</b>	<b>518.4</b>	<b>17.3</b>	<b>15.8</b>	<b>18.0</b>	<b>19.4</b>	<b>19.0</b>	<b>19.5</b>
Liquid financial assets	102.7	14.8	15.5	17.7	21.3	13.0	13.5
<i>Cash and cash equivalents</i>	67.0	35.4	30.2	28.8	24.6	6.1	11.7
<i>Other liquid financial assets</i>	35.7	-13.5	-5.4	1.4	16.2	27.8	16.8
Other financial assets	415.7	18.0	15.9	18.1	18.9	20.7	21.1
Or which: <i>Claims on non-financial corporations and households</i>	192.6	8.3	8.5	9.0	8.1	8.9	13.9
<i>Claims on rest of the world</i>	126.7	48.4	37.3	41.7	39.9	38.1	38.3
<b>Total liabilities</b>	<b>558.0</b>	<b>13.2</b>	<b>13.8</b>	<b>17.2</b>	<b>17.2</b>	<b>16.7</b>	<b>18.6</b>
Bank financing plus fixed-income securities	345.7	14.5	13.7	19.9	20.2	20.0	23.3
<i>Credit from resident credit institutions</i>	235.0	12.5	10.4	14.2	13.0	13.0	16.7
Other financial liabilities	212.3	11.3	13.9	13.1	12.8	11.7	11.7

Source: Banco de España.

(a) EUR billions.

(b) The data for 2000 Q1 are provisional estimates.

er, one percentage point up on the end-1999 rate.

### 5.2.1. Financial flows of households

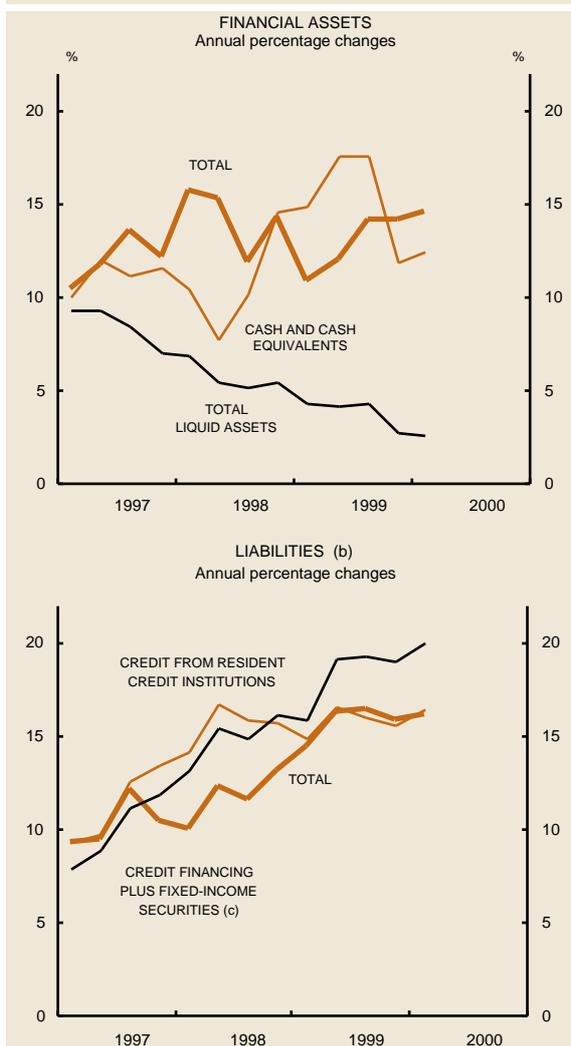
The most significant development in respect of household finances during 1999 Q4 was the fact that their net financial saving diminished drastically to 0.9 % of GDP, the lowest level of the past two decades. This has come about due to a series of factors that have encouraged spending and debt to the detriment of saving. Such factors include most notably: the increase

in the financial wealth of the sector, underpinned above all by the rise in stock market prices; favourable finance conditions, which have been conducive to households incurring bank debt at a notable rate; and, lastly, the favourable economic outlook, which leads to a reduction in precautionary saving.

In 2000 Q1, in line with recent quarters, the growth of assets has accelerated slightly while the pace of liabilities has moderated (see Chart 24). It is estimated that total financial assets have grown in this period at a year-on-year rate of 12 % (similar to end-1999). In terms of their

CHART 23

Non-financial corporations and households (a)



Source: Banco de España.

- (a) The data for 2000 Q1 are provisional estimates.
- (b) Excluding shares.
- (c) Excluding trade credit.

composition, the contribution of liquid financial assets has once more remained very moderate, running at a rate of virtually zero (0.3 %). Both cash and cash equivalents and the remaining liquid assets appear to have held at a stable growth rate compared with 1999. Thus, the former posted a rate of increase close to 13 % year-on-year, while the growth rate of other liquid assets was negative of the order of 8 %. In this respect, the most salient development in recent months has been the shift in saving from fixed-income mutual funds towards other financial instruments, such as deposits with an agreed maturity, equity and international funds, and insurance products. Among the latter, demand appears to be concen-

trated in unit-linked funds, which offer an attractive, tax-efficient return.

The expansion of household financial liabilities, which had exhibited a very high growth rate throughout 1999 (15 %), may have moderated in 2000 Q1 to a rate below 13 % year-on-year. The rate of advance of finance obtained via resident credit institutions, the main source of finance for this sector, has fallen to 16 % year-on-year, two percentage points down on the end-1999 rate. Drawing on information on the end-use of credit in 1999 Q4, credit extended for house purchases is holding at a high rate of 19 %, while that to finance durable goods acquisitions has, in line with the trend throughout the year, moderated appreciably to 8 % in relation to the same period a year earlier.

5.2.2. Financial flows of non-financial corporations

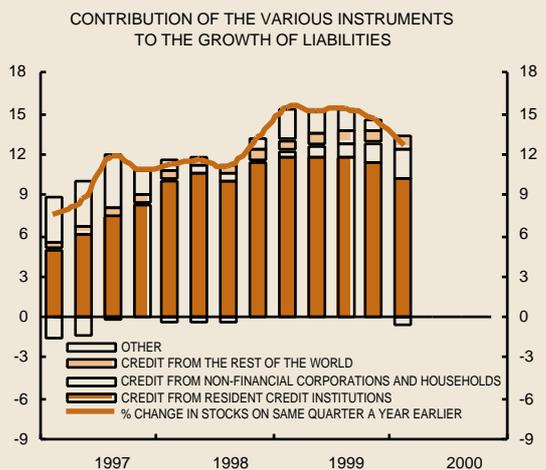
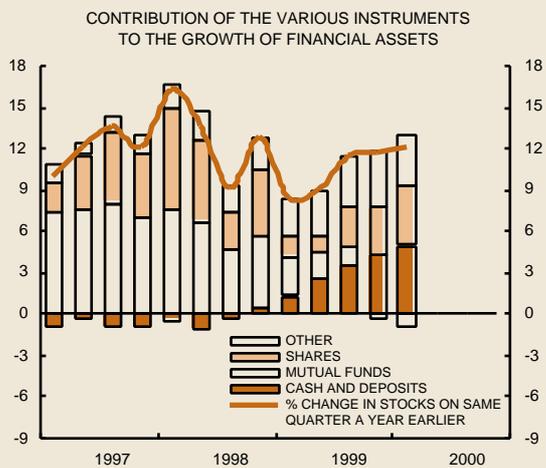
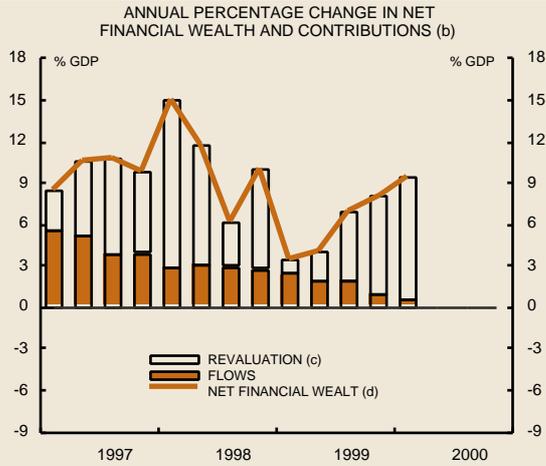
The financial flows of firms show the respective growth rates of financial assets and liabilities to be more balanced than in the case of households. That has made for stable net financial saving in this sector, which stood at -1.2 % of GDP in 1999 Q4. This level, similar to that seen in recent years, shows that firms are financing the current phase of economic growth without having to incur significant debt in net terms. The sector is therefore generating a high volume of own resources to finance its investments and, moreover, Spanish firms are clearly targeting more of their investment abroad. In fact, irrespective of whether financing is via debt or capital increases, the external expansion of corporate activity does not affect net financial saving, since it involves in parallel an increase in the financial assets held by firms.

With regard to recent developments in financial assets, these were as buoyant in 2000 Q1 as in previous periods. The growth of total financial assets could be close to 20 % compared with the same period in 1999. As in previous periods, it is the less liquid financial instruments which continue to make the highest contributions (see Chart 25), and notable among these are assets vis-à-vis households and firms (so-called inter-company credit), and claims on the rest of the world.

In parallel with the growth of financial assets, it is estimated that firms' financial liabilities increased considerably in 2000 Q1, up to a rate close to 19 % year-on-year, two percentage points higher than the end-1999 rate. This rise is attributable to the increase in credit obtained both from the resident banking system and from other households and firms, the year-on-year growth rates for both of which increased by

CHART 24

Households (a)

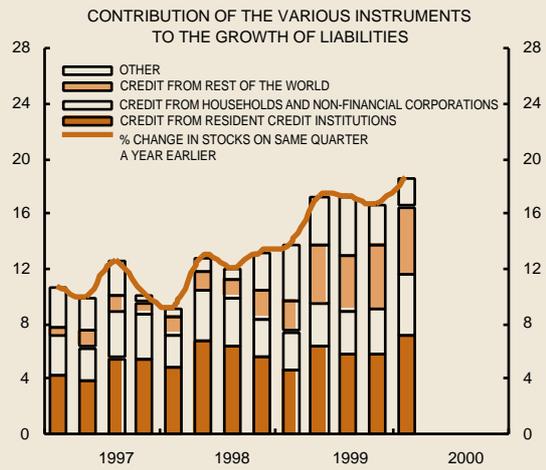
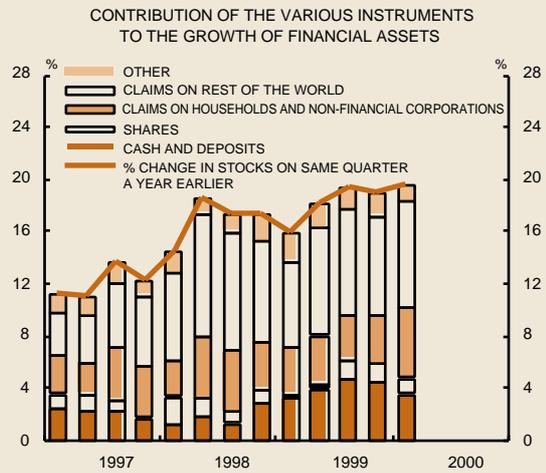
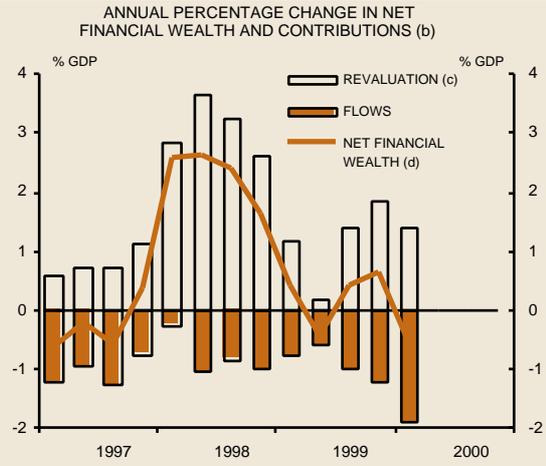


Source: Banco de España.

- (a) The data for 2000 Q1 are provisional estimates.
- (b) The flows and revaluation are cumulative data over the latest four quarters.
- (c) Difference between the change in the stock and the flow.
- (d) Calculated using an estimate of the assets valued at market prices.

CHART 25

Non-financial corporations (a)

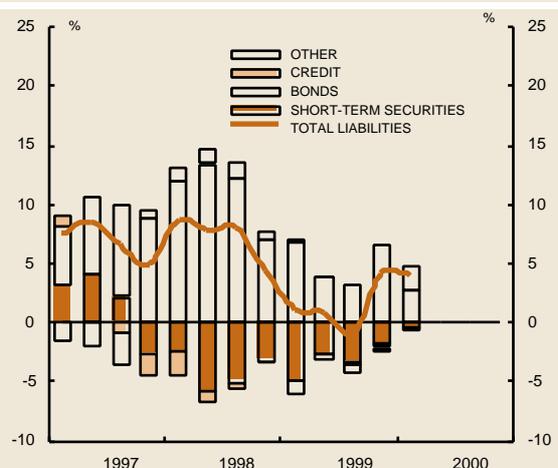


Source: Banco de España.

- (a) The data for 2000 Q1 are provisional estimates.
- (b) The flows and revaluation are cumulative data over the latest four quarters.
- (c) Difference between the change in the stock and the flow.
- (d) The liabilities do not include shares. Calculated using an estimate of the assets valued at market prices.

CHART 26

**Growth of general government liabilities**



Source: Banco de España.

around four points in relation to the previous quarter.

Information on the destination of bank finance for 1999 Q4 shows notable restraint in lending extended to productive activities. The related growth rate was 12 %, four points down on the previous quarter. This restraint was due to the reduction in credit extended to the industrial sector and to services, which ended the year expanding at respective rates of 9 % and 11 %, six percentage points down on the previous quarter in both cases. Nonetheless, credit to construction activity held on a rising trend, running at 20 % year-on-year, five points above the rate for the preceding quarter.

**5.3. General government financial flows**

Cumulative general government net borrowing during the four quarters to 1999 Q4 fell to

1.1 % of GDP, three-tenths of a point below the budget target set at the beginning of the year. The information available for 2000 Q1 suggests this improvement has continued, with the estimated net financial saving for the sector as a whole in line with that budgeted for the entire year.

Unlike in previous quarters, financial liabilities have recently been on a rising course (see Chart 26), running at a year-on-year rate of change of 3 % in 1999 Q4, a very similar rate to that expected for 2000 Q1. This does not contradict the data on the course of net financial saving, since this also depends on changes in financial assets. Moreover, the pattern of interest payments in the opening months of the year has meant that net borrowing in this period has been greater than in previous years, without this bearing on the annual targets set.

Notable in connection with the composition of the stock of financial liabilities was that throughout 1999 there were positive net issues of long-term liabilities, while the stock of short-term instruments diminished drastically. This meant that, at end-1999, the average life of peseta-denominated government debt was 5.3 years, compared with five years at the close of 1998. In the period from January to April 2000, there have been negative net issues of public securities for an amount of EUR 1.7 billion, the result of redemptions of both long- and short-term borrowings for EUR 0.6 and 1.1 billion, respectively. Nonetheless, in the case of medium- and long-term debt, this figure is strongly influenced by the sizeable redemption of three-year bonds that took place in mid-April. Accordingly, these funds may once more be re-invested in medium- and long-term bonds at the related May tenders. The outstanding balance of six- and twelve-month Treasury bills has declined, while that of 18-month bills has increased.

26.4.2000.

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# Results of non-financial corporations in fourth quarter of 1999 and summary year-end data (1)

## 1. INTRODUCTION

On the information collected in the Central Balance Sheet Office Quarterly Survey (CBQ) for the reference period, there was a pick-up during 1999 Q4 on the trend recorded in the three previous quarters of the year. However, the provisional year-end CBQ data for 1999 show a decline in activity compared with the related 1998 figures (2.8 % against 4.2 %). Evidently, though, once the annual (CBA) year-end data for 1999 are available, a trend for the period in keeping with the initial national accounts figures will be obtained. This is because the downward bias of the CBQ sample (2) (which, among other things, incorporates falls in prices that cannot be extrapolated to the national total into its nominal trend) will be rectified.

The favourable position of manufacturing industry in 1999 Q4 [gross value added (GVA) in this period was up 5.8 % on four quarters earlier] was due to the performance of exports and the continuing resilience of domestic demand. This position, which was shared by the distributive trade and, to a lesser extent, by other services, meant that positive growth rates were sustained for the whole of 1999, albeit at the aforementioned more moderate pace. Behind such moderation is the effect of price rises in oil inputs and, on the production side, the lower prices and tariffs resulting from the liberalisation of communications and the electricity sector. As these sectors are over-represented in the CBQ sample, they contribute to reducing the growth rate of the total aggregate of firms.

Personnel costs increased moderately in 1999 as a whole (1.4 %), although in the second half of the year they grew more briskly, in step with activity. The rise in Q4 was due both to the growth of staffing levels and of average remuneration. Nonetheless, in the year as a whole the wage restraint of prior periods was maintained. Testifying to this was the fact that the growth rate of costs per employee during the four quarters of 1999 compared with the same period a year earlier was 1.8 %. This containment of labour costs helped the sample firms to absorb the higher prices of inputs

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(1) This article is based on data provided to 15th March 2000 by the firms that report to the CBQ (an average of 784 over the four quarters of 1999). In all, these firms account for 16.5% of the activity of the non-financial firms sector (measured in terms of this sector's coverage in relation to GVA).

(2) For 1998 the CBA figures reflected nominal growth in activity of 6.7%, compared with the figure of 4.2% predicted by the CBQ figures.

