

# ANNUAL REPORT

## 2006

BANCO DE **ESPAÑA**  
Eurosistema





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## ABBREVIATIONS

AIAF	Association of Securities Dealers	GVA	Gross value added
BCBS	Basel Committee on Banking Supervision	HICP	Harmonised index of consumer prices
BE	Banco de España	IADB	Inter-American Development Bank
BIS	Bank for International Settlements	ICT	Information and communications technology
CBSO	Central Balance Sheet Data Office	IGAE	National Audit Office
CCR	Central Credit Register	IMF	International Monetary Fund
CEMLA	Center for Latin American Monetary Studies	INE	National Statistics Institute
CEPR	Centre for Economic Policy Research	INEM	National Public Employment Service
CNE	Spanish National Accounts	INVERCO	Association of Collective Investment Institutions and Pension Funds
CNMV	National Securities Market Commission	LIFFE	London International Financial Futures Exchange
CPI	Consumer price index	MEFF	Financial Futures and Options Market
DGS	Directorate General of Insurance and Pension Funds	MEFF RF	Fixed-income derivatives market
EAGGF	European Agricultural Guidance and Guarantee Fund	MEFF RV	Equity derivatives market
ECB	European Central Bank	MFIs	Monetary financial institutions
ECCO	ECB External Communications Committee	MiFID	Markets in Financial Instruments Directive
ECOFIN	Council of the European Communities (Economic and Financial Affairs)	MMFs	Money market funds
EDP	Excessive Deficit Procedure	MROs	Main refinancing operations
EMU	Economic and Monetary Union	MTBE	Banco de España quarterly macroeconomic model
EONIA	Euro overnight index average	NAIRU	Non-accelerating-inflation rate of unemployment
EPA	Official Spanish Labour Force Survey	NCBs	National central banks
ERDF	European Regional Development Fund	NPISHs	Non-profit institutions serving households
ESA 79	European System of Integrated Economic Accounts	OECD	Organisation for Economic Co-operation and Development
ESA 95	European System of National and Regional Accounts	OPEC	Organisation of Petroleum Exporting Countries
ESCB	European System of Central Banks	PFs	Pension Funds
EU	European Union	PPP	Purchasing power parity
EU-15	Countries making up the European Union as at 31/04/04	QNA	Quarterly National Accounts
EU-25	Countries making up the European Union as from 1/05/04	RoW	Rest of the World
EU-27	Countries making up the European Union as from 1/01/07	SCLV	Securities Clearing and Settlement Service
EUROSTAT	Statistical Office of the European Communities	SDRs	Special drawing rights
FASE	Financial Accounts of the Spanish Economy	SICAV	Open-end Investment Companies
FDI	Foreign direct investment	SMEs	Small and medium-sized enterprises
FIAMM	Money market funds	TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
FIM	Securities funds	TFP	Total factor productivity
FISIM	Financial Intermediation Services Indirectly Measured	ULCs	Unit labour costs
GDI	Gross disposable income	VAT	Value added tax
GDP	Gross domestic product	WTO	World Trade Organisation
GFCF	Gross fixed capital formation	XBRL	Extensible Business Reporting Language
GNP	Gross national product		

## COUNTRIES AND CURRENCIES

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

BE	Belgium	EUR (euro)
BG	Bulgaria	BGN (Bulgarian lev)
CZ	Czech Republic	CZK (Czech koruna)
DK	Denmark	DKK (Danish krone)
DE	Germany	EUR (euro)
EE	Estonia	EEK (Estonia kroon)
IE	Ireland	EUR (euro)
GR	Greece	EUR (euro)
ES	Spain	EUR (euro)
FR	France	EUR (euro)
IT	Italy	EUR (euro)
CY	Cyprus	CYP (Cyprus pound)
LV	Latvia	LVL (Latvian lats)
LT	Lithuania	LTL (Lithuanian litas)
LU	Luxembourg	EUR (euro)
HU	Hungary	HUF (Hungarian forint)
MT	Malta	MLT (Maltese lira)
NL	Netherlands	EUR (euro)
AT	Austria	EUR (euro)
PL	Poland	PLN (Polish zloty)
PT	Portugal	EUR (euro)
RO	Romania	RON (New Romanian leu)
SI	Slovenia	EUR (euro)
SK	Slovakia	SKK (Slovakian koruna)
FI	Finland	EUR (euro)
SE	Sweden	SEK (Swedish krona)
UK	United Kingdom	GBP (Pound sterling)
JP	Japan	JPY (Japanese yen)
US	United States	USD (US dollar)

## 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.
Q1, Q4	Calendar quarters.
H1, H2	Calendar half-years.
bn	Billions (10 <sup>9</sup> ).
m	Millions.
bp	Basis points.
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.

## ANNUAL REPORT 2006

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## 1 OVERVIEW

### 1 Introduction

The year 2006 and the opening months of 2007 saw the continuation of the phase of high growth the Spanish economy has been experiencing for somewhat over a decade. This was against a considerably dynamic international background, in which the euro area also participated, following a long spell of cyclical sluggishness. GDP moved on an accelerating course throughout the year, posting an average increase of 3.9%. The figure was up on 2005 owing to the improved contribution of net external demand. Adding in 2006 to the continuing influence of the factors that have underpinned the strength of the Spanish economy during this long upturn was the favourable international economic situation and, in particular, the take-off in activity in the euro area. Domestic expenditure began to slow mildly, except in its equipment investment component, which rose substantially. This meant that a scenario of more balanced growth than in recent years began to be discernible in 2006.

Prominent among the determinants of the economy's buoyancy was the financial impulse stemming from integration into the euro, which has continued to operate despite the relative tightening of monetary conditions. A further factor was the demographic expansion, which has once again exceeded all forecasts. This first chapter of the Annual Report reviews the essential features of the Spanish economy's trajectory in 2006, paying particular attention to its external environment. It further outlines the short-term prospects, along with the economic policy challenges and requirements that have to be addressed in order to take the headway made by the Spanish economy in recent decades forward into the medium and long term. The conjunctural overview this chapter offers is complemented by the specific subject-matter of chapter 2, which analyses in depth and over a greater time span the role played by financial conditions and demographic developments in the Spanish economy's dynamism. It also broaches the scope of the potential risks of imbalances accompanying such a long phase of forceful residential expenditure and the potential means of adjustment in the face of such risks.

### 2 The international setting and the euro area

Another boom year for the global economy ...

In 2006 the world economy posted a growth rate of around 5% for the third year running. That gave rise to the biggest three-year expansion in global activity since the 70s, this moreover in a low-inflation setting. Last year was also marked by the more balanced dynamism of the main developed areas; the US growth rate held at slightly over 3%, and the less dynamic areas, such as the United Kingdom, the euro area and Japan, saw their economic activity accelerate, very sharply so in the first two instances. In turn, the contribution of certain emerging market economies to this economic boom remained notable, to the extent that China and India accounted in combination for around 40% of world growth in 2006.

assisted by favourable financial conditions...

The global economic expansion was assisted by continuing favourable financial conditions, despite the tightening of monetary policies, which reacted in step with the increase in inflationary risks and the maturation of business cycles. Excepting the bout of turbulence on the stock markets between May and June, global financial markets remained calm against a backdrop of scant volatility and small risk premia. Real interest rates held relatively low, stock markets posted notable gains and credit, corporate and sovereign spreads remained at historically low levels. Such was the climate until March 2007, when there was an episode of instability on the financial markets which revealed greater uncertainty over the valuation of risks.

The buoyancy of global economic conditions throughout last year further entailed an increase in trade, which grew at a slightly higher rate than 9%, 2 pp up on the previous year. Nonethe-

less, the future outlook for world trade worsened mid-year, following the suspension of the Doha Round multilateral negotiations.

and compatible with moderate inflationary pressures.

The average increase in oil and commodity prices during the year and the marked rise in global economic activity did not, however, translate into significant underlying inflationary pressures. Indeed, in the industrialised economies, average inflation rates last year were similar to those in 2005, and there was scarcely any pass-through of dearer energy to other components of the consumer price basket, as reflected by the contained behaviour of core inflation. Oil prices reached an all-time high in August 2006, declining notably thereafter as a result of the increase in crude oil stocks and the mild winter in the northern hemisphere. In the opening months of 2007, however, oil prices rose once again.

Wage moderation in the main countries, despite the expansion in employment and lower unemployment rates, and the stability of goods import prices, against the background of heightened global competition, largely contributed to this performance.

However, macro-financial imbalances persist...

Despite the regional restructuring of world trade and the depreciation of the dollar, there was no easing off of the prevailing imbalances, in place principally as a result of the saving-investment gaps in the main countries. The depreciation of the dollar amounted to almost 5% in nominal effective terms during 2006, responding largely to the prospect of diminished economic strength in the United States and to the narrowing of dollar interest rate spreads against currencies such as the euro and sterling. In fact, the persistence of these macro-financial imbalances and uncertainty as to how they may be absorbed remains a factor of vulnerability for the continuing high rate of expansion of world output in 2007, as anticipated by most international agencies. One significant risk lies in the possibility that there may be a sharper-than-expected slowdown in the United States (if the real estate market adjustment becomes acute or if it feeds through to other spending components via the wealth effect) and that its consequences for other areas are greater than currently envisaged.

and inflationary risks have become more relevant.

Tighter monetary conditions, global competition and the potential reduction in energy prices may contribute to keeping inflation rates contained. But there are risks that the upward pressures on prices resulting from the absorption of labour and goods market slack will ultimately materialise, especially if they feed through to agents' inflation expectations.

The euro area economy is finally gathering steam...

Spurred by the favourable international setting, the pick-up in activity in the euro area initiated in mid-2005 finally took root in 2006, leaving a long phase of diminished dynamism behind. The recovery, underpinned by the strength of internal demand and exports, was stronger than anticipated. That prompted a gradual upward revision of the forecasts by international agencies for last year. For the year on average the increase in GDP was 2.8%, and it was over 3% in Q4, a rate not seen since 2000. Despite this high growth, the output gap that had progressively opened up during the recent phase of cyclical sluggishness has not yet closed.

driven by the external setting, expansionary financial conditions, despite interest rate rises, and the favourable employment response.

Among the factors conducive to the initial impulse to activity (arising from greater foreign demand) being channelled towards domestic expenditure, mention should be made of the persistence of generous liquidity conditions, despite the rise in interest rates, the soundness of companies' financial position and higher corporate earnings. All these factors boosted investment, in a setting in which capacity utilisation posted the highest levels for the last five years. The favourable response of employment, the growth rate of which rose to a rate not seen since the beginning of the decade, suggests that

labour market reforms and wage moderation are bearing fruit. The subsequent improvement in labour income, which translates virtually in its entirety into consumer spending, and the gradual restoration of consumer expectations contributed to boosting household spending.

The indicators for the first half of 2007 support the favourable outlook for the euro area.

Admittedly, certain exceptional factors also came into play in the economic recovery, such as the bringing forward of expenditure to the closing months of 2006 ahead of announced tax rises, and the favourable weather. But the balanced contribution of the final demand components to the increase in output and the across-the-board improvement in economic activity in the euro area countries suggest the expansion has a more permanent basis compared with other recent improvements that proved to be transitory. Among the euro area countries, the economic recovery has been most notable in Germany, a fact perhaps reflecting the jettisoning of the structural burden weighing on the country since reunification. The economic indicators in the early months of 2007 corroborate the diagnosis of a sustained recovery. Consequently, the most likely scenario for the coming quarters is one of a rising output path, in line with growth potential, although the aforementioned macro-financial external risks persist in the medium term.

Despite the absence of underlying inflationary pressures, the upside risks to prices prompted an adjustment in monetary conditions.

The recent behaviour of inflation in the euro area was due to the performance of the most volatile components and, in particular, to oil prices. This took the rate to close to 2.5% during the first eight months of 2006, with the end-year rate standing below 2%. However, no significant effects of a pass-through of dearer energy to other consumer prices were perceived, as shown by the fact that core inflation held around 1.6%, and nor was the pattern of wage restraint affected. In any event, upside risks to price stability emerged as the economic recovery took hold and as the feed-through of dearer energy to the different stages of the productive process became more likely. And this, combined with emerging wage pressures, necessitated the adjustment of the expansionary monetary conditions that had remained in place during the prolonged phase of weak economic growth. The ECB governing Council thus raised its key interest rate on six occasions between December 2005 and December 2006, and again in March 2007, taking it to the current level of 3.75%. That said, interest rates in the euro area, in both real and nominal terms, held at relatively low levels at all times, meaning that monetary conditions continued to be propitious for the prolongation of the economic upturn.

The course of market interest rates indicates that the monetary policy decisions adopted by the ECB during this expansionary phase have been duly discounted. Further, although inflation was above 2% for most of the year, the monetary authority's credibility could be seen in the indicators of medium-term inflation expectations, which remained anchored at levels consistent with the price stability objective.

The cyclical improvement has helped shore up the fiscal position, but more decisive progress is needed to reduce the structural deficit...

In the fiscal policy realm, budget balances improved in 2006. This was a partly unexpected result, even after taking into account the fact that the recovery was sharper than had been expected a year earlier, since the revenues on certain taxes grew, on the information available, more robustly than could be explained by the trend of the related bases. The general government deficit for the area fell last year by 0.9 pp to 1.6%, indicating an improvement in both the cyclical and structural components. However, it should be recalled that the procedures habitually used to obtain this breakdown tend to overestimate the fiscal correction effort made in economic upturns. Accordingly, the national authorities would be mistaken to believe that restructuring public finances has become a less pressing task. On the contrary, it is during this upswing that the correction of budgetary imbalances should be stepped up, moving resolutely towards attaining structural balances close to equilibrium, in line with the content of the

		2001	2002	2003	2004	2005	2006
GDP PER CAPITA AND EMPLOYED AS PROPORTION OF TOTAL POPULATION	GDP per capita at current prices (in EU-25 PPPs) (b)	93.2	95.2	96.7	96.6	97.9	97.5
	GDP per capita at current prices (in euro area PPPs) (b) (c)	85.9	88.4	90.2	90.8	92.4	92.4
	Employed as proportion of total population (d)	60.7	61.2	62.1	63.1	64.6	66.0
DEMAND AND OUTPUT. VOLUME INDICES (e)	Private consumption	3.4	2.8	2.8	4.2	4.2	3.7
	Government consumption	3.9	4.5	4.8	6.3	4.8	4.4
	Gross capital formation	4.4	3.4	5.3	5.1	6.9	6.5
	<i>Fixed capital in equipment</i>	-0.3	-2.9	4.1	4.4	9.0	9.7
	<i>Fixed capital in construction</i>	7.6	6.3	6.2	5.5	6.0	5.9
	Exports of goods and services	4.2	2.0	3.7	4.1	1.5	6.2
	Imports of goods and services	4.5	3.7	6.2	9.6	7.0	8.4
	Gross domestic product	3.6	2.7	3.0	3.2	3.5	3.9
EMPLOYMENT, WAGES, COST AND PRICES (e)	Total employment	3.2	2.3	2.4	2.6	3.1	3.1
	Unemployment rate	10.6	11.5	11.5	11.0	9.2	8.5
	Compensation per employee	3.6	3.3	3.6	3.1	2.6	3.4
	Unit labour costs	3.2	2.9	3.0	2.5	2.2	2.7
	GDP deflator	4.2	4.3	4.1	4.0	4.1	3.8
	Consumer price index (12 month % change)	2.7	4.0	2.6	3.2	3.7	2.7
	Consumer price index (annual average)	3.6	3.5	3.0	3.0	3.4	3.5
	Consumer price differential with the euro area (HICP) (f)	1.0	1.3	1.0	0.9	1.2	1.4
SAVING, INVESTMENT AND FINANCIAL BALANCE (g)	Resident sectors: saving (h)	22.9	24.0	24.5	23.5	23.0	22.8
	<i>General government</i> (h)	2.9	3.3	3.5	3.2	4.7	5.7
	Resident sectors: investment	26.4	26.7	27.4	28.3	29.5	30.6
	<i>General government</i>	3.4	3.6	3.5	3.4	3.6	3.9
	Resident sector: domestic net lending (+) or net borrowing (-)	-3.5	-2.7	-2.9	-4.8	-6.5	-7.8
	<i>General government</i>	-0.5	-0.3	0.0	-0.2	1.1	1.8
	General government gross debt	55.5	52.5	48.7	46.2	43.2	39.8
MONETARY AND FINANCIAL INDICATORS (i)	ECB main refinancing rate	4.3	3.2	2.3	2.0	2.0	2.8
	Ten-year government bond yield	5.1	5.0	4.1	4.1	3.4	3.8
	Synthetic bank lending rate	5.8	4.9	4.4	4.0	3.8	4.6
	Madrid Stock Exchange General Index (DEC 1985 = 100)	853.4	723.6	706.4	863.3	1,066.1	1,344.0
	Dollar/euro exchange rate	0.90	0.94	1.13	1.24	1.24	1.26
	Nominal effective exchange rate vis-à-vis developed countries (j)	96.57	97.29	100.03	100.71	100.83	101.13
	Real effective exchange rate vis-à-vis developed countries (k)	98.21	99.77	103.95	106.48	107.73	109.72
	Real effective exchange rate vis-à-vis the euro area (k)	101.96	102.35	103.43	105.02	106.22	108.17
	Cash and cash equivalents	6.8	10.5	12.0	11.3	14.8	11.5
	Liquid assets (l)	9.5	8.7	8.8	6.4	11.9	8.6
	Households: total financing	12.7	16.3	19.1	20.2	20.9	19.3
	Non-financial corporations: total financing	17.4	12.4	13.5	13.2	21.1	28.2

SOURCES: INE, Intervención General del Estado, AMECO and Banco de España.

a. The National Accounts data are calculated on the basis of base year 2000.

b. EU=100 and euro area = 100.

c. Not including Slovenia.

d. AMECO database of the European Commission.

e. Rates of change, except for unemployment rate, which is expressed in levels.

f. Until December 2001, the differential is calculated using the series published at that date.

g. Levels as percentages of GDP.

h. Includes net capital transfers received.

i. Annual average levels for the General Stock Exchange Index, interest rates and exchange rates and rates of change for financial assets and liabilities.

j. 1999 H1 = 100.

k. 1999 H1 = 100. Measured with unit labour costs.

l. Includes cash and cash equivalents, other bank liabilities and money-market funds.

preventive part of the Stability and Growth Pact, once reformed. Achieving this goal is essential for widening the scope available to maintain budgetary stability in less favourable times and to meet the future challenges raised by population ageing, as well as to provide for the proper working of the automatic stabilisers.

and to improve growth potential.

But the national authorities should also make a bolder effort to eliminate the structural obstacles holding back growth potential. The attainment of high economic growth rates in the face of the pressure exerted by US technological and productive leadership and the growing competition from the emerging countries require far-reaching changes in how the area's economies work. The disappointing results in the euro area in terms of economic expansion in the past decade are largely attributable to the scant dynamism of labour productivity. And this, in turn, is due to a series of factors, including the relatively modest pace of innovation (and its diffusion to the rest of the economy), shortcomings in investment in human capital and the still-excessive regulation of product markets, especially in services. Indeed, the move towards lessening the regulation of these markets in recent years may have contributed to the recently detected incipient progress in trend productivity. Regarding the labour market, although there has been an improvement in the use of this factor, there is still much scope for combating underlying rigidities, as reflected in the still-high unemployment rate and the low employment rates for certain groups such as women, youths and the elderly.

### **3 The Spanish economy**

Activity in the Spanish economy quickened, extending the long expansionary phase.

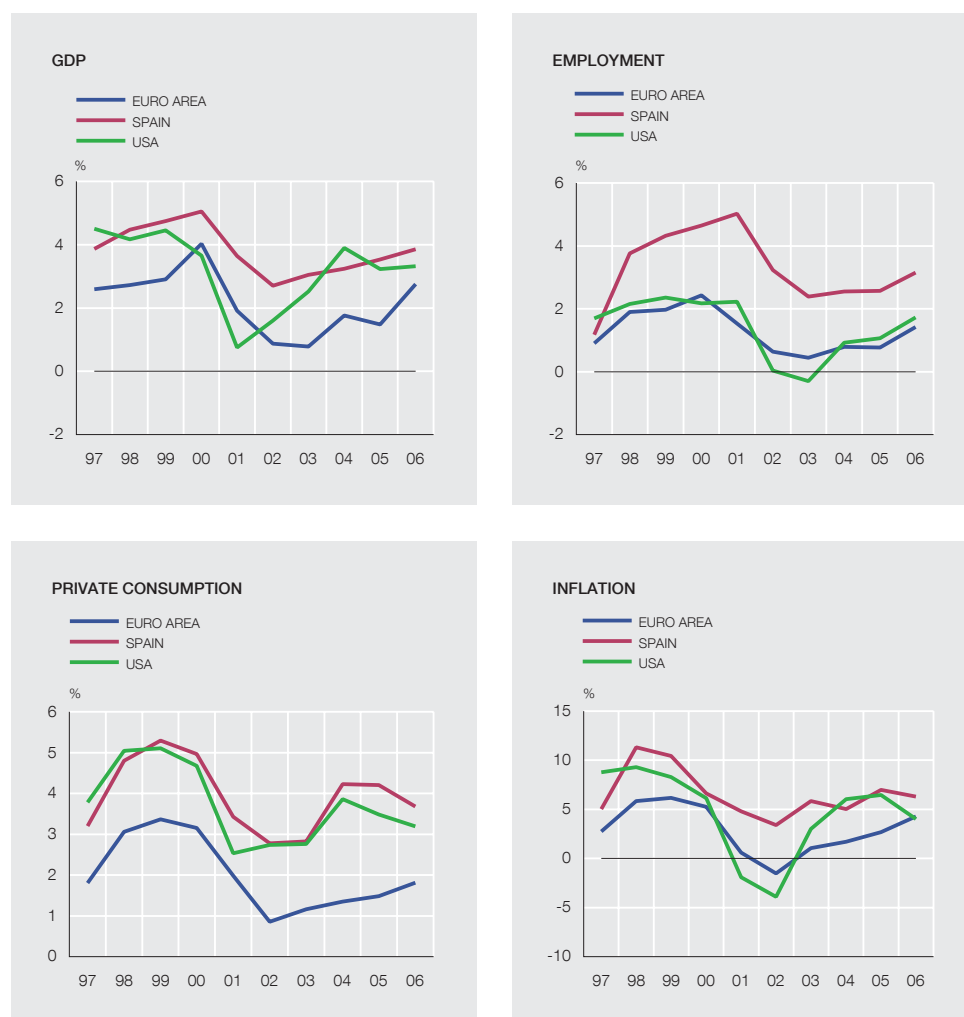
Activity quickened in the Spanish economy in 2006, extending the expansion witnessed, with mild oscillations, since the mid-90s (see Chart 1.1). As a result, GDP growth rose to 3.9% in 2006 from 3.5% the previous year, while there was some re-balancing of the relative contributions of domestic expenditure and net external demand to the increase in GDP, following three years of progressive divergence between both demand components. Domestic demand slowed moderately in 2006, posting a rate of 4.6% for the year on average, but the contribution of net external demand to GDP growth improved to a greater extent, narrowing from -1.7 pp to -1 pp.

The rise is underpinned by the permanence of the expansionary factors present in this cyclical phase ...

In 2006 the strength of economic activity was supported, as in previous years, by several factors: the favourable monetary and financial conditions, despite the relative tightening of monetary policy during the year; the continuing rise in real and financial asset values; and the buoyancy of the labour market, underpinned by surging migratory flows and the rise in female participation. The backdrop to this was the fairly moderate effect, as in most developed economies, of dearer oil and the pursuit of economic policies geared to macroeconomic stability.

and by a more buoyant external environment, boosted by the take-off in activity in the euro area.

Adding to all these expansionary factors was the effect of the favourable international situation and, in particular, the recovery in the euro area. The improvement in net external demand was due to the pick-up in exports of both goods and services in a setting in which imports continued to show considerable momentum. Real goods exports, with growth of 5.6% for the year on average, resumed a rate similar to that in the early years of this decade, after having stagnated markedly in 2005. They were driven by the notable rise in world trade, the take-off in economic activity in the euro area and the buoyancy of the emerging markets. The expansionary effect on exports of the pick-up in markets should have exceeded the potential countervailing effect of the deterioration in the price competitiveness indices, which continued in 2006, albeit at a slacker pace than in previous years. Also, last year, there was an easing in some of the factors that had checked exports in 2005, such as the notable impact then exerted by the strong penetration by China and other emerging countries on Community markets.



Goods exports picked up across the board...

The increase in goods exports in 2006 was relatively generalised and extensive to all geographical areas, albeit with differing intensity. It also affected a good number of products, with varying technological characteristics. As to services exports, tourism increased in real terms at a rate of 1.7%, slightly down on the previous period. This performance is in line with the increase in the number of tourists globally, although tourism receipts continued to feel the effects of the likewise widespread changes in the habits of tourists, who are making more trips but for shorter periods and spending less in real terms. However, in the opening months of 2007, tourism receipts have been somewhat more expansionary.

while imports were once again very strong ...

As mentioned, imports in real terms were once again very strong in 2006, posting average growth of 8.4%, up on the previous year. The thrust of final demand and the favourable trend of prices in euro of non-energy imports, which remained virtually unchanged over the year on average, account for this high dynamism. In terms of products, there was a sharp increase in purchases of non-energy intermediate goods, which were necessary for the industrial expansion recorded in 2006, as discussed elsewhere in this report. And by country of origin, purchases in non-Community countries grew sharply too. The performance of services imports was also very expansionary, owing to the momentum of non-tourist services, most particularly passenger and freight transport services, and business services.



and the net borrowing of the nation increased once more.

Despite the improved contribution of net external demand to GDP growth, the net borrowing of the nation increased once more in 2006 to 7.8% of GDP, 1.3 pp up on 2005. Behind this widening of the external deficit is an increase in the trade deficit, which rose to 8.1% of GDP, and a deterioration of a lesser proportion in the other sub-balances of the current account: that of services, whose surplus declined by 0.1 pp, and that of income and current transfers, whose respective deficits rose by 0.1 pp.

Household spending remained considerably dynamic, although it turned slightly downwards...

Household spending on both consumption and residential investment remained considerably dynamic in 2006, albeit with somewhat lower growth rates than in the past two years. Consumption rose at a rate of 3.7% in 2006, underpinned by the increase in disposable income and in wealth which, however, slowed in relation to the previous year. Also acting in favour of household spending was households' bright outlook concerning their permanent income, against a background of strong employment generation. Indeed, disposable income was highly influenced by the buoyancy of employment and compensation per employee, offsetting the subtraction of income prompted by the increase in tax revenue, while the impact of interest rates was virtually zero. Household wealth was sustained by the rise in the value of financial and real estate assets, although in the case of the latter the increase was on a lesser scale than the previous year. This was because of the continuation of the slowing profile of house prices, which grew by 9.1% in year-on-year terms in 2006 Q4, almost 4 pp down on the close of the previous year. The orderly normalisation of this market continued in the opening months of 2007, since the growth of this variable dipped by almost 2 pp.

and the household saving ratio declined, also raising their net borrowing.

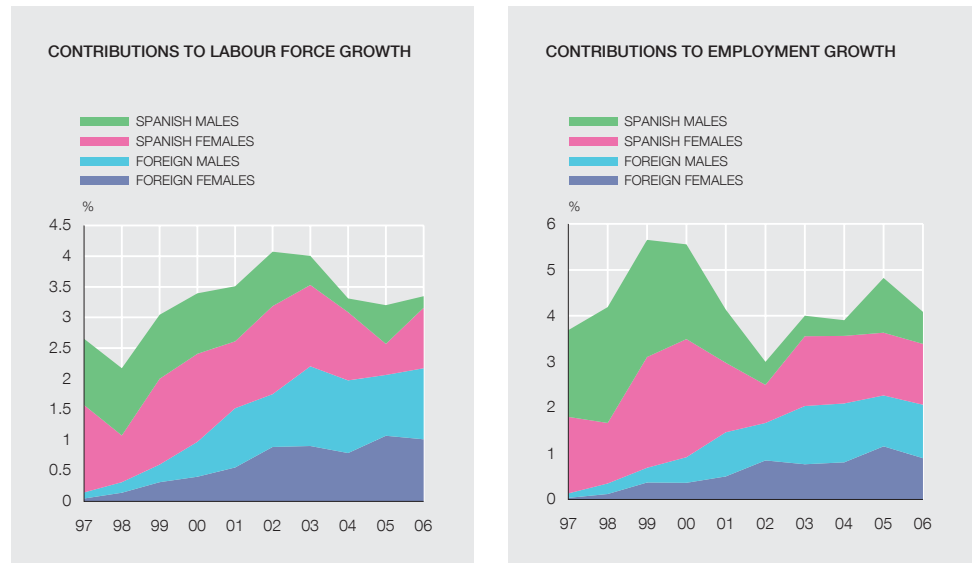
As a result of these expansionary forces, household consumption outgrew disposable income in 2006, prompting a fresh decline in the household saving ratio to 9.8%. There were sustained increases in investment in housing, similar to those of the previous year, in response to a population that continued to increase robustly and to sustained increases in wealth. The decline in the saving ratio, together with the strength of residential investment, translated into a deterioration in household net borrowing of almost 1 pp to 2.6% of GDP, and into a fresh increase in the resort to bank credit, albeit with a moderately slowing profile in the second half of the year, possibly in response to the tightening of financing conditions.

Firms pursued major equipment investment plans...

Corporate investment was also markedly dynamic in 2006. This took the form of substantial equipment investment plans, against the background of the recovery in final demand, a sound financial position and favourable earnings expectations which, in fact, were confirmed as the year unfolded. All these factors offset the tightening of financial conditions that companies had to face when taking their hiring and investment decisions. In addition, there were significant corporate acquisition operations in 2006, following a strategy of diversification and internationalisation. These were mainly led by real estate companies, which increased the sector's net borrowing and the demand for external financing.

which coincided with an increase in general government investment activity.

The general government sector contributed last year to the expansion in expenditure, mainly through the gross capital formation component and, in particular, through civil engineering construction works (driven by the forceful investment activity of the regional governments), which exceeded the already high rate of increase in 2005. Government consumption remained more stable. However, the buoyancy of economic activity was manifest in the momentum of tax revenue takings, being reflected in turn in the general government account, which posted a surplus of 1.8% of GDP in 2006, far above the target of 0.2% programmed in the budget for that year. The public debt ratio fell to 39.8% of GDP, from 43.2% of GDP the previous year. Overall, the fiscal policy stance in 2006, having regard to the primary structural balance, was moderately contractionary for the sixth year running.



SOURCES: INE and Banco de España.

The momentum of activity spread to all the productive branches...

On the supply side, the momentum spread to all the productive branches, with the exception of agriculture and fisheries which, nonetheless, showed a significant recovery during the year. The construction sector was notably resilient, retaining in 2006 the momentum of previous years, in both its residential construction and civil engineering components. And the industrial sector expanded strongly, following four years of marked slackness. The increase in activity, which was initially centred on the production of goods for domestic consumption and on intermediate products linked to the construction sector, gradually spread to other products, especially goods for export and capital goods. Overall, the industrial recovery is proving very broad-based, after a long period of adjustment; it is hinging, however, on the expansion of the sector in the euro area.

and the process of employment generation was once again very intense.

Given the resilience of activity, the process of employment generation was once again very intense; it was, however, some way off the profile followed by that of value added, with a rise in productivity of up to 0.8% for the year on average taking place at the aggregate level. Employment economy-wide grew at the same rate as the previous year, namely 3.1%, with a mildly slowing profile during the year and a composition by productive branch similar to that of previous years. As a result, the biggest number of jobs was generated in the construction and market services sectors. In industry, in contrast, and despite the strong recovery in activity, the momentum of employment was weaker, prompting a notable increase in productivity, with positive growth only in Q4, while significant job destruction was recorded in agriculture.

The increase in female participation and immigrant flows continue to boost labour supply...

The expansion of the labour supply was also on a notable scale in 2006, outpacing that of the previous year. As will later be analysed, that prevented the emergence of significant pressures in the labour market. The growth of the labour supply was mainly boosted by the increase in female participation, with the related participation rate rising to 48%, 1.5 pp up on the previous year. Also influential was the contribution of the foreign labour force, which increased at a rate of 19.4% and accounts now for 13% of total manpower (see Chart 1.2).

and the buoyancy of employment led to a fresh decline in the unemployment rate.

Overall, the economy's employment-generating capacity allowed the fresh increases in labour supply to be absorbed and the unemployment rate to be reduced to 8.5% for the year on average, and at the same time there was a very marked decline in long-term unemployment.

On the latest available estimates, both the increase in the labour force and the fall in unemployment lie behind the expansion in the Spanish economy's growth potential and, foreseeably, they will continue to do so in the future, albeit with a diminishing contribution.

Favourable supply-side responsiveness did not sufficiently offset expenditure pressure...

Favourable supply-side responsiveness in the course of 2006 did not suffice to counter expenditure pressure on costs and prices. Changes in labour costs prompted a rise in compensation per employee, the annual increase in which stood at 3.4% for the whole economy and at 2.8% for the market economy, moving in both cases on a markedly accelerating profile throughout the year. However, this increase was lower than that recorded by wage settlements under collective bargaining agreements, which rose at a rate of 4.1% once account is taken of the effect of the indexation clauses owing to the deviation by the previous year's inflation, estimated at almost 1 pp in 2006. The gap between wage settlements and compensation per employee may be reflecting the presence of factors that add to labour market flexibility, factors induced by the changes in the composition of labour supply. In a setting in which productivity gains in the market economy were low, the rise in compensation passed through to unit labour costs, which rose by 2.7%, outgrowing the rate in the euro area countries. A notable exception to this behaviour is industry, the branch most exposed to foreign competition. Here, unit labour costs fell by 0.3%.

and there was a rise in labour costs and inflation.

The rise in labour costs, the hike in oil prices in the first half of the year and the ongoing process of widening margins, albeit at a lesser pace than in previous years, saw the following results for 2006 as a whole: consumer prices edged up to an average rate for the year of 3.5%, and the inflation differential with the euro area widened once more to 1.4 pp (see Chart 1.3). The inflation profile during the year was highly influenced by oil prices, which surged until the summer and slowed markedly thereafter. But the persistence of services inflation – where prices sustained average growth of 3.9% – should also be underscored, as should the slight rise in the prices of non-energy industrial goods, which made for a small increase in underlying inflation. In the opening months of 2007 inflation has continued slowing, driven by the decline in energy prices on a year earlier, and posted a 12-month growth rate of 2.5% in March, taking the prices differential to 0.6 pp. Nonetheless, core inflation held stable at a similar level (2.5%) to that recorded at end-2006.

