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Abbreviations

AIAF	Association of Securities Dealers
BE	Banco de España
BIS	Bank for International Settlements
CBA	Banco de España Central Balance Sheet Data Office Annual Survey
CBQ	Banco de España Central Balance Sheet Data Office Quarterly Survey
CBSO	Banco de España Central Balance Sheet Data Office
CNE	Spanish National Accounts
CNMV	National Securities Market Commission
CPI	Consumer price index
EAGGF	European Agricultural Guidance and Guarantee Fund
ECB	European Central Bank
ECOFIN	Council of the European Communities (Economic and Financial Affairs)
EDP	Excessive Deficit Procedure
EMU	Economic and Monetary Union
EONIA	Euro overnight index average
EPA	Official Spanish Labour Force Survey
ESA 79	European System of Integrated Economic Accounts
ESA 95	European System of National and Regional Accounts
ESCB	European System of Central Banks
EU	European Union
EU15	The fifteen current European Union Member States
EURIBOR	Euro Interbank Offered Rate
EUROSTAT	Statistical Office of the European Communities
FIAMM	Money market funds
FIM	Securities funds
GDP	Gross domestic product
GDPmp	Gross domestic product at market prices
GVA	Gross value added
HICP	Harmonised index of consumer prices
ICT	Information and communications technology
IMF	International Monetary Fund
INE	National Institute of Statistics
INEM	National Employment Office
INVERCO	Association of Collective Investment Institutions and Pension Funds
IPOs	Initial Public Offerings
LIFFE	London International Financial Futures Exchange
MEFF	Financial Futures and Options Market
MFIs	Monetary financial institutions
MMFs	Money market funds
MROs	Main refinancing operations
NCBs	National Central Banks
NPISHs	Non-profit institutions serving households
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of Petroleum Exporting Countries
PPP	Purchasing power parity
QNA	Quarterly National Accounts
SCLV	Securities Clearing and Settlement Service
SDRs	Special Drawing Rights
TARGET	Trans-European Automated Real-Time Gross Settlement Express Transfer system
TFP	Total factor productivity
ULCs	Unit labour costs
VAT	Value added tax

Abbreviations of countries and currencies in ECB publications:

Countries		*Currencies*	
BE	Belgium	EUR	Euro
DE	Germany		
GR	Greece		
ES	Spain		
FR	France		
IE	Ireland		
IT	Italy		
LU	Luxembourg		
NL	Netherlands		
AT	Austria		
PT	Portugal		
FI	Finland		
DK	Denmark	DKK	Danish krone
SE	Sweden	SEK	Swedish krona
UK	United Kingdom	GBP	Pound sterling
JP	Japan	JPY	Japanese yen
US	United States	USD	United States dollar

In accordance with Community practice, the EU countries are listed using the alphabetical order of the country names in the national languages.

Conventions used

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

M2 M1 + deposits redeemable at notice of up to three months + deposits with an agreed maturity of up to two years.

M3 M2 + repos + shares in money market funds and money market instruments + debt securities issued with an agreed maturity of up to two years.

bn Billions (10^9).

m Millions.

pp Percentage points.

... Not available.

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

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

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CHAPTER 1

OVERVIEW

I.1. INTRODUCTION

Developments in the Spanish economy during 2002 and in early 2003 unfolded against an adverse international background marked by the persistence of significant factors of uncertainty that have detracted from the expected pick-up in the world economy. The euro area has also been markedly weak, showing great vulnerability to external disturbances and a scant ability to generate economic momentum of its own accord. The weakness in Europe has evidenced a relative delay in incorporating technical progress, the limited headway made in the structural reforms needed and the scant headroom available to apply counter-cyclical policies owing to the presence of certain inflationary biases and the tardiness in consolidating public finances. The Eurosystem's monetary policy managed, however, to maintain a growth-sustaining stance, the scope of which widened when the risks for price stability progressively cleared.

The behaviour of the main macroeconomic variables shows that the Spanish economy has proven notably resilient to the adverse external environment. And although it has slowed somewhat, it has been able to negotiate the cyclical downturn with a positive growth rate of around 2%, and has continued to generate employment at a rate of over 1%. Progress in real convergence has thus continued to be made in the downward phase of the cycle, which is when slippage in this process used to occur.

These results clearly show the benefits reaped from the change in macroeconomic regime that accompanied entry into the euro area, from the adoption of policies geared to a balanced budget, from the anchoring of expectations around low inflation rates, from the moderation of wage growth and from the structural reforms applied. As a result of these changes, the strong monetary impulses generated by the convergence of interest rates and EMU membership – which have made for a strong expansion of credit financing – have been conducive to the growth of household expenditure and companies' ordinary profits being achieved in a manner compatible with the general requirements of macroeconomic stability.

Yet these results, in contrast to the difficulties besetting a large number of euro area economies, are not free from certain factors of risk for the continuity of real convergence, once the transitory impulses of the initial phase of monetary integration gradually peter out. Such continuity will require a substantial increase in productivity to complement the buoyancy of employment that has sustained real convergence in recent years. Also, the prolonged expansion of domestic demand, in conjunction with the persistence of certain structural rigidities, has allowed significant inflation differentials to remain in place. Despite the improvement in recent inflationary figures, such differentials may pose a risk for competitiveness and growth in the future. Likewise, the forceful increase in financing, which reflects the natural adaptation to a sustainable scenario of low interest rates, is fuelling an overvaluation of house prices. High debt levels may, if prolonged, ultimately limit the future spending capacity of households and firms.

Overall, the economy is potentially poised to resume more buoyant growth, once the international context improves. Ongoing real convergence will increasingly depend, however, on domestic developments. Consequently, sustaining appropriate macroeconomic policies and furthering structural reform is of paramount importance. This is vital for promoting the generation and assimilation of new technologies and securing the productivity gains required to ensure competitiveness against the background of heightened competition resulting from globalisation and, above all, from the imminent enlargement of the European Union. To face these challenges, the economy will need to adapt its productive specialisation via a reallocation of resources that will only be possible if agents, markets and institutions show sufficient flexibility.

The key recent economic developments analysed in this *Annual Report* thus turn on the deterioration in the international climate and European weakness, on the resilience displayed by the Spanish economy in the recent period and on the challenges that must be addressed to ensure continuing real convergence.

I.2. THE WORLD ECONOMY AMID HIGH UNCERTAINTY

During 2002 the world economy picked up to some extent following the sluggish pace of activity seen the previous year. Nonetheless, growth was weak and hesitant, thwarting the forecasts made, and was very uneven across the different areas.

In 2001, the international economy had lost a striking amount of steam as a result of the crisis in the information and communications technology (ICT) industry, the marked decline in international stock market prices and high oil prices. The terrorist attacks on 11 September that year considerably disrupted economic conditions, although their effects became only clearly apparent in early 2002. Then the deterioration in certain key industries such as air transport and insurance and, above all, the fall in consumer and investor confidence, became patently manifest. Indeed, the events that day marked the start of a phase, still in train, of international political tension which has seen military conflict in Afghanistan and, more recently, war in Iraq. This geopolitical uncertainty affected financial-market and crude oil prices, which were considerably volatile throughout last year. Further, it impacted the foreign exchange markets, where the dollar depreciated against other currencies. In particular, the euro appreciated by 14.1% against the dollar in 2002. The upward course of the euro has continued in the opening months of the current year, enabling it to make up the ground lost in its cumulative depreciation between 1999 and 2001.

The stock markets were also rocked in 2002 by various financial scandals, especially in the United States. The irregularities identified in major corporations' financial statements highlighted the shortcomings of their management control procedures and cast doubt on the veracity of the favourable earnings reported by companies in recent years, which contributed to the marked rise in equity prices in the second half of the nineties.

The backdrop of international political conflict coupled with the unfavourable developments on financial and oil markets detracted from the process of recovery in the main areas. While, generally, economies maintained a degree of cyclical synchrony, assisted by the salient leading role of the US economy in the world cycle and the globalisation of financial activity, significant differences could be seen in terms of the different exposure of each region to the aforementioned political and financial disturbances, their capacity to adjust and the policies applied in each case (see Box I.1).

The US economy, despite being directly exposed to the political and financial turbulence, managed to increase its growth rate markedly to 2.4% in 2002 (see Chart I.1). Contributing to this was the capacity it showed during 2001 rapidly to make part of the adjustment required by the deterioration in economic conditions. Private consumption proved notably resilient, underpinned by the wealth effects derived from rising house prices (which offset the decline in the value of financial assets), while employment continued to trend adversely. Further, domestic demand was assisted by the highly accommodative stance of monetary policy, which kept nominal and real interest rates at their lowest levels of recent decades. Fiscal policy adopted a strongly expansionary stance, on both the expenditure and the revenue sides, meaning the budget deficit rose to 3.6% of GDP last year.

The buoyancy of current expenditure thus allowed the US economy to increase its growth rate appreciably in 2002, despite the strong contraction (of almost 6%) in non-residential investment. However, although the private saving ratio picked up slightly, the intense resort to mortgage lending prevented any reduction in the high rate of household debt. The above-mentioned trend in public finances led to the re-emergence of a budget shortfall on a scale unseen since 1994, and prompted an increase in the current-account deficit to close to 5% of GDP.

BOX I.1

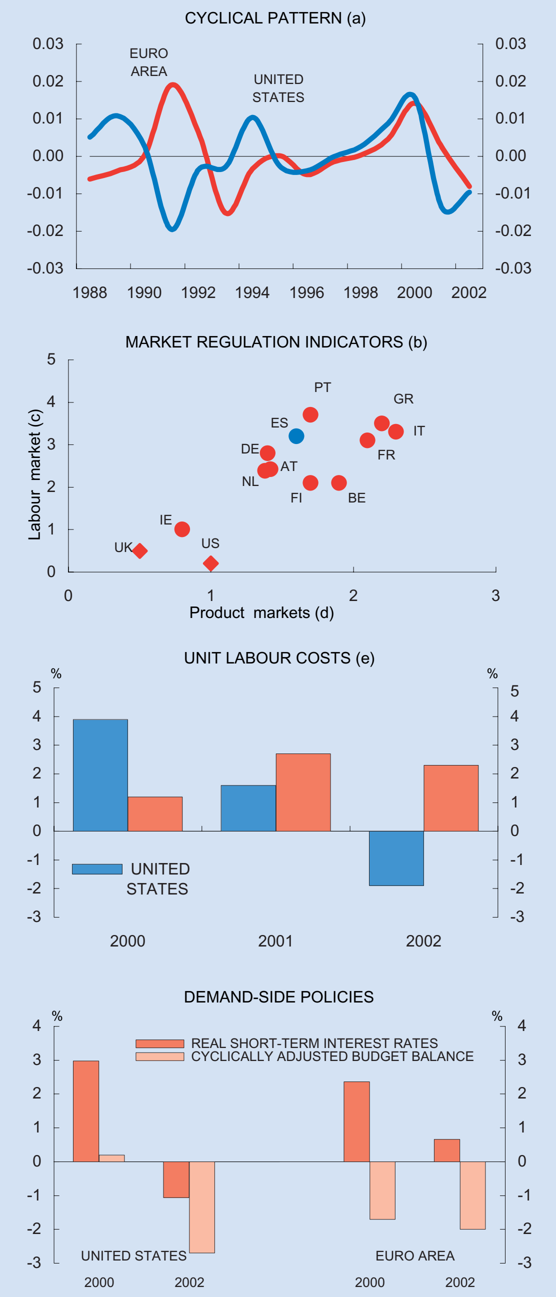
Determinants of the differences in US and euro-area cyclical patterns

In the second half of the nineties the euro-area and US cycles moved, as the first panel shows, relatively similarly. Indeed, the maximum correlation between the cyclical movements in the two areas was about 90% during the 1995-2002 period, with the US cycle two quarters ahead of that of the euro area. This figure is far higher than that obtained if the entire period depicted in the accompanying chart is considered.

The greater cyclical synchrony experienced by these economies in recent years has largely been related to the influence of global shocks, such as the new technologies crisis, the rise in oil prices and, more recently, the geopolitical tension following the 11 September terrorist attacks. The effect of these global disturbances was amplified by the channels permitting the international propagation of economic fluctuations. Thus, the greater geographical diversification of corporate interests and of households' and financial intermediaries' portfolios has prompted a greater correlation in economic agents' spending decisions. The progressive trade, financial and business integration of the United States and the euro area in the world market in recent decades has therefore increased the possibility that disturbances that arise may have a symmetrical impact on both areas.

Nonetheless, against the background of this greater economic integration, the euro area showed a lesser capacity for recovery in 2002 than the United States. This evidences the euro area's greater sensitivity to global shocks, testifying to which may be the poorer performance of stock market prices compared with that in the United States. In the euro area, moreover, the greater inertia of wages and of inflation (brought about largely by the presence of significant structural rigidities) means the absorption of shocks is slower. In fact, as the second panel shows, both the labour and goods markets are more strictly regulated in most euro area countries than in the United States. That hinders the rapid adaptation of the productive system to changes in demand conditions and results in a lesser adjustment of the economy's nominal variables in the presence of shocks. Hence whereas in the United States unit labour costs have, as a result of wage moderation and higher productivity, reacted more swiftly to the economic downturn, allowing margins to pick up and business profitability to improve, in the euro area they have shown notable downward stickiness (see the third panel), due fundamentally to the scant sensitivity of wages to general economic conditions.

The presence of structural rigidities also limits the responsiveness of demand-side policies. The reduction in interest rates in the euro area has thus been more modest than in the United States partly because the starting point for the former was a lower level at the onset of the downturn, but mainly because of the downward stickiness of inflation, despite the sluggishness of economic activity (see the bottom panel). Budgetary policy in the euro area has also seen its room for manoeuvre curtailed by its inability during the upturn to improve the public finances position. Conversely, the comfortable budgetary position attained in the United States in the closing years of the high-growth phase provided leeway to resort to a demand-boosting policy. However, the strongly expansionary stance in place recently may, in the medium term, have uncertain effects on the macroeconomic equilibria.



Sources: Banco de España, national statistics and OECD.

(a) The cyclical has been obtained applying an ARIMA model and the so-called band-pass filter.

(b) The higher the value for the indicator, the stricter the regulations.

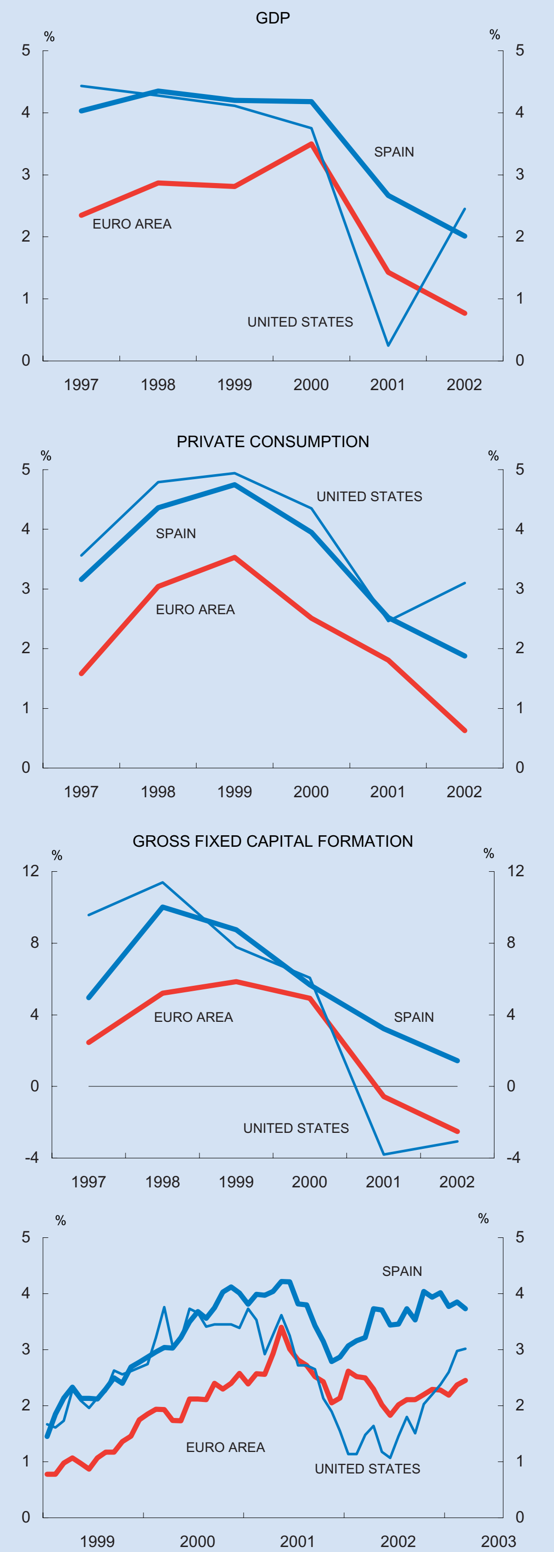
(c) Considers direct firing costs, administrative difficulties associated therewith and, in the case of temporary contracts, the maximum permitted duration in the use of successive contracts and the restriction on their use in certain groups of employees.

(d) Includes factors relating to direct State intervention in the economy, to the presence of barriers to business enterprise and to obstacles to trade and investment flows with other countries.

(e) Year-on-year percentage change.

CHART I.1

GDP, private consumption, gross fixed capital formation and inflation (a)
Year-on-year percentage changes



Sources: Eurostat and national statistics.
(a) Year-on-year percentage change in harmonised consumer prices in the euro area and in Spain, and in consumer prices in the United States.

The Japanese economy remained very weak, in a deflationary environment, despite the relative improvement in its exports. Behind this was the sluggishness of domestic demand, which traditional macroeconomic policies had proven incapable of checking. Conversely, the south-east Asian economies showed an appreciable acceleration in GDP, closely linked in most cases to expanding exports, although in the particular case of China, domestic demand was a significant contributory factor to the economic buoyancy displayed.

Elsewhere, the Latin American economies posted practically zero growth in 2002, due largely to the heavy contraction of GDP in Argentina. The other main countries in the region maintained positive growth rates of between 1% and 2%, although the political uncertainty in Brazil contributed to worsening financing and, in particular, public-sector conditions considerably. In any event, increased vigour began to be discernible across the area in the second half of the year, on the basis of the possibility of access to international markets and of the attendant cost of financing moving onto a more normal footing. That said, some of the economies in the region remain substantially vulnerable.

Among the main economies in the world, that of the euro area was the only one to record substantially lower growth in 2002 than a year earlier. The increase in GDP was 0.8%, far below that of the other industrialised economies, except Japan. This scant growth was moreover mostly based on the expansionary contribution of the foreign sector, despite the appreciation of the euro. Internal demand – and investment in particular – remained very weak, highlighting once again the pronounced sensitivity of the euro area economy to developments in its international environment.

Indeed, the euro area economy and its financial markets in particular have displayed considerable vulnerability to global disturbances. Stock market prices and the value of private fixed-income instruments were greatly affected by the general crisis in the ICT industry, which was made worse in Europe by the deterioration in the outlook for any return on major corporate projects undertaken in this sector. Further, the balance sheets of insurance corporations, a particularly weighty sector in the European economy, were impacted by specific circumstances (such as the terrorist attacks in 2001 and floods in 2002) and, above all, by the diminished value of the equities making up part of their net worth. This, combined with the faltering economic activity in the area, explains why the declines in the main European indices were notably higher in 2002 than in the United States, and why spreads on corporate bond yields should have held at relatively high levels. The higher cost of capital entailed by these developments (despite the low level of interest rates), the increase in non-financial corporations' debt ratios and the tightening of credit terms in some countries contributed to intensifying the decline in investment which, in the case of capital goods, was around 5%. The scant increase in disposable income, the prevalent uncertainty and the fall in financial wealth – which was offset, albeit to a lesser extent than in other areas, by the rise in real estate values in some countries – account for the slackness of consumption.

In addition to the impact of conjunctural factors, the recent course of the economy also reflects its structural shortcomings and, in particular, the insufficient incorporation of technical progress and the prevailing inefficiencies in the workings of its markets. Thus, the increase in labour productivity in 2002 held at a very low rate, even bearing in mind the potential cyclical component, and signs of a recovery were only recorded at the end of the year, in step with the stagnation of employment. Although labour costs moved on a moderate course, the relative insensitivity of real wages to general economic conditions exerted pressure on business margins and contributed to slowing job-creation. Finally, while consumer prices were subject to the upward effect of various supply-side disturbances and, in particular, to dearer oil prices, the downward stickiness of inflation, which held at over 2% despite the loss of momentum in private expenditure, suggests the presence of rigidity in price formation mechanisms which hamper their adjustment to changes in aggregate demand. This same rigidity, along with the insufficient competition characterising certain industries and the differing degree of dynamism in the various economies, largely explain the current dispersion seen in national inflation rates and, above all, the persistence of inflation differentials. This heterogeneous price pattern, insofar as it is in response to structural deficiencies, may have a bearing on the relative competitiveness of each economy and cause an inefficient reallocation of resources between the industries relatively exposed to and those sheltered from competition. Moreover, by entailing divergences in real interest rates, it contributes to generating persistent discrepancies in the financial conditions prevailing in the euro area Member States.

Given the significance of these shortcomings, the limited reforming drive witnessed in most European economies is unsatisfactory. This lack of resolve is, as acknowledged in the recent EU spring summit, manifest in the slow pace at which the conclusions of the respective Lisbon and Barcelona European Council meetings in 2000 and 2002 are being implemented. In this respect, and except for the steps taken to refine the regulations on European financial markets and intermediaries, aimed at the deeper integration of the markets for financial services, there was an evident loss of momentum in the process of reform last year. Increased innovation and improved conditions for incorporating new technologies into productive processes are, along with the achievement of more flexible markets, matters still to be addressed. Successfully doing this will depend, among other things, on the European economy improving its responsiveness in the future to shocks such as those recently experienced.

Although macroeconomic policies have contributed to tempering the scale of the slowdown, it became apparent last year how their capacity to support economic dynamism in the euro area during downturns is more limited than in other areas. The stabilising role of fiscal policy was thus undermined in several euro area countries by an absence – as a result of the lack of budgetary consolidation during high-growth phases – of sufficient leeway that would have allowed a more effective operation of the automatic stabilisers, without this jeopardising compliance with the rules laid down in the EU treaty and in the Stability and Growth Pact (see Box I.2). Moreover, the difficulties certain Member States have faced in keeping their public finances in line with the rules established has tested the effectiveness of the mechanisms for the control and multilateral surveillance of national fiscal policies in the EU. As indicated in the communiqué recently released by the European Commission and Ecofin, while it is important to fine-tune how compliance with the rules is assessed, that should not involve any weakening of the commitment made by each Member State to maintain a sound fiscal position, since this is a requirement for the proper functioning of Monetary Union.

The monetary policy decisions adopted by the European Central Bank enabled the impact of the slowdown to be lessened without disrupting price stability. Interest rates, which were already low at the start of the year, were further cut last December as a result of worsening economic conditions. More recently, given the deterioration in the outlook for economic activity – owing to geopolitical uncertainty and the continuing slackness of investment – and the relative tightening of financial conditions resulting from the trend of prices on securities markets and from the appreciation of the euro, the ECB further adjusted its monetary policy stance, lowering its main interest rate to 2.5%. However, the ECB's conduct throughout 2002 and early this year was influenced by the downward stickiness of inflation, despite the lesser momentum of economic activity which, as indicated, was due to various supply-side shocks and to the insufficient flexibility of price- and wage-setting mechanisms.

As part of its assessment of the Eurosystem's monetary policy strategy, the Governing Council of the ECB decided in May this year to confirm its definition of price stability (originally adopted in October 1998) as a year-on-year increase in the HICP for the euro area of below 2%, to be maintained over the medium term. At the same time, it made it clear that, in order to meet its primary objective, it will attempt to keep the inflation rate close to 2% in the medium term. This clarification indicates an undertaking by the ECB to ensure sufficient margin for manoeuvre is available to act as a cushion against deflationary risks, and it conforms to the possible existence of measurement biases in the HICP and to the need to take into account the implications of inflation differentials among the euro area countries.

The economic conditions prevailing in the first half of 2003 preclude any substantial acceleration in GDP in the main economies, despite the rapid outcome of the military conflict in Iraq and its favourable impact on international stock market and crude oil prices. In particular, high household debt levels in the United States and job destruction are an obstacle to private consumption taking off. Likewise, the state of the current capital adjustment is uncertain, as is too – by extension – the outlook for the recovery in investment, the financing of which is not helped by the growing current-account and fiscal imbalances. Further, the health crisis triggered by Severe Acute Respiratory Syndrome (SARS) may temporarily impair the growth of some of the world's more dynamic economies.

In the European economy, internal demand remains relatively lacklustre, despite the favourable monetary conditions. This is due above all to the foreseeable continuity of slack investment, linked in part to the corporate balance-sheet restructuring process in certain countries. Any increase in private consumption will be highly conditional upon the course of employment, which has trended unfavourably in recent quarters. Finally, the sharp appreciation of the euro recently is fuelling the decline in the contribution of the external sector to GDP growth. It is still to be expected, however, that the absence of significant macroeconomic and financial imbalances in the euro area as a whole will, in a relatively short time, provide for a recovery of growth to rates closer to the average for recent years.

Finally, mention should be made in this section of the enormous challenge to the European Union of its enlargement to 25 Member States as from next year. In the short run, this entails a need to adapt Community decision-making procedures to what was laid down in the Nice Treaty. As regards the European Central Bank, the recent Brussels summit has approved the reform of its Governing Council voting arrangements, as proposed by the ECB itself. This will allow it to continue functioning properly when new countries adopt the single currency (1). Institutional changes aside, however, the EU enlargement will, over the longer term, entail a significant qualitative change that will affect both the global weight of Europe in the international economic setting and the patterns of growth and productive specialisation of the various European Member States.

1.3. THE SPANISH ECONOMY'S RESILIENCE IN THE FACE OF AN ADVERSE ENVIRONMENT

In an international setting clouded by uncertainty, the Spanish economy achieved favourable results last year both in terms of real growth and job-creation capacity, and of maintaining its macroeconomic fundamentals, despite the rebound in the rate of in-

(1) For further details, see the *Official Journal of the European Union* of 1 April 2003, which includes Council Decision 2003/223/EC, on an amendment to Article 10.2 of the Statute of the European System of Central Banks and of the European Central Bank, and the article in the May 2003 edition of the ECB *Monthly Bulletin* entitled "The adjustment of voting modalities in the Governing Council".

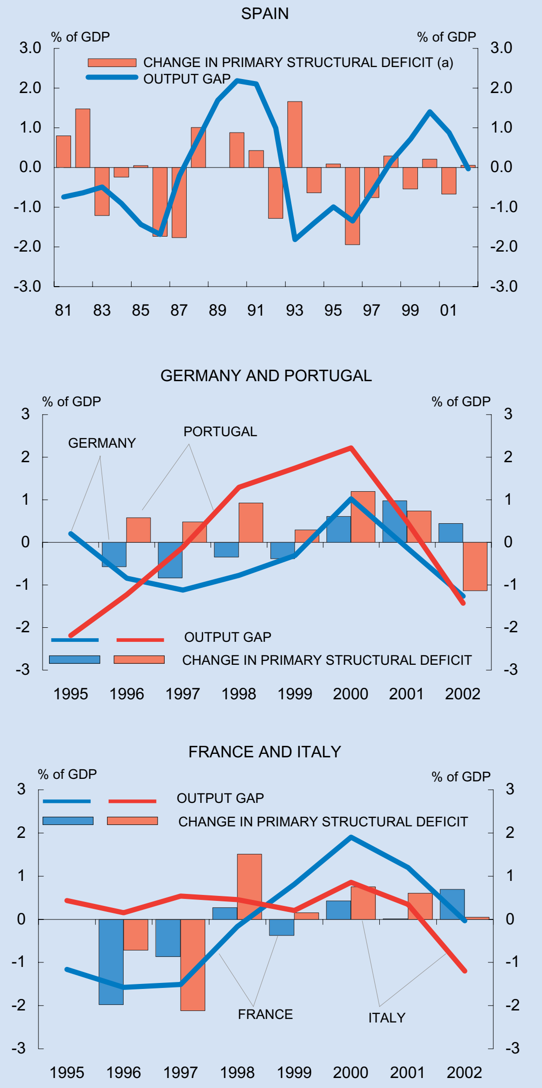
The importance of fiscal discipline for cyclical stabilisation

The experience acquired by OECD countries in recent decades shows that the persistence of fiscal imbalances reduces the possibility of fiscal policy acting as a stabilising force; indeed, it makes it necessary to apply tight fiscal policies during downturns so as to avoid excessive budget deficit slippage. The recent international economic slowdown has once again highlighted the importance of maintaining sound public finances so that fiscal policy's role as a macroeconomic stabilisation mechanism may be recovered.

The behaviour of fiscal policy in Spain in recent decades illustrates the benefits that can be reaped from budgetary stability policies (see the accompanying top panel). Comparison of the economy's cyclical position, measured by the output gap, and the fiscal policy stance, proxied by the change in the primary structural deficit, reveals that Spanish fiscal policy maintained a clearly pro-cyclical bias (1) in the 1980-1997 period. As a result, the economic expansion in the 1988-1991 period was accompanied by an expansionary fiscal policy that made it necessary to concentrate the fiscal adjustment during the phase of lower economic growth (1993-1997). The behaviour of fiscal policy in Spain during the latest upturn (1998-2001), in which a slightly restrictive stance was maintained on average, is therefore in contrast to what occurred in previous economic expansions. Accordingly, the virtually balanced budget position at the outset of 2002 has enabled the authorities to let the automatic stabilisers operate, thereby contributing to economic stabilisation without jeopardising budgetary stability.

The conclusions that may be inferred from the analysis of fiscal conduct in recent years in the four European Union countries (Germany, France, Italy and Portugal) currently with high budget deficits are along these lines. As can be seen in the middle and bottom panels, these fiscal imbalances have arisen, above all, from a certain abandonment of fiscal adjustment policies in these countries during the last upturn. The fiscal policy stance between 1998 and 2001 may even be characterised on the whole as pro-cyclical, hence the cyclically adjusted balance of over 2% of GDP in these four countries at end-2001. As was to be expected, the current economic slowdown has worsened the fiscal position of these countries, which has drastically restricted the headroom for it to perform its stabilising function. In the case of Portugal, the high budget deficits recorded have even made it necessary to apply restrictive fiscal policies at the height of the economic slowdown.

Fiscal stance and business cycle



Sources: Ministerios de Economía y de Hacienda, European Commission and Banco de España.

(a) Adusted for temporary effects in 1997, 2000 and 2001.

These events highlight the importance of compliance with the Stability and Growth Pact, which stipulates that a budgetary position close to equilibrium be maintained over the medium term. Observing this clause in the Pact would preclude the pursuit of pro-cyclical policies and allow for the symmetrical functioning of the automatic stabilisers throughout the cycle, in line with the recommendations of the recent Spring European Summit (2).

(1) Fiscal policy in a specific year is characterised as pro-cyclical when the respective changes, as a percentage of GDP, in the primary structural deficit and the output gap are of the same sign.

(2) See the conclusions of the Presidency of the European Council of 20-21 March 2003.

crease of prices and Spain's continuing positive inflation differential with the euro area countries. Real GDP posted a rate of 2% in 2002, 0.7 p.p. down on the previous year, but around half a percentage point above the average for the euro area. Spanish GDP per capita now stands at 84.5% of that of EU as a whole. Yet while this is an increase of about six points on 1994 (the last year in which there was slippage in convergence), it also gives some idea of the ground that remains to be covered.

Table I.1, which summarises the main macroeconomic variables for 2002, shows how real GDP growth was rooted exclusively in the increase in national demand (2.3%, only half a percentage point less than the previous year), as the net contribution of external demand was negative and subtracted 0.3 p.p. from the increase in output (0.2 p.p. more than in 2001). Once again, household expenditure on consumption and on housing was notably robust, although in both cases the related rate tended to moderate as the year progressed. Investment in capital equipment by companies remained depressed (the situation may have begun to ease in the closing months of the year), and only private productive investment in construction showed signs of buoyancy. The impact of general government spending on economic activity was also positive owing to the operation of the automatic stabilisers. Notwithstanding, the year closed with a negligible deficit, equivalent to scarcely 0.1 p.p. of nominal GDP. Foreign trade flows showed no signs of picking up until well into 2002, following their marked slackness in the first half of the year. As the rise in exports (lower, in any event, than that in imports) became progressively apparent, industrial activity improved; however, the unfavourable results of the tourism sector adversely affected certain services branches.

The moderate slowdown in real GDP fed through to employment, the year-on-year rate of change of which in terms of QNA equivalent jobs was 1.3% for the year as a whole (somewhat over one point down on the figure for 2001), as a result of which labour productivity picked up slightly. As to the behaviour of prices, the growth rate of the GDP deflator climbed to 4.4% during the year. Contributing to this was the trend of consumer prices, which ended 2002 at a rate of 4% and with a differential in December, therefore, of 1.7 p.p. (1.4 p.p. for the year on average) vis-à-vis the euro area.

The data available for the opening months of 2003 show that the trends apparent at the end of last year have generally been maintained. The growth rate of the economy has stabilised at around 2%, waiting for the pick-up in the world economy to firm. The most dynamic factors thus continue to be domestic in origin and they have been boosted by the interest rate cut last March and by the entry into force of the new personal income tax reform. The two most favourable features of this period have been continuity in the process of employment creation (which has even stepped up) and the slowdown in consumer prices. As a result, the 12-month growth rate of the HICP in April stood at 3%, reducing the differential with the euro area to one percentage point.

These results confirm the break, anticipated in last year's *Annual Report*, by the Spanish economy from what was its traditional pattern of cyclical behaviour, namely a build-up of substantial disequilibria in upturns which were then corrected by means of drastic adjustments in growth and increases in the unemployment rate (see Chart I.2). The reasons for this change lie mainly in the application of macroeconomic policies firmly geared to stability and of other microeconomic measures that have equipped the economy with greater flexibility. In addition, private agents have assumed patterns of behaviour more in keeping with these premises. In particular, the shoring up of sound public finances during the expansion years allowed for the operation of the automatic stabilisers, as the pace of activity progressively slowed, without jeopardising the balanced budget. Likewise, labour market reforms and the slowdown in wages have played a pivotal role, boosting job creation. Moreover, a more stable setting has encouraged agents to make use of their finance-raising capacity to soften the effect of the trend of their income on their spending decisions.

The greater resilience of the Spanish economy to adverse phenomena, which is the corollary of all the changes it has undergone, has also been manifest during the period under study in its capacity to absorb the impact of the crisis that struck certain Latin American economies, to which sizable direct investment flows had been routed in recent years. Although the main investors in Latin America had to withstand sizable costs, their financial position has remained sound. The overall effects on the pace of Spanish growth have also been relatively insignificant and, in any event, offset by the economic vigour on the home front.

TABLE I.1

Main indicators of the Spanish economy

	1998	1999	2000	2001	2002
REAL CONVERGENCE INDICATORS: (Spain/EU) (a):					
GDP per capita (b)	82.2	83.2	83.5	84.0	84.5
Apparent labour productivity	*94.6*	*94.2*	*93.5*	*93.4*	*93.5*
Employed as proportion of total population	*84.5*	*85.7*	*86.5*	*87.0*	*87.6*
Population aged 16-64 / total population	*103.0*	*103.1*	*103.2*	*103.3*	*102.4*
DEMAND AND OUTPUT AT CONSTANT PRICES (c):					
Private consumption	4.4	4.7	3.9	2.5	1.9
Government consumption	3.7	4.2	5.0	3.1	3.8
Gross capital formation	10.7	8.9	5.2	3.0	2.0
Fixed capital in equipment	*14.5*	*7.6*	*4.7*	*-1.2*	*-4.1*
Fixed capital in construction	*7.8*	*9.0*	*6.2*	*5.8*	*4.5*
Exports of goods and services	8.2	7.7	10.1	3.4	1.4
Imports of goods and services	13.2	12.7	10.6	3.5	2.2
Gross domestic product	4.3	4.2	4.2	2.7	2.0
EMPLOYMENT, WAGES, COSTS AND PRICES (c):					
Total employment	4.1	3.6	3.4	2.4	1.3
Compensation per employee	2.7	2.7	3.7	4.1	4.0
Unit labour costs	2.5	2.1	3.0	3.8	3.2
GDP deflator	2.4	2.7	3.5	4.2	4.4
Consumer price index (12-month % change)	1.4	2.9	4.0	2.7	4.0
Consumer price index (annual average)	1.8	2.3	3.4	3.6	3.5
Consumer price differential with the euro aera (HICP) (d)	0.6	1.1	1.2	1.0	1.4
SAVING, INVESTMENT AND FINANCIAL BALANCE (e):					
Resident sectors: saving (f)	23.5	23.6	23.2	23.6	24.5
General government (f)	*0.3*	*2.3*	*2.4*	*3.1*	*3.3*
Resident sectors: investment	23.3	24.6	25.7	25.8	26.1
General government	*3.3*	*3.5*	*3.1*	*3.3*	*3.4*
Resident sector: domestic net lending (+) or net borrowing (-)	0.2	-1.0	-2.4	-2.1	-1.6
General government	*-3.0*	*-1.2*	*-0.8*	*-0.1*	*-0.1*
General government gross debt	64.6	63.1	60.5	56.9	54.0
MONETARY AND FINANCIAL INDICATORS (g):					
ECB weekly intervention rate	—	2.7	4.0	4.3	3.2
Ten-year government bond yield	4.8	4.7	5.5	5.1	5.0
Synthetic bank lending rate	5.9	4.9	5.9	5.8	4.9
Madrid Stock Exchange General Index (DEC 1985 = 100)	817.7	894.4	994.8	853.4	723.6
Dollar/euro exchange rate (h)	1.1	1.1	0.9	0.9	0.9
Nominal effective exchange rate vis-à-vis developed countries (i)	100.4	98.8	95.8	96.3	97.1
Real effective exchange rate vis-à-vis developed countries (j)	99.6	99.1	97.6	99.1	101.3
Nominal effective exchange rate vis-à-vis the euro area (i)	100.1	100.0	100.0	100.0	100.0
Real effective exchange rate vis-à-vis the euro area (j)	99.2	100.4	102.1	103.0	103.9
Cash and cash equivalents	10.4	14.4	8.5	3.9	10.4
Liquid assets (k)	1.7	2.4	8.8	8.6	8.7
Households: total financing	16.5	19.1	17.5	14.1	14.1
Non-financial corporations: total financing	11.6	18.3	20.9	19.0	16.0

Sources: Instituto Nacional de Estadística, Intervención General del Estado and Banco de España.
(a) EU = 100.
(b) Calculated using series at constant 2002 prices and in EU PPPs.
(c) Rates of change.
(d) Differentials calculated using the Eurostat series with information to December 2001, before methodological changes were introduced.
(e) Levels as percentages of GDP. The saving and investment figures for 2002 are Banco de España estimates.
(f) Includes net capital transfers received.
(g) Annual average levels for interest rates and exchange rates and rates of change for financial assets and liabilities.
(h) Prior to 1999, dollar/ecu exchange rate.
(i) 1999 H1 = 100.
(j) 1999 H1 = 100. Measured with unit labour costs.
(k) Includes cash equivalents, other bank liabilities and money-market funds.

CHART I.2

Cyclical developments in the economy: comparison with the previous cycle

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

The growth of the Spanish economy has thus been based on increasingly favourable foundations, which have enabled the expansionary boost entailed by participation in EMU to be harnessed without jeopardising the economy's fundamentals. Further real convergence with the EU countries will hinge decisively on these foundations firming. That might require certain changes in agents' behaviour in respect of the consumption/investment mix of private expenditure and the resort to borrowed funds. It will also be necessary to push through reforms conducive to the greater competitiveness of the economy and that help correct the imbalances that have begun to be discernible in the form of relatively high price growth in certain industries. Although these latter price rises are due partly to the persistence of the generous monetary and financial conditions that have boosted household spending, they also reflect the presence of rigidities in the workings of certain markets.

In 2002 the continuing real convergence by the Spanish economy resided, as earlier discussed, on the relative firmness of household spending. In real terms, private consumption and residential investment grew at respective rates of 1.9% and 1.5% which, while down on the increases posted in previous years, jointly accounted for 1.2 p.p. of the increase in GDP last year. The deterioration in the sector's financial wealth, which fell by approximately 11% as a result – above all – of the contraction in equity prices, and the heightened uncertainty surrounding the economy adversely affected household spending decisions. Conversely, Spanish household disposable income (which once again outpaced GDP) and continuing generous financing conditions contributed positively to sustaining the expansion of these variables.

The increase in household disposable income was grounded, first, in the buoyancy of employment. Despite the slowdown in activity, employment continued to post a positive rate of increase, in marked contrast to previous downturns. Moreover, nominal wages quickened in 2002, although the rebound in prices prompted a slight reduction in wages in real terms. Along with the role played by employee compensation, mention should also be made of the positive contribution of general government to the increase in household income in 2002. This came about via the greater provision of welfare benefits and a lesser personal income tax take.

The financing received by Spanish households as a whole grew by 14% in nominal terms, practically unchanged on the previous year. This higher rate reflects the expansionary nature of the financing conditions facing households and highlights the importance of this factor in holding up their spending decisions. The expansion of loans was essentially fuelled by the attendant interest rates which, after the summer, resumed the declining path on which they had moved throughout the previous year, owing to expectations that the monetary policy stance would be relaxed. Such expectations were fulfilled in December, against the background of heightened bank competition. But the increase in credit was also sustained, on the demand side, by the behaviour of employment and the rise in house prices.

House prices increased by 13% in 2002 in real terms. In Spain, as in other countries, owner-occupied housing is a basic component of household wealth, whereby higher house prices have boosted household spending decisions. It should be borne in mind that this rise in prices increases households' possibility of access to financing and thus contributes to sustaining their consumer spending. However, on the data available, mortgage lending would not appear to have been earmarked for greater consumption, as has occurred in other countries, but primarily for residential investment. The effect of higher house prices on consumption has thus been channelled via a reduction in the propensity to save, partly countering the opposite-running impulses stemming from the high degree of uncertainty and the deterioration in financial wealth. The net outcome has thus been a very moderate increase in the household saving ratio in 2002.

With the increase in financing received, Spanish household debt ratios – while still below those for countries such as the United States, the United Kingdom or Germany – rose in 2002 to the average euro-area level. The sector's financial position remains sound and the course of interest rates has meant that the associated financial burden has grown by a lesser proportion than liabilities. That said, the current debt levels involve a greater sensitivity of spending decisions to wage income, to the interest rates that determine the cost of financing received and to the prices of both financial assets and, above all, of housing. To maintain a balanced financial position and the capacity to spend, the rate at which resources are raised has to move more closely in line with increases in household income.

From this standpoint, the behaviour of house prices becomes important. Recent trends can largely be explained in terms of the variables underlying the behaviour of the supply of and demand for housing, and of the habitual pattern of price adjustment in this market. Nonetheless, current price levels show a certain overvaluation, comparable to that witnessed in similar episodes previously. Accordingly, the rising trend of recent years should not be expected to continue for long; rather, a progressive move towards more moderate rates is more likely. An orderly process along these lines would be of decisive importance for the financial stability of households and their spending patterns.

Consequently, the ability of Spanish households to continue contributing to the growth of the Spanish economy in the coming years will depend essentially on the continuity of the employment growth process, hinging less on the factors that have been pushing up their debt. Although job creation held at what is still a significantly vigorous pace, it ultimately proved inadequate to absorb the rise in the labour force in 2002. This vigour was not unrelated to the moderate behaviour of real wages, the consequence of a more-negative-than-expected price performance in 2002. It should be borne in mind that deviations by the inflation rate from its forecast value may endanger the continuity of wage restraint.

In parallel, if the real convergence of the Spanish economy is to be soundly entrenched, it is vital, in addition to having employment growth as its main underpinning, that productive investment should emerge from its contractionary phase. That depends on companies' economic and financial position as well as on the potential return on and the risk associated with plans to expand capacity. Admittedly, the change in the economy's cyclical pattern has also impacted the behaviour of Spanish corporations, which have not been as adversely affected by the current slowdown in activity as in previous cycles. The number of bankruptcies and failures increased – as was to be expected – in 2002, but this affected only 0.21% of the sector's total liabilities (0.31% in terms of GDP). According to information from the Banco de España Central Balance Sheet Data Office, companies' average ordinary return on equity held at around 12%, although the figure was somewhat lower in manufacturing industry than in services or in the energy sector. However, for the second year running the year ended with a notable decline in business profits. This was due to the heavy provisions made for capital and other losses incurred in certain Latin American countries and in the telecommunications industry. In any event, levels of return are far above borrowing costs, meaning that conditions have remained propitious, from this standpoint, to the adoption of investment decisions. Foreign direct investment, the expansion of which in 1999 and 2000 may have affected domestic investment, posted a moderate growth rate; consequently, this factor would not appear to help account for the lacklustre investment by Spanish companies last year either.

Total financing received by non-financial corporations continued to grow at a relatively high rate (14%), which made for a moderate increase in their debt ratios. The generous conditions under which fresh funds were raised explain how the associated burden nevertheless held stable in 2002 compared with the levels observed in 2001. Thus, although greater volumes of debt mean a heightened sensitivity of spending decisions to the future cost of refinancing these loans, no signs of weakness in the sector's financial position were detected.

Given these conditions, the fall in private productive investment in capital goods in 2002 was largely due to the uncertainty clouding global economic activity. Doubts about the true scale of the cyclical slowdown have meant that many companies both in and outside Spain have put back their investment plans (even those with a clearly positive expected return) until risk returns to a more moderate level. Only construction-related activity and infrastructure works, which have their own dynamics that are more in keeping with domestic considerations, have continued to expand notably.

National economic policy instruments have a limited capacity to exert influence on these external factors shaping business expectations and investment decisions. However, they can play a much more influential role when it comes to promoting an efficient and competitive environment that ensures the competitiveness of Spanish products, both at home and abroad. As a result, as uncertainty progressively clears and the vigour of markets increases, Spanish companies may be in a position to resume the more dynamic investment path the economy requires.

Spanish exports in 2002 fared in keeping with the behaviour of foreign markets, without any significant changes in the related shares in the different areas, as has been habitual since Spain joined the euro area. In fact, there was a modest increase in the export share last year (similar to that in 2001) owing to the performance in certain non-Community markets. This was particularly the case in the OPEC members and the central and eastern European countries, where an overall real growth rate of around 5% was attained. The real increase in exports to the EU was, however, virtually zero. Generally, Spanish products continued to be competitive on foreign markets, although the effects of the appreciation of the euro were felt in the second half of the year, as some of the habitual indicators show.

As international markets regain momentum, it is important that Spanish companies should be in a position to increase the presence of their products appreciably on foreign markets and to defend their share in the internal market. In this connection, the efficiency and competitive fundamentals of the economy must be improved, as the exchange rate can no longer be used to correct mismatches. The economy has to face increasingly stiffer competition from the EU accession countries, whose productive structures and export patterns are, in many cases, not so different from those of the Spanish economy. From this perspective, the risk that the build-up of inflation differentials with the euro area countries may pose for continuing competitiveness is a serious one.

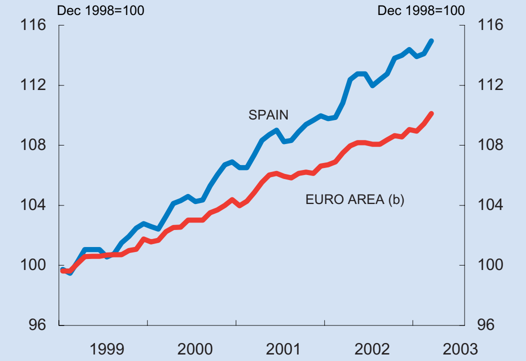
Since the outset of EMU, Spain has had a persistent inflation differential with the average for the area, more markedly so in relation to our main trading partners (France and Germany). This should be a cause for concern, since it is very difficult to believe that this tendency can continue indefinitely without eroding the competitive advantages on which the Spanish economy's position in the European Union rests (see Chart I.3). And the more so when the relative productivity of the tradable goods sector in Spain is below that of the euro-area average, while the behaviour of the margins of the non-tradeables industries most sheltered from competition continues to uphold the inflation differences. At issue, then, is a pattern which, if maintained, may pose a risk for competitiveness. Like those derived from the rapid growth of financing, this risk is related to the looseness of the monetary conditions the Spanish economy has experienced since joining the euro area. But it is also a response to the inadequate adaptation by certain markets to the new open and integrated environment.

The rebound in the consumer price index in 2002 partly reflected the increase in labour costs. But the rise was to some extent a temporary one, as shown by the data for the opening months of the current year. Pressures in the oil market, the effect of the introduction of the euro on some products' prices and the upward trend of certain food prices all had a bearing on the CPI in 2002. Last year, moreover, saw the application of a new methodology for compiling the index, with significant changes in the treatment of certain relevant events such as the sales season. In April this year, the 12-month growth rate of the CPI stood at 3%, approximately one percentage point down on the end-2002 rate. Contributing to this has been the performance of food and energy prices, along with the substantial cuts in the respective rates of increase of services and of non-energy manufactured goods prices, which were those most impacted at the start of last year by the transitory upward effect associated with the introduction of the euro.

This recent improvement in inflation has helped reduce the scale of the differential and has revealed a greater responsiveness in price formation to the conditioning factors of demand, potentially paving the way for a correction of the recent inflationary biases. In this connection, and so as not to jeopardise continuing job creation, moderation in the growth of unit labour costs would be necessary. In 2003 Q1 these costs increased at a rate of over 4%, due partly to the rise in wage costs and partly to the low growth of productivity. What is required, therefore, is a firm and sustained recovery in business investment so as to gain access to the technological innovation needed to underpin productivity growth in the economy. Wage moderation should also be further pursued, so that collective bargaining may be accommodative to the improvement in inflationary expectations. Only thus may the economy's competitiveness be maintained so as to ensure continuing real convergence.

CHART I.3

Cumulative inflation differential between Spain and the auro area (a)



Sources: Eurostat and Banco de España.
(a) In terms of the harmonised indices of consumer prices. Homogenous series.
(b) The euro area includes Greece only as from its entry.

I.4. HEADWAY IN REAL CONVERGENCE

At present, the main challenge the Spanish economy faces is to continue growing above the euro-area average and narrow the distance in terms of economic well-being with the core European countries. From the standpoint of macroeconomic fundamentals, Spain's starting position is a favourable one. In future, however, it will not be assisted by the expansionary demand impulses that have accompanied entry into the euro area, and it will be subject to the limits, as far as independent demand-side policy management is concerned, imposed by EMU membership. Accordingly, to continue generating employment, the processes required to entrench a stable economic environment, to promote competitive behaviour and to provide a soundly underpinned growth model must be undertaken.

The process of real convergence followed by the Spanish economy in recent years has been mainly based on the growth of the rate of employment, the productivity gap with the European countries having scarcely been corrected. Reflected in this process, therefore, have been some of the characteristics of the current cycle, in which the intensity of job creation has proven a key factor in the Spanish economy's resilience in the face of the decelerating impulses from the rest of the world. However, to ensure the long-term sustainability of economic growth, it is of paramount importance to boost productivity and, therefore, to increase the share of equipment investment in the composition of domestic demand and to promote the development of human capital (see Box I.3).

The prolonged weakness of investment may ultimately detract from the economy's growth capacity, through its impact on total factor productivity and labour productivity. Investment in capital goods usually acts as a conduit for technical progress and innovation, which is why there is normally scant innovation – and, by extension, limited advances in productive efficiency – during periods of low business capitalisation.

The sluggishness of total factor productivity in Spain in recent years appears to reflect the presence of some of these effects. In turn, the capital/labour ratio has maintained a moderate growth rate, against a background of brisk job creation. These risk factors should not however mask the fact that, during the current slowdown, this ratio has grown more in Spain than in the EU on average, owing to the comparatively greater significance of investment in infrastructure. Despite everything, therefore, the Spanish economy's capitalisation drive in the recent past has contributed to narrowing the differences in terms of economic well-being with the euro area countries.

Taking real convergence further will, in the new circumstances described, impose certain requirements on economic policy design. Such policies should remain geared to maintaining macroeconomic stability and withstanding the pressures that may arise in an environment in which, in all likelihood, the single monetary policy stance will in the near future remain relatively loose, as will then the monetary and financial conditions for the Spanish economy. Within the monetary union, the stabilising function at the national level is essentially in the hands of fiscal policy. And in implementing fiscal policy, proper use should be made of its capacity to influence demand-side conditions. This capacity is limited, but is of great importance when monetary policy sovereignty is no longer an option.

Drawing on the budgetary stability laws and the latest update of the Spanish stability programme, fiscal policy for the coming years is aimed at maintaining sound public finances, giving the automatic stabilisers sufficient room to operate without jeopardising the objectives of the Stability and Growth Pact. At the current cyclical juncture, the attainment of a balanced budget in 2002 and its maintenance in 2003 conform to the need for internal stabilisation. But the design of budgetary strategies should bear in mind the potential need to address future situations that might require expenditure-moderating measures.

It is also necessary to continue pushing through labour market reforms, so that the duality and fragmentation problems still evidenced by certain features of current hiring arrangements may be alleviated. The collective bargaining system should seek a greater and more efficient use of the labour factor and ensure employee remuneration arrangements in line with the specific conditions of each company, along with continuing wage moderation in general. The latter factor is pivotal for employment generation and for setting a low-inflation environment in place.

Likewise, further liberalisation and deregulation are necessary to improve the competitive behaviour of the economy and its companies. The structural reforms yet to be addressed are vital for ensuring a permanent low-inflation scenario. That should prevent the build-up of losses in competitiveness which, in the absence of powerful adjustment mechanisms (such as the role performed in the past by interest rate rises and currency devaluations), could lead to a path of low growth, limiting the possibilities of real convergence. Reform plans such as those on the agenda of the Lisbon and Barcelona European Council meetings that simultaneously foster technological dynamism, market flexibility, the adaptability of human capital and a level playing field will tend to promote a more efficient allocation and use of resources, both between industries and within companies. And the economy's growth potential will be greater as a result.

Last year's *Annual Report* focused on certain structural reforms pending in different areas of the economy, namely: the labour market, the network industries, land-use and the pensions system. It would be worth reiterating here that most of what was then said remains fully valid. There have, however, been significant advances in the labour market, where the qualifying criteria for unemployment benefit have been tightened, and the impact on firing costs of wages payable after dismissal has been lessened. In addition, amendments to the complex regulatory framework for land-use need to be considered with greater urgency, given the importance that distortions in this market can have on property

Spain, Portugal and Ireland: three different instances of real convergence following EU entry

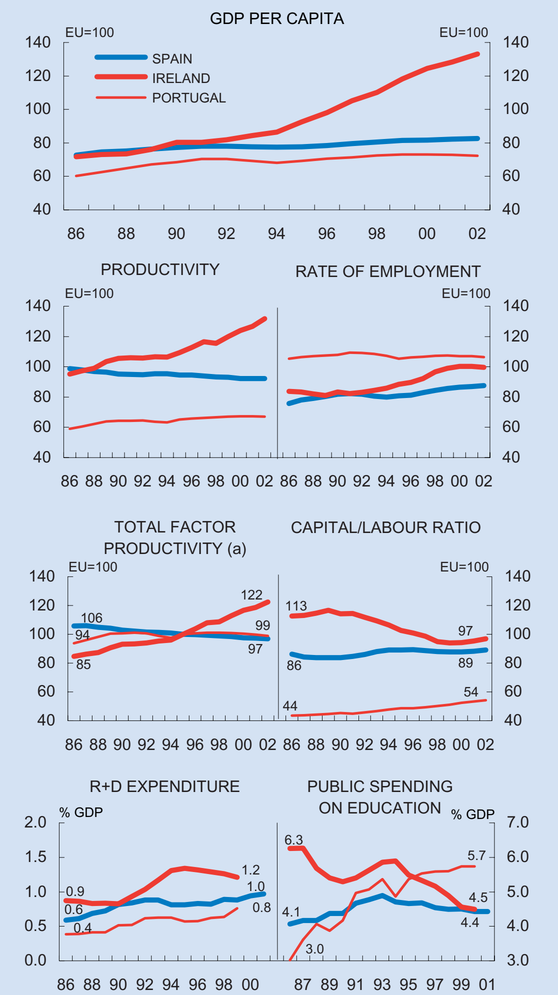
Since the second half of the eighties, Spain, Portugal and Ireland, three recipient countries of structural funds from the EU, have posted higher cumulative growth in terms of GDP per capita than the average for the EU. There are, however, appreciable differences regarding the intensity and composition of the real convergence that these economies have followed. They are due in part to the significant discrepancies in their economic structures (size, degree of external openness and weight of the services sector, among others) and to the different starting positions from which they embarked on economic integration into Europe, but also to the different determinants of economic growth in each country.

As can be seen in the top panel, in 1986 the three countries had a lower level of GDP per capita than that of the EU average. By 2002, Spain and Portugal had appreciably narrowed the gap in terms of economic well-being that they evidenced prior to EU entry (attaining levels of income of 84.5% and 69.2%, respectively, relative to the EU) and Ireland far exceeded the average level of GDP per capita in Europe.

The breakdown of GDP per capita into its explanatory factors (see the second panel) shows that there are indeed appreciable differences in these economies' growth determinants. In Spain, the narrowing of the differences in terms of economic well-being has come about essentially owing to greater intensity in job creation, especially in the latter years of the period analysed, while apparent labour productivity growth has been more moderate than the average for the EU. In Portugal, which departed in 1986 from a very favourable position in terms of its rate of employment, real convergence has been based on sustained increases in apparent labour productivity, which has increased at a sharper rate than in the EU as a whole. Finally, in Ireland, economic growth has been driven both by sizable productivity gains and by intense job creation, and – particularly in the nineties – by the strong increase in the working-age population.

The breakdown of apparent labour productivity, into the degree to which primary productive resources are used (capital and labour) and total factor productivity (a variable which proxies gains in productive efficiency – see the third panel), indicates that the contribution of the capital/labour ratio to differential productivity growth in Spain and Ireland has been influenced by the strong growth of employment in both economies. As a result, despite the investment drive during this period, its contribution to differential growth vis-à-vis the EU has been limited. Conversely, in Portugal, which started from a considerably lower level of capitalisation, the gap in the capital/labour ratio with the EU has been more forcefully narrowed. From the standpoint of the consequences for the growth potential of the three economies, the different growth rates of total factor productivity may be more important. With all the due caution that such an assessment requires, higher increases than in the EU on average are seen in Portugal and Ireland, which are in contrast to a more hesitant growth rate in Spain, which is lower than that of the EU as a whole.

GDP per capita, components and determinants



Sources: Banco de España, drawing on European Commission and Eurostat databases.

(a) The ratio depicted in respect of the EU should be interpreted as the cumulative growth differential in relation to this area, taking 1995 as the base.

Among the determinants that may have had a bearing on the uneven behaviour of factor productivity in these three countries, mention may first be made of the differing intensity of innovation, which can be tentatively proxied by R+D spending (see bottom panel) or by the different weight in output and in imports of manufactures that incorporate the latest technological advances. Also important to this end is the different rate of accumulation of human capital, which can be proxied, albeit also very tentatively, by per-capita public spending on education. As can be seen in the bottom panel, Ireland has outperformed the other two countries in each of these indicators.

In sum, the growth patterns displayed by Spain, Portugal and Ireland over recent decades show the correction (to a differing degree of intensity in each country) of their main shortcomings: in the cases of Spain and Ireland, the inadequate use of the supply of labour available, especially among women and the young, and an insufficient endowment of capital in the broad sense of the term; and in Portugal, a bigger lag in the endowment of productive (physical, technological and infrastructure) capital.

price formation and on labour mobility, not forgetting the need to bolster the rental market. All these reforms are particularly important in the light of the challenges posed by advancing globalisation and, above all, the EU enlargement.

Economic policy requirements aside, it should be stressed that, to ensure a high growth rate in the medium term, certain features characterising the Spanish economy's growth model in recent years should be modified. Also, some of the limitations on its productive specialisation and trading patterns need to be lifted. In this respect, the growth of the Spanish economy, which has been reliant in recent years on private consumption and residential investment, should move towards a productive investment- and export-led pattern. As seen, such a change is necessary to overcome some of the weaknesses discerned in recent developments that could curtail the intensity of economic recovery.

The robust rise in investment in construction in recent years has contributed to increasing the weight of this industry in GDP to above European levels. As construction is highly sensitive to interest rates, especially in its residential component, it has benefited exceptionally from the loose monetary conditions currently prevailing. The industry has managed to remain highly dynamic, and the operating margins of construction companies have increased. In this way, the construction sector has absorbed resources which, under other circumstances, might have been channelled towards financing investment projects with a greater impact on growth potential. However, the expansionary course of construction in recent years is partly linked to the process of real convergence, the requirements of which include the development of the infrastructure needed to improve economic efficiency, and the extension and modernisation of residential capital.

In respect of manufacturing industry, there are two angles to developments in recent years. On the positive side are features linked mainly to the process of European integration and external openness, while the reverse side suggests risks regarding the industry's ability to compete in an increasingly globalised economy in which the EU enlargement from 2004 will heighten competition. The positive features include, first, the significant gains in the share in output and in manufactures exports since EU membership; and further, the approximation of productive and trade structures to the European model, in which manufactures with a higher technological content have been gaining weight to the detriment of the more traditional labour-intensive industries with low technological requirements.

In Spain, this change in productive specialisation has had most significant consequences, as it has entailed the transformation of the model on which its industrial development had been based prior to EU entry. In this respect, the shifts in manufacturing output reveal a diversion of resources from industries undergoing intense restructuring (such as basic metals or shipbuilding), or from the activities most affected by growing competition from the newly industrialised countries (mainly textiles and footwear), towards industries with greater growth potential occupying a key position in terms of the patterns of demand in the developed economies (the production of motor vehicles and of machinery and mechanical equipment). Generally, direct investment from abroad has favoured this change in productive specialisation.

Significantly, however, the switch towards manufactures with a higher technological content has not extended to high-tech activities (the production of computers and electronic equipment, among others), which are those where the biggest productivity gains in this period have been seen. Moreover, this characteristic of the Spanish productive system has not been offset by more buoyant imports of this type of good, and nor has a significant inflow of foreign direct investment towards these activities been detected.

The tertiary sector, for its part, has become increasingly important in recent decades, in step with the increasingly service-based orientation of the more developed economies. Nonetheless, the increase in the share of the services industry in GDP and in employment in the economy as a whole has been mainly based on the expansion of non-market services (i.e. those supplying the public sector); the growth of market services has been lower and, in any event, below that of the European economies. A particularly relevant case in point is that of services relating to the new information and communications technologies (such as IT services or business services), which are essential for increasing productivity and have taken up a leading and dynamic role in the world economy.

Particular attention in the services sector should be paid to tourism, since this is one of the Spanish

BOX I.4

Future enlargement of the EU: some implications for the Spanish economy

The enlargement towards Eastern Europe is one of the major challenges facing the EU in the next few years. The size of the new EU partners and their heterogeneity compared with the current members confers special characteristics on this new enlargement, the implications of which will make themselves felt in numerous areas of the EU's political, institutional and social workings.