TABLE 1

**Profit and loss account. Year-on-year performance**  
**(Growth rates of the same firms on the same period a year earlier/**  
**% of GVA at factor cost in the case of the net profit)**

Data bases	CBA			CBQ			
	1996	1997	1998	96 Q1-Q4 95 Q1-Q4 (a)	97 Q1-Q4 96 Q1-Q4 (a)	98 Q1-Q4 97 Q1-Q4 (a)	99 Q1-Q4 98 Q1-Q4 (a)
Number of firms/Total national coverage	8019/38.6 %	7953/38.3 %	6342/35.4 %	727/20.9 %	725/20.7 %	832/19.9 %	784/16.5 %
<b>1. VALUE OF OUTPUT</b> (including subsidies)	5.7	10.1	6.3	6.7	8.1	3.2	9.4
Of which:							
1. Net amount of turnover and other operating income	6.6	10.0	6.9	7.2	7.8	3.5	10.2
<b>2. INPUTS (including taxes)</b>	7.3	11.7	6.0	10.0	10.0	2.5	14.1
Of which							
1. Net purchases	6.0	11.9	3.4	10.2	9.8	1.0	17.2
2. Other operating costs	8.9	10.9	10.8	8.4	9.3	7.0	9.6
<b>S.1. GROSS VALUE ADDED AT FACTOR COST</b>	<u>2.8</u>	<u>7.1</u>	<u>6.7</u>	<u>2.1</u>	<u>5.2</u>	<u>4.2</u>	<u>2.8</u>
<b>3. Personnel costs</b>	<u>3.9</u>	<u>4.1</u>	<u>5.1</u>	<u>3.2</u>	<u>2.2</u>	<u>3.2</u>	<u>1.4</u>
<b>S.2. GROSS OPERATING PROFIT</b>	<u>1.5</u>	<u>11.0</u>	<u>8.6</u>	<u>1.1</u>	<u>7.8</u>	<u>5.1</u>	<u>3.9</u>
4. Financial revenue	5.1	11.2	10.0	13.3	19.4	15.3	24.8
5. Financial costs	-12.9	-13.4	-8.6	-11.8	-15.5	-8.9	-6.9
6. Corporate income tax	9.8	21.8	31.9	5.7	20.4	17.7	21.3
<b>S.3. FUNDS GENERATED FROM OPERATIONS</b>	5.6	16.8	10.0	7.2	14.9	8.6	8.0
7. Depreciation and provisions	-4.0	25.7	18.0	3.6	16.5	-5.2	5.5
<b>S.4. TOTAL NET PROFIT (% of GVA at factor costs)</b>	11.1	15.0	15.9	13.0	15.8	19.0	19.8
<b>PROFITABILITY RATIOS</b>							
R.1. Ordinary return on net assets (before taxes) (b)							
R.2. Interest on borrowed funds/ interest-bearing borrowing	7.3	7.6	8.4	7.6	8.0	8.9	8.7
R.3. Ordinary return on equity/ (before taxes) (b)	8.0	6.7	5.7	8.4	7.5	6.4	4.8
R.4. Debt ratio	6.9	8.1	9.7	7.2	8.2	10.0	10.6
R.5. Leverage (R.1 – R.2) (b)	42.6	38.9	39.3	42.2	37.2	37.3	38.4
	-0.8	0.9	2.7	-0.9	0.6	2.5	3.9

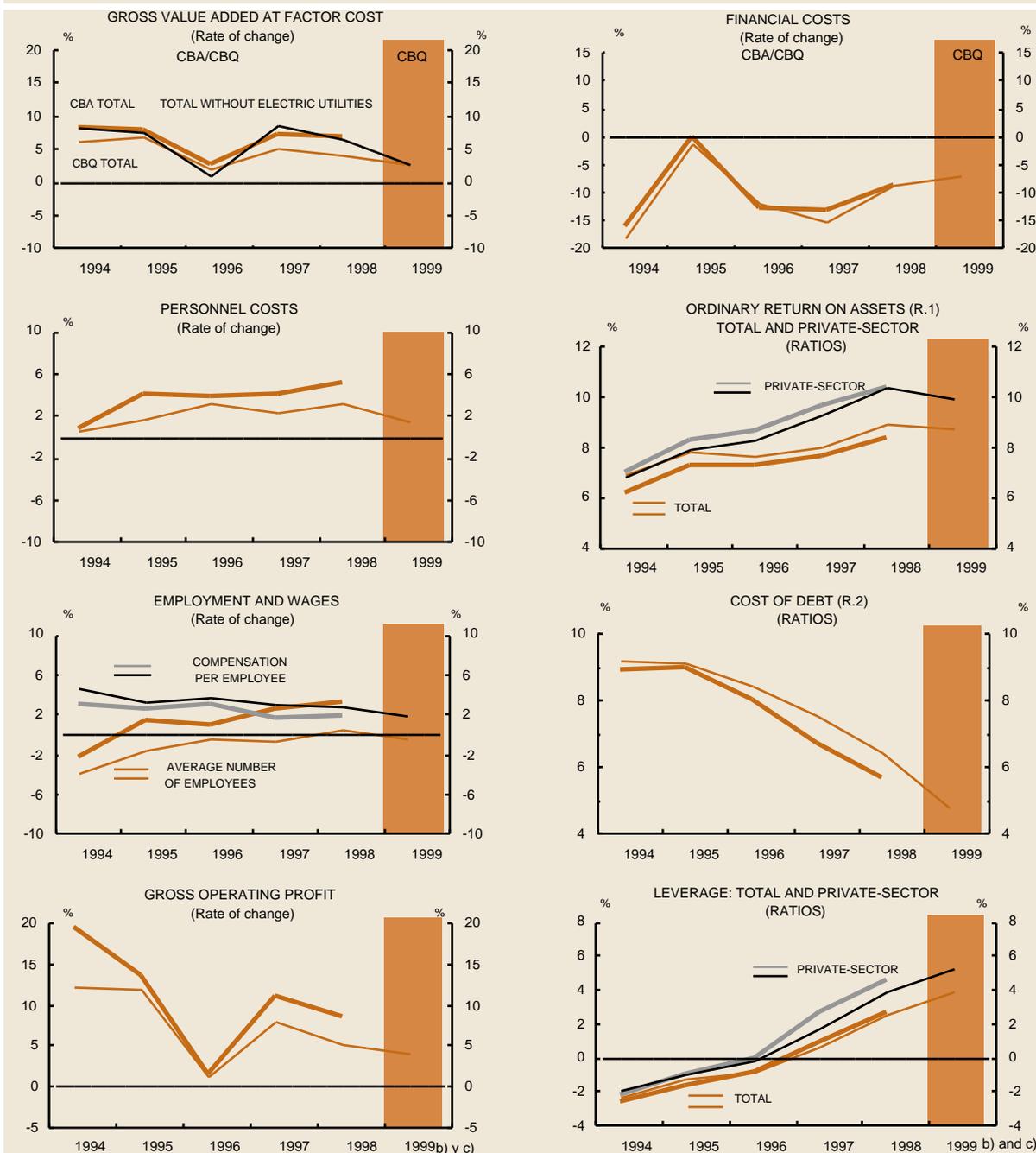
Source: Banco de España.

(a) All the data in this column have been calculated as the arithmetic mean of the quarterly data.

(b) Ratio calculated in accordance with the new methodology explained in this article and in the annual monograph of the Central Balance Sheet Office.

CHART 1

Non-financial firms reporting to the Central Balance Sheet Office (a)



		NUMBER OF FIRMS					
CBA		7,838	8,111	8,019	7,953	6,342	
CBQ		615	722	727	725	832	784
		% OF GDP OF NON-FINANCIAL CORPORATION SECTOR					
CBA		34.6	36.9	38.6	38.3	35.4	
CBQ		18.4	21.5	20.9	20.7	19.9	16.5

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CBQ		18.4	21.5	20.9	20.7	19.9	16.5

Source: Banco de España.

(a) Information available to March 15th 2000 (CBA and CBQ).

(b) The 1994, 1995, 1996, 1997 and 1998 data are based on information from the firms included in the annual survey (CBA) and the average of the four quarters of each year in relation to the previous year (CBQ).

(c) The 1999 data are the average of the four quarters of 1999 in relation to the same period in 1998.

TABLE 2.a

**Value added, employees, personnel costs and average compensation**  
**Breakdown by size, ownership status and main activity of firms**  
**(Growth rates of the same firms on the same period a year earlier)**

	Gross value added at factor cost				Employees (average for period)				Personnel costs				Average compensation			
	CBA		CBQ		CBA		CBQ		CBA		CBQ		CBA		CBQ	
	1997	1998	98 Q1-Q4 (a)	99 Q1-Q4 (a)	1997	1998	98 Q1-Q4 (a)	99 Q1-Q4 (a)	1997	1998	98 Q1-Q4 (a)	99 Q1-Q4 (a)	1997	1998	98 Q1-Q4 (a)	99 Q1-Q4 (a)
<b>Total</b>	<b>7.1</b>	<b>6.7</b>	<b>4.2</b>	<b>2.8</b>	<b>2.5</b>	<b>3.2</b>	<b>0.5</b>	<b>-0.4</b>	<b>4.1</b>	<b>5.1</b>	<b>3.2</b>	<b>1.4</b>	<b>1.5</b>	<b>1.9</b>	<b>2.7</b>	<b>1.8</b>
<b>Total, except electricity sector</b>	<b>9.1</b>	<b>7.9</b>	<b>6.3</b>	<b>2.6</b>	<b>2.7</b>	<b>3.6</b>	<b>1.2</b>	<b>0.3</b>	<b>4.4</b>	<b>5.6</b>	<b>3.9</b>	<b>2.3</b>	<b>1.6</b>	<b>1.9</b>	<b>2.8</b>	<b>2.0</b>
SIZE:																
Small	8.3	8.3	—	—	4.0	4.3	—	—	6.5	7.3	—	—	2.4	2.9	—	—
Medium	10.3	10.2	8.6	6.0	3.8	5.7	3.4	5.3	7.1	8.8	6.9	7.0	3.1	2.9	3.3	1.6
Large	6.6	6.2	4.0	2.5	2.2	2.7	0.2	-1.0	3.5	4.5	2.9	0.9	1.2	1.7	2.7	1.8
OWNERSHIP STATUS:																
Public-sector	-0.9	5.2	4.5	5.7	-2.8	-1.3	0.2	0.7	-0.2	2.0	2.9	3.9	2.6	3.4	2.7	3.2
Private-sector	9.2	6.9	4.1	2.4	4.0	4.3	0.6	-0.7	5.3	5.8	3.3	0.6	1.2	1.5	2.7	1.3
BREAKDOWN OF INDUSTRIES BEST REPRESENTED IN THE SAMPLE:																
Manufacturing	11.0	6.7	6.9	0.5	1.0	2.2	1.6	-0.8	4.0	5.6	4.9	1.8	3.0	3.3	3.3	2.7
Production and distribution of electricity, gas, and water	-4.3	0.1	-3.2	3.6	-1.5	-5.9	-6.1	-7.4	-0.4	-1.9	-2.4	-5.8	1.1	4.3	3.9	1.8
Distributive trade	9.5	14.2	12.7	8.7	3.1	8.2	3.5	6.3	4.9	9.4	5.9	8.1	1.8	1.1	2.3	1.7
Transport, storage and communications	8.5	5.6	4.0	1.2	-1.1	-0.5	-1.6	-5.5	2.1	3.2	1.3	-1.3	3.2	3.7	3.0	4.6

Source: Banco de España.

(a) All the data in these columns have been calculated as the arithmetic mean of the quarterly data.

TABLE 2.b

**Employment and personnel costs**  
**Breakdown according to changes in staff levels**

	Total CBQ firms 1999 Q1-Q4	Firms increasing (or not changing) staff levels	Firms reducing staff levels
<b>Number of firms</b>	<b>784</b>	<b>466</b>	<b>318</b>
<b>Personnel costs</b>			
Initial situation 1998 Q1-Q4 (EUR millions)	18,429.8	7,945.2	10,484.6
Rate 99 Q1-Q4 / 98 Q1-Q4	1.4	9.5	-4.8
<b>Average compensation</b>			
Initial situation 1998 Q1-Q4 (EUR)	34,866.5	31,403.9	37,579.2
Rate 99 Q1-Q4 / 98 Q1-Q4	1.8	1.2	3.8
<b>Number of employees</b>			
Initial situation 1998 Q1-Q4 (thousands)	532	253	279
Rate 99 Q1-Q4 / 98 Q1-Q4	-0.4	8.3	-8.3
<b>Permanent</b>			
Initial situation 1998 Q1-Q4 (thousands)	466	203	263
Rate 99 Q1-Q4 / 98 Q1-Q4	-1.2	7.0	-7.5
<b>Non-permanent</b>			
Initial situation 1998 Q1-Q4 (thousands)	66	51	15
Rate 99 Q1-Q4 / 98 Q1-Q4	5.0	13.2	-21.6

Source: Banco de España.

and the lower prices of finished goods, moderating the impact of both effects on operating margins or surpluses which, as in the two previous years, continued to outgrow personnel costs. As has been reported in previous editions of this article, the growth in recent years has had a clear bearing on the employment figures of the sample firms, which have shown net increases since 1995 in the CBA and during 1998 in the CBQ. The growth in staffing levels during 1999 in most of the firms of the CBQ sample is not reflected in the total rate, which posted a decline of 0.4 %, although it is apparent in that of non-permanent employees, which grew by 5 %. The performance of total employment in the sample highlights the persistence of isolated processes of restructuring in certain large corporations belonging to sectors undergoing liberalisation (communications and electricity), as discussed in preceding articles. Further, the moderation of average compensation during 1999 is evidently influenced by the lower cost of newly hired workers. That said, the quarterly series reveals a rise in average compensation in Q4 that may reflect the course of con-

TABLE 3

**Purchases and turnover of firms reporting data on purchasing sources  
and sales destinations  
Structure**

	CBA		CBQ	
	1997	1998	98 Q1-Q4 (a)	99 Q1-Q4 (a)
<b>Total firms</b>	<b>7,953</b>	<b>6,342</b>	<b>832</b>	<b>784</b>
Firms reporting source/destination	7,953	6,342	779	735
	%	%	%	%
<b>Net purchases</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
SOURCE OF PURCHASES:				
Spain	66.2	65.4	68.4	74.5
Total abroad	33.8	34.6	31.6	25.5
<i>EU countries</i>	22.1	23.9	23.6	16.8
<i>Third countries</i>	11.7	10.8	8.0	8.7
<b>Net turnover</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
SALES DESTINATIONS:				
Spain	80.3	79.7	85.7	88.4
Total abroad	19.7	20.3	14.3	11.6
<i>EU countries</i>	14.6	15.2	10.8	7.8
<i>Third countries</i>	5.1	5.1	3.5	3.7

Source: Banco de España.

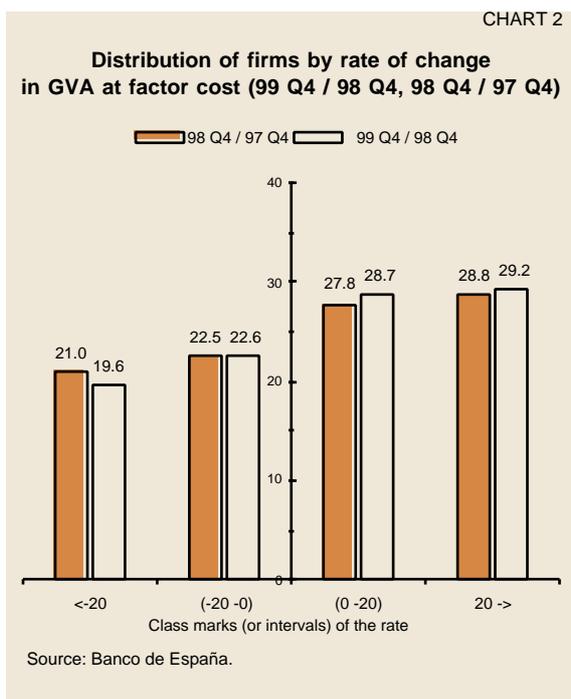
(a) All the data in this column have been calculated as the arithmetic mean of the relevant quarters, including the figure for the total number of firms.

sumer prices and which should be analysed in the light of the data arising in the coming quarters.

In 1999 as a whole, the expansion of activity and the containment of personnel costs led to an increase in the operating surplus or margin of the firms of the sample, albeit at a lesser rate than the previous year. Financial costs continued to fall gradually (they declined by 6.9 %) which, as has habitually been the case in recent years, allowed the profitability levels secured in 1998 to be maintained and contributed to the favourable trend of funds generated. Lastly, the final section of the profit and loss account highlights a considerable decline in «other net revenue» (capital gains less capital losses and extraordinary revenue less extraordinary costs), and growth in depreciation and provisions. The negative trend of both headings compared with the previous quarter is due to extraordinary costs being incurred and to fresh provisioning to cover restructuring and modernisation costs, which affect few firms but ones that are nevertheless large and in sectors undergoing liberali-

sation. In any event, and despite this increase in extraordinary expenditure and the rise in provisions, net profits held at a slightly higher level than in 1998 (representing approximately 20 % of GVA).

In sum, the close of 1999 saw an acceleration in the growth rate of the activity of CBQ firms, which had been losing momentum during the first three quarters of the year. This recovery has essentially been due to the performance of manufacturing industry and the distributive sector, which accurately reflects exports and domestic demand, as evidenced by other indicators. The firming of this course largely depends on how productive factor prices trend and on the continuing moderation of wages and of operating margins. Profitability ratios remain at high levels, as does the level of leverage (return on assets less cost of borrowing). Foreseeably, however, given the course of interest rates, the fall in financial costs is tending to level off following the uninterrupted decline since 1996 Q1.



## 2. ACTIVITY. NOMINAL GROSS VALUE ADDED

The information obtained by the CBQ survey on 1999 confirms that corporate activity continued to grow, albeit at a more moderate rate than in 1998 (the nominal growth rate of GVA for 1999 was 2.8 %, compared with 4.2 % for 1998; see Table 1 and Chart 1). The 1999 figure has been affected by several opposing factors. First, the sound performance of output earmarked for domestic demand, which ran at a sustained growth rate throughout the year and acted as the driving force of production in the opening quarters of the year, when the effects of the international crisis were being felt. Next, the pick-up in exports, which was particularly marked in Q4 when turnover and value added were notably buoyant in manufacturing companies (their GVA grew by 5.8 % in nominal terms in Q4; see Table 2.a and Box 1). And finally, the decline in selling prices for certain productive sectors (the prices applied in those sectors being opened up to the market were reduced) set against the increase in the price of oil and other imported inputs had a contractionary effect on GVA. Illustrating this was the nominal increase in purchases in 1999, which ran at 17.2 % (33.5 % in Q4) compared with 1 % in 1998. If the firms in the oil refining sector were stripped out of the sample, the 1999 rates would fall drastically (by eight percentage points in terms of the annual rate and twenty points in that of the final quarter). The increases in inputs have come about against a background of greater

integration with foreign markets and of liberalisation, meaning that they have not been reflected in full in the turnover of these companies: in terms of output, GVA fell by more than two points over the whole of the year. Table 3 provides some structural information on these variables. Sector by sector, the distributive trade grew vigorously and outpaced its counterparts, albeit with a lower rate than in 1998 (8.7 % in 1999 compared with 12.7 % a year earlier). As to the production and distribution of electricity, gas and water, there was a surge in the demand for electric power in 1999 (6.5 %) (3), providing further evidence of the economy's buoyancy. Value added in this sector duly increased (3.6 %), despite the contraction arising from the cuts in tariffs and lower rainfall for 1999 as a whole. Finally, the transport and communications sector grew slightly, by 1.2 % in nominal terms, as a result of expanding activity (in real terms), although this was not evident in the associated nominal figures. During 1999 the sector progressively opened up to competition, with new operators emerging both in fixed and mobile telephony, which had a bearing on prices.