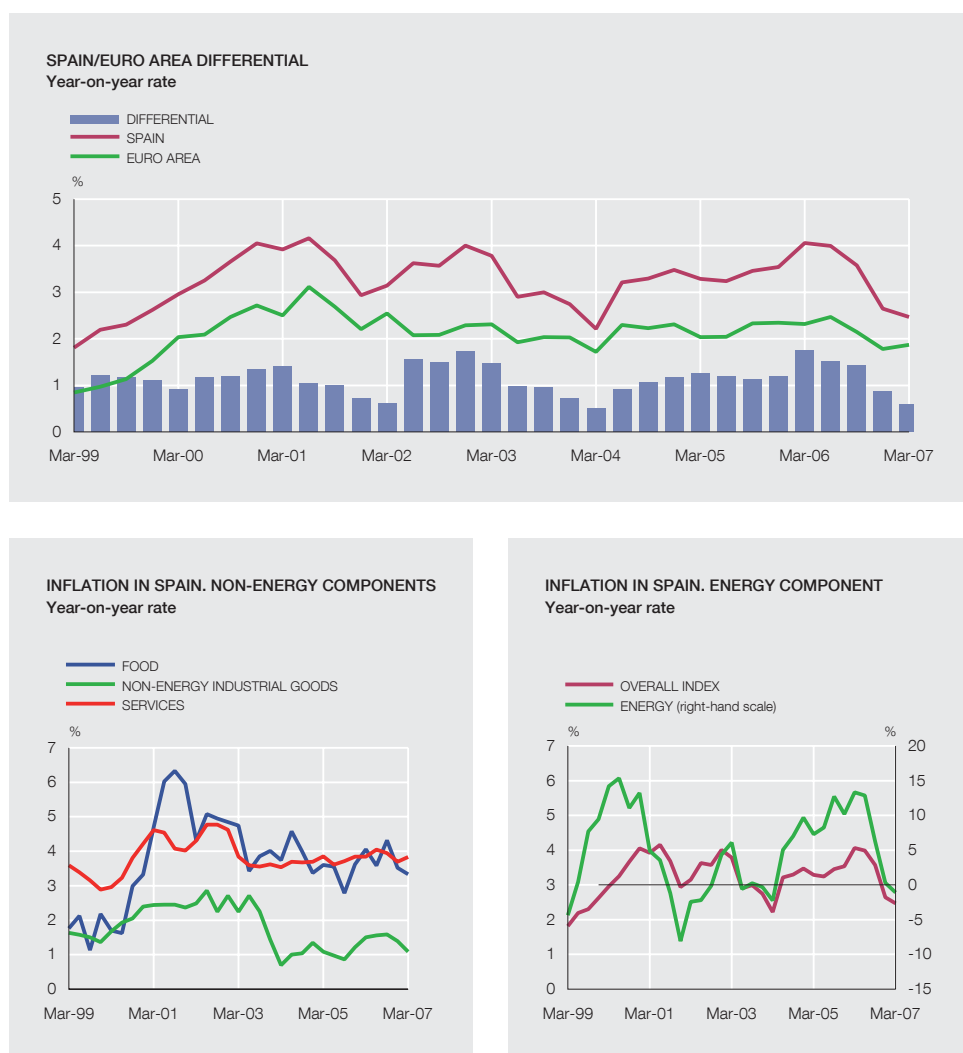
#### **4 Assessment, outlook and challenges**

The resilience of the Spanish economy has been greater than was foreseeable at the start of the year...

The more expansionary nature of some of the factors behind the long growth phase of the Spanish economy in the current cycle and, particularly in 2006, the improvement in net external demand, both underpinned the resilience of the Spanish economy last year, which was greater than was foreseeable at the start of the year. Among the expansionary factors at play in the current situation, mention should be made of the extensive influence of the financial impulse stemming from euro area membership. This continues to provide for generous monetary and financial conditions domestically (see Box 1.1), despite the rise in interest rates in 2006. The powerful demand stimuli have continued to enjoy favourable conditions on the supply side, as a result of the population expansion, the rise in labour supply and a setting conducive to employment generation.

and the process of real convergence has continued.

The strength and duration of these expansionary impulses, together with the development of certain factors providing for resilience in the face of imbalances and for flexibility in adaptability, as a result of growing external openness, demographic dynamism and increased market liberalisation and integration (see Box 1.2), have allowed the Spanish economy to experience significant improvements in real convergence. Spain's GDP has risen over the past eight years by 6 pp relative to the average for the countries making up the euro area, standing at a relative level of 92.4% in 2006. In terms of the EU 25, the rise in GDP per capita has been higher, standing at 97.5% in 2006.



SOURCE: Eurostat.

The outlook for the continuity of the expansion is favourable...

The Spanish economy ended the year posting very sound growth, which has continued into the opening months of 2007. It is estimated real GDP growth has slightly exceeded its end-2006 figure of 4%, while employment has continued to show signs of robustness, running at a similar rate to that in late 2006. Under national demand, household consumption has remained strong and investment in equipment dynamic, while investment in construction has continued on the mildly slowing path initiated in the closing months of 2006. The ongoing improvement in the contribution of the external sector to GDP growth is estimated to have continued, in a setting in which the slowdown in imports was more marked than the deceleration in exports. In sum, the expansionary phase of the Spanish economy has held firm in the early months of 2007 and the outlook for the more immediate horizon is that this will continue.

but there are risks arising from the growing pressure of expenditure and from the losses in competitiveness generated thereby...

Some uncertainties remain, however, about the continuity of growth in the economy over the more distant horizon. These relate to the scope of the imbalances that have been building up in this long expansionary phase and to the pace at which they may be reabsorbed. Following the boom climate generated by the ongoing expansion, there are, along with the factors underpinning the upturn, a series of latent medium-term risks which must be taken into account in agents' strategic decisions and, above all, in the design of economic policies.

There are various indicators for assessing the degree of pressure or stimulus exerted by the monetary conditions in an economic area. A short-term real interest rate is the measure most commonly used. Since a central bank intervenes directly in the money markets, this measure is linked to the behaviour of official interest rates and is closely related, through the term structure of interest rates, to the rates that determine agents' spending and investment decisions. However, it does not take into account other factors that contribute to determining the monetary policy stance. It is thus customary to combine the movements in the real interest rate with the changes in the local currency's exchange rate. This is done by constructing so-called monetary conditions indices (MCIs), in which the weight assigned to each of the two variables depends on how strongly they influence economic activity.<sup>1</sup> Moreover, the impact of monetary policy is not independent of the economy's stage in the cycle, since a given real interest rate level can be contractionary in sluggish growth conditions and expansionary in a robust setting. To capture this effect, the indicators normally used are based on the Taylor rule. Finally, monetary and financial conditions are often analysed by looking at the behaviour of the main monetary and credit aggregates.

1. For further details of this indicator, see the article "Un índice de condiciones monetarias y presupuestarias", in the *Boletín Económico*, Banco de España, July-August 2006.

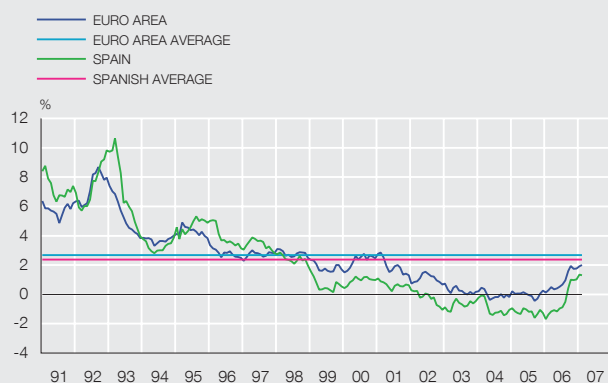
As can be seen in the top left-hand panel of the accompanying chart, the Spanish economy has, since it joined the euro area, had historically low short-term real interest rates, which have even been negative for much of the period under consideration. Also, the official interest rate has been lower than that estimated using a standard monetary policy rule of the type proposed by Taylor.<sup>2</sup> Since the late 1990s the MCIs have mainly been below their historical average, while at the same time the money supply (M3) and the volume of credit extended to the private sector have increased as a percentage of GDP in the overall period elapsed since the start of Stage Three of EMU. That is to say, all the indicators analysed point to the expansionary nature of the monetary conditions in Spain in this period. These indicators also show that the monetary conditions in the euro area are generous, although less so than in Spain.

2. The so-called "Taylor rule" establishes a relationship between official interest rates and an equilibrium real interest rate ( $r^*$ ), a target inflation rate ( $\pi^*$ ), the deviation between actual and target inflation ( $\pi - \pi^*$ ) and a measure of demand pressure ( $y - y^*$ ):

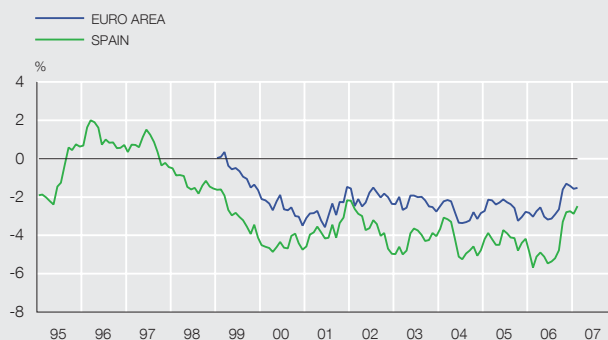
$$i_t = r^* + \pi^* + a_1(y - y^*)_{t-1} + a_2(\pi - \pi^*)_{t-1}$$

The values used for ( $a_1$ ) and ( $a_2$ ) are 0.5 and 1.5, respectively, that for ( $r^*$ ) is 2% and that for ( $\pi^*$ ) is 2%. Owing to the lack of consensus on the equilibrium interest rate, this indicator is usually calculated for the interest range (1%-3%) whose mid-point is 2%. The conclusions reached are similar regardless of which real interest rate is chosen in this interval.

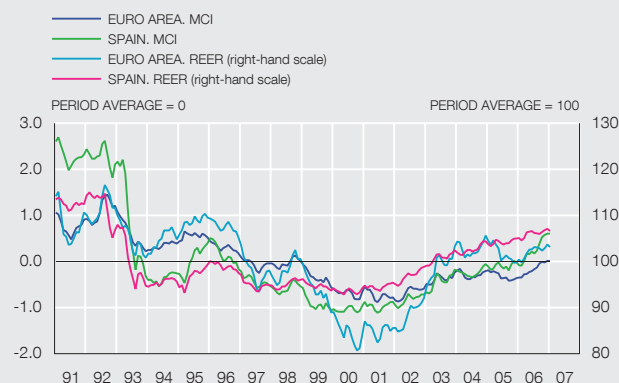
### 1 INTERBANK MARKET, 3-MONTH REAL INTEREST RATES



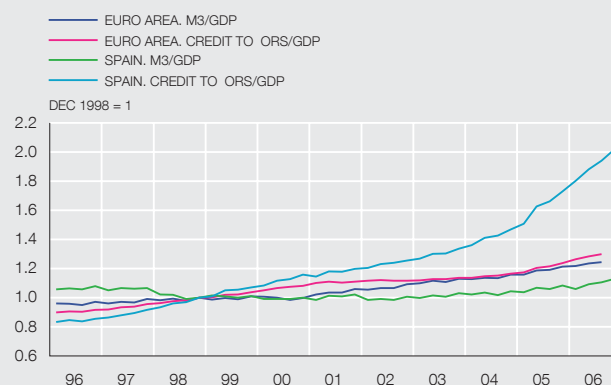
### 3 DIFFERENCES BETWEEN THE OFFICIAL INTEREST RATE AND THE TAYLOR RULE



### 2 MONETARY CONDITIONS INDEX AND REAL EFFECTIVE EXCHANGE RATE



### 4 RATIOS OF M3 AND OF CREDIT TO THE PRIVATE SECTOR TO GDP



SOURCES: ECB and Banco de España

Since late 2005, the emergence of upside risks to price stability in the euro area as the economic recovery gained strength has led the ECB to gradually eliminate some of that expansionary monetary stimulus. However, the indicators presented here show that, from a long-term historical perspective, the monetary conditions in early 2007 can still be classed as relatively generous, particularly in the case of Spain.

Short-term real interest rates in Spain stand at a low level (below 2%), which in the current cyclical setting of the Spanish economy represents a significant expansionary stimulus, as shown in the bottom left-hand panel of the accompanying chart.<sup>3</sup> In terms of the MCI, the cumulative loss of competitiveness since 1999 and the estimated

significant impact of exchange rate movements on the Spanish economy (three times greater than the related effect on the euro area) give rise to a sharper decrease in the monetary stimulus in Spain, which, according to this indicator, is lower than that for the euro area as a whole. The easiness of the current monetary conditions is reflected also in the high growth that private sector credit and money supply, as proportions of GDP, continue to post. Thus, although the former started to show signs of slowing in the second half of 2006, its rate of change in Spain is still very high and above that in the euro area (16.7% and 6.7%, respectively, at end-2006). Also, the relative volume of liquid assets held by the public showed rates above 4% in both areas.

Overall, although there was a significant normalisation of monetary conditions in the euro area in 2006, by historical standards they remain supportive of agents' spending decisions, particularly in the case of the Spanish economy.

3. Note also that, as a result of the changes in the macroeconomic setting and in the financial markets, the current cost of bank financing and of that raised on the medium- and long-term debt markets stands at historically low levels.

During the lengthy period in which demand growth has systematically exceeded the dynamism of value added, price and cost increases have, as indicated, been outpacing those of our competitors, prompting a relatively generalised deterioration in the price competitiveness indices throughout the period of Spanish euro area membership. That said, the starting point was a favourable one, owing to the conversion rate to the euro, and the cumulative mismatch is less than that recorded in previous episodes of losses of competitiveness (see Chart 1.4). It should be borne in mind, however, that this loss of competitiveness occurred when major changes were under way in the worldwide trade structure and in the organisation of productive processes, as a result of the emergence on international markets of powerful new competitors, such as China and other Southeast Asian and Central and Eastern European emerging economies, some of which exhibit similar productive and trade specialisation patterns to those of the Spanish economy.

as shown by the decline in export shares...

Admittedly, many of the recent transformations at the international level and actually within the Spanish economy tend to blur the relationship between the price competitiveness indices and trade flows, and to hamper diagnosis of their true extent. But it remains necessary to monitor closely all factors that may be posing potential risks to the Spanish economy's competitiveness.

Thus, for the third year running, 2006 saw the continuation of the loss of Spanish export share in its export markets, albeit at an appreciably lower rate than in the two previous years. The loss was centred on the EU market, despite the pick-up in sales of Spanish products in EU countries. The share in non-Community markets remained relatively stable, following the poor results in 2005. The decline in shares is proving a relatively widespread phenomenon among the developed countries, against the background of growing globalisation described. But in Spain the scant headway made by Spanish products abroad has begun to be discernible in the years following euro area membership at the close of the last decade, stabilising at levels somewhat below those that the Spanish economy's weight in global GDP would warrant. Spanish export diversification by product and country is progressing slowly – although, as earlier indicated, the recovery in sales

Following the recession of the early 1990s, the Spanish economy has enjoyed a period of continuous economic growth which has enabled it to reduce appreciably the per capita income differential separating it from the other European economies. This progress in real convergence has been underpinned by a series of factors that have boosted supply and demand in the economy, but also by an appreciable improvement in the economy's structural functioning, which has been fundamental for accommodating the intensity and duration of this economic growth process.

Panel 1 of this Box shows that in this period the structural, or long-term, component of unemployment has decreased substantially from over 15% in the mid-1990s to somewhat below 9% in 2006, on the available estimates.<sup>1</sup> This reduction in the equilibrium unemployment rate has contributed decisively to sustained job creation by notably mitigating the inflationary pressures that could have been triggered by such a large fall in the unemployment rate.

The various labour reforms of the 1990s contributed to this improved structural behaviour of the labour market, although the additional

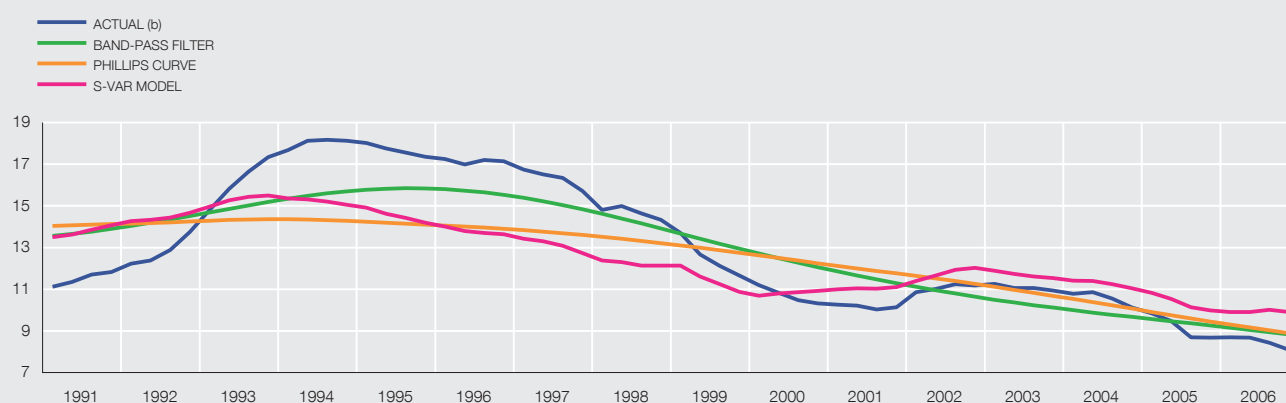
progress in the most recent period cannot be attributed solely to changes in labour market institutions. First, external factors such as the process of European integration or the heightening international competition may have played an important role. Second, the surge in the labour supply, mainly due to immigration but also to the increasing female participation rate, has in the last five years been a decisive factor in explaining the fall in the structural unemployment rate of the economy. This increase in supply has also brought a notable rise in the potential growth rate of the economy, which in the period 2001-2006 moved up to 3.5%, nearly half a percentage point above that estimated for the decade of the 1990s.

Furthermore, various estimates indicate that the Spanish economy has become more flexible in recent years, in that a greater response or ability to adjust to different economic shocks has been observed. One way of measuring the flexibility of the economy is to estimate the rigidity of real wages, a key variable in the adjustment of the economy to different shocks. This estimate can be made using a structural VAR model that relates unemployment to real wages.<sup>2</sup> In this model, real wage rigidity is estimated from the cost, in terms of unemployment, of a temporary

1. For more details, see Izquierdo, M. and A. Regil (2006) "Actualización de las estimaciones de la tasa de desempleo estructural de la economía española", *Boletín Económico*, Banco de España, September, pp. 57-62.

2. A similar estimate is made for European countries before they join a monetary union in J. Viñals and J. F. Jimeno (1996), *Monetary Union and European Unemployment*, CEPR Discussion Paper 1485.

#### 1 ACTUAL UNEMPLOYMENT RATE AND ESTIMATED NAIRU (a)



#### 2 ESTIMATED REAL WAGE RIGIDITY (c)

	Unemployment in levels	Unemployment in differences
1980-1997	5.53	1.34
1998-2005	1.43	0.58

#### 3 PRICE AND WAGE ELASTICITIES ACCORDING TO THE BANCO DE ESPAÑA QUARTERLY MACRO MODEL

	1980-1998 estimates		1986-2005 estimates	
	Short-term	Over 3 years	Short-term	Over 3 years
VALUE-ADDED DEFLATOR				
Real wage	0.43	0.73	0.23	0.78
Productivity		0.26		0.52
WAGES				
Productivity	0.47	0.88	0.45	1.02
Unemployment	-0.19	-0.39	-0.32	-0.26

SOURCES: INE and Banco de España.

a. Seasonally adjusted series.

b. Before 2005, series linked by the Banco de España's Directorate General Economics, Statistics and Research.

c. Cumulative increase in long-term unemployment after a short-term shock to real wages, estimated using the stimulus response function of the VAR model.



shock to wages that may be related to either the supply of or the demand for labour. The long-term response of unemployment to this temporary shock diminishes as the adjustment of wages in real terms becomes more flexible. This model has been estimated for two sub-periods (1980-1997 and 1998-2005). The results are presented in panel 2 of this Box. It can be seen that the measure of real wage rigidity, i.e. the estimated cost in terms of higher unemployment following the wage shock, decreases significantly in the second sub-period, indicating a considerably increased response of real wages to a shock.<sup>3</sup>

3. The model has been estimated with unemployment in levels and in differences to check the extent to which these results depend on the assumption about the seasonality of the unemployment series; but, as can also be seen in panel 2, the results are similar in both cases.

Finally, the Banco de España's quarterly model, recently re-estimated using data from 1986 to 2005, can be used to analyse the extent to which an economy functions more flexibly by examining how nominal variables such as wages or prices adjust to real shocks. The response of the new model, estimated using data up to 2005, is compared with that yielded by the previous model, based on data from 1980 to 1998. As can be seen in panel 3 of this Box, the new estimates suggest that the prices in the economy (measured through the value-added deflator of the market economy) depend most on their determinants in real terms, such as productivity or real wages. The new model also identifies a greater response of wages in nominal terms to a productivity shock and to changes in unemployment, although in the case of unemployment the greater sensitivity is only detected in the short term.

was relatively widespread in 2006 – while the presence of Spanish products in non-Community markets is meagre, with greater potential for growth, and excessively concentrated in sales related to the car industry, which is subject to an extensive restructuring process globally.

and growing import  
penetration...

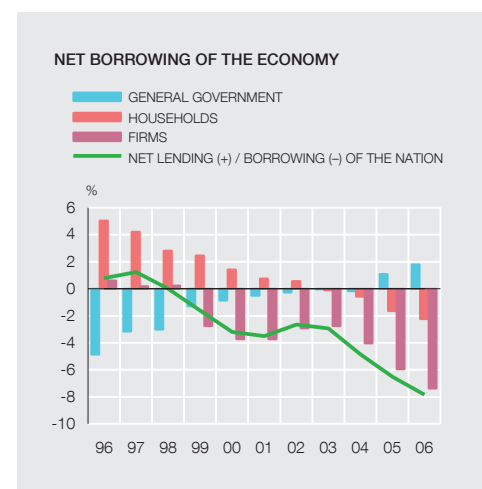
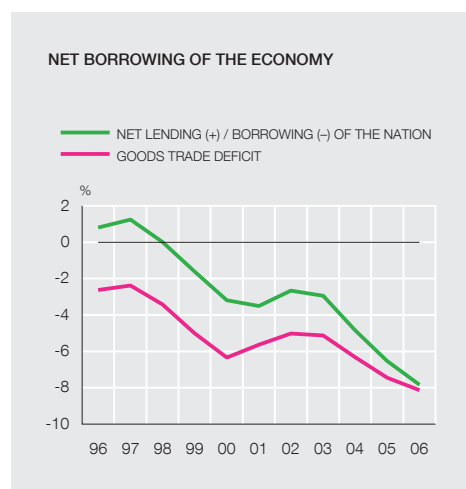
The momentum of imports also points to the presence of risks of a loss of competitiveness, in that it denotes sustained growth in import penetration in the Spanish domestic market, in particular imports from the rapidly industrialising countries. A portion of these imports is closely related to investment in equipment and to the industrial recovery under way. But this also reflects a high leakage of expenditure pressures abroad.

which is why the external deficit  
continues to rise...

The external deficit continues to rise owing to the increase in the trade deficit, but also to the deterioration in other balance of payments captions, such as the net income that has to be paid in connection with the growing build-up in external debt and current transfers abroad, due to the greater weight of migrants' remittances. Ultimately, the prolongation of a scenario of this type may adversely bear on income-generating capacity in the domestic economy and affect GDP growth. It must be borne in mind that, within a monetary union, a recovery in competitiveness can only come about through relative costs and prices; accordingly, the nature and extent of the adjustment largely depend on the degree of nominal and real flexibility that the economy shows. If there are sizeable rigidities, the adjustment will tend to come about through a slowdown in the pace of growth of output and employment, and absorbing the losses in competitiveness will be more difficult and costly.

reflecting the growth of  
household and corporate debt.

The deterioration in the external deficit reflects the persistence of an increase in residents' spending that is outpacing income. This is manifest in the growing resort by households and non-financial corporations to debt, which cannot grow indefinitely without these agents seeing their spending capacity affected. From this standpoint, the external deficit is a sign of the difficulties agents may meet in sustaining a pattern of spending that gives continuity to the domestic momentum to growth in the medium term. The following chapter delves into the nature of the risks generated by buoyant spending within the euro area and the processes of redressing the imbalances.



SOURCES: INE and Banco de España.

Household resort to credit financing continued to increase, although it turned down in the second half of the year...

In the case of households, the resort to credit financing to pursue their consumption and residential investment plans continued apace in 2006, with increases of around 20%. In the closing months of 2006 and early 2007, there was a turnaround in this rate connected, no doubt, to the increase in borrowing costs, which was more marked in credit for house purchases, given that consumer credit continued to quicken to some extent. In any event, the expansion in credit once again exceeded the increase in household income, prolonging for another year the rising profile of the debt/growth disposable income ratio, which ended the year at 125%. This, together with the rise in the cost of financing, meant that once household financial obligations had been met, their saving capacity underwent a fresh decline.

while companies' resort to financing moved on a clearly accelerating path.

The growth of business activity – which, as seen, was highly buoyant in 2006 – nevertheless required growing resort to borrowed funds, a variable which was growing at the end of the year at a rate of slightly over 28%. That prompted fresh increases in the debt/earnings ratio and, as a result of the increase in the cost of borrowing, a rise in the proportion of earnings earmarked to cover financial costs.

The tightening of monetary conditions and the slowdown in house prices are helping correct some factors of risk...

Overall, there was some headway in 2006 in correcting the risk factors relating to the household financial position. For one thing, the slowdown in house price increases – which ended the year having risen by slightly over 9%, compared with 12.8% as at end-2005 – points to a gradual normalisation of the real estate sector following the sharp boom; for another, the rais-

ing of interest rates is contributing to slackening the pace of household credit, after several years' strong expansion and rising exposure of the sector to potentially adverse developments. In contrast, in the case of corporations, indebtedness has been growing due, to some extent, to the diversification strategies pursued in the light of the maturity of specific productive activities. But such strategies are not exempt from the uncertainties surrounding the launching of new business lines or penetration in new markets.

but economic policies have to be designed to head off the potential emergence of such risks.

It is necessary, however, to continue striving to correct the factors of risk still in place, as their materialisation might eventually affect agents' decisions and, ultimately, the growth path of the economy. The economic boom years must therefore be harnessed to design economic policies (addressed later in this report) that further those implemented in recent years – for instance, in respect of budgetary consolidation – and contribute to mitigating these risks and to preventing their emergence when some of the factors that have underpinned this long expansionary phase start to peter out. The Spanish economy will then be in better condition to withstand unexpected shocks and to continue making headway in real convergence.

Monetary conditions remain loose and fiscal policy should contribute to containing expenditure pressure.

The marked accommodative stance of monetary policy in 2006 has gradually been withdrawn. But monetary conditions, which will be dictated by the need to maintain price stability in the euro area as a whole, will most likely continue to be loose in the course of 2007 as far as the requirements of the Spanish economy are concerned. Accordingly, fiscal policy should continue contributing to containing and re-balancing domestic demand. In 2006 the general government sector posted a surplus of 1.8% of GDP, furthering a strategy to restructure public finances initiated in the second half of the 90s, which positioned Spain among the group of European countries with the best fiscal results. Throughout this process, public debt has been cut to an exceptional extent, to a level of 39.8% of GDP.

The government's fiscal projections in the latest update of the Stability Programme extend the surplus on the general government account over the next three years, moving on a declining trajectory. The better starting point offered by the final balance on the general government account in 2006, which exceeded the projection in the aforementioned update by 0.5 pp, and continuing economic dynamism in the short term suggest, however, that it would be advisable to earmark surplus revenue, if any, for shoring up the fiscal position, as has, in part, been the practice in recent years.

Budgetary policy has to bear in mind that the sound fiscal results obtained in recent years also reflect a combination of exceptional factors that have contributed to increasing revenue temporarily (to some extent this is the case of the increase in revenue related to the buoyancy of the real estate market) and to reducing expenditure owing to the cumulative decline in interest charges. Accordingly, budgetary programming for the coming years should tend to avoid slippage in the level of primary spending as a proportion of GDP and focus fully on fostering efficiency gains in the management of public spending and revenue that allow leeway for promoting improvements in the quality of public finances. Here the regional governments have an essential role to play, given that they are responsible for managing major expenditure items related to public services, such as education and health, which are of paramount importance for boosting long-term growth and social well-being. The regional governments will also be predominantly responsible for managing situations of dependency.

Despite their current soundness, public finances face considerable challenges in the medium and long term as a result of the pressure that an increasingly older population will exert on public spending. That will push upwards not only spending on pensions but also that on health and care for the elderly. At the current juncture, the strategy adopted to address this issue is

based essentially on contributions to the reserve fund and on cuts to the public debt/GDP ratio. Nonetheless, these initiatives must be complemented by others that further those adopted in 2006, encouraging the participation of the elderly in the labour market and contributing to rationalising pension and insurance systems, in line with the measures being adopted in other European countries. These latter measures consist mainly of the revision of certain parameters of pay-as-you-go systems and the introduction of capitalisation arrangements at different levels.

but progress is also needed on reforms to increase the economy's adjustment capacity...

At the same time, the economy must be given new flexibility mechanisms, further capitalisation is needed, on a broad basis, and the competitive environment in which agents take their decisions must be strengthened. These advances are necessary to boost productivity growth, to promote the efficiency gains required to absorb the losses in competitiveness that have built up in recent years and to increase medium-term growth capacity.

undertaking the changes still to be made in the labour market...

The workings of the labour market have improved substantially in recent years, allowing high employment generation capacity to be reconciled with a degree of wage moderation, albeit insufficient to correct the labour costs differential with the euro area countries. This has come about, however, without substantial changes having been made to labour market institutions. Accordingly, the elements of flexibility observed during this long phase of robust job creation may have been due, above all, to the fact that the sizeable increase in labour supply was led by groups with the lowest reservation wages and offering most regional and occupational labour mobility, particularly in the case of immigrant workers.

In this respect, the two basic problems of the Spanish labour market are the problems of rigidity built into collective bargaining – which does not sufficiently tailor wage increases to the differential features of industries and firms – and the high firing costs that permanent contracts entail. The latter lie behind a bias towards temporary hires which, so far, last year's labour reform does not appear significantly to have alleviated. The consequences arising from these elements of rigidity are less significant in an expansion such as that currently under way; but there is a risk that, in the face of a cyclical slowdown, wages will react to a lesser extent and the adjustment will fall mainly on temporary employment, with continuing employment generation not being guaranteed in less favourable macroeconomic circumstances. Further steps to reduce the rigidity of permanent hires and to amend the bargaining system so as better to adapt wages to the specific conditions of companies are thus needed.

improving the quality of education...

These measures should be complemented by a substantial improvement in the quality of education and of human capital that enables labour force skills to be matched to new demands. That will require the implementation of reforms to redress the secondary education deficit, to adapt university courses and to promote continuous training for workers.

and completing the liberalisation processes undertaken in recent years.

Perseverance is required with the implementation of liberalisation policies, which help generate the appropriate incentives for the diffusion of innovation and of efficiency gains in productive processes. Indeed, reinforcing the competitive environment in which companies pursue their activity is a prerequisite for such companies being better placed to compete abroad. In this connection the liberalisation processes undertaken in recent years, chiefly in the network industries, must be completed. This is potentially a very powerful way of spreading improvements in efficiency to the economy as a whole. In the electricity industry, competition must be boosted at all levels and, in particular, changes to clarify the remuneration arrangements for the different segments of activity need to be addressed. In the telecommunications market, the effects of heightened competition on prices and charges have been felt more sharply, although there remains a significant gap in respect of the implementation of new technologies in

Spanish homes, which may denote underlying problems in the industry. Finally, regarding transport, the delay in the scheduled liberalisation of the railway industry has held back the introduction of competition in this sector.

Moves must also be made first, to define a simpler and more transparent regulatory framework, especially in the field of services activities, so as to ensure firmer progress in the construction of the single market; and further, to speed the application of the services directive. In this respect, the existence of regulations at regional government level, which impose different degrees of restriction on activities as important for the working of the whole economy as are the retail trade and land use, do not contribute to attaining this objective and may ultimately generate distortions in the allocation of resources.

In short, if high growth in the future is to take root, the economy's growth potential must be increased and the flexibility available improved. The set of measures mentioned in this last section in relation to public finances, the labour market, human capital and increased competition in the markets for goods and services are to a large extent included in the National Reform Plan approved by the government in October 2005. Firm resolve in implementing the measures envisaged in the Plan, within the framework of the annual reviews foreseen, will no doubt contribute to the attainment of the aforementioned objectives.



### 1 Introduction

As mentioned in Chapter I of this Report, the long upturn in the Spanish economy that began in the mid-1990s is still in progress. This phase of sustained growth has been the consequence of a number of triggering factors generally related to the nominal convergence process and subsequent admission to the euro area. Thus, the establishment of a framework for macroeconomic stability, assisted by the anti-inflation credibility of the common monetary authority and fiscal consolidation, the increase in labour-market participation, the improvement in labour market functioning, as a consequence of successive reforms, and the liberalisation and privatisation processes undertaken have had a pronounced expansionary effect. Among all these developments, the factors that have boosted the growth of our economy most in recent years have been the changes in agents' financing conditions and the heavy inward migration flows.

Against a background of less uncertainty regarding the future path of income, the improvement in the conditions of access to financing and the reduction in its cost have led firms and households to reduce their propensity to save and to increase their investment spending through borrowing. A large part of the financing obtained by the private sector of the economy has been used to acquire real estate assets, which has helped to fuel a pronounced expansion of activity and rising prices in the market for residential assets. This has occurred while immigration, by raising the availability of the labour factor, has made it possible to expand productive capacity and has helped contain wage costs.

Both factors, the reduction in financial costs and immigration, are not only at the root of the dynamism of the Spanish economy in recent years, but also help to explain certain features of the pattern of growth followed. This is the case of the predominance of the labour intensive sectors, as a consequence of the changes in the endowment and relative costs of factors, and of the effects that the decline in the cost of financing has had on the composition of resident sectors' spending.

Despite the expansionary effect of immigration on the economy's aggregate supply, domestic spending has grown more strongly than private-sector income, so that there has been a pronounced increase in the net borrowing and debt ratios of households and non-financial corporations. Despite the saving generated by general government, this has led to an increase in the financial commitments of the economy as a whole, which resident agents will have to meet in the future.

To analyse the outlook for the Spanish economy, it is necessary to study the nature and, in particular, the persistence of the factors that have driven its growth in recent years and the macroeconomic implications of the increase in the nation's net borrowing. This chapter analyses in depth these two factors that have boosted the growth of the Spanish economy, characterising the financial conditions of the economy and exploring the available evidence on the macroeconomic effects of immigration. In addition, the significance of the increase in the economy's net borrowing, against the background of its integration in the euro area, and certain characteristics of a possible adjustment scenario are considered.

### 2 Financial conditions

Considerable reduction in the cost of financing,

The most graphic way of illustrating the considerable loosening of financial conditions in Spain is by depicting the path of interest rates. As seen in Chart 2.1, one-year nominal interest rates fell by almost 13 percentage points between 1990 and 1999. Since then, they have remained low, and below the historical average of those countries with the longest tradition of price





SOURCES: INE, Colegio de Registradores and Banco de España.

- a. Mibor to December 1998 and Euribor from January 1999. Annual average.  
 b. Spread between the rates on new business and the one-year interbank rate (absolute value).  
 c. From 2004, the data come from the Colegio de Registradores (Association of Registrars). A linear interpolation has been used for prior dates based on data obtained from the Asociación Hipotecaria Española (Spanish Mortgage Association).  
 d. Resident individuals with outstanding debts as a proportion of the total population over the age of 20. Circular 3/95 reduced the limit for declaring debts from four to one million pesetas.

stability, despite the rise since end-2005, which is leading to a gradual normalisation of monetary conditions. The low level of interest rates has been the consequence of a moderation in inflationary pressures against a background of weak activity in the euro area, which has prompted the ECB to keep its monetary policy accommodative. Thus, the impulse arising from the reduction in interest rates during the convergence process has been reinforced in recent years by a common monetary policy stance oriented towards the cyclical conditions of the euro area as a whole, which have been persistently less expansionary than those of the Spanish economy.

although possibly less than suggested by conventional indicators

Interest rates act on economic conditions, in the first instance, through their effect on the value of financial and real assets and, especially, on the cost of financing (or the opportunity cost of) spending. Although the specific level of this cost varies with the borrower's creditworthiness and the financing instrument chosen, it should, in any case, be directly related to the minimum real remuneration required by savers to lend funds when their investment is risk-free. In the absence of inflation-indexed instruments, this real interest rate may be calculated as the difference between the nominal rate of interest at the relevant term and the average expected infla-

tion at that horizon, plus a premium to compensate for the risk arising from the uncertainty regarding the future path of prices.