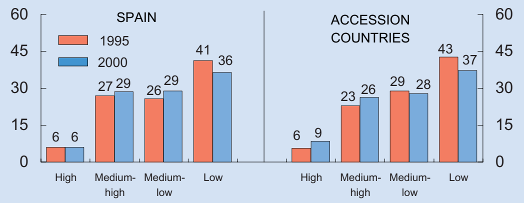
Before commencing the membership process, the accession countries (Cyprus, Slovakia, Slovenia, Estonia, Hungary, Latvia, Lithuania, Malta, Poland and the Czech Republic) generally had production structures strongly focused on industries making intensive use of natural resources and unskilled labour, although some of them had structures in which metallurgy and the production of capital goods and transport equipment were strongly represented. In recent years these economies have made notable efforts to adapt themselves to and integrate themselves commercially and financially with the EU countries, while at the same time overhauling their organisational and business structures.

The first panel shows the structure of bilateral trade between Spain and the ten accession countries and the trade performance – based on indices of revealed comparative advantage – for 1995 and 2002. As can be seen, Spain's trade pattern with these countries differs from that with other less developed economies to which Spain exports basically technology-intensive products and from which it imports labour-intensive goods. The main difference is in imports, where Spain's purchases from the new members consist predominantly of medium-high technology manufactures, with a growing (although moderate) weight of high-technology manufactures. Meanwhile, the structure of Spain's exports to the Eastern European countries displays a high and growing concentration in the medium-high technology industries, with motor vehicles to the fore.

Analysis of the comparative advantage indices reveals Spain's favourable balance in its bilateral trade relations with these countries, which have over the years had to weather the dismantling of tariffs vis-à-vis their future EU partners. This performance is underpinned basically by the medium-high technology industries, particularly chemicals and motor vehicles, although the latter declined appreciably during the period analysed. By contrast, the trade balance in the higher-technology industries deteriorated appreciably.

STRUCTURE OF SPANISH FOREIGN TRADE WITH THE ACCESSION COUNTRIES IN TERMS OF TECHNOLOGICAL INTENSITY

STRUCTURE OF AND CHANGES IN MANUFACTURING OUTPUT



INDICATORS OF TECHNOLOGICAL EFFORT, HUMAN CAPITAL AND LABOUR COSTS (2000)

	Spain	EU-15	Accession Countries
R+D expenditure (b)	0.9	1.9	0.8
Public spending on education (b)	4.4	4.9	5.3
Stock of human capital (c)	38.3	63.5	78.8
Labour costs (d)	14.2	22.7	4.2

Sources: Eurostat, Departamento de Aduanas and Banco de España.

(a) Calculated as the deficit or surplus of each industry (X-M) in relation to total trade in that industry with accession countries (X+M).

(b) As a % of GDP.

(c) Proxied by the proportion of the population aged 25-64 who have at least secondary education.

(d) Labour costs in euro per hour.

The second panel shows that the pattern of productive specialisation of these countries has gradually shifted towards the higher-technology industries. Indeed from 1995 to 2000 – the latest year for which information is available – the most dynamic sectors were, in addition to motor vehicles, those producing ICT goods. Thus the Spanish production structure currently exhibits certain similarities with that of these countries, although in the latter the high-tech industries have greater weight.

These transformations are closely tied to the considerable inflow of foreign direct investment and to the strategy of multinationals, which have tended to concentrate in certain strongly export-oriented high- and medium-high technology industries, and in other low-technology industries such as food, beverages and tobacco, which produce mainly for the domestic market. This development, along with the favourable performance of other indicators relating to investment in technology and human capital formation and to the accession countries' advantages in terms of labour costs, is evidence that the pattern of productive specialisation being pursued by these countries entails certain elements of risk for Spain's position as a supplier to EU countries and for its ability to sustain competitive positions in third-country markets. Furthermore, the Spanish economy's commercial and financial presence in the Eastern European countries, despite having increased in recent years, remains at very moderate levels, thereby limiting its potential for participating in the expansion of these countries.

economy's main sources of activity and of employment generation. The diminished buoyancy of recent years reflects the slowdown in the world and European economy; and this deceleration may have been amplified following the heightening of uncertainty in the wake of the events of 11 September 2001. Yet the impact of other, structural factors cannot be ruled out. The limited diversification of the supply of tourist services or insufficient advances in the quality thereof may ultimately affect Spain's standing as a leading tourist destination. The biggest risk, however, stems from cost and price rises, which may prompt losses in competitiveness, especially in competition with countries that have retained the flexible management of their exchange rate.

In sum, the changes in the Spanish productive and trading structure confirm its proven capacity to adapt to a more competitive and increasingly globalised environment. But they also indicate a certain lag in incorporating the latest innovative technologies, which has consequences not only for the dynamism of these productive branches but also for the rest of the economy. That may ultimately hold down the productivity gains needed for sound headway in convergence.

Following the success of the process of European integration and during the initial stages of participation in monetary union, the forthcoming EU enlargement will bring additional competitive pressures to bear and pose new challenges for the Spanish economy as a whole. These stem mainly from the great similarity to our productive and trading structures of those of the accession countries, which have undergone rapid transformation, spurred by the substantial direct investment flows they have received (see Box 1.4). Under these circumstances, heightened competition will be mainly to be found in those medium and medium-high technology industries in which the Spanish economy has specialised in recent years. It is significant in this respect that, while these industries are the most dynamic core of output and those where the highest proportion of foreign sales is concentrated, the associated foreign direct investment flows have slowed in recent years. Moreover, some of these countries are considerably increasing their capacity to compete in the international market for tourist services.

Consequently, maintaining a competitive productive structure will involve reducing the risk of delocalisation of medium- and medium/high-technology manufacturing activities. But an effort must also be made to prevent the weight of industries in which the Spanish economy has traditionally maintained a competitive edge from diminishing further, as a result of pressure from the newly industrialised countries. To address these challenges, the localisation and cost advantages offered by the accession countries must be countered through adopting differentiation strategies, improving the quality of goods and services and increasing productive efficiency via innovation, capitalisation, investment in human capital and the efficient working of factor and product markets.

In short, progress in macroeconomic and budgetary stability, the structural reforms undertaken and the headway in real convergence have left the Spanish economy well positioned to resume a more dynamic growth path, once the uncertainty clouding the recent past is dispelled. It may thus continue drawing closer to the standards of living and wellbeing of the more developed countries. To do this it will no longer be able to rely on some of the stimuli that stemmed from the effects generated by entry into the euro area; rather, it will depend on homegrown capacity for economic expansion. Prolonging the path of real convergence will require more of an investment- and export-led growth standard. And to attain that will involve implementing policies that ensure macroeconomic and budgetary stability and promote the liberalisation of the economy, the competitiveness of firms and more flexible markets. Such a gearing of policies is now particularly necessary, first, to avoid risks arising from inflation differentials and from excessive private-sector debt; and further, to promote, in turn, productivity gains and enhance competitiveness via a productive specialisation model tailored to tackle the challenges posed by economic globalisation and, in particular, EU enlargement.

CHAPTER II

THE EXTERNAL ENVIRONMENT OF THE EURO AREA

II.1. A WEAK AND WAVERING RECOVERY

Following the marked decline in the pace of economic activity in 2001 prompted by the crisis in the ICT industry, the slump in stock market prices, dearer oil and, in the second half of the year, the international political tension stemming from the 11 September attacks, the world economy picked up last year, with inflation holding at a low rate.

The brisker pace of activity in the external environment of the euro area was, however, generally moderate, hesitant and not as sharp as had initially been foreseen, despite the more expansionary stance of the macroeconomic policies adopted. The differences in economic developments across the various regions were also notable, as was the marked dependence of the rest of the world on the United States.

When explaining the weakness of the recovery, two factors should be borne in mind: first, the adverse impact of various shocks on agents' confidence; and further, the persistence of certain disequilibria which were not sufficiently corrected during the preceding downturn. These features have lasted and, in the case of geopolitical uncertainty, have in fact heightened during the opening months of the current year. As a result, entrenching the recovery will hinge closely both on the ebbing of international political tension, now the Iraq war is over, and on applying solutions for the substantive problems underlying the international economy.

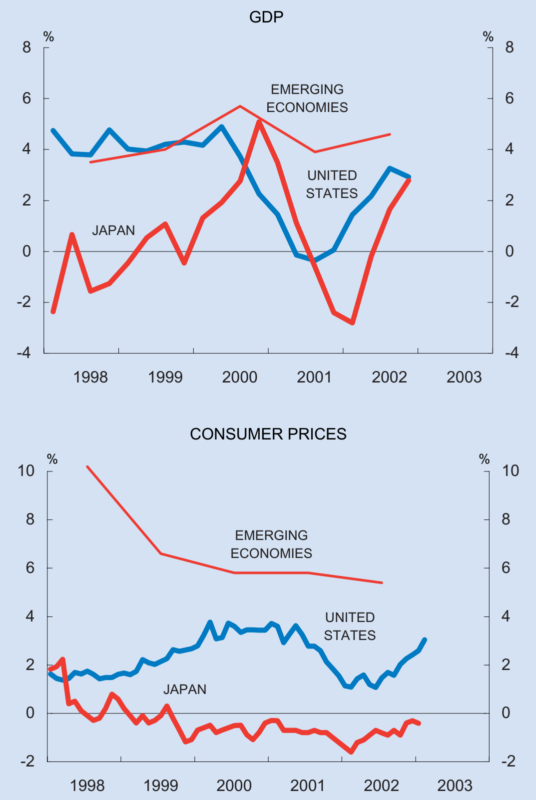
Undoubtedly, the tempered increase in activity and the fact GDP remains below potential in most regions largely account for inflation having held at a low rate, despite the oil price increases last year. In turn, this situation contributed to monetary policies remaining fairly accommodative, while fiscal policies adopted a more expansionary stance. That said, there were notable differences in the room for manoeuvre available to the respective national authorities and the use they made of it.

Against an international backdrop of globalisation, trade is an important conduit connecting the various countries' economies. In this respect, it is telling that, following the stagnation of world trade the previous year, it should have grown only moderately in 2002 – at a rate of 2.9% – and slowed during the second half of the year. The expansion of trade has thus been considerably less than that seen on average during the nineties (6.3%), and less too than might have been expected given the growth of the world economy last year. Significantly, despite progress in certain bilateral negotiations to boost trade liberalisation, the multilateral negotiations under the Doha Round have come to something of a halt.

A key characteristic of the pick-up in 2002 is the high dependence of world growth on the US economy. Although the slowdown the previous year placed the three main developed areas in a synchronised position at the bottom of the cycle, recovery was more clear-cut in the United States (where GDP growth climbed from 0.3% in 2001 to 2.4% in 2002). Meanwhile, in the euro area, growth was lower (0.8%, against 1.4% the previous year), and the Japanese economy remained beset by stagnation and deflation (see Chart II.1 and Table II.1). The main Anglo-Saxon countries (United Kingdom, Canada and Australia) also offered a relatively more buoyant performance in 2002, as did the central and eastern European and, above all, the south-east Asian countries.

CHART II.1

GDP and consumer prices
Annual percentage changes



Sources: National statistics and IMF.

Conversely, Latin America saw its output shrink for the first time in 20 years.

Even in the most buoyant countries or regions in 2002, the recovery was also weak and, in the second half of the year, growth turned downwards. There follows a brief review of the factors behind the sluggishness and wavering nature of the recovery (see Chart II.2).

Since the 11 September attacks in 2001, the world economy has moved in a climate of substantial uncertainty, which has progressively undermined consumer and business confidence. This effect was amplified by the rise in oil prices, which climbed from $20 to $31 per barrel last year and reached $34 in the opening weeks of 2003. Following the Iraq war, however, oil prices dipped to more moderate levels, albeit showing notable volatility. The oil price hike was not solely attributable to the situation in Iraq but also to domestic political problems in other producer countries, such as Venezuela.

The composition of demand in most industrialised countries, which is very biased to consumption to the detriment of investment, is one of the factors of concern regarding the fragile recovery under way. The slackness of investment is closely related to the excesses of the late nineties when, in a climate of euphoria over the booming new economy, particularly in the United States, companies built up a stock of capital which ultimately proved excessive. Despite the drastic adjustment of over-investment since 2001, there is uncertainty over whether this slack has been fully taken up, although the low capacity utilisation levels, especially in the United States, suggest that the adjustments are not complete, at least in certain industries. In these circumstances, the processes of corporate financial restructuring have perhaps further curbed investment decisions.

The decline on stock markets was also initially induced by the excesses of the second half of the nineties. Compounding this further was the impact of a more uncertain international climate and the scandals concerning major corporations' financial statements, especially in the United States. Under these circumstances, financial intermediaries and non-financial corporations had a greater preference for safer, more liquid assets, which explains the momentum behind public debt markets throughout the year.

Although some of the imbalances in the world economy have begun to be corrected (cases in point being the overvaluation of stock markets and the exchange rate of the dollar), others have worsened. The latter include most notably the increase in current-account imbalances between the main economies (see Chart II.3), the risks that the strongly expansionary fiscal policies recently pursued in certain countries entail for the medium- and long-term sustainability of public finances, and, finally, the high levels of household debt, associated in many cases with heavy increases in house prices.

An additional factor that may have contributed to holding back recovery in 2002 has been the persistence of problems in certain emerging economies, which are analysed in a subsequent section of this chapter. This characteristic has been a constant in the world economy since the Asian crisis broke in 1997, whereafter bouts of financial instability have successively occurred in emerging countries, albeit with different protagonists. These upheavals

TABLE II.1

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

	1998	1999	2000	2001	2002	2002 Q1	2002 Q2	2002 Q3	2002 Q4
UNITED STATES:									
GDP (a)	4.3	4.1	3.8	0.3	2.4	1.4	2.2	3.3	2.9
Private consumption (a)	4.8	4.9	4.4	2.5	3.1	3.0	3.1	3.8	2.7
Private investment (a)	11.4	7.8	6.1	-3.8	-3.1	-6.3	-3.7	-2.7	0.6
External demand (b)	-1.2	-1.0	-0.8	-0.2	-0.7	-0.8	-1.4	0.0	-1.6
General government financial balance (c)	-0.1	0.5	1.2	-0.7	-3.6				
CPI (a)	1.5	2.2	3.4	2.8	1.6	1.2	1.3	1.6	2.2
Current-account balance (c)	-2.3	-3.2	-4.2	-3.9	-4.8	-4.4	-4.9	-4.8	-5.2
Unemployment rate (d)	4.5	4.2	4.0	4.8	5.8	5.6	5.8	5.8	5.9
JAPAN:									
GDP (a)	-1.1	0.1	2.8	0.4	0.3	-2.8	-0.2	1.7	2.8
Consumption (a)	0.4	1.1	1.8	1.9	1.6	1.2	1.3	2.4	1.7
Gross fixed capital formation (a)	-3.9	-0.9	2.7	-0.9	-4.2	-8.2	-5.3	-3.6	1.2
External demand (b)	0.3	-0.1	0.5	-0.7	0.7	0.2	0.8	0.7	1.0
General government financial balance (c)	-5.5	-7.1	-7.4	-7.2	-7.7				
CPI (a)	0.6	-0.3	-0.7	-0.7	-0.9	-1.4	-0.9	-0.8	-0.5
Current-account balance (c)	3.0	2.6	2.5	2.1	2.8	2.9	2.8	2.5	2.4
Unemployment rate (d)	4.1	4.7	4.7	5.0	5.4	5.3	5.4	5.4	5.4
UNITED KINGDOM:									
GDP (a)	2.9	2.4	3.1	2.1	1.8	1.2	1.6	2.2	2.2
Consumption (a)	3.2	4.3	4.4	3.7	3.8	4.2	4.3	3.6	3.3
Gross fixed capital formation (a)	12.8	0.6	1.9	1.0	-3.2	-4.5	-4.1	-2.9	-1.1
External demand (b)	-2.2	-1.4	-1.1	-0.6	-0.9	-1.4	-0.3	-0.7	-1.4
General government financial balance (c)	0.2	1.4	4.0	0.8	-1.5				
CPI (a)	3.4	1.6	2.9	1.8	1.6	1.2	1.2	1.5	2.6
Current-account balance (c)	-0.6	-2.2	-2.0	-1.3	-0.8	-0.9	-1.2	-0.5	-1.4
Unemployment rate (d)	6.4	6.0	5.5	5.1	5.2	5.1	5.1	5.3	5.1

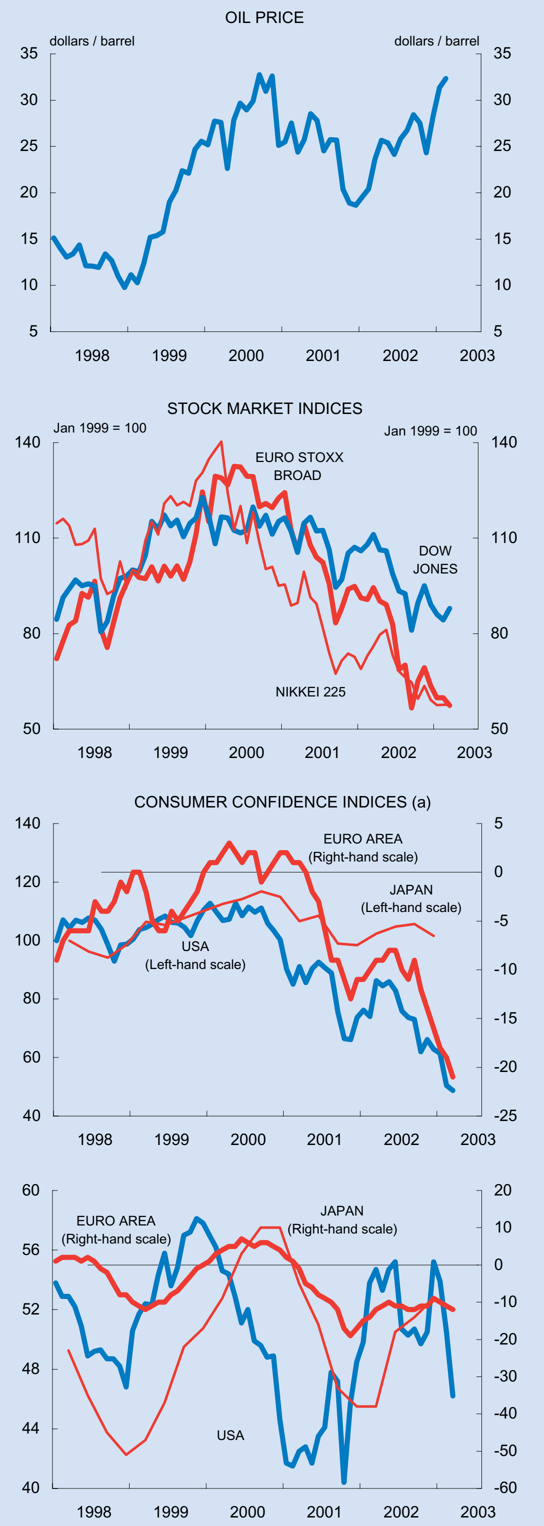
Sources: IMF and national statistics
(a) Annual rate. For the CPI, average annual percentage change.
(b) Contribution to the increase in GDP.
(c) Percentage of GDP.
(d) Percentage of labour force. Average for each period.

have prompted extensive reflection on how to improve crisis-resolution mechanisms (see Box II.1). There have since been notable improvements in the international financial system, however. These have led to greater transparency in respect of information from national authorities and to a better ability on the part of the financial markets to discriminate between countries. Overall, the outcome has been less contagion. This was particularly evident last year, if regard is had to the discrepancies between developments in most of the Asian and central and eastern European emerging countries – whose debt differentials narrowed and whose currencies generally appreciated – and most of the Latin American countries, joined by Turkey in the second half of the year, where developments were in the opposite direction.

Although the central scenario of the outlook for 2003 continues to point to a gradual pick-up in world activity, uncertainty over the situation in the Middle East is clouding the horizon. It is thus to be hoped that overcoming geopolitical tensions will contribute to creating a more propitious climate for entrenching the recovery during the current year. Nonetheless, for this to occur an orderly solution must also be found for the problems underlying the international economic situation.

CHART II.2

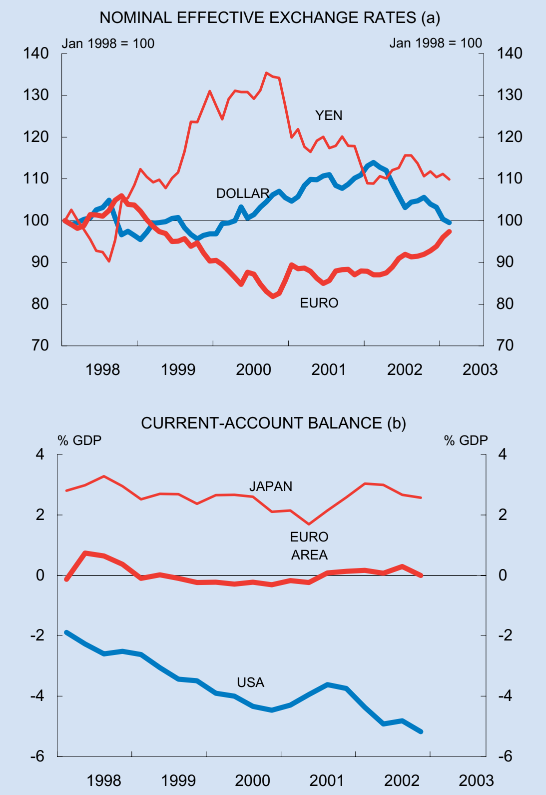
International economy: oil prices and stock market and confidence indices



Sources: Banco de España and Bloomberg.
(a) USA: Conference Board (Jan 98 = 100); Japan: Econ.and Social Res. Instit. (1998 Q1 = 100); Euro area: European Commission index.
(b) USA: ISM; Japan: Tankan; Euro area: European Commission index.

CHART II.3

Exchange rates and current-account deficit



Source: Banco de España.
(a) Against developed countries. An increase (decrease) denotes an appreciation (depreciation) of the currency.
(b) (+) Surplus, (–) deficit.

II.2. THE MAIN INDUSTRIALISED ECONOMIES

II.2.1. United States

The US economy posted moderate growth of 2.4% in 2002, following the previous year's recession, which resulted in an increase in GDP in real terms of only 0.3%. The fact that this improved rate was attained under very difficult conditions, in general, largely reflects the flexibility of its economic system. However, a more complete assessment should note that the recovery witnessed last year had an irregular profile and was more lukewarm than on previous occasions, a fact attributable in part to the particularities of the preceding recession (see Box II.2). Given below-potential GDP growth, inflationary pressures were generally contained, despite dearer oil, meaning that the inflation rate fell, in annual average terms, from 2.8% in 2001 to 1.6% in 2002.

BOX II.1

Recent discussions on sovereign debt restructuring

Countries facing financial crises can cover their external financial shortfall in three ways: internal adjustment, official financing and private-sector participation in resolving financial crises. Internal adjustment measures do not, in many cases, suffice to offset heavy capital outflows. Therefore, the rest of the existing gap has to be bridged with – more or less voluntary – participation by the private sector and with official financing, generally from the IMF.

Private-sector co-operation in resolving crises is fully justified. For one thing, limited official resources are not enough to cover the volume of financing needed to resolve the current crises. For another, even if this were possible, it would not be desirable, given the increase in so-called "moral hazard" entailed on the part both of the creditor and of the debtor.

The debate surrounding private-sector participation in resolving financial crises has focused on seeking to ensure that debt restructuring processes are, when inevitable, undertaken as soon as possible and in an orderly fashion. Countries facing acute financial crises are generally reluctant to embark on restructuring processes and delay this decision, which frequently makes the crisis worse, increases its costs and the scale of adjustment required, and leads to a greater delay in regaining access to capital markets.

One of the factors behind this belated reaction is uncertainty over the outcome of debt rescheduling, owing to the co-ordination problems between the debtor and its creditors and among the creditors themselves. The latter may, individually, try to recoup their debt as soon as possible or to block the restructuring process for their own benefit, instead of reaching a joint solution. In recent years, the increase in bond financing has hampered sovereign debt restructuring processes owing to the rise in the number of creditors and the variety of jurisdictions in which such bonds are issued.

The international financial community has attempted in recent years to establish a framework which: *a)* encourages the reaching of restructuring agreements and prompt dialogue between debtors and creditors; *b)* allows co-ordination and collective action problems to be resolved; *c)* properly safeguards creditors' rights and the value of their assets; *d)* promotes equitable treatment among the various creditors; and *e)* reduces the need for official financing, whether bilateral or multilateral.

The approaches for crisis-resolution currently under discussion may, though different, be considered as more complementary than alternative:

a) The inclusion of collective action clauses (CAC) in bond issuance contracts. Faced with the risk of a debt restructuring process grinding to a halt owing to a small minority of creditors, these clauses restrict their ability to block such agreements; their use might therefore provide for more orderly restructuring. The inclusion of CACs is voluntary, so their implementation should be incentive-based. They are effective in resolving collective action problems between the debtor and the holders of the instrument that contains them, but they are not applicable to the rest of the debt. To maximise their use, they should be employed for all types of debt, their wording should be standard and interpretation by the courts should be uniform.

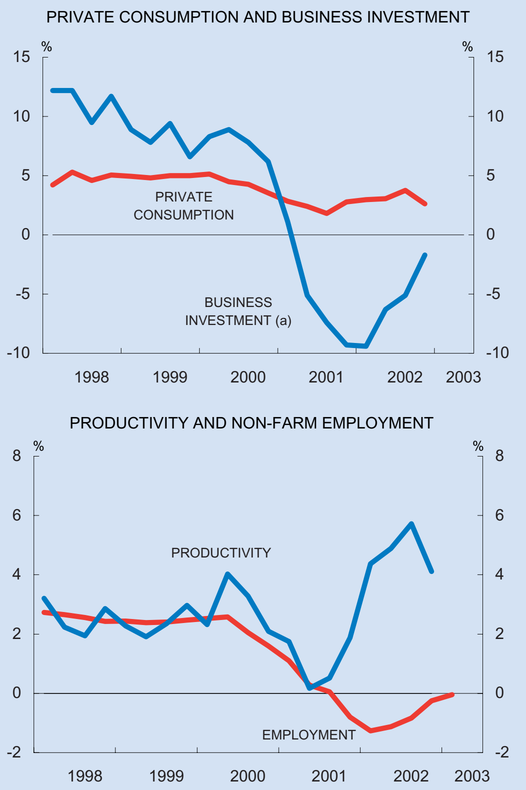
The most frequent CACs are: majority action clauses, in which the restructuring terms agreed by a majority of creditors is also binding upon the dissident minority; collective representation clauses, which facilitate majorities being obtained by allowing bondholders to delegate to representatives; and sharing clauses, which mean that creditors who have managed to collect on their claims through litigation must share on a proportional basis with other bondholders.

b) The sovereign debt restructuring mechanism (SDRM). This IMF proposal would be applied to crisis situations involving unsustainable debt, in which obtaining a viable debt profile in the medium term would inevitably entail the reduction of its current net value. It would be based on a centralised framework with an international legal underpinning. Moreover, it is planned to set up a forum for resolving disputes, with administrative (notifications, creditors' register, administration of voting, etc.) and quasi-legal (resolution of disputes between debtors and creditors, and among creditors) powers. The essential feature of the SDRM, and at the same time its principal advantage, is that it would enable the agreement adopted by the debtor and a majority of creditors to be binding on all the parties, thereby resolving the problems of discriminate application to different types of debt (the aggregation problem). The mechanism leaves the main decisions to the agreement between the debtor and the creditors. Further, to prevent litigation from hampering agreements being reached, the SDRM could include the temporary suspension of creditors' rights to initiate legal proceedings against the debtor country. Likewise, the provision of new financing by the private sector could be encouraged, with a preferred creditor status being conferred. Despite the intense discussions it has sparked, there would not so far appear to be sufficient support behind the SDRM as to advance its adoption in the near future.

c) There have also been proposals at recent IMF meetings to develop a code of good conduct for debt rescheduling. Based on a set of principles and good practices, such a code would clarify the role of all participants and allay uncertainty over the final outcome of the restructuring process. Some versions of this code include CACs and other elements for crisis-resolution, such as consensual suspension of payments or voluntary fora for the resolution of debtor/creditor disputes. The code would be voluntary and its implementation would be based on incentives and on the idea that market pressure would drive its adoption and application. The code could be used in any type of crisis, with sustainable or unsustainable debt, in which rescheduling were deemed advisable.

CHART II.4

United States. Real sector indicators
Annual percentage change



Source: National statistics and WEFA.
(a) Non-residential gross fixed capital formation

In terms of demand components (see Chart II.4), and apart from the technical rise in stocks in Q1, growth last year was essentially underpinned by the buoyancy of private consumption, which grew by 3.1%. Acting in favour of this were the impulses stemming from very expansionary fiscal and monetary policies, which provided, on one hand, for a significant increase in personal income and, on the other, for the reimbursement of a portion of real-estate capital, in a setting of lower mortgage interest rates and house price rises. These factors tended to counter the unfavourable impact on household spending of the deterioration in confidence, the stock market decline and the fall in employment.

Conversely, gross fixed capital formation contributed negatively to growth, in a year marked by the relatively unfavourable outlook for corporate earnings, misgivings about the mechanisms for the governance and control of major corporations and, generally, international political tensions. Finally, the external sector also contributed to reducing growth, as exports were hindered by the economic situation in the rest of the world, despite the depreciation of the dollar in effective terms.

The monetary policy stance remained very accommodative during 2002. The absence of inflationary risks allowed the Federal Reserve to hold its target interest rate at 1.75% as from the start of the year and, in November 2002, to cut it to 1.25% in the light of the evident signs of a slowdown in activity. The proximity of interest rates to zero, against a background of low inflation rates and downside growth risks, has prompted some concern about the limited margin for manoeuvre currently available to the monetary authorities to counter the adverse effects stemming from the possibility of such risks materialising.

The expansionary fiscal policy, which began with tax cuts in 2001 and continued with the stimulus package introduced in March last year, led to a rapid and considerable deterioration in public finances, where there was a turnaround from a surplus of 1.2% of GDP in 2000 to a deficit of 3.6% in 2002. In 2003, with the recently approved measures cutting taxes on dividends and capital gains and the bringing forward to this year of the tax cuts initially envisaged for subsequent years, as well as military spending in Iraq, the deficit is expected to far exceed that of 2002. In any event, the biggest problem with public finances is their sustainability over the long run. In this respect, the recent stimulus measures would reinforce the pressures stemming from greater spending on health care and pensions and might prompt an increase in future deficits and higher interest rates in the long term, as well as hampering the adjustment of the balance of payments. In turn, the legislative rules which, in the last decade, managed to cap spending increases based on the growth of nominal GDP, are no longer in force. And there is no perceptible possibility of their being re-enacted, which further hinders control of the budget deficit in the future.

One favourable aspect of the recovery was the ongoing increase in productivity. It grew by 4.8% in 2002, underpinned both by increases in the volume of output, the result in part of the technological improvements introduced in previous years, and by the flexibility of corporate staff adjustments (see Chart II.4). The rise in productivity had a clearly cyclical component last year. That said, this increase is in any event particularly notable if regard is had to the fact that the average for the last 20 years

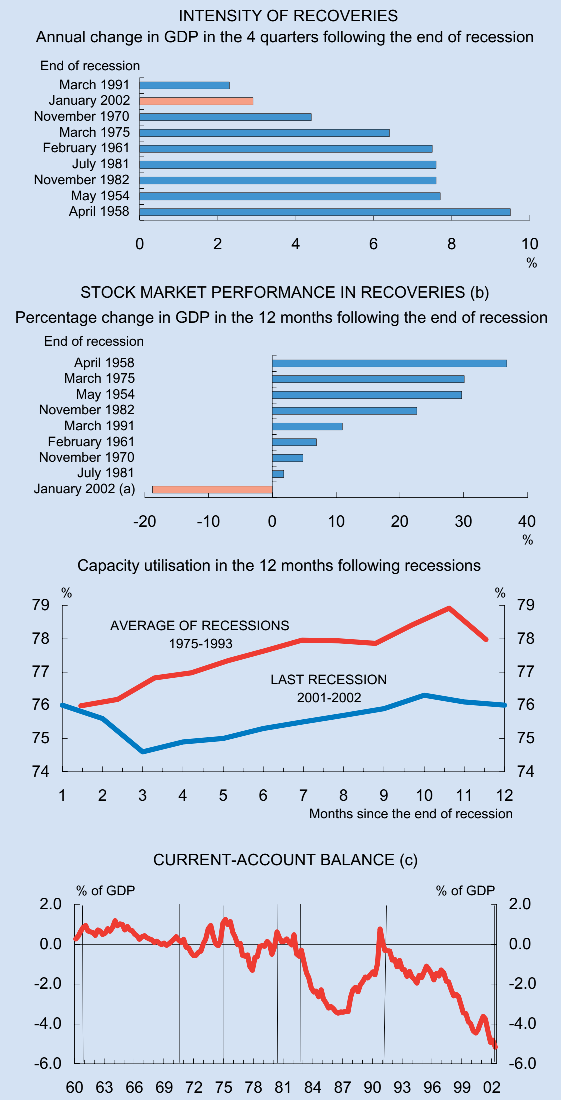
BOX II.2

Characteristics of the current recovery in the United States

The current recovery in the US economy evidences specific characteristics distinguishing it from previous recoveries and which are rooted in the particular way in which the recession in 2001 was managed and in the authorities' reaction at that time. The recession began after the longest upswing seen in the post-war period, which lasted 10 years from March 1991 to March 2001 (according to the National Bureau of Economic Research). This upturn was accompanied by a likewise unprecedented speculative bubble on the stock markets. The bursting of this bubble, collapsing business profits and the strong downward adjustment of the excess productive capacity that had built up were among the main causes triggering the 2001 recession. Adding to these characteristics is the geopolitical uncertainty that has been present throughout the recovery, which was reflected last year in the rise in oil prices and in the volatility on financial markets.

Unlike previous recoveries, characterised by a strong rebound in GDP in the year following the end of the recession, on this occasion GDP growth has been much more moderate, higher only than that ensuing after the 1991 recession (see top panel). Moreover, the stock market has held on a clearly falling trend, when what would have been normal for an upswing would be a market rise (see second panel). The loss of wealth entailed by the stock market decline has weighed on consumption. But this latter variable has held at a positive rate, supported by very expansionary monetary and fiscal policies and by the refinancing of mortgages under better conditions thanks to historically low interest rates and to the strong rise in real-estate values.

The evident excess of productive capacity has conditioned the reaction of business investment, which fell strongly in the recession and regained slightly positive rates of increase only after nine quarters. Reinforcing this sluggishness was the need for certain companies to undertake financial restructuring processes and the above-mentioned factors of uncertainty. The third panel shows the possible influence on this lack of recovery in investment of the very low capacity utilisation in this cyclical phase, compared with the average for similar cyclical phases in the 1975-1993 period. Further, there is sound evidence that the application of new technologies and the capacity for staffing adjustments have continued to have durable effects on productivity, which has shown high increases that are unusual when similar phases of previous cycles are analysed. Thus, the increase in average productivity in the first four quarters of the recovery was 4.8%, very similar to the average of 4.7% posted in the same period of the recoveries seen between 1954 and 1970 (during which years productivity grew forcefully), and higher than the figure of 3.2% recorded in the upturns from 1970 to 1991. Employment has still to resume a positive growth rate in this cycle, having recorded an average increase of 2.1% in the recoveries in the 1954-1991 period.



Sources: Banco de España and BEA.

(a) Approximate end of the recession, although a date has not yet been determined by the NBER.

(b) Dow Jones Industrial Average.

(c) The vertical bars mark when the recession bottomed out.

Unlike in other recession phases, the external deficit was scarcely corrected in 2001 and it has subsequently continued beating past records (see bottom panel). The factors behind this increase in the economy's imbalances were, during the slowdown, the strong increase in consumption and, more recently, the shift from a budget surplus to a budget deficit.

Finally, while in certain areas of the financial sector (such as insurance or semi-public mortgage bodies) an increase in fragility has been detected, in the latest recession market instability – especially the heavy stock market declines – has not translated into banking problems, as the various capital and risk ratios testify. The resilience of the banking sector is related to the development and extension of new credit securitisation and risk transfer markets, which has allowed risks to be spread and channelled towards the agents most prepared to assume them. However, debt as a proportion of household disposable income has risen to 110%, an all-time high which may condition the future growth of consumption.

has been around 2%, and that even during the strong upturn in the second half of the nineties, it did not in any year exceed 3% in annual average terms. The course of productivity in recent years thus gives grounds for cautious optimism about GDP growth potential.

On the negative side, the relatively greater momentum of domestic demand led, against a sluggish international background, to the deterioration of certain domestic disequilibria and of the US current-account deficit, which had scarcely been corrected in the recessionary phase, as was habitually the pattern in the past. Hence, although the private-sector saving ratio picked up slightly, the increase in mortgage lending placed household debt at historically high levels. Low interest rates have hitherto contained the financial burden of the debt, but this high indebtedness increases vulnerability to potential interest rate rises, to more unfavourable employment and wage-income trends, or to a correction of house prices. Moreover, the rapid deterioration of the budget deficit contributed to widening the current-account deficit, which stood at 4.8% of GDP. In previous years, this deficit was comfortably financed thanks to capital inflows attracted by high-yielding US assets. But last year signs of a change in the composition of capital inflows were detected, with an increase in short-term and government securities, to the detriment of direct investment and the acquisition of private bonds and equities. In the absence of a change in the rate of expansion of demand in the United States and in its trading partners, the ongoing increase in its net debit position vis-à-vis the rest of the world heightens the pressure on the correction of the current-account deficit taking place via an adjustment of the dollar exchange rate. And that, in turn, raises concerns as it would have a contractionary impact on economies in the rest of the world, at a time at which growth in many of them is low.

II.2.2. Japan

The Japanese economy remained beset by stagnation and deflation in 2002, and there was scarcely any progress in resolving the banking-sector crisis. GDP growth was, at only 0.3%, very similar to that for 2001 (0.4%), despite the positive contribution of external demand (see Table II.1 and Chart II.5). Domestic demand, departing from a negative rate of change, picked up until Q3, but tended to flatten thereafter. Private consumption grew moderately, moving on a slowing trend in the second half of the year owing to the delicate labour market situation and to the decline in wages, while there were strong annual declines in private and public investment. Conversely, exports of goods and services grew notably, which made for something of an improvement in industrial production and contributed to widening the surpluses on the trade and current-account balances.

Sharp deflationary pressures continued throughout the year and consumer prices posted a decline of 0.9%. Under these conditions, the Bank of Japan maintained its zero-interest-rate monetary policy accompanied by liquidity expansion targets, on which it had embarked in March 2001. On three occasions last year it upped liquidity injection and also gradually increased monthly purchases of long-term government debt on the secondary market. Although the monetary base grew 20% during the year, the money supply did so only at a rate of 2% and bank lending fell for the fifth year running. That evidenced the flawed functioning of the monetary policy transmission mechanism (see Chart II.5), against the background of the banking system's strong reluctance to extend credit to the private sector in the light of the delicate situation of lending portfolios and the serious difficulties beleaguering companies.

Given the persistence of the banking industry's serious problems, the Bank of Japan announced plans in September for a substantial purchase of shares held by banks directly from the institutions themselves. In principle, the purchase was to be at market prices over a period of two years. The Japanese executive renewed for a further two years the full guarantee of sight deposits for banks declared in crisis and, after extending the process of exceptional examinations of credit institutions over more than one year, it submitted last October a new banking restructuring plan aimed at reinforcing and accelerating the ongoing elimination of bad debts. However, the associated quantitative objectives are pending specification, and a clear timetable for the application of these arrangements to banks has not been proposed, raising fresh doubts about the pace at which the necessary reforms will finally be undertaken.

Lastly, the public finances position also continued to worsen last year. The budget deficit widened to

7.7% of GDP, despite the medium-term budgetary consolidation plans drawn up by the government. Moreover, the government has temporarily suspended the ceiling of 30 trillion yen on the annual volume of new public debt issues, owing to the deterioration of the Japanese economic situation and of the world context. Consequently, public debt will have risen to the worrying figure of 154% of GDP.

II.2.3. Other developed economies

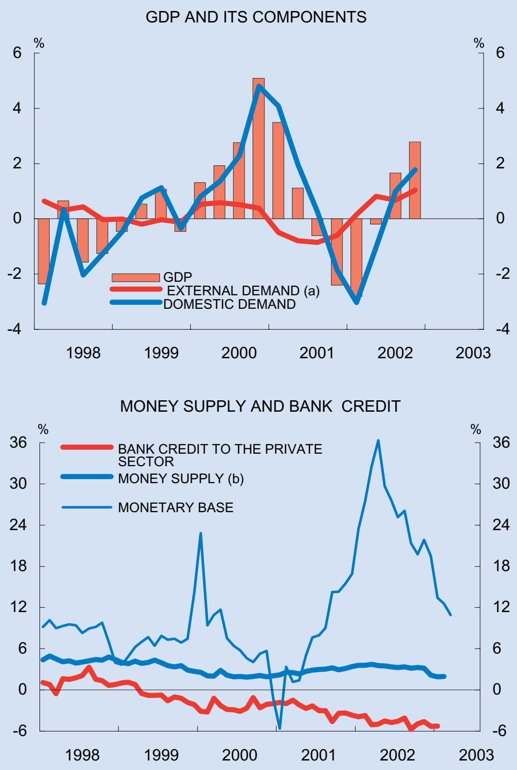
Economic growth in 2002 in other developed economies was relatively high, in particular in certain Anglo-Saxon countries such as the United Kingdom, Canada, Australia and New Zealand, but also in the Nordic countries. As in the United States, a series of factors in these countries combined to shore up the resilience of private consumption. Such factors included the effects of expansionary monetary policies and, in the cases of the United Kingdom and Australia, the strong rise in house prices. Moreover, the fairly healthy public finances position enabled these countries to pursue expansionary fiscal policies, with increases in public spending or tax cuts, which contributed to sustaining consumers' disposable income.

The particular case of the United Kingdom shows how the amplification of certain imbalances, such as high household debt and the strong rise in house prices, provided for sustaining private consumption and economic growth, although this also gave rise to economic policy problems. The Bank of England's monetary policy thus faced the dilemma of whether to cut interest rates, in the light of the sluggishness of external demand and of the industrial sector, or to retain a degree of monetary tightness so as not to continue fuelling the increase in credit and the growth of house prices. Against this background, the Bank of England held its official interest rate at 4% throughout 2002, until trimming it to 3.75% in February 2003 in the face of clear signs of weakness of economic growth.

In the other EU countries that are not members of the euro area, there was a moderate economic recovery on 2001 in Sweden and Denmark, thanks essentially to the support of private and government consumption, while inflation rates held stable at slightly over 2%. Budget surpluses were lower than in 2001, mainly because of tax cuts, but public finances continued to show a positive balance.

CHART II 5

Japan. Real sector indicators
Annual percentage change



Sources: National statistics and WEFA.
(a) Contribution to annual GDP growth.
(b) M2 and certificates of deposit.

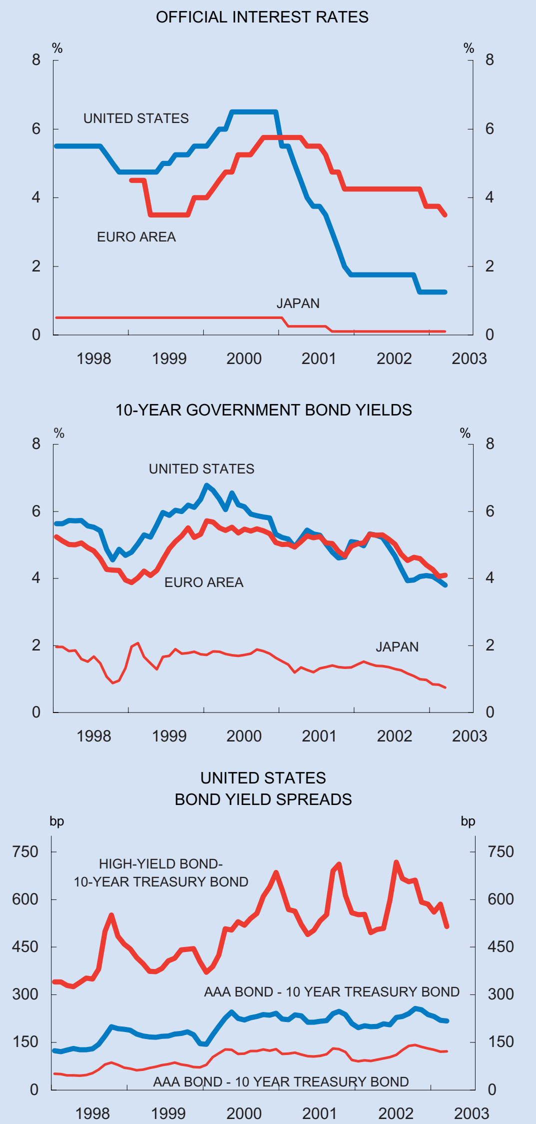
II.3. THE INDUSTRIALISED COUNTRIES' FINANCIAL MARKETS

Developments in financial markets in the main economies outside the euro area last year not only reflected the substantial uncertainty clouding the international economic situation but also affected this situation through the impact that changes in prices and volumes of financial assets had on agents' economic decisions. Agents were less willing than in the past to take on high risk.

Following the correction initiated the previous year, equity markets continued to experience heavy losses in 2002 (see Chart II.2). International stock markets moved substantially in synchrony, with the exception of Japan. The Japanese market reacted more to home-grown factors, particularly the measures adopted by the authorities to tackle the persistent problem of deflation and the banking industry crisis, and it closed the year showing a decline of 19%, below that of other developed mar-

CHART II. 6

International economy
Interest rates



Sources: Banco de España and Bloomberg.
(a) The data on private bonds are for bonds isued by industrial corporations rated AAA by Standard & Poor's and an aggregate of 10 year high-yield bonds rated B2.

kets. The decline on the US markets was around 23% over the year as a whole in the overall indices, and higher than 30% in the case of technology stocks. In relation to the peak reached in March 2001, the overall index lost around 40% of its value, with the technology index down by over two-thirds. After this correction, price/earnings ratios are at levels more in keeping with – though still higher than – their historical averages. Possibly, however, following the scandals involving certain corporations' financial statements, the recent corporate earnings figures are more realistic than in the past, which might justify a somewhat higher price/earnings ratio.

Volatility was high on stock markets in 2002. The international political uncertainty following the 11 September attacks, which continued with the military conflict in Afghanistan and with the heightening of tension in Iraq in the second half of last year, was compounded by economic and financial uncertainty. This stemmed from a lack of confidence in corporate governance and in the veracity of companies' accounting information, and from doubts over the course of the recovery, its strength and the outlook for earnings.

The crises affecting Enron Corporation (in late 2001), WorldCom, Conseco and Global Crossing, among others, all of which had very high volumes of assets as they went into bankruptcy, triggered far-reaching mistrust in respect of the information in companies' financial statements – companies which had withstood the previous overvaluation by the stock markets – and of the independence of auditors and investment banks. At the same time, the adequacy of accounting regulations and of the information supplied to the markets was called into question. The case of Enron in particular had adverse effects on the workings of certain financial markets owing to the dominant role of this company in the trading of certain financial derivatives and risk-transfer instruments.

Last year the sovereign bond markets saw a significant uptrend in prices and a downtrend in yields (see Chart II.6). In the United States, ten-year yields stood in May 2003 at around 3.6%, a low for the past forty years, against levels of over 5% at the start of 2002. This significant fall was associated to some extent with the decline in short-term interest rates, against the background of a stable and moderate inflation rate; with the expectations of a less robust recovery; and, above all, with the safe-haven role played by sovereign debt in the light of the poor performance of equity and the greater perception of risk by investors, who switched to safer, more liquid assets. The abnormally high correlation between long-term interest rate movements and equity prices would, among other indicators, sustain this explanation of the rise in government bond prices, despite the deterioration in public finances seen, as mentioned, in some of the main developed countries, principally in the United States.

Spreads between corporate and government bonds fluctuated notably during the year as a whole, although they remained at a high level. After peaking in October and November, spreads narrowed significantly in December and during the opening months of 2003. The performance of the poorest quality bonds was generally more volatile than that of high-rated bonds.

In 2002 certain segments of the global financial system showed signs of weakness. In some countries, defined-benefit pension funds were adversely affected by the fall in equities, in which a substantial portion of their assets were placed. Insurance and reinsurance companies, one of the sectors most directly hit by the negative impact of 11 September, were also harmed by the stock market decline, although this effect tended to be centred on certain European countries where some of the biggest companies are headquartered. A cause for concern in the United States is the high exposure to credit and interest-rate risk of two semi-public institutions (Fannie Mae and Freddie Mac) that provide liquidity to the mortgage market through purchasing from lenders the loans they have extended and issuing mortgage-backed securities. In these circumstances, the soundness of banking systems in most developed countries is sufficient. However, the situation in certain countries such as Japan is worrying. Overall, the global financial system, the strength of which contributed forcefully to the 2001 recession proving shorter and milder than usual, has retained a notable capacity to withstand the turbulence seen, although the aforementioned elements of fragility would advise continuing watchfulness and caution by the authorities.

Finally, on the currency markets, the year 2002 was marked by the significant depreciation of the dollar, which lost around 8% of its value in nominal effective terms (see Chart II.3). The depreciation, which was heavier against the euro (33% between December 2001 and May 2003) than against the yen (10% over the same period), is in keeping with the movement that is to be expected given the current-account balance positions of the three main regions. Nonetheless, the relative strength of the yen (which the Japanese authorities have sought to temper in certain periods through currency market interventions) is an added difficulty for the correction of deflationary pressures in Japan. Moreover, the high dependence of the international economy on a US recovery means that the downward movement of the dollar arouses some concern. This is because it entails a diversion of world demand towards the US economy, at a time at which the economies of the rest of the world would not appear to be able readily to replace the fall in exports towards the United States with greater domestic demand.

II.4. THE EMERGING ECONOMIES

In 2002, the emerging economies were, overall, somewhat more dynamic than the previous year, although the situation differed greatly from one region to another. While already-high growth rates quickened in the south-east Asian countries and dipped only slightly in the EU accession countries in relation to 2001, Latin America posted a negative growth rate on the whole (see Table II.2).

Given the connection existing between the amount and composition of international capital flows and the situation of the emerging economies, regard should be had to the course followed by such flows during 2002 (see Chart II.7).

As far as their overall amount is concerned, the containment of the fall in bank loans contributed to an increase in total private capital flows towards the emerging economies in relation to 2001, despite the fact that the other two components trended very differently: foreign direct investment shrank significantly and portfolio investment remained negative, albeit less so than the previous year. It is likewise worth noting the heavy reduction in official flows, from almost $40 billion in 2001 to $25 billion in 2002.

The regional breakdown of private capital flows showed a shift towards the Asian emerging countries and the transition economies, to the detriment of Latin America. In particular, private flows to Asia (mostly to China) practically quadrupled in relation to the previous year, while they almost doubled in the case of the central and eastern European economies. Conversely, they fell by half in the case of Latin America. It is telling that, both in Asia and in central and eastern Europe, the increase in flows should have had a similar profile, with greater growth in foreign direct investment than in portfolio investment (especially in Asia) and with a positive contribution by bank loans. In Latin America, by contrast, foreign direct investment – the component of the capital-account balance

TABLE II.2

Emerging markets: main macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002
GDP (a):							
Asia							
South Korea	6.8	5.0	-6.7	10.9	9.3	3.0	6.1
China	9.6	8.8	7.8	7.1	8.0	7.3	8.0
India	7.5	5.0	5.8	6.7	5.4	4.1	5.0
EU acceding countries							
Hungary	1.3	4.6	4.9	4.2	5.2	3.8	3.3
Poland	6.0	6.8	4.8	4.1	4.0	1.0	1.3
Czech Republic	4.3	-0.8	-1.0	0.5	3.3	3.3	1.9
Russia	-1.0	1.8	-4.9	5.4	9.0	5.0	4.3
Latin America							
Argentina	5.5	8.1	3.8	-3.4	-0.8	-4.4	-10.9
Brazil	2.7	3.3	0.1	0.8	4.4	1.4	1.5
Mexico	5.2	6.8	5.0	3.6	6.6	-0.3	0.9
INFLATION (b):							
Asia							
South Korea	4.9	4.4	7.5	0.8	2.3	4.1	2.7
China	8.3	2.8	-0.8	-1.4	0.4	0.7	-0.7
India	9.0	7.2	13.2	4.7	4.0	3.8	4.3
EU acceding countries							
Hungary	23.5	18.3	14.3	10.0	9.8	9.2	5.3
Poland	19.9	14.9	11.8	7.3	10.1	5.5	1.9
Czech Republic	8.8	8.5	10.6	2.1	3.9	4.7	1.8
Russia	47.9	14.7	27.8	85.7	20.8	20.7	16.0
Latin America							
Argentina	0.2	0.5	0.9	-1.2	-0.9	-1.1	25.9
Brazil	15.8	6.9	2.5	4.9	7.1	6.8	8.4
Mexico	34.4	20.6	15.9	16.6	9.5	6.4	5.0
GENERAL GOVERNMENT FINANCIAL BALANCE (c):							
Asia							
South Korea	1.0	-0.9	-3.8	-2.7	2.5	3.2	
China	-0.8	-0.8	-1.2	-2.1	-2.8	...	
India	-8.1	-8.7	-8.5	-9.6	-11.2	-10.8	
EU acceding countries							
Hungary	-3.1	-4.5	-6.3	-3.7	-3.4	-4.5	
Poland	-2.5	-1.3	-2.4	-2.0	-3.5	-3.9	
Czech Republic	0.9	-1.9	6.6	-1.6	-4.2	-7.0	
Russia	-7.9	-7.0	-5.0	-1.7	4.3	2.0	
Latin America							
Argentina	-2.5	-1.5	-1.4	-2.6	-2.4	-3.0	-1.5
Brazil	-5.9	-6.3	-7.9	-10.0	-4.6	-5.2	-10.3
Mexico	-0.3	-1.4	-1.2	-1.3	-1.1	-0.7	-1.2
CURRENT-ACCOUNT BALANCE (c):							
Asia							
South Korea	-4.4	-1.7	12.7	6.0	2.7	2.0	1.5
China	0.9	4.1	3.3	1.6	1.9	1.7	
India	-1.7	-1.2	-1.4	-1.0	-0.9	0.0	
EU acceding countries							
Hungary	-3.8	-2.1	-4.9	-4.4	-2.9	-2.1	-5.3
Poland	-2.3	-4.0	-4.4	-8.1	-6.3	-3.0	-3.3
Czech Republic	-7.1	-6.7	-2.4	-2.8	-5.3	-4.6	-4.2
Russia	2.9	0.8	0.8	12.4	17.4	11.3	
Latin America							
Argentina	-2.4	-4.1	-4.9	-4.2	-3.1	-1.8	2.9
Brazil	-3.0	-4.2	-4.2	-4.8	-4.1	-4.6	-1.7
Mexico	-0.8	-1.9	-3.8	-2.9	-3.1	-2.9	-2.7

Sources: IMF and national statistics.
(a) Annual percentage changes.
(b) Annual average percentage change in consumer prices.
(c) Percentage of GDP.

which had been most buoyant in previous years – fell by almost half. These differences across regions were also apparent in the differing trend of financial indicators (see Chart II.8).

II.4.1. Latin America

Economic crises, political tensions and the difficulties of gaining access to international financial markets all came to bear on Latin America in 2002. Admittedly, economic problems were fairly widespread and there were bouts of contagion, from Argentina to its smaller neighbours and from Brazil to a good number of the countries in the area. But to talk of a regional crisis in the true sense of the term may be unwarranted, since most of the problems that emerged during the year had a markedly national background. Nonetheless, the outcome of the Argentine crisis contributed, especially in the first half of the year, to making international investors nervous about the possible reversal of reforms in the region.

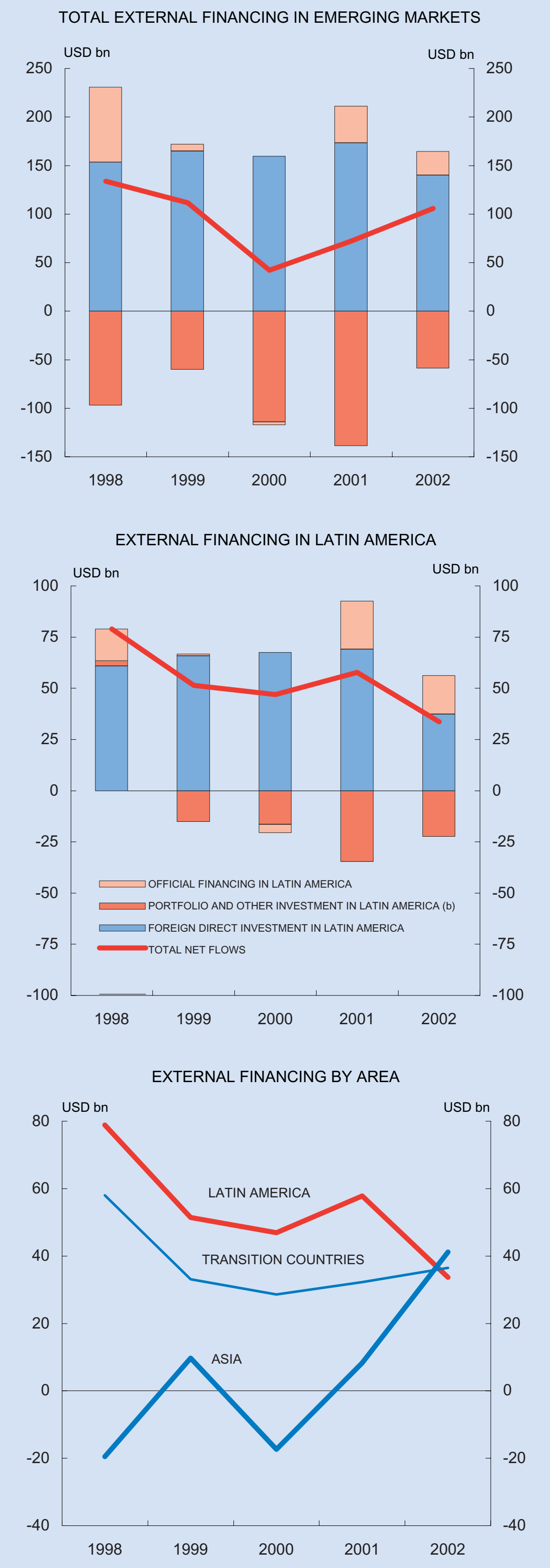
Drawing on data from the eight main economies, Latin America is estimated to have seen a decline in output of 0.8% of GDP in 2002, the worst figure posted since 1983 (see Table II.2). Even if the declines in activity in the countries beset by serious economic crisis were excluded (the case of Argentina, Uruguay and Venezuela, where GDP has fallen by between 10% and 20%), economic growth in the rest of the region would scarcely have amounted to 1.6% in 2002, compared with 0.8% the previous year. However, something of a rebound in activity has been observed in most of the countries in the closing months of 2002 and in 2003 to date.

The weak economic situation in the region, the difficulties in servicing debt or rescheduling it in certain countries and the fear that populist policies might be pursued in others prompted a fall-off of private capital flows. Against this background, the maintenance of official flows, largely routed through IMF support programmes, alleviated the effects of private flows drying up.

The crises in certain countries and the external financing difficulties faced by most Latin American economies led to forceful adjustments of current-account balances, which moved from an overall deficit of 3.1% in 2001 to a situation close to balance in 2002. The adjustment mechanism generally

CHART II.7

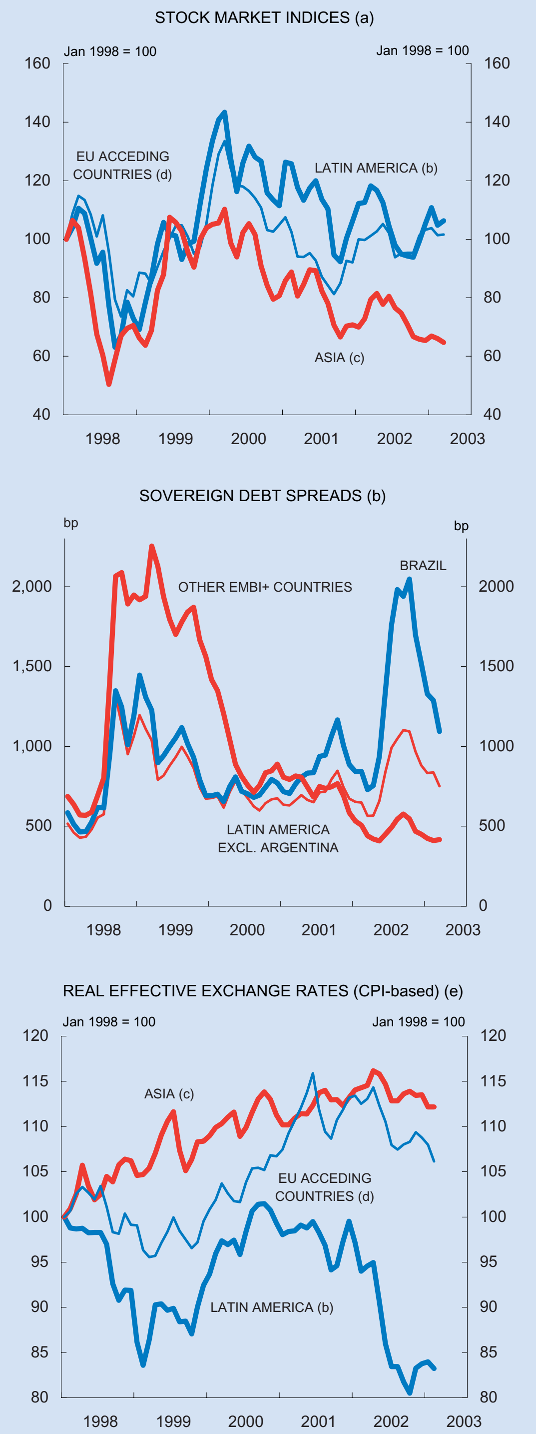
Emerging markets. External financing (a)



Source: International Monetary Fund.
(a) Total net capital flows in billions of US dollars.
(b) Includes bank loans.

CHART II 8

Emerging economies: financial indicators



Sources: Banco de España, JP Morgan and Bloomberg.
(a) January 1998 = 100. Weighted by GDP in PPP of the countries indicated.
(b) Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
(c) China, Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore and Taiwan.
(d) Latvia, Lithuania, Estonia, Czech Republic, Hungary, Poland, Slovenia and Slovakia.
(e) An increase in the index denotes a loss of competitiveness.