In terms of size, the activity of medium-sized firms – traditionally the most flexible and dynamic companies – was seen to increase most forcefully. In addition, Chart 2, which depicts the firms on the basis of their GVA growth rate without considering their size and weight in the sample, shows the generalised expansion of business in 1999 Q4. A majority of firms continue to expand their productive activity (GVA increased in 57.9 % of firms in Q4), the percentage being slightly higher than in the same quarter a year earlier. Moreover, this same increase is apparent in the proportion of firms whose GVA grew by more than 20 %, thereby confirming the momentum the recovery in productive activity is gathering.

## 3. EMPLOYMENT AND PERSONNEL COSTS

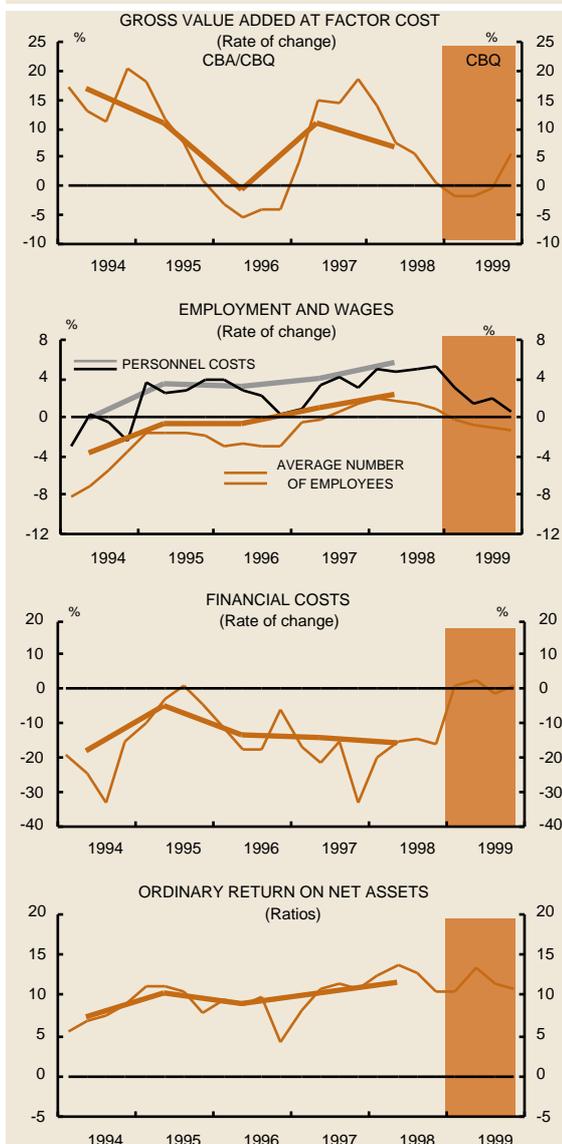
A highlight of the available 1999 data is the firming of the employment creation process. This is the case for most of the firms making up the sample analysed (see Tables 2.b and 4), and furthers what was already seen in preceding quarters. Only certain short-term economic factors have been able to cloud employment creation, to the point of turning the rate of change negative for the sample as a whole even though, as indicated, growth was positive

(3) According to data from Red Eléctrica de España.

## Analysis of the manufacturing sector

Owing to its significance, representativeness and explanatory power, the manufacturing sector merits a detailed analysis. The nominal growth rate of GVA in this sector was 0.5 %, notably down on that of the previous year (6.9 %). This change over the course of the year is the outcome, however, of differing behaviour from the first to the second half of the year. In the first six months foreign activity was clearly affected by the international crisis. This affected some trading partners that were buyers of Spanish domestic manufactures. As the year unfolded, and especially in 1999 Q4, the pick-up in exports became clearly apparent, in parallel with the regained stability in the international economy. Thus, the Q4 growth rate for GVA was 5.8 %. In addition, the strong uptrend throughout the year in international crude prices and the rise in the euro price of other imports affected manufacturing industry and, in particular, the oil refining sector. Regarding this latter sector, the 18.4 % reduction in its GVA in 1999 bore most substantially on the performance of the overall manufacturing sector. Among the remaining sub-sectors there was an increase in business at firms engaged in food, beverages and tobacco and in the manufacture of transport equipment (the latter has benefited greatly from the unremitting growth of new passenger car registrations). The staff restructuring that has affected certain large companies in different sub-sectors and the adverse performance of activity in the opening quarters of the year impacted manufacturing companies as a whole. In aggregate terms, these saw a slight reduction in employment in 1999. Average compensation, for its part, grew by 2.7 %, somewhat down on the previous year's figure of 3.3 %, and practically the same as the 1999 inflation rate. Against a background of liberalisation, internationalisation and global competition, in which price increases in inputs cannot be passed through to finished products, wage settlements should advisably enable a suitable balance to be maintained in the structure of productive costs and in the operating surplus. Indeed, the growth rate of the operating surplus was negative of the order of -0.6 % in 1999, compared with 1998 growth of 9.8 %. At the same time, firms' fund-generating capacity was affected (funds generated grew by 1.9 % in 1999). Nonetheless, the course of these indicators in Q4, when highly positive growth rates were posted, means the immediate future can be viewed with optimism. Also as a result of the greater moderation in productive activity, profitability ratios were somewhat down on the previous years, although they held at high values. Thus, the ordinary return on net assets for manufacturing industry as a whole was 11.5 % in 1999, against 12.8 % for 1998. The reduction in financial costs entailed a decline in the ratio calculating the cost of borrowing which, for the period under study, stood at 4.8 %, one point down on the related ratio a year earlier. This reduction, registered across the board for all sub-sectors, led once again to highly positive values for the leverage ratio, which rose to 6.8 %, marginally up on the aggregate manufacturing sector figure (6.6 %) for the previous year. In sum, the manufacturing sector, having seen business activity clearly slow in the opening quarters of the year, appears to have emerged from this situation. It is once again exhibiting great buoyancy, driven by the pick-up in exports. This will no doubt be conducive to boosting surpluses and returns and, in turn, to resuming a path of employment creation.

## Performance of the manufacturing firms which report to the Central Balance Sheet Office (a)



		NUMBER OF FIRMS				
CBA		3,127	3,258	3,225	3,309	2,617
CBQ		3,127	3,258	3,225	3,309	2,617
		% OF GDP OF TOTAL MANUFACTURING FIRMS				
CBA		37.2	39.3	38.2	38.5	31.7
CBQ		37.2	39.3	38.2	38.5	31.7

Source: Banco de España.

(a) Information available to March 15th 2000 (CBA and CBQ). The CBQ data are growth rates on the same quarter of the previous year.

TABLE 4

**Personnel costs, employees and average compensation  
% firms in specific situations**

	CBA			cbq			
	1996	1997	1998	97 Q1-Q4 (a)	98 Q1-Q4 (a)	99 Q1-Q4 (a)	99 Q4
<b>Number of firms</b>	<b>8,019</b>	<b>7,953</b>	<b>6,342</b>	<b>725</b>	<b>832</b>	<b>784</b>	<b>541</b>
<b>Personnel costs</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Falling	26.4	24.1	21.0	31.6	27.7	30.0	30.0
Constant or rising	73.6	75.9	79.0	68.4	72.3	70.0	70.0
<b>Average number of employees</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Falling	32.8	28.4	25.4	50.4	40.1	40.0	37.3
Constant or rising	67.2	71.6	74.6	49.6	59.9	60.0	62.7
<b>Average compensation (relative to inflation) (b)</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Lower growth	48.4	44.0	40.5	41.3	42.1	48.7	47.1
Higher or same growth	51.6	56.0	59.5	58.7	57.9	51.3	52.9

Source: Banco de España.

(a) Arithmetic mean of the four quarters.

(b) Twelve-month percentage change in the CPI.

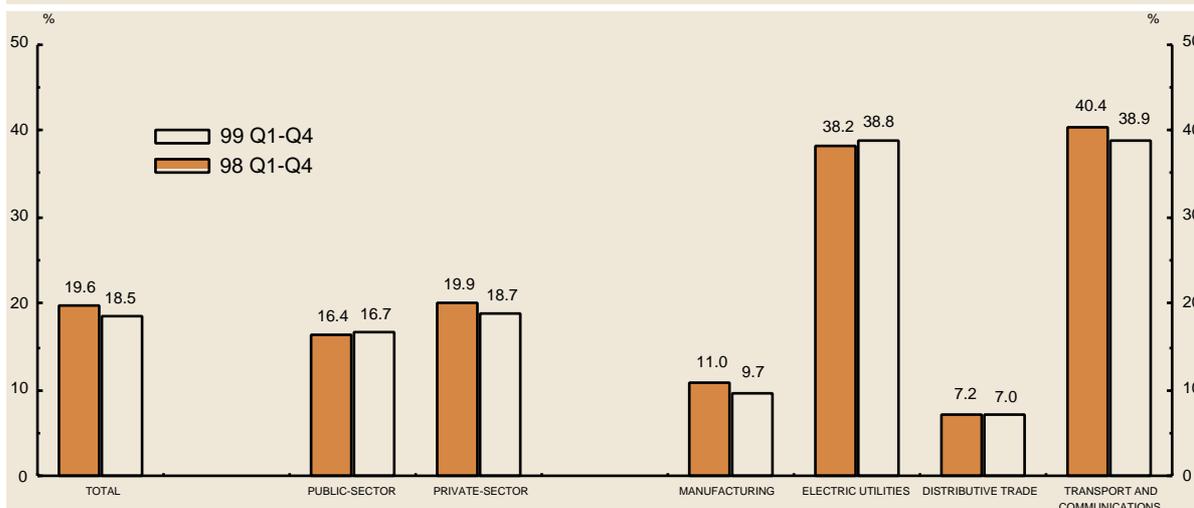
in most of the reporting firms. These factors were, namely: the impact of the crisis besetting some international economies on the aggregate of manufacturing firms; the subsequent deterioration in foreign trade in the first half of the year; and the existence of highly specific labour restructuring processes in sectors undergoing reorganisation and liberalisation. Thus, shifting the analysis to the sectoral level (which is more significant in this case for the reasons set out), different performances are apparent. The distributive trade, in keeping with what was stated in the section on business activity, showed most considerable employment-creation capacity throughout 1999, with employment growth running at a rate of 6.3 %, up even on 1998. Notable in the services sector was the highly positive figure throughout 1999 for advisory and consultancy firms, along with other corporate services companies, whose business increased most forcefully in response to the demand arising from the Y2K effect. Manufacturing industry, however, sustained marginally negative figures over the course of 1999, as a result of the restructuring processes affecting some companies in certain sub-sectors (food, beverages and tobacco, oil refining and shipbuilding) and of the slackness of business activity in the opening quarters of the year. Nonetheless, once the effects of these particular processes disappear, expectations are very sound for the coming quarters as regards business forecasts for the sector. Transport and communications

companies along with firms engaged in the production and distribution of water, gas and electricity were notable for their negative contribution to the trend of employment. Both sectors are undergoing liberalisation and being opened up to competition, and the major companies are restructuring with, in most cases, substantial staffing adjustments. The weight of these firms within the sample explains why the overall figure does not reflect the trend seen in most of the companies. Table 2.b provides an analysis segregating firms creating jobs from those destroying them, and Table 4 shows the generalised nature of the recovery in employment. The firms creating employment (60 % of the sample in 1999) did so at a high rate in the period considered (when their employment rose by 8.3 %). If the final quarter of the year is taken in isolation, the percentage of firms creating or maintaining employment rises to 62.7 %, which gives an idea of how the phenomenon is spreading.

Personnel costs rose moderately in 1999, at a rate of 1.4 %, as against 3.2 % in 1998. This reduction is explained by the employment developments described above and by the containment during the year of average compensation, due to the lower cost of newly hired workers. Moreover, the staff adjustments made by certain major firms in the sample did not affect personnel costs, as provisions had already been set aside to cover the full costs of com-

CHART 3

## Operating margins (a)



Source: Banco de España.

(a) Gross operating profit/net amount of turnover and other operating income.

pensation (4). Average compensation (approximated by personnel costs per worker) was fairly restrained, growing by 1.8 % in 1999, which was significantly below the 2.7 % rate of growth of the previous year. The explanation for this moderation is to be found in the difference between the wages paid to newly hired workers and to existing staff, as can be seen in Table 2.b, discussed above. A sectoral analysis (Table 2.1) shows that those sectors which clearly generated employment, such as the distributive trade, had rates of growth of average compensation below those of the rest of the aggregate. This was also the case in consultancy and computer firms, as a consequence of the strong generation of employment seen therein. Table 4 provides qualitative data on the extent of this phenomenon. More than half of the firms still recorded above-inflation increases in average compensation. Considering also that the firms which reduced their staff increased their average compensation by 3.8 % (a rate which, as mentioned above, does not include a large part of the compensation paid during the year), and that the final quarter of 1999 showed, for the aggregate of all the firms, a clear upturn in this growth rate, this variable will need to be closely monitored in forthcoming quarters. If the capacity to create employment is to be pre-

(4) The quarterly data only extend to "personnel costs", which do not include the application of these provisions. When the CBA data for this period become available in November 2000, these costs will be included as part of compensation of wage-earners, giving a better indication of average total staff costs.

served in a liberalised and globalised environment, then firms' competitiveness must not deteriorate.

#### 4. PROFITS, MARGINS AND RATES OF RETURN (5)

The expansion of productive activity and the containment of personnel costs in 1999 led to growth in gross operating profits during the year, although at a slower pace than in 1998 (3.9 % in 1999, as against 5.1 % in 1998). This more moderate performance is explained by the effect of the international crisis on external activity in the first half of the year, along with the reductions in selling prices in certain sectors, and the increase in oil prices. In any event, the gross operating surplus still grew at a higher rate than value added. That said, it should not be forgotten that the gross surplus (gross operating profit), expressed as a percentage of turnover (approximation to the concept of the operating margin), fell sharply in the period considered. In a more liberalised environment, it has not been possible for non-financial firms to

(5) The calculation of the profitability ratios was changed with the publication of the annual monograph with the results for 1998 and of the article which analysed the data to the third quarter of 1999 in the January 2000 *Economic bulletin*. Summary indicators of the capacity to generate ordinary operating profits are obtained from the profitability ratios so calculated. At the same time, the new profitability ratios use an approximation of current prices, rather than historical prices, as the latter are affected by balance sheet restatement operations.

TABLE 5

**Gross operating profit, funds generated, ordinary return on assets and leverage  
Breakdown by size, ownership status and main activity of firms  
(Growth rates of the same firms on the same period a year earlier)**

	Gross operating profit				Funds generated				Ordinary return on assets (R.1) (a)				Leverage (a)			
	CBA		CBQ		CBA		CBQ		CBA		CBQ		CBA		CBQ	
	1997	1998	98 Q1-Q4 (b)	99 Q1-Q4 (b)	1997	1998	98 Q1-Q4 (b)	99 Q1-Q4 (b)	1997	1998	98 Q1-Q4 (b)	99 Q1-Q4 (b)	1997	1998	98 Q1-Q4 (b)	99 Q1-Q4 (b)
<b>Total</b>	<b>11.0</b>	<b>8.6</b>	<b>5.1</b>	<b>3.9</b>	<b>16.8</b>	<b>10.0</b>	<b>8.6</b>	<b>8.0</b>	<b>7.6</b>	<b>8.4</b>	<b>8.9</b>	<b>8.7</b>	<b>0.9</b>	<b>2.7</b>	<b>2.5</b>	<b>3.9</b>
<b>Total, except electricity sector</b>	<b>16.8</b>	<b>11.0</b>	<b>9.0</b>	<b>2.9</b>	<b>22.0</b>	<b>11.3</b>	<b>12.7</b>	<b>9.1</b>	<b>7.9</b>	<b>8.7</b>	<b>9.3</b>	<b>8.9</b>	<b>1.0</b>	<b>2.8</b>	<b>2.7</b>	<b>4.1</b>
<b>SIZE:</b>																
Small	11.3	10.1	—	—	18.6	14.8	—	—	10.4	10.4	—	—	1.6	3.3	—	—
Medium	15.7	12.2	11.2	4.8	18.0	13.1	12.8	14.1	10.1	11.2	10.4	10.6	2.9	5.1	4.5	6.2
Large	10.4	8.1	4.9	3.8	16.6	9.6	8.4	7.9	7.3	8.1	8.8	8.6	0.7	2.5	2.4	3.8
<b>STATUS:</b>																
Public-sector	-2.0	18.9	8.4	11.5	6.6	10.8	33.8	20.4	3.3	0.9	3.1	3.6	-2.9	-4.6	-3.2	-1.2
Private-sector	13.9	8.0	4.8	3.7	18.6	10.0	6.8	7.0	9.6	10.4	10.4	9.9	2.6	4.6	3.9	5.2
<b>BREAKDOWN OF INDUSTRIES BEST REPRESENTED IN THE SAMPLE:</b>																
Manufacturing	22.0	8.3	9.8	-0.6	24.7	9.1	8.8	1.9	10.1	11.5	12.3	11.5	3.2	5.7	6.6	6.8
Production and distribution of electricity, gas, and water	-5.5	0.8	-3.6	6.6	0.5	5.2	-1.0	6.9	6.8	7.6	8.2	8.4	0.7	2.4	2.2	3.6
Distributive trade	17.1	21.3	22.5	9.9	18.6	19.5	24.1	11.0	10.5	12.3	10.8	11.4	3.6	6.8	4.7	6.6
Transport, storage and communications	14.7	7.7	6.0	2.9	21.4	10.6	14.8	7.1	6.1	7.1	8.0	6.9	-1.3	0.8	0.9	1.9

Source: Banco de España.

(a) Ratio calculated in accordance with the new methodology explained in this article and in the annual monograph of the Central Balance Sheet Office

(b) The data in these columns have been calculated as the arithmetic mean of the quarterly data.

pass the increase in the prices of productive factors through to their customers. Consequently, the margin has narrowed by somewhat more than one percentage point (the gross operating profit as a percentage of turnover fell from 19.6 % in 1998 to 18.5 % in 1999). Chart 3 shows how this reduction affected the various kinds of firms.