A simple way of approximating the real cost of financing is to deflate interest rates by the actual inflation rate (ex-post real rates). This variable has declined in Spain somewhat less than nominal rates (by some ten percentage points since 1990), owing to the reduction in inflation over the period. For ex-post real interest rates to be a good approximation of the interest rates relevant to agents' spending and financing decisions, there should be no systematic deviations between expected and actual inflation. In the 1990s, however, expected inflation was persistently higher than actual inflation, as a consequence of the uncertainty regarding completion of the convergence process, which did eventually take place. Accordingly, the fall in ex-post interest rates may reflect, in addition to the genuine reduction in the cost of financing in real terms, systematic surprises regarding the path of inflation to the benefit of savers and to the detriment of borrowers, without the behaviour of either being affected. It is therefore likely that the fall in ex-post real interest rates is a somewhat exaggerated approximation of the reduction in the real cost of financing which actually lay behind firms' and households' decisions during the convergence period.<sup>1</sup>

Other developments have accentuated the loosening of financial conditions:

In any event, although the relevant real interest rates in Spain may have fallen by less than would be implied by simply deflating nominal rates, the loosening of financial conditions has been significantly accentuated by a number of developments that occurred in parallel with completion of the nominal convergence process. In particular, the consolidation of a macroeconomic stability framework, along with the increase in the openness, competition and efficiency of the financial system, has led to three types of expansionary effect on the demand for credit and, in short, on the economy's aggregate spending: *a)* the narrowing of the spread between bank lending and deposit rates and market interest rates; *b)* the progressive lengthening of the terms of bank loans and *c)* easier access to bank financing.

the narrowing of bank spreads

Chart 2.1 presents some evidence to illustrate the scope of these three phenomena. Thus, as a consequence of the greater competition between financial intermediaries, the difference between bank rates (especially lending rates) and market rates has fallen significantly in recent years. This, along with the decline in commissions, has helped to reduce the cost of borrowing for firms and households and has mitigated the fall in the remuneration of their savings. The expansionary impact of the reduction in interest rates has thus been accentuated.

the lengthening of bank loan terms

Competition has not only helped to strengthen the effect of the reduction in interest rates on the demand for credit, it has also prompted expansion of the range of instruments that credit institutions offer to their customers and the development of new formulas for financing credit and managing the associated risks. Possibly the most important innovation has been the lengthening of the terms of the loans granted and, in particular, of mortgage loans. Chart 2.1 shows how the average mortgage repayment period has doubled since 1990, reaching 27 years in 2006. This increase in maturities has been facilitated by the notable reduction in the macroeconomic uncertainty resulting from admission to the euro area, and by the strengthening of confidence entailed by the considerable reduction in unemployment.

the generally readier access to credit

Finally, the development of the financial system and the general improvement in prospects have permitted a significant widening of access to bank credit. As also illustrated in Chart 2.1,

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1. See R. Blanco and F. Restoy (2007): *Have real interest rates really fallen that much in Spain?*, Working Paper No 0704, Banco de España, and R. Gimeno and J. M. Marqués (2007): *Uncertainty and the price of risk in a nominal convergence process*. In the latter paper, the fall in the real interest rate between 1990 and 1999 is estimated to have been around 2.5 pp, well below the reduction in deflated nominal rates (ex-post real rates) during the same period.

according to Central Credit Register (CCR) data, in 2006 more than 42% of individuals over the age of 20 had some type of debt with credit institutions, four times the percentage in 1990. The new economic and financial environment has thus eased the restrictions that used to hinder the participation of very broad segments of the population in the credit market.

and, especially, the interaction between the credit and property markets.

In any event, the phenomenon that has possibly boosted the expansionary effects of the reduction in interest rates most has been the housing boom experienced by the economy since 1998. A reduction in interest rates increases the value of assets by an amount that depends positively on their maturity. Accordingly, it has a particularly marked impact on the price of perpetual assets, like land. In addition, considering the preponderance of mortgage credit among the different types of financing, there have been feedbacks between the demand for credit and the price of housing. The improvement in the conditions of financing for the acquisition of real estate has, along with the demographic expansion, been conducive to strong demand pressure in this sector and, therefore, sustained price growth. At the same time, the increase in the value of real estate assets has generated wealth effects on consumption and fuelled the demand for residential investment which has, in turn, been boosted by the increase in the collateral available to secure bank loans. The feedbacks between credit growth and house prices occur very rapidly. According to the available estimates, growth of 1 pp in loans leads to growth of 0.15 pp in property values in the same quarter. Also, a rise of 1 pp in house prices results in an increase of almost 0.1 pp in credit for the acquisition of residential assets.<sup>2</sup>

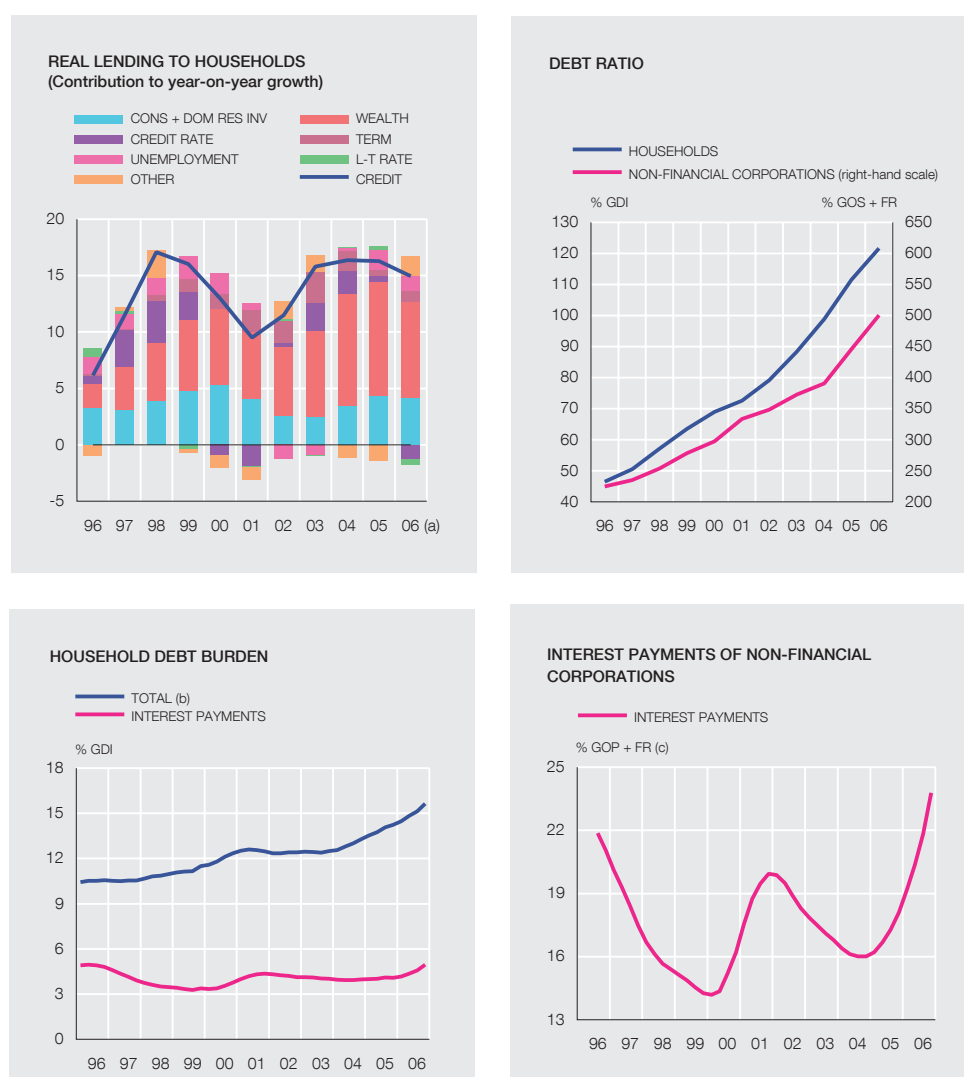
An illustration: household demand for credit.

The result of these developments has been a substantial increase in firm and household debt ratios, although the increase in the debt burden has actually been much more moderate (see Chart 2.2). A way of illustrating the effects of each of the factors involved in the loosening of financial conditions is to study its impact on loans granted to households. The growth of credit in this sector, which has taken its debt ratio to levels of around 125% of gross disposable income, is perhaps the best reflection of the profound transformation in agents' financial decisions. As Chart 2.2 shows, approximately 25% of average credit growth is explained by the scale variable (consumption plus residential investment). The rest is the consequence of the reduction in uncertainty regarding future income (approximated by the unemployment rate) and financial conditions. Among the latter, interest rates had a significant direct impact, which diminished over time as interest rates stabilised at low levels. However, the lengthening of loan maturities has had at least as important an average impact as the reduction in interest rates. That said, the increase in wealth, closely linked to the rise in house prices, is the most important explanatory factor, which confirms the significant boosting effect of property market developments on the demand for financing and, ultimately, on the economy's aggregate spending.<sup>3</sup>

Likely tailing-off of the boosting effect of financial conditions

Both the reduction in interest rates and the rest of the factors that explain the considerable loosening of financial conditions have exerted an expansionary effect on spending and financing, and continue to do so. In late 2005, however, interest rates began to rise in a process that is bringing about a gradual normalisation of monetary conditions, so that it currently appears likely that monetary policy will have a less accommodative stance than in the past. Moreover, although competition in banking markets may continue to intensify, there seems to be little room for this to lead to further significant changes in bank rates, particularly in those that affect the cost of financing for firms and households. Also, although loan maturities may continue to lengthen somewhat, the effect on borrowers' annual debt burden (and therefore

2. See R. Gimeno and C. Martínez Carrascal (2006): *The interaction between housing prices and loans for house purchase*, Working Paper No 0605, Banco de España. 3. See F. Nieto: *The determinants of household credit in Spain*, Working Paper No 0716, Banco de España.



SOURCE: Banco de España.

- a. The 2006 data are for Q3.  
b. Estimated interest and principal payments.  
c. Gross operating profit plus financial revenue.

on the demand for financing) will tend to be increasingly small. Finally, the latest property market data indicate a progressive slowdown in prices, which would help to reduce the buoyancy of credit and, in general, to moderate the rate of expansion of spending. For all these reasons, the loosening of financial conditions, which explains a substantial part of the boost to domestic demand in recent years, is giving way to a phase of greater normalisation, which is beginning to be apparent in an incipient slowdown in credit. In the absence of other stimuli, this would entail a tendency for the economy's aggregate spending growth to moderate gradually.

### 3 Immigration

The resident foreign population in Spain has risen to over 4 million,

The resident foreign population in Spain has increased from 920,000 in 2000 to around 4.1 million, according to electoral roll data for 1 January 2006, with annual inflows of around 700,000 in the last two years. As a result, the percentage of foreigners has risen from 2.3% of the total population at the beginning of this decade to around 10% in 2006.

AVERAGE ANNUAL PER CAPITA GDP GROWTH RATES	1.70
Demographic factor	0.16
<i>Contribution of natives</i>	-0.15
<i>Contribution of immigrants</i>	0.31
Employment rate	1.06
<i>Contribution of natives</i>	0.79
<i>Contribution of immigrants</i>	0.27
AVERAGE ANNUAL GDP GROWTH RATE PER PERSON EMPLOYED	0.48
<i>Contribution of natives</i>	0.65
<i>Contribution of immigrants</i>	-0.18

This large increase in immigration into Spain is part of a global tendency for international population movements to intensify. In particular, in the early 1990s there was a considerable flow of population from eastern Europe towards western European countries, following the collapse of the Communist regimes. Also, in the mid-1990s there was a significant increase in emigration from Africa and Latin America to various industrialised countries, as a consequence of the economic crises afflicting the home nations.

Spain has been one of the main recipients of migration flows to Western Europe. A fundamental role has been played here by its geographical position between Europe and Africa and its cultural proximity to the Latin American countries, but especially by the strong demand for employment that has characterised the long upturn in the Spanish economy over the last ten years. At the same time, the growing intensity of flows of immigrants has been boosted by the attraction effect that foreign workers resident in Spain have exerted over new immigrants from the same home countries.

which has obviously contributed to income growth,

Immigration has had direct stimulating effects on the Spanish economy, by increasing its endowment of labour and thereby raising its potential growth. It has, moreover, contributed to the appreciable growth of per capita income in recent years. According to the calculations in Table 2.1, the impact of immigration on the growth of output per head was equivalent to 25% of all the growth observed in the period 2001-2005.<sup>4</sup> These calculations are based on a simple accounting breakdown of per capita GDP into three factors: the working age population as a proportion of the total population, the rate of employment (i.e. the employed labour force as a proportion of the working age population) and productivity per person employed. As seen in Table 2.1, over the period 2001-2005, per capita GDP in Spain grew at an average annual rate of 1.7%, of which the demographic factor explains 0.2 pp, the employment rate 1 pp and productivity 0.5 pp. The total effect of immigration is obtained as the sum of its contribution to the observed growth in each of these three components.

owing to the direct expansionary effect on the working age population and on the employment rate,

The impact on the demographic component underpinning the growth of per capita GDP has been particularly apparent. Indeed, the arrival of foreigners explains the whole of the increase in the working age population as a proportion of the total population. This phenomenon has also contributed, although more moderately, to the increase in the employment rate, which has been the most important factor boosting the economy, primarily thanks to the increase in the

4. Qualitatively similar conclusions are obtained in Oficina Económica del Presidente (2006): *Inmigración y economía española: 1996-2006*. This paper concludes that approximately 20% of the growth in per capita income over the last five years can be explained by the contribution of immigration.

female participation rate and to the large reduction in unemployment. The contribution of immigration to the increase in the employment rate during the period 2001-2005 was approximately a quarter of the total, as a consequence of the foreign population's high participation rate (given its age composition), although the unemployment rate of this group is higher than that of the native population.

despite the fact that the impact on aggregate productivity has probably been negative,

The measurement of the impact of immigration on apparent labour productivity is especially complex, as no direct information is available on workers' individual performance. In any case, since foreign workers perform occupations predominantly in sectors with below-average productivity, the arrival of immigrants has had a negative composition effect on aggregate productivity.

The magnitude of this composition effect can be estimated by approximating the productivity differential between native workers and immigrants by means of observed wage differentials, controlling for different educational levels, occupations, sex, age and work experience, and using the information available on the weight of immigrants in the total employment of the sectors for which information is available. According to this approximation (based on the assumption that the remuneration of immigrants does not incorporate any wage discrimination element), immigration reduced the average annual growth rate of productivity per person employed in the economy as a whole by 0.2 pp to 0.5% over the period 2001-2005.

although there are other indirect effects on the labour market that are difficult to quantify.

These accounting calculations should be treated with great caution, not only because they are subject to the problems of productivity measurement, but because they ignore the effect that the increase in the foreign population may have on the employment situation of native workers. Depending on the composition of the immigrant population and the jobs they do, their skills are complementary to those of certain population groups and substitutes for those of others. On one hand, it is likely that part of the increase in employment participation and in the number of hours worked by the national population, especially women and the most highly skilled native workers, stems from the availability of a larger supply of labour for personal services, such as housework and caring for dependent persons. On the other hand, the greater competition in certain segments of the labour market may have been translated to some extent into a higher rate of unemployment in groups of the native population in low-skilled jobs, where wage adjustment is limited by the level of minimum wages.

The precise measurement of these effects is a complex task, owing to the limitations of the available data and the difficulty involved in identifying the relevant causal relationships. However, most of the studies available in the economic literature on this subject indicate that the effects of immigration on the employment situation of the native population seem to be limited in magnitude, both when there exist relationships of complementarity and when substitution effects predominate.<sup>5</sup>

On the demand side, immigration has contributed notably to the increase in investment,

Besides the effect that the increase in population has had on the endowment, degree of use and productivity of resources, the growth of immigration flows has generated important effects on the economy's aggregate demand and, in particular, on gross capital formation.

5. There is still not much empirical evidence on the Spanish experience in this respect. For a first approximation of the impact of immigration on the employment rate and wages of the native population in Spain, see R. Carrasco, J.F. Jimeno and A.C. Ortega: "The effect of immigration on the labor market performance of native-born workers: some evidence for Spain", *Journal of Population Economics*, gone to press. For an approximation of the economic analysis of immigration and an overview of the most important empirical results, see G. Borjas (1999): "The Economic Analysis of Immigration", in O. Ashenfelter and D. Card (eds): *Handbook of Labour Economics*, vol. 3A. North Holland, and D. Card (2001): "Immigrants inflows, Native Outflows, and the Local Labour Market Impacts of Higher Immigration", *Journal of Labour Economics*, 19(2), pp. 22-64.

The increase in the working age population and in the participation rate, as well as the greater competition in the labour market, caused by the arrival of immigrants, have reduced the capital/labour ratio in productive processes. As a consequence, the productivity of capital and, therefore, investment demand, both for equipment and construction, has increased. In this setting, it seems likely that the greater availability of labour has contributed significantly to the growth of the economy's rate of investment, which has been 3 pp over the period 2001-2005.

while having an ambiguous effect on the economy's saving ratio.

Less immediate is the analysis of the influence of immigration on consumer spending. This task requires, first, knowledge of patterns of assimilation and return of immigrants which is currently lacking. On one hand, a high proportion of foreign workers probably devote a significant part of their wages to financing spending in their countries of origin.<sup>6</sup> These immigrants would thus display a lower propensity to spend, in National Accounts terms, than national workers with the same level of income.

At the same time, the concentration of these workers in lower income strata, in which the average propensity to save is low, should normally have a negative impact, through the composition effect, on the aggregate saving ratio. Also, the age profile of the immigrant population and the expectations of progressive growth in its income mean that a relatively low saving ratio can be expected, especially among those intending to stay longer.

Box 2.1 uses a general equilibrium model with overlapping generations to obtain some indication of the quantitative impact of some of the effects indicated. Although the model is very stylised, the results suggest that the expansionary effects of immigration on the economy's rate of investment may be rather pronounced. By contrast, the simulations indicate that recent demographic developments have probably had a relatively modest influence on the saving ratio over the last few years.

#### **4 The absorption of imbalances inside the euro area**

##### **4.1 THE CONSEQUENCES OF A PROLONGED EXPANSION WITHIN THE EURO AREA**

Both the modernisation of the financial system, within a macroeconomic stability framework, and the phenomenon of immigration involve an expansion of the productive resources available and an enhancement of allocation mechanisms, since they help to improve the functioning of capital and labour markets. The developments described thus contribute to raising the economy's potential output and boost the process of convergence with the income levels of the most advanced euro area economies. However, in the short term, these developments have had a significantly greater overall effect on aggregate demand than on output capacity.

The growth of spending has led to an increase in the net borrowing of resident sectors.

Thus, the main factors driving the Spanish economy's dynamism have helped to raise spending by more than residents' incomes. As a result, households and firms have seen their net lending decline and have increased their borrowing. Also, the expansion of aggregate demand, by acting directly on insufficiently flexible markets, has exerted upward pressure on domestic prices and costs. This has made national output more expensive, relative to the output of competitors, containing export growth and increasing import penetration. The combined result of the increase in the economy's propensity to spend and the increase in its relative prices has been a rise in the nation's net borrowing, from somewhat more than 1% of GDP in 1999 to 7.8% in 2006.

6. According to balance of payments data, immigrants' remittances have increased from 0.3% of GDP in 2001 to 0.7% in 2006. However, there are certain difficulties involved in measuring them, which may mean that these figures are underestimates. See F.J. Álvarez, M.T. García and P. Tello (2006): "Workers' remittances in the Spanish Balance of Payments", *Economic Bulletin*, Banco de España, July 2006.



Calculating the effects induced by immigration requires taking into account the characteristics of the flows of immigrants received, the consumption and labour supply decisions of households and the demand for labour and investment of firms. Only in this way is it possible to quantify the effects of immigration flows on the economy's aggregate supply and demand.

The availability of an overlapping generations model<sup>1</sup> enables some of these effects (in particular, those with repercussions for the economy's saving and investment patterns) to be identified, on the basis of a stylised analysis. As in every model with microeconomic foundations, individuals maximise their utility over their life cycle, choosing paths for their consumption, saving and labour supply, while firms maximise profits, deciding on their demand for labour and their investment plans. These decisions are taken on the basis of, among other determinants, the expected path of the prices of factors of production, which are determined endogenously in the relevant markets.

To characterise the immigration flows received by the Spanish economy as precisely as possible, it is first considered that both natives and immigrants can work in different occupations characterised by different skill levels. This aspect enables the extent to which aggregate productivity depends on the average skill level of immigrants relative to the native population to be analysed. Also the possibility is envisaged that the employment rates by age for the native and immigrant populations are different, in order to measure more accurately the effect on employment at the aggregate level. Finally, the immigrant's age at the time of entering the country has been taken into account. This detail is important for two reasons. First, the impact on the labour force differs according to the age profile of the immigrants. Second, immigrants' consumption and labour supply decisions vary according to the number of years they have remained in the country, because, among other reasons, these decisions depend in turn on the wealth accumulated over the life cycle.

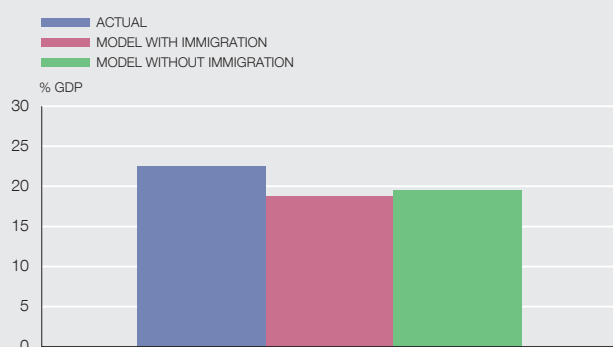
1. See M. Izquierdo, J.F. Jimeno and J.A. Rojas (2007): *On the aggregate effects of immigration in Spain*, Working Paper No 0714, Banco de España.

The calibration of this model for the Spanish economy produces behaviour that is qualitatively similar to that observed in the Spanish economy between 2001 and 2005. The average annual rate of growth of per capita GDP is 1.8%, only 0.1 pp higher than the actual rate. The contribution of immigration to the three factors that explain this growth is 0.3 pp to the demographic factor, 0.6 pp to the employment rate and -0.8 pp to productivity. That is to say, compared to the accounting breakdown set out in the main text, the model predicts a somewhat larger impact on the rate of employment and a somewhat smaller one on productivity.

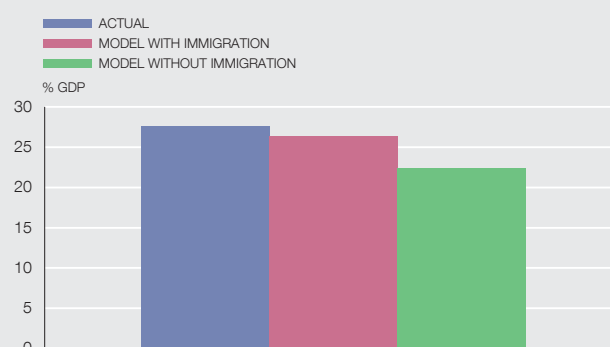
The implications for aggregate demand derived from the model are summarised in the chart. It shows the average rates of saving and investment in the period 2001-2005, in the model calibrated with and without immigration flows. The model with immigration yields an investment rate (26.3%) that is very similar to the actual rate (27.6%) and notably higher than the one that would have occurred, according to the model, without immigration (22.4%). In other words, according to the simulations, part of the significant increase in the Spanish economy's rate of investment is attributable to the increase in the profitability of investment associated with the decline in the capital/labour ratio caused by the arrival of immigrants. As regards the saving ratio, these simulations indicate that immigration entailed a reduction of 0.8 pp, mainly as a consequence of the fact that immigrants, since they have steeper income profiles over time than natives, have a lower propensity to save.

The limitations of the model obviously require that the results be treated with caution. In particular, the analysis does not incorporate the effects that a short horizon of stay in Spain may have on the propensity to save, or the implications of the lesser accessibility of credit for individuals at lower income levels. Accordingly, it is likely that, despite its moderate absolute value, the estimated negative effect of immigration on the economy's saving ratio is an upper limit for the actual value. All in all, the analysis suggests that, although the direct impact of immigration on consumption has not been very pronounced, the induced effect on aggregate demand, through investment, may have been notable.

1. AVERAGE SAVING RATIO (2001-2005)



2. AVERAGE INVESTMENT RATE (2001-2005)



	2001	2002	2003	2004	2005	2006 (b)
National economy	-3.5	-2.7	-2.9	-4.8	-6.5	-7.9
Non-financial corporations	-2.7	-0.4	0.0	2.2	1.2	3.6
Households and NPISHs	0.7	1.5	0.8	0.8	0.8	0.7
General government	-1.7	-1.3	1.0	-3.1	0.4	-0.5
Banco de España	-2.6	-0.4	-0.2	1.7	0.3	1.1
Institutional investors (c)	5.5	2.3	4.7	1.7	2.8	1.4
Credit institutions	-1.1	-2.2	-7.1	-3.5	-3.6	-3.7
Other financial institutions	-0.8	-1.7	-2.8	-5.0	-9.0	-11.7
Unsectorised	-0.7	-0.2	0.6	0.5	0.6	1.3

SOURCE: Banco de España.

a. A negative (positive) sign indicates that the rest of the world extends (receives) financing to (from) the counterpart sector.

b. Cumulative four quarter data to 2005 Q3.

c. Insurance corporations and collective investment institutions.

Inside the monetary union the Spanish economy has increased its capacity to attract foreign savings.

However, the nature and scope of the external constraint have been considerably modified by Spain's membership of a monetary integration area. When an economy has its own currency and the exchange rate fluctuates, the uncertainty over the exchange rate makes external financing more expensive and limits its availability, which tends to give rise to adjustment processes when the external deficit reaches high levels. However, in a monetary union, the price and availability of external credit are determined by the same factors influencing the cost and accessibility of domestic credit and, in particular, by the solvency of the agents demanding financial resources.

In Spain, the financial situation of the agents ultimately demanding funds (firms and households) has been solid in recent years. Among other factors, this is due to the fact that a large portion of the financial resources has been used to finance investment and not current spending, while the value of the non-financial private sector's assets has risen significantly. In addition, as reflected in Table 2.2, the channelling of foreign flows has largely been mediated by credit institutions and, increasingly in recent years, by other financial institutions. Among the latter, financial vehicle corporations have been particularly important, a high percentage of their securities having been sold to international investors.

The solidity of the financial situation of resident sectors and the large safety margins that credit institutions have in the form of reserves and provisions, are conducive to the bulk of the economy's financing being obtained at a low cost, without the payment of significant risk premiums. In principle, these conditions will permit the Spanish economy to continue to tap foreign savings to cover its net borrowing.

However, the maintenance of current trends could lead to high levels of indebtedness

The persistence of high levels of net borrowing entails an upward trend in the debt burden and an increasing exposure of resident economic agents to possible shocks, irrespective of whether such borrowing is easy to finance.

In a context in which the restriction on the availability of external funds loses its relevance, the economic significance of the nation's external balance declines. This balance is, essentially, the direct result of aggregating the autonomous spending and financing decisions of resident agents. Therefore, when interpreting changes in the nation's net borrowing, the analysis should

focus on assessing the consistency of firms' and households' intertemporal spending plans with the foreseeable changes in their income and interest rates. In fact, if agents form well-founded expectations regarding their future spending capacity and they have access to the credit market, they will be in a position to plan their intertemporal consumption profile which, in the absence of unexpected shocks, will be free from excessive fluctuations.<sup>7</sup> In accordance with this approach, rational behaviour on the part of agents would enable one to expect that, provided their forecasts are fulfilled, the net borrowing existing at any given moment will be reversed in future.

In Spain, real convergence explains part of the growth in debt.

In an economy undergoing a process of real convergence, increases in per capita income tend to raise future spending capacity. The growth of per capita income in Spain in recent years, at 1.2 pp above the euro area average over the last ten years, and the high current rate of investment, which was almost 9 pp higher than the aggregate rate for the euro area in 2005, indicate that the process of real convergence may, at least partly, explain the rise in resident private sector debt. Box 2.2 explores this hypothesis in detail with the help of a simple intertemporal decision model. Following this approach, it is found that the increase in net debt in recent years may be linked to the existence of reasonable expectations of growth in per capita income. Also, the low level of real interest rates in the more recent past may have had an additional expansionary effect on the demand for credit. However, the analysis suggests that the current difference between firms' and households' income and expenditure implies that agents have relatively optimistic expectations regarding future growth in their income. That said, this inference is surrounded by the uncertainty arising from the capacity of the relatively simple conceptual framework used to incorporate the bases for the decisions behind the various spending components.

It is inferred from this conceptual framework that when the spending patterns of the non-financial private sector have exceeded what might be attributed to reasonable anticipation of the expected increase in their resources, an adjustment will tend to take place through a gradual revision of their expectations and gradual adaptation of their consumption and investment plans towards more moderate and sustainable paths, as recently seen in Spain, in the form of a slowdown in domestic demand and net borrowing. Continuation of the process of gradual adjustment will reduce the probability that some households and firms may have to moderate their spending more sharply in the event that a certain type of shock arises.

Moreover, competitiveness losses, stemming from spending pressure, have an adverse effect on income generation.

The hypothesis that the adjustment of private sector net borrowing may require spending moderation is also supported by the impact that the competitiveness losses experienced by the Spanish economy may have on its capacity to generate income. Competitiveness is a complex concept involving much more than changes in relative prices and costs vis-à-vis competitors. Specifically, the way in which the price indicators take into account the changes in product quality that are relevant to the analysis of competitiveness is not satisfactory.

In any event, as mentioned in Chapter 1, the Spanish economy has experienced a progressive increase in its prices and costs relative to those of its main competitors (and in particular those of the euro area countries), which may eventually have an effect on net exports. Thus, for example, when the trade deficit is broken down mechanically into the component explained by scale variables (growth of domestic demand vis-à-vis the growth of export markets) and that

7. For a general overview of the intertemporal approach see, for example, M. Obstfeld and K. Rogoff (1999): "The intertemporal Approach to the Current Account", in G. Grossman and K. Rogoff (eds.), *Handbook of International Economics*, vol. 3, Chapter 34. pp. 1731-1799. For the European case, see J. M. Campa and A. Gavilán (2006): *Current Accounts in the Euro Area: An Intertemporal Approach*, Working Paper No 0638, Banco de España.

This box analyses private sector net borrowing in Spain on the basis of simulations performed using a simple intertemporal decision model for resident agents. The exercises make certain simplifying assumptions. In particular they do not directly consider the determinants of investment by individuals, so that they cannot aspire to making a precise description of the factors that have generated the increase in net borrowing and all its macroeconomic implications. As a result, the results should be treated with caution, particularly given the importance of residential investment in the Spanish economy's spending dynamics.

The financial position of agents depends on their income and their spending decisions which, in accordance with the intertemporal approach, are geared towards maximising welfare over the life cycle. At all times, individuals have the income generated during the year and the possibility of access to bank credit. With these resources they must decide on their consumption and undertake investment so as to enjoy a larger amount of goods and services in the future. When agents decide on a volume of consumption and investment expenditure that exceeds their current income, they will record *net borrowing* and otherwise, *net lending*.

Intertemporal models postulate that agents' behaviour is geared towards limiting the variability of their consumption over time. Accordingly, their net borrowing at any time shall be compatible with their expected future income which, after deducting the financial costs and investment of the period, gives them sufficient resources to avoid significant adjustments in their level of consumption. Thus, in accordance with the model, the existence of net borrowing indicates that agents expect a future increase in their resources available for consumption, i.e. in their disposable income net of investment expenditure. In fact, the higher the expected net income and the lower the financing costs, the greater will be the future capacity of agents to finance with their own income the desired consumption profile, and the higher the present level of indebtedness they can incur.

In the most simple (and also the most usual) formulation of the intertemporal approach it is possible, under certain conditions, to express net borrowing at any time as a function depending linearly on income and interest-rate expectations. When these variables are expressed

as deviations from the actual values during a reference period, this function may be approximated as follows:

$$nf_t = E_t \sum_{i=1}^{\infty} \beta^i (\Delta y_{t+i} - r_{t+i}) \quad [1]$$

Where  $nf$  represents net borrowing (as a percentage of disposable income) and  $y_n$ , disposable income net of investment expenditure.  $\Delta y_{t+i}$  is the increase in  $y_n$  between period  $t+i$  and  $t+i-1$  and is therefore the variable that approximates the change in disposable own funds for financing consumption.  $r_{t+i}$  is the real interest rate in period  $t+i$ ; and  $\beta$  and  $\gamma$  are parameters representing, respectively, the discount rate and the intertemporal elasticity of substitution (IES). This latter parameter reflects agents' readiness to exchange present for future consumption. The equation shows that the higher the IES, the readier agents will be to redistribute their consumption over time and, thus, the more sensitive will be their decisions to interest-rate changes. Given expectations regarding the paths of net income and interest rates, equation [1] describes what the financial position of agents would be, which corresponds to their desire to limit fluctuations in their consumption over time.

Insofar as households are considered to be the owners of firms, both their income and their consumption and investment expenditure will correspond to those of the private sector as a whole. From equation [1] it is therefore possible to derive the net borrowing of this sector for different future paths of disposable income, investment and interest rates, once certain values have been postulated for the discount rate and the IES. These calculations enable the financial position of the private sector to be obtained, which would be consistent with maintenance in future of the dynamism of private consumption observed in recent years.

In the case of the intertemporal substitution parameter there is no agreement in the literature regarding the value that should be used, only estimates that vary significantly with context and modelling strategy. Given this ambiguity, a range has been assumed for this parameter of 0.25 to 1, which contains most of the available estimates.

The most critical element of the exercise concerns the assumptions for the expected paths of disposable income and investment. Ideally,

## PRIVATE SECTOR NET BORROWING

(Ratio of notional to actual value in 2005)

Disposable income	IES = 0.25	IES = 1
Average growth rate between 1995 and 2005	0.26	0.33
Slow convergence scenario	0.74	0.89
Average convergence scenario	0.78	0.97
Rapid convergence scenario	0.82	1.06

IES: Intertemporal elasticity of substitution.

these paths would be derived taking into account the endogeneity of (productive and residential) investment decisions and their influence on the future income of the private sector through their effect on factor employment and productivity. Despite the limitation involved for the scope of the exercise, plausible scenarios can be designed exogenously for the foreseeable growth in these variables, as a first approximation, in order to derive the net borrowing predicted by the model in each case and to compare it with observed data.