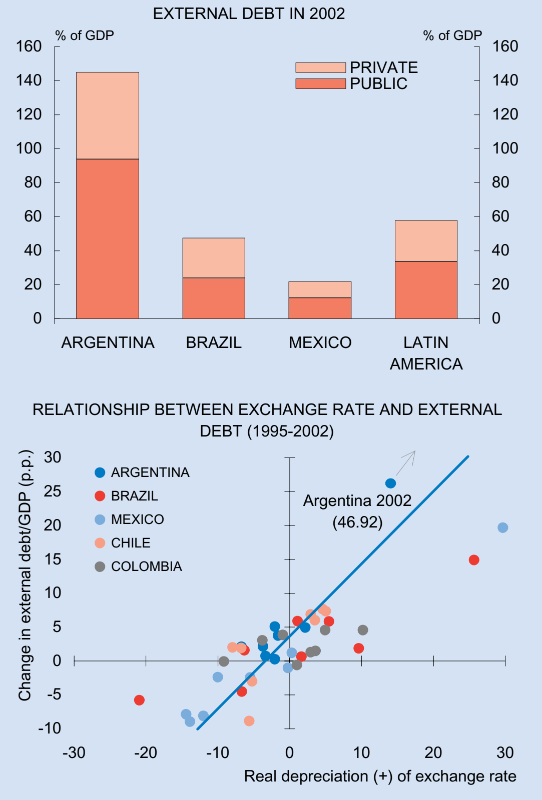
required a marked depreciation of exchange rates against the dollar. This was all the more notable in that it took place at a time the dollar was notably weak, which gave rise to significant gains in competitiveness. The trade balance adjustment was induced, first, by the contraction of imports, and more recently by the expansion of exports too. Indeed, the external sector was by far the most buoyant demand component, contributing three points to GDP growth in the area. As a result, the fall in domestic demand (the negative contribution of which to GDP growth was –3.7 points) did not lead to a bigger fall in output.

However, the beneficial effect of exchange rate depreciations on the trade balance was partly countered by the pressure on the net external position, which in most Latin American countries is heavily on the debit side and denominated in foreign currency. As Box II.3 explains, devaluations in these circumstances entail an increase in the present and future financial burden for the debtor country, which reinforces the scale of the depreciation required for a given adjustment of the current-account balance. The increase in foreign debt servicing arising from these devaluations has cast doubt on their sustainability in certain countries and has seriously curbed the headroom for pursuing counter-cyclical fiscal policies.

The heavy cumulative depreciations have also had unfavourable effects on price developments. Despite the fact the pass-through of the exchange rate to domestic prices has been relatively limited, against a backdrop of weak demand, inflation has risen as from the third quarter, virulently so in certain cases. That has prevented inflation targets being met in certain countries such as Mexico, Colombia and, above all, Brazil. Given financial turbulence and sluggish domestic demand, monetary policies did not react at first to the deteriorating inflation outlook. In fact, in countries such as Mexico and Colombia, monetary policy was eased. However, in the closing months of 2002 and early 2003, as the overshooting of targets became increasingly more patent, the monetary policy stance has tended to tighten in a growing number of countries.

Probably, the key event in 2002 was the outcome of the Argentine crisis, not only because of its scale but because the means of tackling it was particularly traumatic and involved a break with the reform-based model of the nineties. The defence of convert-

Exchange rate adjustments, dollarisation of liabilities and vulnerability in Latin America



Sources: National statistics and Banco de España.

A characteristic of Latin American countries is that they maintain generally high levels of foreign debt, a substantial portion of which corresponds to the public sector (see top panel). One of the fundaments of this debit position is the existence of a persistent negative gap between saving and investment, which translates into strong dependence on external financing, current-account deficits and a build-up in external liabilities. Nonetheless, Latin America's vulnerability derives not so much from this dependence on external flows as from its financial track record, in which suspensions of payments and other difficulties abound (1), and which largely determines the characteristics of its debt: persistently high risk premia, sudden stops in capital inflows and difficulties in borrowing long-term in local currency. This latter factor entails the dollarisation of financial liabilities, which is a characteristic of the region and which not only affects foreign liabilities but also many instruments issued on the local market, in dollars or dollar-indexed, by the banking system, companies or the public sector.

The dollarisation of liabilities hampers economic adjustment processes, especially in periods of financial turbulence such as that in 2002, which highlighted how these factors of vulnerability affect the area. Fewer capital inflows and dearer risk premia have triggered a vicious circle involving loss of confidence, fall-off of flows and increased premia, making a strong adjustment of the foreign accounts necessary. A mechanism central to this adjustment has habitually been the depreciation of the exchange rate, which has its theoretical justification in balance of payments-based exchange rate determination models. These models show the long-run relationship between the real course of the exchange rate and the external position: to avoid an unsustainable deterioration of the current account, the growing interest payments arising on the build-up of foreign liabilities will tend to be accompanied by a depreciation of the real exchange rate, prompting an improvement in the trade balance.

While the reduction in external flows has been the immediate trigger, the sharp currency depreciations last year in practically all Latin American countries, in both real and nominal terms, could arguably be in response to an adjustment of this type. True, the gains in competitiveness have allowed trade surpluses to be generated and the current-account deficit to be corrected substantially. But when dollarisation of liabilities takes place, the depreciation of the exchange rate has an adverse effect on the sustainability of the external financial position and also on that of the industries incurring debt in dollars or through dollar-indexed instruments, since their revenue and assets are denominated, in the main, in local currency.

Regarding the external position, the fall in domestic relative prices brought on by the depreciation of the exchange rate in real terms, which is steeper the more closed the economy is, substantially increases the amount of debt in terms of national income. As can be seen in the bottom panel, this is a particularly marked characteristic in the Latin American countries: real depreciations of the exchange rate are traditionally accompanied by increases in the debt/GDP ratio and this ratio is statistically significant. The increase in external debt also has consequences for exchange rate adjustment dynamics. Since this negative impact of depreciation on the external position also brings about a greater debt interest burden, the scale of the exchange rate depreciation needed to place the external position on a sustainable basis will have to be greater than in the absence of a significant dollarisation of liabilities. The extreme case might arise where the negative effect on the stock of debt might counter the positive flow effect on the trade balance, in such a way that the external imbalances might not be corrected.

(1) See Eichengreen & Hausman (1999), Exchange rates and financial fragility, NBER Working Paper, No. 7418.

ibility in 2001 and the abandonment of this regime in 2002 were accompanied by the adoption of numerous unorthodox methods, breaches of contracts and legal, social and institutional unrest which gave rise to fears of political contagion to other countries in the region which, fortunately, have not materialised.

The withdrawal restrictions on deposits at end-2001, known as the "corralito", were followed by the abandonment of convertibility, the suspension of foreign debt payments, the asymmetrical "pesoification" – at different exchange rates – of bank assets and liabilities, the partial freezing of prices and wages, and the introduction of various financial and foreign exchange restrictions. The scale of the fall in GDP (10.9% in 2002, and 21% counting from 1999) gives some idea of the depth of the crisis. The fears of a return to hyperinflation did not materialise, however. This was partly because economic activity was depressed and also because of the rigid interventionist measures set in place. As a result, annual average inflation was 26%.

Agents' diminished confidence was accentuated during most of the year by the little headway made in the process of economic restructuring. However, from the third quarter the economic depression began to show signs of having touched bottom. The production and sales indicators rose, bank deposits began to increase, the exchange rate rebounded and public finances also improved, albeit assisted by the non-payment of external debt, where scarcely any progress in rescheduling has been made. This incipient but precarious recovery, which may be explained in part by its very depressed starting point, has allowed some economic and financial restrictions to be partially lifted and has been backed by the temporary agreement reached with the IMF in January 2003. Nonetheless, pending the measures the new government may carry out, institutional uncertainty persists.

The seriousness of the crisis in Argentina had a most adverse effect on some of its smaller neighbours: Paraguay, Bolivia and Uruguay. In the latter economy, which is closely linked to Argentina economically and financially through trade ties and the substantial volume of deposits traditionally held by Argentine residents in Uruguayan banks, contagion from the Argentine crisis was particularly evident. The depreciation of the currency, deposit withdrawals by non-residents and the fall in activity led to a deterioration of the financial system and the fiscal position, despite the IMF's support programme.

The financial turbulence in 2002 particularly affected Brazil, the region's economic powerhouse. The imminence of elections and the fear that the new government might adopt unorthodox policies gave rise during the summer to a lack of confidence on international financial markets. The subsequent rise in risk premia and the depreciation of the exchange rate seriously deteriorated the outlook for public finances, since the servicing of Brazil's sizable public debt is highly sensitive to both variables. That set in train a vicious circle in which worsening public finances and deteriorating financial variables fuelled each over mutually. This spiral peaked in the summer, motivating the extension of a new IMF support programme. Backing by the IMF and, following the elections, the commitment by the new government to market principles and economic discipline prompted a notable improvement in the climate on markets, which has continued into 2003 Q1. However, the authorities face the formidable challenge of raising Brazilian growth, which is currently below 2%, to bring it into line with the country's potential. At the same time, inflationary pressures must be controlled; these have become more evident at the onset of the current year and have been combated with a tightening of the monetary policy stance.

Chile and Mexico had relatively fewer difficulties during the year and retained a degree of responsiveness in the face of the slowness of the recovery. This was especially so in Chile's case, whose monetary and fiscal policies were the most clearly accommodative in the area. That said, the economic results in both countries were worse than expected at the beginning of the year, and they posted respective growth rates of 2.1% and 0.9%, a figure attributable in Mexico's case to the hesitant US recovery. Capital flows fell, and this was reflected in the significant depreciations of the two countries' currencies. In Mexico, inflationary expectations arising from the weakness of the peso led to a tightening of monetary policy in early 2003. Finally, in Chile's case, there was notable progress in trade liberalisation in the form of agreements with the European Union and with the United States.

As regards the Andean countries, developments were uneven. Peru posted the highest growth in the region (5.2%), while Colombia experienced greater difficulties, related in part to its precarious fiscal po-

BOX II.4

The enlargement of the European Union

The enlargement of the European Union (EU) currently envisages the accession in the medium term of up to 13 countries, 10 of which (Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia) will be joining in May 2004 (1), as agreed at the Copenhagen European Council in December 2002. Previously, all the countries will have to ratify the Treaty of Accession, which was signed at the Athens European Council in April 2003.

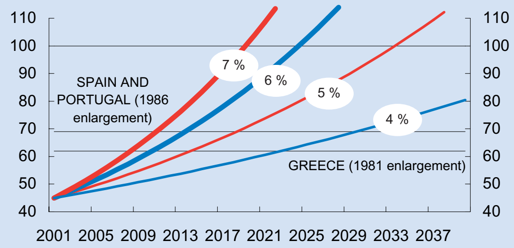
This enlargement of the EU is the most ambitious to date in terms of both the number of countries, geographical span and the number of inhabitants (over 100 million), and of the structural and purchasing power differences between the current members and the acceding and accession countries (see accompanying table). The challenges thus facing these countries, and the EU as a whole, are manifold, although so too are the opportunities that a single market comprising almost 500 million people will offer.

Among the main challenges enlargement involves are, first, the need to reform Community institutions and policies to enable a 25-member EU to function. This reform will be considered at the next Inter-Governmental Conference in 2004, on the basis of the conclusions reached by the European Convention. Second, the economic and social integration of these countries into the EU requires them to make as swift as possible headway in nominal and real convergence towards the current EU members, especially with a view to the future adoption of the euro. In this connection, they will have to show a satisfactory degree of sustainable convergence, which will be evaluated in accordance with the Maastricht criteria that were applied to the current Member States. One of these criteria is to have remained, for at least two years prior to the convergence examination, within the normal fluctuation margins established by the EMS exchange rate mechanism (ERM-II), without devaluations on the initiative of the country concerned and free from serious pressures. Consequently, the earliest date these countries could meet all the convergence criteria is 2006 and the first possible date for adopting the euro would be 2007. While all the acceding countries have expressed an interest in adopting the euro as soon as possible, it seems clear that the optimum period for doing so will depend on the degree of convergence they have achieved in nominal and real terms.

Acceding and accession countries
Basic indicators (2001)

	Population (millions)	GDP (% of EU GDP)	GDPcp (PPP) (% of EU average)	Agric. employment (% of total)	Unemployment rate (% of working pop.)
Cyprus	0.6	0.11	74	4.9	3.9
Czech Republic	10.3	0.71	59	4.9	8.0
Estonia	1.4	0.07	40	7.1	12.4
Hungary	10.0	0.65	53	6.1	5.7
Latvia	2.4	0.15	33	15.1	13.1
Lithuania	3.7	0.09	38	16.5	16.5
Malta	0.4	0.04	58	2.2	6.5
Poland	38.6	2.23	40	19.2	18.4
Slovakia	5.4	0.25	47	6.3	19.4
Slovenia	2.0	0.23	70	9.9	5.7
Acceding countries (a)	74.8	4.57	47	13.3	14.5
Bulgaria	8.5	0.17	24	8.3	19.7
Romania	22.4	0.50	24	42.8	6.6
Accession countries (b)	105.6	5.25	45	15.7	13.1
EU	377.5	100	100	4.3	7.2

CONVERGENCE SCENARIOS (c)



Source: Eurostat.
(a) Sum for the ten countries that will join the EU in 2004, weighted by GDP.
(b) Excluding Turkey.
(c) Percentage of average GDP per capita of the EU. Average growth rate of the EU: 2.5%. Average growth rate of the Accession countries: 4%, 5%, 6% and 7%.

The progress in nominal convergence in these countries has been substantial to date in respect of inflation control and the reduction of long-term interest rates, but much more uneven in terms of fiscal consolidation. Further, some of the recent headway in nominal convergence might not be sustainable, in particular the maintenance of inflation at very low levels, as the liberalisation of regulated prices takes greater hold, especially if the strong appreciation of these countries' currencies is reversed. Moreover, their high current-account deficits could pose financing problems if the burgeoning capital flows they currently receive grind to a halt or undergo a change in sign. Indeed, a portion of these flows is related to privatisation processes, which are tapering off, and to taking advantage of the government debt interest rate spread over the euro area, which has almost been cancelled out in some cases.

The acceding and accession countries' progress in real convergence has been modest, meaning that the per-capita income differential with the EU (2) remains very wide. As a result, real convergence will perhaps extend far beyond the first date possible for the adoption of the euro. It is estimated that with a growth rate of 4%, equivalent to the average attained by the acceding and accession countries in the past seven years, they would take almost 30 years to catch up with Spain's and Portugal's per capita income relative to the EU average at the time these two countries joined (see accompanying chart). However, this process should be quickened as a result of the favourable impact of European funds, in particular structural funds, and the more so if the future members undertake the reforms needed to make their markets more flexible, which would allow them to increase their growth potential. In addition, sustainable advances in nominal convergence, provided they are accompanied by the necessary structural reforms, should accelerate real convergence, and vice versa, since they are mutually reinforcing processes.

(1) Entry for Bulgaria and Romania is scheduled for 2007. The possible date for the start of negotiations for Turkish accession is 2005.
(2) See "La adhesión europea: convergencia real y nominal", *Boletín económico*, Banco de España, diciembre 2002.

sition, although the recent budgetary adjustment programme and the agreement with the IMF provided for something of an improvement. Lastly, the deterioration of the political and social situation in Venezuela, particularly in the second half of the year, had a deeply adverse effect on activity; oil production and exports fell and private enterprise ground to a halt, leading to a decline of 8.8% in GDP in 2002. The worsening of the situation in the opening months of 2003 prompted the introduction of rigid exchange controls and the start of an internal public debt restructuring process, in the light of the public sector's servicing difficulties.

II.4.2. The EU accession countries

The key event for these countries last year was the agreement reached at the Copenhagen summit on EU accession for an initial group of 10 countries in 2004 and the possibility of a further two joining in 2007 (see Box II.4).

Real GDP growth held at a relatively high level in most of the accession countries last year, although it slowed slightly on 2001 owing to the lack of buoyancy of external demand (see Table II.2). Generally, the resistance of the economies of these countries to a slowdown in the face of an adverse international environment was based on the strength of domestic demand, underpinned by foreign direct investment inflows and by expansionary fiscal and monetary policies, which boosted consumption. Overall, growth differentials with the EU widened slightly in favour of the accession countries in 2002. However, the degree of convergence of per capita income levels with the EU in recent years remained limited (on average, the GDP per capita of the accession countries stood in PPP terms at around 44% of the EU average), suggesting that the process of real convergence will probably continue for a number of years after EU accession.

Significant headway continued to be made in the process of disinflation, to the extent that, at the end of the year, the average inflation rate of the 10 countries that will be joining the EU in 2004 was, in general, comparable with that of the euro area. Nonetheless, factors of an exceptional nature were quite important in 2002. These included most notably the favourable trend of food prices, delays in price deregulation and the appreciation of exchange rates. Given the absence of inflationary pressures and the appreciating trend of their currencies, official interest rates were cut in most of these countries.

In respect of public finances, there was a notable deterioration last year in certain countries of this group. As a result, the deficit of around 6% of GDP was posted in the three biggest economies (Poland, the Czech Republic and Hungary). If the exceptional business and banking restructuring measures are included, the deficit rose in certain cases, such as Hungary, to 10% of GDP. The deterioration was due, in most cases, to discretionary measures. Hence, in the future, it will be vital for these countries to make sound progress in fiscal consolidation and to restructure their spending accordingly. This is because, on one hand, they will have to face heavy investment and growing expenditure pressures within the EU and, on the other, they already have fairly high current-account deficits, and these may prove difficult to finance if the forceful capital inflows relating to privatisation are curbed or stopped.

The prospects of EU accession influenced financial markets in central and eastern Europe and, to a certain extent, protected them from the turbulence beleaguering Latin America. That provided for a narrowing of the sovereign spreads on external debt to historical lows. Stock markets trended moderately downwards or held stable, while the exchange rate of the main currencies of this area tended to appreciate against the euro. In Hungary's case, the massive inflow of speculative capital made intervention on the foreign exchange market necessary in order to defend the +15% fluctuation band set for its unilateral exchange rate regime against the euro, along with heavy interest rate cuts.

Turkey, a country aspiring to join the EU in a more distant future than the foregoing countries, posted notable GDP growth in 2002 of 7.8%, following a deep recession in 2001. Contributing significantly in this respect were domestic demand and the foreign sector, assisted by the strong depreciation of the Turkish lira. The financial markets rallied during most of the year, thanks to fairly strict compliance with the IMF programme. However, in the second half of the year the markets (for money and foreign exchange in particular) remained highly sensitive to political events, against a background of doubts over whether the fiscal drive was sufficient to ensure the sustainability of debt and also over problems in the banking industry being resolved.

II.4.3. South and East Asia and Russia

The great majority of South and East Asian countries saw their growth rates accelerate last year, the outcome in most cases of positive contributions by external demand not only from the developed countries but also from the region itself, where bilateral trade has increased notably in recent years, particularly with China (see Table II.2). Notable too in several countries in the region were the positive contributions of domestic demand, assisted by the moderate expansionary impulses of fiscal policies and by greater domestic and financial market stability. In the particular case of China, whose estimated output growth was 8%, both the contribution of exports and the strong momentum of domestic investment (chiefly government investment) are notable, accompanied by high direct investment inflows. However, in the opening months of 2003, the picture for countries in the region has worsened, partly as a result of the SARS outbreak.

Overall in 2002, the price moderation witnessed in previous years remained a constant in the economies in the region. In most countries the annual average increase in consumer prices did not exceed 3%, and in some cases a downward trend in prices persisted, namely in Hong Kong (–3%), China (–0.7%) and Singapore (–0.3%). However, deflation in these latter countries is characterised by complex and specific features in each case, generally different from those in Japan. Thus, in China's case it is due to the combination of strong increases in productivity, against the background of a fixed nominal exchange rate regime against the dollar, and spare capacity, along with the impact of tariff dismantling further to World Trade Organisation membership. Given the weight of China in the region's trade, the fall in the price level in this country has fed through in differing degrees to the price levels of its neighbouring economies via trade.

The performance of the financial markets was generally positive, in step with the strong growth in the region. This prompted sovereign debt spreads to hold at low and stable levels over the year as a whole. The stock markets withstood the first half of the year relatively well, although there was a gradual deterioration thereafter, which heightened in 2003 Q1. The countries with fixed exchange rates against the dollar (China, Hong Kong and Malaysia) benefited from a direct improvement in competitiveness against the other countries in the area, whose exchange rates tended to appreciate, at least initially, against the dollar; at the same time, however, they depreciated in effective terms against their trading partners as a whole, owing to the relative strength of the yen.

Finally, economic growth in Russia was relatively sustained in 2002. Russian GDP grew by 4.3%, despite slowing for the second year running from 9% in 2000 and 5% in 2001. Of note were the contribution of private consumption and the progressive improvement in investment, in line with rising oil prices, given the close link in Russia between fixed investment and crude oil output and exports. Fresh headway was also made in reducing inflation, which dipped from 20.7% in 2001 to 16% in 2002.

CHAPTER III

THE EURO AREA AND THE COMMON MONETARY POLICY

III.1. ECONOMIC CONDITIONS IN THE EURO AREA

In 2002, the rate of expansion of euro area output was very weak, for the second year running, at just 0.8%. The downturn in economic activity that commenced in mid-2000 bottomed out, in terms of quarter-on-quarter growth rates, in late 2001. The subsequent recovery has been characterised, however, by a notable lack of momentum, disappointing the expectations that existed at the beginning of last year. In fact, the growth rates of all the final demand components, with the exception of government consumption, fell significantly, so that only 0.2 percentage points of the small increase in GDP corresponded to domestic spending, the rest being attributable to the external sector, despite the modesty of the increase in exports. In 2002, therefore, the euro area showed little domestic vitality and a high degree of sensitivity to external developments.

Despite the loss of momentum in private spending, inflation held at over 2%, owing to certain adverse supply shocks, but also to the presence of rigidities in certain markets which hampered the necessary adjustment of income to the worsening in the economic outlook. Against this background, macroeconomic policies helped moderate the slowdown, although the downward stickiness of inflation and the scant effort made to consolidate finances in the upturn left little scope for monetary and fiscal policy to stimulate demand in the euro area.

III.1.1. Activity and employment

Annual GDP growth in the euro area was more subdued in 2002 than at any time since the start of Monetary Union, as the expected recovery in activity to close to trend, following the slowdown from mid-2000, failed to materialise. The favourable signs that, at the beginning of the year, had fuelled expectations of a progressive recovery, gave way to a modest, faltering improvement.

The contribution of domestic demand (excluding stockbuilding) to GDP growth was only 0.3 percentage points (p.p.) (see Table III.1). The negative contribution, of more than half a percentage point, from gross fixed capital formation, was particularly notable here. The significant contraction in investment in equipment (by around 4%) reflects, in the first instance, the adverse effects of the high level of uncertainty currently prevailing. Moreover, business investment was negatively affected by the moderation in margins and, in some cases (especially in the technology and telecommunications sectors), by the need to use surpluses to strengthen balance sheets, given the high levels of debt carried as a consequence of the expansion decisions of recent years. At the same time, despite the low level of real interest rates, other cost components of business liabilities remained relatively high. The risk premiums required on the bonds issued by non-financial corporations barely fell, and were still significantly above the levels prevailing before 11 September 2001, while the steepening of the decline in share values tended to make it more difficult and more expensive to finance investment projects. Finally, there are signs that credit institutions have adopted more cautious lending policies. Meanwhile, the significant fall in construction investment (which contracted by 2.5%) reflected the impact of uncertainty over future levels of household disposable income, against a backdrop of gradual deterioration in employment prospects.

Private consumption grew by 0.6% in 2002, about half the rate of real disposable income, so that there was an increase in the savings ratio. As in

TABLE III.1

Euro area: main macroeconomic indicators (a)

	2000	2001	2002	2002 Q1	2002 Q2	2002 Q3	2002 Q4
DEMAND AND OUTPUT							
Gross domestic product	3.5	1.4	0.8	0.4	0.4	0.3	0.1
Domestic demand	2.9	0.9	0.2	0.1	0.2	0.1	0.5
Private consumption	*2.5*	*1.8*	*0.6*	*-0.2*	*0.3*	*0.5*	*0.4*
Government consumption	*2.0*	*2.1*	*2.6*	*0.9*	*0.8*	*0.4*	*0.3*
Gross fixed capital formation	*4.9*	*-0.6*	*-2.6*	*-0.7*	*-1.2*	*0.2*	*0.2*
Exports	12.6	2.8	1.2	-0.2	2.0	2.1	0.0
Final demand	5.4	1.4	0.5	0.0	0.7	0.7	0.4
Imports	11.3	1.5	-0.4	-1.1	1.7	1.7	1.0
Contributions to GDP growth (b)							
Domestic demand	2.8	2.8	0.2	0.1	0.2	0.1	0.5
Change in stocks	*0.0*	*-0.4*	*-0.1*	*0.1*	*0.1*	*-0.3*	*0.1*
External demand	0.6	0.5	0.6	0.3	0.2	0.2	-0.3
PRICES AND COSTS (c):							
Consumer prices (annual average)	2.1	2.4	2.3	2.5	2.1	2.1	2.3
Final demand deflator	3.0	2.0	1.4	1.5	1.2	1.4	1.4
GDP deflator	1.3	2.4	2.4	2.6	2.3	2.6	2.1
Unit labour costs	1.3	2.7	2.2	3.4	2.2	1.8	1.3
Compensation per employee	2.6	2.7	2.6	3.0	2.5	2.4	2.4
Labour productivity	1.3	0.0	0.4	-0.3	0.3	0.7	1.1
GENERAL GOVERNMENT (d):							
Total expenditure	48.3	48.1	48.4				
Current expenditure	44.5	43.5	43.9				
Interest payments	*4.1*	*3.9*	*3.7*				
Public investment	2.6	2.6	2.5				
Total receipts	48.4	46.6	46.2				
Primary deficit (-)/surplus (+)	4.2	2.5	1.5				
Deficit (-)/surplus (+)	0.1	-1.6	-2.2				
LABOUR MARKET:							
Total employment	2.1	1.4	0.4	*0.1*	*0.0*	*0.0*	*0.1*
Unemployment (e)	8.5	8.0	8.3	8.1	8.2	8.3	8.5
BALANCE OF PAYMENTS (d):							
Current account	-0.9	-0.2	0.9	0.7	0.2	1.4	1.2
Capital account	0.2	0.1	0.2	0.2	0.2	0.1	0.2

Sources: ECB and European Commission.
(a) Quarter-on-quarter rates, unless otherwise indicated.
(b) Percentage points of the percentage change in GDP.
(c) Year-on-year rates.
(d) As a percentage of GDP.
(e) As a percentage of the labour force.

the case of residential investment, this stemmed from greater caution on the part of households in their consumption decisions, linked to the gradual slowdown in the demand for labour and to the general increase in uncertainty over economic prospects (see Chart III.19). In addition, the fall in share prices helped to reduce households' propensity to spend through its impact on financial wealth and confidence, although this effect was offset in some countries, at least partially, by the increase in real wealth entailed by the house price boom.

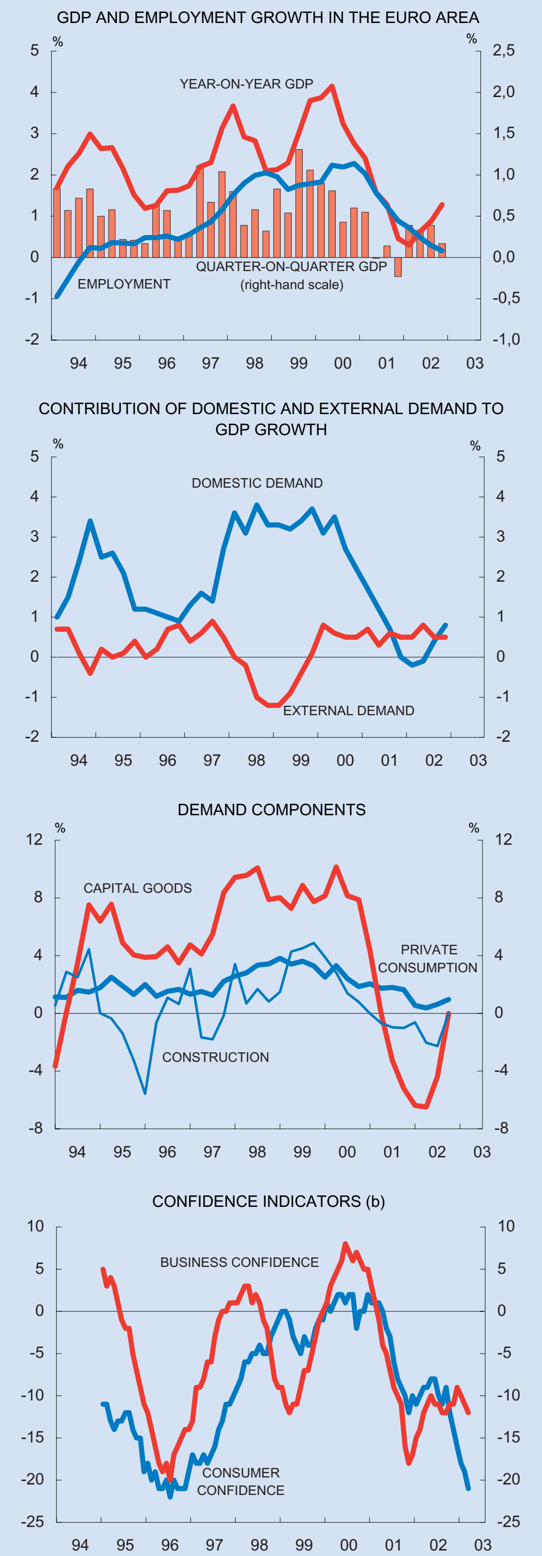
Trade flows between the euro area and the rest of the world slowed further in 2002, although the pattern over the year was different (see Table III.1). Export growth (1.2%) was held down for the second year running by weak growth in world trade, which was exacerbated by the appreciation of the euro (see Box III.1). Meanwhile, the slackness of final demand in the euro area meant that imports declined by 0.4%, even though their prices fell relative to national products. As a result of these developments in exports and imports, net external demand made a positive contribution of 0.6 p.p. to output growth, very similar to those seen in previous years. The current account balance improved, to a surplus of 1.1% of GDP.

The countries of the area have generally displayed a high degree of synchrony in the current cyclical downturn. In 2002, GDP slowed in all of them, with the exception of Austria and Finland. However, there were notable differences in GDP growth and in its composition. The economies whose growth was most clearly above average (Greece, Spain, Ireland and Finland) were also those with the highest potential growth rates. As for the composition of growth, there were notable cross-country differences (see Chart III.2). The weakness of domestic demand was more acute in the Netherlands, Austria, Portugal and Finland, and most especially in Germany, where capital goods purchases fell by more than 9%, while investment in construction continued to decline at a rate close to 6%. The mediocre performance of the German economy in the last two years stems from the cyclical downturn affecting the area as a whole and, most especially, from its own structural weaknesses, which have become evident during the process of absorption of the effects of reunification. Significant here is its low potential growth, often attributed to causes such as the high tax pressure and the generation of perverse incentives by social protection systems. Given Germany's financial system, in which credit institutions play a particularly important role in the financing of business (and which also suffers from certain structural weaknesses), the increase in the risk of the assets of the banking sector has possibly been a further factor which, in conjunction with those described for the area as a whole, has generated a particularly adverse scenario for business expansion.

The slowdown in activity in the euro area was gradually reflected in labour market developments during 2002. The rate of unemployment increased by 0.3 percentage points to 8.5% of the labour force at the end of the year, while employment slowed more sharply than output, with growth in the year as a whole of 0.4%. As a result, apparent labour productivity grew at a positive rate (also

CHART III.1

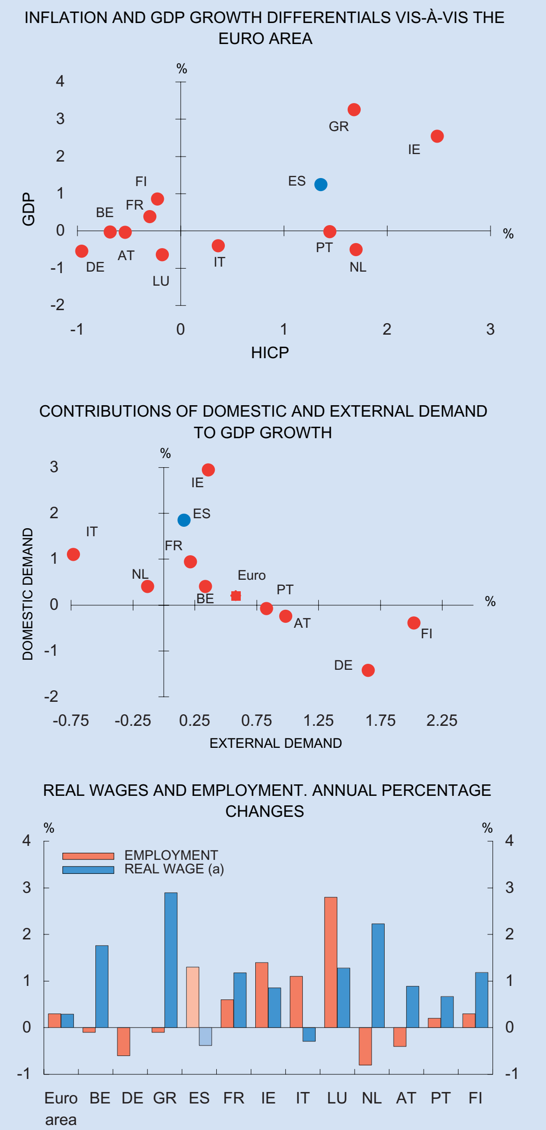
Euro area: composition of growth and confidence indicators (a)



Sources: Banco de España, European Central Bank, European Commission and national statistics.
(a) Annual percentage changes, unless otherwise specified.
(b) Percentage balances.

CHART III. 2

Economic performance by country in 2002



Sources: Eurostat, European Commission and national statistics.
(a) Compensation per employee divided by the GDP deflator.

0.4%) which, although very modest, was higher than in 2001. In the first half of the year, as in 2001, employment growth was relatively sustained, given the lags with which this variable usually responds to fluctuations in activity. However, the perception on the part of employers that the loss of momentum in activity might be temporary may also have played a part here. In any event, the low sensitivity of wages to changes in economic conditions and continued weak output growth meant that employment grew at year-on-year rates of almost zero in the second half of the year. As a result, apparent labour productivity recovered significantly, growing at rates of more than 1% in the final quarter (see Chart III. 3).

The economic outlook for the coming months hinges on how the unknowns surrounding the geopolitical situation and developments on the financial and oil markets are resolved. In the short term, it is likely that agents' spending will be curbed by the need for firms to continue their financial restructuring and, in the case of households, by the worsening labour market conditions. In principle, if the financial and foreign-exchange markets soon become more stable, now that the military conflict is over, output will foreseeably gain momentum from the middle of this year and the growth rate of euro area GDP will progressively draw closer to its potential. These prospects are favoured by the absence of widespread macro-financial imbalances in the area, given that the household savings ratio is high and that the current account is almost balanced. The main risk threatening this scenario is the possibility that new complications may arise in the Middle East, which could lead to a further deterioration in agents' confidence. Also, the employment outlook is highly uncertain; in the absence of sufficient wage moderation, the consequent growth of unit labour costs and extended demand weakness could prompt firms to make greater staff adjustments than they have in the past.

III.1.2. Prices and costs

The path of inflation in the euro area in 2002 was marked by the upward impact of various supply shocks and by the downward stickiness of wages and non-tradables prices, despite the weakness of demand. In addition, the dispersion of national inflation rates, which has been notably persistent in recent years, increased slightly in 2002.

The rate of increase in the final demand deflator fell by more than half a percentage point in 2002, largely as a consequence of the sharp reduction in the prices of imported goods and services, since domestic prices, approximated by the GDP deflator, grew at the same rate as in the previous year (see Table III.1). The imports deflator reflected both the moderate increases in the export prices of Spain's main trading partners in their own currencies and the appreciation of the euro. As regards domestic costs, the strong growth in net indirect taxes per unit of output prevented the GDP deflator slowing

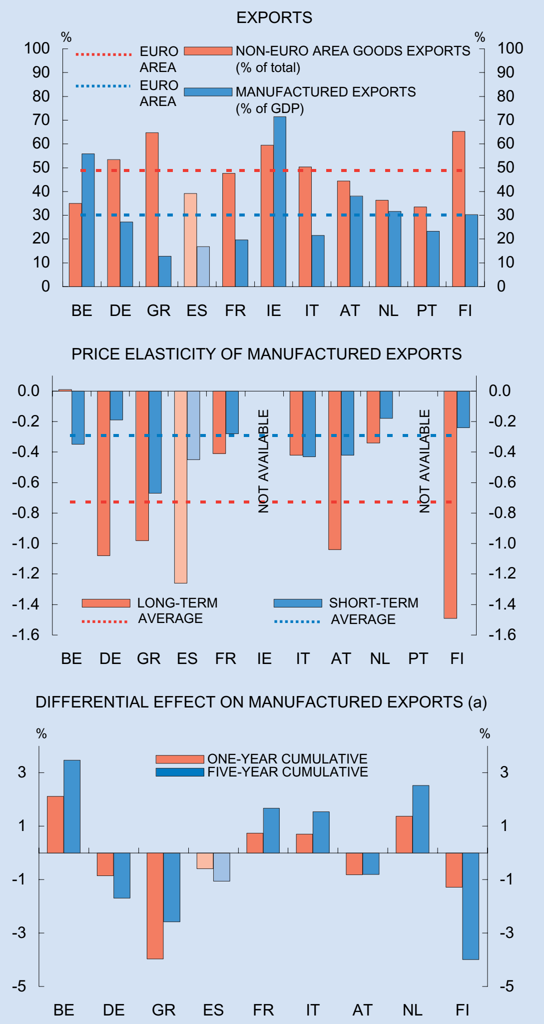
Differential effect of the euro's appreciation on exports by euro area countries

In 2002 and the first few months of 2003 the euro exchange rate appreciated sharply both in nominal and real effective terms. This trend may lead to a diminished buoyancy of exports outside the euro area, which would adversely affect the rate of expansion of the area's GDP. Moreover, the appreciation of the euro may have uneven effects on economic activity across countries, depending on the disparities in their production and trade structures, and on the differences in the workings of their factor markets.

In particular, just how much the exports of euro area countries are affected by the euro's appreciation will turn basically on three factors. The first is the geographical structure of trade, since it can be expected that, if a higher percentage of a euro area country's sales is to non-euro area countries, the euro's appreciation will feed through more fully to its nominal effective exchange rates. Second is the extent to which exporters respond by reducing their euro-denominated prices to offset the currency's appreciation and thereby maintain export markets. And third is the response of demand for exports to changes in relative prices.

The first of the adjacent panels shows that the share of non-euro area exports in total exports ranges from 60% for Ireland, Greece and Finland to somewhat below 40% for the Netherlands, Portugal, Belgium and Spain. Also, there is notable disparity among countries in how their exports respond to changes in competitiveness. The second panel compares the estimated elasticities of demand for each euro area country's manufacturing exports to changes in competitiveness, using data series for the period 1975-2002. It can be seen that manufacturing exports scarcely vary in response to changes in the real exchange rate in Belgium and the Netherlands, but are very sensitive in Finland and Spain. This heterogeneity reflects, in addition to specific factors in each country, the differences in export structure. Notable among the idiosyncratic factors is the considerable significance in Belgium and the Netherlands of re-exports, i.e. tradable goods with origin and destination in third countries, which have a price elasticity of nearly zero.

Determinants and effect of 10% appreciation of the euro



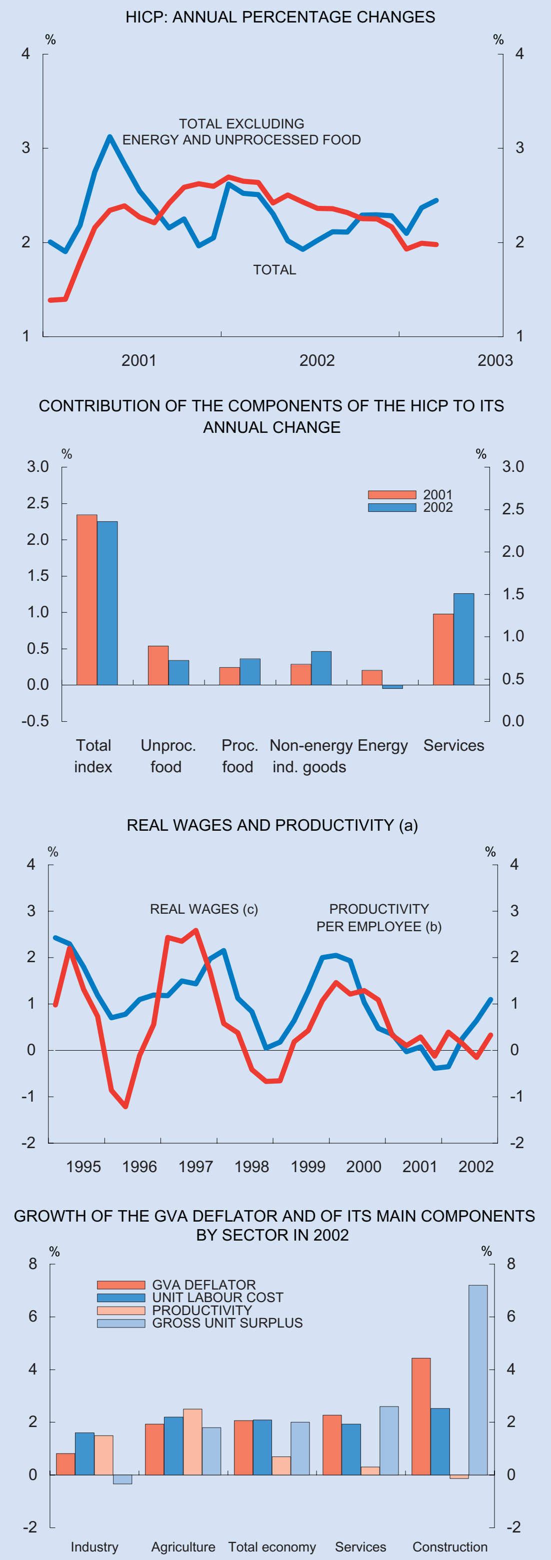
Sources: Eurostat, OECD and Banco de España.
(a) Expressed as deviation of the impact on each country from the average. Positive (negative) values indicate a lower (higher) than average fall in exports.

To assess the differences in how each country's foreign sales respond to an appreciation, it has been assumed, for the sake of simplicity, that export prices in euro respond to an appreciation in the same proportion in all countries. Therefore the differential effect of the appreciation on exports derives directly from the two variables mentioned in the previous paragraph: the share of non-euro area exports and price elasticity. The third panel shows the differential effect of an appreciation of 10% (expressed as deviations of the impact on each country from the average). The largest decreases in foreign sales are in Finland and Greece, countries in which high price elasticity is combined with a significant share of non-euro area trade. At the opposite extreme are Belgium and the Netherlands, due to low price elasticity.

Lastly, the first panel shows the share of manufacturing exports in GDP or the degree of openness of each member country. This variable also exhibits marked differences across countries, since it exceeds 50% in Belgium and Ireland and is below 20% in Greece and Spain. The low degree of openness of the latter two countries can be expected to notably mitigate the extent to which the estimated decline in their exports translates into GDP changes. However, the effect of appreciation on the GDP of the various countries, in addition to depending on how exports perform, is determined by many other factors, such as the response of imports and the impact of the appreciation on other macroeconomic aggregates, employment or domestic prices.

CHART III. 3

Euro area
Harmonised indices of consumer prices and wages



Sources: ECB, Eurostat and national statistics.
(a) Annual percentage changes.
(b) Difference between the changes in GDP and employment.
(c) Difference between the change in compensation per employee and the GDP deflator.

further. In fact, the value-added deflator which excludes the direct impact of most of the net indirect taxes fell more sharply, as a consequence of the slower growth of unit labour costs and of the gross operating surplus per unit of value added.

The slowdown in unit labour costs stemmed from the slight recovery in productivity, since wages grew at the same rate as in 2001, but it was not sufficient to allow profit margins to widen (see Chart III.3). In fact, although the sustained increase in nominal wages (partly reflecting multi-year settlements signed at a more favourable stage of the business cycle) enabled household purchasing power to improve, it also reduced the buoyancy of employment. The slowdown in the gross operating surplus is consistent with the progressive weakening of demand pressure, although margins performed very differently across the various industries, narrowing significantly in those that are more sensitive to international competition and increasing in the more sheltered ones (see the lower panel of Chart III.3).

The average rate of change in the Harmonised Index of Consumer Prices (HICP) was 2.2% in 2002, 0.2 percentage points less than in the previous year. The behaviour of the HICP during the year was determined by its more volatile components and displayed two very different trends: a continuous decline in year-on-year rates during the first half, to 1.8% in June, as a consequence of a reduction in the effects on the food component of the period of adverse weather, and a subsequent pick-up, as the oil price increased. The rate of increase in the prices of the group of products whose prices tend to be more stable (known as the IPSEBENE) rose from 2% in 2001 to 2.5% in 2002, although the trend during the year was slightly downward. Services prices increased, on average, at the highest rate and, although they were less buoyant from September, their rate of increase never dropped below 3%.

The studies carried out to estimate the effect on inflation of the introduction of euro notes and coins all highlight the moderate importance of this phenomenon. The increase in prices may have been attributable to the existence of price adjustment costs (menu costs), which prompted firms to concentrate their price changes at the time of the change in their denomination. Also, the setting of attractive or round prices may have had an upward impact. However, most of the impact seems to have arisen from the passing through of the costs of the changeover from producers and retailers to consumers and, in some cases, from an attempt by firms to widen their profit margins, as is evidenced by the fact that the effects on prices were mainly concentrated in certain services sectors, where suppliers have greater market power.

In 2002, the rate of change of the prices of the HICP items most affected by the changeover steadied, so that the repercussions on inflation will foreseeably prove to be temporary, although further effects may still arise. Although consumers perceived an inflation increase in 2002 above that reflected in the HICP (which they attributed to the conversion of prices to euro, as shown by the significant increase in the level of the perceived inflation indicator compiled by the European Commission), medium-term inflation expectations have held steady, which suggests that consumers consider that the effect on prices of the launch of the euro will prove to be temporary.

As mentioned above, the dispersion of inflation rates across the euro area countries was relatively wide (see Chart III.2). Although the different cyclical position of each country seems to explain part of the differences in inflation, this is not sufficient to explain the level and persistence of the observed inflation differentials. In fact, in addition to factors associated with the process of convergence in price and income levels that may have some medium and long-term influence, the observed differentials seem to be closely related to differences in the degree of flexibility in factor and goods and services markets, which amplify the effect of demand shocks (whether common or idiosyncratic) on national price indices. The different behaviour of wages and margins in each country's price formation process suggest that stickiness in the adjustment of nominal variables to shocks and the differences in the degree of competition in goods markets give rise to significant differentials that may have lasting effects on the competitiveness of each national economy (see Box III.2).

The inflation rate rose again at the beginning of 2003, largely on account of the rise in the price of oil as a result of heightened international political tension, while the most stable components remained on the downward trend that commenced at the end of last year. Accordingly, the process of price moderation can be expected to resume, once the factors that have driven the increase in the price of energy unwind. Moreover, the delayed effects of the cumulative appreciation of the euro in 2002 and in the first few months of 2003 will probably have a moderating effect on the prices of some components.

III.2. FISCAL AND STRUCTURAL POLICIES IN THE EURO AREA

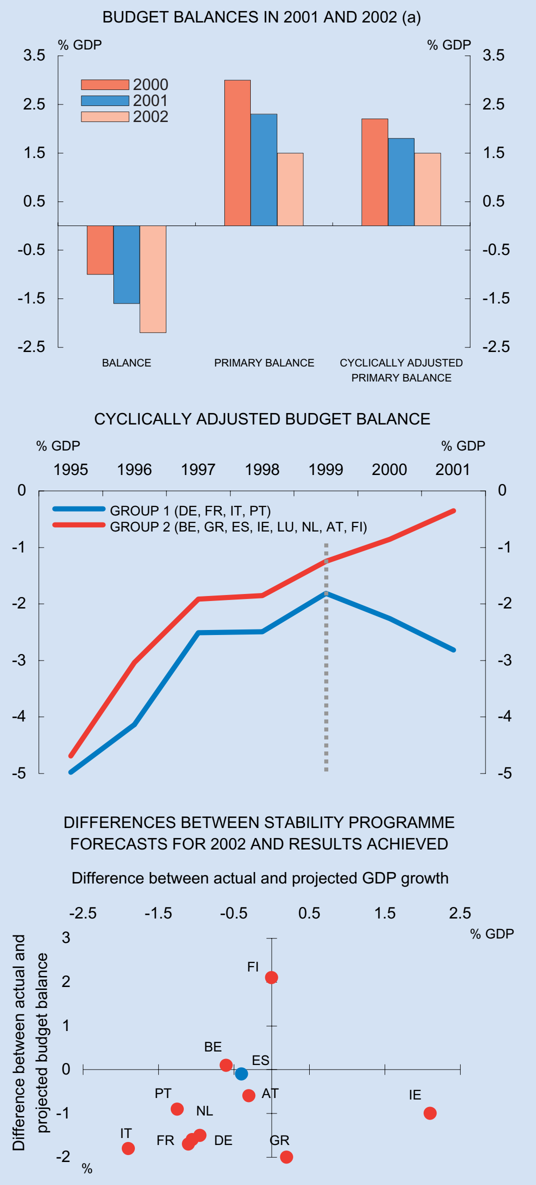
III.2.1. Fiscal policy

Public finances in the euro area deteriorated considerably last year. The budget deficit increased by 0.6 percentage points from 2001, to 2.2% of GDP. This was the result of a 0.3 percentage point decline in the share of total revenues in GDP and a 0.5 percentage point increase in the weight of primary spending (in particular on current transfers), while interest payments fell by 0.2 percentage points (see Chart III.4). According to European Commission calculations, half of the deterioration was attributable to the impact of the economic downturn on tax revenues and on spending on unemployment benefit. The cyclically adjusted primary surplus is estimated to have fallen by 0.3 percentage points of GDP in 2002. Budget balances deteriorated, relative to the previous year, in all the Member States, except for Greece, Spain, Italy and Portugal, while only Belgium, Spain, Luxembourg and Finland either fulfilled or else narrowly missed the targets set in their respective stability programmes, both in nominal and cyclically adjusted terms.

Analysis of the national budget results for 2002 confirms the existence of two groups of countries whose public finances have diverged since 1999 (see the middle panel of Chart III.4). Until that year, in general terms, all the countries of the area had made efforts to move towards a budgetary position close to balance. However, the group of four countries that still have significant imbalances today, in terms of actual budget balances (i.e. Germany, France, Italy and Portugal), failed to capitalise in 1999 and 2000 on the economic upturn to intensify the consolidation drive, while the slowdown in activity in the following two years was accompanied by a further increase in the deficit. Meanwhile, the other eight countries continued, on aggregate, to draw nearer to a position close to balance, which they attained in 2001 and maintained in 2002. The failure of the first group of countries to attain a budget position consistent with the requirements of the Stability and Growth Pact (SGP), postponing the attainment of balance in their successive stability

CHART III.4

Euro area: fiscal policy



Source: European Commission (autumn forecasts).
(a) Proceeds from the sale of third generation (UMTS) mobile telephone licences are not considered

programmes, has restricted the scope for fiscal policy to perform its potentially stabilising role in the current situation.

This deterioration of the budget balance in various countries of the area, to the point where the deficit limit of 3% of GDP laid down by the Treaty on European Union was initially put in jeopardy and subsequently breached, led to application of the mechanisms envisaged in the SGP. Thus, in January 2002, given the risk that the German and Portuguese deficits would exceed the 3% limit, the European Commission initiated the *early warning* procedure for both countries. However the ECOFIN Council decided not to adopt the Commission's recommendation in view of a commitment by both Member States to take the necessary measures to avoid a breach of the deficit limit.

However, the new budget-outturn information emerging during the course of the year in both countries led the Commission to activate the provisions of the SGP again. In July, the results of a revision of the Portuguese public accounts for 2001 were released, according to which the deficit had been 4.1% of GDP that year, and not 2.2% as notified in the spring by the Portuguese authorities. Likewise, in the autumn, the European Commission forecast a German deficit for 2002 clearly in excess of 3% of GDP. As a result, the ECOFIN Council recognised, in November 2002 and January 2003 respectively, the existence of an excessive deficit in Portugal and in Germany, and recommended to the authorities of both countries that they take the necessary measures to resolve the situation. In the case of Germany, the government promised (with the approval of the Council) to adopt, if necessary, the budget measures needed to achieve the target deficit of 2.8% of GDP in 2003, provided that economic growth is not significantly below the 1.5% level forecast in the programme for this year.

Finally, in November, the Commission initiated the early warning procedure for France, when the French government estimated that the deficit would reach 2.7% of GDP in 2002, greatly limiting the margin available to absorb additional minor shocks without breaching the 3% limit. In fact, after the adoption by the ECOFIN Council of the related recommendation in January, the French authorities announced that the deficit had reached 3.2% of GDP. This led the Commission, in April, to initiate an excessive deficit procedure against this country too.

Experience since the entry into force of the SGP, spanning two quite different stages of the business cycle, has served to demonstrate that this is an instrument that sets appropriate targets for the public finances of the area. From a short-term viewpoint, the SGP is excessively restrictive for countries that have failed to fulfil the requirement of maintaining a position of balance on average over the cycle. However, achieving such a position affords automatic

BOX III.2

Inflation differentials in the euro area

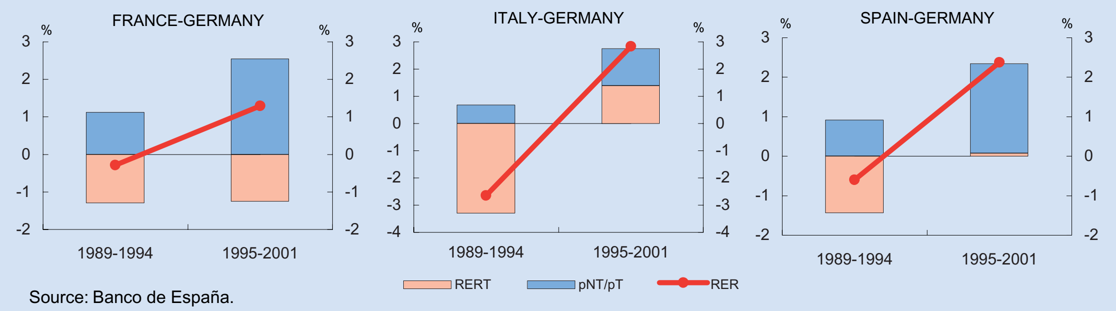
The irrevocable exchange rates set between the euro area countries have not eliminated the possibility that relative prices between member countries will continue to change, thus generating inflation differentials which, in a monetary union, are tantamount to variations in the bilateral real exchange rate. To analyse the determinants here, the historical variations in the real exchange rate can be broken down into, on the one hand, the tradable sector price growth differential with prices expressed in the same currency and, on the other, the inter-country growth differential of relative prices of non-tradable versus tradable goods.

The top panel shows the average growth of the bilateral real exchange rate (RER) for the economy as a whole, of the real exchange rate for the tradable sector (RERT) and of the differential of the relative prices of non-tradable versus tradable goods (pNT/pT) of France, Italy and Spain with respect to Germany. The panel distinguishes between the period 1989-1994 (before the creation of the euro area) and the latest period on which data are available, 1995-2001. The data are annual sectoral figures taken from the OECD STAN database. In no country is the growth of the real exchange rates of tradable goods equal to zero, as should be the case if the single price law holds. In fact this component explains most of the total real exchange rate behaviour in the first period, although its contribution diminishes in later years as a logical consequence of progress towards the single market. The panel also reflects significant growth differentials between the relative prices of non-tradable versus tradable goods in these countries, particularly in the later years, when they became the factor that best explains the change in the real exchange rate or, what amounts to the same thing, the inflation differential, from 1999.

Relative price growth can also be broken down into the growth of its determinants: margins, wages and apparent labour productivity. The lower panel shows these relative price growth differentials with respect to Germany as well as the contributions to this differential growth of its three components. According to the Balassa-Samuelson convergence theory, long-term inflation differentials reflect changes in the relative productivity of the tradable sector with respect to the non-tradable sector and therefore do not affect a country's competitiveness. However, for the overall period analysed, the behaviour of sectoral productivity differentials does not sufficiently explain the changes in relative prices. In the last period analysed (1995-2001), only in the case of France is the sectoral productivity differential the main component of the price differential. In the case of Spain, the price differential with respect to Germany is mainly accounted for by margins and, in the case of Italy, by relative wages.

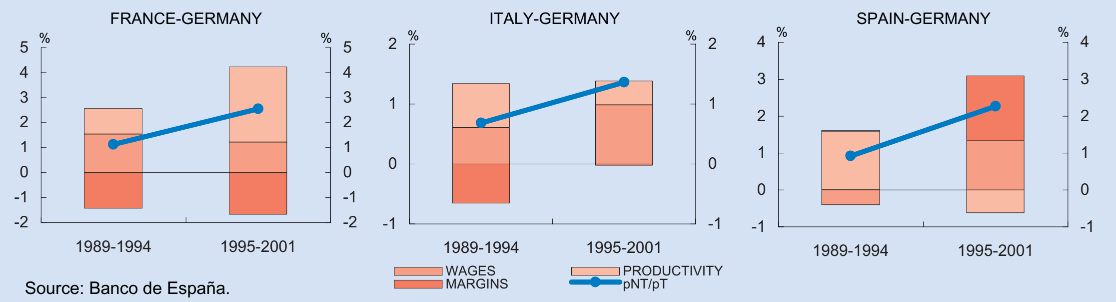
This evidence reflects the existence of persistent deviations in inflation differentials that are unrelated to the process of structural adjustment. If these wage or relative margin growth differentials persist over time in any of the euro area countries, inflation differentials will continue to be generated which may reflect the existence of different degrees of rigidity in goods and labour markets and may affect the competitiveness of these economies.

Breakdown of growth in real exchange rate vis-à-vis Germany (a)



Source: Banco de España.
(a) Average annual growth in each sub-period of the total real exchange rate (RER), of the real exchange rate of tradable goods (RERT) and of the growth in the relative price of non-tradable versus tradable goods (pNT/pT) vis-à-vis Germany.

Breakdown of the growth differential of relative prices of non-tradable versus tradable goods (pNT/pT) vis-à-vis Germany (a)



Source: Banco de España.
(a) Average annual growth rate in each sub-period.

stabilisers sufficient margin to operate freely. A consensus has progressively been forged, as a result of this experience, around the idea that the fiscal rules established for the area so as to provide a framework for disciplining budgetary policies are generally appropriate, although they need to be applied more symmetrically over the cycle and in accordance with each country's specific circumstances. This conviction led the ECOFIN Council to approve a report on the strengthening of fiscal policy co-ordination (subsequently subscribed to by the European Council of March 2003) which, without modifying the rules of the SGP, tries to clarify its interpretation. According to this report, achievement of the targets in national programmes should be assessed on the basis of cyclically adjusted balances, countries with high levels of debt should reduce them quickly, steps will be taken to ensure that policies are not pro-cyclical during upturns and more attention will be given to the way in which population ageing affects the long-term sustainability of each country's fiscal situation. Also, it was reaffirmed that countries whose budgets are still far from being close to balance should follow a strategy based on an annual improvement in their underlying budget position of at least 0.5% of GDP.

Finally, a fundamental ingredient for the existing mechanisms to function satisfactorily is the rapid availability of high quality budget statistics. Although undoubted progress has been made in this area in the last few years, some recent episodes involving significant revisions to certain countries' data, incomplete information on certain transactions and delays in receipt of the six monthly notifications of budgetary data from the Member Sates have shown that there is room for further improvement. Moreover, recognition of the importance of using cyclically adjusted balances in the procedures to supervise developments in fiscal policy requires an improvement in the analytical tools available to calculate them. So far this has led to adoption by the European Commission of a new method to obtain such balances, which could still be improved.

III.2.2. Structural policies

In 2002, the EU structural reform process did not generally advance at the speed necessary to achieve the goals set at the Lisbon Council for 2010 to raise EU potential growth to 3%. The weakness of the pace of reform may have been related to the cyclical position of the European economy and of public finances in some countries and also, in the odd case, to factors of a political kind. In March 2003, the European Council, meeting in Brussels, thus gave fresh impetus to the Lisbon programme, reaffirming its importance in view of the forthcoming expansion of the union. The Council specified a number of concrete actions that should be taken during the next twelve months in the areas of employment and social cohesion, innovation and entrepreneurship, connecting Europe and strengthening the internal market and, finally, environmental protection for growth and jobs.

With regard to employment, measures have been adopted in recent years to stimulate labour-market participation and the adjustment of worker profile to the demands of firms (employability). Such measures have been uneven and, generally, unambitious, yet they do seem to be gradually influencing the behaviour of euro area labour markets. In particular, female participation continues to be promoted in some countries, measures have been taken to adapt the education and ongoing training system to the needs of the labour market and public placement services have been modernised. This has helped the rate of employment to grow regularly in recent years, although on the latest information available, it is still more than 5 p.p. below the 70% target set at Lisbon (see Table III.2).

However, the reforms of tax and social benefit systems to stimulate employment have been few and incomplete, most of them affecting taxes rather than reforming subsidy systems. Also, little progress has been made in eliminating barriers to geographical mobility, in particular in relation to the housing market. In any event, the slowdown in employment in the final part of the year and the downward stickiness of wage growth in 2002 illustrate the permanent nature of imperfections in the workings of the labour market which require more far-reaching reforms. The recent Brussels European Council established an Employment Task Force to analyse the European labour market, in order to identify practical reform measures so that the targets set can be achieved. Its conclusions will be published in the spring of 2004.

A basic component of the Lisbon strategy, emphasised in the conclusions of the recent Brussels Council, is the transition to an information and

TABLE III.2

Structural indicators for the European Union

	EU			
	1999	2000	2001	2002
LABOUR MARKET:				
Employment rate (15-64)	62.4	63.4	64.1	
Female	52.9	54.1	55.0	
Male	72.0	72.8	73.1	
Employment rate (55-64)	37.1	37.8	38.8	
Female	27.1	28.0	29.1	
Male	47.5	48.0	48.8	
Unemployment rate	8.7	7.8	7.4	7.5
Female	10.2	9.2	8.5	8.6
Male	7.5	6.7	6.4	6.7
Long-term unemployment rate	4.0	3.5	3.1	
Direct taxes and social contributions on low-wage earners	39.1	38.6	37.8	
KNOWLEDGE SOCIETY				
R&D (% GDP)	1.9	1.9	1.9	
Percentage of homes with Internet access		18.3	36.1	40.4
Percentage of enterprises with Internet access			70.3	79.5
Patent applications per million inhabitants	210.4	232.7	241.2	
Expenditure on information and communication technology, as % GDP	6.4	6.9	7.0	
On information technology	3.9	4.2	4.2	
On communication technology	2.5	2.7	2.8	
Percentage of high-technology exports	18.9	19.9	19.8	
Venture capital investment (% GDP)	0.1	0.2	0.1	
Public expenditure on education (a)	5.0	5.0	4.9	
Continuous training (% population 25-64)	8.2	8.5	8.4	8.4
ECONOMIC INTEGRATION AND COMPETITION				
Sectoral prices				
Price of telecommunications (EUR/10 mins)				
Local call	0.41	0.40	0.41	0.40
National call	1.69	1.34	1.16	1.09
Call to USA	3.56	3.17	2.71	2.31
Electricity prices (euro/kWh)				
Industry users	0.063	0.064	0.063	0.061
Households	0.105	0.104	0.103	0.102
Gas prices (euro/GJ)				
Industry users	3.50	5.03	6.14	5.42
Households	6.71	7.81	8.72	8.24
Foreign trade, as % GDP (b)				
Intra-EU trade	16.3	17.8	17.6	16.9
Extra-EU trade	9.6	11.5	11.4	10.8

Source: European Commission.
(a) Average level in the five countries for which information is available for 2001.
(b) Average of total exports and imports

knowledge-based society. This embraces some highly diverse initiatives, such as the eEurope 2005 Action Plan, the creation of a European Research Area and policies to promote innovation and education, especially in the area of new technologies. Advances have been made, above all, in Internet penetration, despite the delay in the widespread availability of broad band services. In other areas, such as human capital development, R&D investment and information and communication technologies, progress has been scant (see Box III.3). The existence of a genuine Community patent, a most important institutional factor for R&D activity and its productive application, is hindered by the existence of significant technical barriers. However, the European countries reached an agreement in March 2003 for the Community patent to become a reality in 2005, at a significantly lower cost than under the current system. This will facilitate registration and, therefore, stimulate the development of industrial and scientific inventions.