Financial costs continued to fall in 1999, at a rate of -6.9 %. This item has been progressively declining in importance in the profit and loss account (currently representing 2.7 % of total output, half its 1995 level), but it has played a significant part (against the above-mentioned backdrop of restrained growth in the surplus and even its decline in weight in structural terms) in

maintaining the firms' capacity to generate funds and their profitability ratios. The factors explaining the fall in financial costs in 1999 with respect to 1998, on CBQ data, are as follows:

<i>Change in financial costs</i>	-6.9 %
<i>A Interest on borrowed funds (1+2)</i>	-7.6 %
1. Due to the cost (interest rate)	-30.8 %
2. Due to the amount of Interest-bearing debt	+23.2 %
<i>B. Commissions and cash discounts</i>	+0.7 %

These figures confirm that the reductions in interest rates have continued to be passed

TABLE 6

**Structure of reporting firms' ordinary returns  
on net assets and on equity**

	CBQ			
	Ordinary return on net assets (R.1)		Ordinary return on equity (R.3)	
	98 Q4	99 Q4	98 Q4	99 Q4
<b>Total firms</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
R 0 %	27.1	24.4	30.7	26.1
0 % < R 5 %	14.3	14.4	11.7	12.4
5 % < R 10 %	15.5	15.9	10.7	12.4
10 % < R 15 %	12.1	12.0	10.4	11.1
15 % < R	31.0	33.3	36.6	38.1
<b>Number of firms</b>	<b>796</b>	<b>541</b>	<b>796</b>	<b>541</b>
MEMORANDUM ITEM:				
Average return	8.8	8.2	9.8	9.9

Source: Banco de España.

through to corporate costs, at the same time as firms have been increasingly resorting to external funds to finance new investment, capitalising on the favourable conditions offered in the market. This investment includes the moves made by large Spanish firms to penetrate foreign markets, basically in strategic sectors in South America (telecommunications, gas, electricity, etc.), which demonstrate the ability of Spanish firms to rise to the challenge of globalisation.

The increase in the operating surplus (3.9 % in 1999) and the reduction in financial costs caused funds generated to grow sharply, at a rate of 8 %, practically the same as in 1998 (see Table 5). As regards sectors, once again the strong increases in the distributive trade, with growth of 11 %, and in firms providing corporate services (advisory, consultancy and computing firms) were notable.

The strong increase in extraordinary costs affected the final net profit (19.8 % of GVA). These extraordinary costs are attributable to the need for certain large firms carrying out major reorganisations to set aside provisions for the costs they will shortly have to incur to modernise their productive equipment. The new technologies hold out great business opportunities for firms, but they also pose considerable organisational and productive challenges, as equipment must be replaced more frequently and employees need to be more highly trained.

The ordinary rates of return (both on net assets and on equity) held at very high levels. In 1999, the ordinary return on net assets was 8.7 %, practically the same as in 1998. At the same time, the cost of borrowing, as made clear by the comments made when analysing financial costs, fell significantly; from 6.4 % in 1998 to a new historic low of 4.8 %. The conjunction of these figures gave rise to a strongly positive leverage (+3.9), which is unprecedented in the series studied by the Central Balance Sheet Office.

Finally, Table 6 enables conclusions to be drawn regarding the distribution of firms by profitability, irrespective of their size and ownership status. The most significant development observed is a slight increase in 1999 Q4 in the percentage of firms with positive ordinary returns on net assets (75.6 %, against 72.9 % in 1998). Moreover, a significant part of this increase occurred in the group of firms with the highest returns. Thus, while in 1998 Q4 31 % of the firms analysed earned returns of more than 15 %, in the same quarter of 1999 the percentage was 33.3 %. This is certainly the best indicator of the healthy position of Spanish non-financial firms: practically one third of the firms generated returns four times as high as those on financial assets; and two thirds of the firms posted positive ordinary returns.

In short, the firms ended the year with expectations of significant growth and expansion in all spheres (activity, employment and prof-

itability). They displayed an expansionary profile over the course of the year, once the uncertainty stemming from the international instability and its effects on foreign trade had been dispelled. The healthy outlook for the year 2000 is clouded, however, by the rise in international oil

prices. To the extent that its effects are controlled and corrected without damage to corporate competitiveness, the firms will be able to face the future with prospects of sustained buoyancy, rising investment and employment creation.

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# Interpreting inflation differentials in the euro area

*The author of this article is Enrique Alberola Ila of the Banco de España Research Department.*

## 1. INTRODUCTION

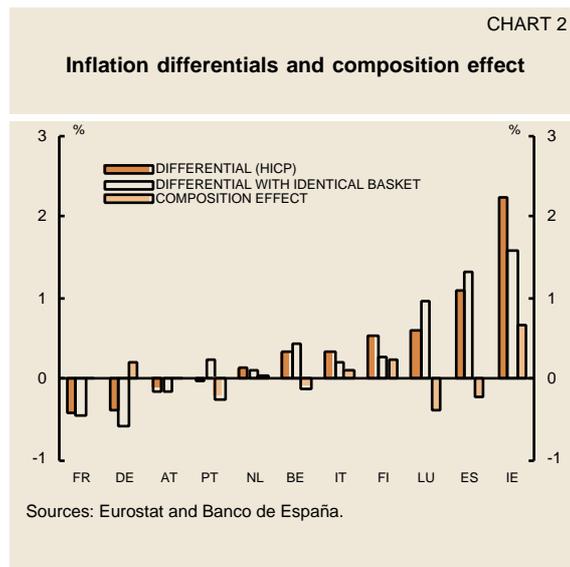
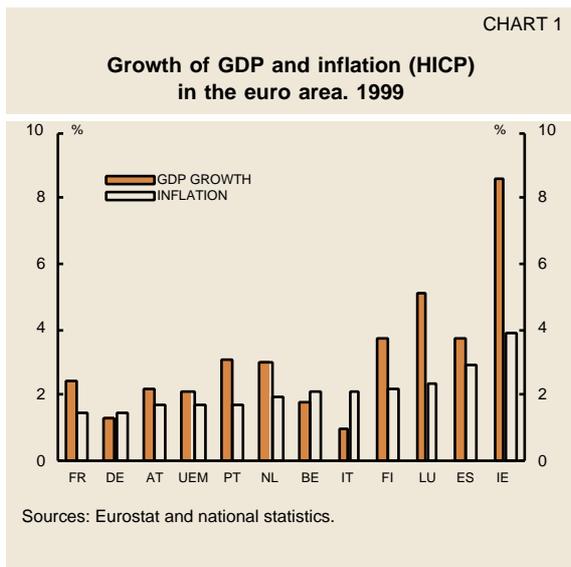
Since the start of Economic and Monetary Union (EMU), inflation differentials between the euro area countries have persisted, standing at around one percentage point in 1999. The differentials are relatively small and the evidence is that inflation differences on this scale are not infrequent between the regions of a country. But analysis of the determinants of divergent price developments between euro area countries is important for at least two reasons.

First, inflation differentials in the euro area may be due both to (i) factors relating to disequilibrium and rigidities in the economy, in which case greater inflation would translate into a loss in competitiveness; and (ii) to a process of real and productivity-related convergence by the less developed countries towards the European average, where the inflation differentials would not prompt losses in competitiveness or macroeconomic disequilibria. These interpretations give rise to opposing views on the nature [worrying in (i), more benign in (ii)] of inflation differentials in a monetary union.

Second, in a monetary union there is, by definition, no possibility of carrying out nominal adjustments domestically via monetary policy or the devaluation of the exchange rate. Were inflation differentials attributed to the more negative interpretation, i.e. were they to be associated with the existence of rigidities and disequilibria in the economy, there would be reasons for expecting the subsequent adjustment to have greater effects in real terms than when an autonomous monetary and exchange rate policy were in place.

This article considers the theoretical arguments behind the two foregoing interpretations so as to assess as far as possible the nature of the inflation differences observed since the adoption of the single currency.

One conclusion to emerge from the analysis is that the inflation differentials observed have arisen from both favourable and unfavourable factors, the relative significance of which is, unfortunately, difficult to quantify. In general, sustained processes of real convergence can be affirmed to be accompanied in the medium term by positive inflation differentials in relation to the more developed countries of the area. However, if the differentials are excessive, in that they reflect the influence of the inadequate function-



ing of markets or of demand-side disequilibria, convergence may be jeopardised.

## 2. THE MEASUREMENT OF INFLATION AND THE COMPOSITION EFFECT

Chart 1, to which reference will be made throughout the article, shows inflation in 1999 as measured by the Harmonised Index of Consumer Prices (HICP), along with the growth rate of each country. The chart illustrates that it is generally those countries that are most growing which have higher inflation rates.

Before turning to the theoretical factors behind these differentials, it is worth highlighting some technical aspects that may have a bearing on the measurement of inflation differentials between euro area members.

The reference inflation rate in the euro area is given by the changes in the HICP. This index seeks to place on a uniform footing the list of goods contained in the national CPI baskets, which show substantial disparities in some cases. Harmonisation does not mean, however, that the weight of each of the goods in the consumption basket is equal across countries. Indeed, as is the case in the regional CPIs in Spain, the weight of each good aims to reflect its proportion in relation to household spending in the geographical area in question, in this case the euro area countries (1).

(1) Thus, for instance, the weight of unprocessed goods in the HICP is substantially greater in Spain than in the euro area aggregate (16.3 % against 8.97 %), while it is less in services (30 % against 36 %).

Different weights mean that, although the prices of each good grow at the same rate in all the countries, the resulting aggregate inflation may differ across countries owing to the differing composition of the baskets. This *composition effect* may, if very significant, ultimately distort assessment of inflation differentials, since higher inflation in one specific country might not derive from a greater general increase in prices but from the fact that goods whose prices have most increased have a greater relative weight in the consumption basket of that country.

Chart 2 offers information that is broadly illustrative of the relevance of this composition effect for the actual inflation differentials between the euro area countries in 1999. The first column gives the inflation differentials as measured by the HICP; the second column the differentials that would arise if countries' weights in each of the five major goods groupings were the same; and the third column the composition effect, which is simply the difference between the first and second columns. As can be seen, the composition effect is not, in general, very significant, accounting for only 14 % of the variance of the differentials observed. Nonetheless, this effect is of some degree in the case of Spain (-0.2 %), Luxembourg (-0.4 %) or Ireland (+0.7 %) (2).

In sum, the composition effect may, in some cases, be a factor for consideration in explaining inflation differentials. But it is not fundamental since inflation differentials persist after con-

(2) The negative composition effect in Spain is essentially due to the lesser weight of two of the groupings with bigger inflation increases over the past year, namely services and, in particular, energy goods.

sidering this effect, as the second column in Chart 2 shows.

### 3. THE CONVERGENCE HYPOTHESIS

Once demonstrated that the means of measuring inflation in the area does not substantially affect the scale of the differentials, the underlying theoretical arguments can be addressed.

Despite it being broadly acknowledged that inflation entails costs that reduce the economy's growth capacity, there are theoretical arguments with a degree of empirical backing which help show that, in a monetary union, greater growth can give rise to positive inflation differentials (3). So viewed, inflation differentials may be considered as inherent to convergence and integration processes like those currently under way in economies such as Spain's. And, therefore, the possibility that these differentials may be reflecting the economy's structural or competitiveness-related problems can be ruled out. These arguments are set out briefly below, with the associated critiques being assessed.

#### 3.1. Income and price-level convergence

The first argument departs from the observation that countries with a higher level of income also tend to have the highest price levels. If the poorer countries were to converge in real terms towards the European average, their prices would likewise be expected to level. As the exchange rate is irrevocable between the euro area countries, price-level convergence for these countries would mean a continued, positive differential vis-à-vis the European average until the convergence level were reached. In a recent study the European Commission (1999) calculated that if the Spanish economy were to reach 90 % of the average income of the European Union over the next ten years, the average inflation differentials in relation to the area

(3) It should be stressed that, as is explained below, the causation mechanism in this case is inverse and of the opposite sign to that of the theory of inflation costs: it is not inflation that affects growth but greater growth which, endogenously, generates greater inflation. In any event, both types of argument are compatible with one another in practice. Indeed, although empirical research on the cross-country relationship between growth and inflation shows that the relationship is weakly negative, consideration of the relationship between both variables in a context of fixed exchange rates, i.e. in a similar setting to that of EMU, shows that it is not possible to find a significant relationship between inflation and growth in the medium and long run. See Andrés et al. (1996).

would be around 1.5 % per annum over the course of that period (4).

The correlation between the level of income and the level of prices is, however, far from perfect. Examples such as that of the United States, whose price level is slightly lower than that of the European Union while its per capita income is considerably higher (5), or the patent price differences between Spanish provinces with similar income levels, show that the argument should be qualified on certain occasions. Generally, however, both variables are expected to be positive and significantly correlated.

#### 3.2. The Balassa-Samuelson model

The debate on the assessment of inflation differentials in the euro area has turned predominantly on a model developed almost forty years ago by Bela Balassa and Paul Samuelson to explain why countries with a lower income level have a lower price level. Given its theoretical relevance in this context, it is worth setting out the model's arguments in some detail.

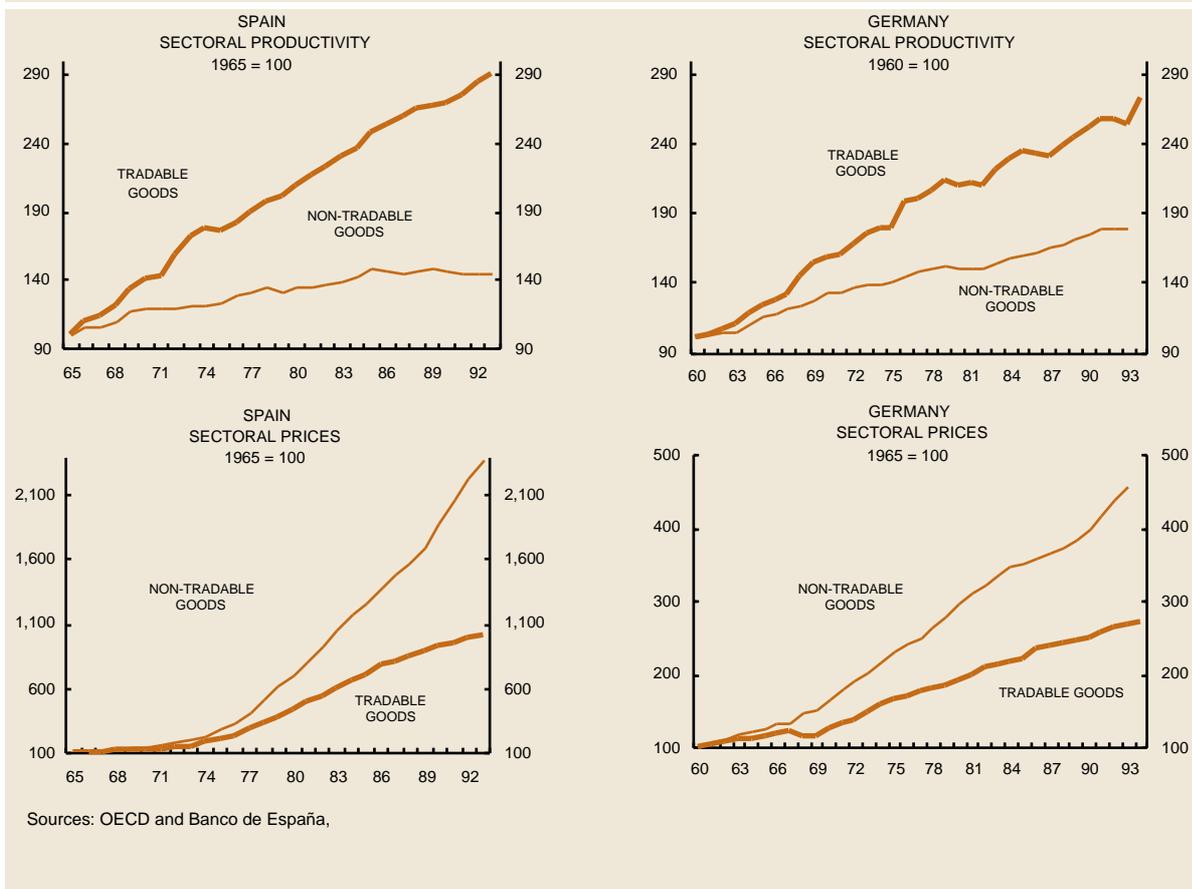
As a starting point, two sectors in the economy should be distinguished. On one hand, a tradable goods sector which is therefore *exposed* to foreign competition, whose prices are essentially determined on international markets (e.g. manufactures). And on the other, a non-tradable goods sector (encompassing most services), *sheltered* from foreign competition and whose prices are determined domestically.

Departing from this distinction, Balassa and Samuelson observed that productivity tends to grow more in the exposed sector than in the sheltered sector, owing to the fact that the former is generally more capital-intensive and, therefore, benefits more from technological progress. This characteristic, along with the condition that real wages in the long run in each sector grow approximately at the sector's productivity rate and the observation that nominal wages tend to grow uniformly economy-wide

(4) The European Commission study made these projections using income measured in terms of purchasing power parity. It would be more correct to make the comparison in terms of euro since, in future, income convergence will be in the common currency. If this were done, the inflation differentials would widen appreciably, as income divergence in the area is greater when measured in terms of euro.

(5) These data arise from the purchasing power parity calculations by the OECD. According to these data, per capita income in the United States was 42 points above the EU average in 1997 and prices 5 points lower.

Spain and Germany. Sectoral productivity and prices



(owing to the mobility of the labour factor or to the common wage bargaining mechanisms in the various countries), helps explain the existence of sectoral inflation differentials.

The greater productivity in the exposed sector pushes nominal wages across the whole economy upwards in such a way that, if real wages are to reflect appropriately the sectoral productivity gains, the prices of non-tradable goods must outgrow the prices of tradable goods. This is how a *dual inflation* situation arises.

Understandably, this dual inflation is *not*, in principle, a problem since it arises from the differing rate at which the sectors assimilate technical progress, i.e. from supply-side factors acting in the long run, and there is thus no underlying macroeconomic disequilibrium.

If it is accepted that real convergence processes are underpinned by productivity gains in the tradable goods sector, inflation in the sheltered sector will be greater in the countries with higher growth. That likewise entails higher ag-

gregate inflation, since inflation in the exposed sector will be similar to the rest of the euro area owing to competition.

The following charts illustrate the empirical significance of the model's hypothesis, according to which the higher productivity growth in the tradable goods sector should make for higher price growth in the sheltered sector in the long run.

Chart 3 plots sectoral prices and productivity for Spain and Germany. It can indeed be seen how the greater thrust of the productivity associated with tradable goods runs parallel to the higher price growth of goods in the sheltered sector. The same result recurs for all the euro area countries. With this evidence, and after testing more rigorously the Balassa-Samuelson hypothesis for eight European countries, it has been possible to perform an exercise that enables the inflation differentials in the area resulting from extrapolating past trends in sectoral productivity to be simulated. The results are offered in Chart 4. The range of the differentials can be seen to be similar to those currently in

place, and Spain has an estimated positive differential of around 1.5 %, which is also consistent with the findings of the above-mentioned European Commission study (6).