In particular, the scenarios considered should take into account that the Spanish economy is undergoing a process of real convergence characterised by per capita GDP growth rates that are above the euro area average, but also by higher rates of investment than in the more mature countries. The increase in these rates, especially in their residential component, explains a large part of the expansion of the nation's net borrowing in the recent past. For example, over the period 1995-2005, the average rate of growth of per capita GDP was 1.2 pp higher than the euro area average, while the average rate of investment relative to GDP was 5 pp higher in Spain than on average in the euro area. On the basis of these premises, four different scenarios have been considered for per capita GDP growth which, on the assumption that public expenditure remains constant relative to GDP, is equal to the growth in per capita disposable income. As regards the investment/GDP ratio in scenarios 2 to 4, it is assumed to decline gradually, the cumulative reduction over the convergence horizon being 5 pp in each case. The real interest rate is assumed to follow a path that starts from 1% at end-2005, that reaches 2% (considered to be its equilibrium level) after two years, and that remains at that level thereafter. The average of the relevant variables during the period 1995-2005 has been used as the reference for the deviation calculations required by equation [1]. Accordingly, the scenarios considered are as follows:

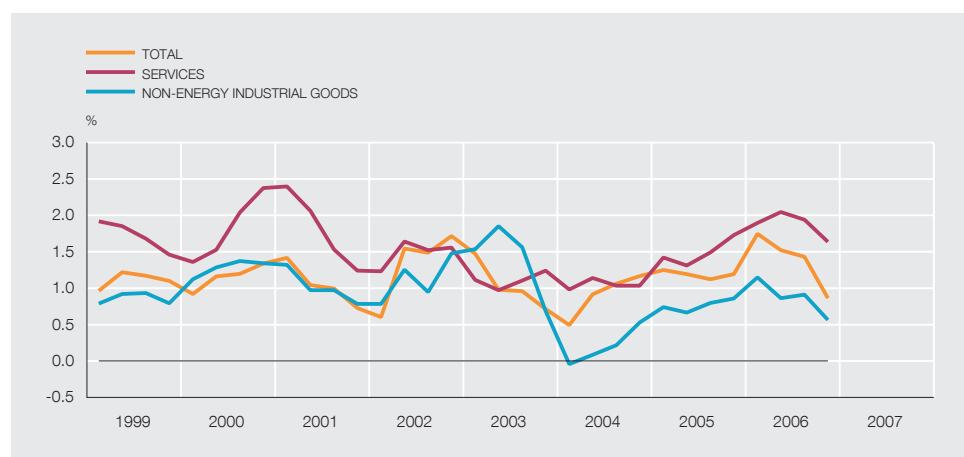
- Growth in per capita disposable income not assigned to investment equal to the average rate during the period 1995-2005 (1.5% per annum).
- A *slow convergence scenario*, in which the average level of per capita GDP in the euro area is attained after 20 years. In this scenario per capita disposable income grows, over the period 2006-2025, at a rate of 1.8%, which is approximately the average for the period 2001-2005. Thereafter, it increases at a rate of 1.4% per annum, a value that is slightly above the growth rate of per capita disposable income in the euro area during the last five years of the reference period (1.3%).<sup>1</sup>

<sup>1</sup> This assumption is equivalent to a long-term trend for productivity growth (i.e. when all the possibilities for increasing the use of the labour factor have been exhausted) of 1.4%, approximately half a percentage point above conventional estimates.

- An *average convergence scenario*, in which the average level of per capita GDP in the euro area is attained after 15 years. In this scenario, disposable income in Spain grows at a rate of 1.9% over the period 2006-2020, and 1.4% thereafter.
- A *rapid convergence scenario*, in which the average level of per capita GDP in the euro area is attained after 10 years. In this scenario, disposable income grows at a rate of 2.1% during the period 2006-2015, and 1.4% thereafter.

The adjoining table shows, for each of these four scenarios, the private sector net borrowing predicted by the model in each case, expressed as a ratio of actual net borrowing at end-2005 (6.5% of disposable income). A ratio of less than one implies that the model yields an estimate below the actual figure. In the first scenario, in which income net of investment does not grow at a higher rate than on average in the period 1995-2005, the private sector net borrowing explained by the model accounts for around 30% of that actually observed. In the other three scenarios, in which the future growth rates of income net of investment are higher, the model predictions are closer to the actual figures, standing at between 74% and 106% of the latter. However, only in the fourth scenario would the private sector net borrowing observed at end-2005 be in line with the levels resulting from the simulations made, for relatively high values of the intertemporal elasticity of substitution. Thus, if the model is sufficiently close to reality, it can be inferred that private-sector net borrowing may be compatible with the indefinite maintenance of the current dynamics of private consumption, in the event that per capita GDP and the rate of investment follow a pattern like the one described in the more rapid convergence scenario.

It should be noted that the calculations presented assume that all resident agents have unrestricted access to credit. The values of net borrowing predicted by the model should be corrected downwards in accordance with the proportion of agents who do not have access to external financing. In any case, although the results of the simulations offer useful illustrations, the relative simplicity of the exercise means that the dynamics of the private sector financial position cannot be fully characterised. In particular, the increase in net borrowing recorded by the Spanish economy in recent years is largely a consequence of the significant expansion in investment in property-related activities. These developments reflect certain highly complex cultural, demographic and financial determinants, whose effects on agents' decisions and on the future growth of the economy cannot be easily captured by stylised models like the one used in this box.



SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

linked to relative prices, the deterioration in the trade balance in recent years (by 3 pp of GDP between 2003 and 2005) can be seen to be largely attributable to the latter factor. In order to understand this result, it should be taken into account that although aggregate demand has grown significantly more in the Spanish economy than in the euro area, the expansion of activity in other geographical areas has managed to sustain the dynamism of international markets.

The rise in the relative prices of Spanish products is directly related to the persistently positive inflation differential vis-à-vis the euro area countries. Although the growth of nominal wages has generally been in line with that of prices, the inflation differential has had an upward effect on relative wage costs, which has not been offset by the growth in labour productivity. The available evidence<sup>8</sup> indicates that the inflation differential of the Spanish economy is closely linked to the strength of demand which, against a background of insufficient price and wage flexibility in the euro area as a whole, has led to higher price growth than in other euro area countries with less dynamic economies. As seen in Chart 2.3, the effects of this demand pressure on prices have been most significant in the sector sheltered from international competition (in particular, in services), as a consequence of the higher relative intensity of spending on this type of product and, especially, of suppliers' greater ability to adjust margins.

#### 4.2 THE ADJUSTMENT MECHANISMS

The adjustment will foreseeably take place through a gradual moderation of spending,

As argued above, the external deficit of the Spanish economy is linked to the rise in borrowing by firms and households, as a consequence of the improvement in growth prospects, against a background of macroeconomic stability and low interest rates. Also, although it reflects an increase in debt ratios, this has not damaged the solvency of the resident private sector. Moreover, membership of the euro area, by eliminating exchange risk in commercial and financial transactions with our main trading partners, makes it unlikely that the external deficit will in itself be an effective restriction on maintenance of the Spanish economy's dynamism. Finally, given the way in which financial flows are being channelled from abroad, the availability and conditions of access to foreign financing are unlikely to change significantly in the future.

8. See, for example, A. Estrada and D. López Salido (2005): *Understanding Spanish dual inflation*, Working Paper No 0503, Banco de España, and D. López-Salido, F. Restoy and J. Vallés (2005): "Inflation differentials in EMU: the Spanish case", *Moneda y Crédito*, vol. 220.

	GDP	GDP deflator	Exports	Imports	External sector contribution
Interest rate (+ 1pp)	-0.8	-0.4	0.1	-1.1	0.4
House prices	-0.8	-0.9	0.3	-1.1	0.5
Productivity (+ 1pp)	0.7	-3.0	0.8	-0.3	0.3
Margins	0.4	-3.0	0.7	-0.5	0.4

SOURCE: Banco de España.

a. Simulations using the Banco de España Quarterly Model (MTBE). Cumulative deviations over six years relative to the baseline scenario in pp. Interest rate shock: 1 pp higher than in baseline scenario for 6 years. House price shock: increasing deviation from the baseline scenario over 6 years, calibrated to have the same cumulative effect on GDP as the interest rate shock. Productivity shock: TFP growth permanently 1 pp higher than in the baseline scenario. Margin shock: reduction in margins relative to baseline scenario, calibrated to have the same cumulative effect on the GDP deflator as the productivity shock.

In these circumstances, the adjustment that can be expected, as the current upturn matures, will be primarily induced by a gradual revision of agents' consumption and investment (and thus financing) decisions, until their levels are more in accord with the likely scenarios of future income growth. This adjustment would, moreover, enable the demand pressures on markets to ease and would thereby help to strengthen the Spanish economy's ability to compete (through prices and costs) on international markets.

Recent developments are consistent with the commencement of a gradual slowdown in the economy's aggregate demand and an easing of the imbalances. In particular, the process of normalisation of monetary conditions in the euro area as a whole and the progressive absorption of the overvaluation that characterises the property market are tending to have a moderating effect on consumption and investment (especially residential investment), and are conducive to a recovery in the saving ratio and containment of the demand for financing.

In order to obtain a rough idea of the magnitude of the effects of the slowdown in spending on the external sector, the Banco de España Quarterly Model<sup>9</sup> has been used to perform some simulations of the impact that certain selected exogenous shocks would have on the contribution of net exports to GDP growth. Specifically, contractionary shocks have been introduced to two of the variables that determine residents' demand (the level of interest rates and house prices).

First, it is assumed that the level of short-term interest rates stands for six years at 1 pp above the level that would correspond to a generic baseline scenario. Table 2.3 sets out the results of the simulations. As seen, this shock would entail a cumulative GDP deviation over the six years of -0.8 pp with respect to the baseline. In addition, it would involve a cumulative effect on the GDP deflator of -0.4 pp over the period. As a combined result of the slowdown in domestic demand and the competitiveness gains stemming from the lower spending pressure, the contribution of the external sector would improve by 0.4 pp thanks, above all, to the containment of imports. Second, the effects of a decline in house prices, with respect to the baseline, were simulated. The decline was calculated in order to have the same effect on GDP after six years as the 1 pp increase in interest rates. As seen in the second line of the table, the effect on the net contribution of the external sector is similar to that of the first simulation. Both results suggest that the model, in the absence of other shocks, enables a relatively robust relationship between the changes in aggregate demand and the changes in net exports to be captured.

9. See E. Ortega, P. Burriel, J.L. Fernández, E. Ferraz and S. Hurtado (2007): *Actualización del modelo trimestral del Banco de España*, Working Paper No 0717, Banco de España.



Thus, using the elasticities implicit in the exercise performed, a slowdown in aggregate demand involving a 1 pp fall in the annual GDP growth rate relative to the baseline would, in the absence of other changes, increase the contribution of the external sector by 3 pp after six years and would reduce the goods and services deficit by somewhat more than 2 pp of GDP over the same period. These results suggest, while bearing in mind the particular limitations of this kind of simulation with macroeconomic models, that the adjustment of spending through its direct effect on the demand for imports and competitiveness has a slow, though significant effect on the external imbalance.

whose magnitude will depend on the advances made on the supply side.

Naturally, the effect of the slowdown in domestic demand on the correction of the external deficit would be more pronounced if it were accompanied by improvements in the efficiency of the economy. To illustrate this, two other simulations have been performed in which increases in the supply response capacity are introduced exogenously, through productivity increases, in one case, and profit margin containment in the other. The third line of Table 2.3 presents the results of a simulation that assumes a permanent increase in total factor productivity (TFP) of 1 pp above baseline levels. As seen, the assumed shock would involve cumulative competitiveness gains (measured by the GDP deflator) of 2.8 pp, and would also boost economic activity. However, the expansionary effect is moderate (0.7 pp of GDP, in cumulative terms) despite the fact that potential growth is increased by the shock. This is because of the inhibiting effects that technological improvements have on investment and job creation in the short term in this type of model. In any event, the increase in productivity would involve a cumulative deviation in the contribution of net exports to output of 0.3 pp, primarily as a consequence of the impact of the competitiveness gain.

In the last line of the table, instead of the increase in TFP, lower growth of profit margins is assumed. This growth is calculated so as to have the same cumulative effect on the GDP deflator after six years. The impact of this shock on economic activity is somewhat smaller than that caused by the increase in TFP, owing to the depressive effect on investment of the lower growth in surpluses. On the other hand, the upward deviation in the contribution of the external sector is more pronounced in the case of the margin shock, as a consequence of its greater contractionary impact on the demand for imports.

The level reached by the Spanish economy's external deficit is the result of an expansion in the net borrowing of firms and households that has been able to exceed what might be attributable to the foreseeable growth of future income and, therefore, to lead to a downward revision in resident agents' spending plans. The simulations show significant sensitivity on the part of the external deficit to the slowdown in demand and to the competitiveness improvements that this may generate, so that it would be feasible for the adjustment process to be compatible with the maintenance of an appreciable degree of dynamism. This process may occur, therefore, in such a way that the imbalances accumulated after so many years of expansion are gradually and smoothly reabsorbed, without a sudden halt to growth. For this to be the case, the adjustment should logically include a slowdown in consumption and investment demand which would help contain the indebtedness of firms and households, as well as an increase in competitive pressure in sheltered sectors to facilitate the containment of margins and convergence of productivity growth with the levels prevailing in the euro area as a whole. Naturally, the larger the improvements on the supply side and in the competitiveness of the economy, the greater the economic momentum that will be compatible with the adjustment in resident sectors' net borrowing.



### 3 THE EXTERNAL ENVIRONMENT OF THE EURO AREA

## The external environment of the euro area

### 1 Overview

#### 1.1 THE WORLD ECONOMY IN 2006

The world economy once again posted strong growth with moderate inflation, despite the less expansionary stance of macroeconomic policies.

During the year the expansion became more balanced across the developed countries.

Oil prices fluctuated strongly...

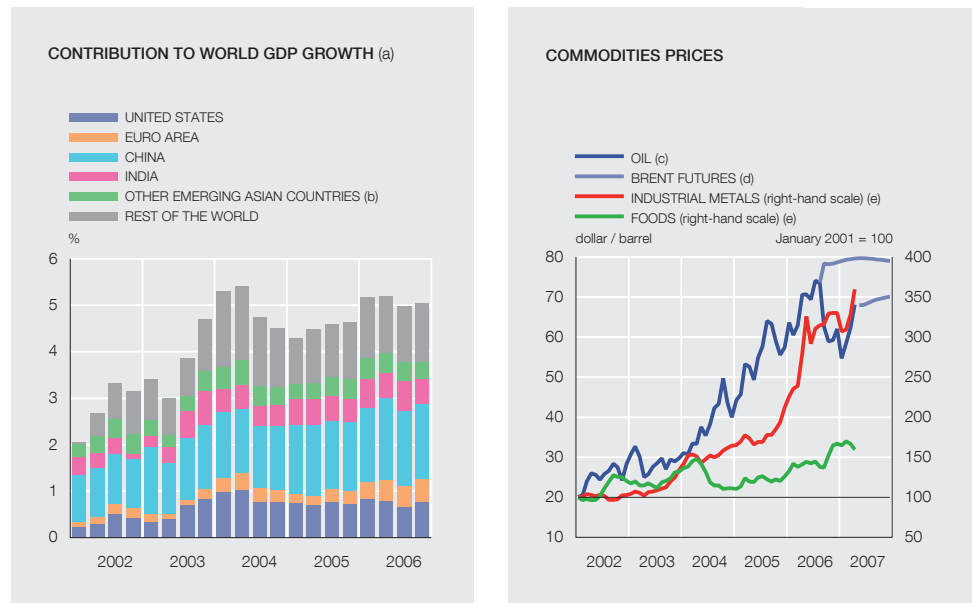
but inflation remained contained and there continued to be no discernible second-round effects.

In 2006 the world economy once again posted high growth, in a setting of moderate inflation, underpinned by favourable financial conditions. The upturn continued despite the rise in oil prices for much of the year and the less expansionary stance of macroeconomic policies. However, after four consecutive years of expansion, the cycle has reached a more mature stage in some economies, prompting greater uncertainty over the course activity and economic policies may take in the future. This is particularly the case of the United States, where the maturation of the cycle has become patent in conjunction with a slowdown in the real estate market. Financial markets generally behaved favourably, with substantial rises in asset values, although the bouts of turbulence in mid-2006 and early 2007 were a reminder that a sharp correction in the prices of certain assets remains a possibility, especially following the long period of low volatility and strong demand for riskier investments. Global imbalances have not only not been corrected, but have even increased slightly. Inflation rates held at moderate levels and the pass-through of energy cost increases to core inflation was limited. However, the gradual absorption of productive slack in many economies raises fears of greater pressures on prices in the future.

Over the year as a whole the growth rate of the world economy was 5.4% (see Chart 3.1), 0.5 pp up on 2005 and 0.1 pp more than in 2004. As the year unfolded, the gradual slowdown in the US economy, along with the pick-up in the euro area and in the United Kingdom, and the firming of activity in Japan, led to greater balance among the growth rates of the developed economies, although this progressive homogenisation remains somewhat obscured in terms of annual averages (see Table 3.1). The fact that the economic weakening in the United States was centred on the residential sector, which is relatively closed, and the continuation of benign financial conditions mitigated the transmission of this slowdown to other economies. The emerging economies continued to expand. Chiefly to the fore were the Asian economies, particularly China and India, which together directly contributed 43 pp to world growth, compared with 12 pp in the case of the United States. Also of note was the acceleration in Latin America and in Eastern Europe. In any event, these last three years have seen the most globally dynamic period since 1970, a fact attributable, among other factors, to the acceleration in productivity, especially in the developing economies, underpinned largely by the far-reaching reallocation of resources and factors occurring worldwide.

Oil prices remained high throughout 2006 (see Chart 3.1). For the year on average, the price of a barrel was \$66, 20% up on the previous year. The price moved in two clearly differentiated stages. During the first, it increased by 35% on the end-2005 level, reaching an all-time high in August of over \$78 per barrel, due essentially to the geopolitical pressures on some of the main producer areas. From September, the upward trend reversed, and oil prices ended 2006 at a similar level to the close of 2005, at around \$60 per barrel. The easing of activity in the United States, the increase in non-OPEC output, crude oil stocks and the exceptionally mild winter in the northern hemisphere all contributed to the reduction in price in the closing months of the year. Metal prices rose significantly due to strong world demand and to their attractiveness as an investment class, while the cost of agricultural commodities grew more moderately. Into 2007, oil prices rose again, due once more to geopolitical factors.

Despite higher commodities (including energy) costs, prices trended moderately (see Chart 3.2) and most economies were able to square continuing low inflation with high growth rates. Several factors have contributed to making this possible. First, the reduction in tradeable



SOURCES: National statistics, Goldman Sachs and IMF.

- a. Contribution in percentage points to the annual change in world GDP, calculated drawing on the data of 56 countries, accounting for 91% of world GDP.  
 b. Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines.  
 c. Brent crude.  
 d. Brent futures as at 7 August 2006 and average for the week 9-13 April 2007.  
 e. Goldman Sachs indices.

goods prices, owing both to the direct effects of import penetration from the emerging countries and to the greater competition this entails. Next, the containment of wage growth, largely attributable to the impact of migratory flows and the globalisation of production on local labour markets. And finally, the anchoring of inflation expectations at a lower level, as a result of the credibility gained by central banks. Core inflation was slightly higher than in 2005 owing to the acceleration in industrialised countries' prices, where less spare capacity prompted, moreover, a gradual increase in inflation expectations. As to inflation across the different regions, core inflation in the emerging countries notably drew closer to the rates prevailing in the industrialised economies (see Chart 3.2), when foreseeably the real convergence processes under way in the former should have led to a positive inflation differential if these countries' currencies did not appreciate substantially.

Most central banks raised their official interest rates...

Against the background of the maturation of the business cycle and of a certain rise in underlying inflationary pressures, the central banks of the main developed economies and of most emerging countries raised their interest rates in the first half of the year (see Chart 3.3), giving rise to a progressive withdrawal of the monetary policy stimulus. From the summer, some central banks sidelined this process, as they faced a situation of greater uncertainty over developments in prices and activity, which made the future course of monetary policies less predictable. This was the case of the United States, where the Federal Reserve had to strike a difficult balance between persistent inflationary pressures and activity that was weakening as the year unfolded. It duly left its official interest rate stable at 5.25% as from June. The Bank of Japan, meanwhile, set about progressively normalising its monetary policy, taking advantage of the sustained economic recovery and the signs of the economy emerging from deflation. The Japanese monetary authorities abandoned quantitative goals in favour of a target for the overnight interbank interest rate, which increased in July from 0% to 0.25%, for the first time since 2001, rising to 0.50% in February 2007. However, the uncertainty over the inflation rate taking root in clearly positive ter-

	2002	2003	2004	2005	2006
UNITED STATES					
GDP	1.6	2.5	3.9	3.2	3.3
CPI (a)	1.6	2.3	2.7	3.4	3.2
Current account balance (% of GDP)	-4.5	-4.8	-5.7	-6.4	-6.5
General government balance (% of GDP)	-3.8	-4.8	-4.6	-3.7	-2.6
JAPAN					
GDP	0.3	1.4	2.7	1.9	2.2
CPI (a)	-0.9	-0.2	0.0	-0.6	0.2
Current account balance (% of GDP)	2.9	3.2	3.7	3.6	3.9
General government balance (% of GDP)	-8.0	-8.0	-6.2	-4.8	-4.3
UNITED KINGDOM					
GDP	2.1	2.7	3.3	1.9	2.7
CPI (a)	1.3	1.4	1.3	2.0	2.3
Current account balance (% of GDP)	-1.6	-1.3	-1.6	-2.4	-2.9
General government balance (% of GDP)	-1.6	-3.2	-3.1	-3.0	-2.5
CHINA					
GDP	9.1	10.0	10.1	10.4	10.7
CPI (a)	-0.8	1.2	3.9	1.8	1.5
Current account balance (% of GDP)	2.4	2.8	3.6	7.2	9.1
General government balance (% of GDP)	-3.0	-2.4	-1.5	-1.3	-0.7
LATIN AMERICA (b) (c)					
GDP	0.1	2.3	6.3	4.5	5.3
CPI (a)	9.4	10.9	5.9	6.2	5.2
Current account balance (% of GDP)	-0.3	0.9	1.2	1.7	1.9
General government balance (% of GDP)	-4.8	-1.9	-0.7	-0.6	-0.5
NEW EU MEMBERS (b) (d)					
GDP	2.7	4.1	5.2	4.9	6.2
CPI (a)	2.7	2.1	4.1	2.5	2.4
Current account balance (% of GDP)	-4.4	-4.1	-5.6	-3.9	-4.9
General government balance (% of GDP)	-4.8	-4.8	-3.5	-3.0	-3.4
MEMORANDUM ITEM: GDP growth					
World	3.1	4.0	5.3	4.9	5.4
Euro area	0.9	0.8	1.8	1.5	2.8

SOURCES: Banco de España, IMF and national statistics.

a. Annual percentage change in CPI index.

b. The aggregate for the different areas has been calculated using the weight of the countries making up such areas in the world economy. Based on IMF information.

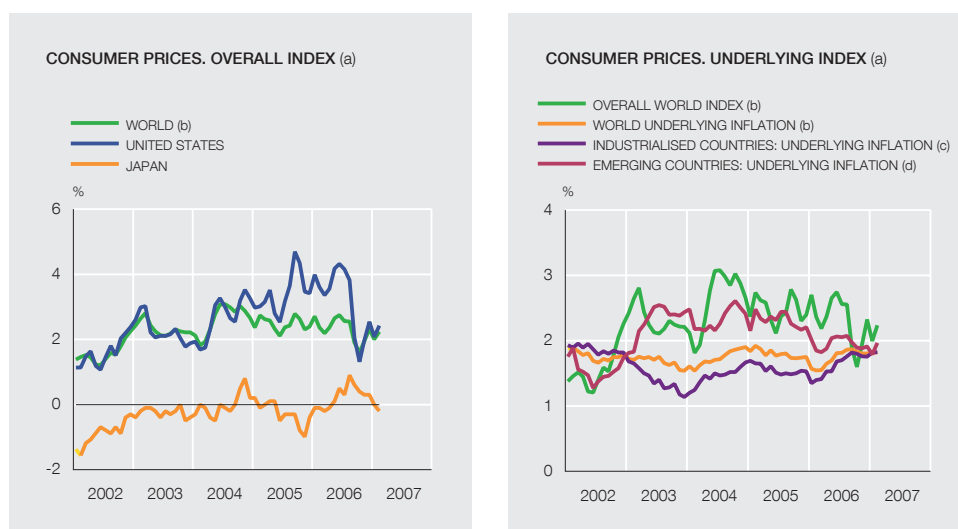
c. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.

d. Latvia, Lithuania, Estonia, Czech Republic, Hungary, Poland, Slovenia, Slovakia, Cyprus and Malta.

ritory has slowed the process of interest rate increases. Official rates in the euro area continued their gradual ascent and also trended upwards in the other EU countries. In the main emerging economies, with the notable exception of Brazil, there were likewise rises in official interest rates. Many central banks pursued their strategies of accumulating international reserves, aimed essentially at containing the appreciation of their currencies, although in some cases they encountered growing problems managing the resulting increase in liquidity.

and fiscal balances improved across the board.

Turning to fiscal policy, budget deficits tended to be corrected in the main developed and emerging economies (see Chart 3.3). This reduction was the outcome, in many cases, of the unusual strength of public revenue, rather than of expenditure-curbing measures. Indeed, in many countries - including the United States - revenue growth exceeded what might be attributed to the sound economic situation, according to historical elasticities, for reasons that



SOURCES: National statistics and Banco de España.

a. Annual rates of change.

b. Aggregate calculated drawing on the data from 30 countries, accounting for 70% of world GDP.

c. United States, Canada, Japan, Euro area, United Kingdom, Denmark, Norway and Sweden

d. Brazil, Chile, Mexico, Poland, Hungary, South Korea, Thailand and South Africa.

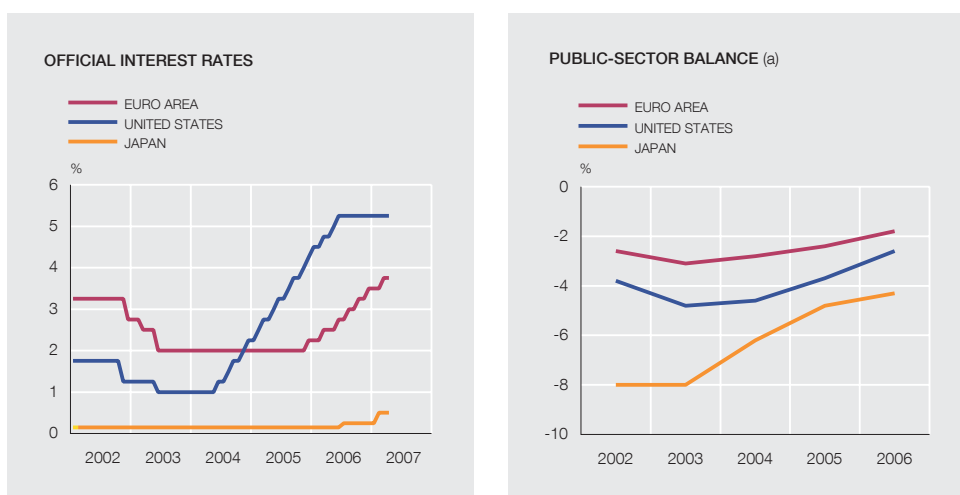
are not sufficiently known and which cannot be ruled out as being temporary. Accordingly, although the habitual measures of the cyclically adjusted structural balance improved substantially, which would in principle be indicative of a less expansionary fiscal policy stance, it is difficult to attribute this improvement directly to greater fiscal consolidation. Among the emerging economies, fiscal policy retained a relatively disciplined stance in Latin America, though this was also assisted by the exceptional increase in revenue, while in the new EU countries and in Asia it was pro-cyclical.

International trade quickened in 2006, despite the obstacles to progress in the Doha Round.

International trade quickened in 2006, especially in the first half of the year. It was driven by world demand and posted a growth rate of 9.2%, compared with 7.4% in 2005. The Doha Round multilateral negotiations were suspended in the second half of the year in view of the lack of agreement on matters such as agricultural policies, which accelerated the signing of regional or bilateral agreements observed among smaller economies. The efforts by the World Trade Organisation in early 2007 to re-launch the multilateral talks give room for some hope about the possibility of steering the trade liberalisation process in this area, making it compatible with the progress in bilateral and regional agreements (see Box 3.1). However, protectionist pressures can be seen to be emerging in several countries, sustained in part by the persistence of burgeoning external imbalances and by the perception that the exchange rates of some Asian economies are notably below what may be considered equilibrium values.

The dollar and the yen depreciated slightly in real effective terms...

The dollar depreciated by 4% in real effective terms between December 2005 and April 2007. The depreciation took place mainly in the second half of 2006, in response to the doubts raised over US growth and expectations of a progressive narrowing of the short-term interest-rate differentials against currencies such as the euro and sterling. The yen depreciated by 7% in real effective terms during this period, partly as a result of the downward revision of expectations of a rise in Japanese official rates, which took place as from Q3. Most of the emerging economies' currencies appreciated against the dollar. In particular, the Chinese renminbi climbed 4.5% against the dollar between December 2005 and April 2007, although its real effective exchange rate held virtually stable.



SOURCE: Datastream.

a. (+) surplus, (-) deficit.

despite which global imbalances continued to widen.

Despite the depreciation of the dollar in real terms, and the progressive geographical redistribution of growth during the year, global imbalances widened further in 2006 (see Chart 3.4). In the United States, the current account deficit widened by 0.1 pp to 6.5% of GDP. The counterpart of the increase in the US external deficit was the rise in the surpluses of the oil exporting countries, China and, to a lesser extent, Japan. As a result, the anomalous situation whereby the emerging countries cover the net borrowing requirements of certain industrialised countries continued. That said, headway was made in the strategy for the multilateral resolution of global imbalances (outlined, among others, by the International Monetary Fund); there was a partial correction of the US fiscal deficit and a reduction – the first in six years – in its net oil trade deficit, a moderate appreciation by the Asian currencies and a pick-up in growth in Europe and Japan, although there has not been substantial progress in structural reforms in these regions.

Capital inflows and the accumulation of reserves remained high in the emerging economies.

Net capital flows towards the emerging economies remained high (see Chart 3.4), though slightly down on 2005. The combination of capital inflows and high current account surpluses translated into a brisk rate of accumulation of reserves in cases such as China (where international reserves exceeded \$1 trillion), other Asian countries and Latin America. The Central and Eastern European countries were once again the main recipients of net capital flows and, at the same time, this was the only emerging region to post current account deficits. In the oil exporting countries, in contrast, net capital outflows were recorded, but the substantial size of their external surpluses made for a strong increase in their international reserves. In the emerging economies as a whole, foreign direct investment inflows continued to be very sizeable, both in gross and net terms. But the strong increase in direct investment from the biggest emerging economies towards other countries, including in some cases the developed nations, is striking; indeed, some of them, such as Brazil, posted a negative net balance.

## 1.2 THE CONTINUATION OF BENIGN FINANCIAL CONDITIONS

The financial markets performed favourably in 2006...

The financial markets once again recorded very favourable results – with the prices of most assets higher – in 2006, supported by the expansion of activity and improved economic fundamentals. In particular, the growth of corporate earnings, companies' sound financial position, the continuation of a historically low default rate (both for companies and households) and the reduction of financial vulnerability in most emerging economies all contributed to these favourable results.

The mission of the World Trade Organisation (WTO), founded in 1995 and preceded by the General Agreement on Tariffs and Trade (GATT) created in 1948, is to promote international free trade in goods and services. Like the GATT, its aim is to coordinate the lowering of the international trade barriers set up between the First and Second World Wars.

The need for this coordination is explained by the incentives in place for unilaterally imposing and maintaining trade barriers.<sup>1</sup> Multilateral negotiations based on the principle of reciprocity make it possible to align each country's incentives to lower its own trade barriers since these negotiations make it easier for domestic producers to gain access to foreign markets, partly offsetting the losses of the domestic market share. In this setting, the optimal protection level is lower than if it had been set unilaterally and could even be zero.

In the first three multilateral rounds of the GATT (Kennedy, Tokyo and Uruguay), considerable reductions were made to tariff (see accompanying panel 1) and non-tariff barriers. At the same time, numerous bilateral agreements were signed (between countries, commercial blocs or both), trade barriers were reduced unilaterally and a tendency towards regionalism emerged (customs unions and free trade areas). Multilateralism, regionalism and unilateralism developed in parallel in the years preceding Doha and regional agreements were viewed as a move towards international free trade complementing multilateralism.

However, the last meeting of the WTO Doha Round in July 2006 ended with negotiations on goods grinding to a halt and the liberalisation of services not even being discussed. At this meeting, the group of developed countries (Australia, the European Union, Japan and the United States) and several emerging countries (Brazil and India) did not reach any agreement on agricultural protection

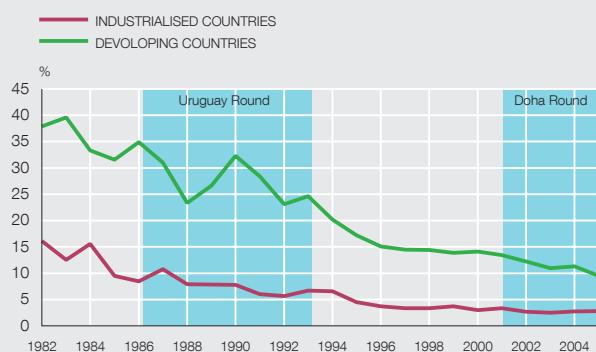
and subsidies to agriculture, which preempted any debate on greater access for non-agricultural products or services.

This deadlock in multilateral negotiations can be partly attributed to the change in the role of regionalism, which has progressed from complementing multilateralism to replacing it. The largest regional blocs seem to prefer to negotiate directly with countries, since this increases their bargaining power relative to multilateral rounds. The disadvantage here is that regionalism might now pose an obstacle to international free trade at the global level. This switch in the role of regional agreements may be due to several factors. Firstly, these agreements, conceived initially as an exception regime in relation to multilateral agreements, have become more common and involve a larger number of countries than in previous rounds (see panel 2). Since regional agreements frequently have different rules to the WTO, they may be incompatible with proposals in multilateral negotiations, for example rules of origin for imports.<sup>2</sup> Secondly, countries which have already signed regional agreements may bring pressure to bear against tariff reforms based on the "most favoured nation" principle (compulsory within the WTO), as they may reduce their domestic tariffs thus weakening the future development of international trade liberalisation. Thirdly, also partly due to the differences in bargaining power between the blocs, trade liberalisation has been relatively asymmetrical since it includes in particular the industrial sector, sidelining agriculture and certain manufacturing industries such as the textile sector and services.<sup>3</sup> In particular, industrialised countries that have already signed regional agreements have fewer incentives to participate in multilateral negotiations including developing countries with small markets that are highly dependent on agricultural and textile exports. The

1. See, for instance, K. Bagwell and R. Staiger (2002) "The Economics of the World Trading System" MIT Press, and G. Grossman and E. Helpman (2002), "Special Interest Politics", MIT Press.

2. Rules of origin are the requirements a product must fulfil in order to be considered to have originated in a place or area, which determine that cross-border trade in such products may take place in accordance with free trade agreements. 3. On 1 January 2005 the export quota system for textile products envisaged in the Multifibre Agreement was eliminated. However, following the elimination of quotas, this sector is still subject to high tariff barriers.

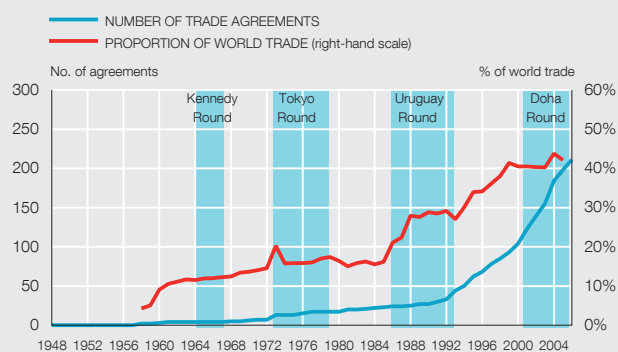
1. AVERAGE TARIFFS (a)



SOURCE: World Bank.

a. Weighted average according to the value of each country's imports.

2. REGIONAL AGREEMENTS REPORTED TO WTO





foregoing has detracted from multilateralism and its potential for providing for international trade liberalisation.