The achievements have not been satisfactory either as regards the functioning and integration of product markets. On the tenth anniversary of the Internal Market a certain increase in the directive transposition deficit has been noted. After falling from 1992 there has recently been a rise, so that the percentage of directives overdue for transposition stood at 2.1% at the end of 2002, as against 1.8% in May. Moreover, effective application of the transposed regulation is far from satisfactory, given that the number of infringement proceedings open is holding steady at around 1,500 cases, without any decline in this figure in 2002. In any event, economic integration, the objective of the internal market programme, has slowed somewhat in certain fields, judging by the indicators available on intra-Community trade and cross-border direct investment.

In the network industries, liberalisation is proceeding somewhat indecisively, with significant cross-country differences. In telecommunications, the former monopolies still have high market shares (around 80% in twelve Member States). Given these limitations, and the fact that six years had passed since the sector was liberalised, in February 2003 the European Commission established a new regulatory framework to extend competition in this market. Likewise, the high industrial concentration in the gas and electricity sectors is conducive to a certain degree of downward price stickiness, which shows that the level of competition is still insufficient. It should be recalled that 2004 was the deadline set at the Barcelona Council for freedom of choice of supplier for non-household gas and electricity consumers, while 2005 was the date set for cross-border electricity interconnections to reach at least 10% of production capacity. The conclusions of the Brussels Council included an express reference to the need to complete the reforms pending in this area.

Possibly the clearest progress has been made in the financial sphere. Thirty of the forty-two measures included in the 1998 Financial Services Action Plan have been finalised, notable progress having been made in securities markets. In 2002, the arrangements proposed in the Lamfalussy Report to speed up the production of harmonised legislation, by means of the establishment of two new committees of regulators and supervisors, were put into operation. Also, the initiative to transfer these arrangements to the sphere of banking and insurance was approved, so that in future new committees will also start to function in these fields, the objective being to achieve full integration of all financial services markets in 2005. Finally, the Financial Services Committee (replacing the former Financial Services Policy Group) was set up in March 2003, with responsibility for advising the ECOFIN on the most important financial issues. The creation of this Committee is an acknowledgement of the growing importance of factors relating to financial stability in the debate of the European economic authorities.

Also noteworthy were the initiatives taken in Europe to promote the better functioning of capital markets, to make up for investors' loss of confidence as a result of the accounting irregularities detected in recent years in certain US firms and also, albeit to a lesser extent, in European ones. Following the informal ECOFIN meeting in Oviedo in April 2002, the European Commission, along with the Member States, began to analyse issues relating to the quality of the financial information provided by firms, the behaviour of analysts and rating agencies, the need for audit firms to be independent and the need for firm's internal governance practices to be improved. The European Commission, in May of this year, published a Communication detailing the specific measures that may be applied in the near future in relation to some of these issues.

BOX III.3

Productive specialisation of Europe in comparison with the United States

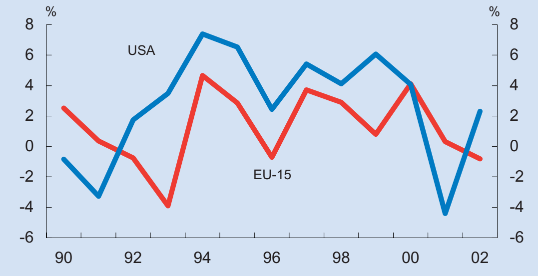
In the 1990s European manufacturing industry recorded moderate growth rates in comparison with those observed in the United States (see first panel). This disparity in manufacturing growth rates in the two economies re-emerged in 2002, after the sharp fall in value added in the United States in 2001. Thus the gross value added of European manufactures, expressed at constant prices, rose by 1.2% on average in the period 1990-2002, compared with 2.7% in the United States in the same period. Analysis of the characteristics and transformations of the pattern of productive specialisation in these regions could help to explain the reasons for such disparate behaviour.

The second panel shows the composition of gross value added at constant prices of the EU and the United States for 2000 (the latest year for which information is available), grouping the various industries by technological intensity. As can be seen, the structure of European manufactures was characterised by the predominance of medium-high technology industries, including most notably motor vehicles, electrical and electronic machinery, mechanical machinery and equipment and chemicals. The traditional industries with low technological requirements, particularly food, beverages and tobacco, also represented a high proportion of European industry, while those based on more advanced technology accounted for a small share. In the composition of US manufactures, production by medium-high technology industries was also significant, but particularly notable was the higher relative importance of manufactures involving the use of new technologies, such as the office materials and IT equipment and the electronic and communications materials sectors.

The transformations during the 1990s indicate that the productive structure of both areas shifted towards the higher technology sectors to the detriment of the so-called traditional activities. However, the increase in the share of high-technology manufactures in the productive structure of the EU, which amounted to 2.7%, was more moderate than that registered in the United states (5.6%), thereby widening the traditional gap between the United States and Europe in the relative weight of these sectors. Also the share of medium-high technology industries in the productive structure of the United States rose significantly – with particularly notable rises in electrical machinery and mechanical machinery – and in 2002 their weight was similar in the two areas. This contrasts with the relative position at the beginning of the 1990s, when the EU showed a certain relative specialisation in this type of production.

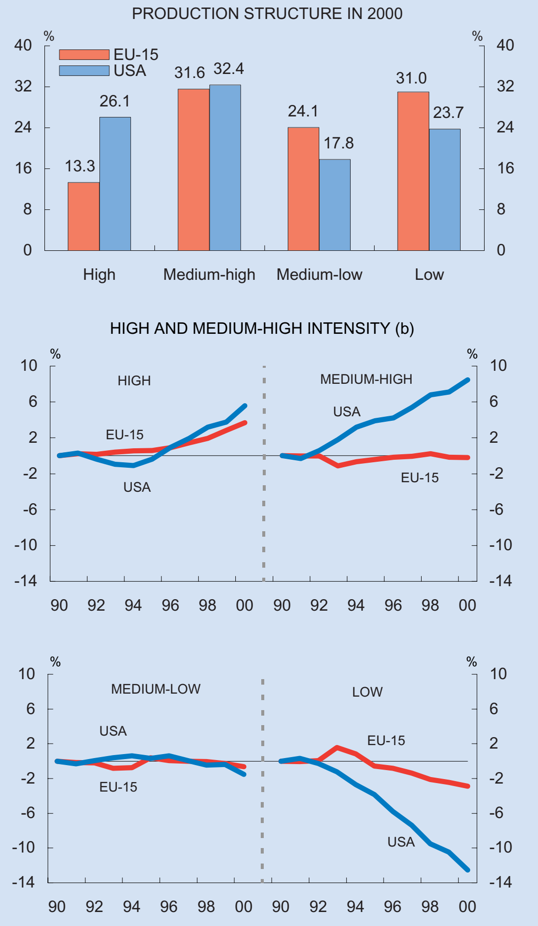
In all, the expansion of manufactures with greater technological requirements in the US economy has, on average, been much more marked than in the EU. Consequently, in 2000 the industrial structure of the EU as a whole continues, in comparision with the United States, to focus more on the lower technology sectors. The fact that European industry is more oriented towards traditional industries characterised by less buoyant world demand and higher competitive pressure from the more recently industrialised countries, may, among other factors, help to explain the reduced buoyancy of the European manufacturing sector in those years.

Gross value added of manufactures (a)



Sources: Banco de España, using AMECO databases (European Commission).
(a) Rate of change of the series at constant prices.

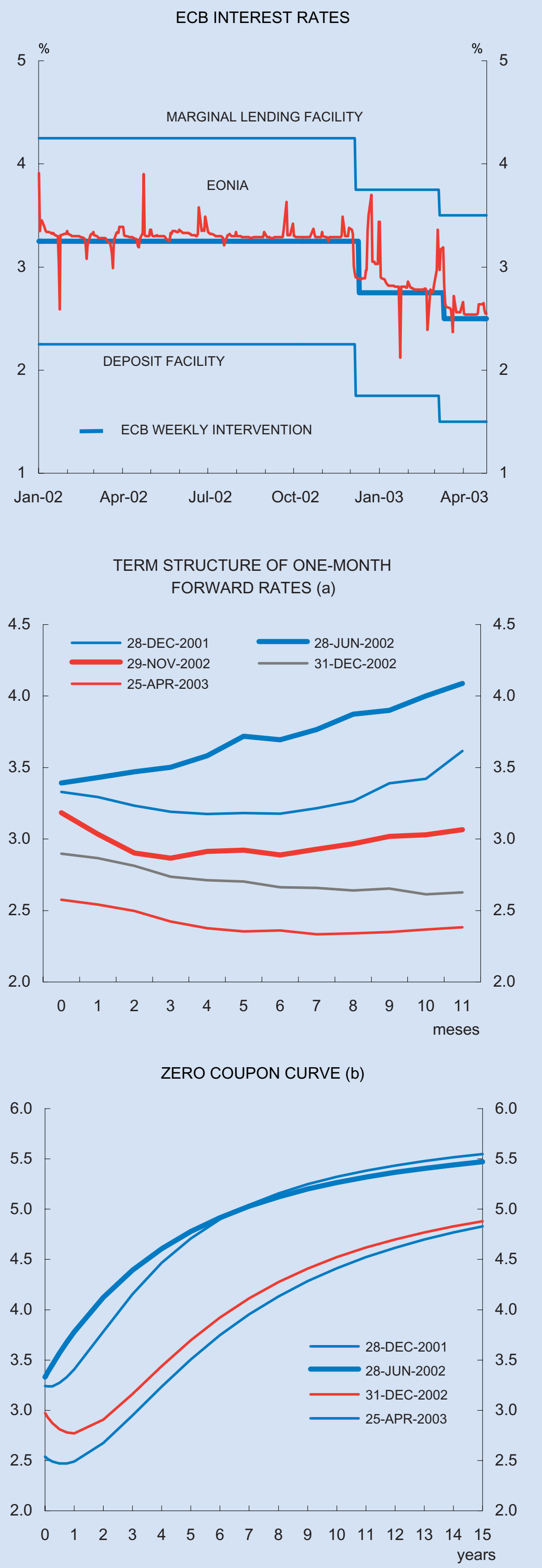
Productive specialisation by technological intensity (a)



Sources: Banco de España, using STAN (OECD) databases.
(a) Obtained from the value added at constant prices.
(b) Change with respect to 1990 in each product group's share in the structure.

CHART III.5

Euro area interest rates



Sources: Banco de España and ECB.
(a) Estimated using EURIBOR data.
(b) Estimated using swaps market data.

III.3. THE COMMON MONETARY POLICY AND MONETARY AND FINANCIAL CONDITIONS IN THE EURO AREA

III.3.1. Monetary policy decisions

In 2002, the growth of activity and, in particular, of domestic demand remained weak in the euro area for a large part of the year. This, along with some downward stickiness in inflation, made the monetary policy decision making process more complex, yet the ECB was still able to keep monetary conditions conducive to economic activity and compatible with its priority objective of preserving price stability.

In 2001, the existence of a relatively favourable inflation outlook had enabled the ECB to accommodate its policy to the downturn in the euro area. Interest rates were lowered by 1.5 percentage points that year, to 3.25% in November. In the first few months of 2002, the economic indicators were pointing to a gradual increase in real GDP growth over the year, helped by the improvement in the international environment. On the side of prices though, certain inflationary pressures were beginning to be discerned. These stemmed, in part, from the incipient economic recovery and from the behaviour of the less volatile components of the price index. As a result, the markets began to anticipate a change in stance towards a more restrictive monetary policy (see Chart III.5). However, the Governing Council of the ECB, even though it perceived certain inflationary risks at that time, decided to maintain a cautious approach, in view of the continued weakness of the economic recovery.

In the summer, it began to transpire that the recovery was not progressing as rapidly as expected, either in the euro area or in its external environment, while the time at which GDP growth in the area was expected to reach its potential rate receded to 2003. There was thus a deterioration in the confidence of economic agents which, along with further falls in stock values, had a negative impact on private spending decisions. The subdued tempo of economic activity, together with the appreciation of the euro (linked to the international tension, the imbalances in the US economy and the excessive depreciation of the European currency since 1999) relieved price pressures, although these were still being fuelled by the rise in oil prices and – despite the weakness in activity – continued wage inertia.

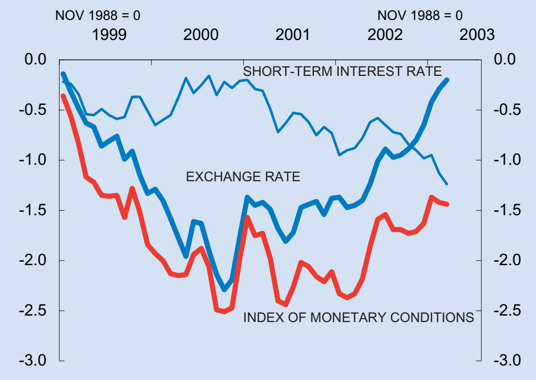
In the latter months of the year, growth expectations in the euro area deteriorated further. The appreciation of the euro intensified, mitigating the upward effect on prices of the rise in the dollar price of a barrel of oil, and the less volatile components of inflation began to abate for the first time in the year. Meanwhile, the further falls in stock values and the high level of risk premiums on private fixed income, along with the rise in the euro, meant that financial conditions were tighter than the level of interest rates and the rate of expansion of monetary aggregates implied (see Chart III.6). All this led the ECB, at its meeting of 5 December 2002, to reduce the rate on its main refinancing transactions by 50 basis points to 2.75%. In the opening months of 2003, global economic conditions deteriorated further, owing to the worsening of the political crisis associated with the war in Iraq and the consequent increase in instability on the financial and foreign-exchange markets. Against this background, the ECB again eased the stance of its monetary policy, on 6 March, lowering its policy rate at 2.50%.

As regards the implementation of monetary policy, there were certain moments in 2001 and 2002, marked by strong downward expectations, when the amounts demanded in the liquidity tenders were less than the Eurosystem's estimated liquidity requirements, hampering the smooth functioning of money markets. As a result, the ECB has proposed a change in the operational framework, which will come into force in 2004 (see Box III.4).

Also, in the first few months of 2003 the Eurosystem carried out a detailed evaluation of the performance of the monetary policy strategy during the four years since the start of Stage Three of EMU. The Governing Council concluded, on the basis of this evaluation, that the strategy had functioned satisfactorily and it confirmed its definition of price stability as "a year-on-year increase in the HICP for the euro area of below 2%". In addition, it clarified that in the pursuit of price stability it aims to maintain inflation rates at levels close to 2% over the medium term, in order to guard against the risks of deflation, while taking into account the possible measurement bias in HICP and the implications of national inflation differentials within the euro area. It also confirmed that its monetary policy decisions will continue to be based on a comprehensive analysis of the risks to price stability founded on a two-pillar framework. It resolved, however, to restructure the President's public statements, in order to stress the existence of a unified assessment of the outlook for prices based on the parallel evaluation of macroeconomic and monetary developments. The economic analysis identifies the short to medium-term inflationary risks. It is cross-checked with the monetary analysis, which is conducted from a medium to long-term perspective. The latter will continue to cover a wide range of indicators, including M3 whose reference value will no longer be reviewed by the Governing Council on an annual basis.

CHART III.6

Index of monetary conditions in the euro area: contributions (a)



Source: Banco de España.
(a) Rises in the index denote contraction, and falls, expansion. The index of monetary conditions is equal to the sum of the contributions.

III.3.2. Financial developments in the euro area

Developments on money and debt markets in 2002 were largely governed by the change in growth expectations for the area. Up until May, interest rates on interbank deposits increased, the longer the term the larger the rise, so that the slope of the yield curve changed with respect to December 2001. The improvement in the world economic outlook also helped to raise long-term interest rates in the euro area, in line with the movements seen in other economic areas. However, from June, pessimism on the future performance of activity led to falling yields. The decline in long-term rates was, to some extent, a result of financial shifts from equities towards safer assets, against a background of high uncertainty. Likewise, the exchange rate of the euro displayed two different trends. Following the weakness that it continued to display up until April, in May it embarked on an upward path that it remained

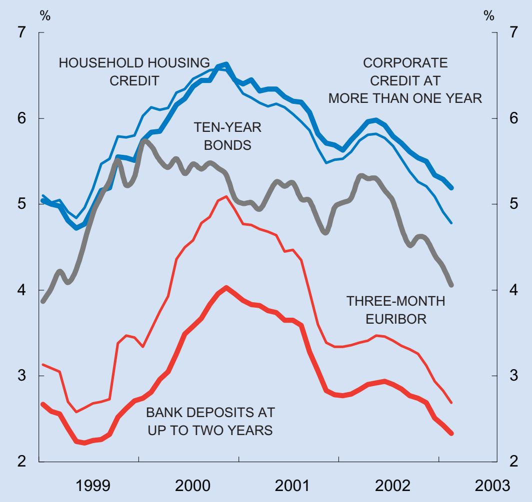
CHART III.7

Nominal euro exchange rate against the US dollar and the yen

Source: Banco de España.

CHART III.8

Euro area interest rates



Sources: Banco de España and ECB.

on in early 2003. Thus, between end-2001 and mid-May 2003 the euro appreciated by 30% relative to the US dollar (see Chart III.7).

The path of interest rates applied by credit and deposit institutions vis-à-vis their customers during the year was similar to that of interbank market rates (see Chart III.8). The interest rate on loans to enterprises with a maturity of more than one year stood in December 2002 half a percentage point below its end-2001 level, although it is likely that the deterioration in borrower creditworthiness was reflected in greater caution on the part of institutions when extending finance. Indeed, the increase in risk premiums on private fixed income and the notable fall in share prices for the third year running made it more difficult for firms to finance their investment projects (see Chart III.9). European indices fell by more than those of other areas, largely as a consequence of the deterioration in profitability prospects for significant projects in the IT and telecommunications field, the significant weakening of the macroeconomic outlook, and the unfavourable performance of European insurance companies, which were heavily penalised for certain disasters (such as 11 September and the floods of summer 2002) and for the decline in value of their own marketable assets (see Box V.2).

The significant shifts in agents' portfolios were also reflected in a strong rise in the demand for liquid assets, so that M3 growth held at high rates of around 7% throughout the year (see Chart III.10). Given that this greater preference for liquidity was not based on any need to carry out transactions, but rather stemmed from portfolio adjustment, the ECB considered that the strong increase in liquid assets did not in itself pose a risk to price stability, within its two-pillar strategy framework, so it did not bear on the decisions taken to ease monetary policy.

Financing to the private sector from Monetary Financial Institutions (MFIs) grew at a moderate rate throughout 2002 (4.7%). The more subdued economic activity in the euro area and the desire on the part of non-financial corporations to rebuild their balance sheet offset the effect of the reduction in interest rates.

A sectoral analysis reveals a loss of momentum in lending to non-financial corporations and an increase in lending to households, owing to the strength of loans for house purchase. Household debt thus increased again in 2002, to 51% of GDP, which is below the current ratio in the United States, Japan and the United Kingdom. By contrast, the level of debt of non-financial corporations (which, besides credit, includes corporate bonds and pension fund reserves) was more buoyant than bank loans, although it also slowed in 2002. Even so, the sector's debt-to-GDP ratio stood at historically high

BOX III.4

Measures to enhance the efficiency of the operational framework of monetary policy

The single monetary policy operational framework includes, as one of its basic tenets, a minimum reserve ratio whereby credit institutions are required to maintain for a specific time period (known as the maintenance period) a set average liquidity balance in their accounts with the central bank of the country in which they operate. In addition, the Eurosystem provides the bulk of liquidity through its main refinancing operations (MROs) which, since June 2000, have been conducted via a variable-rate tender (American or multiple-rate method) with a minimum interest rate for bids.

This means of establishing minimum reserves has a stabilising effect on money market interest rates since, if faced with an unexpected liquidity shortage (surplus), institutions are not obliged to turn immediately to this market to remedy it – which would drive interest rates up (down) – but can make use of their central bank deposits and offset, over the following days, the effect that this may have had on their average balance (1). However, this stabilising property is weakened when expectations (on occasions unfounded) of changes in the Eurosystem intervention rate become widespread. The second of the adjacent panels illustrates this by drawing on the experience of the four MROs in 2001, in which, as a result of the market's conviction about the imminent easing of monetary policy, the quantities demanded fell below the system's estimated liquidity requirements.

Standard deviations in daily changes in overnight interest rates

	EONIA (Euro area)	Fed Funds (USA)	Sonia (United Kingdom)
1999-2002	0.148	0.153	0.536
1999	0.173	0.184	0.406
2000	0.143	0.151	0.586
2001	0.155	0.182	0.493
2002	0.118	0.068	0.629

Deviations of the EONIA-minimum MRO rate spread from the average (a)

Basis points

MRO	Five days before the MRO	Five days after
13-Feb-01	-8.8	31.6
10-Apr-01	-8.8	74.2
09-Oct-01	-10.8	8.6
02-Nov-01	-6.8	25.0

Source: Banco de España.

(a) Deviation (five-day average) of the spread between the EONIA and the MRO minimum rate from the average of this series between June and November 2001.

Thus, if an institution expects a rate cut, it will wish to reduce its balance with the central bank now, when liquidity is relatively more expensive, with the intention of replenishing it after the cut. This will lead to downward pressure on interbank interest rates. The table shows how, in the days preceding those tenders, the spread between the EONIA and the minimum bid rate indeed tended to stand below the average level. In addition, the institution will demand fewer funds in MROs. If these expectations become general, the quantitites demanded in the tender will, overall, be insufficient to cover the system's needs and the lack of liquidity will become apparent immediately after the tender. This means that, as confirmed by the table, money market rates will tend to stand above their average. In short, expectations cause rates to be more volatile than would be desirable.

This is the background against which one must view the measures recently adopted by the ECB Governing Council to change the scheduled maintenance periods and reduce the MRO maturity period from two weeks to one week (2). Together with the decision adopted in autumn of 2001 whereby the assessment of the monetary policy stance – and possible intervention rate changes – will generally only take place in the first of the Governing Council's two meetings each month, these changes will enable the destabilising effects of money market expectations to be eliminated.

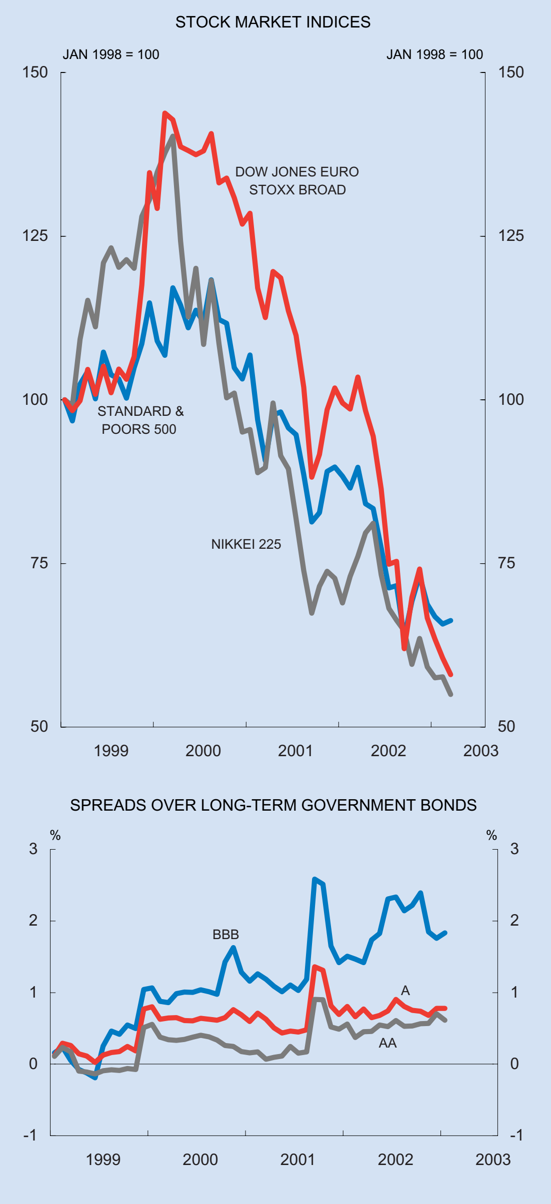
Following the new measures, each maintenance period will commence with the first MRO after the Governing Council meeting held to assess the single monetary policy stance, and end just before the equivalent tender the following month. Also, MROs will cease to overlap as they have done to date, so none of them will provide liquidity that can be used to cover minimum reserve requirements relating to two consecutive maintenance periods. Consequently, at the beginning of each maintenance period, the institutions will know the minimum bid rate that will be in force for all the tenders in which liquidity can be obtained to cover the minimum reserve requirements for that particular period. Thus, even if, at a given time, the institutions expect a change in the minimum rate, they will know that the change will not occur until the current maintenance period has ended and, therefore, will not have any incentive to change either the management of their deposits with the central bank or the volume of their bids in Eurosystem liquidity tenders.

(1) Table 1 shows, for illustrative purposes, the short-term interest rate volatility that has resulted from the different monetary policy operational frameworks in the euro area, the United States and the United Kingdom.

(2) Their entry into force is planned for 2004 Q1.

CHART III.9

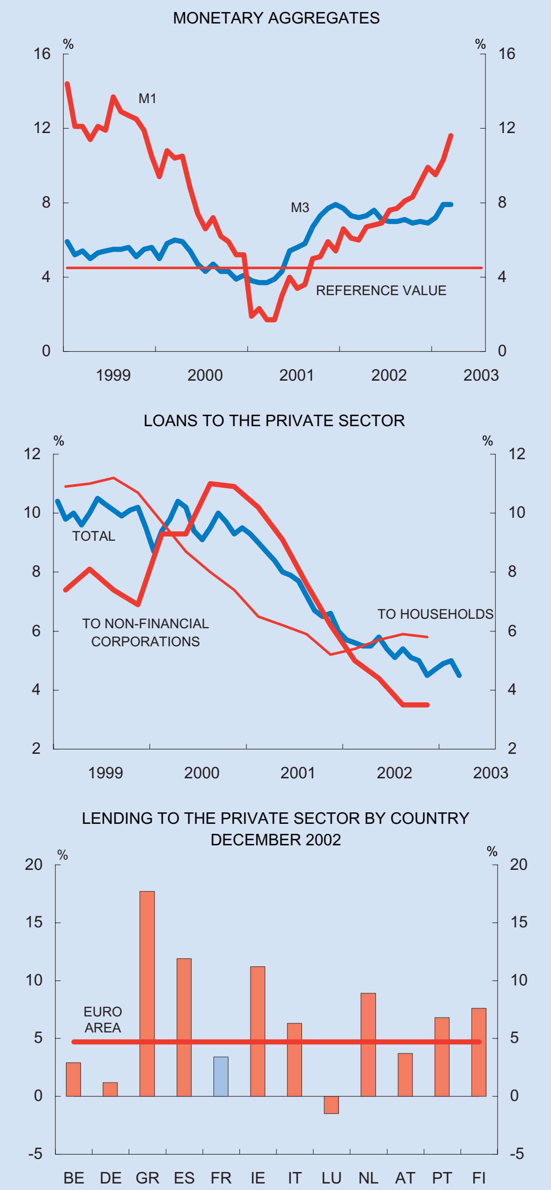
Stock market indices and corporate bond rates (a)



Sources: Banco de España and ECB.
(a) Euro-denominated bonds issued by non-financial corporations.

CHART III.10

Monetary and credit aggregates in the euro area Annual percentage changes



Sources: Banco de España and ECB.

levels (around 60%), largely as a result of the considerable increase in debt to finance mergers and acquisitions activity and the purchase of third generation (UMTS) mobile telephony licences between 1998 and 2000. Nonetheless, the debt service burden of non-financial corporations was lower at end-2002 than at the beginning of the 1990s, owing to the decline in interest rates.

Across countries, the behaviour of lending to the non-financial private sector also varied widely. Those economies in which nominal interest rates fell most as a result of participation in Stage Three of EMU and those in which property purchases remained buoyant, were also those with the highest rates of growth of financing (see Chart III.10). At the other extreme, the case of Germany was notable. Its unfavourable cyclical position, combined with greater caution on the part of institutions in their lending policy, partly related to certain structural weaknesses in the sector, led to stagnation in lending to the private sector.

The moderate rate of expansion of lending, together with the increase in bank deposits, enabled credit institutions to increase their net external assets considerably. As a result, net loans from euro area MFIs to the rest of the world totalled about €137 billion last year, which contrasts with the large flows of financing raised abroad by MFIs in 1999 and 2000. In 2002 there was also an increase in the net inflows of portfolio investment and a significant reduction in outflows of direct investment. In terms of the basic balance (defined here as the current and capital account balance, together with the net stock of direct and portfolio investment), these movements meant that the euro area recorded a surplus in 2002, for the first time since the start of Stage Three of EMU, which may have helped the euro to rise during the year.

CHAPTER IV

THE SPANISH ECONOMY

IV.1. ECONOMIC POLICIES

IV.1.1. Monetary and financial conditions

Throughout 2002 relative financing conditions, which are analysed in greater detail in the following chapter, were considerably generous in Spain, to a greater extent than in the euro area on average. Despite the prevailing uncertainty, households and companies retained their confidence that a framework of macroeconomic stability would firm. As a result, the generosity of financial conditions led private-sector agents to resort to greater debt to finance their spending decisions, thereby contributing to limiting the intensity and scale of the current cyclical downturn.

As discussed in the previous chapter, money market interest rates in the euro area resumed from mid-2002 the declining path that characterised their behaviour throughout 2001. They were influenced by the expectations of a cut in the ECB official intervention rate, which came about in December and, again, in March this year. In Spain, banks' lending and deposit interest rates moved in the same direction, although the decline was more marked in the case of the former which ended the year 46 basis points (b.p.) below the related figure as at December 2001; deposits rates, for their part, fell by 16 b.p.. This trend has continued into the opening months of 2003.

Spanish long-term government debt yields also declined substantially during 2002, ending the year at around 4.4% in the case of 10-year bonds, with a virtually zero spread over the related German *bund*. This trend has also been maintained in the early months of the current year. However, the pass-through of these movements to the financing costs relevant to business decisions would not seem to be complete, since the risk premia of the biggest Spanish corporations traded on the credit derivatives markets increased, and some even saw their credit quality downgraded.

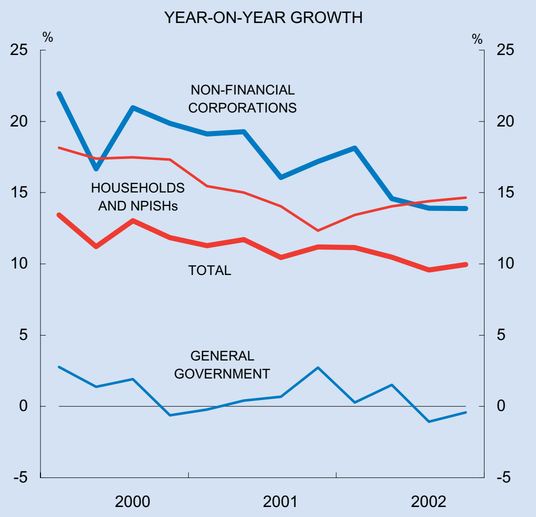
The impact of short- and long-term interest rate cuts on the habitual indicators of monetary and financial conditions was heightened by the increase in the inflation rate compared with the previous year. Conversely, the gradual appreciation of the euro during 2002, discussed in detail in the previous chapter, operated in the opposite direction, as did movements in stock market prices.

In fact, for the third year running the main domestic stock market indices fell back (by 28.1% in the case of the IBEX 35), by a similar proportion to those in the United States, but less so than was the case in most European centres. These lower prices were accompanied, moreover, by high volatility, which ran into the opening months of 2003. This reflected the substantial uncertainty still prevailing in most of the main developed economies.

The adverse impact of the fall in share prices on Spanish household wealth tended to be offset by the favourable effect derived from rising house prices, the main asset held by households. The average price of appraised houses grew in 2002 by 16.6% according to official Spanish data (Ministerio de Fomento), 1.2 p.p. up on 2001, giving a cumulative increase of more than 70% over the past four years. This increase is largely due to changes in the fundamental determinants of house prices, such as income and interest rates. Nevertheless, the presence of an element of overvaluation is increasingly evident, though it is likely this will gradually be corrected in the future, as was the case following the last expansionary phase of the house market at the beginning of the nineties.

CHART IV.1

Financing of non-financial resident sectors



Source: Banco de España.

In these conditions, the annual growth of financing received by Spanish households stood in 2002 at around 15%, up on the rate a year earlier. As to the annual growth rate of financing raised by non-financial corporations, this was around 14%, although the figure shows a slowdown on the previous year, in line with what is to be expected of the comparatively more pro-cyclical nature generally characterising business credit (see Chart IV.1).

The expansionary course of financing to the non-financial private sector in 2002 led households' and companies' debt ratios to increase to high levels. The associated financial burden, however, held relatively stable (it even fell slightly in the case of households), thanks to the above-mentioned trajectory of interest rates. While the increases in their liabilities were compatible with continuing sound financial positions in both sectors, higher debt levels entail a greater exposure of Spanish households and firms to potential disturbances that may adversely affect their revenue, their wealth or their financial costs.

IV.1.2. Domestic macroeconomic policies

Fiscal policy in 2002 was geared, for the second year running, to attaining a balanced budget, and this was duly reflected in the State budget. Nonetheless, the budget was drawn up at a time of great uncertainty in respect of the international macroeconomic scenario, following the 11 September attacks. This prompted the implementation of a series of measures to boost activity and innovation. The Updated Stability Programme for the period 2001-2005, which was unveiled in December 2001, already incorporated a GDP growth forecast in 2002 of 2.4%, a somewhat more moderate figure than the initial budget projection, although it did reiterate the zero-deficit target.

The budget estimated that the achievement of a balanced position in respect of the general government non-financial transactions account would be obtained on the basis of a State deficit of 0.5 p.p. of GDP, a balanced Territorial Government position and a surplus on the Social Security System, also of the order of 0.5 p.p. of GDP. It was thus envisaged that the drive by the different government tiers to achieve a balanced budget would be maintained in 2002, although the latest available data for 2001 and, as will be seen later, also for 2002 indicate a lesser fiscal effort by the Regional Governments, countered by more favourable Social Security results.

Numerous discretionary fiscal measures were applied in 2002 in seeking to meet various objectives. First, the measures which in recent years had underpinned the reduction in primary current expenditure (principally, the updating of civil service wages on the basis of the official inflation forecast and the continuing freeze on public-sector vacancies) were extended so as to remain in force, at the same time that a more dynamic schedule for government investment was laid down. Further, the personal income tax schedule and the amount of the related personal and family tax-free allowances were frozen, certain indirect taxes were revised upwards (dues and fees, the standard VAT rate on toll roads, motorcycles and propane and butane, and excise duties on alcohol, beer and tobacco), and a new tax on retail sales of fuel was created, as part of the reform of regional government financing arrangements. Lastly, a series of measures was introduced, mainly via corporate income tax, with the aim of boosting activity, fostering innovation and promoting the use of new technologies, along with achieving greater neutrality in the treatment of corporate concentrations. The measures included new deductions from gross tax payable (relating to investment in assets intended for R+D activities and technological innovation and to companies' contributions to employee pension schemes), the extension of the scope of application of tax incentives to SMEs and the reduction of the tax on retained earnings which, as will be seen in section IV.7, had a very positive temporary effect on corporate income tax takings during 2002.

This set of fiscal policy measures was expected to exert a moderate restraining influence in 2002 that would, for the second year in succession, enable a balanced budget or a budget surplus to be attained, in compliance with the requirements of the Stability and Growth Pact. On the fiscal projections of the Updated Stability and Growth Pact (2001-2005), this position would be consolidated over the projection period with surpluses on the general government account in 2004 and 2005 of 0.1% and 0.2% of GDP, respectively. This improved fiscal position over the medium term would be accompanied by a significant decline in the public debt/GDP ratio from 55.7% in 2002 to 50% in 2005.

Regarding other aspects of general government conduct, new financing arrangements for the ordinary-regime regional (autonomous) governments were set in place in 2002. These are very important in view of their repercussions in terms of furthering decentralisation and fiscal co-responsibility. The adoption of the new arrangements – which became permanent and particular to all the regional governments- entailed undertaking a far-reaching reform of the previous system, since it provided for the integration of the financing of health care and of social services into the overall system of financing, broadened the territorial tax base underpinning regional government spending and conferred greater enabling power on the regional governments in relation to the taxes assigned. The implementation of the new arrangements entails, however, new challenges. If they are to work properly, the transparency of the regional governments' budgetary outturn must be reinforced and co-ordination between the different general government tiers must be stepped up.

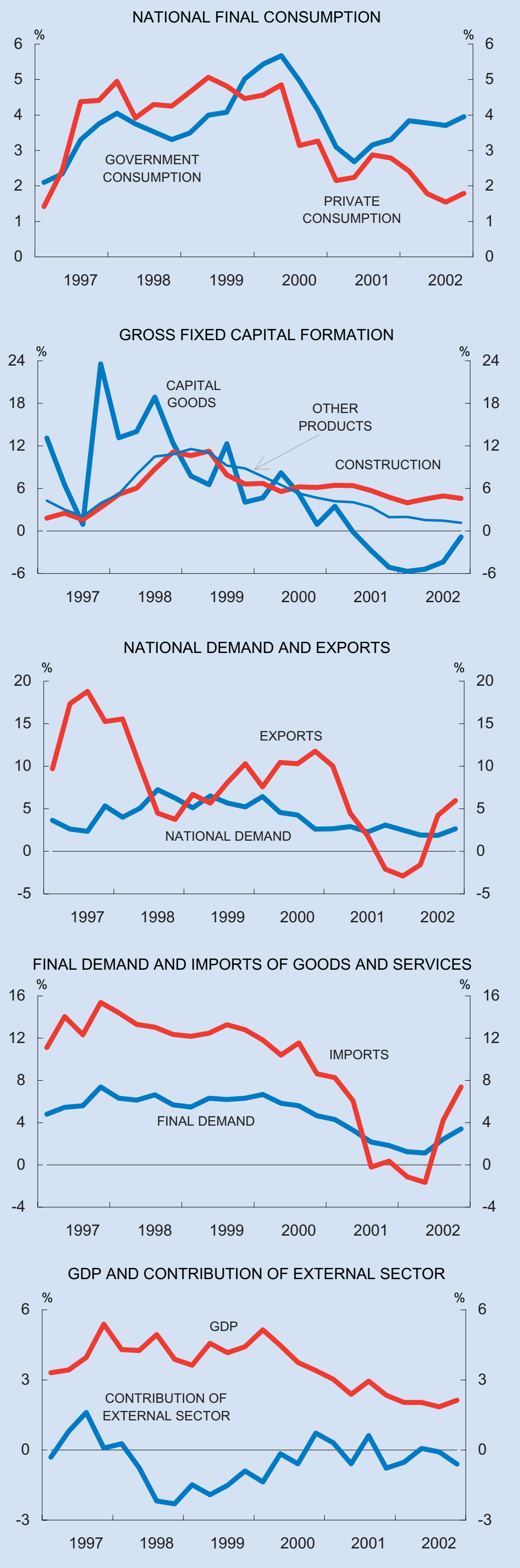
Turning to pension systems, 2002 saw the introduction of a series of measures stemming from the application of the Resolution for the improvement and development of the social protection system, signed a year earlier. Some of the measures (which were included in the 2002 budget) were intended to improve widows' and orphans' pensions, along with certain minimum pensions, and thus had an expansionary effect on welfare benefit spending. Measures were also taken to strengthen the financial position of the Social Security System over the long term, including most notably the incorporation into the budget of a new provision for the reserve fund for pensions (totalling EUR 1.2 billion) and a series of measures to increase the rate of employment and the participation rate of the elderly. The latter measures were implemented mainly through two means: a cut in employers' Social Security contributions, and the setting in place of a gradual and flexible retirement system which, among other developments, makes the retirement pension compatible with part-time work (1). There was no overhaul, however, of the pension system, as had been called for owing to the risks arising from the foreseeable ageing of the Spanish population for the future sustainability of public finances. The European Commission and ECOFIN made an announcement in this connection in their evaluation of Spain's Updated Stability Programme (2001-2005), while favourably assessing the fiscal consolidation drive undertaken in recent years.

Employment policy remained geared to the promotion of stable employment and to the employment of groups with the highest unemployment rates, through the extension of the employment-promoting permanent contract and continuing rebates on social security contributions. Moreover, the government decided in May on a reform of the unemployment benefit system, and its associated agricultural component. This was covered by Royal Decree Law 5/2002 on urgent measures for the reform of the unemployment protection system and on improvements in employability, which was partly revised during its passage through Parliament. Among other aspects, the Royal Decree amended the general conditions for qualifying for unemployment and maintaining the attendant benefits, requiring of the unemployed a signature committing themselves to labour activity, extending the definition of suitable employment and establishing a stricter sanctioning regime, applicable in the event of a job deemed suitable not being accepted. Further, it restricted the access of new beneficiaries to the agricultural benefit system in place until then for casual labourers in Andalusia and Extremadura, and introduced a new contributory system adapted to the characteristics of agricultural em-

(1) As regulated in Royal Decree-Law 16/2001 of 27 December 2001; in Law 35/2002 of 12 July 2002, and in the subsequent regulatory implementation thereof via Royal Decree 1132/2002 of 31 October 2002.

CHART IV.2

Main macroeconomic aggregates (a)



Source: INE.
(a) Year-on-year rates of change based on seasonally adjusted series in real terms.

ployment, extensive to all Spanish regions. More recently (2), an assistance-based system has been established for new casual agricultural labourers in Andalusia and Extremadura, which seeks to alleviate some of the main shortcomings of the previous system. This raft of measures attempts to strengthen the link between the receipt of benefits and job-search by the unemployed, thereby increasing their employment potential. Conversely, no headway was made in reforming collective bargaining.

Finally, policies to liberalise and increase competition in the markets for goods and services focused once again on the implementation of certain measures from the June 2000 liberalisation package still pending (mainly the unbundling of the shareholder base of the companies owning the liquid hydrocarbons and gas distribution networks, and the implementation of an integrated economic system for the gas industry). Measures were also adopted to bolster fair competition, by means of the amendment of the legal nature of Spain's fair trading watchdog agency – which became an independent body in 2002 – and the strengthening of its financial autonomy.

IV.2. DEMAND

Against the background of the monetary and financial conditions and of the economic policies described in the previous section, domestic expenditure continued to slow in 2002, while the weakness prevailing in the international environment led to lower growth in goods and services exports. Overall, final demand grew by 2.1%, against 2.9% in 2001. It moved on a clearly slowing profile in the first half of the year, and improved slightly in the second half, mainly on the basis of the pick-up in exports (see Chart IV. 2). Under national demand, which grew by 2.2% in 2002, 0.5 p.p. down on the previous year, investment in capital goods was cut substantially, while spending on construction and government consumption continued to underpin activity.

The growth of household final consumption spending moderated in 2002, although its rate of change tended to stabilise in the closing months of the year. The annual average increase in this variable was thus 1.9%, 0.6 p.p. less than in 2001, when it had

(2) On 11 April, further to the approval of Royal-Decree 426/2003.

TABLE IV.1

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

	% of GDP		Rate of change					
	1995	2002	1997	1998	1999	2000	2001	2002
HOUSEHOLDS AND NPISHs:								
Final consumption expenditure	59.8	59.2	3.2	4.4	4.7	3.9	2.5	1.9
Durable consumption	*6.6*	*7.8*	*9.9*	*12.9*	*12.2*	*1.3*	*0.5*	*1.0*
Non-durable consumption	*53.2*	*51.4*	*2.3*	*3.2*	*3.6*	*4.4*	*2.8*	*2.0*
Residential domestic investment (b)	5.7	6.5	0.3	8.6	8.6	8.6	1.7	1.5
CORPORATIONS:								
Private productive investment (c)	12.6	14.9	7.8	9.7	9.8	7.1	3.5	0.4
Construction and other products	*6.3*	*7.4*	*4.6*	*3.0*	*11.1*	*10.4*	*9.6*	*6.2*
Equipment and other products	*6.3*	*7.5*	*10.7*	*15.2*	*8.7*	*4.6*	*-1.4*	*-4.8*
GENERAL GOVERNMENT:								
Final consumption expenditure	18.1	18.1	2.9	3.7	4.2	5.0	3.1	3.8
Gross fixed capital formation	3.7	3.3	2.4	14.1	4.9	-5.8	5.2	6.2
Of which:								
Construction and other products	*2.9*	*2.4*	*1.2*	*18.3*	*5.1*	*-9.9*	*5.1*	*6.4*
MEMORANDUM ITEM:								
Gross fixed capital formation	22.0	24.7	5.0	10.0	8.7	5.7	3.2	1.4
Equipment	*6.1*	*7.1*	*10.8*	*14.5*	*7.6*	*4.7*	*-1.2*	*-4.1*
Construction	*12.6*	*13.8*	*2.3*	*7.8*	*9.0*	*6.2*	*5.8*	*4.5*
Other products	*3.3*	*3.8*	*3.3*	*8.7*	*10.1*	*6.0*	*3.4*	*1.5*

Sources: INE and Banco de España.
(a) Data in real terms
(b) Excludes investment by sole proprietors.
(c) Includes investment by sole proprietors.

slowed sharply (see Table IV.1). In terms of the end-uses of spending, the loss of steam affected non-durable consumption and, under durable goods, car purchases (new car registrations fell by more than 6.5%), while purchases of other durables linked to housing picked up notably.

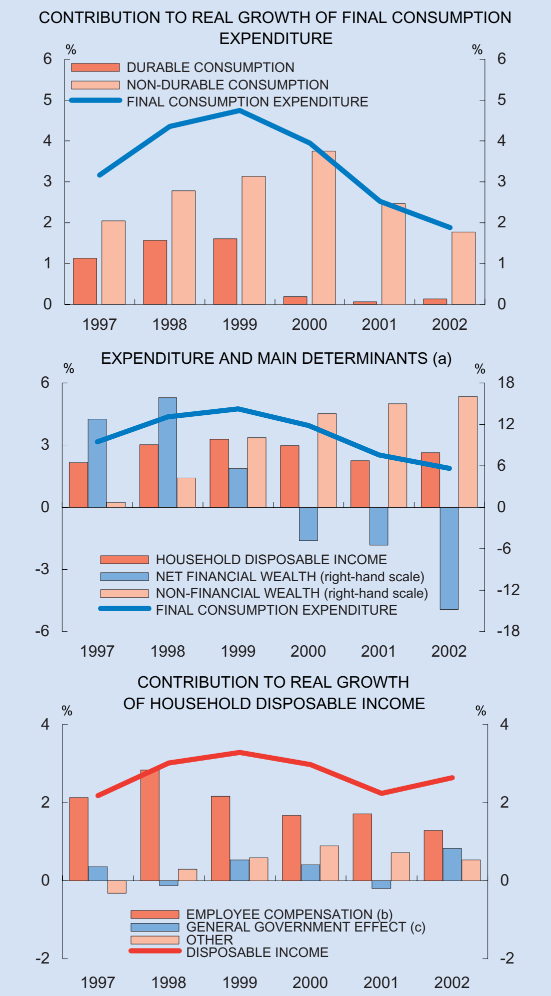
Among the factors contributing to the increase in consumption in 2002 were, first, disposable income, which accelerated slightly on the previous year. In fact, despite the increase in the inflation rate, gross disposable income grew by 2.6% in real terms, 0.3 p.p. up on the related figure for 2001 (see Chart IV.3). This moderate pick-up was due to the bigger general government contribution and to the improvement in the contribution of net property income. In turn, the favourable influence of the public sector on household income was a consequence of a higher contribution by welfare benefits. By contrast, the contribution of wage income (excluding social security contributions) fell slightly, reflecting a more moderate – albeit still positive – pace of job creation. In any event, wages and employment remained the most important factors behind the increase in disposable income.

As indicated, the interest rate cuts in 2002 exerted a restraining influence on households' net financial burden. This effect has added to that habitually arising through the substitution of future consumption and the lesser incentive to save.

Household spending decisions were also influenced by changes in their net worth. As previously mentioned and reflected in Chart IV.3, two effects of differing signs combined here. On one side, there was a reduction in the value of households' net financial wealth which added to those incurred in previous years, bearing negatively on their spending capacity. On the other, the notable rise in real-estate

CHART IV.3

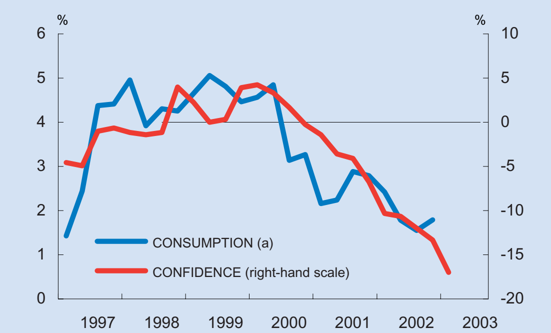
Final consumption of households and NPISHs



Sources: INE and Banco de España.
(a) Real rates of change.
(b) Net of social contributions.
(c) Includes social benefits and taxes on income and wealth.

CHART IV.4

Final household consumption and confidence indicator



Sources: INE and European Commission.
(a) Year-on-year growth rate of the real seasonally adjusted series of final consumption spending of households and NPISHs.

wealth in recent years has tended to offset the restrictive effect on consumption of the losses in financial wealth.

Finally, the turbulence on international financial markets, growing uncertainty over the future course of the world economy and the risks inherent in the geopolitical situation all influenced consumer confidence, which deteriorated notably throughout the year (see Chart IV.4). This loss of confidence may have adversely affected consumption, favouring precautionary saving, although it is difficult to specify the actual contribution. Overall, the information available indicates that the household saving ratio stood at 10.6% in 2002, several tenths of a point up on its level in 2001. Box IV.1 analyses the determinants of the course of private consumption and of the saving ratio over a longer time span running from the start of the nineties to the present day.

The pace of domestic residential investment by households continued to moderate last year, after having expanded notably in the 1998-2000 period (see Chart IV.5). Among the factors behind the diminished buoyancy of house purchases in 2001 and 2002 are the lower growth of household disposable income and the cumulative increase of 50% in the relative price of housing between 1998 and 2002. This notable price rise has been reflected in the deterioration in the affordability indicators (such as the real household income/house-price ratio or wage costs) and in the ongoing increase in the effort required to buy a house through bank financing, despite the reduction in nominal interest rates. The discouragement effects arising from dearer housing may have proven particularly significant for households seeking a dwelling for habitual residence purposes.

However, house-price increases, insofar as they have fuelled expectations of a rise in the value of real-estate assets, may have also stimulated the demand for housing as a means of wealth placement, especially in view of the continuing low return offered by alternative placements in financial assets in 2002, below, indeed, the return arising from house rental (see Chart IV.5). In this respect, the vigour of second-home purchases and the fact that a significant proportion of dwellings remain unoccupied, according to the latest census, would indicate that this type of demand has been most substantial in recent years. Likewise, the demand by non-residents, though it showed clear signs of slowing, continued to exert

Factors explaining the slowdown in private consumption

The slowdown in the final consumption expenditure of Spanish households that began in 2000 continued over the course of 2002. During the upturn, between 1997 and 1999, household consumption had expanded rapidly, at an annual average rate of 4%, well above the rates recorded in the other euro area countries and close to the rate of growth of consumption in the United States (see adjoining table). The factors explaining this rapid growth and the subsequent slowdown are closely related to the cyclical position of the Spanish economy and the changes in household wealth or net worth, and in accordance with the main determinants of aggregate consumption suggested by economic theory. At any rate, that is what is indicated by the results of the consumption equation of the Banco de España's quarterly model (MTBE).

The theoretical literature which analyses household spending decisions within a framework of inter-temporal choice indicates that aggregate consumption expenditure depends on income and non-human wealth, i.e. on the net worth that households have invested in real and financial assets. Also, the real rate of interest affects the time profile of household spending, through its bearing on the rate of substitution between present and future consumption. Interest rate changes indirectly generate an income effect on consumption, the sign of which depends on households' balance sheet position (credit or debit), and a wealth effect, through their effect on the market value of real and financial wealth. Finally, the degree of uncertainty is a further factor influencing household consumption and saving decisions.

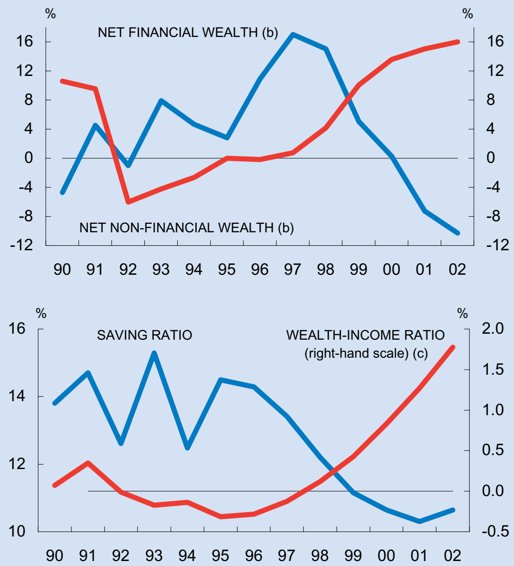
The consumption equation of the MTBE incorporates these determinants, although the degree of uncertainty surrounding household decisions is only incorporated insofar as it affects other variables in the equation. The adjoining table shows the contributions of these factors to annual consumption growth over the course of the 1990s and the first few years of the current decade, distinguishing between phases of stronger and weaker growth in this variable. Real income is seen to be the main determinant of household final consumption, although the time profile of this aggregate is significantly affected by other variables. During the last economic upturn (1997-1999) the growth of household consumption was significantly higher than that of the contribution from real income, essentially because of the rise in the real value of the sector's wealth. The behaviour of financial wealth, stemming from the rise in the value of financial assets, explains the high growth in household net worth between 1996 and 1999 (see adjoining chart). Subsequently the notable increase in real-estate wealth has sustained the growth of total wealth, albeit at a lower rate, since the value of net financial assets has declined over the last two years. These developments in household net worth meant that the contribution of wealth to consumption growth between 2000 and 2002 was smaller. This largely explains the slowdown in consumption, even when the contribution of disposable income held unchanged. Meanwhile, the progressive decline in real interest rates since the mid-1990s tended to be conducive to consumption growth. Even though the direct contribution from this factor was generally moderate, a significant part of the rise in the value of wealth was in fact attributable to the fall in interest rates, so that the contribution through this indirect channel may have been much larger.

The bottom panel of the chart shows the implications of the developments in consumption and its main determinants for the household saving ratio. The strong growth of household wealth in the second half of the 1990s, insofar as it was passed through to consumption expenditure on goods and services, partly explains the increase in the average propensity to consume and the gradual decline in the saving ratio in this period. Also contributing to this decline were the reduction in the real interest rate and the favourable effect of the prospects of membership of the Monetary Union on consumer expectations. However, the decline in the saving ratio moderated and came to an end in 2002, as the main factors driving it (increase in real and financial wealth, decline in real interest rates) petered out and the prospects for the future situation of the economy became more uncertain.

Household consumption
Contributions to the annual change (a)

%

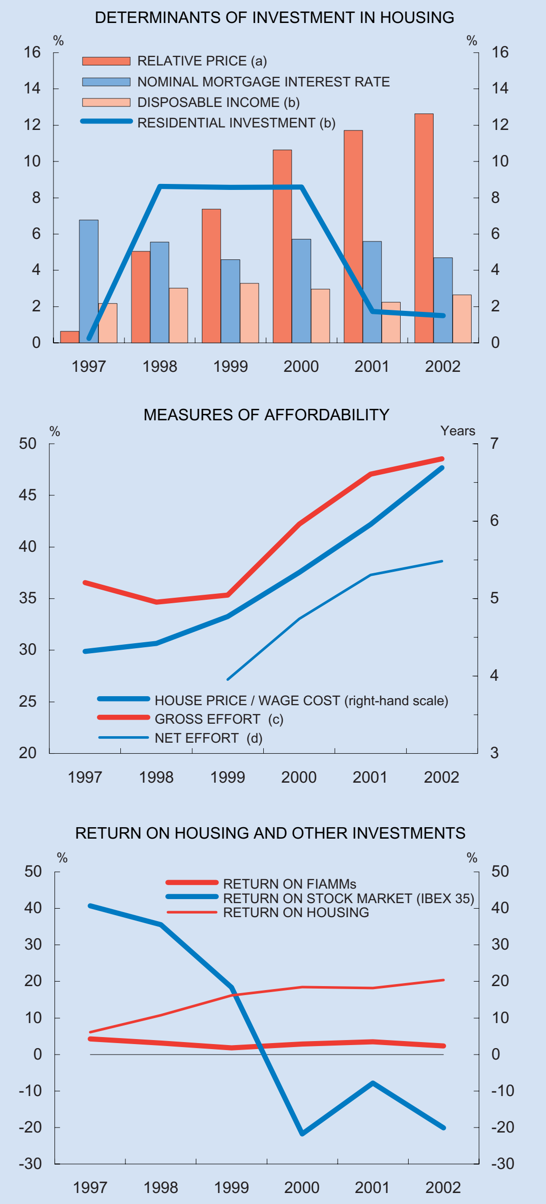
	1991-1993	1994-1996	1997-1999	2000-2002
Private consumption	**1.0**	**1.6**	**4.0**	**2.7**
Gross disposable income	3.0	1.0	2.4	2.5
Wealth	-0.6	0.4	1.1	0.6
Interest rate	0.1	0.0	0.2	0.0
Dummies and unexplained component	-1.5	0.2	0.3	-0.4
MEMORANDUM ITEM:				
Saving ratio	14.2	13.8	12.3	10.5



Sources: Instituto Nacional de Estadística and Banco de España.
(a) In real terms.
(b) Deflated by the consumption deflator. Rate of change.
(c) Cumulative change

CHART IV.5

Residential investment



Sources: INE, Ministerio de Fomento and Banco de España.
(a) Price of new housing in relation to the private consumption deflator.
(b) Real rates of change.
(c) Annual payment as a percentage of wage costs.
(d) Gross effort minus tax rebates.

pressure on the Spanish property market last year, as highlighted by the increase in foreign investment in property.

In 2002 as a whole, corporate gross fixed capital formation is estimated to have increased by 0.4%, extending the ongoing slowdown embarked upon by this aggregate in 2000 into its third consecutive year. As Table IV.1 shows, business investment last year was the result of an uneven performance of its respective components. Whereas investment in construction maintained high growth, holding stable at around 6.2% throughout the year, investment in capital goods fell substantially, at a negative rate of –4.8% in annual average terms, although the rate of deterioration was checked in the closing months of the year. Regarding investment in construction, although non-residential building was considerably robust in 2002, the thrust of investment in civil engineering works by the major state-owned companies was particularly notable, as was the sizable volume of spending on railway infrastructure, which National Accounts record as business investment.

The scant vigour of private productive investment last year was primarily due to the sluggishness of final demand which, as shown in Chart IV.6, increased by scarcely 2.1%. Compounding this, moreover, was the continuing climate (since the second half of 2001) of notable uncertainty over the international economic environment, which continued to affect business expectations in 2002, particularly sharply so in the first half of year. Set against this, the user cost of capital, which reflects the difference between nominal interest rates and the increase in the prices of investment goods, fell as a result, partly, of the lower increase in the price of these assets, which may have influenced their expansionary effect.

The weakness of final demand was reflected in a reduction in capacity utilisation in industry, which stood at around 76% during the first three quarters of the year, clearly below its historical average (78.2%). Drawing on information from the half-yearly investment survey, the investment forecasts for 2002 for industrial companies were systematically scaled back as from autumn 2001. Nonetheless, as indicated, investment in capital goods improved somewhat from the second half of the year, as their rate of decline fell. This was in keeping with the export-led greater buoyancy of final demand in the second half of the year. Both the business confidence indicator and the results of the autumn 2002 half-yearly investment survey reflected this improvement, and also projected a modest recovery for the current year (see Chart IV.7). Likewise, capacity utilisation in industry increased in the closing months of last year to 79.3%, above its historical average.

As earlier mentioned, the user cost of capital fell in 2002, whether measured in relation to the GDP deflator or compared with the cost of the labour factor (see Chart IV.6). Broadly, financing conditions for Spanish companies remained favourable last year. On CBQ information, the weight of financial costs in corporations' cost structure declined considerably as a result of the fall in interest rates. Combined with the increase in the return on net assets, this made for a substantial widening of the differential between the two. Lower interest rates helped offset the effect of the slight increase in the corporate debt ratio on the associated financial burden.

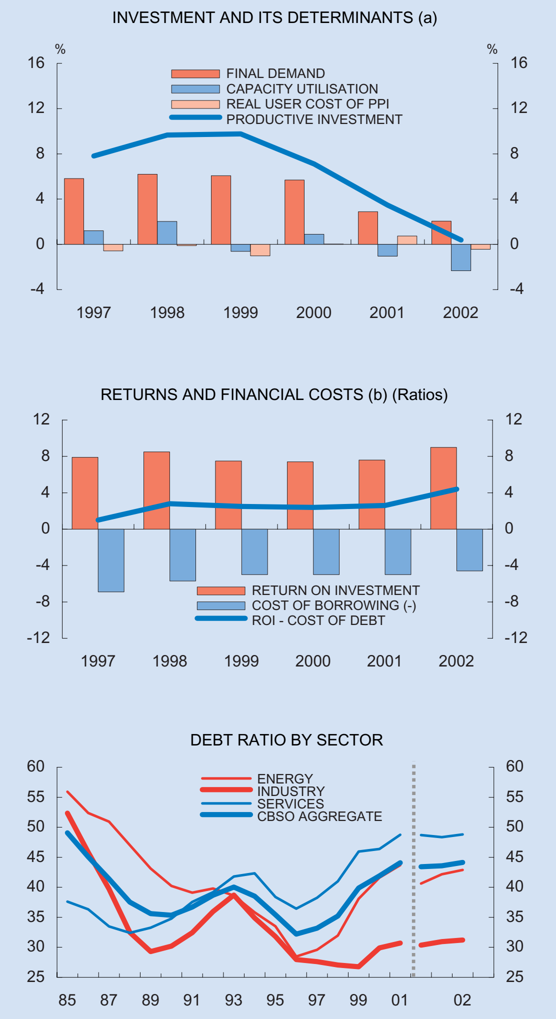
As regards the potential domestic investment shift effect that new investment opportunities abroad – essentially in Latin America – may have had in the past, outward foreign direct investment flows have fallen considerably since 2001 relative to the extraordinary level they reached in 2000. As a result, they stood at 2.8% of GDP in 2002 compared with 9.5% two years earlier.