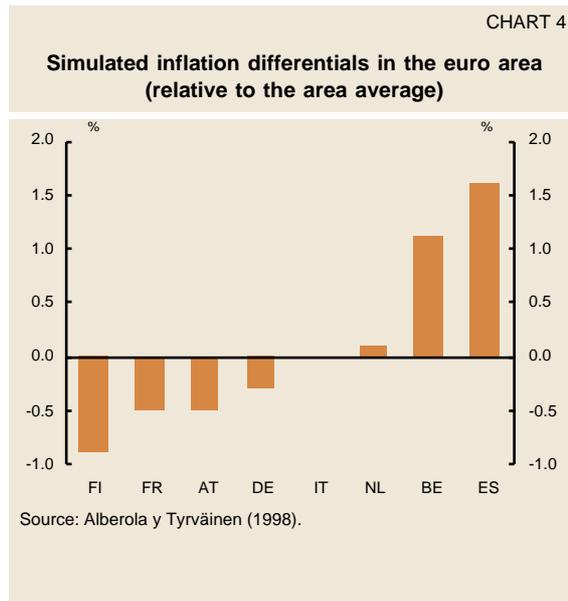
The Balassa-Samuelson model has also been the subject of certain critiques. Although Chart 3 shows that the expected relationship between sectoral productivity and prices is satisfied, it has sometimes been argued that another empirical regularity derived from the model, the growth of the proportion of tradable goods to output, far from holds. In fact, economic growth has been associated in recent decades with the increasing weight of services in total economic activity, entailing a substantial lessening of the relative importance of the tradable goods sector. However, this fact does not refute the Balassa-Samuelson hypothesis. The increasing share of the service sector in the economy is a reflection of how consumer preferences evolve as their income levels rise. For one thing, the demand for services relating to leisure, such as tourism and eating out, tends to increase; for another, social demands in terms of education and health (which are services) are usually greater. Conversely, the Balassa-Samuelson model only looks at developments on the supply side of the economy, while the phenomenon of the increasingly service-based economy primarily affects sectoral demand. The joint consideration of both types of factors would enable the greater growth of the relative prices of non-tradable goods to be reconciled with their growing importance in aggregate output.

In any event, these types of demand considerations are along the right lines as they suggest that changes in relative prices may not depend solely on changes in sectoral productivity but may also be linked to other factors which, as indicated later in this article, may influence the interpretation of inflation differentials.

### 3.3. Economic integration and price convergence

The last argument is based on the deepening of the process of economic integration associated with EMU. Although the prices of tradable goods are generally set by international competition, this does not mean their level can-

(6) For further detail see Alberola and Tyrväinen (1998). In keeping with the spirit of the model, these results indicate long-run trends in inflation and are only an approximate guide, since past trends may prove not to be an adequate indicator of future trends and EMU itself may prompt changes in future sectoral productivity.



not differ from country to country. Various external or domestic charges and other trade, legal or cultural obstacles may make the prices of very similar goods differ. Further, the denomination of prices in different currencies according to the point of sale may hamper international comparison, especially if associated with high exchange rate volatility.

In the euro area, the single currency will reinforce arbitrage mechanisms, undoing –at least partially– the factors hindering the equalisation of price levels. The prices of tradable goods will thus tend to converge towards lower levels (7).

Hence, somewhat paradoxically, price convergence may exert a perverse effect in terms of inflation for the countries whose initial price levels are lower. For example, if German car prices converge towards the lower prices of Spanish cars, this component of German inflation will be negative, prompting a positive inflation differential between Spain and Germany. Accordingly, the greater economic integration stemming from the Monetary Union may induce higher inflation rates in the countries with lower price levels.

### 3.4. Inflation differentials and competitiveness

An increase in relative prices with respect to the external sector is generally, though not al-

(7) Price convergence is likely not be complete since the quality and characteristics of products may differ, owing to the different technologies used and to national differences in consumer preferences.

ways correctly, identified with a loss of competitiveness in the economy. Without the possibility of exchange rate adjustments, the worsening of relative prices is reflected in inflation differentials. However, inflation differentials do not entail competitiveness problems if they arise as a consequence of any of the effects described in the foregoing sections.

First, in the case of the arguments relating to the equalisation of price levels and also under the Balassa-Samuelson model, inflation differentials can be justified in terms of productivity gains, without the relative prices of the goods of the sector exposed to foreign competition having to rise.

Second, in the event that monetary union leads to greater price transparency, there will be an initial gain in competitiveness, which will subsequently disappear as product prices rise. Returning to the previous example, the comparison of car prices in euro, together with the reduction in obstacles to cross-border sales arising from progress towards the Single Market, would entail a higher demand for Spanish vehicles. This higher demand is equivalent to a gain in competitiveness, associated in this case, not with relative prices (which, in principle, do not change), but with the fall in the trade barriers which were obstructing price competition. As prices converge, these gains in competitiveness will disappear, and the previous competitive position will be restored.

In short, the existence of certain inflation differentials within the Monetary Union should not necessarily be seen as a signal of disequilibrium or loss of competitiveness, since it may be compatible with macroeconomic stability and with the absence of significant disequilibria. At the same time, the empirical evidence shows that the inflation differentials observed, of around one percentage point, approximately correspond to what would be expected in accordance with the arguments considered.

Nonetheless, it can only be inferred from this conclusion that under certain circumstances inflation differentials within a monetary union are not a cause for concern. We shall now describe the situations in which they are.

#### 4. THE DISEQUILIBRIUM HYPOTHESIS

There is no doubt that the existence of a single monetary policy and the consideration of the factors mentioned entail a change in the conception of the inflationary process within a monetary union. This new conception, however, does not mean that other demand and struc-

tural factors, which have traditionally served to explain the inflationary mechanisms of an economy, have disappeared. When these factors are considered, the view of inflation differentials may be qualified or modified, possibly to become less benign. Consequently, it is worth developing these arguments in more detail.

##### 4.1. Macroeconomic disequilibria

The first factor to be considered is the existence of macroeconomic disequilibria, and in particular, excessive demand pressure. Aggregate supply is usually considered to be relatively inelastic in the short run. Accordingly, an increase in domestic demand, arising from improvements in the economic outlook or from a healthier employment situation, will tend to generate two effects: upward pressure on domestic prices and higher demand for imports, with the consequent deterioration in the external position. The increase in inflation, in this case, is not the result of a rise in productivity, and therefore the worsening of relative prices with respect to the external sector entails a loss of competitiveness for the economy. This, in itself tends to exacerbate external disequilibria.

The pressure of demand is, in the first instance, a consequence of the cyclical position of the economy. However, the fall in competitiveness it generates may have long-term effects on economic activity (hysteresis). These effects will be all the more important, the greater misalignment of relative prices and the longer it continues. The accumulation of losses of competitiveness over an extended period makes it hard to maintain exports, while being conducive to lasting import penetration. In the medium run, if the losses of competitiveness are not corrected, then the foreign and domestic markets for some products may be permanently lost, damaging future prospects for economic growth.

It is important to stress that monetary union has radically changed the traditional adjustment mechanisms in the economy. First, the exchange rate's irrevocable nature means that the correction of accumulated losses of competitiveness is only possible through the adjustment of domestic relative prices. If the rigidities hampering such adjustment persist, then the correction may only take place after costly adjustments in terms of employment and activity. Second, it can also be argued that monetary union enables external disequilibria to be financed more easily and for longer periods. This is because such disequilibria no longer affect interest rate spreads through the exchange risk premium, as this premium is by definition zero.

The loss of such traditional stabilisation mechanisms under monetary union makes a soft landing for the economy all the more difficult.

It may be conjectured from the foregoing that since, inside monetary union, losses of competitiveness do not activate the traditional adjustment mechanisms, they may be more pronounced, worsening the effects of hysteresis and leading to a more drastic and costly adjustment in real terms.

#### 4.2. Market rigidities

The effects of demand pressure on prices and activity depend, among other factors, on the degree of rigidity in factor and product markets. The greater the rigidities in goods and labour markets, the more demand pressures will tend to be passed through to prices and wages.

It should be recalled that the cornerstone of the Balassa-Samuelson model is the existence of a trade-off between sectoral productivity growth and prices. However, this relationship may not be the result of a healthy process of real productivity convergence; rather it may stem from problems of competition and market rigidities.

This problem of identification may be illustrated by an example. With an irrevocable exchange rate and a situation of excess demand, if labour-market rigidities or wage bargaining mechanisms generate excessive wage pressure, firms will attempt to pass wage rises through to prices. This may be relatively easy in the sheltered sector, but in the sector exposed to competition, once the scope for reducing margins has been exhausted, there will be losses of competitiveness. The eventual result of this process is likely to be *higher inflation in the sheltered sector* and, in the exposed sector, *an increase in apparent labour productivity*, reflecting the necessary adjustment in output and staff, once the scope for adjusting margins has been exhausted.

Note that this example gives exactly the same results as the Balassa-Samuelson model: dual inflation accompanied by inter-sectoral productivity differentials. However, their interpretation is completely the opposite and, certainly, a much more familiar one, involving a lack of competition in goods markets and insufficient flexibility in the labour market.

Chart 5 illustrates this type of situation in the case of the Spanish economy. During the economic crisis in the late seventies and early

eighties, relative income in Spain fell considerably, while relative productivity was moving towards the European average (8). Underlying this apparently paradoxical result is the destruction of employment that took place in the Spanish economy during this period. By contrast, the subsequent real convergence has been accompanied by a fall in relative labour productivity. Market rigidities and imperfections help to explain the changes in apparent labour productivity and, therefore, why the inflation differentials associated with productivity convergence are largely a reflection of structural problems in the economy.

In sum, as the two theories considered give rise to the same behaviour, there is a risk that positive inflation differentials will be seen as benign, when in fact they stem from structural problems in the economy. At the same time, although income convergence can be expected to be accompanied by productivity convergence in the long run, in the case of Spain, real convergence can only be achieved if it involves a considerable rise in employment. This is required not only to reduce the gap in relative unemployment rates but also to equalise the activity rate, which is substantially lower than in the rest of Europe. Accordingly, the rate of productivity convergence will tend to be lower than that of income per capita. This would help to moderate the inflation differentials that, according to the Balassa-Samuelson model, are associated with this process.

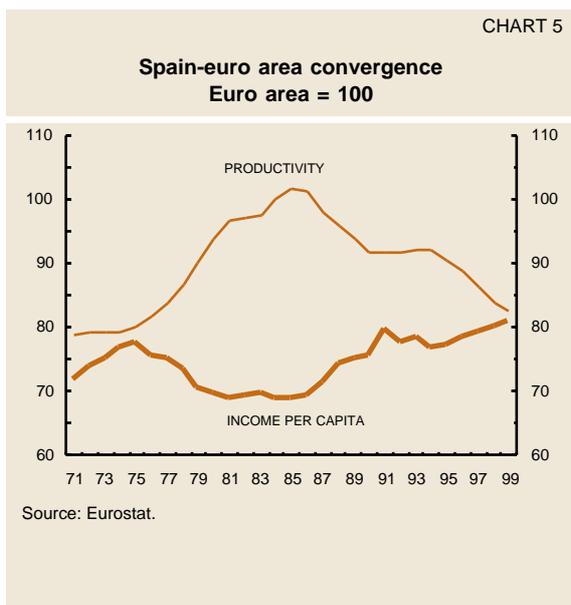
### 5. INTERPRETATION OF OBSERVED INFLATION DIFFERENTIALS

Having outlined these opposing views of inflation processes in a monetary union, it is worth tentatively assessing the nature of the inflation differentials currently observed in the euro area and, in particular, in Spain.

Chart 1 showed that the highest inflation is currently seen in those countries with the highest growth (9). However, this result does not enable the type of factors operating predominantly to be identified. On the basis of the Balassa-Samuelson hypothesis, supported by Chart 3, the inflation differentials could reflect a process of real convergence that is benefiting

(8) It is difficult to accept that Spanish productivity was higher than the European average in 1985 and 1986. In fact, the use of apparent labour productivity gives a rather imprecise idea of actual levels of productivity.

(9) In fact, a regression analysis of the chart data reveals a statistically significant positive relationship between inflation and the growth rate.



countries such as Spain. On the other hand, a less benign view would support the argument that it is excess demand that is generating inflationary pressures in the more dynamic countries and that, in some cases, such pressures may be exacerbated by the rigidities in factor and product markets.

In practice, it is extremely difficult to identify at any given moment what role is being played by each explanatory factor. The possible long-run determinants are distorted by the cyclical position of the economy and, furthermore, as seen above, the theoretical arguments themselves are subject to significant caveats. However, solely for the purposes of illustration, it is possible to attempt to assess the extent of both types of factor in the current economic juncture, starting from the relationship between growth and inflation for 1999, depicted in Chart 1, and considering the present situation of the European economies.

Specifically, two elements can be distinguished in a country's growth: a structural component, associated with the economy's potential growth rate, and a cyclical component, which can be approximated by the output gap (i.e. the difference between the actual and the potential levels of output) (10). The structural component gives an idea of the trend growth rate and would

(10) The potential level of output is defined as that at which the effective resources of the economy are fully and efficiently used. Potential output and its growth rate is determined therefore by productive capital, the effective supply of labour and accumulated technical progress in both resources. When actual and potential output are the same, supply is equal to demand and the economy is therefore free from inflationary pressures.

therefore explain, in a tentative approximation, the inflation associated with long-term convergence processes. By contrast, the output gap is related to the cyclical position of the economy and therefore gives an indication of the inflationary pressures associated with excess demand in the economy. In the long run the inflation differentials can be expected to be determined by the structural component, while in the short run the demand component dominates.

Currently, all the countries with higher inflation, such as Ireland, Spain, Luxembourg and Finland, have a positive output gap, suggesting the possible existence of demand pressures in these countries. However, these countries are also those with a higher *potential* growth rate, which would support the productivity hypothesis implicit in the Balassa-Samuelson model. Accordingly it can be argued – with many caveats given the characteristics of the data – that the inflation differentials during the first year of Monetary Union may be interpreted both in terms of the convergence hypothesis and in terms of the disequilibrium hypothesis.

A more in-depth analysis of which type of element is dominating could be based on an evaluation of the degree of compliance with the assumptions of the Balassa-Samuelson model. In particular, the model requires income convergence to be accompanied by productivity convergence and that the latter, in turn, generate a larger gap between productivity growth in the sectors exposed to and sheltered from foreign competition.

Chart 6 shows the results of such an analysis, comparing inflation and productivity growth in Spain relative to the euro area as a whole between 1997 and 1999, when the exchange rate was practically fixed. In a first approximation, the cumulative inflation differentials (2 % in the three years) could be justified by the higher rate of growth in Spain in recent years (more than 4 % above the rate for the area as a whole). However, this income convergence, has not been accompanied by convergence in apparent labour productivity, which has been less dynamic in Spain than in the area as a whole. Nor are changes in sectoral productivity consistent with productivity convergence. The factor explaining this divergence between the relative growth of income and of productivity is the high rate of employment creation in Spain in recent years. This has led to cumulative employment growth relative to the euro area as a whole of close to 7 % (11). The buoy-

(11) The buoyancy of employment in Spain has been particularly notable in manufacturing, a sector that has suffered from declining levels of employment in Europe. These factors explain the significant sectoral productivity gap apparent in Chart 6.

ancy of employment has cyclical components, although the recent labour market reforms may also help to explain the strength of employment creation. On the other hand, the growing trade deficit, the rapid expansion of lending and the inflationary pressures evident in certain sheltered sectors (housing, hotels and catering, etc.) suggest that demand pressures are present in the current cyclical upturn.

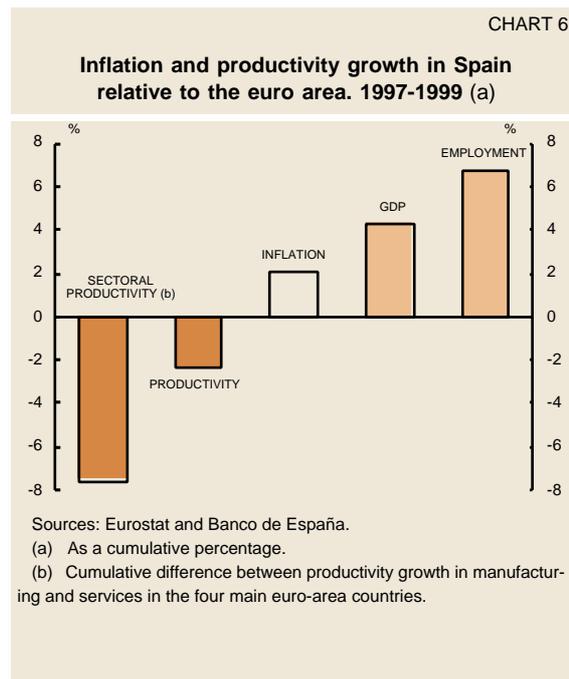
In sum, it is possible to argue that the inflation differentials currently seen in Spain could be reflecting both real convergence of the Spanish economy and demand pressures associated with economic expansion. The latter cannot be completely absorbed by supply without strain on prices, owing to the persistence of certain structural rigidities in the markets.

It is impossible to identify even approximately what proportion of the differential is accounted for by each factor. It is clear, however, that inflation differentials of around one percentage point should not be interpreted too complacently. To some extent they are originating from demand pressures and may be contributing to the accumulation of losses of competitiveness that are capable of generating unfavourable real effects in the medium run.

## 6. CONCLUSIONS

Inflation is normally considered to have a negative impact on welfare. However, economic theory provides sound arguments for thinking that in a monetary union positive inflation differentials need not necessarily have adverse effects and may even be interpreted in a positive light, provided that they are associated with productivity-based growth. Nonetheless, inflation differentials within a monetary union may also frequently reflect negative factors such as rigidities in the workings of markets that exacerbate the inflationary effects of demand pressures. Since growth tends to generate demand pressures, it is possible that both types of factor are simultaneously at work, but it is extremely difficult to determine the extent to which observed inflation differentials are cause for concern or benign.

In the event that inflation differentials are excessive, in the sense that they cannot be solely explained by productivity growth, but must also stem from the negative factors mentioned above, they may have lasting effects on the economy's competitiveness. With the loss of the exchange rate, it could be conjectured that the real effects of losses of competitiveness may be relatively greater within the Monetary



Union, hampering or even reversing real convergence.

In the case of Spain, sustained real convergence will in all likelihood require an increase in the relative productivity of labour, which could in turn generate positive inflation differentials with respect to the rest of the euro area in the long run.

However, in the short and medium run it is possible, probable and even desirable that growth be based on greater use of the underutilised factor, namely labour. If this were the case, convergence would not require substantial gains in labour productivity or, therefore, significant inflation differentials. In this context, the observation of inflation differentials that are relatively high and persistent in the short run should be seen as a possible symptom of excessive demand pressure. The greater the rigidities that persist in factor and product markets, the greater the impact this pressure will have on inflation.

From a policy viewpoint, these reflections suggest two kinds of measure to reduce the inflationary bias of growth: (i) measures aiming to improve the utilisation of the labour factor; and (ii) measures to liberalise and open up to competition those sectors in which anti-competitive behaviour still persists. The first kind of measure would enable increases in relative factor productivity to be less than the relative growth in income per capita, moderating the inflationary effects of sectoral productivity growth. The second kind would restrain prices in general

and would avoid demand pressures being readily translated into higher inflation. At the same time, although fiscal policy should basically be medium-term oriented, it would be advisable to use any available leeway to avoid an increase in demand pressures.