In view of the gradual progress in regional agreements and the impasse in multilateral negotiations, the WTO might need to rethink its strategy. A first option could be to tie the liberalisation of services to that of goods during multilateral negotiations in order to increase the appeal for industrialised countries of multilateral agreements encompassing the textile and agricultural sectors. The WTO can also play an important role enhancing the contribution of regionalism to international free trade, if it evaluates and provides guidance on the consequences of future regional agreements and the enlargement of existing agreements. In particular, in view of the complexity of the current agreements in place, whose legal and eco-

nomical rationale is very subtle, the WTO could offer guidance on their design so that they truly contribute to the goal of international free trade. Thirdly, the many regional agreements differ to a large extent in their application of rules of origin and accumulation and, consequently, the WTO could play an important role in coordinating and standardising them. Lastly, the WTO could promote the creation of customs unions (with a common external tariff) instead of free trade areas (with different external tariffs for their members), which would lead to a reduction in tariffs and, in turn, would lessen the power of national lobbies and the complex nature of rules of origin. That would contribute both to the expansion of existing regional agreements and to their accumulation or superimposition, thus moving closer towards the ultimate aim of the WTO which is to achieve the liberalisation of international trade.

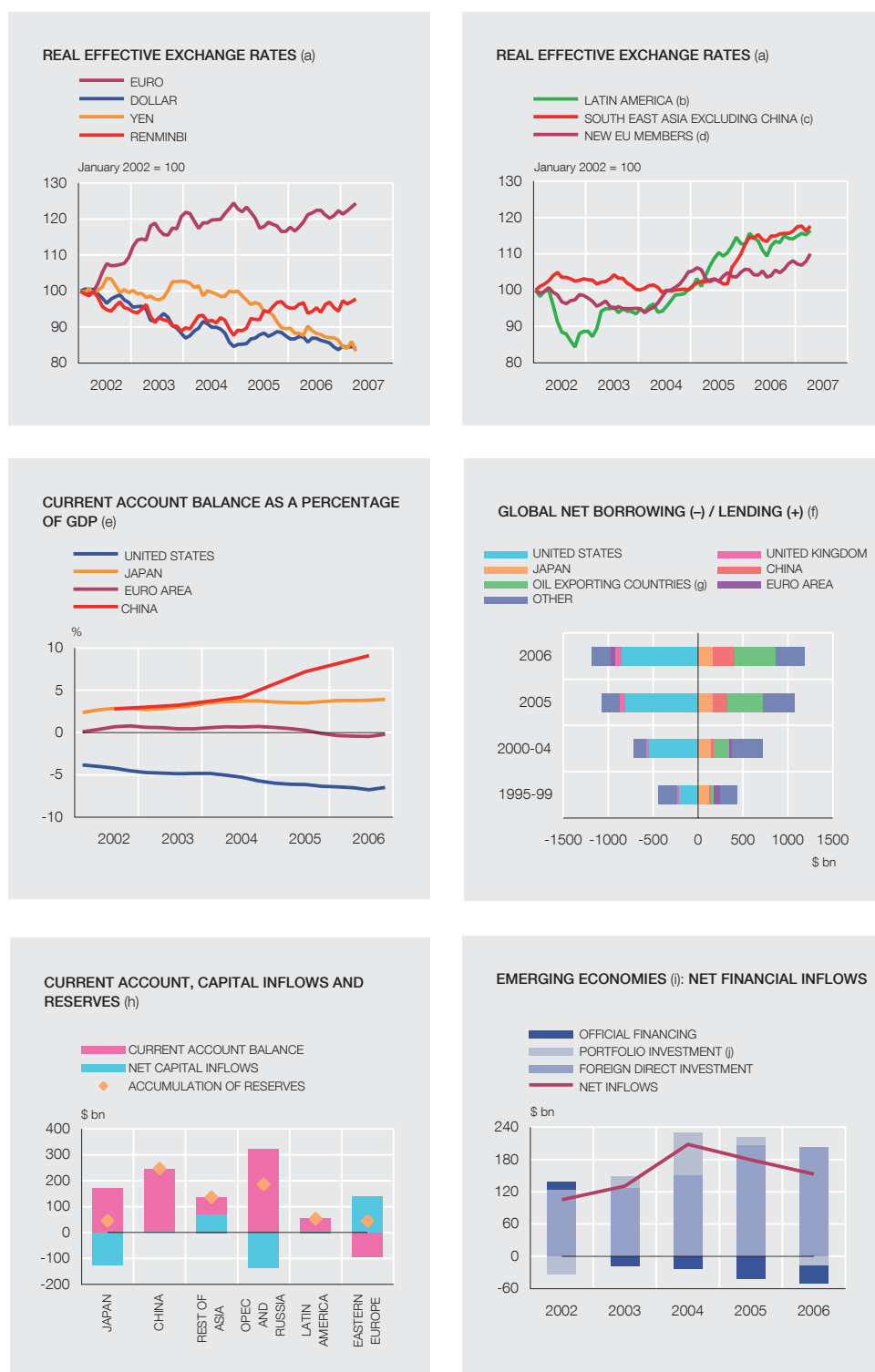
and financial conditions remained generous, despite the less accommodative monetary policy stance...

Against this background, financial conditions remained notably generous, despite the increase in official interest rates. Nominal long-term interest rates rose only slightly in the first half of 2006, easing subsequently to stand in December at 4.8% in the United States, 4% in the euro area and 1.8% in Japan, figures only slightly up on end-2005. After starting 2007 on a slight uptrend, long-term interest rates fell once again during the bout of volatility on the financial markets in early February. Since short-term nominal interest rates tended to increase in line with official rates, the slope of the yield curve, though remaining positive, fell in the main areas, while its negative slope steepened in the United States (see Chart 3.5). As a result, the behaviour of long-term interest rates continued to differ from what might be expected on the basis of the increase in official interest rates, the pressure of budget deficits (which, albeit somewhat reduced, remained significant) and long-term world growth and inflation prospects.

It is difficult to find reasons that fully explain the continuation of comfortable financing conditions globally, which are reflected not only in the low level of long-term rates, but also in low risk premia and in high traded asset prices. However, several factors may have contributed to this, including most notably the growing sophistication and integration of financial markets (which provide for greater leverage and risk dispersion), carry trade operations (where investors borrow funds in currencies with low interest rates to invest them in higher-yielding markets), reserve accumulation policies in numerous emerging markets and the recycling of oil exporting countries' revenues on international financial markets.

which continued to underpin the rising value of financial assets globally and of real estate assets in some countries...

As indicated, low long-term interest rates fuelled the search for returns, including among the riskiest assets. And in combination with the overall soundness of the economy, they helped prop up the rise in real and financial asset prices, which was also a reflection of the additional squeeze on risk premia, which had already begun the year at unusually low levels. Stock exchanges in the developed countries performed very favourably, underpinned by the soundness of corporate earnings, and those in the emerging countries surged, reaching all-time highs in some cases (see Chart 3.5). Corporate bond and sovereign debt spreads in the emerging countries, calculated in relation to the US 10-year bond, tended to narrow across the board, recording all-time lows. Another feature of the behaviour of financial markets was the persistence of implied and actual volatility at historically low levels. Finally, real estate prices continued to show notable



SOURCES: JP Morgan, national statistics and IMF.

a. CPI-based. An increase (decrease) denotes an appreciation (depreciation) of the currency.

b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.

c. Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Philippines, Singapore and Taiwan.

d. Czech Republic, Hungary, Poland, Slovenia and Slovakia.

e. (+) surplus, (-) deficit.

f. In 2006 dollars.

g. OPEC countries plus Russia and Norway.

h. For Latin America, data on net external assets have been used, which include both changes in reserves and operations with multilateral agencies.

i. Latin American and Caribbean countries, Central and Eastern Europe and Emerging Asia.

j. Including bank loans.

growth rates in some economies, though there was some deceleration during the year, especially in the United States. The increases in wealth stemming from higher asset prices were an additional spur to consumption and, to a lesser extent, to investment.

although there were two sharp, but transitory, corrections on the markets.

The favourable behaviour of financial markets was temporarily interrupted in May 2006 and February 2007 by bouts of turbulence which, though they exhibited some significant differences, both highlighted the possible consequences of an unexpected increase in risk premia and a sudden shift by investors towards safer instruments. In both cases, trigger factors included, in part, uncertainty over the US macroeconomic outlook. In the most recent case, such uncertainty particularly affected stock markets and had less impact on the lowest graded bonds and emerging market sovereign issues. The availability of financing on favourable terms and low volatility may have lessened investors' caution about purchasing the riskiest assets. In this respect, the episodes in 2006 and 2007 were a reminder of the risks associated with investment in certain types of assets. Moreover, the overcoming of these episodes and the absence of contagion in the face of other events, such as those in Thailand in the second half of 2006, or the economic policy uncertainty in Ecuador and Bolivia, have offered positive signs of the resilience of markets and of the world economy in situations of stress. Even so, doubts remain over the extent to which the rises in financial assets reflect solely the improvements in economic fundamentals, or whether they respond also to an overly optimistic assessment of economic conditions and prospects.

### 1.3 OUTLOOK AND RISK FACTORS

The central scenario for the world economy for 2007 points to the continuation of recent trends...

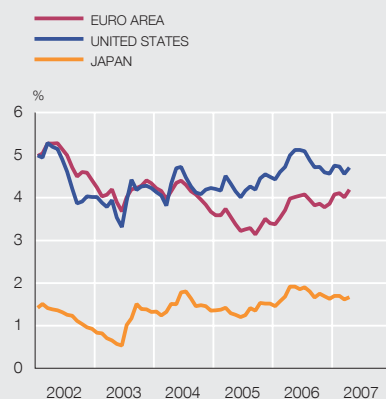
The central scenario for 2007 is for the prolongation of the phase of high dynamism in the world economy - although the pace of world growth is expected to ease slightly - and contained inflation rates. Projected developments in the different economic areas point, moreover, to a more balanced geographical distribution of growth, since the US economy is expected to slow more sharply, set against more sustained growth in other developed or emerging economies. The effect of the monetary policy decisions adopted in 2006 and in early 2007, along with the slight slowdown in the rate of expansion of the world economy (which would contribute to containing energy costs), would enable the pressures on prices arising from higher capacity utilisation to be checked.

with risks from previous years remaining in place alongside new ones, such as that related to a greater-than-expected slowdown in the United States.

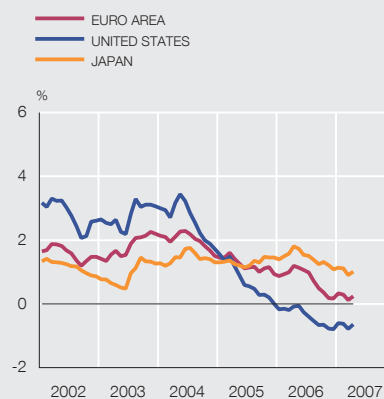
Surrounding this favourable central scenario are downside risks to world growth. Some are from previous years, such as a possible disorderly adjustment of global imbalances - a risk to which the growing difficulties of some Asian economies in managing strong capital inflows are, at the current juncture, contributing - or the possibility of a sharp correction in financial assets and real estate prices. To these should be added the possibility of a sharper-than-expected economic slowdown in the United States, with potential knock-on effects for the rest of the world economy. Inflationary risks remain biased upwards, owing to the maturation of the business cycle.

The United States faces the possibility that the adjustment under way in its real estate sector will ultimately affect the rest of the economy more acutely, especially if it has an impact on private consumption. Further, corporate investment has recently been rather sluggish, which heightens the possibilities of a sharper slowdown. Given this prospect, it should be considered to what extent other economies, such as China, the euro area and Japan, are better placed - on the basis of stronger domestic demand and favourable global financing conditions - than in the past to withstand the adverse impact of a slowdown in the United States. Questions remain in this respect, especially if the economic weakness in the United States is accompanied by an increase in protectionist pressures. Hence the importance of pursuing and entrenching progress in the liberalisation of world trade and, in particular, of resuming the Doha Round negotiations.

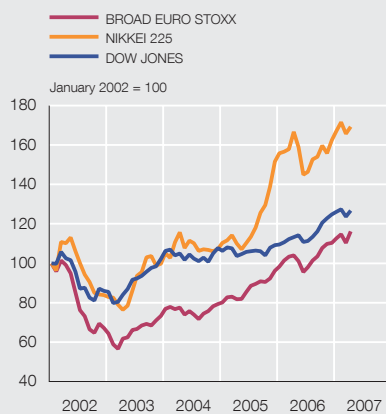
TEN-YEAR GOVERNMENT BOND YIELDS



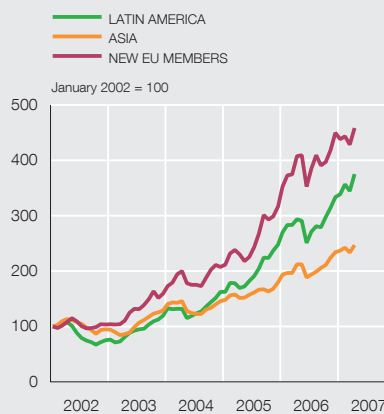
10-YEAR/3-MONTH INTEREST RATE SPREAD



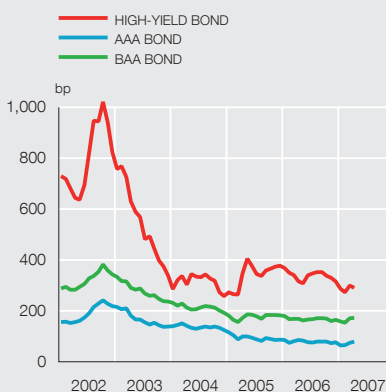
STOCK MARKET INDICES



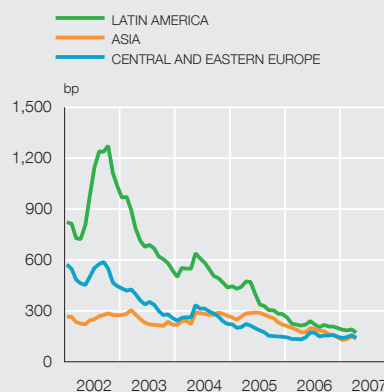
STOCK MARKET INDICES



UNITED STATES. SPREADS OVER TEN-YEAR TREASURY BOND (a)



SOVEREIGN DEBT SPREADS (b)



SOURCES: Banco de España and Bloomberg.

a. Moody's BAA and AAA industrial bonds and Lehman Brothers' high-yield bond.

b. EMBI + for Latin America and Global EMBI for Asia and Central and Eastern Europe.

There are risks of more acute inflationary pressures, owing to the maturation of the upswing...

The upside risks to prices may have increased in step with higher capacity utilisation levels, as the expansionary cycle matured. Many economies have attained low unemployment rates, which might be conducive to a rise in wages, in a setting in which the share of wages in national income has been falling back in recent years. Moreover, the increase in world productive capacity owing to the incorporation of the emerging economies into the global economy might begin to ease off, if some of the pressures towards greater protectionism materialise.

in a setting of uncertainty over the course of oil prices.

The course of oil prices is a further factor of uncertainty, though one perhaps less pressing than in previous years. Some elements would point to an easing in prices in 2007, as a result of less dynamic world demand and of the progressive coming on stream of the investment to increase production and refining capacity undertaken in recent years. It should be borne in mind here that some emerging economies might be significantly affected by a decline in the value of crude and other commodities. However, it is likely that volatility on these markets will remain high and episodes of rising oil prices linked to geopolitical tensions and other factors cannot be ruled out. The materialisation of this risk, against a background of high capacity utilisation, might entail a more marked pass-through to the prices of other products.

In the financial realm, there remains the possibility of a sharp and lasting readjustment in asset prices...

As earlier mentioned, the possibility of a sharp realignment in the prices of certain financial assets - whose valuations are tight relative to their fundamentals - in the face of a rise in interest rates or in risk premia, is a factor of notable uncertainty. Insofar as the valuation of these assets is underpinned by the availability of low-cost financing sources and by an excessively complacent view of risks, following a long period of low volatility on the markets, the reversal of any of these characteristics might lead to a substantial and generalised re-evaluation of risks by financial investors and by other economic agents. Further, the probability of bouts of volatility may have increased against the background of the maturation of the world business cycle, where uncertainty over the future course of global activity and economic policies increases.

which might combine with an adjustment in the global imbalances.

A possible adjustment in the price of financial assets may be amplified by the continuation of growing global imbalances, which would have serious repercussions on global activity. In addition, the risk (referred to in previous reports) remains that the towering US current account deficit will cease to be smoothly financed, especially if the size of this deficit continues to increase. The need to absorb a substantial amount of capital flows from the rest of the world might prompt a sharp increase in US long-term interest rates, which would spread to other parts of the world. Adding to this are the increasingly recurrent pressures assailing the Asian economies, and in particular China, regarding exchange rate policies, the accumulation of reserves and the management of capital inflows, as this region has been pivotal in financing the US external deficit.

In addition to closely monitoring these factors of risk, complacency is to be avoided on the part of economic agents, both public...

Lastly, in addition to these factors of risk, it should be borne in mind that, following a long economic boom period, excessive confidence and complacency on the part of both public and private economic agents may arise, prompting decision-making without an appropriate assessment of risks. The expansionary phase may lead governments to postpone the reforms needed to ensure sustained growth, especially those that are necessary in the fiscal field to address medium- and long-term demographic challenges. As mentioned, the improvement in public finances has been chiefly due to the exceptional expansion of revenue, rather than to consolidation measures. However, it is precisely in economic boom periods when it is most appropriate to implement such reforms, since it is easier to soften the perception of costs that the reforms entail. Also, although the control of inflationary pressures during the recent economic growth phase is due in part to the firm anchoring of inflation expectations brought about by the action of the monetary authorities, the contribution to price containment of growing economic and financial integration internationally and of the incorporation of emerging econo-

mies into the global productive process should not be underestimated. The attendant favourable effects may not be felt with the same intensity in the future.

and private alike.

As regards private agents, the prolongation of the economic expansion may have excessively lessened the likelihood such agents attribute to a crisis occurring, and it may have led them to overestimate the capacity of the financial markets to absorb episodes of turbulence. Regarding the first point, the fact that the risks noted over recent years have not materialised to date does not necessarily lessen the likelihood that they will do so; on the contrary, the persistence of these risks might mean that they materialise with greater virulence, as might be the case of a disorderly adjustment of global imbalances. Nor should the resilience of financial markets in the face of the turbulence in 2006 and early 2007 lead one to conclude that they can absorb any shock, no matter how forceful. In particular, financial innovations, though they have provided for greater risk diversification (a feature welcome in any economy), have also given rise to a distribution of risks which, in some respects, is complex for supervisory agencies to monitor and whose derivations have not been put to the test in a crisis.

## 2 United States

US GDP grew strongly once again in 2006, although the cooling in the real estate market dragged the pace of activity down in the second half of the year;

The key features of the US economy in 2006 were the cooling in the real estate market and the robustness of private consumption, which saw GDP quicken by 0.1 pp on 2005 to a growth rate of 3.3%. However, the rate of expansion of activity, dragged down by the decline in residential investment and the sluggishness of spending on capital goods (see Chart 3.6), dipped significantly from Q3 to below the rates recorded in recent years.

nonetheless, consumption remained robust.

Despite the notable slowdown in house prices and the adjustment in the real estate sector (see Box 3.2), households continued to maintain a high rate of consumption, underpinned by the robustness of the labour market. The unemployment rate was on a clearly declining trend for much of the year, stabilising at around 4.5% in late 2006 and early 2007, as the buoyancy of new hires in services amply offset the decline in employment in the manufacturing sector. The sound performance of the stock markets was also supportive of consumption, cushioning the effect of the less favourable trend of real estate wealth; indeed, as a proportion of disposable income, net household wealth continued growing significantly in 2006 (see Chart 3.6). The household saving ratio fell further, since the increase in consumption once again exceeded that in household income.

Investment held at a moderate rate and the external sector improved.

Running clearly counter to the confidence shown by households, corporations adopted a more cautious stance, despite the rapid growth in corporate earnings. As a result, business investment fell in Q4. Against a background of highly favourable financial conditions, the weakness in investment in capital goods might account for the uncertainty over the future course of the economy. The external sector showed some improvement in 2006, in real terms. The acceleration in exports and the easing in imports meant that the contribution of external demand to GDP growth was virtually zero in 2006 as a whole, for the first time in the last decade. However, the trade deficit widened further, and this, along with the deterioration in the incomes balance, which turned negative, led the current account deficit to increase by 0.1 pp to 6.5% of GDP.

The Federal Reserve concluded the upward interest rate cycle, although inflationary risks have not fully tailed off and the fiscal balance improved.

Inflation increased significantly in the first half of 2006, in both its headline (4.3% in June) and core (2.9% in September) measures. The rise was due to high energy prices, the increase in owners' equivalent rents and the high degree of resource utilisation (patent, among other indicators, in the continuing very low unemployment rate and incipient wage pressures). Although the inflation rate subsequently fell, in parallel with oil prices, the reduction in core inflation was less significant and, indeed, it held in early 2007 at a high rate of around 2.5%. The Federal

Reserve raised its official interest rate by 100 bp during the first two quarters of 2006. From September, against a backdrop of falling oil prices and slowing activity, and despite the monetary authority's insistence that inflationary risks remained in place, relatively forceful expectations of cuts during 2007 took root, which progressively petered out at the start of this year. The federal government fiscal deficit declined from 2.6% to 1.9% of GDP, owing to the strength of revenue, since expenditure grew by 7.4% in nominal terms.

The main uncertainties for 2007 relate to the impact of the slowdown in the real estate market, the sluggishness of investment and the rise in inflation.

In 2007, the main uncertainty for the US economy continues to be the potential intensity and impact of the real estate market adjustment. Under the central scenario, the negative contribution of residential construction to growth would gradually fade out over the course of the year, but a pass-through to consumption and, consequently, to the rest of the economy cannot be ruled out if the decline in residential construction were to have a more marked impact on employment or if house prices were to fall sharply. In this respect, the rise in defaults among floating-rate mortgages extended to borrowers with poor credit records might exacerbate the scale of the adjustment in the house market and bear on credit availability for other agents and on other financial markets. The sluggishness of productive investment is also a cause for concern, not only due to its consequences in the medium term, but also to the possibility that corporations' wariness may ultimately be reflected in job creation and, therefore, affect consumption. The persistence of inflation at relatively high rates is another factor of risk, since it offers little headroom to absorb potential shocks, such as those stemming, for example, from oil price developments. Finally, the primary importance of private consumption as the main driving force of the US economy intensified, which hampers a correction of the swollen external deficit. For this reason, the adoption of policies that provide for the gradual absorption of this imbalance is once again a challenge for the US economic authorities.

### 3 Japan

Growth in Japan was up on 2005, despite the slackness of consumption...

Japanese GDP grew by 2.2% in 2006 as a whole, 0.3 pp above the rate in 2005, as the momentum of private investment and exports allowed the relative slackness of private consumption to be overcome (see Chart 3.7). Among the conditioning factors of the poor performance of consumer spending is the scant dynamism of household income, since although job creation enabled the unemployment rate to be cut by 0.4 pp to 4%, the momentum of wages was not on a par and they grew by only 0.2% in 2006.

and the current account surplus widened.

As regards the external sector, the surplus on the current account balance widened from 3.6% to 3.9% of GDP. Although the trade balance worsened very slightly (by 0.1 pp to 1.9% of GDP), the robust growth of foreign investment revenue boosted the income balance and offset the decline in the trade balance.

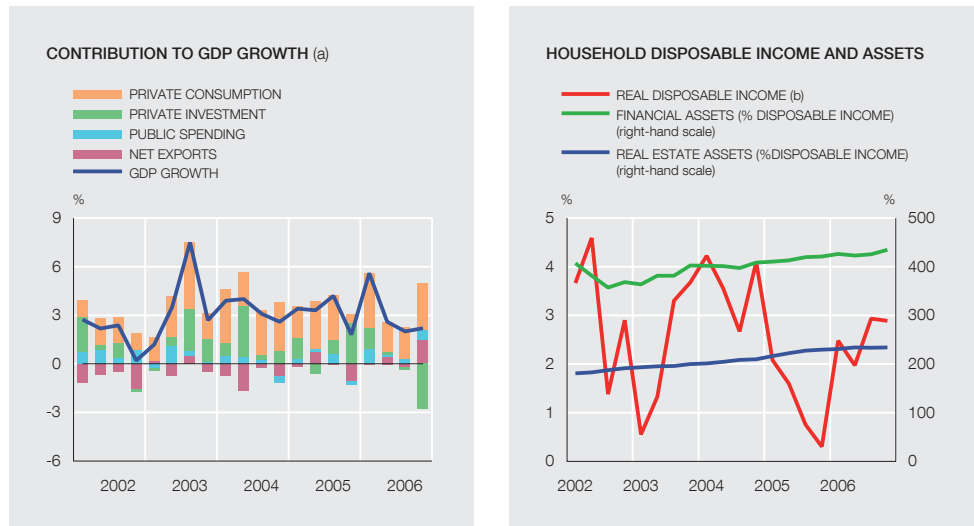
Inflation edged into positive territory...

The data on prices showed progress - albeit limited and hesitant - towards the abandonment of deflation (see Chart 3.7). The consumer price index posted a year-on-year rate of 0.9% in August, further to higher oil prices, but it subsequently slowed and resumed a slightly negative rate in March 2007. Along with the persistence of declines in the GDP deflator and in unit labour costs, this saw continuing concern about a potential return to deflation. Acting in the opposite direction was the rise in urban land values and, most especially, the pick-up in bank credit, which grew for the first time in ten years.

which allowed the Bank of Japan to abandon its ultra-expansionary monetary policy.

The Bank of Japan took advantage of the rise in inflation to announce the abandonment of its monetary policy based on quantitative objectives and adopt a more orthodox arrangement consisting of a target for the overnight interest rate. Following this step, the monetary authority increased its intervention rate on two occasions, moving it from 0% to 0.50%. The prospect of further increases in the short run, which most investors forecast at the beginning of 2006, gradually abated as the reluctance of inflation to take root in positive territory was confirmed, although the gradual normalisation





SOURCES: National statistics and Federal Reserve.

a. Contributions to annualised quarterly GDP growth.  
b. Year-on-year rate.

of the official interest rate will foreseeably continue in the medium term. Turning to fiscal policy, the strength of revenue was decisive in achieving a reduction in the public-sector deficit, although no significant expenditure-control or tax-reform measures were undertaken.

The main risks for 2007 are associated with the persistent slackness of consumption and with dependence on external demand.

The behaviour of private consumption, which is vital for ensuring the continuity of the upturn in 2007, is the main uncertainty clouding the Japanese macroeconomic horizon. The slackness of consumption, due essentially to the stagnation of wage income, might result in diminished corporate optimism, with the subsequent scaling back of investment and hiring plans, and the danger of a return to deflation. Further, excessive dependence on external demand places Japan before the risk derived from a sharper slowdown in the United States. The moderately favourable setting of economic recovery has not been sufficiently harnessed to continue rolling out structural reforms and to raise the economy's growth potential. Measures aimed at making the labour market more dynamic - and, particularly, at limiting the duality between full-time permanent employees and part-time temporary workers - will prove particularly pertinent, as will heightening the degree of domestic competition.

#### 4 China and the rest of Asia

Growth in China continued at over 10%, without apparent inflationary pressures.

GDP growth in China stood at 10.7% in 2006, 0.3 pp more than in 2005 (see Chart 3.8). Although the industrial sector and investment remained the main drivers of the expansion, private consumption was also more dynamic. The authorities, concerned by possible excessive expenditure on investment goods and by the overheating of the economy, implemented a series of restrictive administrative measures in the second half of the year, which were of only limited success. Despite the continuity of very high growth, there were no marked increases in consumer prices, which grew at around 1.5% year-on-year throughout 2006, although they rose to 2.7% in February 2007.

The already high current account surplus widened against the backdrop of a slight appreciation in the renminbi, and international reserves exceeded \$1 trillion.

The current account surplus increased significantly on its high level in 2005 to 9% of GDP. This surplus, along with the continuing inflow of foreign direct investment, led to a \$247 billion in-

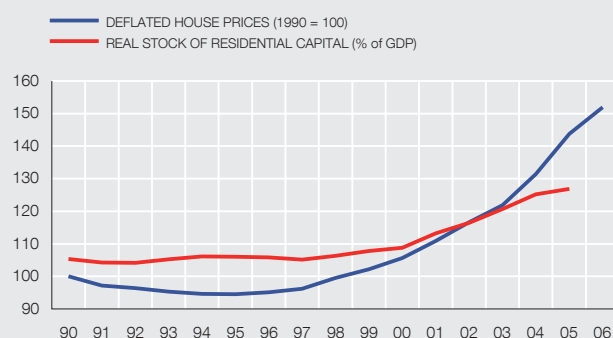
Until 2005 the US property market was expanding, in a phase characterised by rapidly rising house prices and a significant increase in residential investment. During this period the real estate sector was one of the main driving forces of the US economy, both in terms of the direct effect on gross capital formation and employment, and the indirect effect arising from the appreciation of real-estate assets owned by households, which boosted consumption and reduced the household saving ratio. From 2000 to 2005 the US economy's stock of residential capital grew 58%, while house prices climbed by 48% in real terms (see accompanying panel 1).

Financial, economic and demographic factors supported the growth in the US residential stock and its appreciation. Buyers benefited from lower, less volatile real interest rates (and, in general, from benign financing conditions) and the roll-out of new mortgage loan

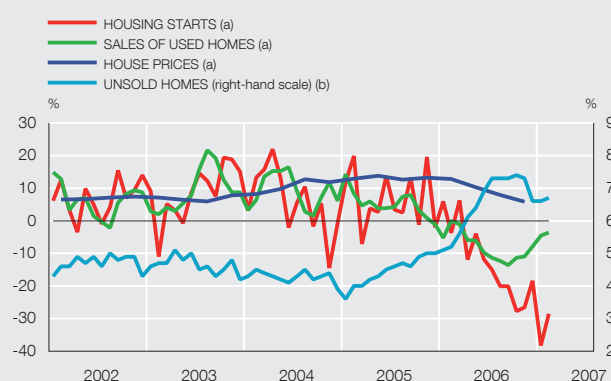
products, making it easier for households to gain access to credit. Furthermore, ongoing economic growth - scarcely interrupted by a slight downturn in 2001 - coupled with relatively low unemployment rates encouraged the sustained increase in household income and, consequently, households' demand for housing. Growth in the indigenous and immigrant populations and the rise in the number of first-time buyers had the same effect. On the supply side, there is evidence in some regions and metropolitan areas that this rise in demand has passed through to prices due to the shortage of buildable land.

From 2005 Q4 the change in the real estate market became evident and initially affected residential construction. The number of housing starts, which peaked at over 2.2 million at the beginning of 2006, stood at 1.5 million in March 2007. As a result, the residential com-

### 1. HOUSE PRICES (IN REAL TERMS) AND RESIDENTIAL INVESTMENT IN THE US



### 2. THE US HOUSING MARKET



### 1. EXPERIENCES OF REAL ESTATE ADJUSTMENT (c)

	USA	UK	AUSTRALIA	NETHERLANDS
<b>HOUSE PRICES</b>				
(in real terms)				
Prior cumulative variation (d)	36.6	65.5	56.5	44.9
Correction (e)	*	*	-1.9	-0.5
Date			(2005)	(2003)
Slowdown (f)	-3.7	-11.6	-16.9	-16.0
Date	(2006)	(2003-2005)	(2004-2005)	(2000-2003)
<b>RESIDENTIAL INVESTMENT</b>				
Prior cumulative variation (d)	36.0	22.7	23.1	13.2
Correction (e)	-4.1	-1.6	-4.9	-10.0
Date	(2006)	(2005)	(2005-2006)	(2002-2003)
Contribution to GDP growth	-0.3	-0.1	-0.2	-0.6
Real financial assets (g)	4.9	10.8	10.4	-2.9
Consumption (g)	3.2	1.4	2.8	0.4

SOURCES: Datastream and Banco de España.

- a. Year-on-year rate.
- b. Unsold used homes in number of months.
- c. Data in percentage, unless otherwise indicated.
- d. Cumulative real change in the five years prior to the decrease in the variable or, if any, prior to 2006.
- e. Decrease in real terms. An asterisk indicates that there were no real decreases in the corresponding variable.
- f. Difference between the year of highest and lowest growth in prices.
- g. Real change during the period of the fall in prices and/or residential investment.

ponent of gross capital formation decreased considerably and even shaved 1.2 percentage points off GDP growth in the last two quarters of 2006 (see Chart 3.6 in the main text). This marked adjustment in construction proved insufficient to offset the easing in demand for new and used homes, and stocks of new available homes climbed rapidly to account for eight months of sales at the beginning of 2007, a figure not witnessed in the last ten years (see panel 2). The build-up in unsold homes gradually put pressure on the valuation of residential assets which, until then, had shown considerable vigour. Prices, measured using the most commonly used index (OFHEO), slowed gradually yet sustainedly from 13.2% year-on-year in 2006 Q1 to 5.9% in Q4. In this scenario, the danger of an employment adjustment in the construction sector affecting other branches and the risk that a levelling off, or even a drop, in property prices might bear on consumption triggered concern about the possible impact of events in the real estate market on the rest of the economy. However, to date, as a result of the sustained dynamism of job creation in services and high household propensity to spend, this impact has been avoided.

Other countries such as the United Kingdom, Australia and the Netherlands, have seen house prices slow considerably in recent years. Housing markets are characterised by significant institutional and structural differences which call for considerable caution when extrapolating experiences from one country to another. Nevertheless, by comparing these episodes, it is possible to draw certain conclusions about the development and impact of the adjustment. As shown in the accompanying table, the increase in US property prices in recent years is within the lower band and the price adjustment in the other countries was restricted to very minor slowdowns or de-

creases in real terms. In all these cases, the knock-on effect on residential investment was on a similar scale to that seen to date in the US economy; however, given the limited weight of this item in GDP, on its own it did not entail a marked economic weakness. Conversely, the impact on consumption was significantly different among these countries. In the Netherlands, where the adjustment was accompanied by a strong correction of stock markets and where, like the US, the use of mortgages for equity withdrawal purposes is widespread, the impact on consumption was notable.

Consumption in the US remained buoyant in the second half of 2006. The reason for this strength, together with the sustained growth in disposable income, was the favourable stock market performance. That said, the adjustment to the real-estate sector was still in progress at the beginning of 2007. However, the US has some specific characteristics which could heighten the intensity of the adjustment in the next few quarters. Insofar as residential construction has been more dynamic than in other areas and may have exceeded demographic growth requirements, the fact that a contraction in residential investment may have to be deeper and more prolonged cannot be ruled out. And that would heighten the possibility of it feeding through to the rest of the economy. Also, the participation of low-income households with sub-standard credit histories has been more significant. The subprime lending segment has contributed to this situation and its recent difficulties could possibly pass through to other financial markets and result in lower availability of credit for other agents. Lastly, in this mature stage of the US economic cycle, it is possible that the valuation of real estate and financial assets might be corrected at the same time, which would affect household wealth and confidence and might ultimately curb buoyant consumption.