The relative slackness of investment by Spanish corporations has contributed to the Spanish economy's low productivity growth and may hamper real convergence with the core EU economies. In this connection, Box IV.2 analyses the contribution of a specific type of investment, namely that in ICT products, to the growth of output and productivity. The foregoing analysis infers that Spanish companies are recording high levels of return and are sustaining healthy financial positions, which pose no obstacle whatsoever to the recovery in investment, although the debt levels reached could curtail the intensity with which new projects are undertaken in less favourable financing conditions. In these circumstances, if investment is to gain greater momentum it is necessary not only that the climate of notable economic uncertainty should abate and that growth prospects improve, but also that the workings of the economy should be sufficiently flexible and efficient for companies to pursue their expansion opportunities to the full.

In 2002 the contribution of stockbuilding to GDP growth was positive (0.1 p.p.), in step with the counter-cyclical behaviour of this variable. The monthly business survey reflected an increase in the involuntary stockbuilding component in the second half of the year, in response to the build-up in inventories in the intermediate goods industry and, more markedly, in the consumer goods industry. Conversely, however, stocks in the capital goods industry moved on a declining path, in line

CHART IV.6

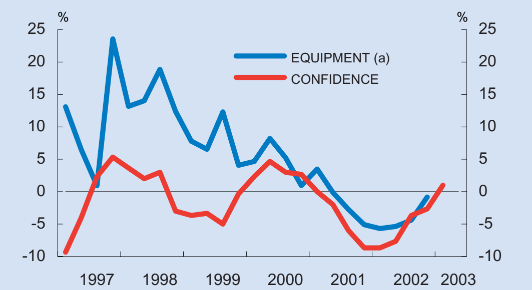
Private productive investment



Sources: INE, European Commission and Banco de España.
(a) Real rates of change and differences for the degree of plant capacity utilisation and for the real user cost of PPI.
(b) CBA data to 2001 and CBQ data for 2002.

CHART IV.7

Investment in capital goods and business confidence indicator



Sources: INE and European Commission.
(a) Year-on-year growth rate of the real seasonally adjusted series of gross fixed capital formation in capital goods.

with the pick-up in investment observed in the second half of 2002.

With respect to general government demand in 2002, final consumption spending by this sector grew by 3.8% in real terms compared with 3.1% the previous year (see Table IV.1). In nominal terms, the acceleration was on a similar scale, with growth of 7%. This performance is due to a significant expansion in net purchases by the public sector (partly as a result of spending arising from the sinking of the oil tanker "Prestige") and in social transfers in kind, which offset the lesser pace of expansion of public-sector employee compensation. Employee compensation grew by 5.2%, one point down on the previous year, owing to the slower pace of job creation in the public sector, since the growth rate of employee compensation held unchanged. Public investment remained highly buoyant, posting real growth of 6.2%. This is related to the implementation of the infrastructure investment plan.

Moving to the analysis of external demand, it should be recalled that the year 2002 began against a backdrop of international uncertainty. As a result, the contractionary course on which real goods and services exports had ended the previous year turned further down at the start of 2002 (see Chart IV.2). In mid-2002, however, as foreign markets picked up, exports gathered notable momentum, which firmed in the final months of the year. In the year as a whole, exports in real terms increased by 1.4%, two points down on 2001. In terms of components, the behaviour of goods and services differed greatly. While goods sales increased at a similar rate to that in 2001 (2.3%), albeit with an opposite profile, exports of services slowed appreciably, by 0.6%. The slippage in tourism receipts in real terms (-4%) was the main reason behind this poor performance.

During 2002, foreign markets remained sluggish, in line with the previous year; that said, developments across the economic regions were uneven. While the deterioration in the euro area markets intensified, with a slight contraction, markets in the rest of the world emerged from the recession at the beginning of the year and embarked on a modestly dynamic course. Against this background, real goods exports in the opening months of the year continued on the contracting trend on which they had moved at the end of the previous year, showing a moderately positive trend from Q2 onwards which firmed in the second half of the year, taking average growth to a rate of 2.3%. In any event, the growth of exports in recent years has been less than that recorded in the previous decade, which highlights the dampening effect that the recent cyclical slowdown concurrently affecting the different regions has had.

Another significant factor for evaluating the scant increase in goods exports in 2002 was the worsening of the competitive position of Spanish products. This was a progressive deterioration which occurred as the rise of the euro bore on the appreciation of relative prices and costs indices (see Chart IV.8). The loss of competitiveness came about despite export prices being contained, which made for an appreciable squeeze on exporters' margins, as discussed in section IV.6. It should be borne in mind that changes in the exchange rate affect competitiveness not only in non-euro area markets but also in the euro area itself, where Spanish products compete with imports from other regions.

The uneven picture across the economies comprising Spain's foreign markets led to the export performance differing according to the economic region involved. On Customs figures, real goods sales to the EU posted zero growth in 2002, in line with the slackness of this market, despite its picking up in Q3. In nominal terms, exports to our main trading partners trended at a more moderate rate than the previous year, and sales to Germany declined. Conversely, goods exports to the rest of the world took off prior to those of the euro area – in Q2 – and, boosted by the surge in demand in certain regions, they quickened notably at the end of the year, growing by 5% in real terms and gaining market share. As has occurred in recent years, sales to the EU acceding and accession countries were notably firm, in step with the buoyancy of these economies. There was also a significant increase in exports to OPEC countries and, on a lesser scale but with a gradual increase in share, in that in exports to China and Mexico. However, sales to the US continued to contract, picking up only at the end of the year, as did those to Japan and, above all, to South America, whose economies are mired in a deep recession.

World tourism in 2001 had been affected by the worsening economic outlook and, most particularly, by the heightened uncertainty that followed the 11 September terrorist attacks. These factors – which appear in certain respects to be altering tourist behaviour – continued to disrupt the normal course of tourist

BOX IV.2

The contribution of new technologies to growth in the Spanish economy

During the second half of the last decade there was an acceleration in the diffusion of new information and communication technologies (ICT) across the Spanish productive sector. This was evident in a notable increase in investment in ICT equipment, which was boosted by the price falls and quality improvements affecting such goods. On the evidence available, the rapid accumulation of this kind of capital contributed significantly to the growth of output and labour productivity.

To evaluate the differences in the pattern of incorporation of ICT capital goods in the productive processes of the manufacturing and market services sectors it is helpful to decompose the growth of output and apparent labour productivity into the contributions from the various productive factors (identifying among them the endowment of capital linked to the new technologies) and from total factor productivity (TFP). The contribution of each factor is in turn given by the product of its rate of change and the share of its cost in the total factor cost. Likewise, the growth of apparent labour productivity can be decomposed into factor contributions and TFP. In this case, the contribution of each factor is the product of the rate of change in the ratio of that factor to labour and of the share of its cost in the total factor cost. Given the lack of aggregate information to analyse the contribution of ICT capital to growth (in particular, the absence of an adequate measurement of the ICT capital stock), a sample of firms from the Banco de España's Central Balance Sheet Data Office for the period 1992-2001 was used as the source of information. The decomposition of growth for the major sectors was obtained by aggregating the results of the decomposition of growth for each firm in the sample (1).

The results may be summarised as follows. First, the contribution of ICT capital to output and productivity growth, although modest in absolute terms, was notable in both sectors. The contribution was especially high in the market services industries, in which, over the period as a whole, the accumulation of ICT capital accounts for somewhat more than 20% of labour productivity growth. Second, the high rate of accumulation of ICT capital in the period 1997-2001 explains the observed increase in the contribution to economic growth of this kind of capital, despite the fall in the cost of ICT capital relative to total costs. Again, this feature was more marked in services, where ICT capital contributed 0.42 p.p. to value-added growth in the period 1997-2001, as against 0.17 in the period 1992-96. In manufacturing, the increase in this contribution was more modest. The fact that the main user industries of the new technologies are in the services sector (communications, business services, distribution) is consistent with the rate of accumulation of ICT capital and the contribution to growth being higher in services than in manufacturing.

This growth decomposition exercise also reveals the notable increase in the contribution of labour to output growth during the period 1997-2001. This stemmed from the significant employment creation that took place in the second part of the sample period and from the increase in the share of labour compensation in total costs. At the same time, TFP has decelerated slightly in manufacturing and accelerated somewhat in services, although without reaching the rate of growth in manufacturing.

(1) The bias inherent in the composition of the sample used, which makes the aggregation of the results obtained for each individual firm difficult, means that the evidence obtained must be interpreted with some caution.

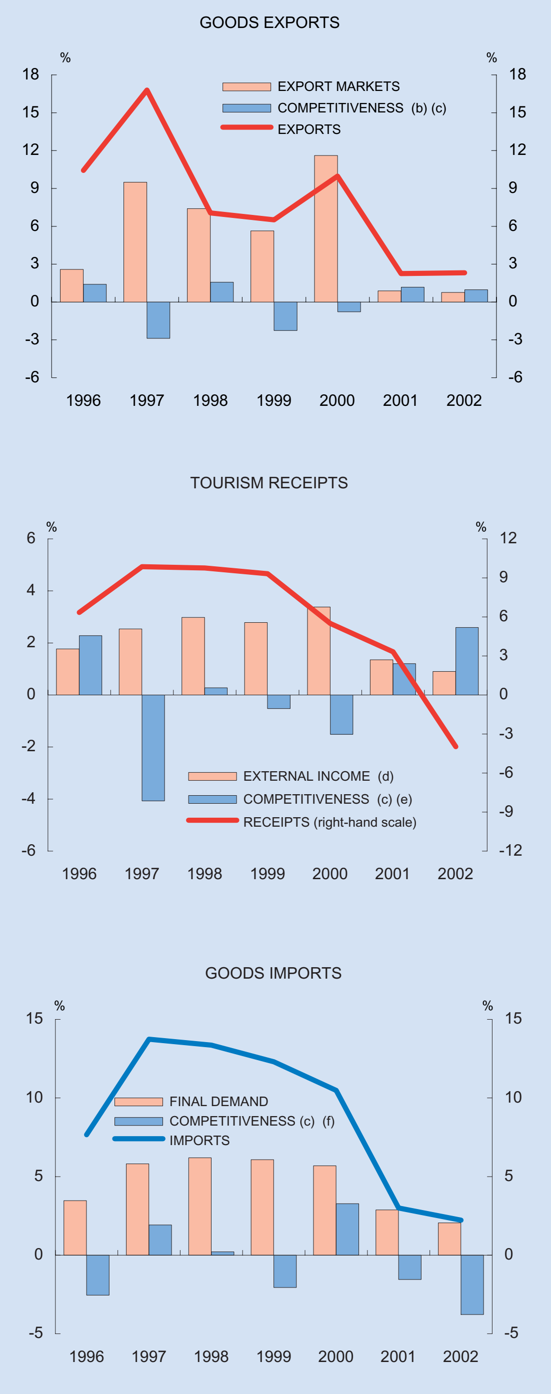
Contribution of ICT capital to growth of GVA and labour productivity (a)

	Manufacturing (b)		Market services (b)	
	1992-1996	1997-2001	1992-1996	1997-2001
GVA growth (%)	**1.79**	**4.39**	**0.67**	**5.42**
Contributions of:				
Employment (c)	-1.68	1.62	0.03	3.44
ICT	0.11	0.19	0.17	0.42
Other capital	-0.18	0.02	0.27	0.30
TFP	3.54	2.56	0.21	1.26
Growth of labour productivity (%) (c)	**3.89**	**2.44**	**0.56**	**1.37**
Contributions of:				
ICT (d)	0.16	0.14	0.14	0.30
Other capital (d)	0.19	-0.27	0.21	-0.19
TFP	3.54	2.56	0.21	1.26
Share in total costs (%)				
ICT	1.77	1.44	2.37	2.13
Other capital	17.63	13.68	19.02	13.71
Growth of productive factors (%)				
Employment (c)	-2.11	1.95	0.11	4.05
ICT	3.87	10.15	4.28	13.86
Other capital	-1.28	0.45	0.27	1.08

(a) Average annual figures for the sub-periods considered.
(b) The figures for the major sectors are the average of their constituent industries, weighted according to their value added. The results for each industry are obtained as the simple average of their constituent firms.
(c) In hours.
(d) The contribution of each type of capital to labour productivity growth is obtained as the product of the rate of change of the ratio between the type of capital in question and labour and of the share of its cost in the total factor cost.

CHART IV.8

External demand (a)



Sources: IMF, OECD, INE and Banco de España.
(a) Year-on-year real rates of change.
(b) Measured by relative export prices, proxied by deflators.
(c) Negative values denote a gain in competitiveness, positive values a loss.
(d) Average of GDP of countries of origin of tourists to Spain, weighted according to the relative significance of the number of visitors.
(e) Index of competitiveness vis-à-vis developed countries, measured with consumer prices.
(f) Prices of Spanish non-energy imports in relation to the non-energy producer price index.

flows in 2002. That said, the WTO reported that the number of international travellers increased by 3.1%, compared with the fall of 0.5% recorded in 2001. By geographical region, the destinations that grew above the average included most notably China and several central and eastern European areas, where tourism can be seen to be increasingly buoyant.

Demand for Spain as a tourist destination, measured in terms of the number of visitors, trended more modestly, although it also posted higher growth than that of world tourism. Indeed, according to the FRONTUR figures, the number of foreign visitors entering Spain across borders in 2002 rose by 3.4%. Nonetheless, other figures substantially qualify this first result, and are more in line with the QNA data on non-resident consumption, in real terms, which fell by 4%. The flow of visitors lodged in regulated accommodation thus slowed notably, while overnight stays in hotels and similar establishments fell by 5%. There was a decline in 2002 in the number of tourists from Germany (for the third year running), the United States and Japan, and a slowdown in tourists from the United Kingdom. Conversely, numbers from France, the Netherlands and Ireland showed considerable buoyancy. The tourism figures generally reveal a change in the average tourist profile, with a fall-off apparent in tourists from the countries furthest away and a shift in the goods and services demanded, such as type of transport and accommodation, which appears to have borne negatively on the recipient country's receipts.

Another factor which may have adversely affected tourism is the loss of competitiveness shown by the relative price indicators, both against client countries and competitor countries (see middle panel of Chart IV.8). Although price is not the only factor influencing competitive position, the sustainability of certain Spanish tourism segments might be affected by adverse relative price trends. In this respect, a fresh mention should be made of the notable robustness of tourist flows towards other Mediterranean countries, especially some of those which will be joining the EU in 2004. The geographical centre of the EU is shifting towards these countries, whose starting point is a highly favourable price-based competitive edge.

As described throughout this section, the pace of both national demand (consumption and investment) and exports lessened in 2002. As a result, the growth of final demand in the Spanish economy was, at 2.1%, 0.8 p.p. down on 2001. The lesser thrust of final demand detracted from the buoyancy of goods and services imports, which slowed slightly more sharply over the year as a whole, posting growth of 2.2% compared with 3.5% the previous year. Nonetheless, during the year real imports of goods and services overcame the contractionary course of the first two quarters and moved on to a notably dynamic path in the second half of the year, on the same track as final demand (see Chart IV.2).

Following a sharp slowdown in 2001, the growth rate of real goods imports was once again checked in 2002. The reduction in their rate of change – down 0.8 p.p. to 2.2% – was, however, more contained (see bottom panel of Chart IV.8). As with the aggregate of goods and services, the contraction marking merchandise purchases at the end of the previous year stepped up in the opening months of 2002, weighed down by the sluggishness of industrial activity and exports. Significant growth in this variable was recovered as final demand gained greater momentum. Import prices were on a declining trend throughout the year, making for greater penetration by imported products in the Spanish market; in fact, in the second half of the year the imports/unit of final demand ratio resumed the rising path that had characterised it prior to 2001.

According to itemised Customs figures, real goods imports from both the EU and the rest of the world grew at a rate of 3.8%. In terms of regions, purchases from the central and eastern European countries were buoyant, growing at over 20%, while those from Latin America edged slightly upwards. By type of product, the pattern of imports was similar to the previous year and in step with the course of demand components. As a result, both consumer- and intermediate-goods imports grew above the average, in real terms, while capital-goods imports declined appreciably. Nonetheless, this caption picked up modestly from Q3, and ended the year growing at a rate of 1.3% year-on-year. Energy imports increased quite vigorously, although in nominal terms they actually fell owing to the decline in oil prices in euro. Finally, tourism expenditure was adversely affected by the weakness of the economic setting and the low level of consumer confidence, and grew by 4.2% in real terms over the year as a whole, against 7.6% the previous year.

As real exports of goods and services grew by 1.4% in 2002, below the rate of increase of imports (2.2%), the external sector subtracted 0.3 p.p. from GDP growth (following a negative contribution of 0.1 p.p. in 2001). This contributed to slowing GDP, which posted growth of 2% over the year as a whole, compared with 2.7% the previous year (see Chart IV.2).

IV.3. PRODUCTIVE ACTIVITY

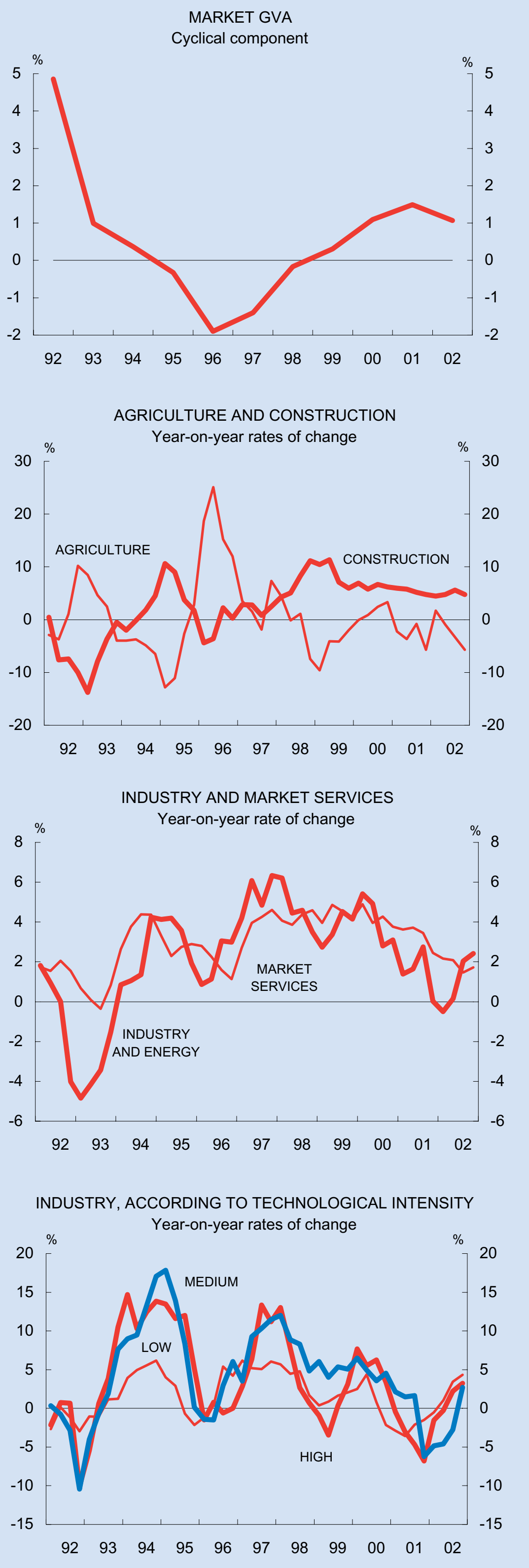
As indicated, the rate of increase of domestic output, which was less intense than in 2001, was trimmed by 0.7 p.p. in 2002. The year ended with real GDP growth standing at 2%, to which the value added of non-market services contributed significantly, its growth having accelerated by 0.6 p.p. to 3.5%. The gross value added (GVA) of the market branches slowed by 1 p.p. to 1.7%. As a result, the difference between market GVA and its potential level – the so-called output gap – narrowed in 2002, though it retained a positive value (see Chart IV.9).

From a disaggregated perspective, the loss of momentum across the branches of activity in 2002 was very generalised. This was not the case, however, in the primary sector, where activity continued to contract, albeit at a lesser pace than in 2001. For the year on average, value added in real terms thus posted a negative rate of –2.1%. Agricultural output was beset by scant rainfall, which affected most crops, while livestock production was more robust than in 2001, boosted by the increase in animals slaughtered for meat, since the production of animal derivatives (milk and eggs) diminished in vigour.

In 2002 as a whole, there was a continuation of the slackness marking industry and energy in 2001, with real growth at 1% compared with 1.4% the previous year. The factors behind the slowdown in 2001 – the lesser momentum of domestic demand and the sluggishness of export markets – were still present at the onset of 2002. However, after beginning the year on a contractionary course, industrial activity began to pick up, driven by the recovery in exports. This boost was checked, especially in the second half of the year, by the strengthening of the euro against the dollar and, in general, by the marked uncertainty of the international economic environment. At a more detailed level, energy output was on an expanding course whereas the strictly industrial branches were less robust, especially the medium-technology industries. Among these activities, the manufacture of capital goods was markedly contractionary, in line with

CHART IV.9

GVA by branch of activity
Cyclical component and rates of change (a)



Sources: INE and Banco de España.
(a) Rates estimated on the basis of seasonally- and calendar-adjusted series.

the decline in this demand component not only in Spain but also in most of the industrialised countries (see bottom panel of Chart IV.9). Conversely, activity in the branches geared to the manufacture of low-technology products, which are more closely related to private consumption, increased over the year as a whole, unlike in 2001. The leading-edge technology branches were in an intermediate position, rising to some extent from the summer after having been the first to lose momentum.

The resilience of construction activity continued to characterise developments in the market economy in 2002. For the fifth year running, this was the most vigorous industry. Notwithstanding, GVA in this sector slowed by 0.5 p.p., taking its annual growth to 4.9%. Behind this expansionary behaviour were civil engineering works and non-residential building, although the vigour of the former diminished somewhat during the year while that of the latter intensified. Conversely, residential building, the growth rate of which had already moderated substantially in 2001 according to National Accounts estimates, held at a low rate of increase, though it did not actually contract.

Markets services slowed notably in 2002, with their growth rate falling by 1.4 p.p. to 1.9%. This sluggishness was extensive to all activities. The slowdown in the ICT branches steepened and, under this category, IT and R+D activities contracted. Among the more traditional activities, tourism performed poorly, with a knock-on effect for other services such as transport (especially air transport) and the hotel and catering trade. In this case, the start of 2002 was marked by the impact of the events of 11 September, which was compounded by the economic weakness of the countries from which tourists emanate and by the heightening of political tension in the Middle East.

IV.4. THE LABOUR MARKET

Employment slowed notably in 2002 in relation to 2001, in line with the lower growth of economic activity. In QNA terms, the rate of net job creation (3) for the economy as a whole was 1.3%, 1.1 p.p. down on the previous year. Employment moved on a mildly declining path as from the second quarter of the year (see Chart IV.10). The deceleration in

(3) Measured by the number of full-time equivalent jobs.

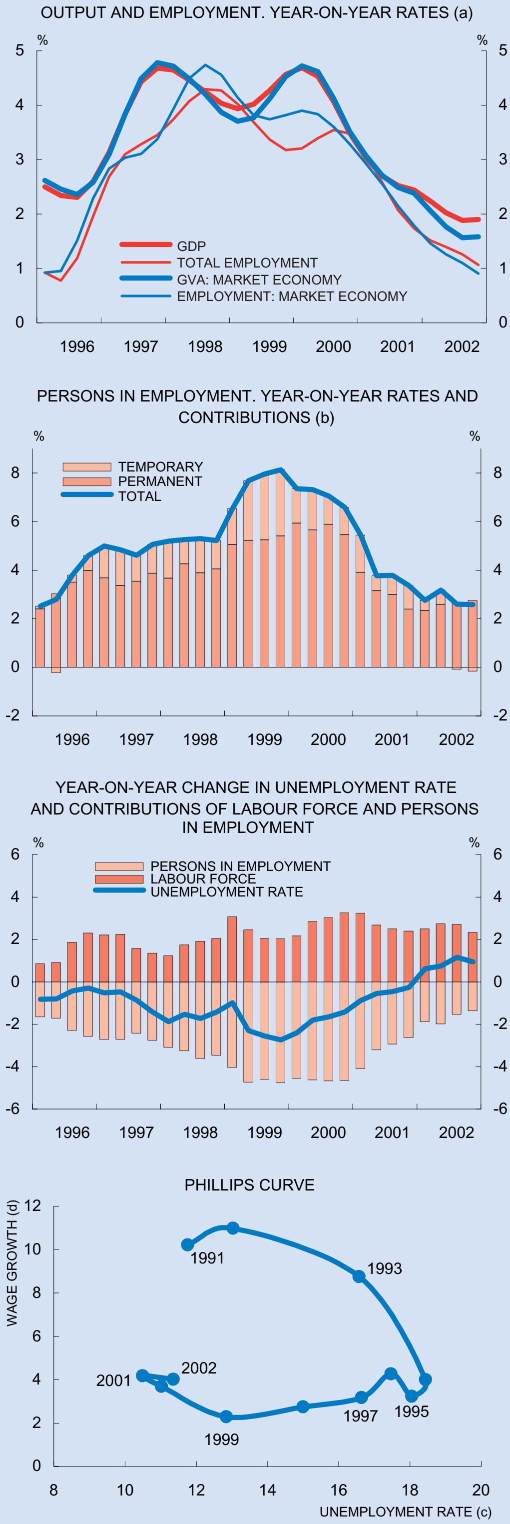
employment was slightly greater in the case of the market economy, which grew by 1.2%, against 2.4% in 2001. As a result, the growth rate of apparent labour productivity increased, but remained modest (0.7% for the economy as a whole and 0.6% for the market economy). Apparent labour productivity thus retained the counter-cyclical nature characterising it since the mid-eighties, when the use of temporary employment contracts became widespread.

The slowdown affected to a greater extent the self-employed, whose numbers fell by 2.1%, while dependent employees increased by 2%, both in the economy as a whole and in the market economy. As regards contracts, lower job creation was absorbed essentially by temporary dependent employment, which fell from 3.1% in 2001 to 0.6% in 2002, according to EPA (Labour Force Survey) (4) figures, with the attendant year-on-year rate of change even turning negative in the second half of the year. In contrast, permanent dependent employment contracts continued to grow at a notable pace (3.8%, 0.8 p.p. down on 2001). Contributing to this were both the rebates applicable to social security contributions and the lower firing costs in respect of employment-promoting permanent contracts, whose validity was extended indefinitely in March 2001. Accordingly, the ratio of temporary to permanent employees dipped by 0.7 p.p., although it continued to stand at twice the average for the EU (31%). That highlights the need to continue introducing measures aimed at reducing the duality of the Spanish labour market. In apparent contrast to the changes in permanent and temporary employees, INEM statistics showed lower growth in the number of employment contracts registered in 2002 (0.9% against 1.6% the previous year). This was due to the change in the number of permanent employees, which fell by 1.5% after having grown 8% in 2001, further to the large-scale conversion of temporary into employment-promoting permanent contracts. Lastly, the growth rate of both full-time and part-time wage-earners declined in 2002, meaning that the latter as a proportion of total employees increased by 0.1 p.p. to 8.2% (half the EU average).

The slowdown in employment was extensive to all branches of activity, according to QNA figures,

CHART IV.10

Labour market: employment and unemployment

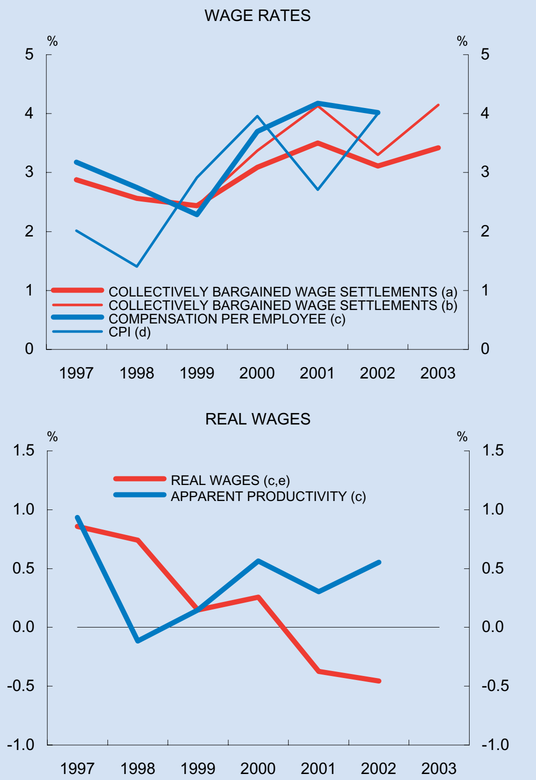


Sources: INE (QNA and EPA) and Banco de España.
(a) QNA. Trend-cycle. Full-time equivalent jobs.
(b) EPA.
(c) EPA. Unemployment series spliced in-house.
(d) Compensation per employee in market economy.

(4) Three significant changes were made to the EPA in 2002 Q1, with notable effects on all the variables addressed by this survey. The April 2002 edition of the *Boletín económico* featured an article explaining in detail these changes, along with their impact on the most relevant variables.

CHART IV.11

Wage determinants



Sources: INE and Ministerio de Trabajo y Asuntos Sociales.

(a) Without indexation clauses. The figure for 2003 shows information to March.

(b) Including prior-year indexation clauses. The ffigure for 2003 shows information to March.

(c) Market economy.

(d) December year-on-year rate.

(e) Compensation per employee deflated by the value-added deflator.

with considerable job destruction in agriculture (–5.3%) and a notable deceleration in the construction industry, where the rate of net job creation was halved (2.7%, compared with 5.4% in 2001), moving on a declining path throughout the year. Nevertheless, construction remained the most dynamic industry, followed by services, and the growth rate of employment dipped by only 0.1 p.p. (to 2.3%). Indeed, employment in market services quickened slightly in 2002 to 2.5%, 0.2 p.p. up on the preceding year. Finally, employment in industry and energy declined by 0.5% (after having grown by 1.4% in 2001), although the progressive pick-up in industrial activity during the year was reflected in employment, which grew by 0.4% in the second half of the year.

Undoubtedly, one of the key aspects of Spanish labour market developments in 2002 was the high growth of the labour force, despite diminished economic momentum. According to EPA figures, the labour force grew by 3%, essentially as a result of the increase in the participation rate by 1.1 p.p. to 54% of the population aged over 16. The increase was even more notable if the participation rate is calculated for the population aged 16-64, as it stood at 67.1% (still 3 p.p. lower than the EU average). Higher labour market participation was centred principally on women, the participation rate for whom edged up from 40.3% in 2001 to 41.8% last year. The extensive system of rebates for the permanent hiring of women, along with other measures adopted to help reconcile working and family life, undoubtedly influenced this result. The male participation rate also increased in 2002, but by only 0.7 p.p. to 66.9%. The difference in this connection between men and women thus narrowed.

The sharp growth of the labour force, along with the lesser pace of net job creation, led to an increase in the unemployment rate, for the first time since 1994 (see Chart IV.10). On EPA figures, the number of unemployed increased by 214,000 during 2002, which translated into a rise in the unemployment rate of almost 1 p.p., to 11.4% of the labour force. Likewise, the official INEM (National Employment Office) figure showed a significant increase in registered unemployment of 6% in annual average terms, which continued into 2003, albeit at a somewhat lesser pace. On 2002 data, the Spanish unemployment rate continues to exceed the EU average by more than 3 p.p., with this variable having ceased, moreover, to converge as it had in recent years. The rise in unemployment affected all groups of workers, with a particularly notable increase in the female unemployment rate to 16.4%, against 15.2% the previous year. This development is in response to the considerable advance in women's participation in the labour market, which the growth of employment was unable to absorb. Also significant was the rise in the rate of youth unemployment which moved from 16.8% in 2001 to 18%, departing from the markedly declining course of previous years.

Long-term unemployment remained on the same trend seen for several years with a fresh decline in the overall figure for 2002, standing at 37.5% of the total unemployed. However, for the first time in several years, there was an increase in the proportion of long-term to total unemployed in Q4. Combined with the scant response by nominal wages to the slowdown in employment (see Chart IV.11), this might be indicative of weakness in the process of reduction of the structural unemployment rate, despite the fact that its level is still very high. All these developments would underscore the need to further the course of reform of the Spanish labour market pursued to date. In this respect, the reform of unemployment insurance in 2002, the main objective of which – as described in the first section – was to offer incentives for more active job-search by the unemployed, is along the right lines although it is still too soon to evaluate its results (5).

During 2002, wage increases agreed under collective bargaining moderated, with average wage settlements standing at 3.1%, against 2.5% the previous year (see Chart IV.11). The source of this restraint was the revision of the pluriannual agreements entered into prior to 2002, since newly signed agreements were affected by agents' rising inflation expectations during the year, as the inflation rate progressively increased, and incorporated higher wage increases (of 3.6%). Bargaining in 2002 was against the background of the signing of the Inter-Confederal Agreement for Collective Bargaining, which was aimed, in principle, at anchoring wage settlements at 2%, plus a degree of drift (no more than 1 p.p.) for productivity gains. The application of this agreement, against a backdrop of a rising inflation rate, gave rise to the widespread use of wage indexation clauses to counter deviation by inflation from the official 2% forecast. The actual deviation at the end of the year (totalling 2 p.p.) entailed a substantial upward revision of wage settlements in 2002 (by about 0.8 p.p.), compared with the related rise (0.2 p.p.) attributable to the same cause in 2001.

QNA estimates show that the growth of compensation per employee – which includes wage drift and non-wage costs along with wage settlements – moderated slightly in 2002 to 4%, in both the economy as a whole and in market activities, compared with respective increases of 4.1% and 4.2% the previous year. After having been deflated by the value-added deflator in the market economy, the profile of compensation per employee remained very moderate (see bottom panel of Chart IV.11). However, these estimates do not include the effect of the application of the wage indexation clauses in 2002 which, as mentioned, is particularly substantial and will lead to a significant increase in the growth of compensation per employee in 2003. This revision qualifies the moderation of labour costs discussed previously, since it may involve a rise in real wages in the current year, which already appears to have been factored in by companies. These developments highlight the effects of indexation clauses on wage dynamics: such clauses initially allow wage settlements based on moderate inflation references to be achieved, but once these references are exceeded, as occurred in 2002, they ultimately pass through the higher inflation to wages, even when the source of such inflation is transitory, thereby hampering the absorption of shocks.

With a view to 2003, the signing of a new Inter-Confederal Agreement for Collective Bargaining by the social partners entails the extension of the wage bargaining framework in place in 2002. And that, along with the expected slowdown in inflation, might contribute to wage moderation this year. That said, the current bargaining arrangements fail substantially to offer efficient results in terms of the flexibility and wage differentiation needed for the proper functioning of the labour market (see Box IV.3). It thus remains necessary to alter the collective bargaining system in such a way as to relate wages more closely to the specific circumstances of companies and employees.

IV.5. COSTS AND PRICES

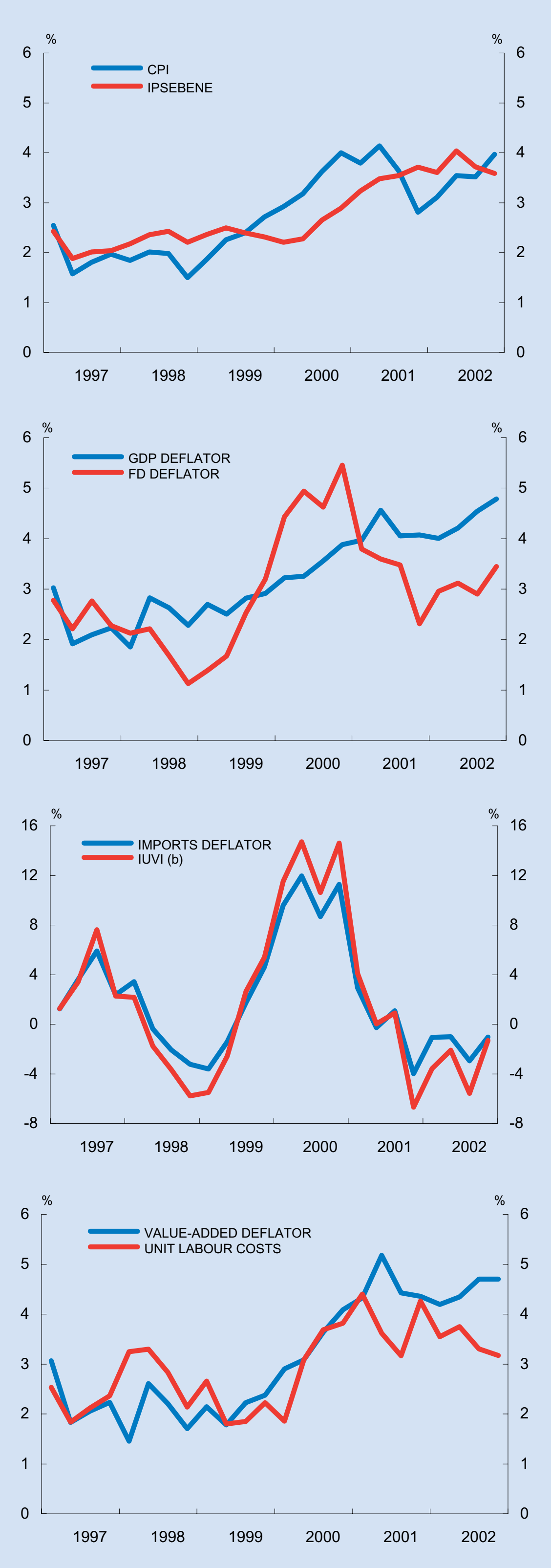
During 2002, the inflation rate in Spain held at a similar level to that of the previous year. In terms of the annual average increase in the CPI, inflation was 3.5% in 2002 compared with 3.6 % in 2001. This was the result of the combination of a significant reduction in import prices – in line with the moderate inflation rates of our main trading partners and with the depreciation of the dollar against the euro – and an acceleration in the domestic component of prices. Behind this behaviour are, on one hand, the rise in certain indirect taxes at the beginning of the year and the effect of the introduction of the euro on the prices of certain goods and services; and, on the other, a greater expansion in operating margins in certain industries. In the closing months of the year, the external determinants of prices worsened, as commodity prices (energy and non-energy alike) rose, and inflation ended the year on a rising path (see Chart IV.12).

The increase in the CPI in 2002 was, at 3.5%, 0.1 p.p. down on the previous year. In terms of compo-

(5) A detailed description of the content of this reform can be found in Box 3 in the "Quarterly Report on the Spanish Economy" in the April 2003 *Economic Bulletin*.

CHART IV.12

Composition of the final demand and GDP deflators (a)



Sources: INE and Banco de España.
(a) Year-on-year growth rate.
(b) Merchandise import unit value indices.

nents, the higher growth of services and processed food prices was only partly offset by the slight improvement in the prices of non-energy manufactured goods, the related index of which (IPSEBENE by its Spanish name) posted average growth of 3.7%, compared with 3.5% the previous year. Specifically, services prices climbed by 4.6% in 2002, moving on a rising trajectory in the first half of the year. Coinciding with the introduction of euro banknotes and coins, price increases in certain services such as restaurants and bars, personal care and repairs were far higher than those recorded in previous years (see Box IV.4). Nonetheless, there were further reductions in telephony prices and hotel rates moderated in the face of diminished tourist demand. With an increase of 2.5% in 2002, somewhat down on the previous year, there was an increase in the variability of non-energy manufactured goods prices. This had to do with the methodological changes introduced into the CPI at the start of the year and, in particular, with the inclusion of sales prices in the calculation of the index. The components most influenced by sales, such as clothing, footwear and household textile articles, showed marked changes around the time of the two annual sales periods; likewise, they accelerated significantly in annual average terms. Conversely, the fall in the prices of video and sound, photographic and computer equipment steepened. Lastly, processed food prices ceased to move on the rising course seen the previous year, although their average growth was 4.3%, against 3.4% in 2001.

Among the CPI components not included in the IPSEBENE index (which strips out fresh food and oil prices), energy prices were virtually unchanged in 2002, set against the reduction of the previous year, moving on a rising path throughout the year which passed through to the overall index. Adding to the effects of the increase in indirect taxes were those derived from the upward trend of crude oil prices on international markets (the average price of oil stood at $25 per barrel, although at the beginning of the year it was $19, while at year-end it had reached $28), which were only partly mitigated by the 5.5% appreciation of the euro against the dollar over the year on average. Further, fresh food prices rose by 5.8% in 2002, against 8.7% in 2001. Meat prices slowed, after putting behind the health crises affecting livestock in 2001. Contrary to this, fruit and vegetable prices moved on a strongly rising trajectory.

The inflation rate improved substantially in the first four months of 2003 (standing at 3.1%), as the

BOX IV.3

Effects of the scope of collective bargaining on its results (1)

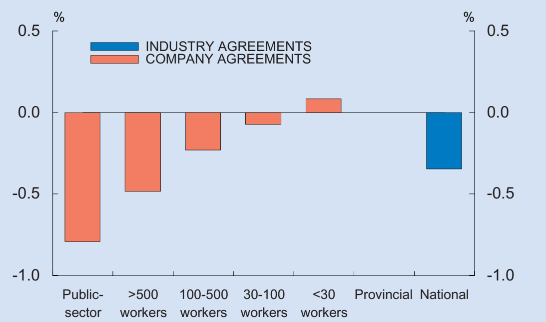
In Spain, the collective bargaining system covers practically all private-sector employees, meaning its study is fundamental to any explanation of the functioning of the labour market. One of the most marked features of the system is its division into different levels of bargaining. As can be seen in the adjoining table, bargaining is basically carried out at the industry level, with different geographical scopes of application (national, provincial or regional), the most important being the industry-provincial, where labour conditions are set for more than 50% of the workers affected by collective bargaining. Company agreements only affect just over 10% of workers, their relative importance having shown a slight downward trend over the last few years.

Distribution of workers affected by agreements, according to the level of bargaining (%)

	1990	2000	Average 90-00
Industry/national	26.10	26.83	26.78
Industry/provincial	54.74	52.89	53.61
Company	15.02	12.07	13.55
Other levels (a)	4.14	8.21	6.06

Sources: Ministerio de Trabajo y Asuntos Sociales and Banco de España.
(a) Includes intra-regional, inter-regional and local industry agreements.

Effect of the level of bargaining on wage settlements relative to the industry-provincial level (1990-2000)



Sources: Ministerio de Trabajo y Asuntos Sociales and Banco de España.

Various theoretical studies have stressed the importance of the degree of centralisation of bargaining in explaining its results. In general, it is argued that when bargaining takes place at an intermediate level of centralisation the results, in terms of the adjustment of wages to labour market conditions, are usually less efficient than at other levels of bargaining. At a highly centralised level bargainers are usually more sensitive to the incorporation of macroeconomic constraints into the bargaining. On the other hand, at the most decentralised level, namely that of the individual enterprise, bargaining achieves wage increases best adapted to the economic and financial situation of each firm, which is perceived more directly by the bargainers. Also there may be cases combining two levels of bargaining, in which wages are set by the more decentralised one.

Empirically, various studies have confirmed the relationship between the degree of centralisation and the results of collective bargaining, although in most cases this finding was obtained on the basis of comparisons across countries with different degrees of centralisation. The availability of information on the individual collective agreements signed in Spain during the whole of the 1990s has enabled the influence of the different features of the agreements on the wage settlements to be analysed, in particular identifying the effect of the level of bargaining. For this purpose, regressions have been estimated relating the settlement to the level of bargaining, taking into account other characteristics of the agreements, such as the industry, the time of the bargaining, the term of the agreement, the level of unrest during the bargaining, the presence of indexation clauses and other terms.

The main results of this analysis are presented above in the lower of the two charts, which shows the different effect on the average settlement attributable to each level of bargaining, with respect to that reached at the industry-provincial level (which, during the period 1990-2001, is normalised to zero). First, the effect of the level of bargaining on its results is significant. As for the sign of this effect, both at the enterprise level (distinguishing here between public and private-sector firms and among the latter according to size) and at the most centralised level (industry-national) settlements have been lower than those obtained at the intermediate level of bargaining. Only in firms with fewer than 30 workers is this result not confirmed, although the percentage of such firms with their own agreement is very small. Also notable is the lower level of wage settlements in public-sector firms.

Thus, empirical analysis of information on individual agreements confirms the theoretical effects identified in the literature regarding the impact of bargaining at intermediate levels of centralisation on wage growth. This is particularly relevant in the case of Spain, given its distribution of bargaining levels, with industry agreements with a provincial scope in the majority.

(1) This box is a summary of the Banco de España Occasional Paper No. 0302 entitled "El sistema de negociación colectiva en España: Un análisis descriptivo con datos individuales de convenios" by Mario Izquierdo, Esther Moral and Alberto Urtasun.

effects arising from the increase in excise duties and from the introduction of the euro in the opening months of 2002 were stripped out. Into April, the heavy rises in energy prices last year were likewise stripped out, adding to which has been a substantial cut in these prices in recent months. The inflation rate is expected to remain on a slowing path in the coming months, against a background of moderating import prices, driven by the low inflation rates of our main trading partners and by the appreciation of the euro.

The rate of increase of the final demand deflator fell back in 2002 to 3.1%. However, both the private consumption deflator – the average growth of which was 3.6%, in line with the CPI – and the gross capital formation deflator, with an increase of 5.6%, accelerated in relation to the previous year. Consequently, it was export prices, whose growth rate declined by 2.7 p.p. until holding stable, which gave rise to the slowdown in final prices. Both the moderate trend of competitor countries' goods prices and, in the second half of the year, the appreciation of the euro against the dollar account for the stability of export prices which, in fact, trended much more moderately in the case of sales outside the EU. Under gross capital formation, the construction deflator quickened once again, in the wake of house-price rises showing no signs of turning around, despite the fact that housing demand was considerably contained. Also, the stockbuilding deflator displayed burgeoning growth, associated with the management of stocks of oil products. By contrast, there was a limited increase in capital goods prices, similar to that in 2001 (1%), owing to the sizable weight of imports in the demand for these products.

In fact, the imports deflator posted a decline of 0.9% in 2002, compared with the increase the previous year (0.6%). For the year on average, the sharpest decline was in energy-product prices, although dearer crude oil prices in the second half of the year meant that marked increases were observed in the final quarter. The prices of the remaining imports – of intermediate goods and certain consumer goods – also declined.

Unlike foreign prices, domestic inflation, proxied by the growth of the GDP deflator, increased by 0.2 p.p. in 2002 to 4.4% (see Chart IV.12). This acceleration was the result of three factors. First, a significant increase in indirect taxes net of subsidies per unit of output that was sharper than the rise in certain excise duties at the beginning of the year would warrant. Next, the considerable moderation of the deflator of non-market services, which grew by only 2.1% in 2002, despite the increase in compensation per employee in the public sector and costlier investment in construction. And finally, a minimal slowdown – of only 0.1 p.p. – in the market economy value-added deflator, which grew by 4.5%.

The bottom panel of Chart IV.12 shows that, among the components of the GVA deflator in the market economy, unit labour costs (ULCs) increased by 3.4% in 2002, 0.5 p.p. down on the previous year. This slowdown was attributable both to greater apparent labour productivity gains, the growth of which nevertheless remained very moderate (0.6%), and to the slight slowdown in compensation per employee (discussed in the previous section). That said, it should be recalled that these estimates do not include the impact of the application of the indexation clauses in 2002. The gross operating surplus per unit of value added increased significantly, giving rise to a fresh widening of the unit margin (proxied by the difference between changes in the GVA deflator and those in ULCs), although this increase would be less sizable if the impact of the indexation clauses were taken into account. As the analysis by branch of activity shows in the following section, the widening of margins was fairly generalised, albeit with certain key exceptions.

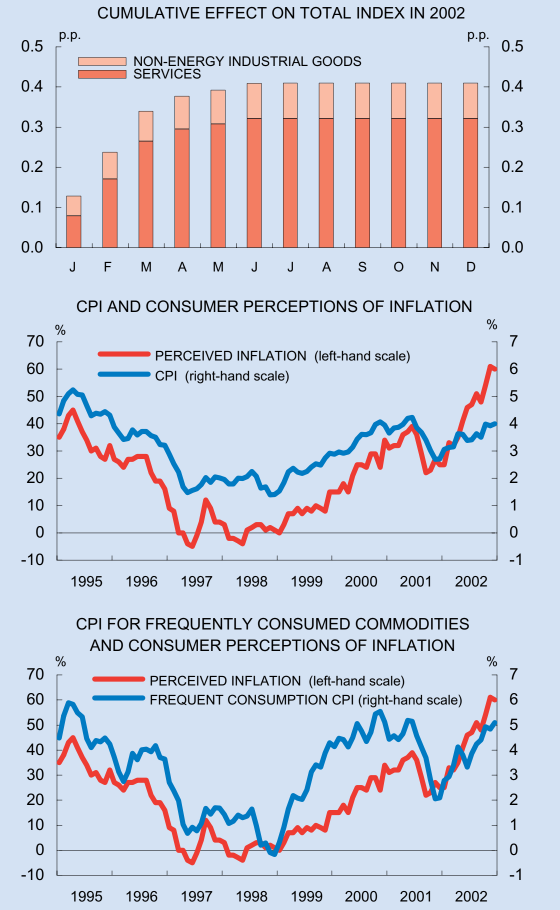
IV.5.1. Costs and prices: the productive branches

As indicated, the unit operating margin widened significantly during 2002, as was generally the case across the different branches of activity. Exceptions were market services, where the margin stabilised, and industry, where it shrank, such that the increase in margins in industry and energy was centred on the latter.

As Chart IV.13 shows, in the primary sector the value-added deflator slowed markedly throughout the year, despite which it grew by 3.2% on average. This behaviour was the result of the adverse effects occurring in 2001 being stripped out of the attendant calculation, the consequence of the health crises in specific products, which translated into a 7.7% increase in the deflator. Despite ULCs accelerating throughout the year, the unit margin widened in relation to 2001.

The effect of the euro cash changeover on inflation

The changeover to euro banknotes and coins in January 2002 entailed the redenomination in euro of all prices previously expressed in pesetas. In principle, this process merely involved the application of a conversion factor and the legally established rounding rule, and the aggregate impact on the CPI should have been practically nil. However, the conversion to euro was accompanied by additional price adjustments, attributable to a number of causes, some related to the process of conversion itself (such as recovery of the costs arising from this process and the search for attractive prices in euro) and others not directly related to conversion (such as using the occasion of the necessary change in prices to euro to make other pending adjustments, deferred on account of the existence of menu costs, to cover changes in production costs or simply to modify unit margins). In sum, the change in currency seems to have been accompanied predominantly by upward price changes, with a positive – albeit moderate – impact on the rate of inflation, as measured by consumer prices.



Source: Eurostat, Instituto Nacional de Estadística and Banco de España.

An *ex-post* analysis of the impact of the launch of the euro on prices should ideally be based on a broad sample of individual prices that enable the price adjustments presumably arising from conversion to the euro to be distinguished from those attributable to other factors. However, suitable databases of individual prices are not available for this purpose, so the analytical approach has to use other channels that enable the set of items consumed by households to be covered with the maximum possible degree of disaggregation.

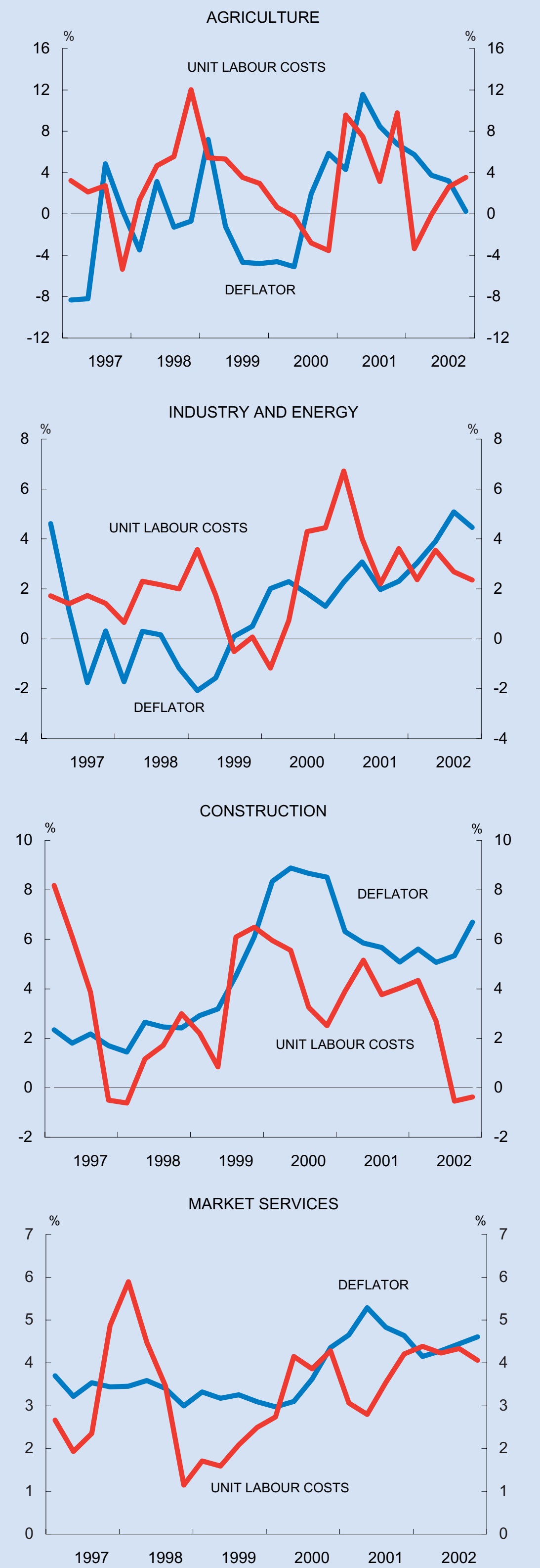
As a result, the analysis has had to be based on a set of 117 CPI time series, re-compiled by the DG Economics, Statistics and Research using the new 2001 base year methodology. First, the set of items was identified for which extraordinary changes were recorded in 2002, especially in the first few months of the year, which were unusual for the dates considered. Then, those changes for which factors existed to explain the extraordinary movements, such as changes in taxes or administered prices, were rejected, as were increases determined by changes in production costs or prices at source. The other extraordinary changes were assumed to be related to the conversion of prices to euro and they were used to form auxiliary variables. These were introduced into the models of behaviour of the main components of the CPI to estimate the effect of the change of currency.

The top panel shows the cumulative impact on the total index of the changeover to the single currency, estimated using the procedure described above. The total amount of the estimated effect on the annual rate of change of the CPI in December 2002 is 0.4 p.p., the effect on the annual average of this index being practically the same amount. This estimate is at the upper limit of the range obtained *ex-ante* for non-extreme upward adjustment scenarios (0.2-0.4 p.p.). The time pattern of the effect is as expected: the impact was greatest in the initial months of the year, subsequently falling to become practically imperceptible by mid-year. By component, the largest effect corresponds to services. Bars and restaurants, which account for practically half of the estimated effect on services as a whole, and hotels were particularly notable. The impact was considerably more moderate in the case of non-energy industrial goods. Finally, in the case of food the effect was not significant.

This estimate − which should be interpreted as an approximation − does not seem to correspond to the perceptions of consumers, who associate the changeover to the euro with large price increases. This at least seems to be implied by the results of surveys carried out by the European Commission, which canvass consumers' perception of prices. As seen in the middle panel, perceived inflation has historically followed the CPI closely, but since January 2002 it has been much higher than actual inflation. A plausible explanation for this divergence is that the public's perception of inflation is determined to a large extent by the prices of the commodities consumed most frequently. The bottom panel shows the relationship between perceived inflation and a price index which only includes the most frequently consumed goods and services (food, energy, urban transport, newspapers and magazines, bars, cafés and restaurants and recreational, sporting and cultural services). It seems clear that consumer perceptions must have been influenced by the predominance of high rises in the unit prices of these commodities.

CHART IV.13

Prices and costs by branch of activity (a)



Source: INE.
(a) Non-centred year-on-year rates based on QNA seasonally adjusted series.

In industry and energy, the value-added deflator grew by 4.1%, 1.7 p.p. up on 2001. The acceleration was progressive and affected both energy prices and those in industry. ULCs, by contrast, slowed considerably on the previous year, since job destruction gave rise to a notable pick-up in apparent labour productivity. Nonetheless, this phenomenon was mainly apparent in the energy branches, while productivity fell in industry. Accordingly, the widening of unit margins at the aggregate level was consistent with a contraction in the industrial branches and a consequent widening in the energy branches. This result highlights how the Spanish economy's inflation differential with our European partners might be beginning to impair the profitability of those companies most exposed to foreign competition.

In construction, the value-added deflator posted very high growth (5.7%), meaning that the widening of the unit margin seen in recent years continued. Unlike in previous years, ULCs grew moderately since, as was seen in the previous section, employment slowed significantly, providing for a forceful recovery in apparent labour productivity.

Finally, the growth of the deflator in market services was 4.4%. Despite this high inflation, the acceleration in ULCs, in a setting in which employment was outgrowing activity, fed through only in part to prices, whereupon the unit margin stabilised. In any event, against a background of limited demand pressure, a greater adjustment of margins might have been expected. This might be highlighting the need for further reform in the markets for these products that makes prices more sensitive to demand conditions.

IV.6. COMPETITIVENESS

In 2002 the Spanish economy's price-competitiveness and cost-competitiveness indicators against the developed countries worsened further. Contributing to this were both price and cost differentials and the nominal exchange rate component (see Chart IV.14). Since 1999 losses in competitiveness have been building up in these indices. Such losses are more sizable when calculated with consumer prices and with manufacturing unit labour costs, and less pronounced in terms of manufacturing or export prices. In this setting, the sluggishness of foreign demand, which is characterising the current cyclical downturn, has further eroded the foreign trade balance, and the gains in market share of Spanish products abroad have been checked. National Accounts data show that, as a percentage of real GDP, the net external balance of real flows of goods and services was –2.3% in 2002, 0.2 p.p. more than in 2001 and 0.5 p.p. more than in 1999. Customs figures show that the merchandise trade balance, in real terms, stood at –7.4% of GDP last year.

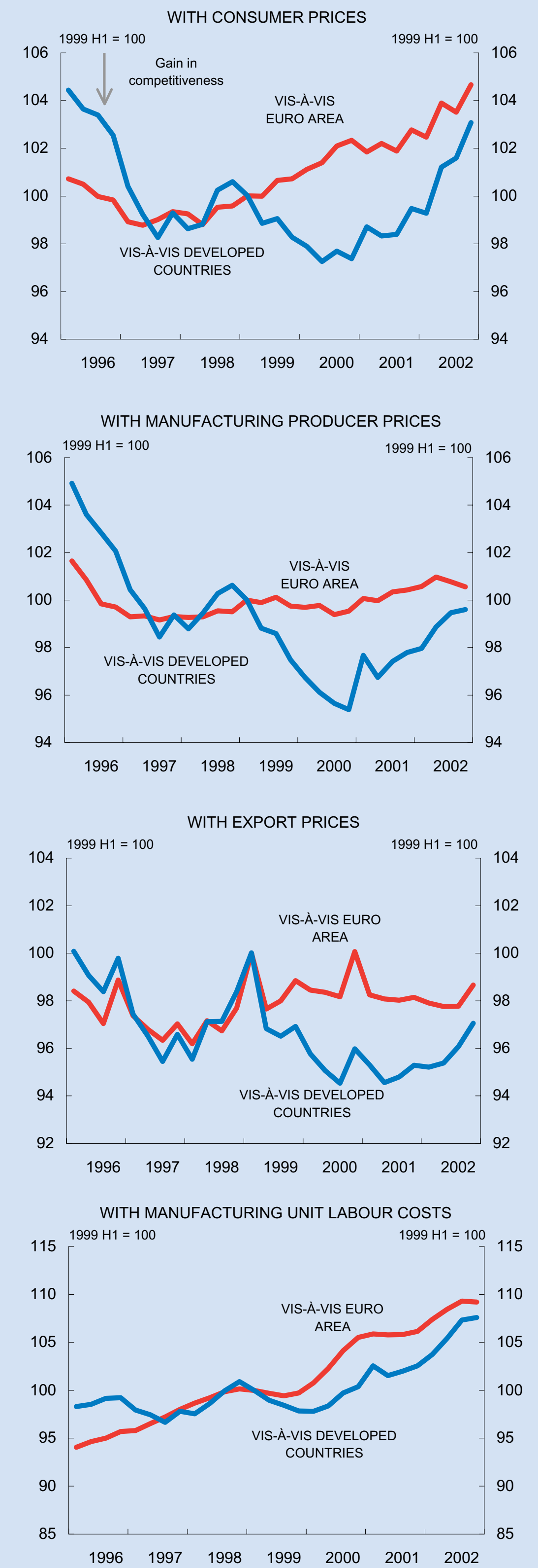
The share of Spanish exports in the developed countries as a whole, in real terms, stands at a similar level to that of four years ago; however, on the information available, growth in exports slightly outpaced that in export markets in 2002. By geographical area, the share of exports to the euro area in the region's trade fell slightly. Conversely, and despite the substantial appreciation of the euro, exports to non-euro area countries grew at higher rates than the market. Exclusively in terms of manufacturing trade, the performance of Spanish exports has been less favourable since, in the past two years, their rate of change was negative and, according to the OECD, notably less than that of overall imports.

Among the indicators of competitiveness vis-à-vis the euro area, the consumer prices-based index was that which appreciated most sharply in 2002. The other relative prices indices were more moderate and the indicator of relative export prices declined slightly. In the case of the indicator calculated with manufacturing ULCs, the loss in competitiveness during the year was relatively minor, as the growth differential of costs (which nevertheless remained higher in Spain) narrowed significantly owing to the greater increase in apparent labour productivity in our country.