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# The disinflation process in Spain. A look at the role of wages (1)

## 1. The disinflation process and the role of factors other than wage behaviour

This article briefly describes the Spanish disinflation process since the mid eighties, with special attention to the role of wage behaviour in this process. Its potential role in the more difficult task of maintaining and even improving the Spanish economy's stability record is also assessed.

Chart 1 (upper panel) shows the path followed by Spanish inflation since the second half of the eighties and illustrates clearly the magnitude of the disinflation process in Spain. Following figures of around 6.5 % for the late eighties, the inflation rate started to decline at a slow pace in the early nineties and this process intensified in the late nineties. As a result, the average inflation rate for the 1996-2000 period (2) was 2.5 %, a figure substantially lower than the average rate in the late eighties (6.5 %).

To properly frame the role played by wage behaviour, it is important to understand the role that can be attributed to factors other than wages in this disinflation process. In this respect, the second panel in Chart 1 shows the behaviour of real GDP growth in Spain over the same period. Significantly, whereas cyclical considerations may account for a sizeable portion of the reduction of the inflation rate during the early nineties, the quickening of the disinflation process in the second half of the decade coincided with a period of a high average growth of close to 3.5 %. Thus, it seems clear that the position of the economy in the business cycle cannot offer a sufficient explanation for the recent pattern of the inflation rate.

Certainly, the rapid decline in the inflation rate in the second half of the nineties cannot be properly understood without a reference to a series of important changes in the design and stance of both fiscal and monetary policy in Spain. The situation of the Spanish economy in the early nineties clearly demanded some changes in this respect, which became particularly pressing after the signing of the European Union Treaty in 1992, when the macroeconomic stability requirements to become a member of the future Union were made explicit. In fact, as from 1992, fulfilling the convergence criteria set in the Maastricht Treaty on time became one of the main guiding principles of Spanish economic policy.

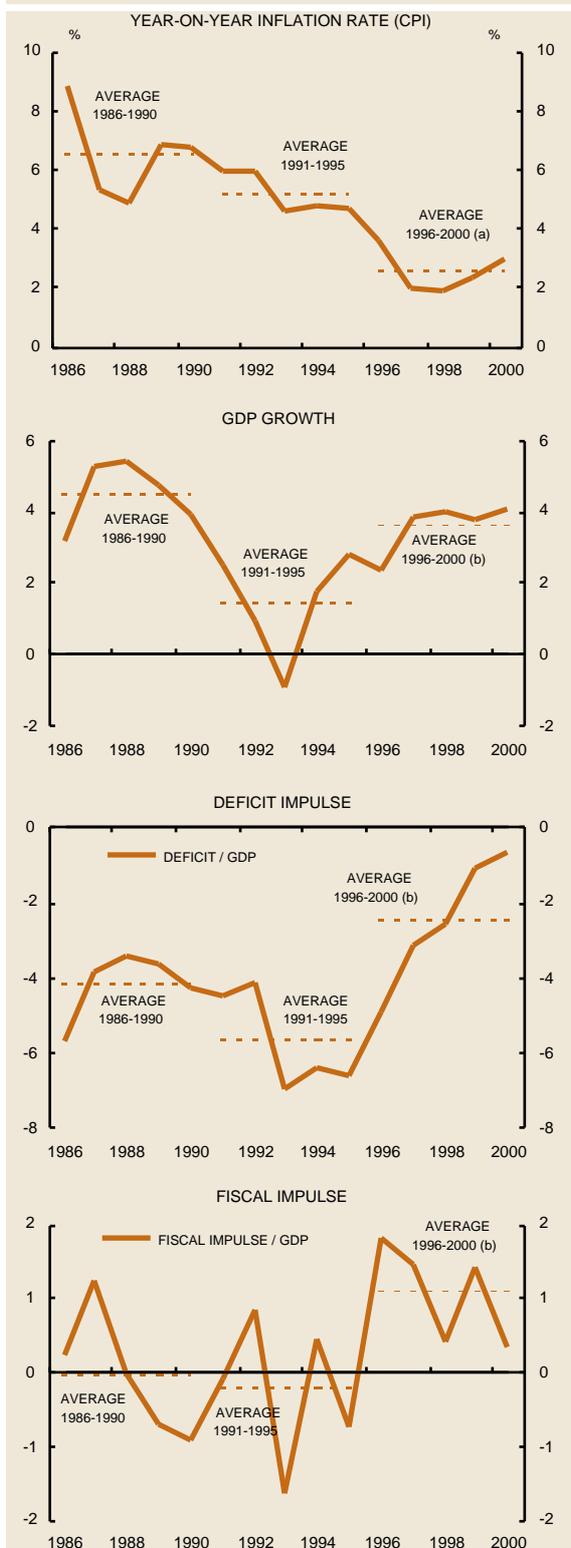
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(1) This article summarises the intervention prepared by Juan Ayuso and Pilar L'Hotellerie, from the Research Department, for the BIS Spring Central Bank Economists' meeting held on 2<sup>nd</sup> and 3<sup>rd</sup> March 2000.

(2) Up to 2000 Q1.

CHART 1

An overview of the disinflation process



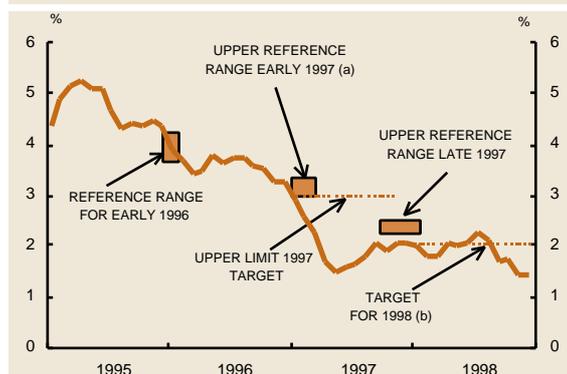
Sources: Instituto Nacional de Estadística and Banco de España.

(a) March 2000.

(b) Forecast.

CHART 2

Year-on-year inflation: Targets



Source: Banco de España.

(a) The CPI growth rate was, in the opening months of 1997, to be close to 3%.

(b) The twelve-month inflation rate was, at end-1997, to be close to 2.5% and around 2% during 1998.

Regarding fiscal policy, the third panel in Chart 1 summarises the important change in its stance in the late nineties. The rising trend that the Spanish public deficit had been following was clearly broken in 1996. The average public deficit in the 1996-2000 period has been around 2.5 %, whereas the figures for the 1986-1990 and 1991-1995 periods were about 4.2 % and 5.8 %, respectively. Although cyclical considerations have played a role in this respect, the break in the trend is also apparent in the so-called fiscal impulse indicator, where cyclical considerations have been filtered out (see Chart 1, bottom panel). This new, less loose fiscal policy stance was implemented, moreover, mainly through mechanisms to curb public expenditure and to enhance its control and management.

Changes in monetary policy making started in 1994, when a new law conferred full independence on the Banco de España to conduct a monetary policy geared primarily towards price stability. One of the first decisions made by the Governing Council elected under the new law was to change the strategy of the Spanish monetary policy. Thus, from 1995 until Spain's incorporation into EMU, the Banco de España pursued a new monetary policy strategy of direct inflation targeting, which replaced the previous strategy based on (broad money) intermediate targets.

The new monetary policy stance was implemented as a gradual policy of disinflation from the relatively high levels prevailing at the beginning of the second half of the nineties to the levels that at that time were thought to be consis-

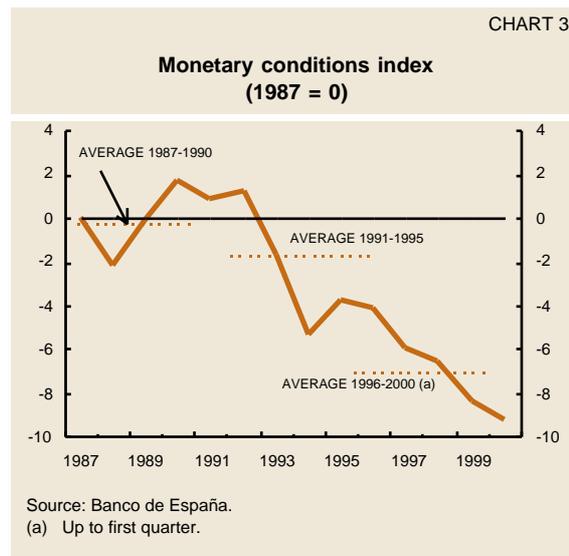
tent with the Maastricht criteria. Chart 2 shows how this gradualism was actually implemented as well as the relative ease with which the different targets were met. As a matter of fact, the main part of the targeted disinflation process was completed almost one year in advance, as the inflation figures for the last three quarters in 1997 were broadly compatible with the target set for 1998, i.e. keeping the inflation rate around 2 %.

To understand the nature, the final aims and the success of these economic policy changes, it is important to recall that Spain had traditionally been a so-called high-inflation country. Inflation had been strongly entrenched in the behaviour of economic agents and in the institutional mechanisms underpinning the workings of the economy. In this framework, it was clearly understood that the success of any programme aimed at reducing the inflation rate would hinge crucially on its ability to break with previous beliefs and behaviour or, to put it another way, on its ability to be credible.

In this regard, the growing general consensus in Spanish society on the need promptly to fulfil the Maastricht criteria, the new economic policy framework and its promising early results laid the foundations for a virtuous circle. Within this virtuous circle, additional headway in the disinflation process improves the credibility of the new policy framework and targets, hence making further advances easier. This is in clear contrast to the vicious circle that seemed to have been at play before the changes. In that vicious circle a low degree of credibility of the economic policy targets increased the real costs of fulfilling those targets and therefore increased the probability of not fulfilling them. This further undermined economic policy credibility.

Chart 3 provides additional information to illustrate – and perhaps to allow for a preliminary evaluation of the relevance of – this virtuous circle. As can be seen, the acceleration of the disinflation process in Spain took place against a background of looser –rather than tighter– monetary conditions. Regarding the patterns of short– and long-term real interest rates and of the real effective exchange rate (the components of the monetary conditions index depicted in the chart), the comparison of the average figures for the 1991-1995 and the 1996-2000 periods shows that real interest rates have decreased by around 4 percentage points from levels close to 6 % and the real effective exchange rate has depreciated by almost 8 %.

To conclude this brief overview of the role that factors other than wages have played in



the recent Spanish disinflation process, the reduction of the inflation rate has also benefited from structural reforms in the product markets. Moreover, transitory developments (such as the pattern followed by commodity and oil prices in the mid-nineties) helped curb inflation at crucial junctures.

## 2. The role of wage behaviour

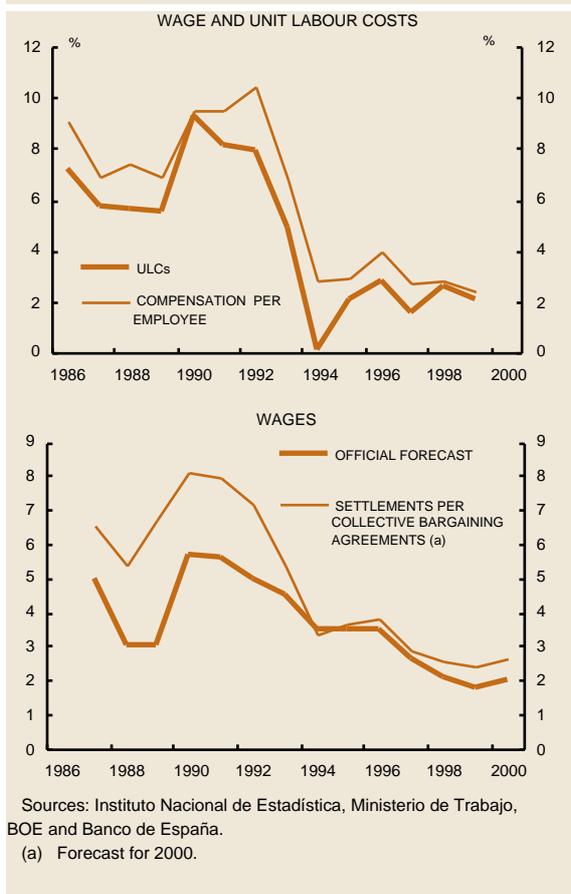
All the information provided so far helps to properly frame the analysis of both the actual role played by the behaviour of wages in lowering the inflation rate in Spain and its prospective role in the task of maintaining price stability in the new framework of EMU. These are the objectives of this section.

The upper panel in Chart 4 shows the pattern of compensation per employee and unit labour costs in Spain since the late eighties. The growing moderation of wage increases is clearly apparent in this chart, showing its important contribution to the observed process of reduction of the Spanish inflation rate. Although the crisis during the mid-nineties may account for some – or much – of this wage moderation, it is striking that moderation has been sustained and even heightened throughout the late nineties, against a backdrop of high growth.

It is worth noting, however, that wages can contribute to shaping a context of macroeconomic stability in two ways. At a “macroeconomic” level, moderate aggregate wage behaviour can make disinflation easier if wage claims are based on inflation expectations that closely match monetary policy targets. Yet there is also a “microeconomic” aspect. For wage behaviour to contribute favourably to a disinflation process, while simultaneously con-

CHART 4

## Labour market conditions



tributing to a high level of employment, wage claims have to be flexible enough to adjust themselves to different sectoral or firm patterns of productivity. While being “macroeconomically” adequate, inappropriate “microeconomic” wage behaviour can bring about changes in relative prices that may reduce competitiveness in some sectors of the economy and might eventually impinge adversely on the aggregate rate of inflation.

A more in-depth analysis of the wage moderation process in Spain with a view to distinguishing these two aspects reveals, first, that aggregate wage behaviour has played an important and positive role. The bottom panel in Chart 4 shows how the gap between wage settlements at the beginning of each year and the official inflation target was sharply reduced in the mid-1990s and that the ex-ante real wage increase was almost brought to zero. This pattern could reflect either a reduction in the equilibrium real wage and/or a lower nominal component of the agreed wage due to increased credibility of the inflation target. Initially, lower wages probably reflected a reduction in the de-

sired real wage, as a result of the recession in 1992/1993 and the related increase in unemployment. However, in the following years, as the economy recovered, wage claims continued to be close to inflation targets as a consequence of the higher credibility of the former, so that expected inflation was equal to targeted inflation. Additionally, the existence of inflation-adjustment clauses in collective agreements (3) has helped moderate initial wage claims. This chart therefore offers another example of how important the virtuous circle referred to earlier has been in explaining the prolonged low inflation figures in Spain. A more credible set of inflation targets has contributed to moderating wage claims and lower wage claims have reduced the pressure on inflation, thus increasing the probability of meeting the targets and, therefore, their credibility.

Nevertheless, the picture emerging from the analysis of wage flexibility at sector and firm level is not so positive. Although the wage bargaining system in Spain has, in principle, an intermediate level of centralisation, there are in fact two important trade unions, which behave in a highly co-ordinated way. This has been beneficial for the disinflation process as long as trade unions have perceived the credibility of inflation targets, which has allowed a reduction in their inflation expectations to be incorporated into the bargaining process, as described in the previous paragraph. But, on the other hand, strong co-ordination among trade unions has resulted in high homogeneity of wage increases across sectors and firms, leaving little room for manoeuvre for sectoral adjustments.

At the beginning of the 1980s the particular characteristics of the wage bargaining system in Spain combined with the very high level of redundancy payments determined a very rigid structure of wages and employment. This rigidity has been addressed in several waves of labour market reform in Spain (1984, 1992, 1994, and 1997), which in general have been aimed at increased flexibility of employment rather than increased flexibility of wages.

Thus, in 1984, the use of temporary labour contracts was given a most significant boost. The percentage of workers with temporary labour contracts increased rapidly through the late 1980s to reach a level of around 33-34%. In the second half of the 1990s, in the wake of the 1992-1993 recession and following new legislative changes in 1994, the duration of

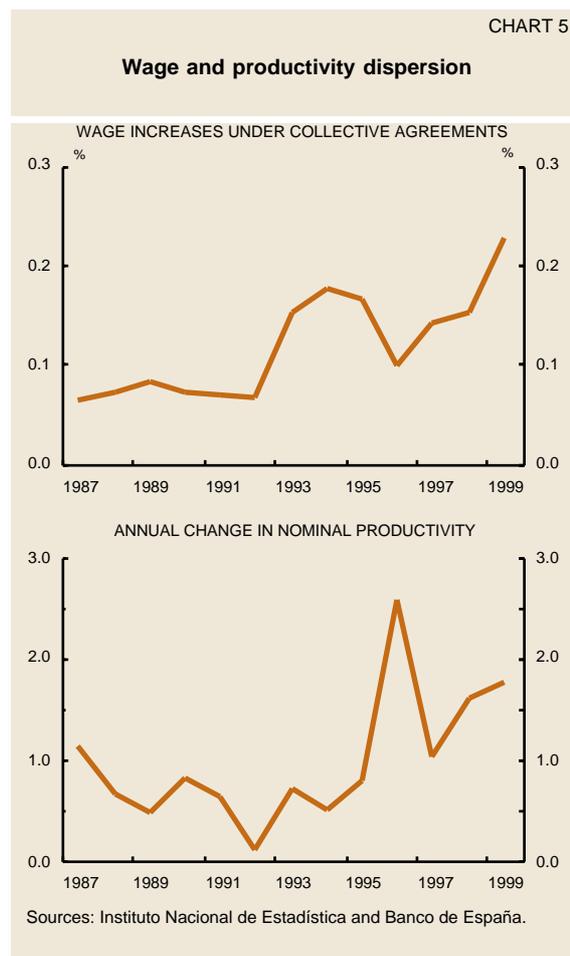
(3) Inflation-adjustment clauses guarantee that deviations of the final outcome for inflation from the expected rate of inflation, used as a reference in collective agreements, are recovered, at least in part, in terms of higher wages.

temporary contracts started to decrease dramatically, giving way to a rapid increase in the ratio of the number of contracts to wage-earners. On the whole, there has been a significant increase in the flexibility of employment conditions since the mid-1980s. Yet increased flexibility only relates to one-third of all employees, those with temporary contracts.

On the contrary, no such significant headway has been made towards wage flexibility. Wage flexibility requires both wage levels to adapt to productivity and other firm- and sector-related characteristics, and, ultimately, wage increases to be related to productivity developments at this decentralised level. In general, a sufficient degree of wage dispersion is needed, both in terms of levels and in terms of rates of change. According to the available information on individual wage distribution (which unfortunately corresponds to 1995), although temporary workers have, in general, lower wages than permanent employees, the aggregate wage distribution in Spain is characterised by excessively high wages at the lower end of the distribution. This is due to high minimum wages for permanent workers, which are explained, in turn, both by the high replacement ratio (unemployment benefits as a proportion of wages) and by the existence of high entry wages. Those entry wages are negotiated in collective bargaining, which set high floors for minimum wages. As a result, average wages are also relatively high.