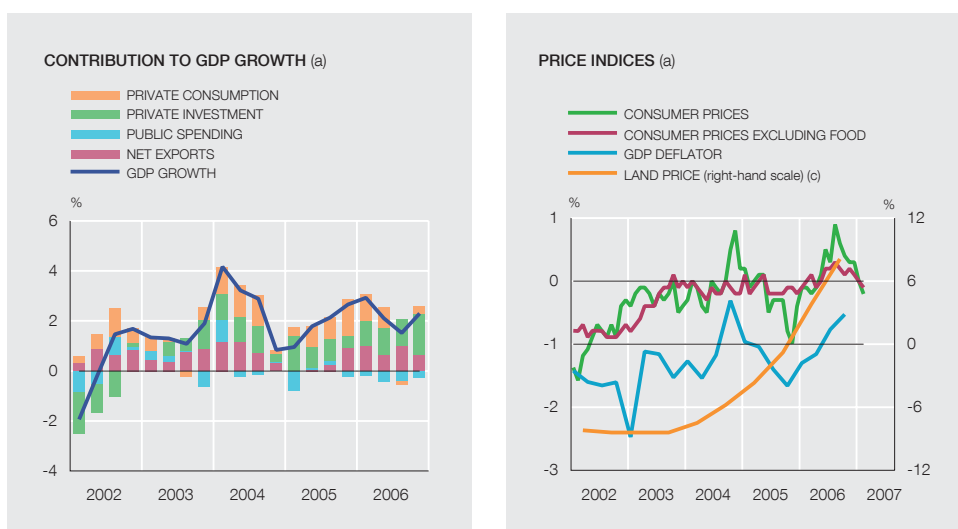
crease in foreign reserves. The stock of reserves thus exceeded \$1 trillion, highlighting the insufficiency of the measures to make the renminbi (which held virtually stable in real effective terms during 2006 and early 2007) more flexible in order to contain these imbalances. Against this background, monetary policy was governed by the need to sterilise the liquidity resulting from the build-up of international reserves. Given the growing difficulties of carrying out this task, the authorities opted to approve successive increases in the bank reserve ratio, increases in key lending and deposit interest rates, and tighter mortgage financing conditions.

The other Asian economies also posted robust growth rates...

Generally, the other Asian emerging economies achieved notable growth, higher on average even than the previous year (6.8% against 6.4% in 2005) (see Chart 3.8). Inflation rose once more, due essentially to the increase in energy costs, although inflationary pressures were generally contained by tighter monetary policies. India recorded a high growth rate in 2006 (9%) and, into 2007 Q1, it witnessed a gradual rise in inflation, which prompted an increase in its official interest rate.

with significant contributions from both domestic and external demand.

Although the essential momentum behind growth was from domestic demand, most countries in the region benefited from the buoyancy of external demand, and current account surpluses widened in many of them. Strong capital inflows prompted the appreciation of the main currencies and



SOURCE: National statistics.

- a. Contributions to annual GDP growth.  
b. Annual percentage change.  
c. Urban land price.

gave rise to growing concern about competitiveness and liquidity management in the area. In Thailand the authorities even resorted to controls on capital inflows, with adverse consequences for their financial markets, while in South Korea and China capital outflows were partly liberalised.

The outlook remains favourable for the region, although the main challenges are associated with the management of inflationary pressures, the accumulation of reserves and foreign exchange policies.

Although the outlook for the region is favourable, a series of major uncertainties continues to cloud the economic horizon. In the short run such uncertainties are associated with the rise in inflation, especially in a setting in which central banks find it increasingly difficult to manage simultaneously capital inflows and the build-up in international reserves. In the specific case of China, these difficulties might have an adverse impact on financial and economic stability. For the region as a whole, the effects of a slowdown in external demand in the United States might also be significant. Moreover, the lack of exchange-rate flexibility in some countries remains one of the stumbling blocks for an orderly adjustment of global imbalances and is conducive to protectionist tendencies in other countries. In particular, given the growing trade links between China and the other economies in the region, the greater exchange-rate flexibility of the renminbi would contribute not only to reducing the rapid build-up in reserves and to promoting more balanced growth in China, but would also lessen the reluctance of other countries in the area to allow a sharper appreciation of their currencies.

## 5 Latin America

Latin America posted its fifth successive year of expanding output...

Latin American GDP grew by 5.3% in 2006, compared with 4.5% in 2005, thus completing its fifth consecutive year of expansion (see Chart 3.8). The main pillars of activity were the strength of domestic demand, assisted by benign financial conditions; the sound behaviour of labour markets, in terms of job creation; and the high prices of commodities exports. Private consumption remained considerably dynamic and there was, moreover, an especially welcome recovery in investment.

with inflation on a declining trend and a buoyant external sector.

Inflation in the area continued, on average, on a marked downward trend, reaching a historical low of 4.7% in 2006 Q4. Notable in this connection was Brazil, where inflation fell from 5.5% in 2006 Q1 to 3.1% in Q4. In Argentina and Venezuela, however, inflation held at an excessively high rate. Assisting the downtrend in inflation in the region was the appreciation of exchange rates and the greater prudence of central banks, which have built up significant cred-

ibility in recent years. The monetary policy stance tended to tighten, especially in the first half of the year. The exception here was Brazil, where the policy of progressive cuts to official interest rates continued. Public finances performed favourably in the main economies, as a result of the propitious cyclical situation and the strong increase in public revenue, also underpinned by the high price of commodities. In any case, and in line with events in recent years, the trend of spending was largely conditional on the sound performance of revenue. Despite the strength of domestic demand, rapid export growth enabled several countries in the region to record new all-time high current account surpluses.

Financial vulnerability continued to diminish...

The maintenance of prudent macroeconomic policies and of current account surpluses helped reinforce the perception of reduced vulnerability in many countries. Further, the authorities in the region continued to take advantage of the high demand from investors in emerging-market debt to improve maturity terms and to increase the weight of local-currency-denominated debt in the securities issued. Many central banks continued to accumulate reserves in response to the appreciating trend of their currencies.

although reforms were very limited.

As has been the case in this expansionary phase, results in the field of structural reforms remained relatively limited in the region as a whole, partly because it was an electoral year in several countries. In the same respect, regional trade liberalisation efforts were jeopardised by the consolidation of two differentiated blocs of countries, with opposing ideas on the trade and regional integration model. This polarisation tended, moreover, to foment the adoption of bilateral agreements with developed countries by the smaller economies.

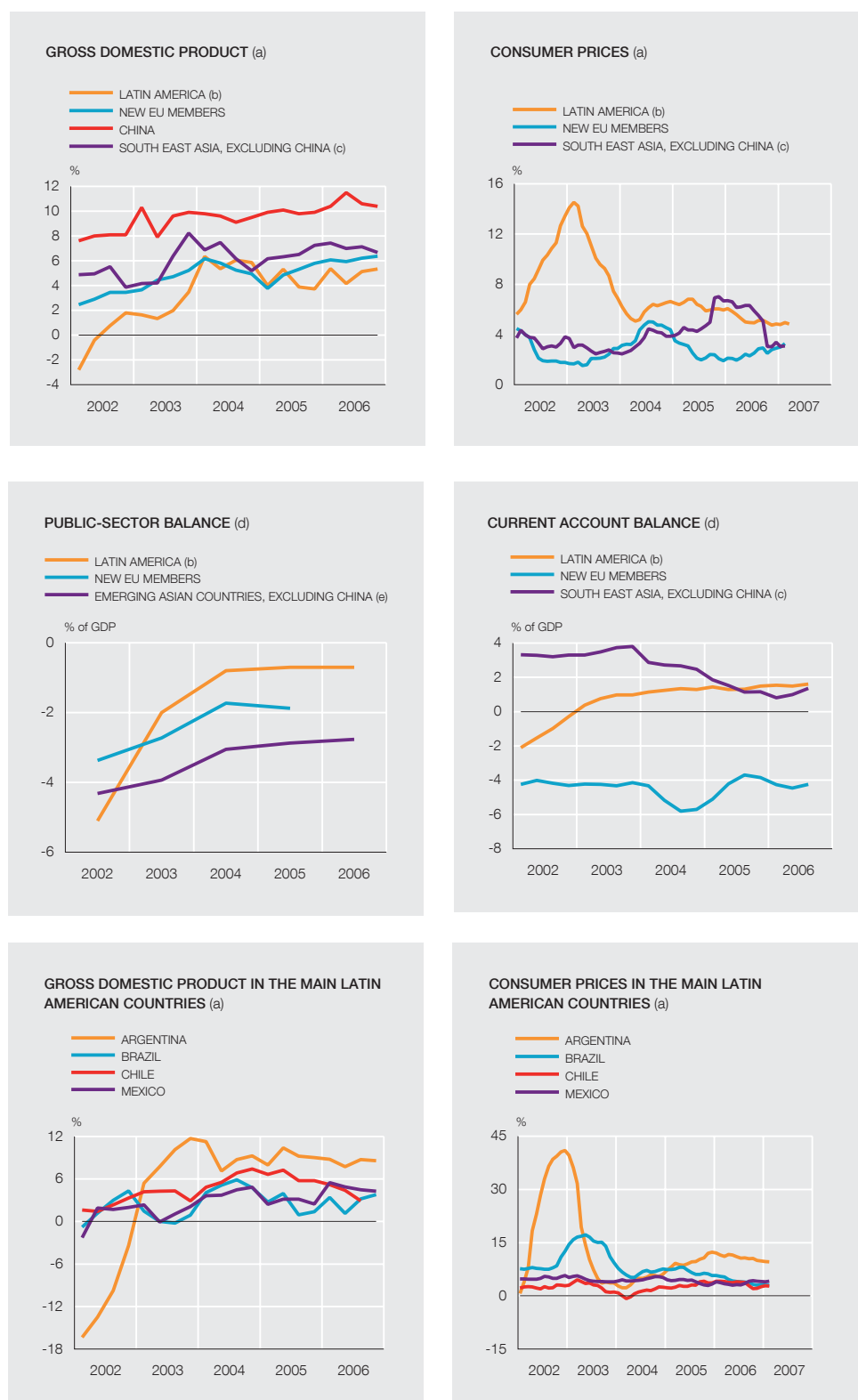
The outlook is favourable, with risks stemming from changes in financial conditions or in the economic policies of certain countries.

The outlook for the year is one of a continuing sound rate of growth, in a favourable external setting, with limited pressures on prices. Among the factors of uncertainty clouding this scenario are a possible reversal of the benign financial conditions on international markets, since at least some of the improvement in these countries' vulnerability indicators has come from the reduction in borrowing costs and the appreciation of the region's exchange rates. The less favourable behaviour of commodities prices is, likewise, a considerable factor of risk. On the domestic front, the chief threat is posed by the unorthodox direction taken in economic policy management in certain countries in the region, which has stepped up with the persistence of the economic boom and which is damaging to the sustainability of growth. In the face of this risk, giving new life to structural reform agendas will be particularly important. Such reforms will allow Latin American countries to integrate more effectively into the global economy, promoting their competitiveness - especially through productivity gains - and firming the foundations of their stability. Newly elected governments and the favourable economic situation should boost these processes.

## **6 Non-euro area European countries**

Economic activity in the United Kingdom quickened forcefully, with inflationary pressures and an increase in the external deficit...

The UK economy emerged in 2006 from the slowdown marking it the previous year and grew by 2.7%, 0.9 pp up on 2005. The contribution of highly dynamic domestic demand, in respect of both private consumption and investment, was the fundamental pillar of this recovery. The soundness of the economic situation led to sustained dynamism in job creation. However, the unemployment rate rose to 5.5%, this being attributable to immigrant workers joining the labour force. The expansion in activity contributed, along with temporary factors, to an appreciable rise in inflation, which exceeded 3% in March 2007 compared with the same month a year earlier, at the maximum limit of the Bank of England's target inflation band of plus or minus 1 pp around its inflation target (2%). The Bank responded in the second half of 2006 and the opening months of 2007 with interest rate rises totalling 75 bp, taking its benchmark rate to 5.25%. The public sector deficit declined, while the strength of domestic demand and the appreciation of sterling contributed to a fresh deterioration in the current account deficit, which widened to 2.9% of GDP.



SOURCES: National statistics and IMF.

a. Annual percentage change.

b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.

c. India, Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines.

d. Surplus (+) or deficit (-).

e. Country aggregates based on IMF (WEO) definition.

as was also the case, with greater intensity, in the new EU members.

In the new European Union member countries - those that joined in 2004 - GDP quickened from 4.9% in 2005 to 6.2% in 2006, driven by investment and, to a lesser extent, private consumption (see Chart 3.8). The recovery in the euro area provided a boost for the external demand of many of these economies. The Baltic states and Slovakia posted the highest growth rates, but the pick-up in activity in Poland was also notable. Inflation rates rose across the board in the opening months of the year owing to the increase in oil prices, and to administered and food prices. In response to these inflationary pressures, most central banks reacted by tightening their monetary policy stance. Nonetheless, the dispersion of inflation across the economies making up this group was most significant, from 1% in Poland to 6.5% in Latvia for 2006 on average. The fiscal policy stance was, in general, more expansionary than in previous years and, in most cases, the general government structural balance worsened, despite the rise in revenue. A particular case in point was Hungary, where public finances deteriorated notably and the deficit was close to 10% of GDP. There was also an across-the-board increase in current account deficits, which in the Baltic states exceeded 10% of GDP.

Containing the external and fiscal imbalances and inflation are the main challenges facing the new EU Member States...

Although the outlook for the region remains favourable, especially in a setting of greater dynamism in the euro area, several significant macroeconomic policy challenges remain in place. In particular, further efforts must be made to gradually correct external imbalances in public finances, while the vigorous growth of credit might be a factor of risk, exacerbated in some countries by the high percentage of such debt denominated in foreign currency. Containing high inflation rates is another priority task in some countries, where structural reform measures to make supply-side conditions more flexible will be particularly necessary.

which were joined, in early 2007, by Bulgaria and Romania.

On the institutional front, Bulgaria and Romania joined the EU on 1 January 2007, while Slovenia became a member of the euro area. The prospects of Turkey joining the EU suffered a considerable setback when the European Council partially suspended negotiations. Turkey underwent a notable slowdown in activity, largely prompted by the interest-rate rises adopted in response to the financial turbulence in May and June 2006, which particularly affected the country.



#### 4 THE EURO AREA AND THE COMMON MONETARY POLICY

### 1 *Economic conditions in the euro area*

The process of economic recovery in the euro area initiated in the second half of 2005 gathered pace in 2006. Euro area GDP growth, which substantially exceeded the forecasts at the beginning of the year, was 2.8%. This rate, which exceeded that for potential output growth, was moreover the highest posted since 2000. In the course of the year the increase in GDP moved on a rising course, climbing to 3.3% in Q4, driven in part by certain temporary factors in the second half of the year. In any event, the buoyancy of activity affected all expenditure items and prompted an acceleration in labour demand.

As in the previous year, inflation in the area stood above 2%. This was in response to the behaviour of the most volatile components of the index and, in particular, to that of energy goods, meaning that core inflation held, as in 2005, at 1.5%. Some signs of a pass-through of higher energy goods prices to other goods began to be discernible during the year, but there were no significant effects on wage demands. Nonetheless, the upside risks to inflation grew in step with the improvement in economic activity and employment. Preventive monetary policy measures contributed to alleviating these risks by gradually correcting the expansionary monetary conditions maintained during the prolonged phase of sluggish economic growth.

Turning to structural reforms, the assessment of the first full year of application of the renewed Lisbon Agenda may be viewed as moderately satisfactory. Perseverance in this process is vital for ensuring that the current upturn is prolonged and for making it easier for the member countries to adjust in the face of idiosyncratic shocks. As to fiscal policy, the improvement in the economic cycle made for an appreciable reduction in the budget deficits of the euro area countries. The favourable budget outturn entails the risk that governments will arrive at the mistaken conclusion that the correction of the structural imbalances of public finances has become less pressing. Conversely, the current juncture should be harnessed to step up fiscal consolidation efforts, since it is in cyclical upswings that there is greater headroom to adopt budgetary reforms, which may in the short run dampen growth to some extent.

The economic outlook for the area for 2007, which has seen Slovenia become the thirteenth euro area member country, is favourable. Specifically, the prospects are for a continuation of the upturn, in a setting in which financial conditions conducive to increased spending and to ongoing robust economic growth, albeit somewhat lower than in 2006, continue to prevail.

#### 1.1 ACTIVITY AND EMPLOYMENT

In 2006, the acceleration in activity was in response to the general improvement in all expenditure components.

GDP growth in 2006 was 1.3 pp up on the rate recorded the previous year. This was as a result of the increase in the contributions of both the net external balance and internal demand (particularly investment), while stockbuilding continued to exhibit a zero contribution to output growth (see Table 4.1). The rate of expansion of private consumption, which quickened by 0.3 pp to 1.8%, was boosted by the growing dynamism of real disposable income. This variable benefited from the gradual increase in the pace of employment generation and, to a lesser extent, from the greater vigour of compensation per employee, and also, in the second half of the year, from cheaper oil. Moreover, the growth of household consumer spending exceeded that of disposable income, entailing a further fall-off in the saving ratio. Specifically, the rise in household financial and non-financial wealth and the strengthening of household confidence, spurred by the decline in the unemployment rate, also boosted consumption.

Investment recovered strongly, on the basis of its fundamentals.

The notable increase in gross fixed capital formation, whose growth rate exceeded that of the previous year by 2.2 pp, taking it to 4.9%, spread to all its components (see Chart 4.1). In

	2004	2005	2006	2006			
				Q1	Q2	Q3	Q4
<b>DEMAND AND OUTPUT</b>							
Gross domestic product	1.8	1.5	2.8	0.8	1.0	0.6	0.9
Private consumption	1.4	1.5	1.8	0.5	0.4	0.7	0.4
Government consumption	1.4	1.4	2.2	1.3	0.0	0.7	0.4
Gross fixed capital formation	1.7	2.7	4.9	1.1	2.2	0.9	1.5
Exports	6.4	4.4	8.5	3.2	1.0	1.9	3.6
Final demand	2.9	2.5	4.2	1.3	1.0	1.0	1.2
Imports	6.2	5.4	7.9	2.4	0.9	2.2	1.7
Contributions to GDP growth (b)							
Internal demand	1.4	1.7	2.5	0.8	0.7	0.7	0.6
Change in stocks	0.2	0.0	-0.1	-0.3	0.3	0.0	-0.5
External demand	0.1	-0.3	0.3	0.3	0.0	-0.1	0.8
<b>PRICES AND COSTS (c)</b>							
Consumer prices (annual average)	2.1	2.2	2.2	2.3	2.5	2.1	1.8
Final demand deflator	1.7	2.3	2.4	2.7	2.8	2.4	1.7
GDP deflator	1.9	1.9	1.8	1.8	1.9	1.9	1.6
Unit labour costs	1.1	0.9	0.8	1.0	1.1	1.1	0.0
Compensation per employee	2.1	1.6	2.2	2.2	2.4	2.3	1.8
Labour productivity	1.0	0.7	1.4	1.2	1.4	1.2	1.8
<b>GENERAL GOVERNMENT</b>							
Total expenditure	47.6	47.6	47.4				
Current expenditure	43.4	43.3	42.9				
— Interest payments	3.1	2.9	2.9				
Public investment	2.5	2.5	2.5				
Total receipts	44.8	45.1	45.8				
Primary deficit (-) / surplus(+)	0.3	0.5	1.3				
Deficit (-) / surplus (+)	-2.8	-2.5	-1.6				
<b>LABOUR MARKET</b>							
Total employment	0.7	0.8	1.4	0.5	0.5	0.3	0.3
Unemployment (d)	8.8	8.6	7.9	8.2	7.9	7.8	7.6
<b>BALANCE OF PAYMENTS</b>							
Current account	0.7	-0.1	-0.2	-0.6	-0.5	-0.2	0.5

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.

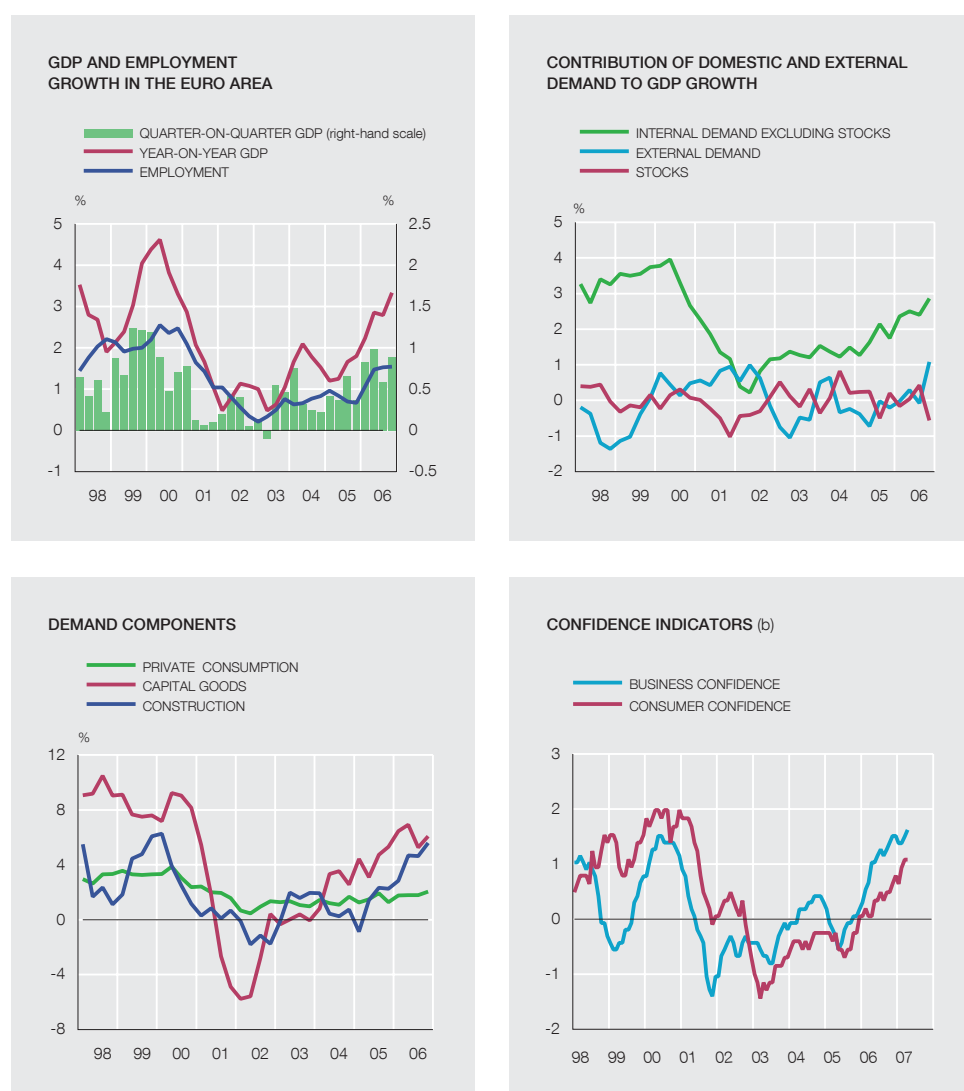
d. As a percentage of GDP.

e. As a percentage of the labour force.

terms of agents, corporate investment was boosted by the momentum of final demand – which translated into a significant increase in capacity utilisation – and by the propitious circumstances for financing expenditure, given the firmness of earnings, the sector's sound balance sheet position and the low cost of capital. The latter stems from the low cost of corporate debt, due in part to narrow corporate bond spreads and the moderate – though growing – levels of bank lending interest rates. Further, the increase in household disposable income and the favourable financial conditions boosted the demand for private residential investment, while in several euro area countries there was an acceleration in public investment spending.

The external sector also boosted euro area output.

External demand also contributed to the buoyancy of economic activity. After having subtracted 0.3 pp from GDP growth the previous year, it made a positive contribution of the same magnitude in 2006. Despite the gradual appreciation of the real effective exchange rate of the



SOURCES: ECB, European Commission, OECD and Banco de España.

a. Annual percentage changes, unless otherwise specified.

b. Balance statistic. Normalised series.

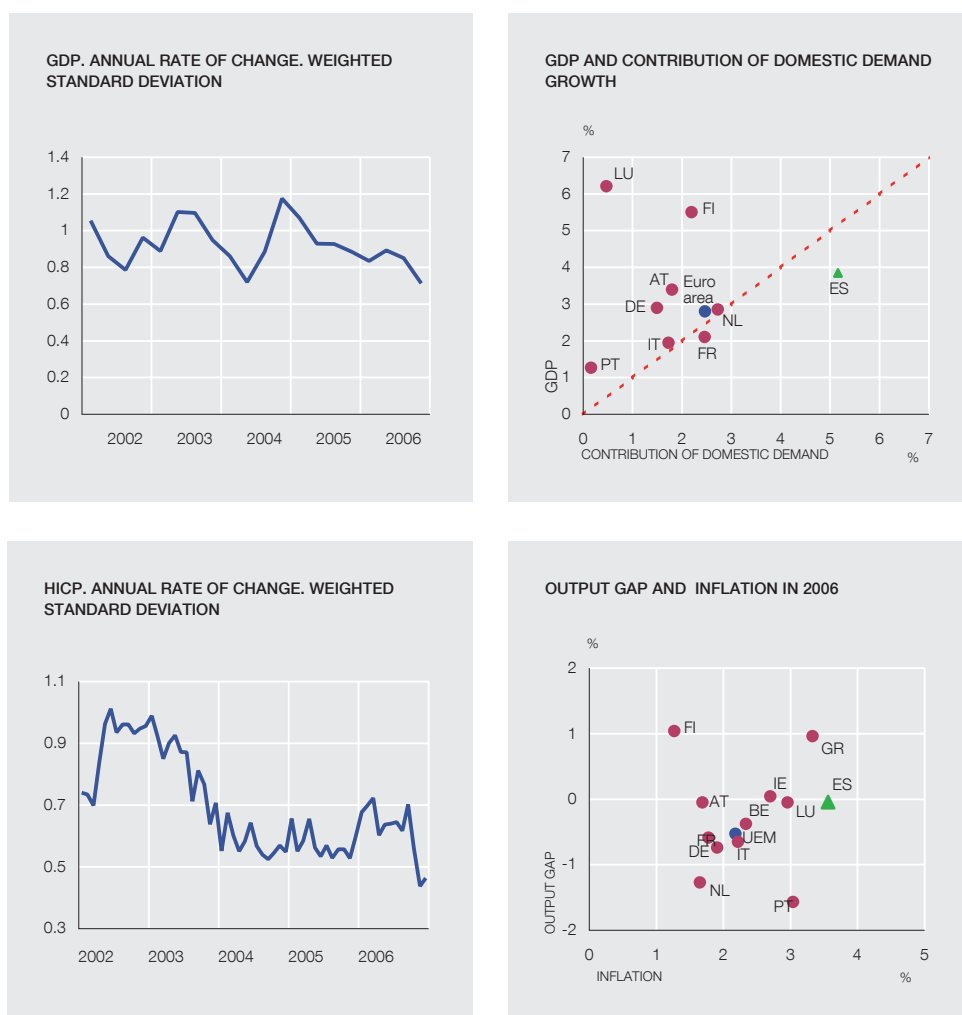
euro during the year, exports increased at a far higher rate than that in 2005, driven by robust world trade. Meanwhile, the acceleration in imports, largely prompted by the pick-up in final demand, was on a much lesser scale. However, the export share of euro area products in other markets worsened and import penetration was greater.

The expansion in activity reflected the acceleration in GDP in most member countries.

The acceleration in euro area output was extensive to all the member countries (except Greece), while the divergence between growth rates diminished (see Chart 4.2). Of particular note was the recovery in the German economy, which is addressed in detail in Box 4.1. As to the composition of growth, the increase in the contribution of the external sector, thanks to the improvement in exports, is a feature common to almost all the member countries. However, the rise in the contribution of internal demand, excluding inventories, observed in the area as a whole was not such a widespread feature, although this was the case in the three biggest economies.

The labour market recovered notably and productivity quickened.

Labour market conditions in the euro area in 2006 improved notably. Employment increased in annual average terms by 1.4% (compared with 0.8% in 2005), moving on an accelerating path throughout the year. This growth was, moreover, higher than warranted by the attend-



SOURCES: European Commission, Eurostat and Banco de España.

ant fundamentals, chiefly economic activity and real wages. The favourable behaviour of employment was observed across the board in all sectors (see Chart 4.3). The unemployment rate fell by 0.8 pp in relation to the average for 2005. On some estimates, a substantial portion of this decline in unemployment was due to a reduction in its structural component, i.e. in the non-accelerating-inflation rate of unemployment (NAIRU). All these developments might be a sign that the labour reforms undertaken in many countries in the area have begun to bear fruit. Despite the higher rate of increase in employment, the strong growth of activity in the area gave rise to a notable acceleration in productivity, essentially as a result of cyclical factors.

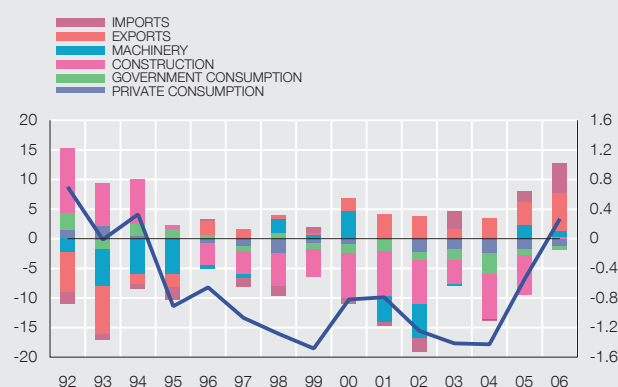
The outlook for 2007 is favourable, although some external risks persist.

Following the robustness shown in 2006, the outlook for the current year suggests growth in the area will expand at a somewhat more moderate rate, although foreseeably above potential. The firming of the improvement in European labour markets, favourable financial conditions and high corporate earnings provide the foundations for the continuation of the expansion in internal demand, while it seems likely that the potentially adverse effects of the VAT rise in Germany on the German economy will peter out in the first half of the year. At the same time, exports will benefit from the strength of world trade. However, some downside risks to growth persist in the medium term. These relate to the possibility of further energy price increases, a disorderly correction of global imbalances, a sharper-than-expected slowdown in the United States and a rise in protectionism worldwide.

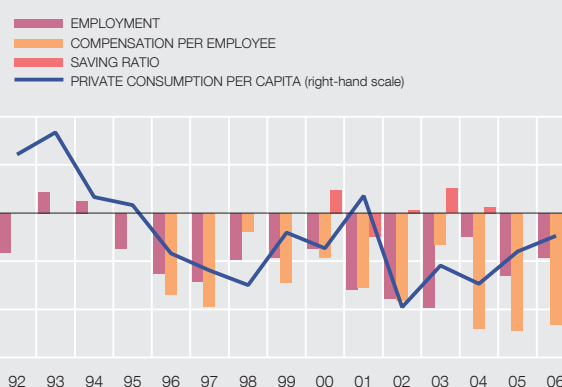
In 2006 Germany posted a GDP growth rate of 3%, 0.3 pp higher than that of the rest of the euro area. That ended a decade in which annual increases in German GDP were lower than those of the other euro area members (in terms of annual averages, the difference between the rate of change in German GDP and the euro area average excluding Germany was -1.1 pp). This was due in particular to the protracted sluggishness in domestic demand. The resumed buoyancy of the German economy considerably strengthens the outlook for the rest of the euro area, as a result, among other factors, of the strong trade relations within the region.

The economic results of the ten-year period 1995-2005 largely reflected the outcome of the necessary correction of certain imbalances generated after reunification. These included the sharp decline in the economy's competitiveness (due to higher prices and costs) and growth in the debt of various sectors. Rigidities in product and labour markets contributed decisively to the prolonged duration of the adjustment. As shown in panel 1, the less dynamic components of GDP, relative to the euro area, were domestic demand (in particular private consumption and investment in construction). Conversely, growth in exports was stronger and imports increased in line with the rest of the euro area.

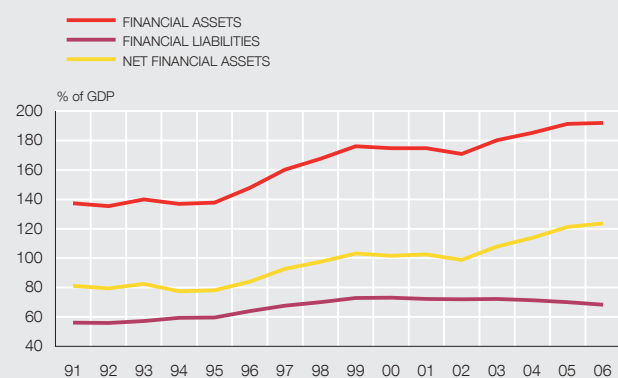
1 GDP AND ITS COMPONENTS (a)



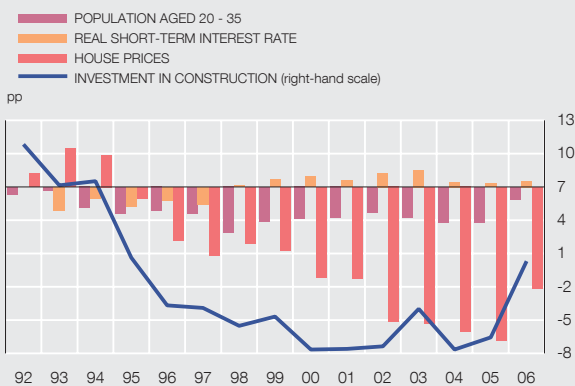
2 PRIVATE CONSUMPTION PER CAPITA AND ITS DETERMINANTS (a)



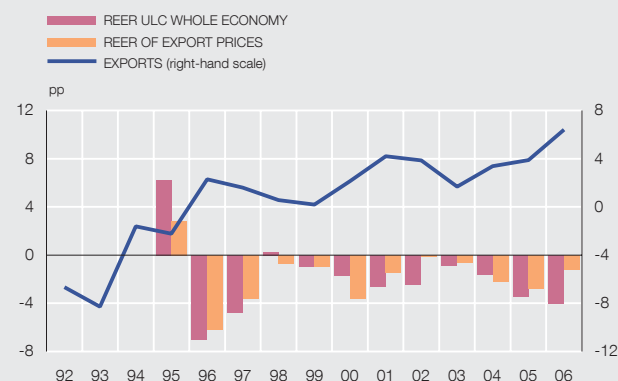
3 HOUSEHOLD FINANCIAL POSITION



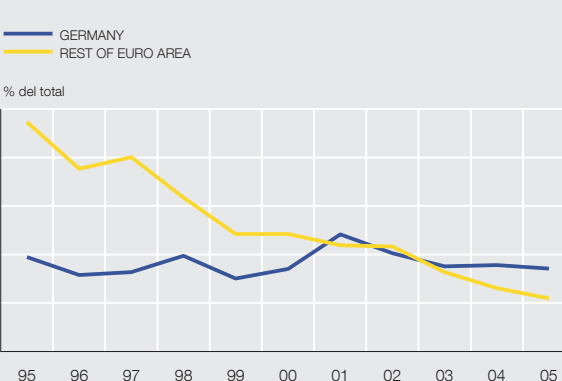
4 INVESTMENT IN CONSTRUCTION AND ITS DETERMINANTS (a)



5 EXPORTS AND THEIR DETERMINANTS (a)



6 IMPORTS OF INTERMEDIATE GOODS



SOURCES: ECB and European Commission

a. Difference between the annual change of each variable in Germany and in the aggregate made up of the rest of the countries in the euro area.

From the mid-nineties, approximately one-third of the private consumption growth differential relative to the euro area could be attributed to the more moderate increase in population, whereas the remainder would be due to the different course of consumption per capita. Specifically, the sluggishness in employment and wages resulted in lower growth in household disposable income. In addition, German households behaved more cautiously and their saving ratio increased by just under 1 pp between 1999 and 2004, whereas it hardly changed in the rest of the euro area. In fact, in recent years the share of household debt in GDP has decreased, following its increase after reunification, while household financial assets rose substantially with the result that their net financial position was strongly boosted (see panel 3). This behaviour is probably linked to uncertainty over the sustainability of benefit systems and the economy's capacity to generate employment.