The competitiveness indices against the developed countries not belonging to the euro area, for their part, showed losses in competitiveness across the board, as the strength of the euro combined with the deterioration in price differentials. Although the gains that came about in the nominal component of these indices, in the two years following the introduction of the euro, continued to show a certain competitive edge against these countries, the persistent increase in the price differential and, above all, in the cost differential is gradually eroding this advantage. A notable development in 2002 was the growth of relative export prices: set against more buoyant external demand in the non-euro area, this seems to indicate that Spanish exports

CHART IV.14

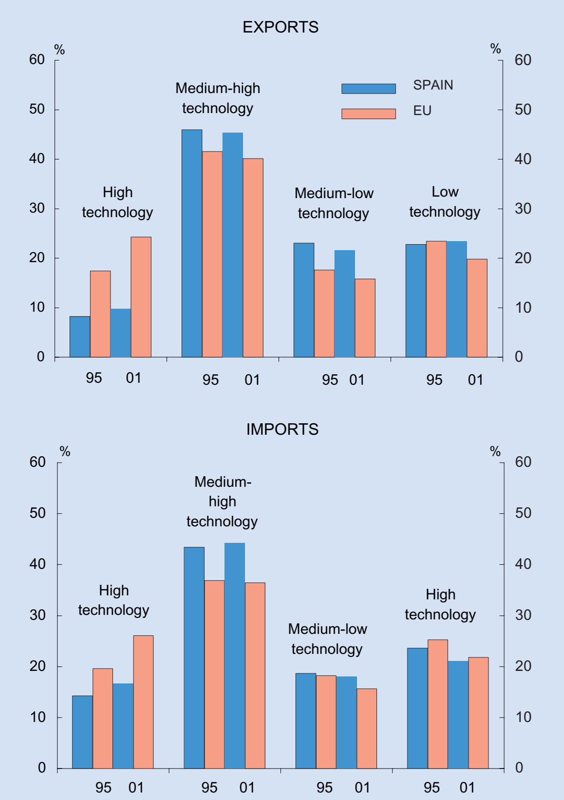
Competitiveness indices for Spain (a)



Source: Banco de España.
(a) An increase in the index denotes a loss in competitiveness, and vice versa.

CHART IV.15

Spanish trade specialisation compared with the EU



Sources: Eurostat, Aduanas and Banco de España.

tended to set different prices in different markets so as to offset, in part, the decline in margins in trade with the euro area.

Indeed, analysis of the behaviour of Spanish exporters' operating margins shows that while they held stable in the period 1995-1999, in the past two years they shrank appreciably. It can also be seen how, on comparing manufacturing export prices with the value-added deflator for these products (which is an overall indicator of manufacturing prices in the economy), export prices have in the past two years grown appreciably below domestic output prices. Moreover, comparing both the latter with ULCs reveals that costs have outgrown final manufacturing producer prices. The lesser profitability of exports would explain why exporting industries have focused on maintaining their share in foreign markets, and not in opening new markets, switching their output as far as possible towards the domestic market. The contraction of relative manufacturing export margins vis-à-vis the EU has stepped up in the past two years.

In addition to the unfavourable performance of exports in terms of profitability, the weaknesses in the Spanish economy's pattern of trade specialisation may also have checked penetration by Spanish products on international markets. As Chart IV.15 shows, the structure of Spanish exports displays a degree of specialisation in the lower technology-intensive industries. And, generally, world demand is less buoyant here and the competitive pressures from the newly industrialised countries are greater. Conversely, the high-technology industries, where many of the technological advances in recent years are concentrated, account for a very small proportion of Spanish exports, relative to the EU. Another distinctive feature of the Spanish economy's pattern of specialisation is the excessive concentration of foreign sales in the car industry, which currently accounts for around 25% of total exports, meaning a degree of vulnerability to trade results. In the case of imports, there is a lesser relative share in the high-technology industries, which are the main transmission channel for technical progress in those countries with insufficient internal generation of technology.

But beyond considerations pertaining to trade results, the competitive capacity of an economy is ultimately reflected in its ability to increase productive efficiency and the well-being of its people. In this respect, and as discussed in Chapter 1 of this Report, the Spanish economy continued in 2002 to reduce its differences in income levels relative to its European partners, with its GDP per capita standing at around 83% of the EU average. The characteristics of this convergence process are allowing a portion of the unemployed labour force to be absorbed, thereby contributing to sustaining household income and spending. But they also comprise some less favourable aspects and, in particular, insufficient capitalisation and a very low productivity growth rate (see Chart IV.2).

As earlier mentioned, this moderate increase in productivity and the persisting positive differential in the growth rate of compensation per employee vis-à-vis the EU countries are gradually eroding the competitive advantages traditionally enjoyed by the Spanish economy in terms of its ULC levels. And that against a background of growing globalisation and liberalisation of international trade that is heightening the competitive pressures exerted by other newly industrialised countries in the relatively unskilled labour-intensive industries which, as seen, account for a high proportion of the Spanish economy's output and exports. Notably, then, EU enlargement poses a challenge for the medium and medium-high technology sectors in which Spanish industry has tended to specialise in recent years. Here, efforts aimed at increasing productive efficiency by means of a greater diffusion and absorption of technical progress and more skilled human capital are of particular importance. The indicators in Table IV.2 summarise the distance relative to the EU average still to be covered by the Spanish economy in terms of adopting new technologies, and they also reveal a slowdown in R+D. In addition, labour skills, proxied by the proportion of the population of working age who have completed higher studies, are still lower than those observed in our main trading partners.

TABLE IV.2

Indicators of real convergence and competitiveness

	1995		2002		Latest year
	Spain	Sp./EU	Spain	Sp./EU	
GDP *PER CAPITA* AND COMPONENTS:					
GDP per capita (a)	16.5	79.2	20.2	84.5	2002
Pop. 16-64/Tot. pop.	68.1	102.4	68.3	103.2	2002
Employment (b)	50.8	80.8	58.9	87.6	2002
Lab. productivity (c)	47.8	95.8	50.3	93.5	2002
TOTAL FACTOR PRODUCTIVITY AND STOCKS OF CAPITAL:					
Total factor prod. (d)	100.0	100.0	102.5	96.9	2002
Tot.cap.stock/employ.	118.2	89.1	126.2	89.1	2002
Technol. cap./GDP	6.4	43.0	6.2	40.8	1999
Hum.cap./pop.16-64	32.3	66.9	36.3	71.7	1999
OTHER SUPPLEMENTARY INDICATORS:					
Spending on R+D/GDP	0.8	47.7	0.9	51.1	2001
GVA ICT branches (e)	3.7	78.3	4.0	72.8	2000
Per cap.expend. ICT (f)	443.3	56.1	1143.1	71.2	2001
Pub.expnd.educ./GDP	4.7	90.0	4.4	89.7	2000
Working age pop. with higher studies/ Total population	29.5	53.2	40.0	82.6	2001

Sources: Eurostat, OECD, FUNCAS, Ministerio de Economía and Banco de España.
(a) Euro PPPs (000s).
(b) Employment/population aged 16-64.
(c) Euro PPPs (000s) per person employed.
(d) 1995=100.
(e) As % of whole-economy GVA.
(f) Euro PPPs per inhabitant.

IV.7. GENERAL GOVERNMENT CONDUCT

The general government deficit stood at 0.1% of GDP in 2002, marginally off the initially planned balanced budget target (see Table IV.3). The primary balance posted a surplus of 2.8% of GDP, 0.2 p.p. down on the previous year, while the public debt/GDP ratio was 54%, appreciably down on the figure of 56.9% recorded in 2001.

The State and its agencies posted a deficit of 0.5% of GDP, as initially budgeted. The Social Security System, for which a surplus of 0.5% of GDP was initially forecast, ran a surplus of 0.7% of GDP. Once again, the Regional (Autonomous) Governments were considerably off target, recording a deficit of 0.3% of GDP as opposed to the balanced budget scheduled. Local Governments, however, achieved a balanced budget as foreseen.

The relatively favourable performance of the general government balance, all the more significant in a year of economic slowdown, was essentially due to the sound behaviour of revenue, which grew by 7.6% (in National Accounts terms) on the previous year, raising its share in GDP by 0.4 p.p. to 40%. This increase was, in turn, based on the substantial growth of tax revenue, while the weight of non-tax revenue in GDP fell appreciably. Public spending grew by 7.4% on the previous year, increasing its share in GDP by 0.3 p.p. to 40.1%. This was due both to primary current expenditure and to capital expenditure, while interest expenses declined significantly.

The rise in tax revenue is attributable both to taxes on production and imports and to current income and wealth tax. The former grew by 9.2% in relation to 2001, raising their share in GDP by 0.3 p.p.. This performance was largely due to two events. On one hand, the financing arrangements for the EU budget came to depend to a greater extent in 2002 on the GNP resource contributed by the Member States, and to a lesser extent on the VAT resource. This means that the portion of VAT takings assigned to Spanish general government is greater, explaining approximately 0.1 p.p. of the increase in the weight of the total for taxes on production and imports in relation to GDP, the counterpoint to which is the increase in current transfers paid arising from the GNP resource. Further, the tax revenue data show a substantial increase in transfer tax and legal documents tax, both assigned to the regional governments, which can be related to developments in the housing market. Finally, indirect tax revenue was favoured in 2002 by the entry into force of the new tax on hydrocarbons.

TABLE IV.3

Main general government financial transactions (ESA 95)

% of GDP

	1999	2000	2001	2002
Total revenue	**39.4**	**39.4**	**39.6**	**40.0**
Current revenue	38.6	38.9	39.0	39.5
Taxes on production and imports	11.7	11.7	11.4	11.7
Taxes on income and wealth	10.2	10.5	10.5	10.9
Social contributions	13.1	13.3	13.6	13.5
Other revenue (a)	3.7	3.4	3.6	3.4
Capital revenue	0.7	0.6	0.7	0.5
Total expenditure	**40.6**	**40.2**	**39.8**	**40.1**
Current expenditure	35.8	35.6	35.1	35.3
Final consumption expenditure	17.4	17.6	17.5	17.6
Social benefits in cash	12.4	12.3	12.2	12.5
Actual interest payments	3.5	3.3	3.1	2.9
Subsidies	1.2	1.2	1.1	1.1
Other transfers	1.2	1.2	1.2	1.3
Capital spending	4.8	4.6	4.7	4.8
Gross capital formation (b)	3.5	3.1	3.3	3.4
Other expenditure	1.3	1.4	1.4	1.4
Net lending (+) or borrowing (–)	**-1.2**	**-0.8**	**-0.1**	**-0.1**
MEMORANDUM ITEM:				
Primary balance	2.4	2.5	3.0	2.8
Gross debt	63.1	60.5	56.9	54.0

Sources: INE, Ministerio de Hacienda and Banco de España.
(a) Includes fixed-capital consumption.
(b) Includes acquisitions of non-produced non-financial assets.

The growth of current taxes on income and wealth was even greater, at 11.3% in relation to the previous year. As a result, their weight in GDP increased by 0.4 p.p.. Once again, this is largely due to a particular circumstance: namely, the higher corporate income tax takings arising from the use by companies of the third transitory provision of the law accompanying the 2002 budget, relating to reinvested capital gains (6). This temporary effect may account for the increase by almost 0.3 p.p. in the weight of direct taxes in GDP. Nonetheless, the cash-basis data also indicate a sound performance by personal income tax, the related revenue from which grew by around 7% on the previous year, with an increase in withholdings on income from labour of 8.5%, largely reflecting the relatively favourable behaviour sustained by employment in 2002.

Revenue from social security contributions increased by 6.2% last year, having slowed significantly from the 8.9% rise recorded in 2001. That has entailed a very slight loss in the weight of social security contributions in GDP, reflecting a relatively favourable trend in the number of social security registrations, albeit with a growth rate of 3%, down on the previous year's rate of 3.9%. Lastly, non-tax revenue was largely determined by the decline in revenue relating to Banco de España profits.

Under primary current expenditure, spending on final consumption quickened appreciably, with growth of 7%, against 6.3% the previous year, with the weight of this variable in GDP increasing by 0.1 p.p.. This acceleration was due to the components other than compensation of employees in the service of general government, as this latter caption increased by only 5.2%, having slowed from a rate of 6.1% the previous year. The data on non-market services indicate that this slowdown is due to the number of employees, while compensation per employee has held at virtually the same growth rate as the previous year. Notable among the remaining components of general government final consumption is the growth of imports (purchases of goods and services), with a rate of 9.7%. This is related to some extent to the acceleration in the second half of the year, owing to the expenses incurred in the *Prestige* accident. Social transfers in kind also accelerated significantly, climbing from growth of 6.6% in 2001 to 9.6% in 2002. These transfers are essentially related to health and State-subsidised private education spending.

Welfare benefits in cash increased by 8.9%, quickening considerably on the 6% growth the previous year, and with their weight in GDP rising by 0.3 p.p.. This reflects, first, the extraordinary payment made to pensioners for the deviation of the CPI from the initially forecast inflation target and, further, the increase in unemployment benefits. Spending on unemployment benefits increased by 15% in 2002 (compared with 11% in 2001), with the number of beneficiaries

(6) As a complementary measure of the 2002 Budget, the effective rate applicable under corporate income tax to reinvested capital gains was reduced from 35% to 18%. These capital gains are now taxable, moreover, in the tax period in which the gains are reinvested. As a result, the previous regime was discontinued, which had allowed the capital gain to be apportioned in equal parts in the tax bases of the tax periods ending in the seven years following the close of the tax period in which the term for reinvestment concluded, but paying tax at the standard rate of 35%. On a temporary basis, however, it was possible, in relation to the income subject to the previous regime and pending integration, for companies to opt in 2002 to avail themselves of the new regime, including all outstanding capital gains in the tax base for fiscal year 2002 and paying tax at 18%, or, alternatively, to retain the previous regime and continue paying tax at 35%. Most companies will have chosen the first option, which accounts for the strong growth of revenue that year.

growing by 12.3% on average for the year. The growth in the number of beneficiaries was far greater than the increase in non-farm registered unemployment among those with previous jobs, which stood at 7.4% on average for the year. That signifies a substantial increase in the net eligibility ratio, which edged up, on average, from 68.5% in 2001 to 71.6% in 2002, following the trend of recent years. Nonetheless, it should be pointed out that this ratio peaked in the summer months of 2002, declining thereafter. Actual interest payments by general government fell by 2.4% on the previous year, meaning a fresh decline of 0.2 p.p. in respect of its weight in GDP, against a background of falling interest rates and a diminishing public debt/GDP ratio.

Turning to public investment, the buoyancy of this variable remained strong in 2002, with a nominal growth rate of 10.7%. The reason behind this is largely the 2000-2007 Infrastructure Plan, which is currently being pursued. As a result, the weight of public investment in GDP has increased by 0.1 p.p. this year. It should be pointed out that this increase in public investment does not reflect in its entirety the greater drive undertaken in the construction of infrastructure in 2002, owing to the significant investment channelled in this area via the business sector, either through State-owned companies or through private concessionaires.

In sum, 2002 may be characterised as a year in which there was a halt in the downward trend of public spending, in terms of GDP, that had been seen in previous years. Primary current expenditure increased significantly, due largely to the growth of government consumption and of unemployment benefits. However, the decline in the interest burden and the relatively favourable trend of revenue, including specific one-off developments such as that which affected corporate income tax revenue, enabled an overall general government budget balance close to zero to be maintained and, in turn, a high growth rate of public investment to be sustained.

Against a backdrop of economic slowdown, the indicators of fiscal policy revealed a restrictive stance in 2002, tighter indeed than had been expected on the basis of the initially approved Budget. However, if the one-off nature of the increase in revenue brought about by the measures affecting corporate income tax is taken into account, the broad fiscal policy stance may be qualified as virtually neutral. In any event, the fiscal policy implemented has provided for continuing fulfilment of the aim of placing the general government balance, in cyclically adjusted terms, close to zero or in surplus, which is the criterion used by the European Commission in its assessment of compliance with the Stability and Growth Pact.

IV.8. THE ECONOMY'S REST OF THE WORLD ACCOUNT AND CAPITAL ACCOUNT

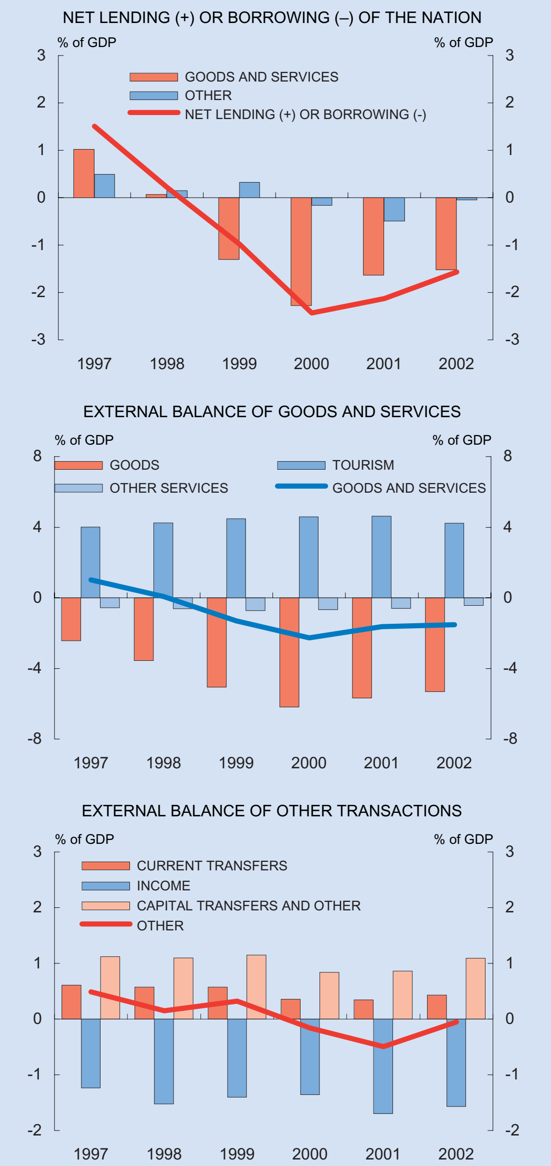
In 2002 the nation's net borrowing declined to 1.6% of GDP, 0.5 p.p. down on the previous year. Practically all the balances contributed to this improvement, with their shares in output increasing or stabilising. The exception was the tourism balance, whose surplus fell by 0.4 p.p. to 4.2% of GDP (see Chart IV.16).

The deficit on the merchandise account balance, which had peaked at 6.2% of GDP in 2000, declined for the second year running to 5.3% of GDP. The nominal growth of both receipts and payments eased significantly (to 0.9% and 0.7%, respectively) owing to the slowdown in trade transactions and to price developments. The correction of the deficit was essentially in the first half of the year and was driven by the improvement in the terms of trade and the strong slowdown in real imports. Nonetheless, this advance turned around in the closing months of 2002, amid escalating oil prices, the continuing fall in export prices and the sharp pick-up in real trade flows. The weight of the balance on services account in GDP declined by 0.2 p.p. to 3.8% as a result of the deterioration in the tourism balance, while the deficit on other services improved slightly.

Net property income continued to post a deficit, but one smaller than the previous year. The deficit stood at 1.6% of GDP, 0.1 p.p. less than in 2001. After several years of strong increases, income received diminished significantly in 2002, due to the widespread decline in yields which was only partly offset by the increase in the stock of financial assets. Income paid also declined over the year as a whole, due likewise to the fall in yields, which was not offset by the moderate increase in the stock of liabilities. Finally, the weight of net capital transfers in GDP increased by 0.2 p.p., reflecting a notable rise in most of the structural funds received from the EU, namely the Cohesion Funds and the EAGGF-Guidance Fund.

CHART IV.16

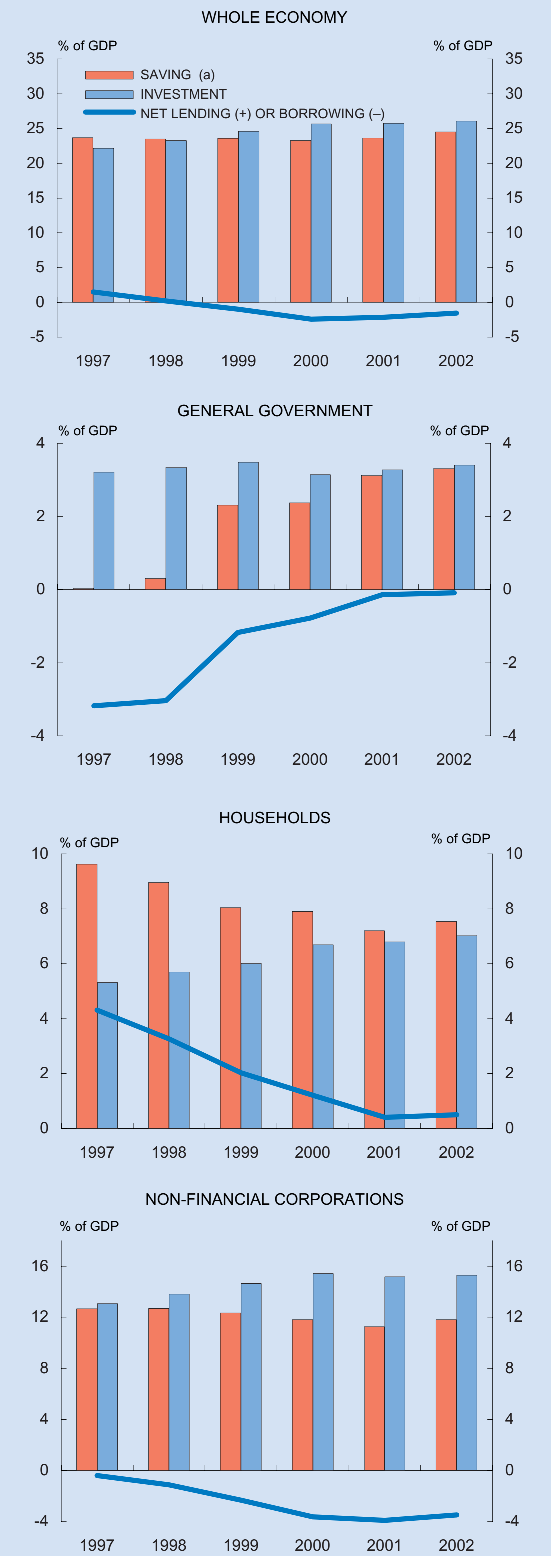
Rest of the world account



Sources: INE and Banco de España.

CHART IV.17

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



Sources: INE and Banco de España.
(a) Gross national saving.
(b) Gross capital formation.

The reduction in the nation's net borrowing was the result of the pick-up in the economy' saving ratio, which provided at the same time for an increase in the share of investment in output (see Chart IV.17). However, this increase in investment arises from the bigger build-up in stocks recorded in 2002, whereas gross fixed capital formation grew at the same rate as output. Across the various sectors, the nation's lower deficit was the outcome of the improvement in households' and non-financial corporations' lending capacity, while the general government budget remained in deficit to the tune of

0.1 p.p. of GDP. The following chapter analyses in greater financial detail how this deficit position has been corrected.

This stabilisation of the budget balance in terms of GDP was the result of an increase in gross saving and of an investment drive. Households' lending capacity improved slightly in 2000 to around 0.15% of GDP, thereby discontinuing the path of continuous decline witnessed in recent years. As mentioned, this improvement came about as a result of the pick-up in the household saving ratio, which had reached historical lows. This recovery allowed for a continuing financing of investment in housing that was slightly higher, in terms of GDP, than that of the previous year.

Finally, Spanish companies reduced their net borrowing to around 2% of GDP. This was mainly the result of the behaviour of non-financial corporations, which recorded a reduction in their deficit balance to 3.2% of GDP. In the case of non-financial corporations, an improvement in gross saving arose from a bigger gross operating surplus and from a smaller financial burden, while the share of investment in output held stable.

CHAPTER V

FINANCIAL DEVELOPMENTS IN SPAIN

In broad terms, the main trends that characterised Spain's financial flows, markets and intermediaries in 2001 continued to hold sway in 2002, though naturally they were influenced by the international environment. The latter was marked by continued uncertainty over the scope and duration of the downturn in the main industrialised economies, by the emergence of a number of financial scandals which damaged the credibility of the public accounts of listed companies and by geopolitical tensions that had built up in various areas.

Spanish corporations and households again increased their debts to sustain their spending. The financing they raised grew at rates of around 14% and, consequently, their debt ratios rose to around the average level in the euro area. Liabilities increased more sharply in the case of households, whose debt reached 83% of their gross disposable income. This behaviour reveals the strengthening of the framework of greater macroeconomic stability which the Spanish economy has progressively moved into, while it also shows the role played by the financial system in channelling flows of funds between agents and in the inter-temporal allocation of their resources.

The increase in liabilities obtained by households and corporations was primarily underpinned by the decline in short- and long-term nominal interest rates, the decline in real rates being greater owing to the increase in inflation. Thus, despite the growth in debt, the debt-service burden borne by agents held steady. In the case of households, the expansionary effect of the fall in rates was amplified by the rise in their wealth, although this was the net result of countervailing movements in its financial and property components. In the case of corporations, however, the effects of lower interest rates were moderated by the rise in the risk premiums negotiated on the markets, in some cases linked to a downgrading of credit ratings, and by the deterioration in financing conditions on stock markets.

Developments in the net financial wealth of the non-financial private sector were driven by the fall in share values, although this was actually less pronounced on Spanish stock exchanges than on other European bourses. The decline in share values, along with the continued high degree of price volatility on these markets, prompted a fresh shift in investors' portfolios towards more liquid and less risky financial assets. Likewise, equity issues lost ground to the bond issues of general government and financial corporations (while non-financial corporations actually made a net redemption of bonds in 2002). Turnover in fixed-income instruments grew significantly, in contrast to the stagnation recorded for equities and the reduction in derivatives turnover.

By contrast, the value of the main component of household wealth, housing, again increased in 2002, by around 17% in nominal terms. The price of this real asset thus showed signs of overvaluation, comparable to that in the last upturn in the market which ended at the beginning of the 1990s (see Box V.1). Increased property wealth was conducive to buoyant household consumption, while a significant portion of the loans received by households was used for house purchases, this type of bank credit growing by more than 17% last year (see Box V.2).

The loans received by non-financial corporations from Spanish credit institutions decelerated somewhat in 2002, although those relating to property activities did not. Thus, total mortgage lending, an essential part of the business of these institutions in Spain, continued to grow at rates of over 20%. The strength of this component explains much of the notable resilience displayed by the Spanish banking system in a markedly adverse environment which, besides the slowdown in activity in Spain, was characterised by the unfavourable performance of other economies in which Spanish banks have investments, by the fall in share values and by the depreciation of the main Latin American currencies. Thus, although their profits fell in 2002, their rates of return held at high levels (average ROE was around 12%), while the sector continued to show a high degree of solvency.

In sum, the financial position of deposit institutions, which continue to play a central role in the channelling of financial flows between the different sectors of the economy, and of Spanish corporations and households should not be an obstacle to a recovery in consumption, investment and employment. However, as stated on other occasions, it also needs to be stressed that this position is now more exposed to certain shocks. In particular, the behaviour of house prices may govern household spending decisions to a greater extent than in the past. Likewise, it is reasonable to think that, in view of the higher levels of debt of the non-financial private sector, consumption and investment will be more sensitive to interest rate changes. Their higher indebtedness also limits the scope for Spanish firms and households to continue sustaining the growth of activity on the basis of a heavy recourse to external financing. Despite this, the information available for 2003 Q1 still shows no clear signs of a slowdown in the financing raised by the non-financial private sector.

V.1. FINANCIAL FLOWS IN THE SPANISH ECONOMY

The financing raised by the non-financial private sector decelerated slightly in 2002 but continued to grow at rates that are high when considering the cyclical position of the Spanish economy and the uncertainty surrounding activity. This slowdown was the net result of a moderation in the rate of growth of liabilities of by non-financial corporations and of a certain acceleration in borrowing by households. In both sectors, however, the strength of property-related credit was notable.

The net financial saving ("net financial transactions", according to ESA 95 terminology) of the non-financial private sector improved as a consequence of the increase in household saving and the lower net borrowing requirements of non-financial corporations (see Table V.1). As for general government, its net financial transactions were low. Overall, the net recourse of the Spanish economy to foreign savings amounted to 1.6% of GDP, as against 2.1% in 2001.

V.1.1. Financial flows of households and non-financial corporations

In 2002, the financial saving of households picked up to 1.4% of GDP, following the downtrend of recent years (see Table V.1 and Chart V.1). However, this was a modest improvement considering the increasing uncertainty last year and the sector's heavy loss of financial wealth as a result of the behaviour of financial asset prices (see Chart V.2). In fact, the recovery in saving was moderated by the rise in the value of housing, the main component of household wealth and thus an important determinant of household borrowing capacity.

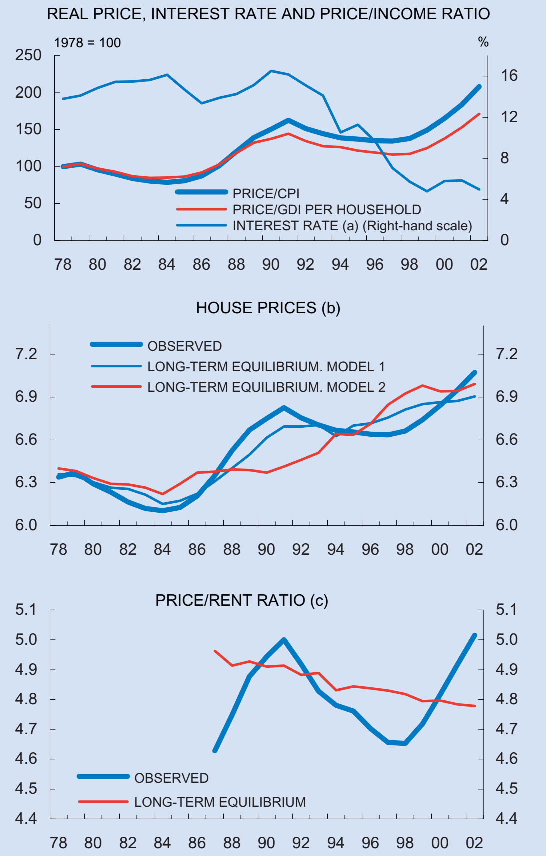
The increasing uncertainty also had a substantial effect on household financial investment decisions. Their net asset transactions, which picked up in 2002, were characterised by a greater relative preference for more liquid and less risky instruments (see Table V.2 and Chart V.2). Cash and cash equivalents (cash and sight and savings deposits) was the main component of the net acquisition of financial assets, although time deposits also received a high volume of investment, within the downtrend that dates back to 2000. Net household investment in mutual funds was still positive although, at 0.2% of GDP, the volume was more moderate than in 2001 and varied according to the type of fund. Thus, while net investment in money market funds and euro-denominated fixed-income FIMs was relatively high, there was a net redemption of shares in other FIMs. At the same time, despite the falls in stock market indices and their high degree of volatility, household investment in listed and unlisted shares was positive. Finally, contributions to pension and insurance schemes were also significant, although lower than in previous years.

On the liabilities side, the funds obtained by households rose to 8% of GDP, of which 6.8 percentage points corresponded to loans from resident financial institutions. This volume of financing was higher than in 2001, when it was 6.6% of GDP, and was largely determined by the persistence of easy monetary and financial conditions. Loan rates were

BOX V.1

Analysis of house prices in Spain

In 2002 the average price of appraised housing in Spain increased by 16.6%, up by more than one percentage point on the rise in 2001, making it the fourth year running of nominal growth above 10%. Moreover, this took place against a background of economic deceleration, which naturally raises the question of what is causing this behaviour. From a longer-term perspective, the adjacent chart (top panel) shows how real housing prices in Spain have doubled in the last 25 years. The expansion recorded is also very high in comparison with that of average household income.



Sources: INE, Ministerio de Fomento, Tecnigrama and Banco de España.
(a) Nominal interest rate on house purchase loans.
(b) Price series, deflated by the CPI, as logarithms.
(c) Logarithm of the ratio.

Given the special nature of housing, which shares the features of both consumer durables and investment assets, there are various approaches that can be used to analyse the changes in its price. For instance, analyses focussing on macroeconomic variables tend to show that house prices can be explained by a small number of factors, including most notably average household income and the user cost of housing, along with a significant inertial component which generates temporary deviations from long-term equilibrium. In Spain there are also other specific developments that may have helped to raise the demand for housing in the recent past, such as changes in the population pyramid, the rise in immigration and the increase in second home purchases by both residents and non-residents. However, available evidence suggests that in Spain, as in other countries, household income and the cost of financing are the variables that explain most fully the trend in property values over the last two decades.

The recent structural changes in the Spanish economy have significantly spurred employment growth, which has led to a rise in household disposable income. At the same time, there has been a sharp fall in nominal interest rates – one of the components of the user cost of housing – which, together with an increase in the average term of mortgage loans, has helped to reduce considerably the financial burden on households. While these factors together explain a large part of the recent rise in property prices, the (negative) correlation between interest rates and income in this period makes it more difficult to estimate accurately the separate impact of each variable. Against this background, the adjacent chart (middle panel) gives an estimate of long-term equilibrium house prices in Spain under two complementary models that combine the above-mentioned macroeconomic variables (1).

Another approach exploits the financial properties of housing assets. It analyses the theoretical relationship between their price and the “dividends” they yield (rent or imputed value of the accommodation services they provide). The adjacent chart (lower panel) gives an estimate based on this alternative financial approach (2).

As can be appreciated, the results of both approaches—macroeconomic and financial—suggest that the housing market was somewhat undervalued in the second half of the 1990s, due to a progressive accumulation of the real price adjustments that commenced in 1991. Thus the expansionary behaviour of prices in this market at the end of the 1990s should be regarded, at least in part, as an adjustment that took prices towards their equilibrium value.

However, prices have increased beyond what was needed to restore their equilibrium value. Thus, at the end of the sample, houses are somewhat overvalued, although this is compatible with the adjustment dynamic that customarily operates in this market. Consequently, and with the due caution that should accompany an exercise such as that carried out here, it is likely that in the near future the growth rate of house prices will gradually move towards levels more in line with the long-term fundamentals.

(1) The main difference between the two models is that in the first (model 1) the income elasticity of house prices is estimated freely, while in the second (model 2) it is restricted to unity. For more details, see the Banco de España Working Paper “Análisis del precio de la vivienda en España” by Jorge Martínez and Luis A. Maza.

(2) For more details, see Banco de España Working Paper No. 0304 “House prices and rents: an equilibrium asset pricing approach” by Juan Ayuso and Fernando Restoy.

TABLE V.1

Net financial transactions and inter-sectoral flows

% of GDP

	NET FINANCIAL TRANSACTIONS					
	1997	1998	1999	2000	2001	2002
National economy	**1.5**	**0.2**	**-1.0**	**-2.4**	**-2.1**	**-1.6**
Non-financial corporations and households and NPISHs	**3.9**	**2.1**	**-0.3**	**-2.4**	**-3.5**	**-3.0**
Non-financial corporations	-0.6	-1.1	-2.3	-3.5	-4.6	-4.4
Households and NPISHs	4.5	3.3	2.0	1.1	1.1	1.4
Financial corporations	**0.8**	**1.1**	**0.5**	**0.7**	**1.5**	**1.5**
General government	**-3.2**	**-3.0**	**-1.2**	**-0.8**	**-0.1**	**-0.1**
	INTER-SECTORAL FLOWS (a)					
	1997	1998	1999	2000	2001	2002
Households and NPISHs	**4.5**	**3.3**	**2.0**	**1.1**	**1.1**	**1.4**
Vis-à-vis:						
Credit institutions (b)	-6.7	-4.6	0.5	-0.2	-1.5	-2.8
Institutional investors (c)	10.9	7.6	0.9	0.4	3.7	2.8
Non-financial corporations	**-0.6**	**-1.1**	**-2.3**	**-3.5**	**-4.6**	**-4.4**
Vis-à-vis:						
Credit institutions (b)	-3.0	-4.5	-4.1	-6.8	-4.0	-2.7
Rest of the world	1.6	0.7	-0.7	2.0	-2.3	-1.0
General government	**-3.2**	**-3.0**	**-1.2**	**-0.8**	**-0.1**	**-0.1**
Vis-à-vis:						
Credit institutions (b)	1.4	1.4	1.3	2.2	-2.3	1.0
Institutional investors (c)	-3.9	-2.6	1.7	3.9	2.9	0.3
Rest of the world	-2.0	-1.1	-4.3	-5.9	-1.6	-1.2
Rest of the world	**-1.5**	**-0.2**	**1.0**	**2.4**	**2.1**	**1.6**
Vis-à-vis:						
Credit institutions (b)	2.7	7.1	1.9	5.1	3.8	2.9
Institutional investors (c)	-2.5	-6.3	-3.6	-5.7	-4.9	-2.4
Non-financial corporations	-1.6	-0.7	0.7	-2.0	2.3	1.0
General government	2.0	1.1	4.3	5.9	1.6	1.2

Source: Banco de España.
(a) A positive sign denotes the extension of financing to the counterpart sector. A negative sign denotes financing from the counterpart sector.
(b) As defined by the First Banking Directive.
(c) Insurance corporations and collective investment undertakings.

at historically low levels and fell even further during the final quarter, given the expectations (subsequently confirmed) of cuts in official interest rates, amid growing competition among institutions. The increase in credit was also underpinned by the rise in employment and the rise in the value of household property wealth (see Chart V.3). The credit was mainly used to finance house purchases, while the annual growth rate of credit for current and durable consumption fell significantly, to 6.4%, in line with the moderation in household spending.

As regards non-financial corporations, there was a fall in the volume of their investment in financial assets and in their acquisition of liabilities in 2002. The slight pick-up in their gross saving and the slackness of gross capital formation meant that there was a modest improvement in the net balance of their financial transactions, following the deterioration of the last few years. This balance was still negative, at –4.4% of GDP, but that was a lower rate of dissaving than at similar stages of the cycle in the past.

The need for funds to finance a broader investment aggregate known as the *financing gap* (which includes, in addition to gross capital formation, financial investment of a permanent nature in the rest of the world) also fell to 7.4% of GDP, as a consequence of a further contraction in outflows of for-

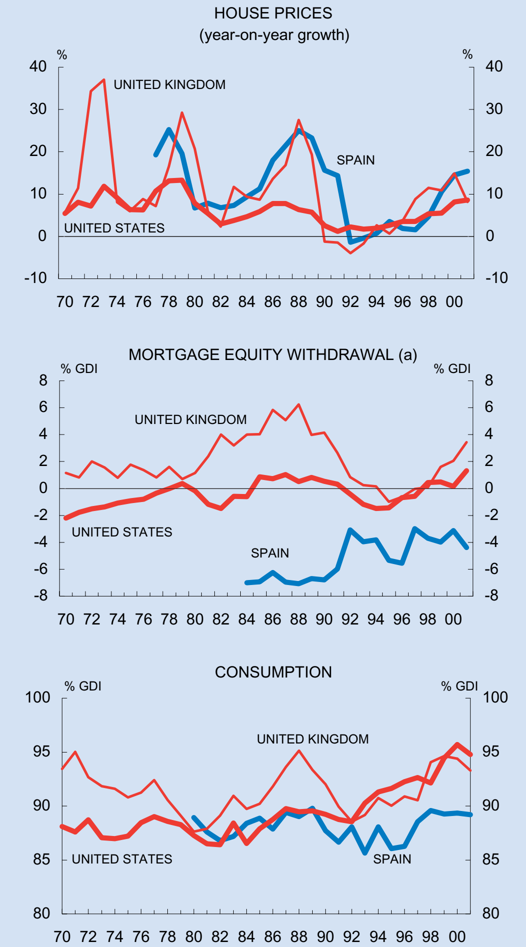
BOX V.2

House prices and household consumption

Many analysts consider that the rise in house prices in certain countries has been a major determinant of household consumption behaviour in the current economic downturn. This explanation, which has been used particularly in the United States and the United Kingdom, is based on a wealth effect whereby household spending increases due to the increase in the value of property assets owned by households. The nature of this wealth effect differs, however, from that caused by a rise in the value of other assets, such as financial instruments, because it is due not to expectations of higher income (an increase in house prices in the present normally implies a higher cost of the accommodation services that the house provides over time) but rather to the role played by property as collateral for obtaining loans.

In this connection, when households decide on their desired combination of present and future consumption, they face constraints on their ability to borrow against future income. In these circumstances, increases in property wealth mean more collateral with which to secure loans and thus tend to relax these constraints. This greater borrowing capacity can give rise to expenditure either through greater demand for bank loans that are immediately used for consumption or through a reduction in the propensity to save, since households know that in the event of an unanticipated future decrease in, say, their income, they will be better placed to qualify for a loan.

Recently, to evaluate the importance of the relationship between house prices and consumption, attention has been given to an indicator known as "Mortgage Equity Withdrawal" (hereafter "MEW"). This indicator measures the difference between the change in mortgage lending to households over one year and the value of their residential domestic investment in the same period. Therefore, if the MEW is positive, the household sector is using part of its mortgage financing for purposes other than house purchases. Such purposes include consumption or investment in other types of assets.



Sources: Bank of England, BIS, European Commission, Federal Reserve and Banco de España.

(a) Calculated as the difference between the change in house purchase lending and residential domestic investment. In the case of the United States and the United Kingdom, mortgage lending is used.

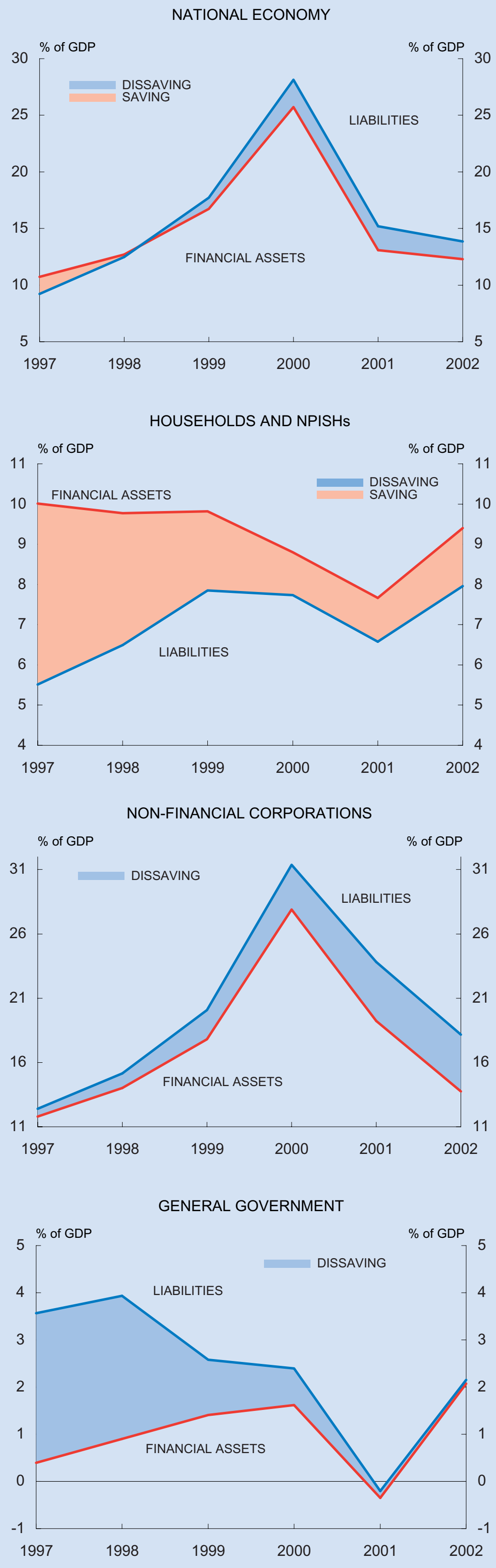
The adjacent chart shows house prices, MEW and consumption in the United States, the United Kingdom and Spain from 1970 to 2001. It can be seen that in the first two countries there have been various periods in which the MEW indicator has been positive, which means that on several occasions households have used mortgage financing for a purpose other than investment in housing. It can also be seen that the MEW is closely related to the pattern of consumption, which suggests that the funds may have been used for this purpose. In the last part of the sample period, when house prices grew substantially, the MEW increased significantly, particularly in the United Kingdom.

By contrast, in Spain the MEW has been negative over the whole period considered. This indicates that, in aggregate, Spanish households not only use all their mortgage loans to acquire new houses, but that the financing of these purchases requires recourse to other additional sources of funds, typically the liquidation of financial assets. This behaviour of the MEW, shared by most euro area countries, suggests that, unlike in the United States and the United Kingdom, Spanish households have not used the higher value of their houses to obtain loans with which to step up their consumption.

However, despite the heightened economic uncertainty and the depletion of their financial wealth, the saving ratio of Spanish consumers has been falling over the last few years and grew only moderately in 2002. This, along with the evidence presented in Box IV.1 on the significance of the *wealth effect* in explaining consumer behaviour, suggests that the rise in house prices has spurred consumer spending mainly by reducing households' propensity to save. In any event, the substantial growth of lending in this context reveals that the rise in house prices has tended to underpin spending on residential investment to a greater extent in Spain than in other countries that have experienced similar processes in the recent past.

CHART V.1

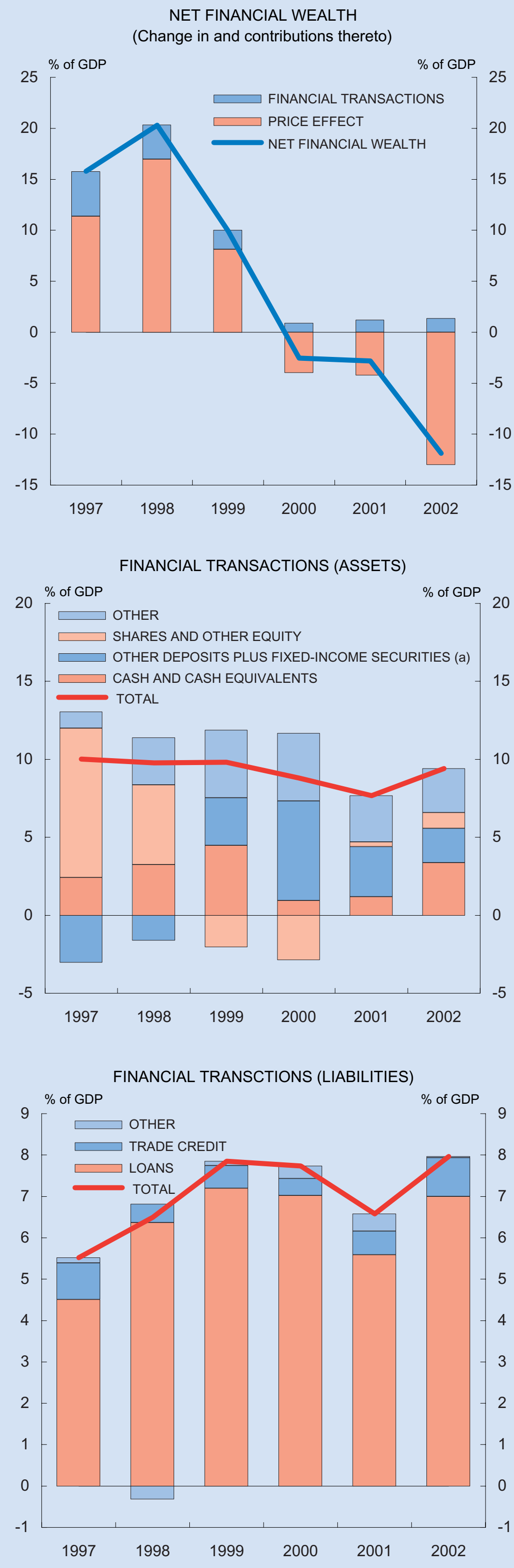
Financial transactions



Source: Banco de España.

CHART V.2

Financial transactions of households and NPISHs



Source: Banco de España.

(a) Not including unpaid accrued interest, which is included under "Other".

TABLE V.2

Non-financial corporations and households and NPISHs

% of GDP

	Non-financial corporations			Households and NPISHs		
	2000	2001	2002	2000	2001	2002
Net financial saving	**-3.5**	**-4.6**	**-4.4**	**1.1**	**1.1**	**1.4**
Financial transactions (assets)	**27.9**	**19.2**	**13.8**	**8.8**	**7.7**	**9.4**
Cash and cash equivalents	0.9	1.7	1.4	0.9	1.2	3.4
Other deposits (a)	1.0	0.4	1.0	6.1	3.4	2.2
Securities other than shares	0.3	0.7	0.4	0.3	-0.1	0.1
Shares and other equity (b)	15.2	5.9	4.2	0.5	-0.5	0.8
Of which:						
Rest of world	11.3	4.9	3.0	-0.4	-0.1	0.1
Shares in mutual funds	-0.3	0.0	-0.1	-3.4	0.8	0.2
Of which:						
Money market funds (FIAMM)	-0.1	0.2	0.0	-1.3	1.3	0.7
Securities funds (FIM)	-0.3	-0.3	-0.2	-2.0	-0.5	-0.5
Insurance technical reserves	0.2	0.3	0.3	3.4	2.5	2.2
Credit and other	10.5	10.4	6.5	0.9	0.4	0.6
Financial transactions (liabilities)	**31.4**	**23.8**	**18.2**	**7.7**	**6.6**	**8.0**
Securities other than shares	-0.7	0.0	-0.3			
Shares and other equity	12.8	5.4	3.1			
Loans	11.2	11.1	10.2	7.0	5.6	7.0
Of which:						
Resident financial institutions (c)	7.6	6.9	6.6	7.0	5.4	6.8
Rest of the world	3.5	4.0	3.4	0.0	0.0	0.0
Trade credit	8.1	7.3	5.4	0.4	0.6	0.9
Insurance technical reserves and other	0.0	0.0	-0.2	0.3	0.4	0.0
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH:						
Financing (d)	19.9	18.2	14.3	17.3	12.4	14.8

Source: Banco de España.
(a) Does not include savings deposits since these are included under cash and cash equivalents.
(b) Does not include shares in mutual funds.
(c) Includes securitised loans.
(d) Includes bank credit extended by resident credit institutions (securitised credit included), foreign loans and fixed-income securities.

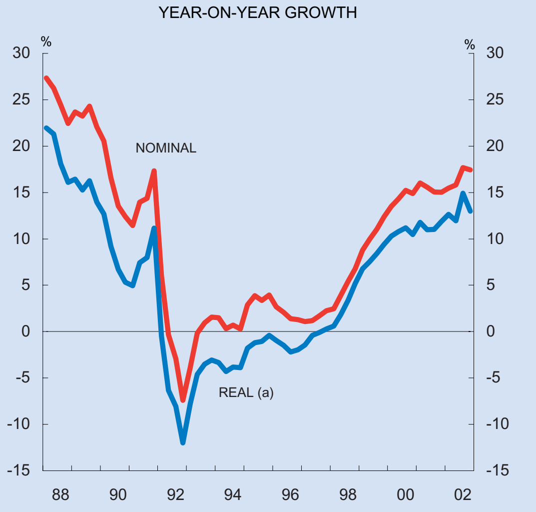
eign investment, in an environment marked by low growth across the main economies, high levels of uncertainty and crisis in some Latin American countries (see Chart V.4).

The net acquisition of financial assets by non-financial corporations continued to follow the path of moderation established in 2001, mainly on account of the lower growth in credit positions vis-à-vis other countries (see Table V.2). However, the latter were still relatively high and represented around 28% of the net financial investment of corporations. A significant portion of the acquisition of financial assets (more than 40%) consisted of trade credit, mostly made up of inter-company transactions (also reflected in the sector's liabilities).

The slowdown in the productive and foreign investment of Spanish corporations resulted in a reduction in the growth rate of their liability transactions, which was reflected in most of the different headings (see Table V.2 and Chart V.4). In 2002, the amount of funds obtained through the issuance of shares and other equity was 3.1% of GDP, as against 5.4% in 2001. Interest-bearing external financing (securities other than shares and credit) rose by 14.3%, which was still a high rate, but notably lower than in 2001 (see the memorandum item in Table V.2). The net issuance of fixed-income securities was negative, especially in the case of short-term securities, and credit financing grew by less than in the previous year, both in the case of its domestic component and in that of foreign loans, although the latter continued to be a significant

CHART V.3

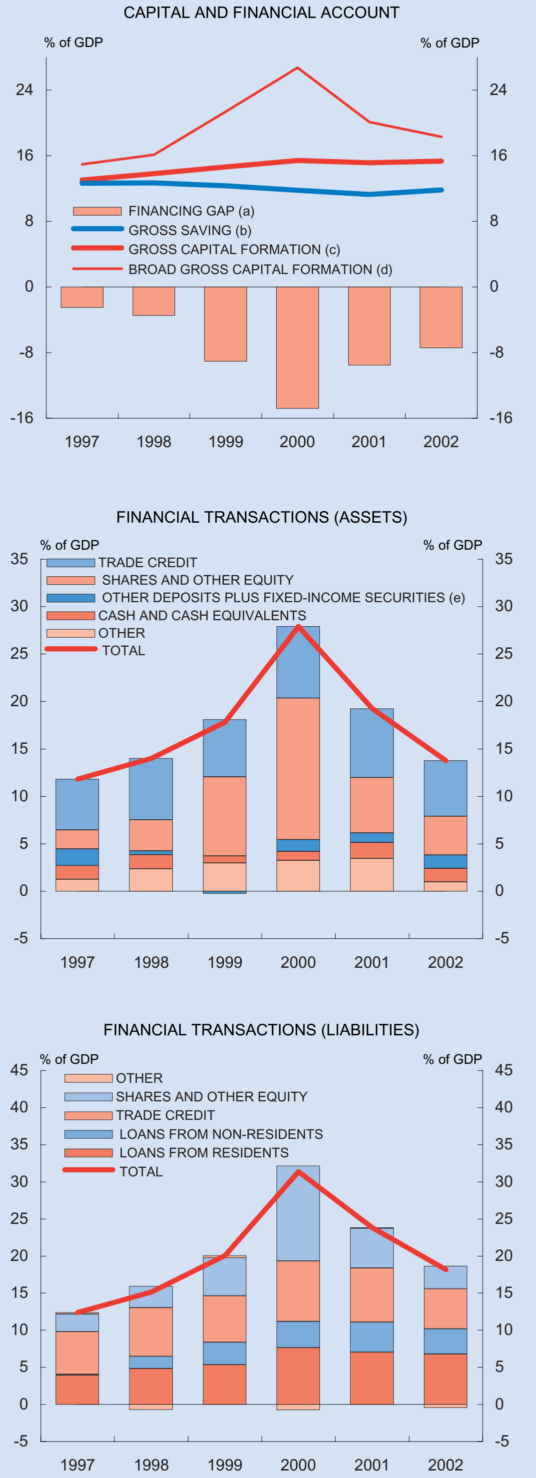
Change in house prices



Source: Banco de España.
(a) Deflated by the CPI.

CHART V.4

Financial transactions of non-financial corporations



Source: Banco de España.
(a) Financial resources that cover the gap between permanent real and financial investment and gross saving.
(b) Includes capital transfers.
(c) Includes, in addition to GKF, stockbuilding.
(d) Calculated incorporating foreign equities.
(e) Not including unpaid accrued interest, which is included under "Other".

source of financing (more than 30% of the net flow of credit financing). Significantly, however, credit did not grow at the same rate across the various productive sectors. In industry (excluding construction) and the services sector (excluding property) moderate annual rates of expansion of 3.2% and 5.7%, respectively, were recorded. However, loans to the construction sector and property services increased at higher rates than in 2001, of above 20%, in line with the buoyancy of this sector last year.

V.1.2. General government financial flows

In 2002, the net balance of general government financial transactions was close to a balanced budget at –0.1% of GDP (see Chart V.5). These net financing requirements stemmed from a social security surplus which almost cancelled out the small central and regional and local government deficits.

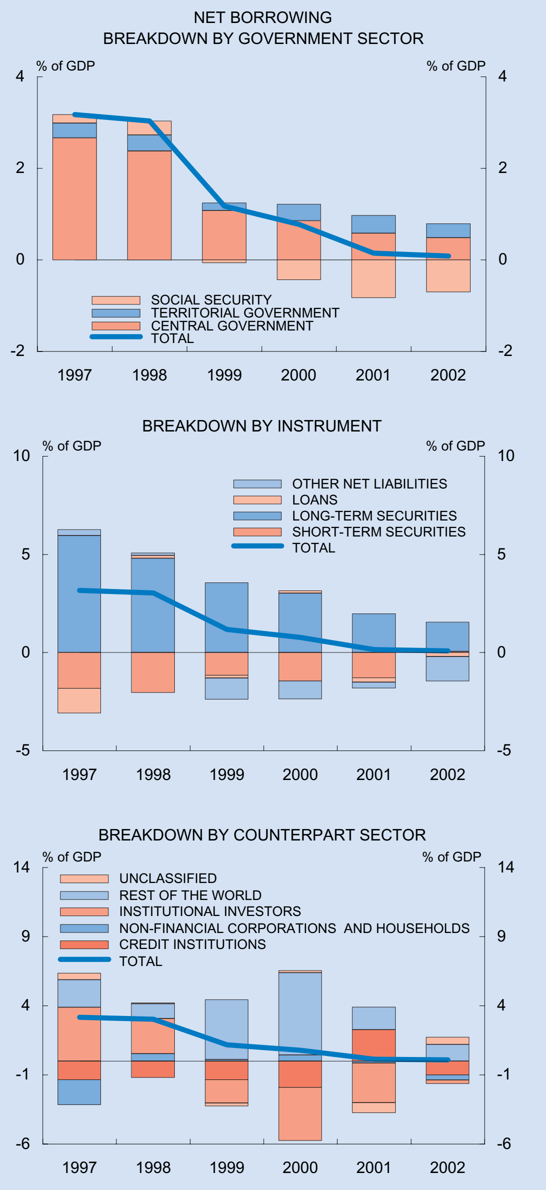
General government increased its net volume of marketable securities issuance, while reducing the balance of credits and other liabilities and increasing its deposits. In the case of the State, net Treasury bill issuance was positive for the first time since 1997, although the amount was small (less than 0.1% of GDP). Two measures were taken to make this segment of the market more liquid:

first, with effect from August, the Treasury changed the frequency of tenders (from fortnightly to monthly), raising the amounts allocated by tender; second, each of the benchmarks began to be tendered on more than one occasion, thereby increasing the outstanding amount thereof. The main source of State financing, however, was still bond issuance, through which a volume of funds representing about 1.2% of GDP was raised. Net issuance of three and five-year bonds gave a negative amount of €6.6 billion, while that of ten, fifteen and thirty-year bonds was a positive amount of €15.8 billion. As regards the average life of State debt, following several years of gradual increase, it stabilised from late 2001 at around six years. Net issuance by regional and local government amounted to 0.5% of GDP and was concentrated at the longer dates.

Of the various sectors, the rest of the world was still the main supplier of financing to general government in net terms. Non-residents held marketable securities representing around 46% of the total portfolio of government debt, a percentage that has been increasing since 1999, when it stood at around 30%. Resident credit institutions, which hold around 30% of government debt, increased their holdings moderately from 2001, when there was a notable increase in their demand, owing to the commencement of Treasury liquidity tenders.

CHART V.5

General government financial transactions



Source: Banco de España.

V.1.3. Investment and foreign financing of the Spanish economy

In 2002, the net balance of the financial transactions of the Spanish economy with the rest of the world amounted to –1.6% of GDP, as against –2.1% the previous year (see Table V.3). This small net inflow of funds was the result of a somewhat sharper reduction in liability transactions than in asset transactions, with respect to 2001, in an environment not propitious to growth in international capital flows.

The Spanish economy's investment in foreign financial assets amounted to 11.6% of GDP, as against 12.2% in 2001. The adverse international environment was also reflected in the composition of these capital flows, which tended to be concentrated in less risky assets. Thus, while the acquisition of cash and deposits increased, other asset transactions declined. Investment in securities other than shares amounted to 4.3% of GDP, which was higher than investment in shares (3.1% of GDP).

Liability transactions with the rest of the world declined moderately to 13.1% of GDP, from 14.3% the previous year. This decline was mainly attributable to the fall, as in 2001, in the net acquisition of shares and other equity of non-residents, which totalled 1.8% of GDP in 2002. However, the investment of non-residents in more liquid and less risky assets increased. Thus, the net acquisition of deposits and fixed-income securities amounted to 4.3% and 4%, respectively, of GDP.

TABLE V.3

Financial transactions of the nation

% of GDP

	1997	1998	1999	2000	2001	2002
Net financial transactions	**1.5**	**0.2**	**-1.0**	**-2.4**	**-2.1**	**-1.6**
Financial transactions (assets)	**9.9**	**12.6**	**15.3**	**25.2**	**12.2**	**11.6**
Gold and SDRs	**0.0**	**0.0**	**-0.2**	**0.0**	**0.0**	**0.0**
Cash and deposits	**1.3**	**3.2**	**1.7**	**2.8**	**-2.7**	**4.1**
Credit system	-1.5	0.0	3.7	2.5	-2.7	2.0
Other resident sectors	2.7	3.2	-2.1	0.4	0.0	2.0
Securities other than shares	**3.6**	**3.5**	**2.9**	**3.9**	**7.2**	**4.3**
Credit system	1.9	-1.4	-0.8	-0.3	2.0	0.6
Other resident sectors	1.6	4.8	3.7	4.2	5.3	3.7
Shares and other equity	**3.2**	**4.6**	**10.1**	**15.6**	**5.2**	**3.1**
Credit system	0.5	0.4	0.8	1.8	0.0	0.0
Other resident sectors	2.6	4.1	9.4	13.9	5.2	3.1
Of which:						
Non-financial corporations	1.9	2.3	6.8	11.3	4.9	3.0
Loans	**1.9**	**1.4**	**0.7**	**2.8**	**2.5**	**0.1**
Credit system	0.8	0.2	-0.2	0.5	0.8	0.0
Other resident sectors	1.1	1.2	0.9	2.3	1.7	0.1
Financial transactions (liabilities)	**8.4**	**12.4**	**16.3**	**27.7**	**14.3**	**13.1**
Deposits	**4.4**	**5.9**	**4.1**	**6.8**	**2.8**	**4.3**
Of which:						
Credit system	4.4	5.9	4.1	6.8	2.8	4.3
Securities other than shares	**2.2**	**0.9**	**5.4**	**7.0**	**3.1**	**4.0**
Credit system	0.2	0.3	0.9	0.7	0.6	1.2
General government	2.1	0.9	4.3	5.7	1.6	1.1
Other resident sectors	0.0	-0.3	0.2	0.5	0.9	1.7
Shares and other equity	**1.4**	**3.3**	**4.2**	**9.4**	**4.7**	**1.8**
Credit system	-0.2	0.1	0.3	1.8	0.5	0.1
Other resident sectors	1.6	3.2	3.9	7.7	4.1	1.7
Loans	**1.2**	**2.2**	**3.8**	**4.5**	**4.8**	**3.8**
General government	-0.1	0.1	0.0	0.0	0.1	0.0
Other resident sectors	1.2	2.1	3.7	4.4	4.7	3.7
Other, net (a)	**-0.8**	**0.0**	**-1.2**	**0.0**	**-1.0**	**-0.7**

Source: Banco de España.
(a) Includes the asset item which covers insurance technical reserves.