Against this background, some gradual changes have been introduced by the labour market reforms of 1994 and 1997. The measures taken have been geared to making permanent employment somewhat more attractive for employers. In particular, in 1997 a new type of permanent contract, with lower redundancy payments and reductions in social security contributions, was created. This contract has been aimed at specific groups of workers (the young, women, the long-term unemployed and – up to 1999 – temporary workers). All in all, these measures have entailed a reduction in the cost of labour for employers additional to that derived from wage moderation itself. The effect of such changes has been a noticeable increase in the weight of permanent contracts up to 1999 (from 4 % of new contracts in 1996, to 9 % of new contracts in 1999). Some measures have also been taken to increase the adaptability of wages to firm-level and sectoral circumstances by introducing opt-out clauses (1994) and by favouring collective bargaining on a multi-tier basis (1997).

Although the dispersion of negotiated wage increases (calculated with sectoral data) has

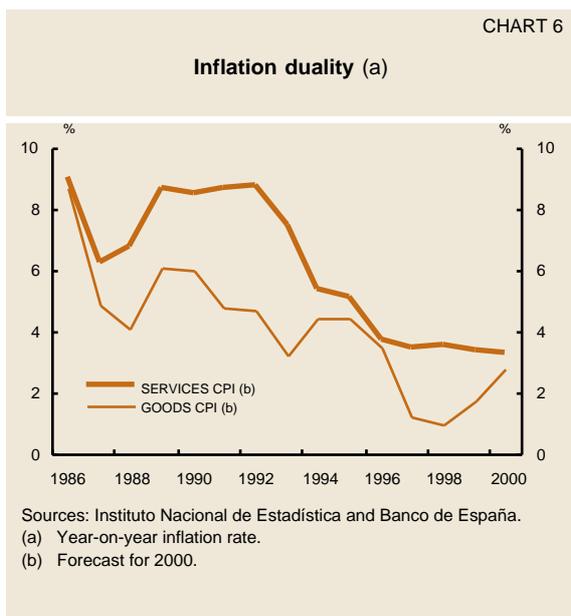


tended to increase, the above-mentioned characteristics of the wage distribution have probably changed little. Chart 5 shows that variability in nominal productivity is much higher than variability in negotiated wages, even if the improvements in the more recent period are taken into account. In any case, updated micro data are needed to confirm the extent of these changes.

Another indirect way of checking to what extent the labour market works efficiently is provided by changes in structural unemployment. A proxy for the level of the structural unemployment rate, long-term unemployment as a proportion of total unemployment, shows that the level of structural unemployment remains high in Spain, indicating a less than flexible performance of the labour market. Nevertheless, in recent years structural unemployment has tended to decrease.

### 3. The duality of inflation

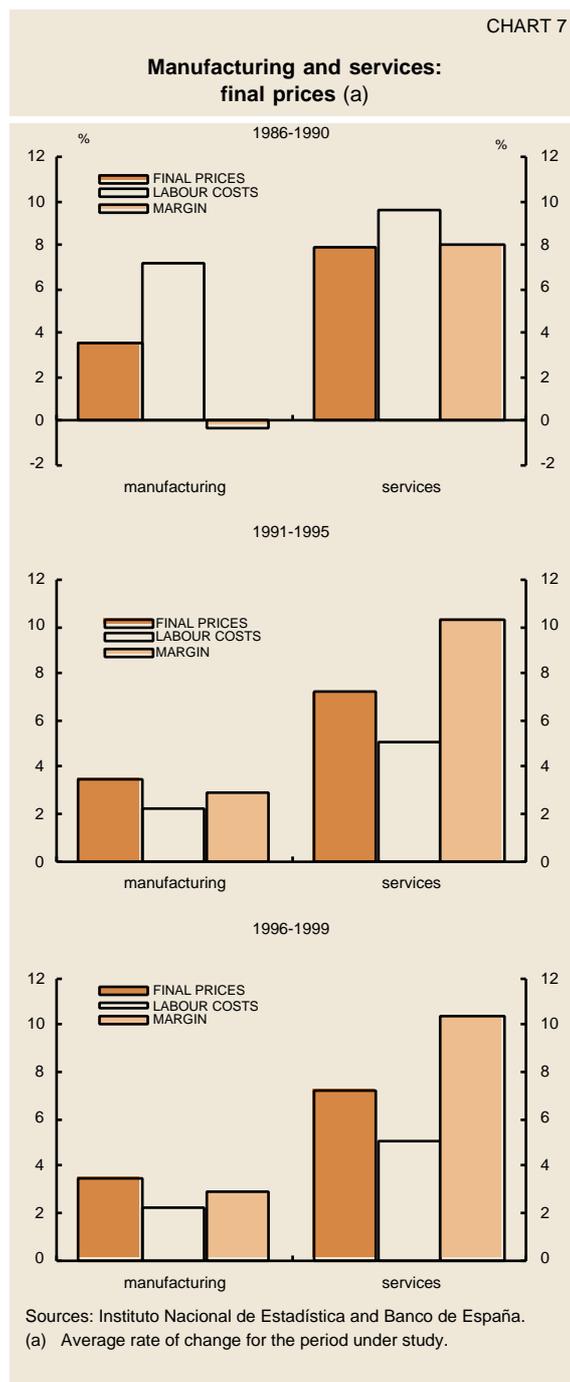
Having analysed the aggregate contribution to disinflation that wages have had in the past, we now turn to assess how the process of reduction of inflation has affected tradable and



non-tradable products. For the sake of simplification, we will take services as being equivalent to the sheltered (non-tradable) sector and manufactures as equivalent to the non-sheltered (tradable) sector. As can be seen in Chart 6, two-speed inflation has been a characteristic of the Spanish inflation process since the 1980s.

In Chart 7 we provide some information on the price formation process in services and manufactures for an insight into the causes of this dual inflation. Looking at the contribution of unit labour costs (ULCs) to inflation, it can be seen that, up to 1995, ULCs increased more in services, in part due to higher productivity growth in manufactures. It appears that higher inflation in services can be explained to some extent by this type of factor (the usual arguments in the Balassa-Samuelson model of dual inflation). But some qualifications are in order. First, higher increases in productivity in manufactures have been associated with reductions in employment (in the 91-95 period). Second, high rates of inflation in services have been accompanied by a widening of margins, irrespective of the cyclical situation of the economy. Third, in the most recent period (1996-1999), ULCs have increased more in manufactures than in services, whereas prices have increased more in services. As a result, margins have contracted in manufactures and widened in services.

These developments are indicative of the lack of (sufficient) competitiveness in services markets. As a result, price adjustments to changes in the nominal conditions of the economy tend to be delayed in these activities. Operating margins in services branches have



widened in general, although there have been some exceptions, such as communications, where market reforms have been implemented, aimed at putting an end to former monopoly situations by gradually opening up the market to new operators.

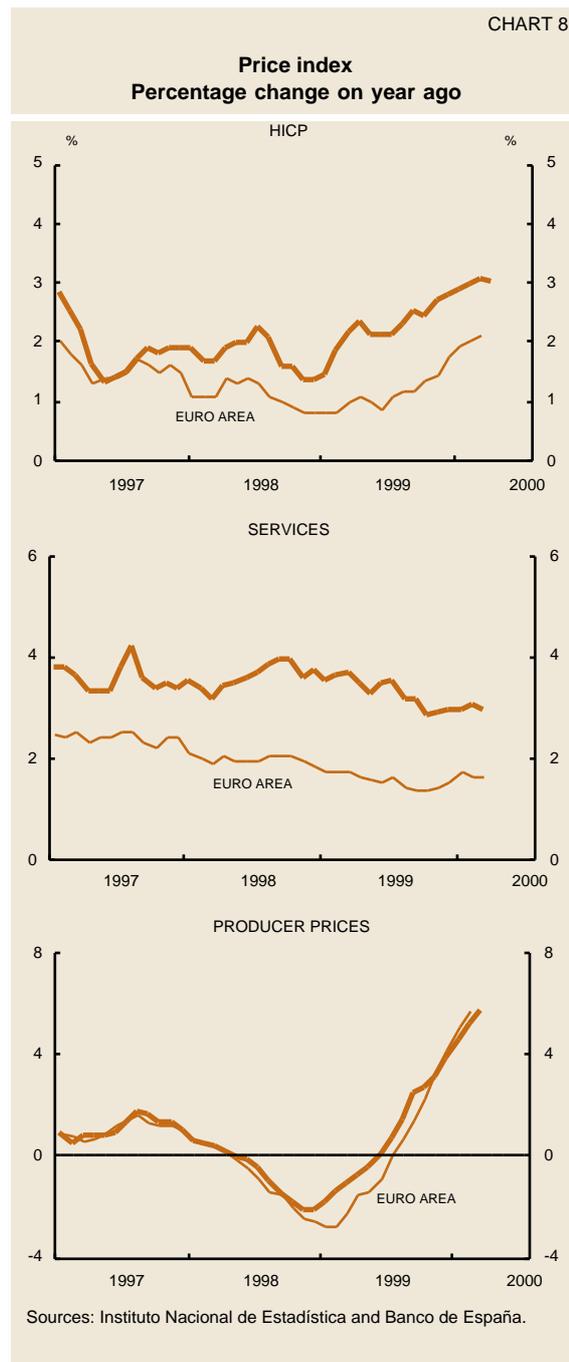
In the comparison with the euro zone, services prices in Spain have maintained a significant inflation differential over the last three years, although a gradual but firm trend towards the reduction of this gap can be seen in the latest data, as can be seen in Chart 8. This is in contrast to producer prices for industrial prod-

ucts, the increases in which have generally been tied to international price developments. Nevertheless, there has been an unusual widening of the differential of these price increases between Spain and the euro area since the beginning of 1999 (see Chart 8). This widening has been partly related to some special factors (i.e. increases in olive oil prices) and possibly to a stronger impact of oil price increases in the case of Spain. But it may also be the result of insufficient adjustment to cost increases through the contraction of margins in tradable sectors showing up as an inflation differential, with both factors pointing to a loss of competitiveness in the non-sheltered sectors of the economy. This loss of competitiveness would be particularly worrying in the context of EMU as it could start a process of adjustment of employment and activity in the non-sheltered sectors, jeopardising the catching-up process of the Spanish economy.

#### 4. Inflation in 1999 and the outlook for 2000

Sharp increases in oil prices during 1999 have heavily affected consumer prices in Spain, as in other countries. Given the greater weight of energy (fuel, in particular) as an input in the production process in services (transport), as opposed to manufactures, the rise in energy prices is further and damagingly fuelling inflation in sectors that already exhibit very high price increases and that are slow to adjust to lower inflation rates. Additionally, these developments have to be placed in the more general context of the strong cyclical recovery of the Spanish economy, accompanied by a somewhat accommodating policy mix. As a result, as can be seen in Chart 8, headline HICP accelerated in 1999, initially widening the inflation differential with the euro area. The year 2000 has started with a reduction in the inflation differential vis-à-vis the euro area. In principle, over the course of the year a downward path in the Spanish inflation rate can be expected, as the same factors that have contributed to widening the differential with the euro area in 1999 may be expected to act in the opposite direction in 2000.

In assessing the inflation outlook for 2000, and taking into account the relatively loose monetary and financial conditions still prevailing in Spain, the main risk to inflation regarding wages is that wage negotiations incorporate the recent acceleration in prices. Looking at wage dynamics in 1999 and the prospects for 2000, the fact that inflation in 1999 was finally higher than the official target taken as a reference in wage bargaining (2.9 % year-on-year at end-



1999, against 1.8 %) activated inflation-adjustment clauses, affecting 60 % of bargaining contracts. The average wage increase finally resulting from collective bargaining was higher than that negotiated in the first place (2.8 % against 2.4 %). This means that due to the indexation mechanism implicit in the clauses, the increase in oil prices has already been incorporated to some extent into wage increases.

For the year 2000, the information available supports the hypothesis that the official inflation target (2 % by the end of the year) is being taken as the initial reference for collective bargain-

ing. If inflation behaves as expected, the virtuous circle of wage increases helping keep inflation low will be restored. But the risks here are twofold. The most immediate risk would be that negotiated wage increases take as a reference the present inflation rate (2.9 % as of April 2000). But there is no definite evidence of that being the case. The second risk would be that even with wage increases initially set in terms of the 2 % inflation target (at around 2.5 %), inflation ends up far above the expected figure at the end of 2000. That would once more activate the indexation mechanism implicit in inflation-adjustment clauses, jeopardising the process of wage moderation and endangering the virtuous circle of nominal stability.

## 5. Final considerations

The Spanish economy has been on a cyclical upturn for more than five years already, and the prospects for 2000 are for this expansion to continue. This period of growth has provided for a significant step forward in the process of real convergence (catching up) with the more advanced countries of the EMU. Notably, the process has run in combination with clear headway towards nominal stability and a decreasing path for inflation. To continue this process in the fu-

ture, it is necessary to act both to maintain macroeconomic stability and to push ahead with structural reforms.

Maintaining nominal stability requires an adequate policy mix to preserve credibility effects. The European framework combining the single monetary policy and the commitment towards fiscal consolidation included in the SGP provides an adequate setting for this. In any case, given that monetary conditions, which are set by the Eurosystem taking into account the euro area situation as a whole, are relatively loose for the case of Spain, an appropriate offsetting fiscal policy stance is especially needed.

Although this article has claimed that inflation has been drastically reduced in Spain with an important contribution by wage behaviour, there is still room for further reforms both in the labour market (to improve its efficiency) and in the more sheltered sectors (to reduce dual inflation). Such structural improvements are particularly important as continuing structural rigidities both in the labour markets and in the more sheltered sectors may ultimately result in excessive wage increases in the non-sheltered sectors, badly impairing their competitiveness and jeopardising the real convergence process of the Spanish economy.

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# 1. Financial regulation: first quarter of 2000

## 1. Introduction

Relatively few financial provisions were enacted during the first quarter of the year 2000 owing largely to the dissolution of the legislative chambers and the subsequent holding of general elections.

With regard to the Banco de España (hereafter «BE»), its internal regulations have been adapted to the amendments made to Law 13/1994 of 1 June 1994 (1) on the Autonomy of the Banco de España. The aim here is to ensure the integration of the BE into the European System of Central Banks (ESCB) and to acknowledge, inter alia, the powers of the European Central Bank (ECB) in the definition of monetary policy in the euro area and the authority of the European Community in relation to exchange rate policy.

In respect of credit institutions, BE Circular 8/1990 of 7 September 1990 (2) on the transparency of operations and customer safeguards, has been adapted to the provisions of the Ministerial Order dated 1 December 1999, in which a new formula for calculating the one-year interbank interest rate (Mibor) was determined.

In the area of government debt, and as has habitually been the case in the opening months of each year, the terms of issuance of government debt in euro for the year 2000 and for the month of January in the year 2000 have been published, observing the limit of 1.7 billion pesetas of net issue set in the State budget law for 2000. Broadly, the same instruments, practices and other features shaping debt policy the previous year have been continued.

On the securities markets, the regulation of the special segment for trading by companies from the innovative sectors – called the *New Market* – has been implemented. This determines the type of companies to which the New Market is geared; listing conditions; issuer disclosure and transparency requirements, and the specific dealing conditions to be established for trading in securities on this market.

Turning to portfolio investment institutions, the securities traded on the recently created Latin American securities market have been considered as eligible for investment on the part of pooled investment institutions, since the

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(1) See «Regulación financiera: segundo trimestre de 1994», in *Boletín económico*, Banco de España, July-August 1994, pp. 86-92.

(2) See «Regulación financiera: tercer trimestre de 1990», in *Boletín económico*, Banco de España, October 1990, pp.76-77.

aforementioned market meets the requirements laid down in the law regulating these institutions.

Finally, mention may be made of the publication of the regulation on the accreditation of certification service providers and the certification of specific electronic signature products.

## 2. Amendment of the internal regulation of the Banco de España

Law 13/1994 of 1 June 1994 on the Autonomy of the BE transposed to Spanish legislation the provisions of the Treaty on European Union relating both to monetary policy and to relations with the Treasury. Further to the law of autonomy, the BE is a state institution under public law enjoying full autonomy in the sphere of monetary policy with the primary objective of attaining price stability. In compliance with the terms of the aforementioned Law, the Internal Regulation of the BE was approved via the Government Council Resolution of 14 November 1996, establishing said Regulation as the basic and highest-ranking legal provision for the self-governing regime of the central bank.

Later, Law 66/1997 of 30 December 1997 (3) on fiscal, administrative and social measures, amended Law 13/1994 so as progressively to adapt it to the requirements arising from the recent constitution of the ECB and of the ESCB, with full exercise of the associated powers taking effect at the outset of the third stage of Economic and Monetary Union. Subsequently, Law 12/1998 of 28 April 1998 (4) amended Law 13/1994 once more, to ensure the full integration of the BE into the ESCB, acknowledging, among other aspects, the powers of the ECB in the definition of monetary policy in the euro area and its execution by the BE, and the authority of the European Commission regarding exchange rate policy. Finally, Royal Decree 1746/1999 of 19 November 1999 regulated the arrangements for the deposit of BE profits with the Treasury.

To adapt the Internal Regulation of the BE to the above-mentioned provisions, the BE Governing Council *Resolution dated 22 February 2000* was published (Official Government Bulletin of 25 February). This Resolution amends

(3) See «Financial regulation: fourth quarter of 1997», in *Economic Bulletin*, Banco de España, January 1998, pp. 90-91.

(4) See «Financial regulation: second quarter of 1998», in *Economic Bulletin*, Banco de España, July 1998, pp.82-83.

certain provisions of the aforementioned Regulation.

Given the significant number of amendments made by the foregoing Resolution, by means of the BE Governing Council *Resolution of 28 March 2000* (Official Government Bulletin of 6 April) a complete Internal Regulation has been approved, repealing the previous 1996 regulation with the above-mentioned amendment.

Grouped under the following headings, the new measures introduced can be clearly viewed.

### 2.1. Legal regime and regulatory powers

With regard to its nature and legal regime, the Internal Regulation incorporates the legal provisions relating to the fact that the BE -which continues to be considered as an institution under public law with its own legal personality and full public and private legal capacity- is an integral part of the ESCB and is subject to the Guidelines and Instructions of the ECB and to all other legally binding instruments.

In relation to the legal instruments of the ECB and the BE, three levels can be distinguished:

1) With regard to the ECB's legal instruments, i.e. *Guidelines, Instructions, Decisions, Recommendations and Opinions* (principally Articles 12.1 and 34 of the Statute of the ESCB and of the ECB), the Internal Regulation reflects what could be called the procedure for the reception and application thereof.