As shown in panel 1, there was a reunification-related boom in residential and non-residential construction at the beginning of the nineties, followed by a continuous decline, and its weight in terms of GDP dropped from 14.3% in 1994 to 9.3% in 2005. The contributing factors, particularly in the case of investment in housing, included the fall in the numbers of the population setting up a home, the comparatively high level of real interest rates (given that since 1994 Germany's inflation has been markedly lower than the rest of the euro area) and the decline in house prices (see panel 4). The negative growth differential of investment in equipment was much narrower than that of construction since the behaviour of some of its determinants (such as final demand and capacity utilisation) was not so divergent from the rest of the euro area, in particular due to the strong surge in sales abroad.

Consequently, exports became the major driving force of the German economy, boosted by progressive productivity gains both in terms of unit labour costs and export prices (see panel 5). Improved competitiveness was underpinned by productivity gains (associated with employment adjustments) and wage moderation. Other factors also contributed to favourable sales abroad: German exports focused more on developing countries, whose markets are more dynamic; they specialised in capital goods, which are less exposed to competition from emerging economies and more in demand there; and there

was greater delocalisation, transferring part of the production of intermediate goods used in the manufacture of exports to lower-cost countries, in particular to the new EU members. The latter phenomenon was illustrated (see panel 6) by the stable relative weight of imports of intermediate goods, which have declined in significance in the rest of the euro area.

Since the cycle troughed in 2003, there has been a gradual, staggered improvement in the various GDP components, resulting in the positive aggregate results for 2006. Consequently, from 2004 the momentum of exports stepped up, driven by the recovery in world trade. Spurred by exports, there was higher growth in final demand, a higher degree of capacity utilisation and a recovery in corporate earnings – to which cost containment also contributed, thus permitting substantial increases in margins – and in business confidence. All these factors prompted a rapid rise in investment in equipment. Lastly, in 2006 this favourable trend was also seen in investment in construction and, to a more moderate extent, in private consumption, which no doubt benefited from the improvements in employment and household confidence, stimulated probably by the various reforms introduced. These reforms included measures aimed at promoting greater use of the labour factor and reducing unemployment, particularly among the long-term unemployed. Consequently, the introduction of favourable tax treatment for part-time jobs, fewer regulatory constraints on employment contracts, the relaxing of legislation governing dismissals and the introduction of a new system of unemployment benefits for the long-term unemployed were approved. Furthermore, measures have been introduced to guarantee the sustainability of pension and insurance systems, such as the recently approved gradual raising of the retirement age to 67.

The outlook for the German economy is bright and its growth over the next few years will foreseeably remain in line with the rest of the euro area. In particular, it seems likely that private consumption will finally pick up, taking into account employment gains and the comfortable financial position of households. At the same time, the rate of change in investment in construction may be expected to move onto a more normal footing following the protracted adjustment process experienced to date.

## 1.2 PRICES AND COSTS

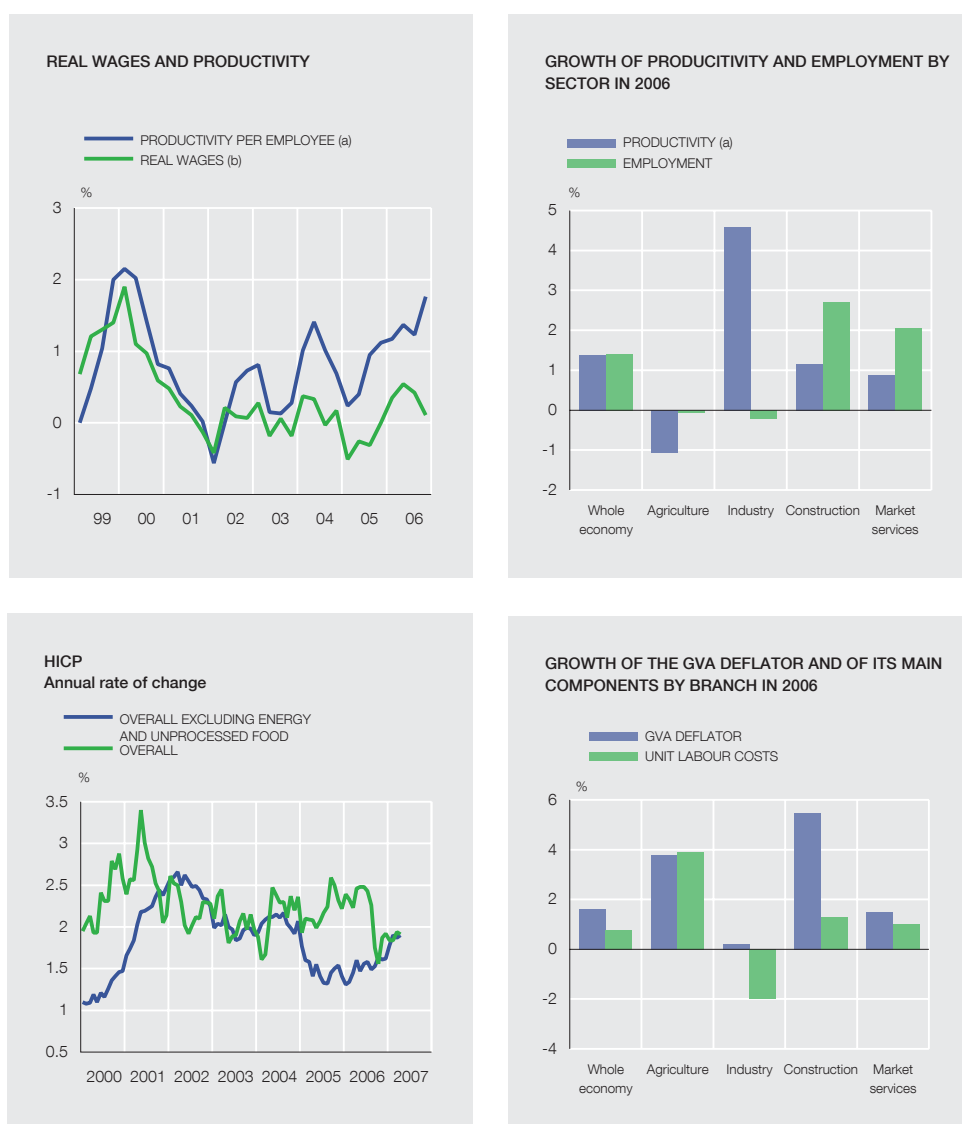
Average inflation stood above 2%, but fell at the end of the year...

The harmonised index of consumer prices (HICP) in the euro area posted average growth of 2.2% in 2006, unchanged on the previous year. Nonetheless, the behaviour of inflation showed two clearly differentiated phases during the year (see Chart 4.3). While inflation in the euro area held to August at significantly higher levels than the reference used in the definition of the price stability target, in the last four months of the year it fell below 2%, owing both to the base effects arising from the performance of the energy component a year earlier and to the lower oil prices recorded in the closing months of 2006.

while core inflation moved on a mildly growing profile.

Conversely, although core inflation – measured by the consumer price index excluding unprocessed food and energy – also held steady in annual average terms in relation to 2005 (at 1.5%), it displayed





SOURCES: ECB, Eurostat and national statistics.

- a. Difference between the change in GDP and employment for the whole economy and between the change in GVA and employment for the various sectors.  
 b. Difference between the change in compensation per employee and the GDP deflator.

a mildly rising trend over the course of the year. Among the less volatile components of the HICP, non-energy industrial goods prices showed an ongoing acceleration, potentially reflecting the emergence of some indirect effects of the past increases in oil and other commodities prices.

Country by country, the growth rate of the HICP in 2006 was very heterogeneous: it was unchanged in France and Italy, it fell in Germany, Belgium, Austria, Greece and Luxembourg, and it rose in the remaining countries. As a result, the dispersion of the average inflation rate within the area rose in relation to the level maintained in the two previous years, which was essentially due to the heterogeneity of the trend of the services component of the core inflation rate (see Chart 4.2).

Domestic costs did not exert additional pressures on prices...

The growth rate of the final demand deflator increased slightly to 2.4% owing to a bigger contribution from the external component, offset in part by the reduction in the contribution of the domestic component. This, in turn, was the outcome of the slowdown in unit labour costs (ULCs) and

net indirect taxes, which allowed the higher rate of increase of the gross surplus to be checked. The moderation in the growth of ULCs was, unlike the previous year, due to the notable acceleration in labour productivity (thanks to the considerable buoyancy of activity), since the rate of increase of compensation per employee rose by 0.6 pp, against the background of the notable recovery in the labour market. Nonetheless, there were significant differences in the behaviour of ULCs from one country to another. In some economies (in particular, in Spain, Italy and France) this variable increased at a notably higher pace than the euro area average.

and the containment of labour costs allowed business margins to expand.

In any event, in real terms, compensation per employee once again increased in 2006 at a lower rate than productivity. This was thanks to the role of containment that the slackness still existing in the labour markets continued to play – insofar as the gap between the unemployment rate and the NAIRU remained open – and to the persistence of other factors that may have contributed to wage moderation in recent years, related to globalisation and to the growing use of capital-intensive technologies. This entailed a further decline in the share of wage income in the economy's value added, which was observed in all countries in the area, with the exception of Italy, and was particularly intense in the cases of Germany, the Netherlands and Finland. The expansion in business margins was generalised in the main sectors of the economy (see Chart 4.3). Of particular note was the acceleration in the construction sector, while the related rate of increase in industry held steady and declined in market services.

The outlook points to a reduction in inflation in 2007, but there are upside risks.

The inflation outlook for 2007 – according to the various forecasts available – points to a figure of around 2% on average for the year. The easing of inflationary pressures arising from the energy component would offset the upward impact of the expected prolongation of the economic upturn and the bigger increase in indirect taxes and administered prices. The risks to these forecasts, however, are on the upside, due on one hand to the potential rises in oil prices and, on the other, to a higher-than-expected increase in wages, given high economic growth and the significant improvement in the labour market.

## 2 Economic policies

### 2.1 FISCAL POLICY

The cycle led to a decline in the area's actual budget deficit...

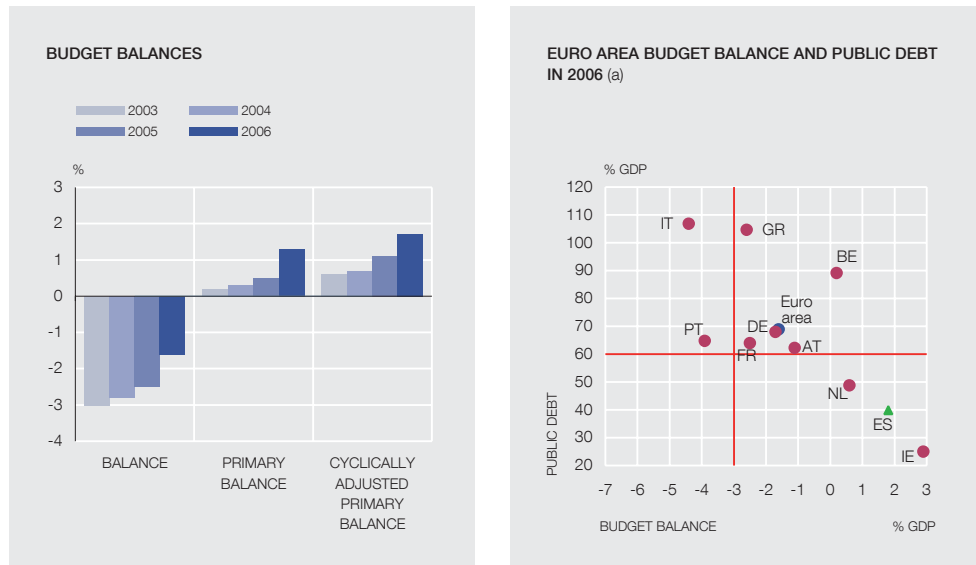
In 2006, the area's aggregate budget deficit declined notably to 1.6% of GDP, 0.9 pp less than in 2005 and 1.4 pp below the related 2003 figure, in which year the general government deficit in the euro area was at its highest since the start of EMU (see Chart 4.4). The improvement in the primary balance was on a similar scale, since interest payments expressed as a proportion of GDP did not change.

but the structural improvement was insufficient...

On the European Commission's calculations, the cyclical and cyclically adjusted components contributed 0.3 pp and 0.6 pp, respectively, to the reduction in the deficit observed last year. The structural balance (i.e. the cyclically adjusted balance, excluding temporary measures) improved by 0.9 pp to stand at -1.1% of GDP. However, this breakdown of the reduction in the deficit in 2006 should be viewed with due caution, given the difficulties of accurately estimating the effects of the business cycle on budgetary balances. In particular, these calculations tend to overestimate the strength of the underlying position of public finances in economic upturns. This is due, in part, to the use of the assumption that the elasticity of tax revenue with respect to nominal GDP is approximately equal to unity, when in many countries the growth of tax revenue in 2006 amply exceeded that of output. This aspect is related to the favourable trend of certain determinants of tax bases, such as corporate earnings, house prices and stock market prices.

although it allowed headway to be made in correcting excessive deficits.

The correction of budgetary balances was generalised across the euro area. Only in Italy was a deterioration recorded (by 0.2 pp to a deficit of 4.4% of GDP), although this was due to specific, exceptional factors accounting for 1.3 pp of the deficit posted.



SOURCE: European Commission.

Among the remaining countries running an excessive deficit, Germany, Greece and Portugal recorded very substantial improvements in their balances, after which the deficit fell below the level of 3% in the first two countries, while it held far above it in the third. Finally, although the adjustment was more modest in France, in January 2007 the ECOFIN Council considered that the excessive deficit situation had been corrected, whereby it decided to repeal the related Excessive Deficit Procedure (EDP). This decision was based on the fact that the deficit stood, for the second year running, below the threshold of 3% of GDP, even though these results were supported both in 2005 and in 2006 by the resort to temporary measures. In February, June and July 2006, the Commission submitted to the ECOFIN Council communications relating to the EDP proceedings initiated against Italy, Portugal and Germany. In the respective texts, the Commission considered that, in the light of the measures undertaken by the authorities, the three countries were well on the way to correcting the excessive deficits by the dates recommended by the Council (2007 in the cases of Italy and Germany, and 2008 for Portugal) and that, consequently, the move to the following stage of the Procedure was not necessary.

The additional correction envisaged in the new stability programmes is very limited.

According to the stability programmes submitted in autumn last year, the aggregate deficit of the area as a whole would fall to 1.4% of GDP in 2007. If national targets were met, only Portugal would continue to run a deficit of more than 3% of GDP in 2007. The budgetary results for 2006, along with the information from the Programmes, allow an assessment to be made of the application of the Stability and Growth Pact (SGP) reform two years after its adoption. On one hand, the part of the pact aimed at ensuring that the member states subject to an EDP rapidly reduce their imbalances appears to have functioned appropriately, insofar as these countries have generally applied correction strategies. On the other, there has been less success when it comes to ensuring that the countries that are not in an excessive deficit position, but which have not attained positions close to a balanced budget, are moving promptly towards such positions, since the related Programmes do not generally comply with the SGP prescription to reduce structural deficits by at least 0.5% of GDP per annum.

More resolute progress is needed.

The improvement in budgetary results seen in 2006 should not lead to complacency, since the European countries' ability to face adverse shocks through the functioning of the automatic stabilisers depends on the room for manoeuvre generated in favourable phases. The emergence of excessive deficits in several countries in the area during the recent period of low economic growth

has its source in the policies applied at the onset of EMU when, in a propitious cyclical setting, the underlying budgetary position was deemed sufficiently sound as to relax the fiscal policy stance. The need to avoid repeating this economic policy error requires that the current circumstances be harnessed to correct the deficits more resolutely, as illustrated by the adoption of a longer time perspective. Thus, while the deficit last year was only 0.3 pp higher than the figure of 1.3% observed in 1999 (the first year of Monetary Union), the primary surplus is 1.3 pp lower, indicating that, in this period, use has not been made of lower interest spending to improve the situation of public finances. Moreover, the attainment of sound budgetary positions is one of the ingredients needed to face the challenges posed by population ageing, the impact of which on public finances may prove very harsh if the necessary measures are not taken.

Budget quality review is a growing priority.

Finally, debate over the level and composition of public revenue and expenditure has become more prominent in economic policy discussions. In particular, on the expenditure side, two avenues for action should be identified: the redirecting of spending towards items supportive of productivity growth in the economy (such as education and R+D) and the increased efficiency of the spending on each item individually considered, so that the same objectives are achieved with a lower volume of resources.

## 2.2 STRUCTURAL POLICIES

The reforms made appear to have begun to bear fruit...

In recent years the euro area countries have, albeit with differing intensity, according to the circumstances, introduced reforms aimed at promoting a greater degree of utilisation of the labour factor and at fomenting productivity growth. The performance of both variables improved in 2006, which was fundamentally due to cyclical reasons, although it is possible that the measures undertaken are also partly responsible. In particular, the sound results recorded by the German economy would indicate that the reforms made may, to some extent, have assisted the economic recovery.

but much remains to be done.

In any event, it should not be concluded from the cyclical boom that the reforms have become less pressing. First, the scope for improving employment and productivity remains considerable. Further, by increasing the economy's rate of growth potential, the structural reforms contribute to ensuring the sustainability of public finances. Finally, for the euro area countries, the flexibility of their economies is particularly important since it helps raise their adaptability in the face of shocks, by providing for the readier reallocation of resources among corporations and sectors.

The process has unfolded within the institutional framework set in place by the European Council.

The process of reforms was given a boost by the March 2005 European Council, which established a division of roles between the Community and national levels, requiring in particular that, in the course of that year, the Commission and the Member States should respectively submit the Lisbon Community Programme (LCP) and the National Reform Programmes (NRPs). Each within their respective fields, these documents identified specific objectives and the policies that should allow them to be met. A year later, in autumn 2006, both the Commission and the various national authorities released their first Progress Reports, describing the progress made in the application of their respective reform strategies. On the basis of these reports, the Commission presented in December 2006 its overall assessment of the status of the process, favourably judging, in particular, the progress in implementing the NRPs, although acknowledging at the same time that headway in the Programmes across countries and economic policy areas was uneven.

To promote employment, the countries are reforming their tax and welfare benefits systems...

Among the measures aimed at allowing a greater use of the labour factor, the national progress reports have particularly emphasised the reforms to tax and welfare benefits systems, in order to raise participation. On some occasions, as in the cases of Germany and Finland, cuts in social security contributions and in tax on labour income have been directed at all workers. In other cases (as in Austria, Belgium, Ireland, France and Italy), measures have been targeted

on specific groups, such as the long-term unemployed, the less skilled and lower paid, youths and elderly workers.

The reforms to unemployment and other welfare benefit systems have been aimed at establishing stricter qualifying conditions, reducing the duration of the maximum period over which benefits are received and giving economic incentives to accept a new job. Among the countries that have introduced measures in this connection in 2006 are the Netherlands, Belgium, Germany, Finland and Portugal. In many Member States, amending the design features of welfare benefit systems that discourage the employment of elderly workers has been a priority. Specifically, there have been measures in several countries to raise the actual retirement age, either through reducing the financial incentives to early retirement or increasing the qualifying contribution period. Further, in some cases the use of unemployment or occupational disability benefits as an alternative to premature withdrawal from the labour market has been restricted. Finally, Germany has approved a staggered raising of the legal retirement age to 67 by 2012.

and, to a lesser extent, other institutional aspects of labour markets.

The progress reports generally pay less attention to the reform of other institutional characteristics of labour markets that may be constraining job creation, such as employment protection legislation, the high level of minimum wages (in particular for specific groups of workers) and collective bargaining arrangements, which lead to excessive wage settlements in certain regions or companies; for instance, through the practice of extending agreements to workers other than those who initially signed the agreement.

Some steps have been taken to make product markets more flexible and in connection with R+D policies.

The policies required to boost labour productivity are geared to reducing the degree of regulation of product markets, to encourage spending on research and development, and to foment investment in human capital. As regards the first of these areas, many countries have introduced measures to spur retail trade competition, they have amended the regulations restricting competition in certain professions and they have simplified the administrative burden on companies (in particular by making the procedure for setting up new companies easier through the establishment of a "one-stop shop").

As to R+D policies, the measures implemented have above all been geared to using public spending as a lever for boosting private spending, through the concession of tax incentives and direct aid or the promotion of public and private partnership initiatives. Moreover, several countries have set up independent agencies to evaluate the quality of public research institutions and reforms have been made to the latter with a view to tying funds extended to a greater extent to the quality of the projects submitted. Lastly, regarding the accumulation of human capital through the education system, attention has focused on aspects such as continuous training and the increased flexibility of educational courses.

At the Community level, progress has been significant...

Along with the national dimension, the Lisbon Agenda covers Community-level measures in those areas in which either the benefits of centralised action outweigh those taken at national level or the distribution of costs and benefits across the different countries is not uniform, which would make it difficult for the measures to be adopted by the Member States individually. Such action, which is basically channelled through the LCP, covers areas such as the single market, competition policy and trade policy. It encompasses the design of strategic priorities, where the initiative falls on the European Commission, and of the pertinent regulations and funding instruments needed, where responsibility mostly corresponds not only to the Commission, the driving force behind the proposals, but also to the Council and the European Parliament, which must adopt the attendant legislative acts.

including most notably the services Directive.

Notable among the legislative processes concluded and approved in 2006 was the services Directive. The degree of competition in services is comparatively less than in manufacturing, a fact due in part to the lesser degree of cross-border tradability of services. However, it is also due to the presence of administrative and legal obstacles which prevent services companies from pursuing their activity in a country other than their home state. The aim of the Directive is to promote cross-border competition through the lowering of these barriers. Nonetheless, the legal text finally approved excludes the possibility of the provision of services without this being through a prior establishment in the host country. Further, the Directive includes, along with a list of sectors to which the provisions are not applicable, the possibility of Member States defining a set of services of general interest that would also remain outside the scope of application of the Directive. Following its approval, and in view of the potential for higher productivity that the services sector offers, it would be desirable for the transposition of the Directive to national legislation, which has to take place before December 2009, to be made as soon as possible.

Fresh momentum must be given to the deregulation of energy markets...

Turning to the network industries, the relevance of deregulation is due not only to the individual weight of the sector but also to its importance for the competitiveness of the rest of the economy. Generally, progress has been limited in the gas and electricity markets which, in a majority of countries, remain beleaguered by an insufficient degree of competition manifest in high levels of concentration and vertical integration and regulated price systems that leave market power in the hands of the dominant operators. In March 2007, the European Council approved a plan of action reaffirming the resolve to establish a genuine single European energy market, providing a further boost to the interconnection of domestic markets.

and to the integration of financial markets.

Progress in the integration of European financial markets has continued thanks to the implementation of the strategy designed in the Financial Services Action Plan. However, headway is still limited in certain areas, namely the retail markets – including the persistence of obstacles to cross-border transactions – and certain market infrastructure elements, such as payment, clearing and settlement systems. The initiatives in this latter field are set out in Box 4 .2.

In other Community areas, headway has been uneven.

As to policies to boost innovation, the year 2006 saw the approval of the Seventh Framework Programme for Research and Technological Development, the basic instrument for financing innovation-related activities in the period 2007-2013. The European Institute of Technology was also founded. However, the creation of the Community patent, which is intended to provide for and lower the cost of protecting new inventions, remains blocked. Moreover, the Commission has adopted initiatives geared to reducing administrative costs and simplifying the regulatory environment, and it has announced that it will unveil a legislative initiative towards the end of 2008 for the design of a common corporate income tax base. No progress was made in 2006 in areas of importance for promoting labour mobility, such as the possibility of transferring pension rights and the elimination of the restrictions on the mutual recognition of professional qualifications. Finally, in spring 2007, the Commission presented its second report on the application of the plan to promote environmental technologies, a key instrument in combating climate change and one geared to fomenting European leadership in the development of innovations in this field.

It is important that reforms be introduced more resolutely.

The results of the first full year of application of the renewed Lisbon strategy are moderately encouraging. The introduction of the NRPs has provided structural policies with a consistent framework for their design and application, and it has strengthened the commitment of each country's social partners to the reforms. Nonetheless, the reforms must be resolutely adopted, since experience shows that, in those instances where measures have been introduced hesi-



Despite the progress made in recent years in the process of financial integration in Europe, certain segments of financial markets are still somewhat fragmented, particularly as regards securities payment, clearing and settlement systems<sup>1</sup>. In order to dismantle the remaining barriers to cross-border transactions in these areas, several initiatives have been taken recently within the EU. The most important features of these initiatives are summarised below.

The aim of the SEPA initiative, which was promoted by the banking community with the support of the European authorities, is to establish a single retail payments area in Europe. To this end, the functioning of three specific instruments – credit transfers, direct debits and card payments – will be changed. Thus, 2008 may see the first transfers and direct debits performed in compliance with the new standards (and therefore subject to the same process, be they domestic or cross-border) and by 2010 the interconnection of national retail payments systems must have been completed, so that domestic and cross-border transactions can be performed in the same way. Any European institution may access the payment processing infrastructures existing in the area. SEPA envisages enlarging the area where cards can be used: it should be possible to use card brands which are currently only domestic throughout the single payments area, irrespective of their country of issue. It also proposes introducing chip technology using the EMV standard. The effort and cooperation of all parties involved are required to achieve these objectives. For this purpose, each banking community is currently designing and preparing its national plans for migration to SEPA. The central banks are playing an important role here, promoting the project and coordinating the groundwork.

Integration has progressed at a considerably faster pace in the area of wholesale payments, thanks to the TARGET system managed by the Eurosystem, which is based on interconnecting participants' national systems. However, in order to make further progress, the Eurosystem has developed a single platform called TARGET2, which will replace the existing platform and process all transactions wheth-

er they are domestic or cross-border. This will permit the harmonisation of tariffs and services for all institutions which use the system, without distinction between domestic and international payments, making it easier for transnational financial groups to manage them in a centralised manner. Spain's banking community will join on 18 February 2008.

Another important initiative, originally promoted by the Commissioner for the Internal Market and Services, Mr. McCreevy, to boost financial integration in Europe, has been the presentation of a code of conduct for securities clearing and settlement. The measures considered cover three basic aspects of trading in equities: transparency of the prices for the various services, conditions of access and the interoperability of the trading and clearing-settlement infrastructures and service unbundling in relation to prices and accounting.

The Markets in Financial Instruments Directive (MiFID) also contains some measures that will boost financial integration in Europe. In particular, before November 2007 the monopoly of trading on securities markets will disappear and the investment services companies of a Member State may choose freely, although subject to certain restrictions, the securities clearing and settlement system of any Member State. At the same time, regulated markets must offer their members freedom of choice regarding the system used for the clearing and settlement of transactions.

The TARGET2-Securities project (also sponsored by the Eurosystem) has emerged against this background. On the basis of the TARGET2 platform for the settlement of large-value payments, it would be possible to centralise the settlement of central depositories' securities accounts in a single platform, in which the related cash settlements would also be processed. In this way securities would be paid for and transferred in real time in the same system. However, the other functions of central depositories would remain intact, including the business relationships with their members. This initiative has obvious synergies with MiFID, since it provides for free choice of post-trading system, and with the code of conduct on clearing and settlement, particularly as regards access and interoperability. The TARGET2-Securities project is currently at the consultation stage and it is planned that a decision will be taken in 2008 on its implementation.

1. For more detail on the barriers and actions proposed see Giovannini Group (2003), *Report on EU Clearing and Settlement Arrangements*, Commission of the European Communities.

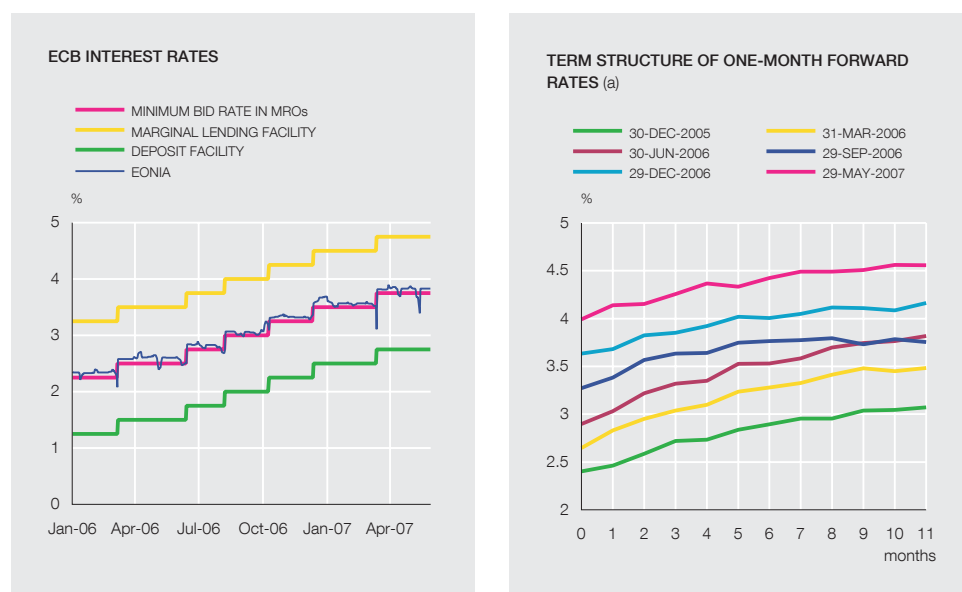
tantly – and even scaled back subsequently – the positive effects have been lessened, which in turn has encouraged scepticism.

### 3 The common monetary policy and monetary and financial conditions in the euro area

#### 3.1 MONETARY POLICY DECISIONS

The emergence of upside risks to price stability, against the background of very loose monetary conditions and the firming of the economic recovery initiated in mid-2005, led the area's monetary policy authorities gradually to adopt a less accommodative stance over the course of the year. In any event, the ECB faced a complex scenario, owing to the uncertainty over the course of oil prices and their possible adverse effects, both direct and indirect, on inflation and economic growth in the area.





SOURCES: ECB and Banco de España.

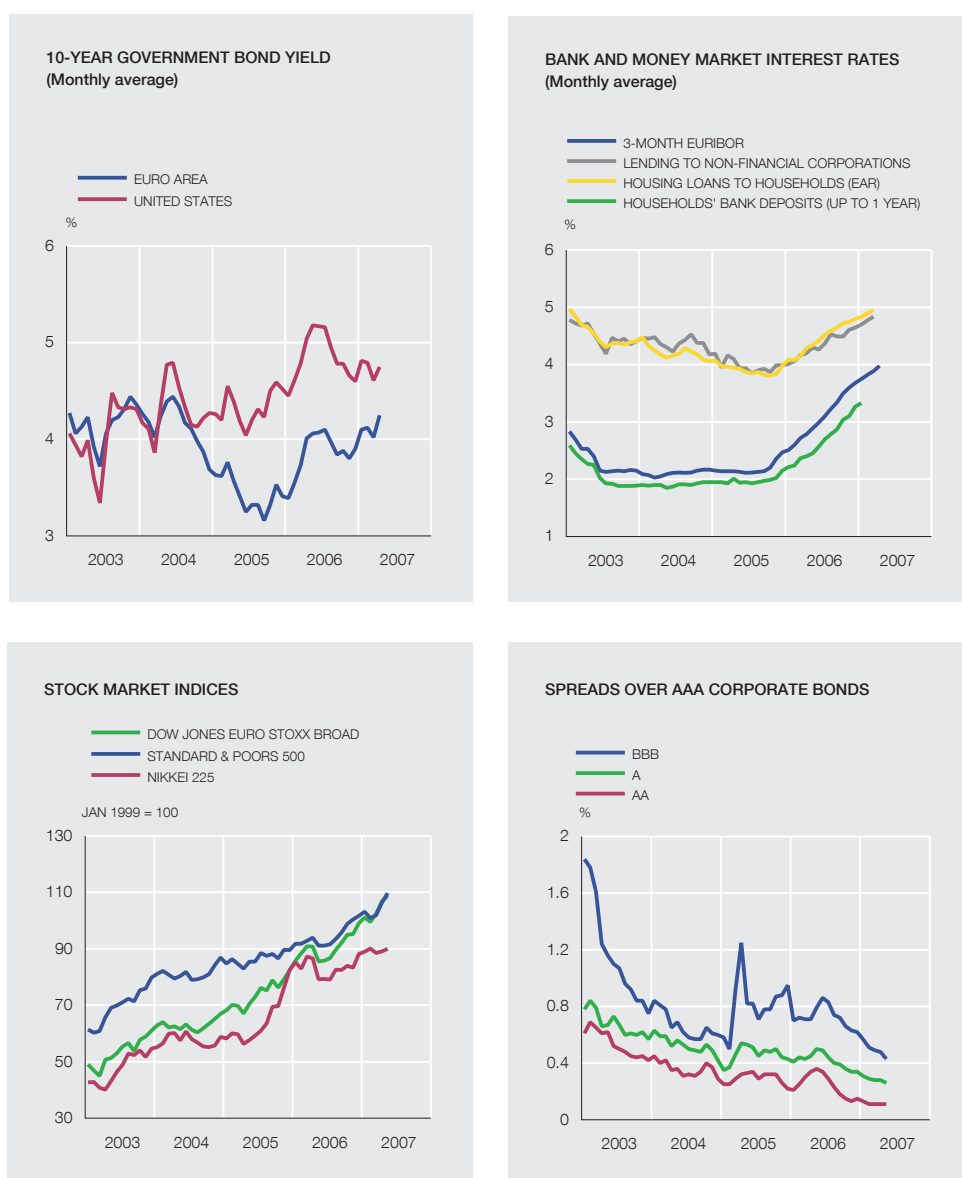
a. Estimated using interbank market data.

The existence of risks to price stability...

The recovery in internal demand allowed the greater dynamism of economic activity in the euro area to become more sustainable and, moreover, more balanced in its distribution by country and productive branch. As a result, both the Eurosystem and most international agencies made successive upward revisions to their growth forecasts for the area, placing estimated rates above potential. As earlier discussed, inflation hinged heavily on changes in oil prices, whereby during the first eight months of the year, the year-on-year rate of change of the HICP held at over 2%, the reference level in the price stability definition used by the ECB. Admittedly, the fall in oil prices and the base effect of its price increase in summer 2005 gave rise to a significant reduction in inflation, to a level of below 2%. But persisting throughout the year was the risk of a deterioration in the inflationary outlook associated with the potential effects of past oil price rises on price- and wage-setting in the economy and with the possibility of greater-than-anticipated increases in indirect taxes and regulated prices.

led to increases in rates, although their level remains moderate.

In this setting, as the year unfolded, the ECB became aware of the need to adjust the accommodative monetary stance maintained during the prolonged phase of sluggish economic growth. This translated into successive 25 bp rises in official interest rates (on seven occasions from December 2005, up to 3.75% in March 2007 (see Chart 4.5). After the first increase, the two following rises were at three-month intervals. However, as from the summer and in the light of its assessment of macroeconomic conditions, the Governing Council stepped up the rate of adjustment of the monetary policy stance, in such a way that the three subsequent increases took place every two months. The last decision of this nature (taken in March 2007) was once again adopted three months later than the decision preceding it. That said, interest rates have held at moderate levels at all maturities, both in real and nominal terms. Accordingly, despite the withdrawal of part of the monetary stimulus, conditions remain propitious for the prolongation of the economic upturn. The course of market rates indicates that the monetary policy decisions adopted were anticipated by the markets. Moreover, the credibility of the monetary authority's objectives continues to be reflected in the indicators of the medium-term inflation outlook, which remained anchored at levels consistent with the price stability objective.



SOURCES: ECB and Banco de España.

a. Interest rates for loan terms over five years.