V.2. THE SPANISH FINANCIAL MARKETS

As already indicated, developments on the Spanish financial markets in 2002 were against a backdrop of economic and geopolitical instability, with the emergence of certain corporate scandals having an adverse effect on the credibility of the public accounts of listed companies. These factors, as in most of the developed economies, led to a significant fall in prices on equity markets and constrained securities issuance on primary markets. The greater uncertainty was reflected in an increase in share volatility, which reached levels even higher than those recorded immediately after the attacks of 11 September 2001. In addition, there was a shift by issuers and investors from equities to fixed-income instruments. In particular, financial institutions issued bonds in order to raise funds to meet the high demand for financing from the non-financial private sector. By contrast, in the case of companies, the adjustment of investment plans, partly linked to the restructuring undertaken by

TABLE V.4

Issuance and public offerings of marketable securities

e m

	1999	2000	2001	2002
Net issuance by residents (a)	**58,022**	**47,176**	**33,654**	**41,508**
Fixed income	48,707	14,305	28,821	37,763
State	*13,583*	*10,688*	*3,856*	*7,109*
Territoral government	*1,662*	*1,166*	*757*	*3,171*
Credit institutions	*24,810*	*-1,772*	*13,226*	*13,475*
Other financial firms	*5,280*	*5,689*	*9,986*	*15,557*
Non-financial corporations (b)	*3,372*	*-1,466*	*996*	*-1,549*
Equities	9,315	32,871	4,833	3,745
Credit institutions	*812*	*10,310*	*2,223*	*1,712*
Other financial firms	*291*	*735*	*323*	*141*
Non-financial corporations	*8,212*	*21,826*	*2,287*	*1,892*
Public offerings	**5,042**	**3,074**	**3,085**	**1,616**
Privatisations	772	0	696	0
Other	4,270	3,074	2,389	1,616
MEMORANDUM ITEMS:				
Net issuance by foreign subsidiaries	**21,389**	**32,191**	**23,138**	**15,933**
Financial institutions	11,806	21,041	11,833	13,484
Non-financial corporations	9,583	11,150	11,305	2,449

Sources: CNMV and Banco de España.
(a) Includes issuance by residents, in both domestic and foreign currency.
(b) Short-term issuance is commercial paper registered with the CNMV.

certain major companies, reduced recourse to the markets.

V.2.1. The primary markets

The net issuance of shares on primary markets, by both non-financial corporations and financial institutions, continued to display moderation in line with the uncertainty on equity markets and the significant reduction in share values. The funds raised through public share offerings fell significantly as a result of the smaller volume of IPOs and the absence of privatisations carried out through this channel (see Table V.4).

In the case of non-financial corporations, this reduction in the amount of funds raised through share issuance was not offset by financing raised on the fixed-income markets. Thus, in 2002, the sector made a net redemption of €1.5 billion of bonds and paper, which contrasts with the amount of almost €1 billion raised the previous year. The volume of funds raised by their subsidiaries abroad also fell significantly, for the first time in the last three years. All these declines are linked to the containment of investment and to the balance sheet restructuring in certain large Spanish companies, those that have in the past resorted most to this type of financing.

Conversely, financial institutions (which, in addition to credit institutions, include other financial intermediaries, such as portfolio investment institutions and securitisation funds) increased their issuance of fixed income on the domestic market significantly. As in the previous year, these transactions were concentrated in long-term securities, most of which were placed through securitisation funds. Thus, credit institutions continued to increase their use of asset securitisation, especially in the case of mortgage loans, as an instrument to meet their financing requirements. In 2002, the volume of funds raised by this means increased by 58.7% over the previous year, so that by the end of 2002 these securities represented 5.1% of the credit extended by Spanish institutions and 29.9% of the outstanding amount of private fixed-income in Spain. Meanwhile, net debt issuance by the foreign subsidiaries of financial institutions increased moderately.

TABLE V.5

Turnover on secondary and derivatives markets

€ m

	1999	2000	2001	2002
Public-debt book-entry market (a)	**13,109,675**	**13,788,917**	**16,237,439**	**18,805,433**
Spot (b)	1,817,465	1,585,460	2,041,091	2,310,943
Repo	11,254,309	12,186,364	14,173,002	16,475,994
Forward (b)	37,901	17,093	23,346	18,496
AIAF fixed-income market (b)	**86,269**	**99,826**	**141,509**	**264,974**
Commercial paper	25,284	46,425	97,801	204,883
Ordinary and asset-backed bonds and mortgage certificates	58,572	52,189	41,488	56,289
Matador bonds	2,413	1,212	2,220	3,802
Stock exchange: fixed-income (b)	**44,718**	**39,692**	**56,049**	**69,820**
State debt	160	73	50	40
Territorial government debt	42,858	38,723	55,105	69,171
Other	1,700	896	894	609
Stock exchange: equities	**291,975**	**492,980**	**445,379**	**445,072**
MEFF derivatives markets (c)	**981,496**	**683,569**	**499,951**	**356,413**
Fixed-income	378,065	109,785	29,050	5,473
Short-term	*20,262*	*335*	*0*	*0*
Medium- and long-term	*357,803*	*109,450*	*29,050*	*5,473*
Equities	603,431	573,783	470,901	350,939
Ibex 35	*588,630*	*541,579*	*435,384*	*320,051*
Stock options	*14,801*	*32,205*	*35,517*	*20,668*
Stock futures	*0*	*0*	—	*10,220*

Sources: AIAF, MEFF, Spanish stock exchanges, CNMV, European Federation of Securities Exchanges and Banco de España.
(a) Only includes transactions involving State securities.
(b) Nominal turnover.
(c) Turnover is expressed in monetary units and has been obtained by multiplying the number of contracts traded by their size.

In the case of general government, as already discussed, there was a significant increase in fixed-income issuance, despite the low financing requirements of this sector. This increase seems to be attributable to the favourable conditions for raising funds, given the historically low level of interest rates.

V.2.2. Secondary market activity

Secondary market activity was governed by the behaviour of the primary markets. There was thus an increase in the trading volume on the public and private-debt markets, no change in the volume on equity markets and a fall in that on derivatives markets, on which trading is primarily in equity-related instruments (see Table V.5).

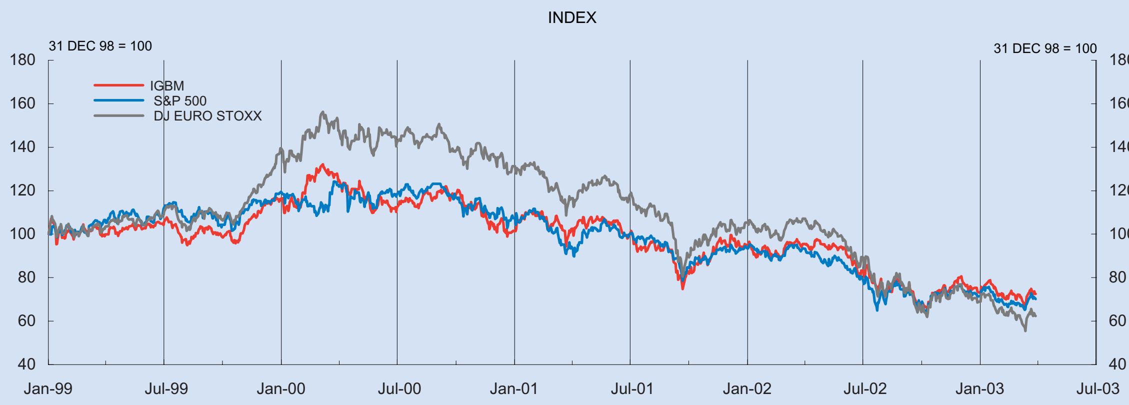
Volumes on the book-entry public-debt market increased by 15%, owing both to the growth of spot transactions and, especially, to the increase in repo and sell and buy-back transactions. This outcome partly reflects the higher volumes of issuance, while the Treasury continued to boost market liquidity.

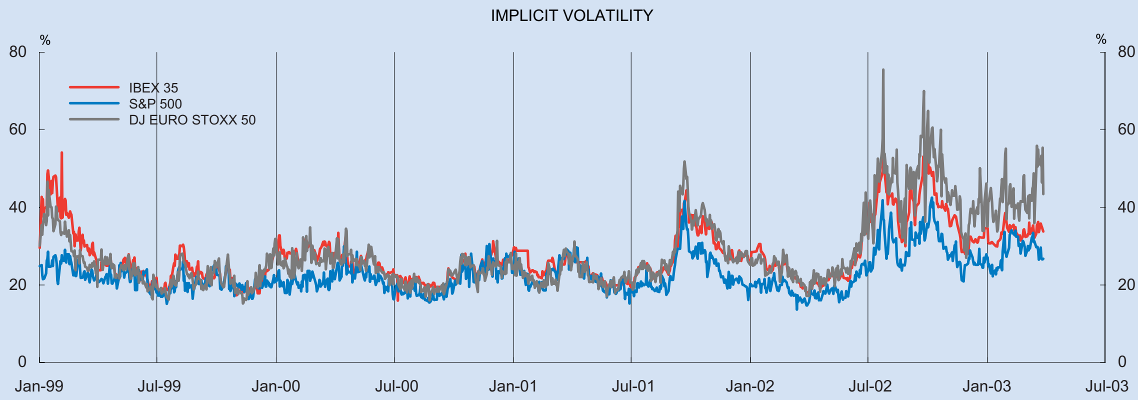
Trading volumes on the AIAF fixed-income market increased significantly (87% over the previous year), largely as a consequence of repos and sell and buy-back transactions, whose volumes were double those of outright transactions last year. In terms of instruments, the growth of activity was concentrated in commercial paper. This boom in trading was also seen, albeit to a lesser extent, in fixed income on the stock exchanges, in which trading grew by 24%, basically owing to transactions in securities issued by the regional (autonomous) governments.

Despite the decline in share values the volumes actually traded on the stock exchanges dipped only slightly. Behaviour was not uniform across sectors; while trading in the shares of certain corporations, such as financial institutions, electricity utilities and

CHART V.6

Stock price indices





Sources: Bolsa de Madrid, Bloomberg and Banco de España.

construction companies increased notably, that in others, such as telecommunications companies, contracted substantially. Meanwhile, the climate of uncertainty affected foreign investment in the Spanish stock exchange, which in 2002 was negative in net terms for the third year running.

On the Spanish derivatives markets, trading once again fell significantly (30%), meaning turnover accounted for little more than one-third of that recorded in 1999. Trading in stock futures, first launched in 2001, did not give rise to significant figures in 2002.

In 2003 to date, there has been no substantial change in financial market activity. Turnover on the debt markets continued to increase while on the stock market, despite a moderate pick-up early in the year, it remained on the decline.

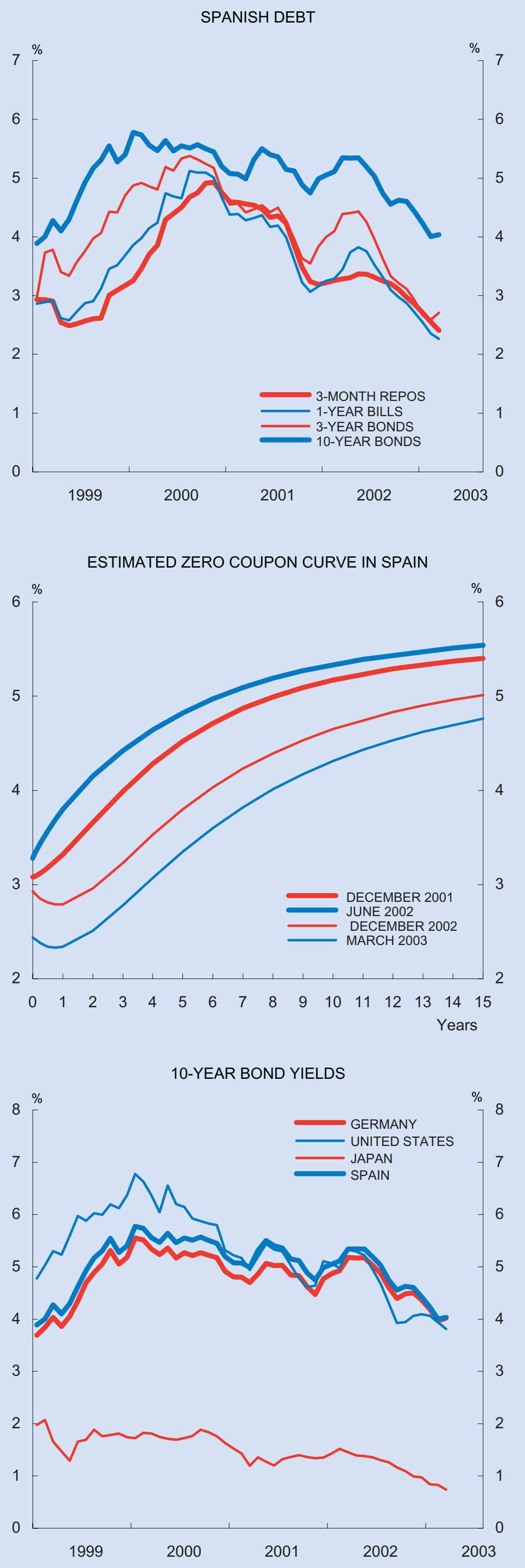
Finally, the ongoing consolidation of domestic markets continued last year. Specifically, February 2002 saw the merging of the domestic financial markets into the company "Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros SA", drawing together all the listing, trading and settlement systems existing in Spain. This process has continued in 2003, and in April "IBERCLEAR" – part of the aforementioned holding company – was set up as Spain's central securities depository, covering trades on the stock, AIAF and government debt book-entry markets.

V.2.3. Secondary market prices

Prices on Spanish stock markets in 2002 continued on the downward course embarked upon by domestic and international equity markets in March 2000 (see Chart V.6). This process, which began with the change in expectations arising in respect of the stocks issued by telecommunications and new technologies companies, was influenced last year by uncertainty about the start of the economic upturn in

CHART V.7

Government debt yields (a)



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

most countries, by corporate earnings expectations, by financial scandals and by the international political situation. In addition, the prices of certain Spanish corporations were affected by the depreciation of the main Latin American currencies and by the Argentine crisis. The behaviour of equity prices did not follow the same pattern throughout the year. Until the middle of Q2, stock market prices held at their end-2001 levels. This stability was interrupted as the delay in economic recovery became apparent and growth forecasts and corporate earnings projections were scaled back. Thus, in October, the main stock market indices reached a low for the past five years. In the closing months of the year, improved corporate earnings and expectations of interest-rate cuts prompted most indices to rally.

Over the year as a whole, the decline in the IBEX 35 (28.1%) was greater than that in the Overall Madrid Stock Exchange Index (IGBM), which fell by 22.9%, reflecting the more unfavourable performance of the most capitalised stocks. This decline was significantly greater than that of the previous year, similar to that of the US markets (the S&P 500 fell by 23.3%), and less than that of the euro area markets (the broad DJ Euro Stoxx registered losses of 34.5%). The greater uncertainty was also reflected in implicit volatilities, which in certain periods even exceeded the level observed in the days following the 11 September 2001 attacks.

The performance of the various sectors making up the IGBM was fairly uneven. The companies with the biggest declines during the year – technology (45%), telecommunications (40%) and banks (27%) – behaved in a very similar way to their European counterparts. The sectors that performed relatively better were food and construction, in contrast to developments in these branches on the euro area markets. In respect of insurance corporations, the trajectory of the Spanish markets was less unfavourable than in Europe, a fact related essentially to the lesser exposure of Spanish insurers to stock market prices (see Box V.3).

Yields on the Spanish government debt market trended similarly to those on other markets, such as Germany or the United States. There was thus a decline in yields on long-term debt, prompted by the scaling back of economic growth projections and agents' preference for highly rated assets against a background of heightening uncertainty. In the case of short-term assets, the contraction in yields also

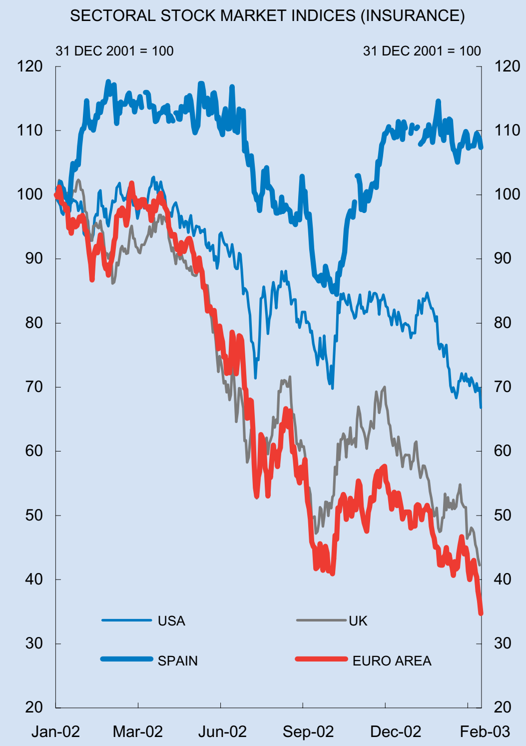
BOX V.3

Comparative impact of recent financial market developments on insurance corporations

The insurance sector is one of the main investors in shares in numerous countries and has therefore been particularly affected by the poor performance of stock markets in recent years. The deteriorating financial position of insurance corporations may in many cases have led them to close out equity positions, thereby exacerbating the fall in market prices. In addition, the decline in the price of the listed insurance corporation shares themselves has also contributed to the fall in general stock market indices.

Worldwide, two main factors have contributed to the worsening situation of insurance corporations: the high payouts on claims in recent years and the fall in returns on their financial investments. The first factor, which primarily affects non-life insurance, can be offset, albeit only partially, by raising the premiums charged to insureds, since they are normally renegotiated every year. The second factor particularly affects life and retirement insurance, since the policies have longer terms and therefore the investment of the premiums received plays a more important role and the insurers have less leeway for correcting potential imbalances between their earnings and their commitments.

International comparison



Source: Bloomberg.

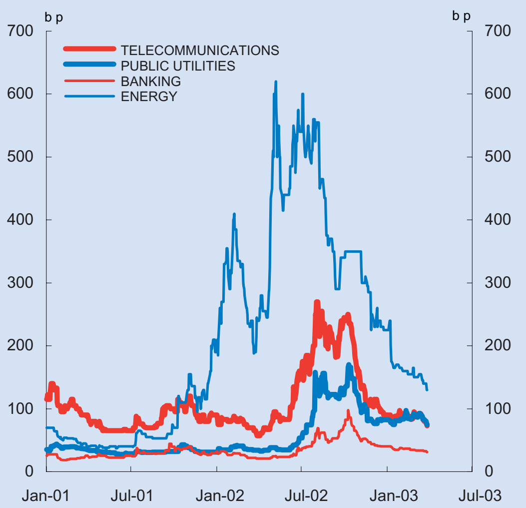
The sharp fall in share prices, the rise in defaults on credit and bond markets, the losses on credit derivatives and low official interest rates are the main reasons for the very low, or even negative, returns on insurance corporations' investment portfolios. The stock market decline has been particularly sizable in those cases in which shares account for a very high percentage of the total portfolio (around 60% in the United Kingdom). In other countries, such as Germany, Switzerland and Japan, although the percentage of equities is lower, the existence of minimum guaranteed returns – which on occasions may be relatively high – has contributed to the worsening solvency of insurers.

Returns on insurers' financial investments have also decreased in Spain. However, given the clearly conservative nature of their portfolios, with a high proportion of government debt and less than 10% invested in equities, the impact has been limited. This, together with the sharp improvement in technical income (before financial results) from non-life business, resulted in growth of the sector's aggregate earnings of over 10% in 2002, according to the first available estimates.

The differing positions of and outlook for national insurance sectors were faithfully reflected in the performance of their share prices. Thus, while the market prices of insurance shares in the United Kingdom and in the euro area have seen a cumulative fall from end-2001 of around 60%, in the USA this fall was 30% and in Spain prices have risen by 7%.

CHART V.8

5-year credit risk insurance premium (a)



Sources: JP Morgan and Credit Trade.
(a) Asset-weighted average premiums.

reflected expectations – which were subsequently confirmed – that official rates would fall. However, the budgetary and economic situation in Germany meant that the fall in the yield on long-term *bunds* was not as steep, so that the spread between the Spanish and German benchmarks narrowed significantly at the end of the year (see Chart.7).

Finally, the prices of the premiums of credit default swaps of most of the Spanish companies whose risk is traded on these markets increased notably, especially from August to October. This increase was partly indicative of investors' greater conservatism, but also of the worsening credit quality of certain companies, which resulted in their being downgraded. This eased the effects of the decline in long-term rates on the bond issuance costs for these companies (see Chart V.8). At end-2002 premiums fell, although they were still above the levels as at the beginning of the year.

In 2003 to date, equity prices have picked up somewhat against a background of high volatility linked to the uncertainty of the effects of the Iraqi conflict and the scant clarity of signals about the prospects for recovery of the world economy. Debt market yields continued falling, although in the case of long yields the trend was interrupted in mid-March, meaning rates stood in April at around early-2003 levels. Finally, risk premiums on the credit derivatives markets held on a relatively stable trend.

V.3. SPANISH FINANCIAL INTERMEDIARIES

The domestic and international economic context and the above-mentioned trend of financial markets affected the results of Spanish financial intermediaries and prompted them to behave more conservatively in respect of their investment policies. Credit institutions thus reduced their exposure abroad, as a result both of the declines in the volume of lending and of the effect on the value of their assets of the depreciation of Latin American currencies. Institutional investors, while continuing to increase their portfolio of foreign assets, did so in the main through the acquisition of euro-denominated fixed-income instruments, reducing in parallel the weight of shares issued by non-residents.

An analysis of these flows shows how credit institutions assigned a greater volume of net financing to non-financial corporations and households than in 2001. However, this was offset by a smaller net flow of funds towards Spanish general government, such that although they continued to require net foreign financing, the amount was similar to that observed the previous year and clearly less than that recorded in the period from 1998 to 2000. Set against this, and in line with the more conservative tendency in the management of their portfolios, institutional investors reduced considerably their disinvestment in general government assets compared with previous years.

V.3.1. Deposit institutions

Spanish deposit institutions saw a fresh deterioration in their results in 2002, against an unfavourable international and financial background which was alleviated only partially by traditional lending-deposit business in Spain. In any event, they maintained a sound balance-sheet position which enabled them to continue providing a high volume of funds, especially to households for house purchases but also to corporations.

Deposit institutions' business, measured by total consolidated assets, has tended to flatten in recent years. After growing by 21.7% in 2000, and by 7.5% in 2001, it increased by only 0.6% in 2002. This is largely due to the depreciation of the Latin American currencies which, along with something of a decline in intermediation activity in the region, entailed

TABLE V.6

Deposit institutions
Structure of balance sheet and profit and loss account

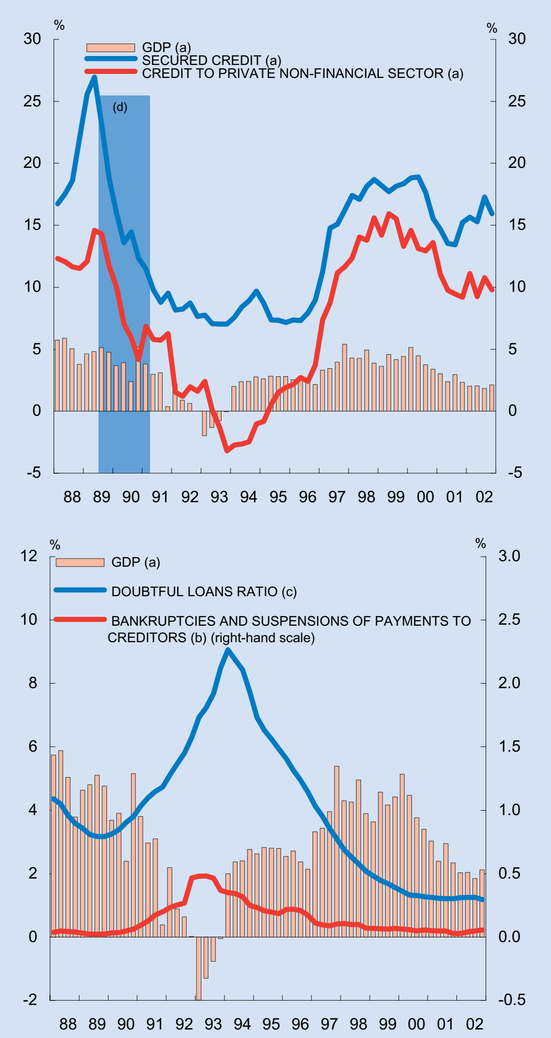
% of average total assets

	Total (a)		Banks		Savings banks	
	2001	2002	2001	2002	2001	2002
ASSETS:						
Cash and central banks (b)	1.4	1.5	1.3	1.3	1.5	1.7
Interbank market assets (c)	16.2	14.9	19.5	18.2	11.7	10.7
Lending	53.4	55.6	47.9	49.9	60.7	62.4
General government	*2.5*	*2.5*	*2.4*	*2.6*	*2.7*	*2.5*
Other resident sectors	*47.5*	*49.9*	*40.7*	*42.9*	*56.4*	*58.5*
Non-residents	*3.4*	*3.1*	*4.8*	*4.5*	*1.5*	*1.5*
Securities portfolio	21.1	20.9	22.5	22.8	19.7	19.2
Of which:						
Government debt	*8.3*	*7.9*	*7.7*	*7.4*	*9.3*	*9.0*
Equities	*6.8*	*6.6*	*8.0*	*8.1*	*5.3*	*5.0*
Other assets (d)	8.0	7.1	8.7	7.8	6.4	5.9
LIABILITIES:						
Banco de España	1.2	1.2	1.3	1.6	1.2	0.8
Interbank market liabilities (e)	19.9	18.2	26.8	24.3	10.5	10.6
Customer funds	60.0	61.5	50.7	52.3	72.7	73.1
Asset repo sales to customers	*7.2*	*7.2*	*6.8*	*7.1*	*8.3*	*7.7*
Creditors: general government	*2.9*	*3.2*	*3.1*	*3.6*	*2.5*	*2.7*
Creditors: other resident sectors	*38.1*	*39.1*	*26.1*	*26.6*	*53.6*	*53.8*
Creditors: non-residents	*8.7*	*8.6*	*11.7*	*11.8*	*4.6*	*4.8*
Debt securities	3.2	3.4	3.0	3.2	3.7	4.0
Own funds, special reserves and subordinated financing	12.8	13.2	13.9	14.6	11.1	11.4
Of which:						
Subordinated financing	*3.3*	*3.6*	*4.0*	*4.1*	*2.6*	*3.1*
Other liabilities (f)	6.1	5.9	7.3	7.3	4.5	4.2
PROFIT AND LOSS ACCOUNT:						
(+) Interest income	5.58	4.65	5.73	4.64	5.33	4.63
Of which:						
Dividends	*0.62*	*0.45*	*0.88*	*0.65*	*0.28*	*0.20*
(-) Interest expenses	*3.14*	*2.38*	*3.47*	*2.57*	*2.70*	*2.17*
Net interest income	**2.44**	**2.26**	**2.26**	**2.07**	**2.63**	**2.46**
(+) Commissions	0.66	0.65	0.70	0.70	0.60	0.58
(+) Profits on financial operations	0.06	0.04	0.06	0.04	0.06	0.04
Gross income	**3.16**	**2.95**	**3.02**	**2.81**	**3.29**	**3.08**
(-) Operating expenses	1.80	1.73	1.62	1.54	2.04	1.94
Net income	**1.35**	**1.22**	**1.40**	**1.26**	**1.25**	**1.14**
(-) Write-downs and provisions	0.61	0.56	0.75	0.62	0.41	0.46
(+) Other income	0.11	0.13	0.13	0.16	0.11	0.08
Pre-tax profit	**0.86**	**0.79**	**0.78**	**0.80**	**0.95**	**0.76**
MEMORANDUM ITEM:						
Pre-tax profit (as a % of own funds)	13.61	12.83	12.43	12.91	15.73	12.96
Average total assets (€ bn)	1,158	1,247	685	714	431	485
Year-on-year growth rate (%)	*11.2*	*7.7*	*9.2*	*4.2*	*14.1*	*12.6*

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

CHART V.9

Credit, doubtful loans and business cycle



Source: Banco de España.
(a) Real year-on-year rates.
(b) Liabilities affected by bankruptcy or suspension of payments to creditors as a percentage of total debt of Spanish non-financial corporations.
(c) Doubtful assets / credit.
(d) Period of credit curbs.

a decline of approximately 25% in total business abroad in 2002 (one-third in the past two years). As a result, there was a reduction in the weight of such business from 27% of the total in December 2000 to a figure 10 p.p. lower at the end of last year. Business in Spain also moderated somewhat in 2002, growing by 8.3% (7.7% if measured by the average total assets of overall individual institutions). Nonetheless, this was consistent with considerable momentum by non-interbank credit to the resident private sector, which accounts for almost half the total non-consolidated balance sheet (see Table V.6).

Hence, after the slowdown in lending to the private sector in 2001, there was something of a rebound in 2002, along with strong growth in off-balance sheet securitisation, especially in the final quarter of the year. The outstanding balance of securitised loans increased by EUR 13.1 billion, almost three times the increase the previous year, accounting for 5% of total credit extended (on- and off-balance sheet). This expanded by 14.7% in 2002, against 11.8% in 2001, accelerating at both commercial banks and savings banks, although the rate of expansion was clearly higher at the latter. In real terms, the buoyancy of this item was less but the progression observed proved notable in the light of the cyclical stage in which the Spanish economy moved last year (see Chart V.9).

The increased buoyancy of credit was due exclusively to the behaviour of real-estate loans (credit to households for house purchases, to the construction industry and to real-estate services), since both consumer and other loans extended to households and those granted to other services and to industry, excluding construction, eased in 2002. Particularly striking is the increase in loans to the construction industry and to real-estate services, which increased overall by 25% and accounted at the end of last year for 16% of the total.

The mortgage market is clearly attractive to institutions. This is because of the lower historical level of default (in the case of credit to households for house purchases, although not so in the case of credit to the construction industry or to real-estate services), the fact loans are secured and the tying of customers to the institution over a long period of time. Indeed, in the past two years it has been traditional business in Spain, of which mortgage credit is a fundamental component, that has allowed institutions to offset in part the poor results obtained in other business areas. However, a strategy geared to maintaining the growth of this item at a year-on-year rate of around 20% is not risk-free. This is particularly so when, although the default ratio is –as discussed elsewhere in this report- low, there are signs of an overvaluation of house prices and relative household and corporate debt has increased sharply in recent years.

Among the factors behind the expansion of credit in 2002 was the low rate of doubtful assets and of bankruptcies and suspensions of payments. Doubtful assets grew last year by 22% (against 8%

the previous year), and by 14% in the case of those relating to the resident private sector. Notwithstanding, the default rate in this sector held at a minimum level of around 1%, and the coverage ratio (provisions/doubtful assets) stood at over 200% on individual data (185% on consolidated data).

The expansion of loans took place, moreover, against the background of the fresh interest-rate reductions applied by institutions to their customers. In 2002 as a whole, then, the synthetic rate on asset-side transactions fell by 46 b.p., more or less in line with developments on the interbank market, and it has continued falling in 2003 to date, coming to stand below 4.3% in March 2003. This level is below that reached in mid-1999, when interbank rates were at a similar level to that at present. Among the related components, however, only the rate on mortgage loans is clearly below the 1999 low, which shows the growing competition between institutions in this business area.

On the liabilities side, resident customer funds grew somewhat less than the previous year. Although for the year on average the increase in sight accounts was greater, this was partly due to the changeover to the euro, which contributed to an acceleration in this type of deposit at end-2001 and in early 2002. In cumulative twelve-month terms, resident customer funds increased by 6.8%, with sight and saving deposits climbing by 7.5% and time deposits by 6.5%. Changes in the new personal income tax legislation for 2003 once again favour shares in mutual funds over bank deposits. Specifically, the so-called "tax toll", whereby changing fund was accorded the same tax treatment as a sale of shares, has been eliminated, and the single rate applicable to capital gains obtained over a period of more than one year has been lowered from 18% to 15%. Consequently, competition to raise deposits will remain heightened, spurred moreover by the high-yield offers of banks operating mainly on the Internet, which maintained strong increases in deposits, although their weight in relation to the total remains small.

As a result of this competitive pressure, the interest rates applied by institutions on both sight and saving deposits and on time deposits declined very moderately in 2002 (by 9 and 10 b.p., respectively). Despite the fact that in the opening months of the current year further cuts were seen, the present levels are between 15 and 25 b.p. higher than those observed in mid-1999. Commercial banks, among which are those specialising in offering on-line Internet services, have been particularly incisive in this respect, passing through cuts in market rates to those on their deposits to a lesser extent than other institutions. Overall, the synthetic deposit rate declined by 39 b.p. from December 2001 to March 2003, two-thirds of the decline seen in the synthetic lending rate.

As a consequence of greater competition in the domestic market, of the deterioration in business in Latin America, of the lower net results on the industrial holdings portfolio and of the trend on financial markets, the net consolidated profit attributable to Spanish deposit institutions fell by 8% in 2002 (against growth of 6.6% in 2001 and 20.9% in 2000). Nonetheless, this entailed a return on own funds of 12% and of 0.7% on total assets, which compares favourably with the average figures for EU banks. The average capital adequacy ratio for the industry – calculated according to Spanish rules – held at 11.1%, more than 3 p.p. above the minimum required level.

Total provisions for bad debts set aside in 2002 were virtually identical to those for 2001, when the high volume of provisioning due to the crisis in Argentina triggered the slowdown in results. The increase in specific provisions was offset by the fall in the statistical provision, such that the latter, in its second full year of operation, has already exerted a significant stabilising effect on the profit and loss account. Conversely, while consolidated net operating income grew by 25% in 2001, last year, since it stabilised, it did not contribute to augmenting profits. Extraordinary income and profits from group transactions also shrank. In absolute terms, the decline in net income attributable was greater at commercial banks (12.3%) than at savings banks (2.8%). However, in relation to total assets, the opposite was the case.

For their part, non-consolidated accounts show growth of 2.9% in net income, unchanged on the previous year but far below the figure for 2000 (20.6%). As can be seen in Table V.6, all margins narrowed except for that of net income before taxes at commercial banks, owing to the effect of lower write-downs and to the capital gains arising on the disposal of property, permanent holdings and the held-to-maturity portfolio.

TABLE V.7

Funds raised by other financial intermediaries

€ m

	1999	2000	2001	2002	2002 Balances (a)
Total (b)	**10,642**	**3,210**	**15,062**	**17,319**	**319,510**
Pension funds					
Net contributions (c)	*3,026*	*6,454*	*6,738*	*6,210*	*48,111*
Life assurance					
Premiums net of claims (d)	*8,065*	*10,973*	*8,299*	*9,742*	*96,664*
Mutual funds					
Net share purchases	*-449*	*-14,217*	*25*	*1,368*	*174,735*
FIAMM	*-7,229*	*-10,172*	*9,556*	*8,329*	*53,366*
FIM	*6,780*	*-4,046*	*-9,531*	*-6,962*	*121,368*
MEMORANDUM ITEM:					
Deposit money institutions: change in accounts payable					
Other resident sectors	*21,282*	*52,424*	*55,174*	*43,830*	*604,333*

Sources: Banco de España, CNMV, INVERCO, Dirección General de Seguros and ICEA.
(a) Balances to December. Net asset value in the case of funds, and mathematical provisions in the case of insurance.
(b) Sum of contributions, premiums and net share purchases.
(c) In-house estimate based on the change in the net asset value and annual yield of the funds.
(d) The 2002 figure is provisional (based on ICEA assuming the same ratio of premiums to claims as in the previous year).

V.3.2. Institutional investors

Institutional investors' business in 2002 trended very similarly to that observed the previous year. The overall net volume of funds raised by mutual and pension funds and by life assurance companies was similar to that recorded in 2001 and below that absorbed by deposit institutions, being concentrated in the main at insurance institutions and pension funds (see Table V.7).

As a consequence of changes in financial asset prices, the results arising on investment portfolios were unfavourable (see Chart V.10). Securities funds and pensions funds posted negative average returns (of around –5%), while that on money-market funds stood at 2.4%, somewhat over 1 p.p. below that for the previous year and clearly below the actual inflation rate for the year. These low (and even negative) returns, which compound the poor profits of previous years, involve a significant loss of financial wealth for savers and a factor of risk for insurers and defined-benefit pension funds. However, as Box V.3 shows, Spanish insurance companies are facing lesser investment risks than those in other industrialised countries.

The obligatory externalisation of companies' pension commitments to their employees (a process which finalised – except for certain minor unresolved issues – on 16 November) contributed, once again, to the growth of saving raised by insurance institutions and pension funds. On the provisional information available, life assurance provisions grew by 14% last year, an identical rate to 2001, with group and retirement insurance expanding and unit-linked provisions falling back once again. The net asset value of pension funds slowed, showing a year-on-year increase of 9.8% in December 2002, against 16.2% in 2001, the outcome of a lower return and, albeit to a lesser extent, of a fall in estimated net contributions. With a view to the future, the reformed personal income tax legislation provides for "retirement security policies". This is a new product that life insurers will be marketing and which offers tax and liquidity features on a par with those of pension funds. It will promote tax neutrality among the various saving and provision vehicles.

Developments in life assurance and pension funds were once again in contrast to the behaviour of mutual funds, the overall net asset value of which declined by 3.6% year-on-year, the outcome of growth of 21.8% in FIAMMs (money-market funds) and a fall of 11.7% in FIMs (securities funds). Overall, net subscriptions of shares in FIMs were negative in all four quarters of 2002, and only short-term fixed-income funds and, to a much lesser extent, global funds posted positive net subscriptions for the year as a whole. In 2003, the elimination of the so-called "tax toll" might increase movements among different types of funds. Moreover, this same measure should promote stiffer competition among institutions marketing and managing mutual funds, accentuating the tendency towards lower average commissions seen in recent years.

The course of subscriptions and of prices negotiated on financial markets entailed a fresh fall in the weight of equity instruments issued by non-residents relative to the total portfolio of securities funds, while domestic equity instruments showed greater stability. Overall, the total equity portfolio accounted for 19% of the net asset value of securities funds in December 2002, compared with 31% in September 2000. In the case of pension funds, the decline was from 26% to 21%. Offsetting the diminished weight of equity instruments was an increase in the fixed-income portfolio issued by non-residents (mainly in euro), meaning that, in 2002, the foreign portfolio continued growing in securities and pension funds up to 53% and 31% of the total, respectively (45% in money-market funds).

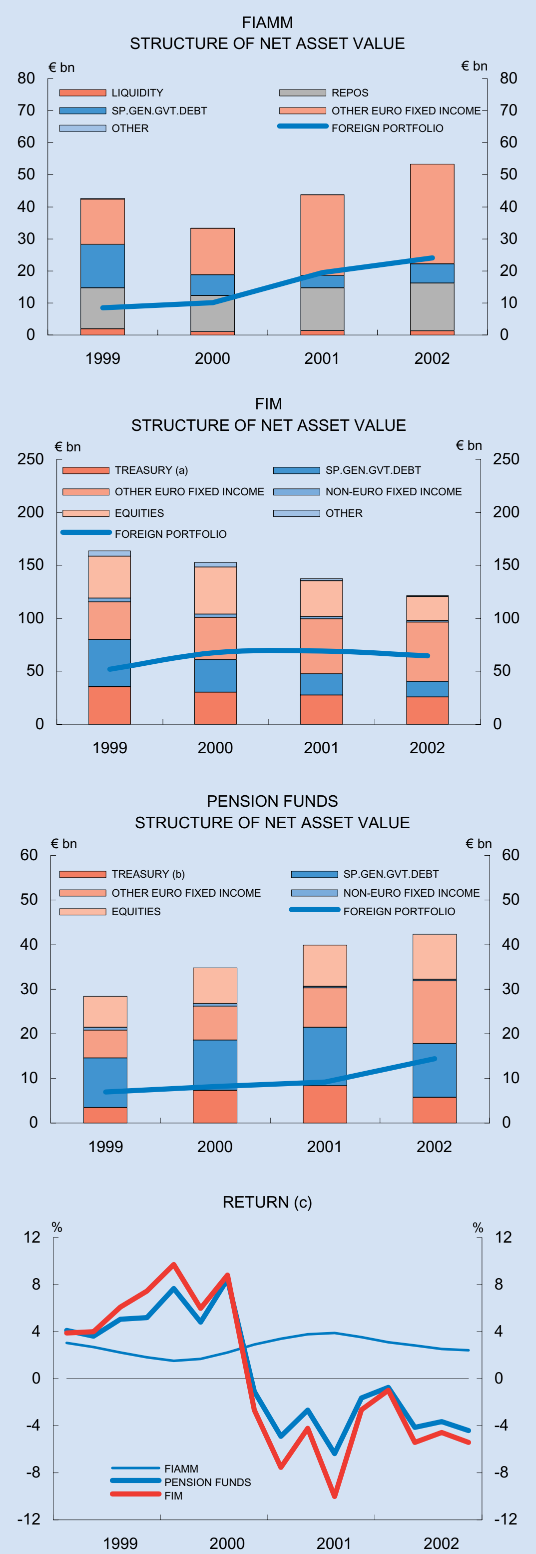
V.4. THE NET WORTH POSITION OF THE PRIVATE NON-FINANCIAL SECTOR

Investment and financing decisions and the behaviour of financial asset prices were reflected in the changes in the net worth position of the private non-financial sector. The sizable increase in recourse to debt made for a fresh rise in the sector's debt ratios, although the declining course of interest rates prevented an equivalent rise in the associated financial burden from occurring. The adverse trend of stock market prices and the increase in liabilities entailed a deterioration in the sector's net financial worth, which was more acute in the case of non-financial corporations. However, the growth in house prices prevented a reduction in the total net wealth of households.

In the case of households, there was an increase in the weight of their lower-risk financial assets. Above all, that reflects the decline in the valuation of equity instruments, but also the sector's lesser propensity to invest in such securities. Thus, at end-

CHART V.10

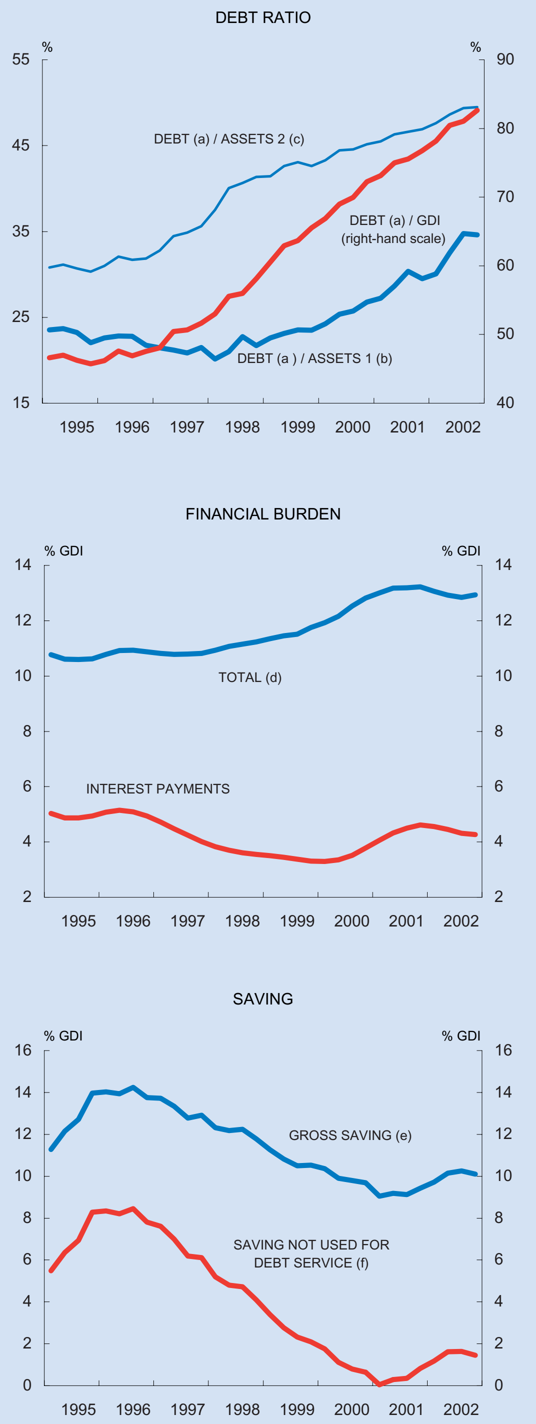
Institutional investors



Sources: CNMV, Banco de España and INVERCO.
(a) Includes repos.
(b) Includes repos and money market assets.
(c) Cumulative return over last 12 months.

CHART V.11

Net worth position indicators for households and NPISHs



Source: Banco de España.
(a) Includes bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation funds.
(b) Assets 1 = Total financial assets – "Other".
(c) Assets 2 = Assets 1 – shares – FIM shares.
(d) Calculated on the bank credit extended by resident credit institutions.
(e) Balance of the use of household disposable income account.
(f) Gross saving less estimated debt repayments.

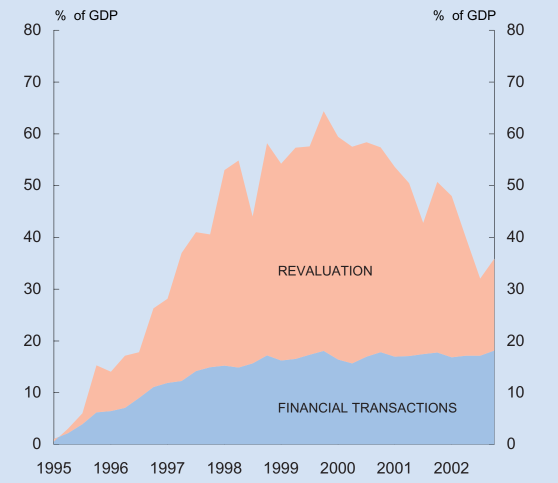
2002, cash, deposits and shares in fixed-income money-market and securities funds accounted for 48.1% of the total portfolio, compared with 42.7% in 2001, while the proportion of direct equity holdings and shares in other securities funds fell by 8 p.p. to 26.4%. The weight of insurance technical reserves continued to increase, in line with the trend of recent years, rising to 15.8% of the portfolio. This shift towards lesser-risk instruments suggests a lesser sensitivity of the sector's gross financial wealth to changes in stock market prices.

With regard to liabilities, the growth of household financing translated into a fresh increase in debt ratios, which is largely due to the reduction in interest rates, the increase in employment and the rise in house prices. In terms of household gross disposable income (GDI), debt rose by 6 p.p. last year to 83% (see Chart V.11), a level which, while still below that of the United States or the United Kingdom, has now reached the euro area average. As a percentage of their gross financial wealth, credit to Spanish households climbed from 29.5% to 34.6%. The increase in relation to the more liquid assets was naturally smaller, given the increase in the weight of the latter instruments in households' holdings. The cost of borrowing, along with the lengthening of average repayment terms, nevertheless led to a slight easing of the associated debt-service burden. Thus, interest payments relative to GDI shrank by 30 b.p. to 4.3%, while the total burden, which includes repayment of principal, fell by a similar amount to 12.9%. Further reflecting the trend of liabilities was the behaviour of gross saving not earmarked for debt service which, though it picked up slightly in 2002, remains limited in the light of the current economic and financial setting.

Household net financial wealth fell by around 15 p.p. in terms of GDP (see Chart V.12). Nonetheless, housing, which is the main component of their total wealth, grew robustly once again, meaning wealth did not deteriorate. In real terms, there has been a rise in the value of housing of 60.7% between 1997 and 2002. That shows, primarily, a correction of the sharp downward adjustment in the real price of housing that took place in the first half of the nineties. Moreover, the trend of the essential determinants of house prices, such as income and interest rates, has been conducive to their expansion recently. However, the evidence at hand suggests housing is overvalued to some extent at present, on a scale not far different from that seen in the previous

CHART V.12

Cumulative change in net financial wealth of households and NPISHs



Source: Banco de España.

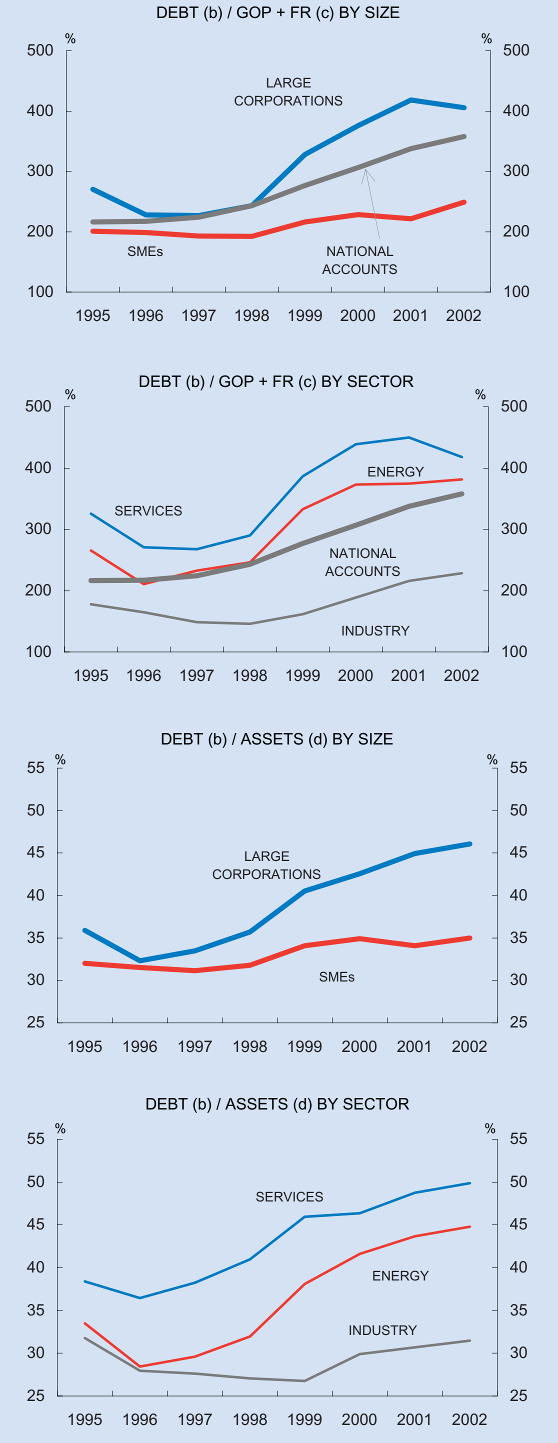
boom a decade back (see Box V.1). As was then the case, the most likely scenario is that a gradual slowdown in prices will begin, with their trajectory moving more closely in line with the behaviour of the long-run determinants of housing. Were this not to occur, the continuing overvaluation of housing would naturally heighten the likelihood of sharper adjustments taking place.

As explained in greater detail in Box V.2, the greater possibilities of indebtedness offered by more highly valued properties, given their role as collateral, were duly taken advantage of by households, against a background of growing competition between banks, to finance an increase in residential investment spending. The rise in house prices also contributed to the expansion of consumption insofar as the greater capacity for potential access to credit reduced households' propensity to save.

The financial position of households remained sound, as testified by the rise in their net wealth, the greater weight of lower-risk assets in their financial portfolio and the reduction of their debt-service burden. Indeed, their default ratio held in 2002 at a low level. However, the high level reached by debt and house prices suggests that the scope for households to increase borrowing is now more limited; consequently, it is unlikely that this factor can continue contributing to the same extent to sustaining consumer and residential investment spending. In addition, the current household debt ratios imply

CHART V.13

Debt ratios of non-financial corporations (a)



Source: Banco de España.

(a) All the series except "National Accounts" are calculated using information from the Central Balance Sheet Data Office (CBSO). Until 2001, the information was taken from the CBSO Annual Survey. From then onwards, the indicators have been estimated from the CBSO Quarterly Survey.

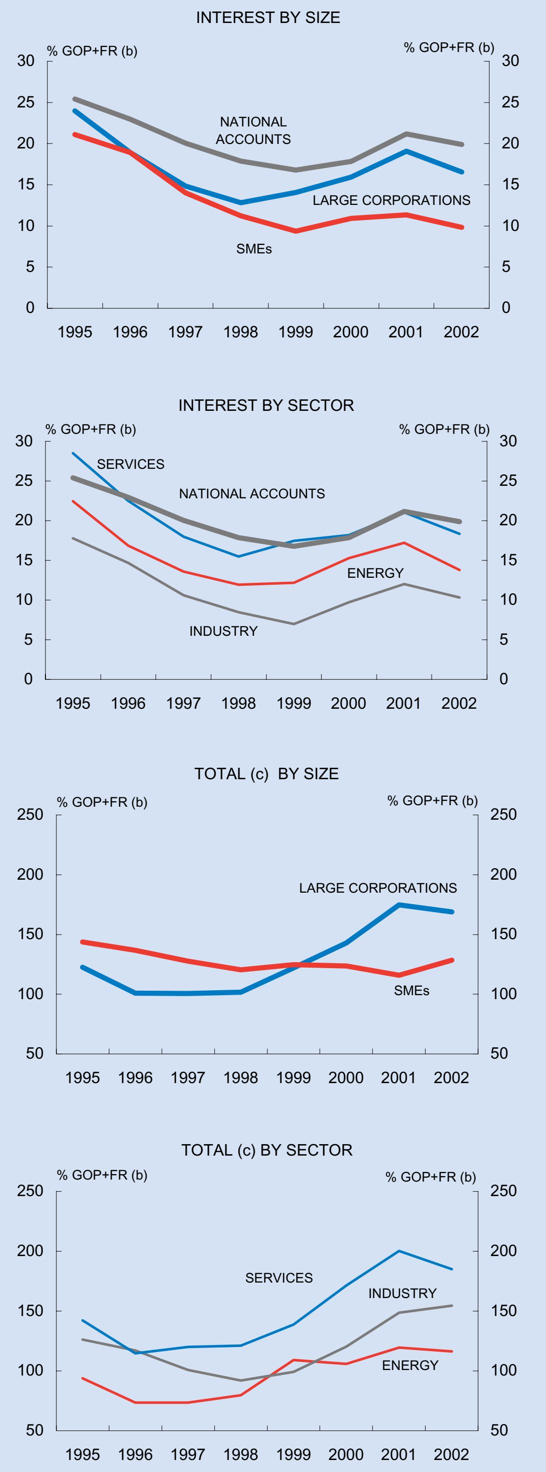
(b) Interest-bearing borrowed funds.

(c) Gross operating profit plus financial revenue.

(d) Defined as total inflation-adjusted assets less interest-free liabilities.

CHART V.14

Financial burden of non-financial corporations (a)



Source: Banco de España.

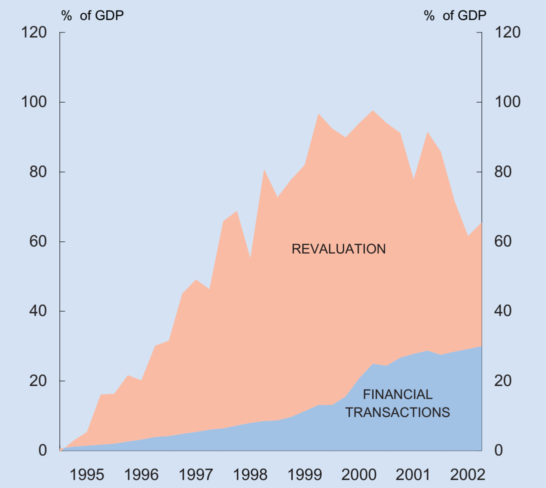
(a) All the series except "National Accounts" are calculated using information from the Central Balance Sheet Data Office (CBSO). Until 2001, the information was taken from the CBSO Annual Survey. From then onwards, the indicators have been estimated from the CBSO Quarterly Survey.

(b) Gross operating profit plus financial revenue.

(c) Includes interest plus short-term interest-bearing debt.

CHART V.15

Cumulative change in the net financial wealth of non-financial corporations



Source: Banco de España.

greater sensitivity of their financial position to changes in borrowing costs, to the behaviour of their income and to how house prices trend. Consequently, future spending decisions will foreseeably be more sensitive than in the past to changes in these variables.

Turning to non-financial corporations, the market value of their holdings of shares and other equity was also adversely affected by the fall in stock market prices. The reflection of this, together with the sector's moderate net investment in equity securities, especially in instruments issued by residents, was a 3 p.p. decline in the weight of shares and other equity in their financial portfolio to 39.6% as at end-2002. As regards more liquid assets, their proportion increased by 0.5 p.p..

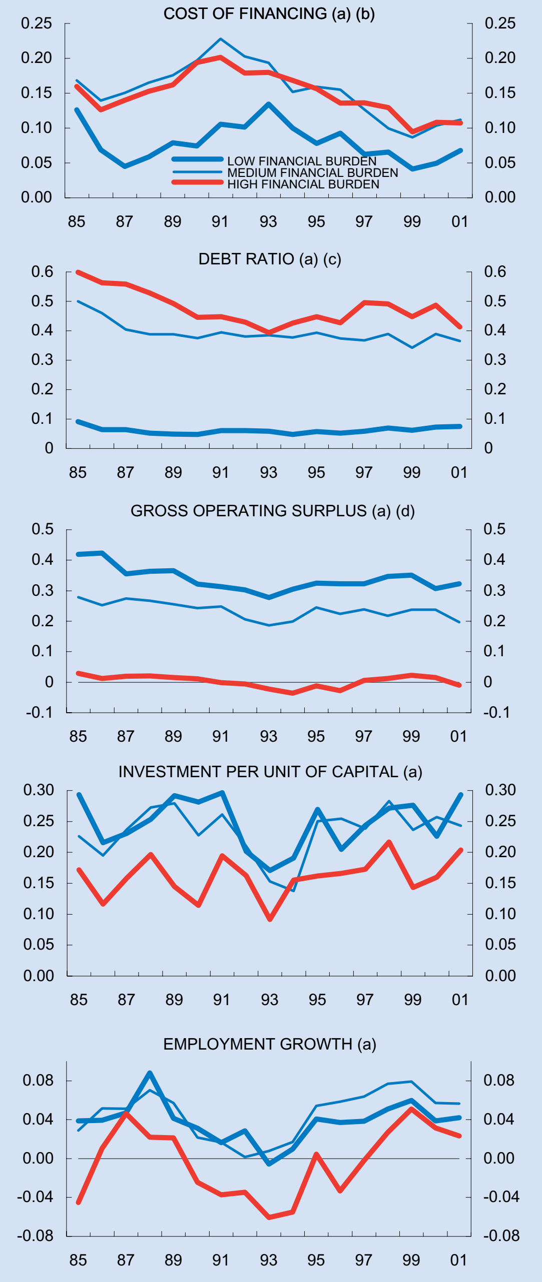
The resort to borrowed funds led to a fresh increase in the sector's debt ratios (see Chart V.13). As regards operating results (defined as the sum of the gross operating surplus plus financial revenue), the value of the sector's debt, measured by the outstanding balance of bank loans and of fixed-income securities, stood at end-2002 as 358%, 20 p.p. above the related level in 2001. On CBSO data, the distribution of this ratio by sector and by company size has been fairly heterogeneous in recent years. It is thus the biggest corporations, in the market services and energy sectors, that show the biggest relative levels of external borrowing. During 2002, the increase in these corporations' debt was more mod-

The financial position of Spanish firms and its impact on the level of activity

The adoption of a disaggregated approach to analysing the financial position of the business sector is essential in order to assess the risk to macroeconomic and financial stability. The aggregate indicators may not reliably reflect the system's financial soundness if the deterioration in the financial position of the more vulnerable firms is more pronounced than that of the sector on average. Using the Banco de España's Central Balance Sheet Data Office database for the period 1985-2001 makes it possible to identify the relative importance of the factors bearing on the financial position of Spanish firms and assess the extent to which their level of activity varies with the degree of financial pressure on them. By way of a synthetic indicator of this degree of financial pressure, use can be made of a measure of the relative debt burden, which is defined as financial costs divided by gross operating surplus. This ratio – which is the net result of changes in interest rates, in business profits and in indebtedness – reflects the capacity to meet interest payments out of funds generated within the business alone and is thus an indicator of firms' financial tightness (or pressure).

The adjacent chart compares the average level of various real and financial variables in different corporate groupings defined on the basis of their financial position. Each panel of the chart presents the average value of a certain variable for the firms belonging to three different deciles of the distribution defined in terms of the ratio of financial costs to gross operating surplus each year. The median decile (that including the firms between percentiles 45 and 55) can be regarded as representative of the behaviour of a firm in an average financial position. Analogously, the top (bottom) decile includes the 10% of firms with the highest (lowest) relative financial burden.

The following comments may be made on the chart. First, the firms with the highest financial burden (top decile) have a similar financing cost to and slightly higher debt level than those of firms subject to average financial pressure. By contrast, these two corporate groupings differ notably in the relative size of their gross operating surplus. It therefore seems that the low profitability levels have contributed to the deterioration of the financial position of the firms that are in a more vulnerable position. Second, no significant differences in demand for factors of production are observed between the firms with most financial pressure (bottom decile) and those with average financial pressure. However, the firms facing a higher financial burden have substantially lower investment and employment growth rates. Moreover, in the case of employment, this difference seems more marked in recessionary phases.



Source: Banco de España.

(a) Each line represents the average value of the related variable for the specified set of firms, i.e. those with low, medium or high financial burden. These sets correspond to the bottom, median and top deciles defined on the basis of the relative financial burden (distribution of the ratio of financial costs to gross operating profit).

(b) Interest on financing received/interest-bearing debt.

(c) Interest-bearing debt/own funds plus interest-bearing debt.

(d) Gross operating surplus/total assets.

This evidence suggests, first, that a firm's profit performance plays an essential role in determining its financial position and, further, that the impact of this position on real activity becomes more pronounced when the financial pressure reaches a certain threshold. Therefore, a poor profit performance would contribute to an effect whereby the increasing indebtedness seen amongst Spanish firms may heighten the vulnerability of the sector, particularly if the financial pressure on a significant number of firms reaches levels at which it has a more pronounced influence on real activity. However, the relative financial burden borne by the business sector is, in historical terms, moderate. Therefore, its effect on their real decisions will foreseeably not be significant. Only in the financially more vulnerable firms would disturbances affecting their financial position be expected to give rise to sharper adjustments in spending decisions.

erate than that observed for Spanish non-financial corporations as a whole.

The declining course of borrowing costs more than offset the effect of the rise in corporate indebtedness on the associated debt-service burden. Interest payments thus accounted for 19.9% of their operating results, 1 p.p. less than in 2001 (see Chart V.14). Lower interest rates benefited most companies, although the impact was naturally greater on those most indebted. On CBSO figures, the interest burden was somewhat higher in the market services branch (18.4%) and at major corporations (16.6%) than at electric utilities (13.8%) and, above all, in the manufacturing industry branch (10.3%). If short-term debt is also included, the aggregate burden on these corporations also fell, albeit only slightly, during 2002.

The composition of debt in terms of instruments scarcely changed last year. Credit extended by resident institutions remained the main source of funds and accounted for 67.4% of interest-bearing borrowed funds, 0.5 p.p. less than at end-2001. Foreign loans continued to gain in weight and stood at 28.2%, 1 p.p. up on a year earlier. The proportion represented by fixed-income securities fell by 0.5 p.p. to 4.4%. The debt restructuring undertaken by certain large corporations, which are those that most use this instrument, would appear to be behind this development.