2) As to the provisions laid down by the BE, its *Monetary Circulars* shall dictate the exact rules for the development of its functions as an integral part of the ESCB. For the proper exercise of the rest of its powers, it shall dictate the provisions required for the implementation or execution of those rules expressly empowering it to this end, which shall continue to be called *Circulars*. The technical aspects required for the applicability of the circulars may be made public, through the related Directorate General, under the name of *Technical Applications*.

3) The BE shall further lay down the internal rules it deems appropriate for the organisation and functioning of its services (the all-purpose name of «Instructions» shall be dropped to avoid confusion with the regulations of the ESCB). The hierarchical order of these rules shall be as follows: 1) *In-house Circulars*, covering rules of a basic, general nature with which all departments must comply; 2) *Ordinances*,

which implement what is laid down in In-house Circulars, or provide for the exercise of the regulatory powers of the governing bodies upon which the internal regulations have conferred authority.

## 2.2. *Aims and functions of the Banco de España*

The primary aim of the BE continues to be that of maintaining price stability. Without prejudice to this objective, it shall continue to support the general economic policy of the government and the general economic policies of the Community, in conformity with the provisions of Article 105 of the Treaty on European Union (TEU). In the exercise of its functions, neither the government nor any other national or Community body shall give instructions to the BE, and nor may the BE obtain or accept them, but shall act independently of the State administration in the fulfilment of its aims. In this respect, the functions previously specified in Law 12/1998 are included in the regulation. Thus, the BE shall *participate* in the performance of the following basic functions assigned to the ESCB:

- a) Defining and implementing monetary policy.
- b) Conducting currency exchange operations consistent with the provisions of Article 111 (formerly Article 109) of the TEU.
- c) Holding and managing the Member States' official currency reserves. Nonetheless, the government may hold and manage foreign exchange working balances, in keeping with the provisions of Article 105.3 of the TEU.
- d) Promoting the sound working of the payment system.
- e) Issuing legal tender banknotes.
- f) Other functions arising from its status as a fully-fledged member of the ESCB.

In addition to the foregoing functions, it shall continue to perform the following: 1) the supervision of credit institutions and of whatsoever other financial institutions and markets whose supervision should have been assigned to it; 2) the holding and management of currency and precious metal reserves not transferred to the European Central Bank; 3) the promotion of the sound working and stability of the Spanish financial system, without prejudice to the terms of d) above; 4) the provision of treasury services, also acting as financial agent for government debt; 5) the placement in circulation of coins and the performance, on behalf of the

State, of all such other functions entrusted to it in this connection; 6) adviser to the government, preparing the appropriate reports and studies; and 7) the preparation and publication of statistics relating to its functions, and assisting the ECB in the compilation of the necessary statistical information for ESCB functions.

## 2.3. *External relations*

In this area there have scarcely been any amendments to the terms established in the previous regulation. Thus, the BE shall continue providing assistance to, co-operating with and advising the judicial authorities in the exercise of their jurisdictional functions, on matters within the central bank's sphere of influence. The BE shall likewise maintain relations with other central banks, financial supervisory authorities, European Union agencies and other international financial organisations. In this connection, it may issue reports on matters under its remit when so requested or when it deems it appropriate to do so, within the limits of its organisational capability and observing the obligation of secrecy imposed by the current regulations.

## 2.4. *Economic regime*

Broadly speaking, the same guidelines set out in the current regulations have been maintained. In this respect, the associated economic regime will not be subject to the legislation governing the budgetary, property and contracting regime applicable to public-sector entities, unless otherwise stated. The accounting system, which shall be adapted to the obligatory rules emanating from the ECB, shall observe generally applicable accounting principles and, in particular, those relating to prudence and uniformity. The annual accounts shall comprise the balance sheet, profit and loss account and explanatory notes to the financial statements. Once profits have been formulated and determined within a maximum period comprising the six months following the close of the related financial year, the Governing Council shall submit them to the Ministry of Economy and Finance for approval by the government which, thereafter, shall disclose them to Parliament. The BE budget for operating expenses and investment shall be prospective in nature and shall be approved by Parliament. Finally, auditing shall be performed by external auditors, by an Accounts Review Commission (whose regime has been laid down in the new Regulation) and by the Tribunal de Cuentas (National Court of Auditors).

## 2.5. *Governing bodies*

The governing bodies of the BE shall continue to be the Governor, the Deputy Governor, the Governing Council and the Executive Commission. The Internal Regulation refers to the powers and to the rights and obligations of these bodies in the same terms as the Law of Autonomy.

Few of the amendments made are worthy of mention. The powers attributable to the Governor are retained, with one new aspect, as envisaged in the Law of Autonomy, being added: namely, the Governor's status as a member of the Governing Council and General Council of the ECB. If the Governor or, should it so occur, the Deputy Governor leaves office, the substitute's term of office shall be the regular one corresponding to the post, namely six years (previously, the post would be held during the time remaining for the previous incumbent to complete the term of office).

Regarding the Governing Council, the Internal Regulation envisages lengthening the term of office of elected Council members from four to six years, as introduced by Law 66/1997. Said members may be re-appointed only once. As in the case of the Governor and Deputy Governor, in the event of a Council member's post becoming vacant before the related term of office has been completed, the substitute's term of office will be that ordinarily corresponding to the post. The Council's functions are likewise adapted to the new situation of the BE as a fully-fledged member of the ESCB. Specifically, it is now entrusted with supervising the contribution of the BE to the implementation of the ESCB's monetary policy by the Executive Commission, observing the Guidelines and Instructions of the ECB and the independence and obligation to secrecy of the Governor as a member of the governing bodies of the ECB. Further, the issue of peseta-denominated banknotes -inasmuch as there should be no issue of euro-banknotes by the ESCB- shall be subject to authorisation by the ECB.

The Executive Commission, for its part, retains its present composition and most of its powers and functions, although some of these are adapted -as was the case with the Governing Council- to fit the new status of the BE. Thus, having played a leading role in the implementation of monetary policy in the previous stage, it must now -as an integral part of the ESCB- contribute to implementing the monetary policy pursued by the System. Regarding the minimum reserves of credit institutions, it is the Executive Commission's responsibility to be aware of and act accordingly in the event of

their non-compliance with such reserve requirements and with statistical reporting obligations, in accordance with ECB Regulation 2818/1998 of 1 December 1998 on the consolidated balance sheet of monetary financial institutions.

## 2.6. *Management bodies of the Banco de España*

The management bodies of the BE, namely the Directorates General and the Steering Committee, have been marginally altered. The directorates general retain their powers and functions, and shall also now report to the Executive Commission, when appropriate, on the measures adopted to implement ECB Instructions. As regards the co-ordinating bodies (internal commissions), minor changes affecting their constitution and functioning have been introduced.

## 2.7. *Organisational structure of the Banco de España*

The organisation of the BE continues to be structured around five directorates general: International Department; Operations, Markets and Payment Systems; Regulation; Research Department; and Banking Supervision. They retain their respective areas of responsibility, albeit adapted to the current functions of the BE.

Lastly, it is stipulated that the arrangements for the deposit of BE profits with the Treasury for the years 1999, 2000 and 2001 shall be as established in Royal Decree 1746/1999 of 19 November 1999.

## 3. **Credit institutions: calculation of the one-year interbank market interest rate (MIBOR).**

The Minister of Economy and Finance was authorised by Law 46/1998 of 17 December 1998 (5) on the introduction of the euro to determine a new formula for calculating the one-year interbank interest rate (Mibor) for use as an official index for mortgage loans, in the event that, owing to technical or market difficulties, it could not be calculated using the existing method.

Since the introduction of the euro, there have been more and more days on which no transactions based on the Mibor rate have been concluded in the interbank market, making it difficult to obtain the official index. A Ministerial

(5) See "Financial regulation: fourth quarter 1998", in *Economic Bulletin*, Banco de España, January 1999, pp. 83-90.

Order of 1 December 1999 has now determined a new formula for its calculation, which entered into force on 1 January 2000.

Under the new formula, on those days on which one-year transactions are concluded on the Spanish interbank deposit market, Mibor will be the average of the rates agreed weighted by the value of the transactions. On those days on which *no transactions are concluded* Mibor will be considered to be the same as the Euribor rate. The latter is an interest rate offered by a sample of banks for one-year euro deposit transactions and is published by the European Banking Federation. The Order also provided that Mibor would no longer be considered the official benchmark rate for mortgage loans executed after 1 January 2000, although it would be maintained for loans prior to that date. In consequence, as from 1 January 2000, Euribor is the only official money market rate used as a benchmark for mortgage loans.

Recently, *Banco de España Circular 1/2000* of 28 January 2000 has adjusted the content of *Banco de España Circular 8/1990* of 7 September 1990 on transparency of transactions and client protection, to the provisions of the Order. Mibor is maintained as the official benchmark for mortgage loans executed before 1 January 2000, with the changes set out in the Ministerial Order of 1 December 1999 introduced into the formula for its calculation.

#### 4. State debt: issuance conditions during 2000 and January 2001.

Law 54/1999 of 30 December 1999 (6) on the State Budget for 2000 authorises the government so that, on the proposal of the Minister of Economy and Finance, it may increase the outstanding balance of State debt during the year 2000 to ESP 1,708 trillion. This limit will apply as at the end of the 2000, and may be exceeded during the course of the year. The Law also stipulated the circumstances that would give rise to its automatic revision. The Ministry of Economy and Finance is empowered to issue, place and manage State debt, subject to the government's criteria and within the quantitative limits set by the State Budget Law, by Royal Decree-Law 1091/1988 of 23 September 1988, which approved the consolidated text of the General Budget Law.

Law 46/1998 of 17 December 1998 on the introduction of the euro, established that State debt issued by the Treasury (hitherto denomi-

nated in pesetas) shall necessarily, as from 1 January 1999, be denominated in euro. In turn, the government, using the powers granted by Law 46/1998, issued Royal Decree 2813/1998 of 23 December 1998 (7), which established the procedure for the redenomination in euro of government debt registered with the Book-Entry System, stipulating that all peseta-denominated government debt in circulation registered with the System as at 31 December 1998 would be redenominated in euro as from 1 January 1999.

As has been becoming customary around these dates, Royal Decree 68/2000 of 21 January 2000 (BOE of 22 January 2000) and a Ministerial Order of 25 January 2000 (BOE of 27 January 2000) have been published, providing for the creation and issuance conditions of State debt for 2000 and January 2001, with the limit for the latter month being 15% of the volume authorised for 2000. In addition, two Treasury Resolutions of 27 January 2000 (BOE of 28 January 2000) provide for particular debt issues and specify the timetable for the regular tenders of Treasury bills and State bonds that will be offered during this period.

Broadly, the same instruments, techniques, practices and other aspects that made up debt policy for 1999 are retained. Specifically, the Minister of Economy and Finance remains authorised to conduct, among other operations, the following:

- a) To continue to conduct borrowing operations using the vehicles provided for, changing the commercial name or grouping more than one vehicle under a single denomination.
- b) To create, within the framework of current fiscal legislation, new government debt vehicles, whether marketable or non-marketable, establishing their commercial name, issuance techniques and other features.
- c) To regulate the practices for issuance and determining coupon interest, allowing issues to be grouped or successive tranches of a single issue to be placed, and thereby securing the volumes of homogenous securities necessary for liquidity in the secondary markets.
- d) For the purposes of debt dealing, to authorise State debt strips (the stripping of the principal and interest of certain issues and their subsequent reconstitution).

(6) See "Financial regulation: fourth quarter 1999", in *Economic Bulletin*, Banco de España, January 2000, pp. 111-112.

(7) See "Financial regulation: fourth quarter 1998", in *Economic Bulletin*, Banco de España, January 1999, pp. 83-90.

In the case of State debt issues which are initially offered or placed abroad, the usual clauses and conditions envisaged under the General Budget Law for these operations may be agreed in respect of the returns paid to non-residents.

As to the formalisation of public debt, this will, as in previous years, be in the form exclusively of book-entry Treasury bills (at six, twelve and eighteen months) and State bonds (at three, five, ten, fifteen and thirty years).

The traditional issuance procedures are retained, namely:

- Tenders (with competitive and non-competitive bidding), that will be conducted in accordance with rules published earlier. They may be for the general public, authorised placers or a restricted group of placers, who acquire special commitments with respect to the placement or trading of the debt.
- Any other technique that does not involve inequality of opportunity for potential purchasers.

The periodicity with which regular tenders are held on pre-established dates is also maintained:

- For Treasury bills: twelve- and eighteen-month Treasury bill tenders coincide and take place every two weeks, while six-month bill tenders are held every four weeks in a week without tenders of twelve- and eighteen-month bills.
- For State bonds: monthly, except for thirty-year bonds, with tenders once every two months, and fifteen-year bonds, for which tenders will now be conducted twice a month. The redistribution of allotment dates for bond tenders will be as follows: in the case of three- and ten-year bonds, on the first Wednesday of each month; and on the following Thursday, five-, fifteen- and thirty-year bonds (the latter in the corresponding month). In both cases this is provided that the days in question are business days for Madrid financial markets.

As for competitive bids, the minimum nominal amount will be EUR 1,000 for twelve- and eighteen-month Treasury bill tenders, EUR 500,000 for six-month bills and EUR 5,000 for bond tenders. In all cases, applications for higher amounts must be integer multiples of EUR 1,000, except for six-month Treasury bills, where they must be multiples of EUR 100,000.

In the case of non-competitive bids, the minimum nominal amount shall be EUR 1,000 for

both twelve- and eighteen-month bills and for bonds, with a maximum nominal amount per bidder of EUR 200,000. Non-competitive bids will not be accepted for six-month bills.

## 5. Stock exchanges: listing requirements for the New Market.

A special new trading segment called the *New Market* has been created on the stock exchanges by the Ministerial Order of 22 December 1999 (8). The securities of high-technology firms will be traded in this segment, which is intended to ensure that the financing requirements of firms in innovative sectors are efficiently served. This Order also provided that the National Securities Market Commission (CNMV) would establish the general criteria to determine which firms' securities would be traded on this market, as well as the listing requirements.

The CNMV has published *Circular 1/2000 of 9 February 2000* (BOE of 17 February 2000) in order to fulfil its mandate under the said Order. This circular determines the type of firms the New Market is aimed at (following the criteria of similar special trading segments in other European stock exchanges), the listing requirements, the information and transparency requirements for issuers, the procedure to apply for listing, and the specific trading conditions that must be established for the trading of securities on this market.

Following the same order as above, the New Market is intended for the trading of the securities issued by firms whose main activity is in an innovative high-technology sector, in so far as the product or the productive process is concerned, or sectors offering great growth opportunities. For securities to be listed on the New Market, issuers must comply with the general requirements laid down in the Securities Market Law, in its implementing provisions and in the stock exchange regulation (9).

As for the information and transparency requirements for issuers, they must comply with the obligations for the periodic release of public information and for publishing relevant facts provided for in the Securities Market Law and in its implementing provisions. At least once a year issuers shall make available to the public, as relevant facts, information explaining the de-

(8) See "Financial regulation: fourth quarter 1999" in Economic bulletin, Banco de España, January 2000, p. 106-107.

(9) These requirements are: a minimum capital of ESP 200 million; a minimum dispersal of their capital (at least 100 shareholders, each holding less than 25% of the share capital); and the submission of a report to the CNMV on their financial and business prospects, and on the results projected for the coming years.

velopments and prospects of the business, and investment and financing plans for its future development.

With regard to the procedure for applying for securities to be listed on the New Market, issuing firms shall obtain from the stock exchanges a non-binding report on their suitability for trading thereon prior to verification of the prospectus supporting the application. In addition, both the procedure for issuance and public offerings and that for applying for listing shall be governed by the Securities Market Law and its implementing provisions, with the incorporation of certain specific information for this type of firm set out in the Circular.

Finally, the specific conditions for trading securities on the New Market are specified. The rules for trading securities established by the stock exchanges must: a) set limits to daily price movements; b) regulate the circumstances and automatic or discretionary mechanisms for widening such limits; c) create systems for dealing with situations which prevent price formation and the trading of securities and d) fix both the limits and the general transparency rules for members, obliging them to promote the liquidity of the securities, without interfering in the correct formation of prices on the market.

#### **6. Portfolio investment institutions: investment in securities traded on the market for Latin American securities.**

Portfolio investment institutions are required by Law 46/1984 of 26 December 1984, implemented by Royal Decree 1393/1990 of 2 November 1984, to have 90% of their assets invested in stock-exchange listed securities and other financial instruments traded on officially recognised organised markets, open to the public, which operate regularly. It is also established that a market has these characteristics when the Minister of Economy and Finance, after a report by the CNMV, determines this to be the case.

The creation of the market for Latin American securities as an organised system for trading securities and other financial instruments, pursuant to the provisions of law 24/1988 of 28 July 1988, was authorised by a resolution of the Council of Ministers of 29 October 1999. This resolution assigned to the Securities Clearing and Settlement Service (Servicio de Compensación y Liquidación de Valores) the functions of registration, clearing and settlement of the transactions executed in this market, and to the CNMV the oversight and supervision of the market for Latin American securities.

Recently, the *Ministerial Order of 10 March 2000* (BOE del 17 March 2000) on the investment of Portfolio Investment Institutions in securities traded on the market for Latin American securities has considered the securities traded on this market as suitable investments for investment companies and mutual funds, since the market meets the requirements laid down in Law 46/1984.

#### **7. Electronic signatures: regulations or the accreditation of certification service providers and for the certification of specific products.**

Royal Decree Law 14/1999 of 17 September 1999 regulated the use of electronic signatures, in harmony with the Community framework for the same. It stipulated the rules for the establishment of voluntary systems for the accreditation of certification service providers and for the evaluation of compliance by electronic signature products with its requirements. Subsequently, Royal Decree Law 16/1999 of 15 October 1999, which adopted measures to fight inflation and promote competition in telecommunications, authorised the Minister of Public Works to implement Royal Decree Law 14/1999.

Pursuant to this authorisation, a *Ministerial Order of 21 February 2000* (BOE of 22 February 2000) has been published, which approves the Regulation of accreditation of certification service providers and of certification of specific electronic-signature products.

The Regulation regulates the operation of accreditation and certification systems, which are based on three kinds of bodies, entities and agencies: 1) bodies competent to accredit providers and issue compliance certificates for electronic-signature products; 2) entities responsible for evaluating and issuing reports or certificates; and 3) the independent agency entrusted with accrediting such evaluation entities, which is designated in this same Regulation.

The Order also determines the legal system for accreditations and compliance certificates, the requirements for obtaining them and the conditions for the recognition of those issued in other States. Certificates of secure creation devices and of electronic signature verification issued by the agencies designated for the purpose by the EU Member States shall be recognised as effective. Likewise, those issued by agencies designated by non-EU Member States shall be recognised when an international agreement for mutual recognition binding on Spain so provides.

12.4.2000.

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