The net financial worth of non-financial corporations shrank by 26 p.p. relative to GDP, 11 p.p. more than that of households. That essentially evidences their greater relative exposure to movements in stock market prices, as well as reflecting the consequences of the crises besetting certain Latin American economies and the cancellation of specific European investments by a major telecommunications operator (see Chart V.15). However, the aggregate financial position of the sector remains sound, as testified, for example, by the low volume of liabilities affected by bankruptcies and suspensions of payments, despite their number increasing in 2002. Moreover, according to the CBSO, ordinary net profit, which excludes extraordinary items, increased by 8%, which meant that the ordinary return on equity held at close to 13%, although in the case of manufacturing industry it was somewhat lower. Likewise, the lesser interest burden entails less financial pressure on spending decisions (see Box V.4).

Against this background, the financial position of the sector at the aggregate level does not appear to pose any significant obstacle to a pick-up in investment and employment, since financial pressure cannot be seen to be at a level that might exert any relevant contractionary effect on companies' spending decisions. Nonetheless, the high level of debt at some of these companies, such as the biggest corporations, suggests that their scope for increasing their debt is now less; consequently, this factor will not be able to continue contributing to the same extent to sustaining expansion projects. Furthermore, as is the case with households, their exposure to potential shocks is now much higher. In this respect, their investment decisions will be more influenced by the course of borrowing costs than they were during the recovery in the previous business cycle.

ANNUAL ACCOUNTS OF THE BANCO DE ESPAÑA

2002

INTRODUCTION

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

In accordance with the provisions of Articles 29 and 32 of its internal rules, the Bank's annual accounts have been audited by the Internal Audit Department and reviewed by the Accounts Review Committee appointed for the purpose by a resolution of the Bank's Governing Council of 21 December 2001. The accounts have also been audited by independent external auditors, as stipulated by Article 27 of the Statute of the ESCB.

Under the provisions of Article 4.2 of Law 13/1994 of 1 June 1994 of Autonomy of the Banco de España, it is for the government, upon proposal by the Minister of the Economy, to approve the Bank's balance sheet and accounts for the year, which will be sent to Parliament (*Cortes Generales*) for informational purposes. The Governing Council of the Bank, under the provisions of Article 21.1 (g) of the aforementioned Law, is responsible for formulating the Bank's annual accounts.

Unless otherwise indicated, the figures refer to millions of euro. It should be pointed out that, due to rounding, on occasions the totals included in the balance sheet, profit and loss account and notes on annual accounts may not equal the sum of the individual figures.

This document presents the accounts for the year 2002. Section I includes the balance sheet and profit and loss account; Section II contains the notes on the accounts, with the accounting policies that have served as a framework for their formulation and explanatory notes on the most important aspects of the balance sheet and profit and loss account; and Section III, in compliance with Article 4.2 of the Law of Autonomy, details the contributions made to the Deposit Guarantee Funds and the loans and transactions agreed on other than an arm's-length basis or which in any other way entail a loss of profit or losses for the Bank, giving estimates of the amount of such loss of profit or losses.

Finally, Annexes 1 and 2 include the reports of the external auditors and of the Banco de España Accounts Review Committee on the annual accounts presented in Sections I-III.

I. BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

Balance sheet of the Banco de España as at 31 December 2002

(€ m)

	Note number	2002	2001
ASSETS			
1. Gold and gold receivables	**1**	**5,499.85**	**5,300.90**
2. Claims on non-euro area residents denominated in foreign currency		**32,347.74**	**33,357.00**
2.1. Receivables from the IMF	2	1,920.38	1,958.01
2.2. Balances with banks and security investments, external loans and other external assets	3	30,427.36	31,398.99
3. Claims on euro area residents denominated in foreign currency		**0.03**	**0.03**
4. Claims on non-euro area residents denominated in euro		**475.34**	**0.00**
4.1. Balances with banks, security investments and loans	4	475.34	0.00
4.2. Claims arising from the credit facility under ERM II		0.00	0.00
5. Lending to euro area credit institutions related to monetary policy operations denominated in euro	**5**	**18,203.30**	**10,546.69**
5.1. Main refinancing operations		17,540.94	8,477.22
5.2. Longer-term refinancing operations		642.12	2,069.47
5.3. Fine-tuning reverse operations		0.00	0.00
5.4. Structural reverse operations		0.00	0.00
5.5. Marginal lending facility		0.00	0.00
5.6. Credits related to margin calls		20.25	0.00
6. Other claims on euro area credit institutions denominated in euro	**6**	**8.17**	**2.57**
7. Securities of euro area residents denominated in euro		**0.00**	**0.00**
8. General government debt denominated in euro	**7**	**9,767.91**	**10,380.90**
9. Intra-Eurosystem claims	**8**	**23,161.13**	**29,603.01**
9.1. Participating interest in ECB		444.68	444.68
9.2. Claims equivalent to the transfer of foreign reserves		4,446.75	4,446.75
9.4. Net claims related to the allocation of euro banknotes within the Eurosystem		0.00	
9.5. Other claims within the Eurosystem (net)		18,269.71	24,711.58
10. Items in course of settlement		**0.80**	**398.84**
11. Other assets		**6,967.56**	**6,549.31**
11.2. Tangible and intangible fixed assets	9	208.91	234.39
11.3. Other financial assets	10	4,402.99	3,572.04
11.4. Off-balance sheet instruments revaluation differences	11	369.25	0.00
11.5. Accruals and prepaid expenses	12	638.62	727.27
11.6. Sundry	13	1,347.79	2,015.61
TOTAL ASSETS		**96,431.84**	**96,139.25**

Balance sheet of the Banco de España as at 31 December 2002 (cont'd)

(€ m)

	Note Number	2002	2001
LIABILITIES			
1. Banknotes in circulation	**14**	**37,505.32**	**46,227.56**
2. Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	**15**	**9,291.35**	**12,273.21**
2.1. Current accounts (covering the minimum reserve system)		9,271.35	12,272.85
2.2. Deposit facility		20.00	0.00
2.3. Fixed-term deposits		0.00	0.00
2.4. Fine-tuning reverse operations		0.00	0.00
2.5. Deposits related to margin calls		0.00	0.36
3. Other liabilities to euro area credit institutions denominated in euro	**16**	**0.00**	**2,451.79**
4. Debt certificates issued		**0.00**	**0.00**
5. Liabilities to other euro area residents denominated in euro		**15,215.26**	**13,289.66**
5.1. General government	17	14,022.99	12,238.04
5.2. Other liabilities	18	1,192.27	1,051.62
6. Liabilities to non-euro area residents denominated in euro	**19**	**48.25**	**61.74**
7. Liabilities to euro area residents denominated in foreign currency		**8.76**	**20.52**
8. Liabilities to non-euro area residents denominated in foreign currency		**1,371.23**	**298.12**
8.1. Deposits, balances and other liabilities	20	1,371.23	298.12
8.2. Liabilities arising from the credit facility under ERM II		0.00	0.00
9. Counterpart of special drawing rights allocated by the IMF	**21**	**387.34**	**425.65**
10. Intra-Eurosystem liabilities	**22**	**18,654.90**	**0.00**
10.2. Liabilities related to promissory notes backing the issuance of ECB debt certificates		0.00	0.00
10.3. Net liabilities related to the allocation of euro banknotes within the Eurosystem		18,587.05	
10.4. Other liabilities within the Eurosystem (net)		67.85	0.00
11. Items in course of settlement	**23**	**44.97**	**90.07**
12. Other liabilities		**870.61**	**1,666.94**
12.1. Off-balance-sheet instruments revaluation differences	24	0.00	67.30
12.2. Accruals and income collected in advance	25	320.30	604.70
12.3. Sundry	26	550.30	994.94
13. Provisions	**27**	**4,004.53**	**3,868.40**
14. Revaluation accounts	**28**	**6,828.55**	**10,667.56**
15. Capital and reserves		**4.54**	**4.54**
15.1. Capital	29	1.37	1.37
15.2. Reserves	30	3.17	3.17
16. Profit for the year	**31**	**2,196.25**	**4,793.49**
TOTAL LIABILITIES		**96,431.84**	**96,139.25**

Profit and loss account of the Banco de España for the year ending 31 December 2002

(€ m)

	Note number	2002	2001
Interest income	1	2,703.31	4,010.60
Interest expense	2	-956.19	-966.07
Net interest income		**1,747.12**	**3,044.53**
Realised gains/losses arising from financial operations	3	727.99	2,048.07
Write-downs on financial assets and positions		-0.87	-85.16
Transfer to/from provisions for foreign exchange rate and price risks		0.00	0.00
Net result of financial operations, write-downs and risk provisions		**727.12**	**1,962.91**
Fees and commissions income		16.88	13.91
Fees and commissions expense		-1.86	-1.66
Net income from fees and commissions	**4**	**15.02**	**12.25**
Income from equity shares and participating interests	**5**	**228.65**	**181.27**
Net result of pooling of monetary income	**6**	**-67.85**	**2.02**
Other income	**7**	**144.87**	**75.02**
TOTAL NET INCOME		**2,794.92**	**5,278.00**
Staff costs	8	-195.83	-182.59
Administrative expenses	9	-70.78	-66.96
Depreciation of tangible and intangible fixed assets	10	-21.25	-18.50
Banknote production services	11	-115.23	-166.97
Other expenses	12	-20.16	-1.43
TOTAL OPERATING EXPENSES		**-423.25**	**-436.45**
Transfers and additions to other funds and provisions	**13**	**-175.43**	**-48.06**
PROFIT FOR THE YEAR	**14**	**2,196.25**	**4,793.49**

Countersigned by
The Governor,

JAIME CARUANA

The Comptroller,

ANTONIO ROSAS

II. NOTES ON THE ACCOUNTS

II.1. ACCOUNTING POLICIES

1. Basic principles

The following accounting principles have been applied in formulating the annual accounts:

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

2. Basis of accounting

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

As an exception to the application of the general historical cost criterion, it should be pointed out that, on 31 December 1998, at the time the ESCB was established and in application of the harmonised accounting standards established for the European System of Central Banks, gold, domestic and foreign securities and foreign currencies were valued at the market prices and exchange rates then prevailing, without recognising profits, in the event of unrealised gains, and with a charge to the profit and loss account in the case of unrealised losses. These unrealised gains are subsequently credited to the profit and loss account, when the sale of the asset in question takes place or, under certain conditions, when unrealised losses arising at a later date can be netted against them.

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

Gold

Gold is recorded at acquisition cost, which is determined by the cash amount paid, including all the expenses inherent in the transaction.

The cost of sales is obtained by applying the daily net average cost method. In the event that the cash to be paid or received is specified in a currency other than the euro, it is translated into euro at the mid-market exchange rate two business days before the settlement date.

On the last day of each month, stocks are valued at the market price in euro per troy ounce of fine gold. Unrealised gains or losses (except for unrealised losses at year-end) are reflected in an adjustment account and credited or debited, respectively, to a revaluation or expense account. Both revaluation and expense accounts are reversed at the end of the following month.

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

Sales of gold against foreign currency under repurchase agreements are recorded as off-balance-sheet items, with no effect on the balance sheet. The foreign currency received by way of consideration is recorded on the assets side, with the obligation to repay it being recorded simultaneously on the liabilities side. Possible differences arising between gold delivered spot and that received forward are recorded as if there had been an independent outright sale or purchase, at the time of maturity of the transaction.

Foreign currencies

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

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

Foreign currencies are revalued monthly to market price. This revaluation is performed without netting unrealised gains against unrealised losses on the various currencies. Unrealised gains and losses (except for unrealised losses at year-end) are reflected in adjustment accounts and credited or debited, respectively, to revaluation accounts and expense accounts. Both revaluation and expense accounts are reversed at the end of the following month.

Unrealised losses existing at the end of the year are taken to the profit and loss account for the year, in which case they affect the average cost of the currency in question. Such losses are considered irreversible.

Foreign banknotes

The criteria applied are the same as those indicated in the preceding section for foreign currencies.

Special drawing rights (SDRs)

SDRs and the net International Monetary Fund (IMF) position are valued at the year-end SDR market exchange rate.

Securities

Securities are recorded at acquisition cost, which is determined by the cash amount paid, after deducting any accrued gross coupon.

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

Securities are revalued monthly to market price. This revaluation is carried out without any netting of unrealised gains and losses on different security codes. Unrealised gains and losses (with the exception of unrealised losses at year-end) are reflected in adjustment accounts and credited or debited, respectively, to revaluation and expense accounts. Both revaluation and expense accounts are reversed in subsequent revaluations.

Unrealised losses existing at the end of the year are taken to the profit and loss account. Their amount is credited directly to the securities account, and the average book price – and therefore the internal rate of return – of the security code concerned is modified. Such losses are considered irreversible, not being reversed at the end of the following month.

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

The above references to acquisition cost and market prices shall, in relation to securities denominated in foreign currency, be understood to refer to the currency concerned, these amounts being translated into euro, as stipulated in the "Foreign currencies" section.

Repurchase agreements involving securities

Reverse repurchase agreements involving securities are recorded on the assets side of the balance sheet as collateralised outward loans for the amount of the loan. Securities acquired under reverse repurchase agreements are not revalued or included in the securities portfolio.

Repurchase agreements involving securities are recorded on the liabilities side of the balance sheet as an inward deposit collateralised by securities, the balancing entry of which is the cash received. Securities sold under this type of agreement remain on the balance sheet of the Banco de España and are treated as if they had remained part of the portfolio from which they were sold. Repurchase agreements involving securities denominated in foreign currencies have no effect on the average cost of the currency position.

In direct loans of securities, repurchase and reverse repurchase agreements conducted simultaneously are accounted for separately, each being recording according to the valuation rules set forth in the preceding two paragraphs.

Automated security loans are not recorded in the balance sheet. The only item accounted for is the income, which is recorded in the profit and loss account. Operations outstanding at year-end are recorded off-balance-sheet.

Doubtful debtors

Where there is any reasonable doubt over the recovery of an asset, it is recorded in a separate account and the relevant provision set aside.

Loans to financial institutions and balances with EU central banks

These are valued at their nominal amount.

Special loans to the State and the Social Security System

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

Shares and participating interests

Shares and participating interests in national and/or international institutions, including the participating interest in the European Central Bank (ECB), are valued at cost.

Tangible and intangible fixed assets

Fixed assets are valued at cost, which includes any non-deductible VAT borne and all additional expenses that may arise until they are in operation. Fixed assets whose cost is less than €120 are recorded as expenses in the year in which they are acquired.

Annual charges for depreciation are calculated on the basis of the estimated economic life of the various assets using the straight-line method. Land and items forming part of the Bank's art collection are not considered to be depreciable assets. Depreciation is taken monthly, starting from the month following that in which the asset is recorded in the accounts or put into operation.

Major expenses relating to projects that will be in effect for several years may be capitalised and depreciated over a maximum period of four years.

In 2002, the depreciation percentages applied to the various fixed assets were the same as those applied in 2001, and were as follows:

	%
• Land and buildings	2
• Facilities	6
• Furniture and office equipment	
— Libraries	10
— Furniture	10
— Offices machines other than computer equipment	20
— Machines for the treatment of banknotes and coins	20
— Computer equipment	25
— Other machines and equipment	20
• Transport equipment	20
• Computer applications	33
• Art collection	0

Banknotes in circulation

The ECB and the 12 participating NCBs, which together comprise the Eurosystem, have issued euro banknotes since 1 January 2002 (1). The total value of euro banknotes in circulation is allocated on the last working day of each month in accordance with the banknotes allocation key (2).

The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation as from 2002, whereas the remaining 92% has been allocated to the NCBs according to their weightings in the capital key of the ECB. The share of banknotes allocated to each NCB is disclosed under the balance sheet liability item "Banknotes in circulation".

The difference between the value of the euro banknotes allocated to each NCB in accordance with the banknote allocation key and the value of the euro banknotes that it actually puts into circulation also gives rise to remunerated intra-Eurosystem balances. These claims or liabilities, which incur interest (3) are disclosed under the sub-item "Intra-Eurosystem: Net claim/liability related to the allocation of euro banknotes within the Eurosystem" (see "Intra-Eurosystem balances" in the notes on accounting policies).

(1) Decision of the European Central Bank of 6 December 2001 on the issue of euro banknotes (ECB/2001/15), OJ L 337, 20.12.2001, pp. 52-54

(2) The banknote allocation key refers to the percentages that result from taking into account the ECB's share of the total euro banknote issue and applying the subscribed capital key to the NCBs' share of such total.

(3) Decision of the European Central Bank of 6 December 2001 on the allocation of monetary income of the national central banks of participating Member States from the financial year 2002 (ECB/2001/16), OJ L 337, 20.12.2001, pp. 55-61

From 2002 until 2007 the intra-system balances arising from the allocation of euro banknotes will be adjusted in order to avoid significant changes in NCBs' relative income positions as compared with previous years. The adjustments are effected by taking into account the differences between the average value of banknotes in circulation of each NCB in the period between July 1999 and June 2001 and the average value of banknotes that would have been allocated to them during that period under the ECB's capital key. The adjustments will be reduced in annual stages until the end of 2007, after which income on banknotes will be allocated fully in proportion to the NCBs' paid-up shares in the ECB's capital.

The interest income and expense on these balances is cleared through the accounts of the ECB and is disclosed under "Net interest income".

The Governing Council of the ECB has decided that the seigniorage income of the ECB arising from the 8% share of euro banknotes allocated to the ECB shall be distributed separately to the NCBs in the form of an interim distribution of profit (4). It shall be so distributed in full unless the ECB's net profit for the year is less than its income earned on euro banknotes in circulation. For 2002, one interim distribution was made on the second working day of 2003. This is disclosed in the Profit and Loss Account under "Income from equity shares and participating interests". From 2003 onwards, interim distributions will be made after the end of each quarter.

Intra-Eurosystem balances

Intra-Eurosystem balances arise from the Banco de España's participating interest in the ECB, claims equivalent to the reserves transferred to the ECB, the net balance resulting from the transfers issued and received by TARGET (5) among the national central banks of the ESCB, including the ECB, and the balances resulting from allocation of euro banknotes within the Eurosystem.

(4) Decision of the European Central Bank of 21 November 2002 on the distribution of the income of the ECB on euro banknotes in circulation to the NCBs of the participating Member States (ECB/2002/9).

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

The intra-Eurosystem balances arising from the allocation of euro banknotes within the Eurosystem are included as a net single asset or liability under "Net claim/liability related to the allocation of euro banknotes within the Eurosystem" (see "Banknotes in circulation" in the notes on accounting policies).

Recognition of income and expenses

Income and expenses are recognised in the period in which they accrue.

Realised gains and realised and unrealised losses are taken to the profit and loss account. To calculate the acquisition cost of items sold, the average cost method is used for securities and the daily net average cost method is used for foreign currencies and gold. In the case of unrealised losses on any item at year-end, its average cost is reduced to the end-of-year market price and/or exchange rate.

Unrealised gains are not recognised as income, but are transferred to a revaluation account.

Unrealised losses are taken to the profit and loss account if they exceed previous revaluation gains recorded in the corresponding revaluation account, and are not reversed in subsequent years against new unrealised gains. Unrealised losses in any one security or currency or in gold are not netted against unrealised gains in other securities or currencies.

Premiums or discounts on purchased securities are calculated and shown as interest income and accrued over the remaining life of the securities concerned, according to the internal rate of return method.

Pension scheme

Contributions to an external pension fund by employees who, having joined the Bank after 31.1.1986, are eligible to and do participate in the Pension Scheme, are established at 6.5% of the so-called "regulating salary", consisting of the salary items determined in the Scheme Rules. The amounts contributed by the Bank are recognised as a current expense in the year to which they relate.

Off-balance-sheet positions (6)

Foreign exchange forward transactions and forward legs of foreign exchange swaps are included in the net foreign currency positions in order to calculate foreign exchange gains and losses.

Interest rate futures are revalued on an item-by-item basis and treated in a similar manner to securities.

Profits and losses arising from off-balance-sheet positions are recognised and treated in a similar manner to those arising from on-balance-sheet assets and liabilities.

Post-balance-sheet events

Assets and liabilities are adjusted to reflect events that occur between the annual balance sheet date and the date on which the Governing Council formulates the financial statements if such events materially affect the asset-liability position.

II.2. NOTES ON THE BALANCE SHEET

1. Gold and gold receivables

The Banco de España's gold holdings amount to €5,499.85 million, consisting of 16,828 million troy ounces of fine gold valued at €326.83 per ounce (7). This amount is €198.95 million higher than at end-2001, basically as a result of the rise in the market price of gold during the year (at end-2001 the price per ounce was €314.99), the number of ounces having remained unchanged during the year, except for slight differences arising from deposit and swap transactions.

2. Receivables from the IMF

These include: *a)* Special Drawing Rights (SDRs) within the reserve tranche (€1,517.64 million) which include the net International Monetary Fund (IMF) position (€1,517.64 million) and the euro tranche position and its balancing account (€2,464.60 million, with a positive and negative sign); *b)* SDRs at the IMF (€337.12 million), and *c)* other claims against the IMF (€65.62 million). In total, receivables from the IMF decreased by €37.62 million, with respect to end-2001, as a result of a net increase of €161.96 million in investments and a reduction of €199.58 in the overall position due to variation in the exchange rate. There was no change in Spain's IMF quota in 2002.

SDRs are valued at the year-end market rate, calculated by the ECB for all the Eurosystem national central banks, of €1 = SDR 0.7714.

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

This sub-item includes security investments, balances with banks, loans and other claims on non-euro area residents denominated in foreign currency. Their total amount is €30,427.36 million, with the following breakdown:

(€ m)

Type of asset	2002	2001
Balances with banks	3,929.91	735.06
Security investments (8)	26,301.63	30,432.89
External loans and other external assets	201.05	238.81
Loan provisions	*–10.07*	*–11.95*
Non-euro area banknotes	4.85	4.18
TOTAL	**30,427.36**	**31,398.99**

At end-2002, 99.97% of the foreign-currency balances with foreign banks, security investments and loans denominated in foreign currency were denominated in US dollars. The equivalent value in euros of this US dollar amount was transferred to the balance sheet at the year-end market exchange rate (€1 = USD 1.0487).

"External loans and other external assets" include, inter alia, certain assets amounting to €10.07 million considered to be of doubtfully recoverable. Country-risk and other provisions have been recorded for the full amount of these assets.

(6) The net position under foreign exchange forward transactions and swaps, and the foreign-exchange gains and losses generated by such position are shown in the balance sheet under sub-items 11.4 on the assets side and 12.1 on the liabilities side, depending on their sign.

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

(8) As at 31 December 2002, repurchase agreements were constituted over part of the USD-denominated securities portfolio, with a market value of USD 1,119.43 million, under automated security lending contracts with the depositories of these securities. Automated security lending contracts allow the depository to lend the securities to a third party in overnight operations under the limits established in the contract.

The decrease in the balance of this item (€971.63 million) was basically due to the net effect of the factors listed in the following table:

(€ m)

Breakdown of the change	
Net purchase/sale of foreign currency	2,103.17
Increase in the outstanding gold swaps position at year-end	165.65
Increase in the market price of foreign securities	307.80
Change in the market exchange rate	–4,992.67
Gain/loss on sale of securities and futures	357.25
Foreign-currency-denominated interest income	1,087.17
TOTAL	**–971.63**

4. Claims on non-euro area residents denominated in euro. Balances with banks, security investments and loans

Substantially all the €475.05 million balance of this sub-item relates to the purchase in 2002 of securities issued in euros by international agencies outside the euro area.

5. Lending to euro area credit institutions related to monetary policy operations denominated in euro

This item includes the amount, classified by type of operation, of the euro-denominated lending to euro area credit institutions through which monetary policy is implemented.

The balance as at 31 December 2002 was 72.6% higher than in 2001 (€18,203.30 million in 2002, as against €10,546.69 million in 2001). The average daily flow of financing extended during the year rose by 7.81% from €13,709.67 million in 2001 to €14,780.41 in 2002.

82.80% of the average daily financing balance was extended through "Main refinancing operations", 16.98% was granted under "Longer-term refinancing operations" to provide additional longer-term financing to credit institutions, and only 0.22% of the average annual balance was financed through other instruments.

6. Other claims on euro area credit institutions denominated in euro.

This item includes claims on credit institutions unrelated to monetary policy operations. Its balance of €8.17 million includes the amount of the correspondent accounts in euro with euro area credit institutions. Also, as a significant event in the year, it should be mentioned that on 1 January 2002 credit institutions were granted €10,325.39 million of interest-free loans recorded in this item, which will be repaid in three instalments of €3,441.80 million each on 2, 23 and 30 January. These loans were granted under the "linear debiting model" established in Guideline of the European Central Bank ECB/2001/1 of 10 January 2001 adopting certain provisions on the 2002 cash change-over.

7. General government debt denominated in euro.

a) State

This item includes loans which, by virtue of their respective laws of creation, were granted to the State prior to the entry into force of Law 21/1993 of 29 December 1993 on the State budget for 1994. Transitional provision seven of this Law states that the terms and maturities originally established in such loans shall be maintained and, in the absence thereof, they shall be repaid on a straight-line basis within twenty-five years, by means of annual payments as from 1999.

The outstanding balance as at 31 December 2002 of the loans granted to the State amounted to €8,359.21 million, broken down as follows:

(€ m)

	31.12.2002	Repay-ment	31.12.2001
Treasury. Law 3/1983 special account	2,147.76	97.63	2,245.39
Treasury. Law 4/1990 special account	5,558.38	347.40	5,905.78
Credits arising from subscription for participating interests, contributions and quotas in international agencies	653.07	40.82	693.89
TOTAL	**8,359.21**	**485.84**	**8,845.06**

The change was solely due to yearly repayments on the above-mentioned loans, as specified in the above table.

b) Social Security System

This sub-item (€1,408.69) corresponds to the outstanding amount of two loans granted to the

Social Security System under Law 41/1994 of 30 December 1994 on the State budget for 1995. The first includes the principal of another loan granted to this institution, which was not paid on its maturity, of €1,539.19 million, and the second includes the interest due but not paid on the previous loan to 31.12.1994, amounting to €501.90 million. The repayment of the first loan, by means of twenty annual instalments starting in 2000, is treated in the same way as established for the repayment of special loans granted to the Sate, referred to above. The loan for interest due to 31 December 1994 is being repaid on a straight-line basis over ten years, the first instalment having been made on 31 December 1995.

€76.96 million of the reduction in the balance of this item in 2001 (€127.15 million) corresponds to receipt of the third repayment instalment on the loan of €1,539.19. The remaining €50.19 million corresponds to receipt of the eighth repayment instalment on the loan of €501.90 million. The amount of this payment was recovered by means of set-off against some of the amounts due to the Social Security System in respect of interest payable on its interest-bearing accounts with the Banco de España.

8. Intra-Eurosystem claims

a) *Participating interest in ECB*

The fully paid-up subscription of the Banco de España to the capital of the ECB amounts to €444.68 million, which is equal to a share of 8.8935% in such capital. This percentage, which remained unchanged during the year, corresponds to the Banco de España in accordance with the capital key established by the European Commission on the basis of Spain's population and GNP.

b) *Claims equivalent to the transfer of foreign reserves to the ECB*

Pursuant to Article 30 of the Statute of the ESCB/ECB, the Banco de España transferred foreign reserve assets to the value of €4,446.75 million to the ECB at the beginning of 1999. These claims are equivalent to this transfer.

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

See Note 22 on the balance sheet.

d) *Other claims within the Eurosystem (net)*

The balance of €18,269.71 million reflects the position of the Banco de España vis-à-vis the ECB, in respect of the transfers issued and received through TARGET by the national central banks of the ESCB, including the ECB. This sub-item also includes the balances held with the Eurosystem NCBs through correspondent accounts, which constitute an insignificant part of the total, and the Banco de España's position vis-à-vis the ECB in respect of the interim dividend receivable relating to the euro banknotes issued by the ECB.

From 30 November 2000, the balances arising from TARGET transfers vis-à-vis the Eurosystem banks, and vis-à-vis other European Union banks, have been netted and replaced by a single balance vis-à-vis the ECB. The year-end balance of €18,203.17 million represents 99.64% of the total of this balance sheet sub-item.

9. Tangible and intangible fixed assets

The balance of this sub-item amounted to €208.91 million at end-2002, of which €413.27 million related to cost and €204.36 to accumulated depreciation.

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

(€ m)

Cost or valuation	Property and facilities	Furniture and equipment	Fixed assets under construction	Other fixed assets	Total
1 January 2002	233.55	84.70	20.91	84.59	423.75
Additions	1.55	29.19	10.03	6.00	46.77
Disposals	0.20	7.46	20.94	28.64	57.24
31 December 2002	234.90	106.43	10.00	61.95	413.27

(€ m)

Accumulated depreciation	Property and facilities	Furniture and equipment	Fixed assets under construction	Other fixed assets	Total
1 January 2002	107.84	63.34	—	18.18	189.36
Change during the year	8.64	3.64	—	2.72	15.00
31 December 2002	116.48	66.98	—	20.89	204.36

The decrease in fixed assets was due to the sale of the Bank's total holdings of silver, which had been included until disposal in "Other fixed assets" (€28.48 million). The rest of the fixed assets increased by €3.01 million in the year.

As a result of the Banco de España's decision to restructure its branch network, a protocol was signed with the Ministry of Finance providing for transfer of the buildings housing the 30 branches to be closed.

10. Other financial assets

99.98% of the balance of this sub-item relates to the portfolio of book-entry domestic State securities, in which the Banco de España has €4,402.24 million invested, €831.12 million more than a year earlier. This increase is basically due to a net purchase of securities (€697.31 million), as well as to the net unrealised gains recorded at year-end (€115 million) and to accrued implicit interest (€18.81 million).

A post-balance sheet event calling for comment is the Banco de España's participation in the capital increase of Sociedad de Gestión de los Sistemas de Registro, Compensación y Liquidación de Valores, S.A. (formerly Promotora para la Sociedad de Gestión de los Sistemas Españolas de Liquidación, S.A.) through non-monetary contributions of the means and resources referred to in Law 44/2002 of 22 November on Financial System Reform Measures. In exchange, the Bank received 4,451 shares which, together with those already held in the former company, amount to 39.39% of the capital.

11. Off-balance-sheet instruments revaluation differences

This sub-item includes the amount of the net debtor position arising from foreign-exchange forward and swap transactions valued at the exchange rates prevailing at the end of the year. When this position is a creditor one, as was the case in 2001, it is recorded under the same heading in liability sub-item 12.1. The end-2002 balance of €369.25 million is the net value of the forward transactions and currency swaps outstanding as at that date.

12. Accruals and prepaid expenses.

The main components of the total balance of this sub-item (€638.62 million) are accrued interest receivable on securities, deposits and other assets denominated in foreign currency (€243.42 million), on book-entry domestic State securities (€126.51 million), on the claims equivalent to the transfer of foreign reserves to the ECB (€125.28 million) and on the net balance of claims within the Eurosystem arising from transfers made through TARGET (€58.90 million).

13. Sundry

The most significant component is the transfer made to the Treasury on 4 November 2002 of €1,156.34 million, equivalent to 70% of the Bank's recorded profits earned to 30 September 2002.

The other major component is the home loans granted to employees, the balance of which amounts to €113.35 million.

14. Banknotes in circulation

The balance of banknotes in circulation includes the Banco de España's share in the total euro banknotes in circulation (see «Banknotes in circulation» in the notes on accounting policies) and the peseta-denominated banknotes not yet exchanged as at 31.12.2002.

Of the above-mentioned balance (€37,505.32 million), €36,217.59 million are the euro corresponding to the Banco de España in application of the key for allocation of euro banknotes within the Eurosystem (10.1020% of total issued banknotes after deducting those corresponding to the ECB, which are 8% of the total). The remainder, €1,287.73 million, relates to peseta-denominated banknotes not exchanged as at year-end. In compliance with the resolution of the Governing Council of the ECB of 5 December 2002, these peseta banknotes were removed from this balance sheet item on 1 January 2003 and included in «Other liabilities – Sundry».

15. Liabilities to euro area credit institutions related to monetary policy operations denominated in euro

The overall balance of the different types of deposit held by credit institutions with the Banco de España amounted to €9,291.35 million at end-

2002. The decrease with respect to the previous year was concentrated in current accounts (covering the minimum reserve system), which fell from 12,273.21 million at 31.12.01 to €9,271.35 million at 31.12.02. This decline was because at end-2001 credit institutions needed financing to pay for one-third of the euro banknotes and coins frontloaded on the first working day of 2002. The average annual balance of this item in 2002 amounted to €11,163.43 million, 7.3% higher than in 2001 (€10,401.04 million).

16. Other liabilities to euro area credit institutions denominated in euro

Although at end-2002 this sub-item did not have a balance, it should be mentioned that until 31 December 2001 it included cash deposits of €2,451.79 million placed by credit institutions to secure that part of the euro banknotes and coins frontloaded up to that date not covered by the existing loan agreements collateralised by securities. These deposits were progressively cancelled throughout January 2002 as payments were made for the frontloaded euro banknotes and coins.

17. Liabilities to other euro area residents denominated in euro. General government

This sub-item includes the deposits held by general government with the Banco de España. The outstanding balance at year-and was €14,022.99 million, which breaks down as follows:

(€ m)

	2002	2001
Central government (State)	2,798.26	2,793.60
Treasury current account	*299.89*	*394.98*
Other central government agencies and similar bodies	*2,498.36*	*2,398.62*
Territorial government	87.97	80.21
Regional (autonomous) governments, administrative agencies and similar bodies	*81.20*	*76.45*
Local government	*6.78*	*3.77*
Social security funds	11,136.76	9,364.23
TOTAL	**14,022.99**	**12,238.04**

The rise in the balance of this sub-item (€1,784.95 million) was basically due to the increase in the balances held by the Social Security System.

18. Liabilities to other euro area residents denominated in euro. Other liabilities

Included here are the current accounts of financial institutions other than credit institutions, such as the Deposit Guarantee Funds, other financial intermediaries associated with securities markets settlement, other intermediaries in the debt book-entry market, etc., as well as the current accounts of employees and pensioners and other accounts of legal entities classified in "Other resident non-financial sectors". The balance at end-2002 was €1,192.27 million, an increase of €140.65 million on end-2001, basically due to the increase in the balances of the current accounts of "State agencies – Regional agencies" (€99.37 million).

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

This item basically includes the balances of euro accounts held by international agencies and central banks that do not belong to the euro area. The balance of €48.25 million was €13.49 million lower than a year earlier.

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

Substantially all of the €1,371.23 million balance of these liabilities at end-2002 related to debts arising under repurchase agreements relating to the management of the foreign-currency reserves of the Banco de España. The total amount of this sub-item rose by €1,073.10 million.

21. Counterpart of special drawing rights allocated by the IMF

This item of €387.34 million shows the amount of the special drawing rights allocated to Spain in proportion to its IMF quota.

22. Intra-Eurosystem liabilities

a) Net liabilities related to the allocation of euro banknotes within the Eurosystem

This item consists of the claims and liabilities of the Banco de España vis-à-vis the Eurosystem in relation to the allocation of euro banknotes within the Eurosystem (see “Banknotes in circulation” and “Intra-Eurosystem balances” in the notes on accounting policies).

b) Other liabilities within the Eurosystem (net)

This sub-item includes the net position vis-à-vis the ECB arising from the contribution and allocation of monetary income in the Eurosystem (see “Net result of pooling of monetary income” in note 6 on the profit and loss account).

23. Items in course of settlement

Of the total balance of this item (€44.97 million), €40.66 corresponds to transfers ordered by credit institutions pending payment at year-end. These transfers also account for most of the decrease with respect to 2001 (€37.66 million out of a total of €45.09 million).

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

See note 11 on the balance sheet.

25. Other liabilities. Accruals and income collected in advance

The most significant components of this sub-item totalling €320.30 million are interest accrued but not yet paid (€223.08 million) and ordinary and pre-system profits. The latter are attributable to the sale of foreign currencies under forward transactions pending execution (€91.24 million) and are therefore considered unrealised until the transactions mature and are executed.

26. Other liabilities. Sundry

The most important components of this sub-item are the contributions payable to the Banco de España employee social welfare scheme (*Mutualidad de empleados*), which amounted to €340.75 million, down €20.38 million on the previous year, and the “Settled credit interest pending allocation”, corresponding to a loan granted in the past to the Social Security System, with a balance at year-end of €100.39 million, down €50.19 million on the previous year (9).

27. Provisions

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

(€ m)

	2002	2001
For exchange rate risks–Pre-system account	3,767.58	3,767.58
For early and regular retirement	128.78	—
For sundry liabilities and charges	107.94	100.54
For other risks	0.22	0.28
TOTAL	**4,004.53**	**3,868.40**

The most important provision relates to pre-system exchange rate risks. It was created by a resolution of the Executive Commission of 26 January 1999 to cover exchange rate risks affecting the external reserves of the Banco de España. It should be pointed out that the balance of this account was held unchanged in 2002 as authorised by the Executive Commission on 24 September 2002, while the risk of unrealised losses on the reserves transferred to the ECB disappeared. As a result, the level of coverage of the Bank’s foreign exchange position increased.

The increase of €136.12 million in the other provisions was basically due to coverage of payments to be made in the coming years for early retirements agreed by the Banco de España with its employees in August 2002, as a result of the closure of 30 Bank branches between 31.12.2002 and 31.12.2004.

28. Revaluation accounts

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

(9) This loan is referred to in Note 7.b) above.

(€ m)

Type of account	2002	2001
Pre-system revaluation accounts	**3,727.85**	**3,879.02**
Due to exchange rate differences	909.43	980.19
Due to price differences	2,818.43	2,898.83
Gold	*2,565.39*	*2,565.53*
Securities denominated in foreign currencies	*2.47*	*11.55*
Book-entry public debt	*250.57*	*321.75*
Ordinary revaluation accounts	**3,100.69**	**6,788.54**
Due to exchange rate differences	638.11	4,949.37
Due to price differences	2,462.58	1,839.17
Gold	*1,353.99*	*1,154.81*
Securities denominated in foreign currencies	*896.68*	*588.42*
Book-entry public debt	*210.94*	*95.94*
Other	*0.97*	—
TOTAL	**6,828.55**	**10,667.56**

The difference between the pre-system and ordinary revaluation accounts is that the former record the unrealised gains existing at end-1998 (immediately before the start of Stage Three of EMU) and the latter those arising since that date.

The decline of €151.17 million in the balance of the pre-system revaluation accounts in 2001 has the following breakdown:

(€ m)

Pre-system revaluation accounts	Breakdown of the change in 2002: Due to the realisation of capital gains in sales and redemptions	Breakdown of the change in 2002: Due to netting against unrealised capital losses	Total
Due to exchange rate differences	–45.57	–25.19	–70.76
Due to price differences	–80.40	—	–80.40
Gold	–0.14	—	–0.14
Securities denominated in foreign currencies	–9.09	—	–9.09
Book-entry public debt	–71.18	—	–71.18
TOTAL	**–125.97**	**–25.19**	**–151.17**

The balance of the ordinary revaluation accounts decreased by €3,687.85 million, with the following breakdown:

Breakdown of change	€ m
Due to exchange rate differences	–4,311.26
Due to price differences	623.41
Gold	*199.18*
Securities denominated in foreign currencies	*308.26*
Book-entry public debt	*115.00*
Other	*0.97*
TOTAL	**–3,687.85**

29. Capital

The capital of the Banco de España, constituted in accordance with the provisions of Royal Legislative Decree 18/1962 of 7 June 1962, totalled EUR1.37 million and remained unchanged during the year.

30. Reserves

Included in this sub-item, which remained unchanged during the year, is the amount of capital, reserves and profits that arose in 1973 when the now-defunct Spanish Foreign Currency Institute was included in the Banco de España.

31. Profit for the year

The net profit for the year, after deducting the transfer to the Beneficent-Social Fund (€4.40 million), amounted to €2,196.25 million, down 54.2% on 2001. Of this amount, €1,156.34 million was paid to the Treasury on 4 November 2002, in accordance with Royal Decree 1080/2002 of 22 October 2002.

The following amounts were also paid to the Treasury during the year out of the profit for 2001.

a) On 1.2.2002, €2,055.78 million, in order to reach 90% of the profit for 2001 (€4,793.49 million).

b) On 26.7.2002, once the Balance Sheet and Profit and Loss Account for the year 2001 had been approved by the Council of Ministers, €479.35 million, representing the rest of the profit for 2001.

The details of the various components of the profit for 2001 are given in Section II.3 below, relating to the profit and loss account.

II.3. NOTES ON THE PROFIT AND LOSS ACCOUNT

1. Interest income

This item includes income from interest accrued on the main assets of the Banco de España. It was made up, in 2002 and 2001, as follows:

(€ m)

	Foreign currency		Euro		Total	
	2002	2001	2002	2001	2002	2001
Securities	949.52	1,659.58	179.06	175.04	1,128.58	1,834.62
Other assets	161.16	183.94	1,413.58	1,992.04	1,574.73	2,175.98
TOTAL	**1,110.68**	**1,843.52**	**1,592.64**	**2,167.08**	**2,703.31**	**4,010.60**

As regards the interest on foreign-currency investments (€1,110.68 million), the majority (€1,004.72 million, equivalent to 90.46%) arose from investments denominated in US dollars, which had an average balance of USD 27,533.11 million and an average yield of 3.7%, compared with 5.6% in 2001. The rest of the interest arose from much less significant investments in SDRs, Canadian dollars and other smaller investments in other currencies.

The interest on euro-denominated investments (€1,592.64 million) arose from the following assets:

(€ m and %)

Assets	Average investment	Amount	Average yield in 2002
Loans to institutions related to monetary policy operations	14,780.42	493.97	3.3%
Net balance with the ECB arising from TARGET operations	22,508.95	746.06	3.3%
Net balance with the ECB arising from accounts related to the allocation of euro banknotes within the Eurosystem	1,290.53	43.19	3.3%
Claims equivalent to the transfer of foreign reserves	4,446.75	125.28	2.8%
Book-entry debt portfolio	3,669.69	178.70	4.8%
Other	—	5.44	—
TOTAL	**46,696.34**	**1,592.64**	**3.4%**

Of the decrease in total euro-denominated interest income (€574.44 million), nearly 80% was due to the fall in the average return on these assets (down from 4.3% in 2001 to 3.4% in 2002) and the remainder was due to the decline in the average investment (€49,160.06 in 2001). It should also be noted that interest of €43.19 million was earned on the days in 2002 when there was a net debit balance in the Eurosystem accounts related to the allocation of banknotes within the Eurosystem.

2. Interest expense

This item includes interest expenditure on liabilities, with the following breakdown:

(€ m and %)

	Average financing	Interest expense		Average cost in 2002
		2002	2001	
Remuneration of minimum reserves	11,163.43	367.88	452.47	3.3%
General government deposits	11,883.92	386.30	456.31	3.3%
Net balance with the ECB arising from accounts related to the allocation of euro banknotes within the Eurosystem	5,514.97	182.84	—	3.3%
Liabilities denominated in foreign currency	802.79	15.78	29.49	1.9%
Other euro- and foreign-currency-denominated liabilities	—	3.39	27.80	—
TOTAL	**29,365.11**	**956.19**	**966.07**	**3.2%**

The decrease in the expense compared with the previous year (€9.88 million) was primarily due to the fall in the average cost of financing received (3.2% in 2002 compared with 4.3% in 2001) – which was main reason for the lower cost of minimum reserves (€84.59 million) and of general government deposits (€70.01 million) – and, to a lesser extent, to the lower interest paid on foreign currency liabilities (€40.95). These decreases in expenses were offset by the amount of the remuneration earned on the days when there was a net debit balance in the Eurosystem accounts related to the allocation of banknotes within the Eurosystem, which amounted to €182.84 million.

3. Realised gains/losses arising from financial operations

This item includes the profits and losses arising from dealing in financial assets. In 2002, there was a net realised gain of €727.99 million, basically arising from the following sources:

— Foreign exchange gains upon the sale of foreign currency totalling €361.32 million, of which €292.60 million corresponded to the profit for the year and the rest, €68.72 million, to the realisation of unrealised gains existing as at 31.12.1998.

  Of the above-mentioned €361.32 million, €195.08 million arose from the sale of US dollars, which amounted to €886.97 million in the year, and €138.08 million from forward operations. The other gains basically related to the net sale of SDRs (€20.02 million) and other foreign currencies (€8.14 million).

— The net price-related gains arising from the purchase and sale of foreign securities amounted to €358.16 million and related in full to the sale of US dollar-denominated securities.

Of the total of €358.16 million, €349.07 million corresponds to gains arising and realised in 2002 and the rest (€9.09 million) to the realisation of unrealised gains existing as at 31 December 1998,

Compared with the previous year, the net profit on these transactions fell by €1,320.08 million, of which €1,294.73 million related to the decrease in foreign exchange gains and €25.35 million to the decline in gains arising from price movements

— The decrease in foreign exchange gains basically arose from the depreciation of the US dollar against the euro and the lower volume of sales of US dollars (USD 3,899.00 million in 2001 compared with USD 886.97 million in 2002). In addition, gains on forward operations in US dollars were €253.28 million lower in 2002 than in 2001, when they amounted to €391.36 million.

— The decrease in gains arising from price movements basically arose on the sales of fixed-income securities denominated in US and Canadian dollars owing, in the first case, to the realisation of lower pre-system gains and, in the second case, to the absence of any sales of this currency in 2002.

4. Net income from fees and commissions

This basically includes income and expenses arising from fees and commissions for banking services and the like (transfers, handling of cheques, custody and administration of securities, telephone service for securities transactions, etc.). It may be broken down as follows:

(€ m)

	Income		Expenses	
	2002	2001	2002	2001
Foreign operations	0.96	0.56	–1.18	–1.17
Domestic operations	15.92	13.35	–0.69	–0.49
TOTAL	**16.88**	**13.91**	**–1.86**	**–1.66**

The increase in fee income in 2002 (21.3%) was mainly due to the rise in the rates charged on operations via the Banco de España's Settlement Service.

5. Income from equity shares and participating interests

Of the total amount of €228.65 million recorded, €226.58 million originates from the ECB, of which €160.03 million corresponds to the distribution in 2002 of the ECB's profit for the year 2001. Also included under this heading is the distribution of the ECB's income on euro banknotes, which amounts to €66.54 million (see "Banknotes in circulation" in the notes on accounting policies).

6. Net result of pooling of monetary income

In 2002 the amount of each NCB's monetary income was determined by multiplying the liability base of each NCB by the main refinancing operations rate. The liability base consists of the following items: banknotes in circulation (including both euro banknotes and non-returned national banknotes); liabilities to credit institutions related to monetary policy operations denominated in euro; net Intra-Eurosystem liabilities resulting from TARGET transactions; and net Intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem. Any interest paid on liabilities included within the liability base is to be deducted from the monetary income to be pooled. The monetary income pooled by the Eurosystem is to be allocated among NCBs according to the subscribed capital key. The difference between the monetary income pooled by the Banco de España, amounting to EUR 1,124.86 million, and reallocated to the Banco de España, amounting to €1,057.01 million, is the net result arising from the calculation of monetary income.

7. Other income

This includes the income and losses that cannot be included in other items, as well as other diverse income of an exceptional nature. It may be broken down as follows:

(€ m)

Description	2002	2001
Profit on book-entry public debt	76.57	30.59
Extraordinary profit	67.70	43.20
Sundry	0.61	1.23
TOTAL	**144.87**	**75.02**

€71.18 million of the profit on the public-debt portfolio relates to pre-system profit arising from gains on debt redeemed in the year and the remaining €5.39 million to profit for the year. In total, this profit was €45.98 million higher than that obtained in this connection in 2001.

The €67.70 million of extraordinary profit arose mainly as a result of the receipt from the Social Security System of interest accrued in previous years (€50.19 million) and of the sale of silver (€27.65 million), offset by the loss resulting from the increase in the provision to cover assistance for death and retirement (€5.91 million) and by the loss on the exchange of banknotes that ceased to be legal tender between the date of publication of the Law of Autonomy of the Banco de España and 31.12.2001 (€6.91 million).

8. Staff costs

This item increased by €13.24 million, basically due to the overtime that had to be worked because of the changeover from the peseta to the euro.

9. Administrative expenses (10)

This item includes expenses arising from the purchase of current assets and of diverse services received during the year. The most important were office expenses (including IT costs), which amounted to €32.38 million, and costs relating to premises (especially maintenance), which amounted to €15.88 million.

It breaks down as follows:

(€ m)

Description	2002	2001
Office expenses	–32.38	–26.94
Property expenses	–15.88	–13.65
Transport and communications	–5.65	–4.82
Surveillance and security	–6.14	–5.52
Training and grants	–1.67	–1.68
Sundry operating expenses	–8.19	–13.54
Local taxes	–0.87	–0.81
TOTAL	**–70.78**	**–66.96**

"Sundry operating expenses" include €112,165.04 (including VAT) relating to the fees of the external auditors PricewaterhouseCoopers, S.L. for the audits in 2002 of the Bank's annual accounts and of the Bank's management of European Central Bank reserves. This firm was also paid €159,068.48 for the purchase of IT products and services.

10. Depreciation of fixed assets

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

(€ m)

Description	2002	2001
Depreciation of property	–8.73	–8.78
Depreciation of transport equipment	–0.26	–0.12
Depreciation of furniture and office equipment	–9.78	–7.30
Depreciation of computer applications	–2.49	–2.28
Other depreciable expenses	—	–0.02
TOTAL	**–21.25**	**–18.50**

11. Banknote production services

This amount (€115.23 million) corresponds to payments made by the Banco de España to purchase banknotes, basically from the National Mint. The decrease with respect to the previous year (€51.74 million) was attributable to the lower volume of euro-denominated banknotes acquired by the Bank, in comparison with the extraordinary volume that had to be purchased in 2001 to cater for the massive exchange of peseta banknotes from 1.1.2002.

12. Other expenses

This item includes extraordinary expenses arising from the peseta/euro exchange process, particularly those relating to the cost of transport and distribution.

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

13. Transfers and additions to other funds and provisions

The balance of this item at €175.43 million was €127.37 million higher than in the previous year, mainly because of transfers to special funds for future early retirement payments relating to the Bank's agreement with its employees in August 2002 and other retirement provisions (€128.78 million). Also included are expenses arising from payment commitments to the Banco de España Employee Social Welfare Scheme (€39.72 million), the transfer to the country-risk provision to cover 100% of the loans extended under the bilateral agreement with Cuba (€2.38 million) and the contribution to the Beneficent-Social Fund (€4.40 million). Since the Banco de España provides financial services, it is not an institution with a high environmental risk. In 2002 it was not considered necessary to record any provision for environmental contingencies and expenses.

14. Profit for the year

As detailed and explained in the preceding notes, the net profit for 2002 amounted to €2,196.25 million, down 54.2% on the previous year.

The table below shows that, pursuant to Royal Decree 1080/2002, €820.28 million was paid into the Treasury on 3 February 2003. This was the amount necessary, taking into account the advance payment of €1,156.34 million on 4 November 2002, to make a total payment of 90% of the Bank's profit for the period ending 31.12.02.

(€ m)

1. Profit for the year 2002		2,196.25
2. Payments to the Treasury:		
— on 4.11.2002, 70% of profit as at 30.9.2002	1,156.34	
— on 3.2.2003, balance to raise the preceding amount to 90% of the profit for the year ending 31.12.2002	820.28	1,976.62
3. Profit pending payment to the Treasury (11)		219.62
TOTAL (2 + 3)		**2,196.25**

(11) The remaining amount due shall be paid to the Treasury when the annual accounts for 2002 have been approved by the Government.

III. SPECIFIC INFORMATION REQUIRED BY ARTICLE 4 OF THE LAW OF AUTONOMY OF THE BANCO DE ESPAÑA

1. Contributions made by the Bank to the Deposit Guarantee Funds (Article 4.2 of the Law of Autonomy of the Banco de España of 1 June 1994)

The contribution of the Banco de España to the Deposit Guarantee Funds is regulated by Article 3 of Royal Decree 18/1982, according to the wording established by additional provision seven of Royal Legislative Decree 12/1995 of 28 December 1995 and Royal Decree 2606/1996 of 20 December 1996, which implemented the legal regime for such funds.

The latter Royal Decree established that the Deposit Guarantee Funds may only exceptionally be supplemented by contributions from the Banco de España, the amount of which shall be fixed by Law. In 2002 the Banco de España made no contributions whatsoever to the Deposit Guarantee Funds.

2. Loss of profit

The table below shows the loans outstanding in 2002 with interest rates below the reference rates used, in order to estimate the loss of profit for the year pursuant to the provisions of Article 4.2 of Law 13/1994 of 1 June 1994 of Autonomy of the Banco de España.

(€ m and %)

Average balances of loans outstanding in 2002 with interest rates below the reference rates

	Estimated average balance in 2002	Interest rate received (%)	Reference interest rate (%)	Estimated loss of profit
Net State debt	8,514.82	0.00	3.27	278.43
Loans to the Social Security System	1,535.50	0.00	3.27	50.21
Home loans and repayable advances to employees	132.14	**1.95**	**3.27**	**1.75**
Home loans	*111.08*	*2.32*	*3.27*	*1.06*
Repayable advances	*21.06*	*0.00*	*3.27*	*0.69*
TOTAL	**10,182.46**	**0.02**	**3.27**	**330.39**

Included under "Net State debt" is the average balance during the year, on a daily basis, of the special loans granted to the State before 1994 and the deposits held by the Treasury with the Banco de España, when there is a net balance in favour of the latter.

As regards the loans to the Social Security System, transitional provision six of Law 41/1994 of 30 December 1994 on the 1995 State budget, when establishing the conditions for repayment of certain loans to the Social Security System, provided that no interest shall accrue on such loans as from 1 January 1995.

The home loans and advances to employees are those granted under the Banco de España's collective agreements with its personnel.

The reference rate used to estimate the loss of profit in all these loans is the monthly average of the interest rate on main refinancing operations during the year.

In 2002 mention should also be made of the non-remunerated loans granted on an exceptional basis to credit institutions on 1 January 2002 in application of the Guideline approved for the Eurosystem by the ECB's Governing Council (ECB/2001/1) to finance the holdings of euro banknotes front-loaded to them up to 31.12.2001 by all the national central banks. In Spain they amounted to €10,325.39, which was paid by the credit institutions in three equal instalments on 2, 23 and 30 January 2002.

In this case, application of the average daily rate on the main refinancing transactions to the daily outstanding balance results in interest of €16.43 million.

ANNEX

1. REPORT OF THE EXTERNAL AUDITORS

AUDIT REPORT ON THE ANNUAL ACCOUNTS

To the Governor and Governing Council of the Banco de España

We have audited the annual accounts of the Banco de España, comprising the balance sheet as at 31 December 2002, the profit and loss account and the notes on the accounts for the year then ended. The Governing Council of the Bank is responsible for the preparation of the accounts. It is our responsibility to express an opinion on the annual accounts taken as a whole based on our audit conducted in accordance with generally accepted auditing standards, which require examination, by means of selective tests, of the documentation supporting the annual accounts and evaluation of their presentation, of the accounting principles applied and the estimates made.

For comparison purposes, the attached annual accounts present, in addition to the 2002 figures, those for the previous year for each balance sheet and profit and loss account item. Our opinion refers solely to the 2002 annual accounts. Our audit report issued on 3 June 2002 on the 2001 annual accounts contained an unqualified opinion.

In our opinion, the attached 2002 annual accounts present, in all material respects, a true and fair view of the net worth and financial position of the Banco de España as at 31 December 2002 and of the results of its operations in the year then ended, and contain the required information, sufficient for their proper interpretation and comprehension, in conformity with the accounting principles and standards referred to in Section II.1 of the notes on the accounts, based on the accounting policies established for the member central banks of the European System of Central Banks, which are consistent with those applied the previous year.

PricewaterhouseCoopers Auditores, S.L.

[signed]

José Wahnón Levy

Partner

29 May 2003

2. REPORT OF THE ACCOUNTS REVIEW COMMITTEE

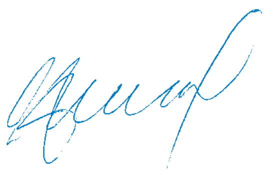
We the undersigned, José Manuel González-Páramo Martínez Murillo, Eduardo Bueno Campos and Jaime Requeijo González, members of the Governing Council of the Banco de España and of the Accounts Review Committee appointed by the Governing Council, were given the task of reviewing the accounts of the institution for the year 2002.

By virtue of this mandate, the Accounts Review Committee has analysed the operations of the Banco de España. This examination basically involved: 1) studying the Annual Accounts of the Banco de España for the year 2002, prepared by the Internal Affairs Department of the Banco de España; 2) studying the audit of the balance sheet and profit and loss account of the Banco de España for 2002, conducted by the Internal Audit Department; 3) studying the documentation requested by the members of this Committee from the independent external auditors; 4) interviewing the persons responsible for the independent external audit, for the Internal Audit Department and for the Control and Accounting Department; and 5) making proposals for the modification, correction or clarification of various matters, all of which have been satisfactorily incorporated in the Annual Accounts by the Control and Accounting Department.

The basic conclusion of our report is that from the analysis carried out of the examination and accounting procedures, of the accounting records and of the internal controls in place, it can be inferred that the Annual Accounts for the year 2002 give a true and fair view of the net worth and financial position of the Banco de España.

Madrid, 28 May 2003.

D. JOSÉ MANUEL GONZÁLEZ-PÁRAMO MARTÍNEZ-MURILLO



D. EDUARDO BUENO CAMPOS

D. JAIME REQUEIJO GONZÁLEZ

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COMPOSITION OF THE GOVERNING BODIES OF THE BANCO DE ESPAÑA

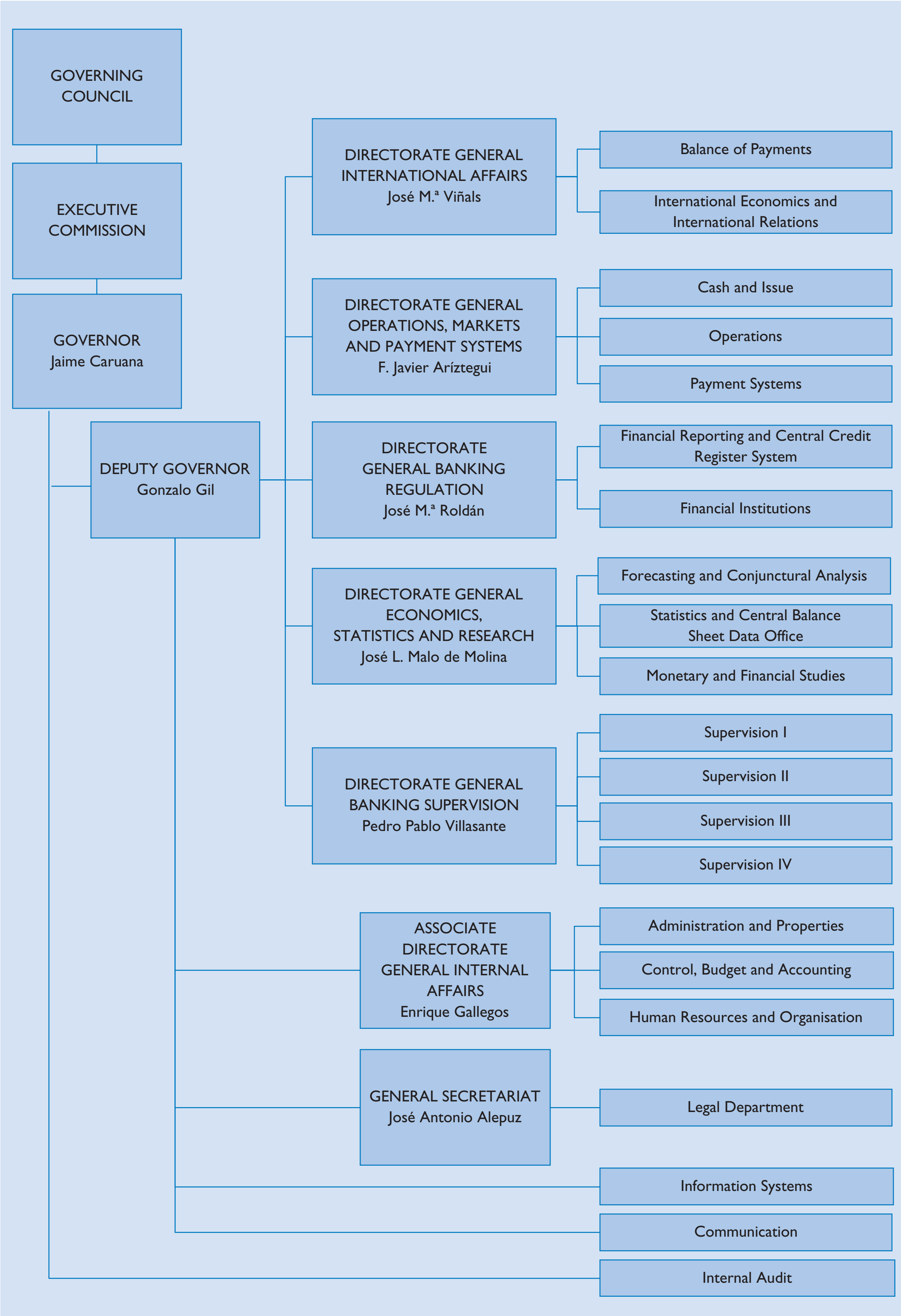
Governing Council

GOVERNOR	Jaime Caruana
DEPUTY GOVERNOR	Gonzalo Gil
COUNCIL MEMBERS	Eduardo Bueno José M. González-Páramo Joaquín Muns Juan Muñoz Jaime Requeijo Julio Segura
DIRECTOR-GENERAL OF THE TREASURY AND FINANCIAL POLICY (No vote on monetary policy issues)	Gloria Hernández
VICE-PRESIDENT OF THE NATIONAL SECURITIES MARKET COMMISSION (No vote on monetary policy issues)	Juan Jesús Roldán
DIRECTORS-GENERAL OF THE BANK (Without a right to vote)	José L. Malo de Molina Francisco J. Arízteguì Pedro Pablo Villasante José M.ª Roldán José M.ª Viñals
SECRETARY (Without a right to vote)	José R. del Caño
REPRESENTANTATIVE OF THE BANK'S PERSONNEL (Without a right to vote)	Isabel Gutiérrez

Executive Commission

GOVERNOR	Jaime Caruana
DEPUTY GOVERNOR	Gonzalo Gil
COUNCIL MEMBERS	José M. González-Páramo Julio Segura
DIRECTORS-GENERAL (Without a right to vote)	José L. Malo de Molina Francisco J. Aríztegui Pedro Pablo Villasante José M.ª Roldán José M.ª Viñals
SECRETARY (Without a right to vote)	José R. del Caño

ORGANISATION CHART



BANCO DE ESPAÑA
PUBLICATIONS

REGULAR PUBLICATIONS

ANNUAL REPORT (in Spanish and English) (⅄)

FINANCIAL ACCOUNTS OF THE SPANISH ECONOMY (bilingual Spanish/English edition) (annual) (⅄)

THE SPANISH BALANCE OF PAYMENTS (in Spanish and English) (annual) (⅄)

CENTRAL DE ANOTACIONES EN CUENTA (annual) (⅄)

BOLETÍN ECONÓMICO (monthly) (⅄)

ECONOMIC BULLETIN (quarterly) (⅄)

BOLETÍN ESTADÍSTICO (monthly) (⅄)

BOLETÍN DE ANOTACIONES EN CUENTA (daily)

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