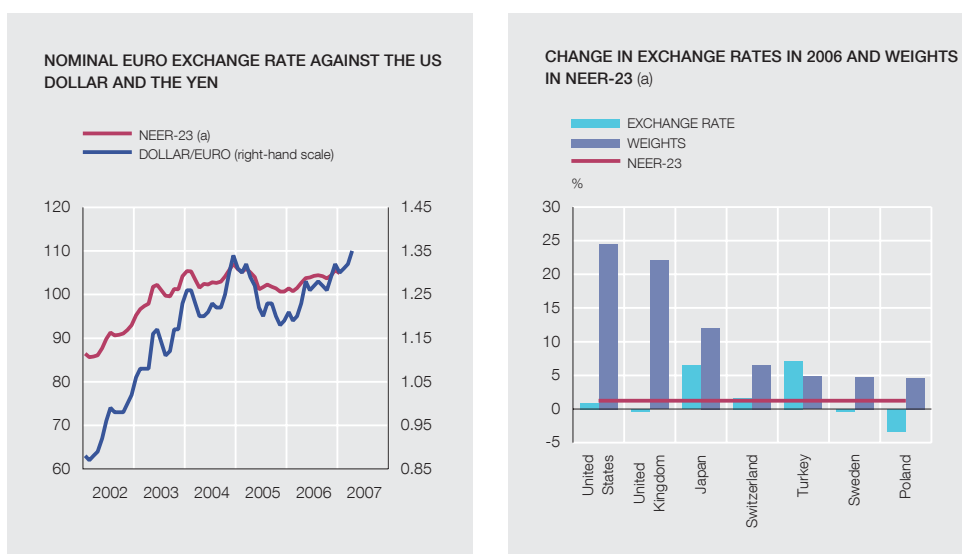
b. Spread in yields on euro-dominated bonds issues by non-financial corporations over yields on AAA bonds issued by non-financial corporations.

### 3.2 FINANCIAL DEVELOPMENTS IN THE EURO AREA

The increase in official interest rates fed through to the money, debt and credit markets

During the year, the firming of economic activity and the uncertainty over the scale of the pass-through of oil price rises to the area's inflation rate led to a progressive increase in money market interest rates at all maturities. Although in the first half of the year the positive slope of the money market yield curve tended to steepen, from the start of the summer the increases were less marked at the longer-dated maturities, which has given rise to a progressive flattening of the curve. As a result, in late May 2007 the spread between one-year and one-month rates was around 45 bp.

On the debt markets, long-term bond yields moved on a rising course in 2006, probably reflecting the growing optimism of market participants about the growth prospects for the area (see Chart 4.6). At the same time, the spread between long- and short-term rates progressively narrowed, without turning negative, unlike in the United States. In March 2007, the 10-year bond yield stood at around 4%.



SOURCES: ECB, European Commission and Banco de España.

a. The NEER-23 is the nominal effective exchange rate against a basket of 23 countries: the 13 EU members that are not in the euro area and the 10 main trading partners of the EU.

In step with the rise in official and market interest rates, the interest rates applied by credit institutions on their transactions with customers also gradually increased in the course of the year. However, the higher cost of credit was compatible with it remaining at a low level by historical standards. Consequently, financing conditions continued to be very favourable, which was likewise reflected in corporate bond yields holding at low levels.

Stock markets continued to post substantial gains.

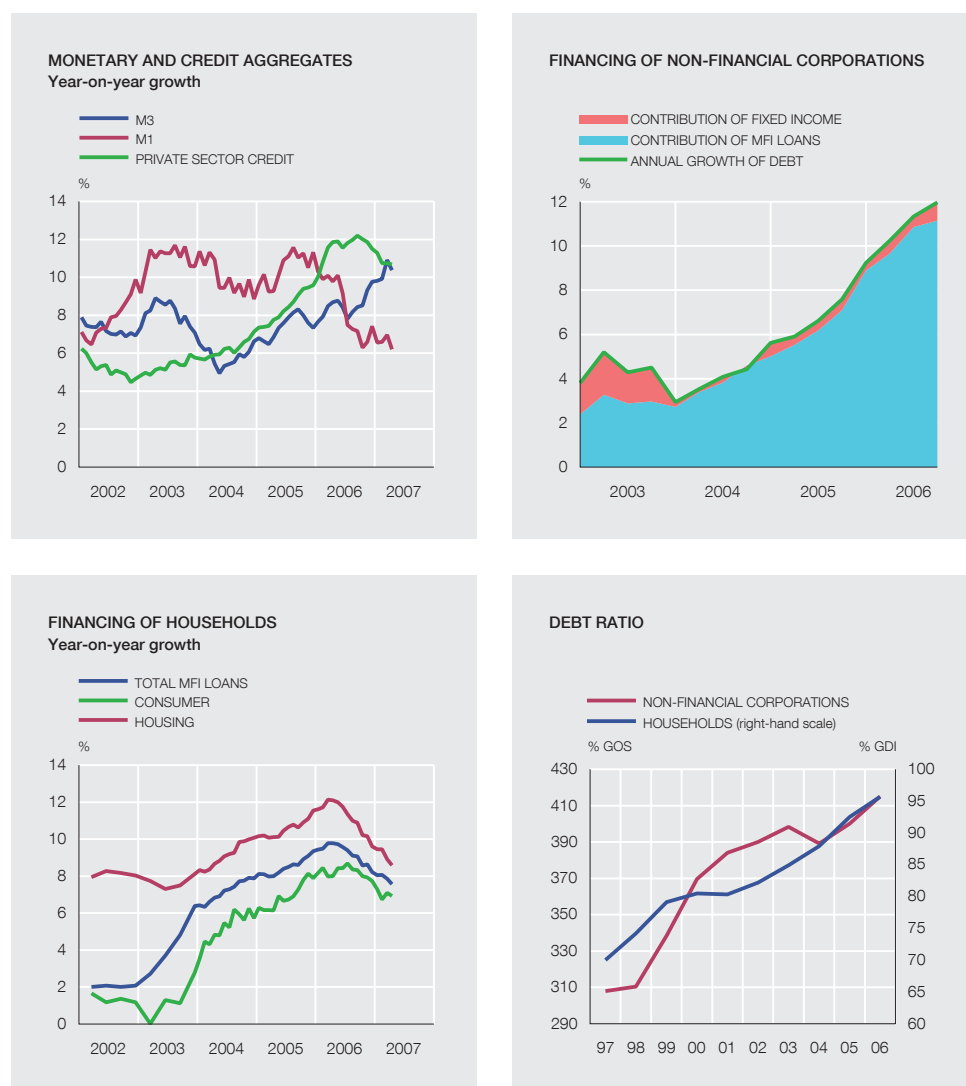
The sustained upward trend initiated in spring 2003 on the euro area equity markets continued, meaning that in 2006 as a whole, the broad Euro Stoxx index grew by over 20%, a higher rise than that seen on other developed countries' stock markets. Prices were pushed upwards by the favourable trend of both reported and expected corporate earnings. The stock market boom continued unchanged during the year, excepting a temporary episode in the May-June period which, in the absence of any changes in fundamentals, might have been due to an increase in uncertainty – as attested to by the strong rise in volatility – and, perhaps, to an increased perception of risk on the part of market participants. In late February 2007 there was a similar though shorter episode.

And the euro appreciated moderately.

During 2006 and in the early months of 2007, the exchange rate of the euro continued on the rising trend initiated in late 2005, appreciating by around 6% in nominal effective terms and by over 10% against the dollar and the yen (see Chart 4.7). In the case of the dollar, the underlying reason may have been the growing evidence of firming economic activity in the euro area, in contrast to the signs of a slowdown in the United States. The weakness of the yen appears to be due, at least in part, to the sizeable negative yield spread on Japanese assets, which would have been conducive to carry trade strategies (with investors borrowing in yen to buy higher-yielding assets denominated in another currency).

The behaviour of the monetary aggregates was very dynamic...

The M3 aggregate became increasingly dynamic in the course of 2006, a trend which ran into the opening months of 2007. In particular, M3 grew in December 2006 by almost 2 pp above its rate at the start of the year (see Chart 4.8). This was the outcome of the acceleration in time deposits, while sight deposits lost considerable momentum. This divergence is consistent with the different responsiveness of the yields on these deposits to the rise in official interest rates.



Sources: ECB and Banco de España.

- a. Gross operating surplus.  
b. Gross disposable income.

as was that of private-sector loans, especially to companies.

In step with the persistence of low debt costs and with the buoyancy of economic activity, loans extended by monetary financial institutions showed notable strength in 2006. The year-on-year growth rate of this variable, which had ended the previous year at around 9%, rose at the beginning of 2006 and stood in March at over 11%. It held at this level until the closing months of the year, when it eased slightly, in keeping with the higher cost of debt. Loans to households and firms moved on divergent courses. Loans to companies posted the highest rate of expansion recorded since the start of EMU (around 13%), and their robustness ran alongside the abundance of funds generated within business, while the growth of financing through securities, including equity issues, was much more modest. According to the Bank Lending Survey, the acceleration in credit is due above all to the need to finance productive investment, although other financial factors (linked to mergers and acquisitions activity) also contributed. In the case of households, the rate of increase of loans weakened during the year due to the house-purchase component, which was affected by the easing off in demand and in real estate prices in certain countries in the area. In any event, the course of loan flows gave rise to a moderate increase in household and corporate debt ratios.



## The Spanish economy

The dynamism of the Spanish economy continued in 2006, with a growth rate for the year as a whole of 3.9%, 0.4 pp up on 2005. As analysed in chapters 1 and 2, the surge in population has been decisive in explaining the momentum of supply and demand. In 2006, moreover, the recovery in the euro area – set against the background of the strength of the external environment – and the tightening of monetary conditions enabled the increase in activity in Spain to be compatible with some rebalancing of the contributions to growth of national demand and of net exports. Indeed, from the expenditure perspective, last year saw a slowdown in national demand and a 0.7 pp improvement in the contribution of the external sector. Despite this, the borrowing requirements of the Spanish economy continued to increase in 2006, rising to 7.8% of GDP (6.5% in 2005). Employment remained highly dynamic, growing by 3.1%, which allowed a significant increase in the labour force to be absorbed and the unemployment rate to be cut to 8.5%. On the inflationary front there was no appreciable progress, since the CPI posted an average rate of increase of 3.5% in 2006, similar to that in 2005, although it diminished substantially over the course of the year in response to changes in oil prices.

### 1 *Economic policies*

#### 1.1 MONETARY AND FINANCIAL CONDITIONS

Private-sector financing conditions tightened in 2006, but they remained benign for the situation of the Spanish economy.

Financing conditions for households and firms tightened during 2006. In line with the rise in money market interest rates, where the change over the year in the one-year EURIBOR was 1.1 pp, the cost of bank credit extended to these sectors rose by 1.2 pp in both cases, as shown in Chart 5.1. The price of the resort to medium- and long-term fixed-income issues by companies increased to a lesser extent (0.6 pp), while the cost of own funds held relatively stable, since the rise in stock market prices – which makes borrowing cheaper – was approximately offset by the growth in dividends. The euro's appreciation against the main currencies (by 4.3% in nominal terms over the course of 2006) also contributed to the tightening of monetary conditions. Notwithstanding, the cost of financial resources held at levels which were low from both a historical perspective and compared with the strength of domestic demand, meaning that monetary and financial conditions may generally be considered as benign (see Box 1.1).

Net household wealth increased significantly, adding to the dynamism of spending.

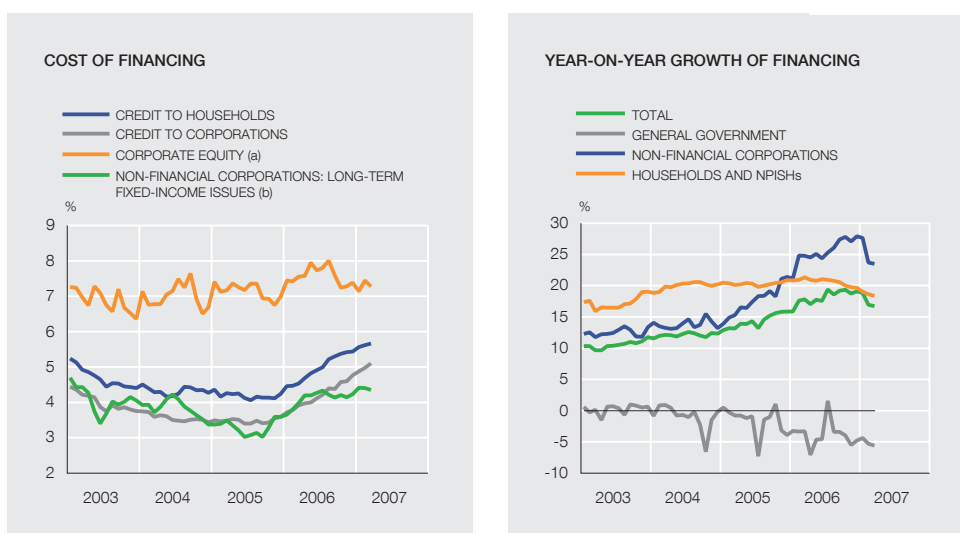
Net household wealth, boosted by the rise in equity and property prices, continued to be supportive of the expansion of consumption and of residential investment. Although the Madrid Stock Exchange general index climbed significantly (34.5%), wealth increased at a lesser pace than in previous years as a result of the slowdown in house prices, which grew by 9.1% year-on-year in 2006 Q4, compared with 12.8% in the same period a year earlier. This deceleration continued in 2007 Q1, as house prices increased in that period by 7.2% year-on-year.

The growth of household debt eased back slightly, although the debt and debt service ratios continued to increase.

The tightening of monetary conditions and the slowdown in household wealth contributed to easing slightly the pace of household debt, although it remained high, growing at around 19% in December 2006 compared with 20.9% at end-2005. Consequently, both the debt and debt service ratios increased once more, while the ability to save, once financial obligations were met, diminished again. That said, the rise in the value of real and financial assets softened the unfavourable impact on the wealth position arising from the behaviour of the foregoing indicators.

Borrowing by companies accelerated and corporate earnings continued to grow.

Conversely, financing extended to corporations accelerated, with its rate of increase rising to over 28% at end-2006. The expansionary behaviour of borrowed funds continued to be highly influenced by the behaviour of corporations in the real estate and construction sectors, the growth rate of whose liabilities increased, although greater dynamism was also seen in funds



SOURCES: Datastream, MSCI Blue Book and Banco de España.

- a. The cost of equity is based on the three-stage Gordon dividend discount model.  
 b. The cost of market-based long-term debt is calculated as the sum of the 5-year euro swap rate and the weighted average of the credit risk insurance premia of Spanish non-financial corporations at that same term.

assigned to the other services branches. The reflection of these developments was fresh rises in the debt and debt service ratios of the non-financial corporations sector. However, the favourable trend of economic activity enabled corporate net profits to continue rising, especially in the case of major corporations.

## 1.2 FISCAL POLICY

The State Budget projected a small general government surplus in 2006.

The State Budget for 2006 was designed on the basis of a macroeconomic scenario of robust growth in the Spanish economy, marked by the resilience of domestic demand. The Budget envisaged a general government surplus, in National Accounts terms, of 0.2% of GDP, in line with the projected Budgetary Stability Targets 2006-2008 established by the government in April 2005, in compliance with the Budgetary Stability Law then in force.

The budgetary targets were based on moderate forecasts of revenue, especially as far as tax revenue was concerned. As a result, the target surplus established in the budget proved attainable and entailed in fact a relaxing of the fiscal consolidation drive. Given the ongoing expansion in the Spanish economy, it seemed advisable for any greater-than-forecast increase in revenue to be assigned to attaining a budget surplus greater than initially established. The spending policies incorporated into the budget were designed with the aim of boosting productivity by means of the growth in investment in infrastructure, R+D+i and education, and the bolstering of social spending.

Having attained a surplus of 1.8% of GDP, the fiscal policy stance was moderately contractionary.

In the course of the year, as clear signs emerged of economic growth targets being exceeded, the budgetary outturn also showed better results than those programmed for public finances. Specifically, the surplus of 1.8% of GDP finally attained and the 0.6 pp improvement in the primary balance give a moderately restrictive character to the fiscal policy actually applied, according to the habitual indicators for calculating the fiscal policy stance (see Table 5.1). There were notable surpluses in the State and Social Security sub-sectors, while in Territorial Governments there was a small deficit, centred on Local Governments, since Regional (Autonomous) Governments as a whole ended the year in balance.



% of GDP	2003	2004	2005	2006
1. NON-FINANCIAL RESOURCES	38.5	39.0	39.8	40.8
Current resources	37.9	38.1	39.1	40.2
— Taxes on products and imports	11.5	11.9	12.1	12.3
— Taxes on income and wealth	10.1	10.2	10.9	11.7
— Social contributions	13.0	13.0	13.0	13.0
— Other current resources (a)	3.3	3.1	3.0	3.2
Capital resources	0.7	0.9	0.8	0.6
2. NON-FINANCIAL USES (b)	38.6	39.2	38.7	39.0
Current uses	33.9	34.1	33.9	33.8
— Final consumption	17.4	17.8	18.0	17.9
— Social benefits other than social transf. in kind	11.7	11.7	11.6	11.6
— Interest (b)	2.3	2.0	1.8	1.6
— Subsidies	1.0	1.0	1.0	1.0
— Other transfers	1.5	1.5	1.5	1.6
Capital uses	4.7	5.1	4.8	5.2
— Gross capital formation (c)	3.5	3.4	3.6	3.9
— Other capital uses	1.1	1.7	1.2	1.3
3. NET LENDING (+)/ BORROWING (–) borrowing (b) (3 = 1 – 2)	0.0	-0.2	1.1	1.8
MEMORANDUM ITEM:				
Primary surplus	2.3	1.9	2.9	3.5
Gross debt (b)	48.7	46.2	43.2	39.8

SOURCES: INE, Ministerio de Economía y Hacienda and Banco de España.

a. Includes gross operating surplus.

b. According to the Excessive Deficit Procedure methodology.

c. Includes net acquisitions of non-financial non-produced assets.

The improvement in the balance came about due to the buoyancy of revenue...

As in previous years, the improvement in the balance was essentially due to the buoyancy of revenue from the main taxes. Tax takings posted very high growth which, in part, should be associated with the real estate and stock market boom, meaning there is a temporary component to this buoyancy. The increase in the tax burden has been channelled, above all, through income and wealth tax, and, to a lesser extent, through taxes on production and imports. These developments have led to further convergence in the weight of both types of taxation in GDP, meaning that direct taxes, indirect taxes and social security contributions contribute virtually one-third each to total revenue.

Despite the immigrant regularisation process, which entailed a substantial increase in the number of Social Security registrations, the weight of social contributions held constant at 13% of GDP for the fourth year running. This stability reflects not only a degree of wage moderation, as analysed elsewhere in this report, but also the impact on public finances of the reduction in employers' social security contributions, especially those relating to unemployment, in application of the labour reform agreed in May. The decline in capital resources is due to smaller capital transfers from the EU in the final year of the Financial Perspectives 2002-2006.

and to the containment of spending, except that on investment.

Current expenditure was somewhat contained, owing to the continuation of the diminishing trend of interest payments, prompted by the decline in debt and despite the slight rise in interest rates on new issues. Further, after increasing continuously for four years, there was a slight reduction in the weight of government consumption relative to GDP, although there are signs

this reduction will be temporary owing to the singular containment of acquisitions of goods and services during 2006, after several years of strong increases.

Turning to social benefits, the relatively high growth rate of unemployment benefits continued apace owing to the increase in the actual eligibility rate, against the backdrop of the reduction, in absolute terms, in the number of unemployed. The improvement in minimum and widowhood pensions was countered by a smaller-than-forecast deviation from inflation than that which had to be paid in 2005, allowing spending on pensions to be contained. Overall, social benefits grew in line with GDP.

It was in fact under the capital expenditure item where the biggest rates of increase were seen, not only in gross capital formation, which prompted an increase in the public investment ratio to almost 4% of GDP, but also in capital transfers. This behaviour is linked, as in previous cycles, to the electoral calendar, since 2006 was the year prior to the holding of local and regional elections.

The general government accounts comply with the commitments entered into in the Stability and Growth Pact.

Once again in 2006, the general government sector comfortably complied with the Stability and Growth Pact, meeting the operational criterion used in the assessment of compliance whereby the cyclically adjusted balance shall be close to zero or in surplus. Likewise, central government met the requirements of the new Budgetary Stability Law, posting a surplus irrespective of that attained by the Social Security sector, while the State observed the spending ceiling set. Public debt continued on a declining path, standing at below 40% of GDP, and the Reserve Fund once again increased further to the surplus resulting from the Social Security sector, standing at an amount of €40,334 million (4.1% of GDP).

The new agreement for the reform of the Social Security system is of limited scope.

In the medium term, the main challenge facing public finances remains the impact of population ageing on public spending on pensions and health care. In this respect, a new agreement for Social Security reform was reached between the government and the social agents in May, within the framework of the Toledo Pact. Like previous agreements, its aim is to ensure the sustainability of the pensions system. However, the measures adopted make only moderate headway in implementing certain proposals of the revised 2003 Pact, such as the closer alignment of contribution bases and wages actually received, and the extension of the qualifying period for calculating the regulatory base of retirement pensions. As a result, its impact on public spending in the medium term will necessarily be limited.

### 1.3 OTHER ECONOMIC POLICIES

The new labour reform retains the current arrangements for hiring.

In the labour market, the government and the social agents agreed on the contents of the labour reform that came into force on 1 July 2006. The main purpose of this reform, like that of others undertaken since the mid-90s, is to reduce the high ratio of temporary to permanent employees. The chief measures agreed were the changes to the rebate arrangements for permanent hires, which included an exceptional rebate period running to end-2006 in the case of conversions of temporary contracts into permanent ones; a widening of the group of workers who may be offered a permanent contract with lower dismissal costs; the setting of new legal limits on the successive renewal of temporary contracts; and a reduction in employers' contributions for permanent contracts. That said, this reform does not amend basic labour hiring arrangements and, in particular, it does not substantially increase the flexibility of stable contracts, which continue to bear high dismissal costs. Accordingly, the effects of the reform will foreseeably be limited.

And collective bargaining arrangements remain broadly unchanged.

The minimum wage increased by 5.4% in 2006 to €540.90 per month, after a target was set for it to end the legislature at a level of €600. Collective bargaining arrangements remained as broadly set under the Interconfederal Agreement for Collective Bargaining, which was renewed

once again for the year 2007. As in previous years, this agreement set a nominal reference of 2% for wage growth, along with an increase relating to productivity gains. Further, most collective bargaining agreements include indexation clauses. This type of agreement adds some nominal inertia to the wage-setting mechanism and a tendency towards the homogenisation of wage increases, which may hamper wage adjustment to the specific circumstances of companies and industries.

The strategy devised under the National Reforms Plan was further pursued in the markets for goods and services...

In the markets for goods and services, the strategy laid down under the National Reforms Plan (NRP), approved in October 2005, was further pursued. Its ultimate aims for 2010 are full convergence in per capita income with the EU-25 and an employment rate of 66%. Broadly, the measures adopted under the plan are along the right lines and set an appropriate starting point to address the structural problems facing the Spanish economy. They should, however, be applied as promptly as possible, and supplemented with additional measures.

In keeping with the NRP monitoring and update mechanism, the application of the first package of the *Plan de Dinamización de la Economía y de Impulso a la Productividad* (plan to bring about a more dynamic economy and boost productivity) – included in the NRP – was evaluated in March 2006. At the same time, a second package of measures was approved, focusing on the energy sector, the mortgage market and rail transport. Specifically, the measures seek first, to heighten the degree of competition and efficiency in the energy sector; next, to add greater flexibility to the mortgage market and, simultaneously, to improve households' adaptability to changing interest rates; and, finally, to make the legislative changes needed to bring about effective competition in railway freight transport.

and its final objectives were practically met in 2006.

October 2006 saw the presentation of the Annual Progress Report on the NRP. The implementation of the plan has progressed soundly, since in its first year somewhat more than half of the measures envisaged were approved, and both per capita GDP and the employment rate have virtually attained the objectives set for 2010. However, the increase in per capita income has been based on the increase in the employment rate and not on improved productivity, where the gap with the European average has widened.

## 2 Demand

### 2.1 NATIONAL DEMAND

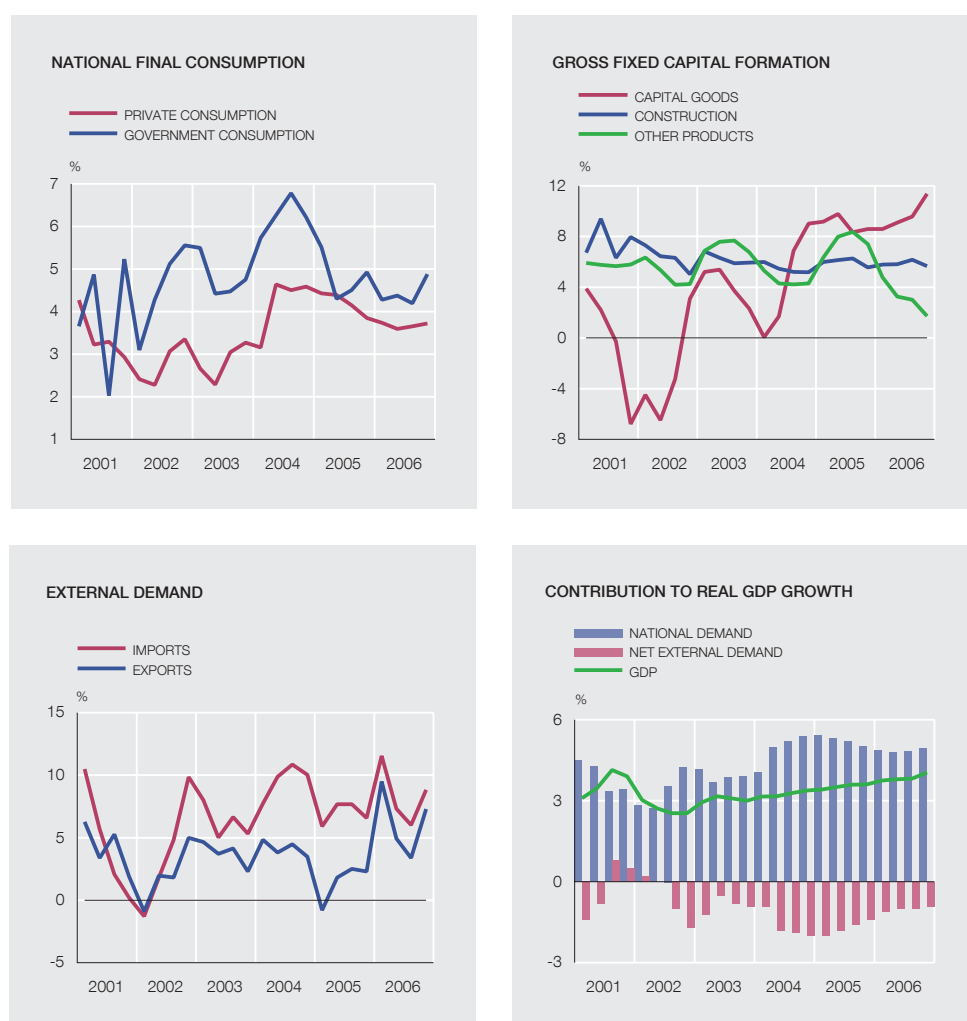
The expansion of national demand once again outpaced output, although the gap between both narrowed.

National demand slowed by 0.4 pp in 2006, posting annual growth of 4.6%. That partly reflected the tightening of financing conditions, although national demand continued to outpace GDP. The rates of increase of both final consumption (government and private alike) and gross capital formation diminished by a similar amount. However, the performance of the various components of investment was somewhat more divergent, since spending on capital goods quickened slightly, construction growth held stable and the rate of change of investment in other products fell significantly (see Chart 5.2).

Household consumption expenditure underwent a slowdown in 2006 which progressively eased as the year unfolded.

Private consumption, though it increased by 3.7% in 2006 (down on its growth in 2005), showed signs of resilience in the face of the rise in interest rates and higher oil prices. The slight slowdown in the first half of the year thus gave way to a stable pattern during the two following quarters. To better understand these movements, Box 5.1 examines in some detail the main factors that influenced consumer decisions.

The pace of spending on non-durable goods and on services fell in 2006, while purchases of durable consumer goods proved more buoyant, as has been the case since 2003, despite the slowdown in spending on cars (see Table 5.2). Both the property boom – which goes hand in hand with purchases of furniture and household electrical goods – and the inflow of immigrants intending to settle permanently in Spain have no doubt contributed to this greater buoyancy of spending on durable goods in recent years. Indeed, beyond the expansionary



SOURCE: INE.

a. Base 2000 National Accounts. Year-on-year rates of change based on seasonally adjusted series of volume indices.

impulse they exert on employment and activity, the arrival of immigrants in the age and income brackets with a greater propensity to consume might also have supported the increase in this variable in recent years, although there are also factors acting in the opposite direction, as discussed in section 3 of chapter 2.

Real household income grew at a slightly lower rate than that in 2005.

Among the determinants of consumption, mention may first be made of real disposable income, which grew at a rate of 3.1%, slightly down on 2005. The rise in employment and the greater increase in compensation per employee contributed to the growth of wage income, although this was more than offset by the slowdown in the individual proprietors' surplus and by a more negative contribution by the general government sector (see Chart 5.3), while the impact of interest rates on the growth in income was virtually zero.

The expansion of investment in housing continued...

The growth of investment in housing remained high in 2006, upheld by the growth in real income and in wealth. Certain socio-demographic factors, such as the reduction in the average size of households, the arrival at adulthood of the baby-boom generations and the rapid growth of the immigrant population, continued to boost the creation of new households and, thereby, the demand for housing.

The economic scenario which prevailed for most of 2006, characterised by successive increases in oil prices and expectations of interest rate hikes, suggested that the pace of growth in consumer spending would ease and that the declining path of the household savings ratio in Spain would level off. However, expenditure on consumer goods and services slowed relatively mildly in 2006 after having stabilised in the second half of the year. What are the reasons for this relative resilience of consumption?

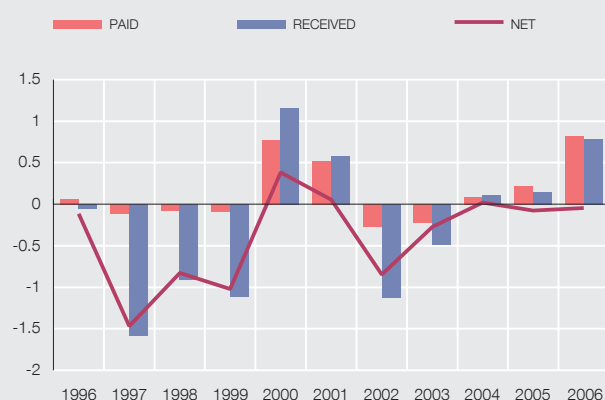
To answer this question, it is worth examining the determinants of consumer spending decisions. Theoretically, these decisions depend on their total wealth or permanent income, i.e. on the current and future revenue agents expect to obtain over their lifetime, be this income from work or from holdings of real and financial assets. Similarly, the real interest rate affects the time path of household expenditure since it influences the trade-off between present and future consumption. Changes in the interest rate also have an effect on income – whether it is positive or negative depends, among other factors, on the relationship between the level of debt and the portfolio of interest-

earning financial assets, and on the sensitivity of the returns on this portfolio and the cost of debt to these changes – and on wealth since they influence the market value of real and financial assets. Lastly, the degree of uncertainty regarding consumer decision-making processes also influences their expenditure plans.

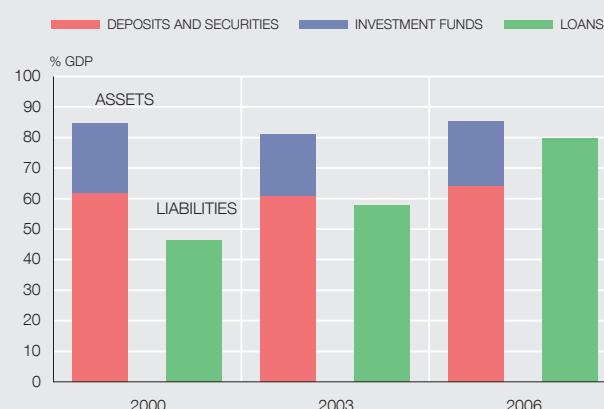
Real income, whose growth declined in the last two years following the expansionary impact of the personal income tax reform in 2004, contributed to the slowdown in consumption in 2006. According to the Banco de España's recently re-estimated quarterly macroeconomic model (MTBE), this variable's contribution to private consumption growth fell 0.2 pp with respect to the average for the previous five-year period (see panel 3).

As discussed in the main text of this chapter, the interest rate rise did not adversely affect growth in nominal income in 2006 since the higher interest burden (approximately 1% of gross disposable income) was almost offset by the increase in interest received by households (see panel 1). Fluctuations in market interest rates feed through to the

### 1 INTEREST OF HOUSEHOLDS AND NPISHs (a)



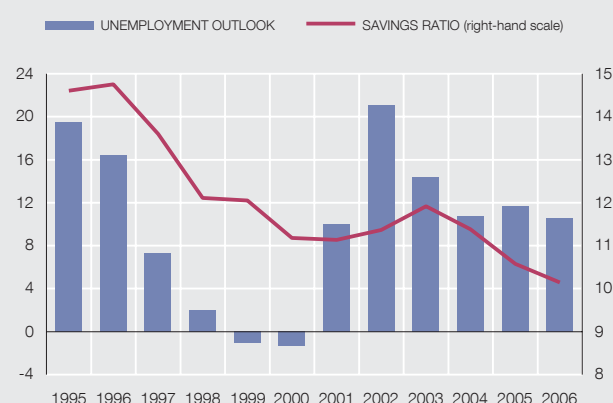
### 2 INTEREST-EARNING FINANCIAL ASSETS AND LIABILITIES



### 3 GROWTH IN PRIVATE CONSUMPTION (MTBE) (b)

	1998-00	2001-03	2004-05	2006
PRIVATE CONSUMPTION	5.0	3.0	4.2	3.7
<i>Contributions</i>				
Real disposable income	2.4	2.8	2.8	2.6
Total wealth	1.7	1.3	1.8	1.3
Real interest rate	0.1	-0.1	0.0	-0.2
Residuals	0.7	-1.1	-0.6	-0.1

### 4 SAVINGS RATIO AND UNEMPLOYMENT OUTLOOK



SOURCES: NSI, Banco de España and European Commission.

a. Annual differences.

b. Percentage points.

rates applicable to household assets and liabilities at a speed and intensity which depend on maturities, the level of competition in banking markets and household bargaining power and financial acumen. Historically, interest rates on loans have reacted more strongly and promptly than bank deposits. However, the magnitude of this effect on households was mitigated by the structure of their financial wealth in which the interest-earning financial asset portfolio – deposits, securities and, partly, mutual funds – has traditionally exceeded the value of loans (see panel 2). In recent years this situation has changed due to the rapid growth of the stock of liabilities and their concentration in floating-rate loans. Foreseeably, then, in 2007, once the pass-through of short-term interest rates to returns on assets and the cost of debt has been completed, the impact on income will be more noticeable and, in the future, interest payments will exceed household interest revenue, if their liabilities continue to grow at a higher rate than interest-earning assets.

The rise in interest rates which began in late 2005 increased real ex-post rates, thus encouraging a “substitution effect” between present and future consumption which cut the growth of private consumption by 0.2 pp in 2006 according to the estimates of the

MTBE model. Also, according to this macroeconometric model, the contribution of financial and non-financial household wealth to growth in private consumption (1.8 pp in 2004 and 2005) dipped by 0.5 pp in 2006, mainly as a result of the slowdown in house prices.

As a result of these considerations, a more marked slowdown in private consumption might have been expected. However, there is another series of factors, related to consumer attitudes about the future, such as their income growth prospects or the level of uncertainty factored into their decisions, which also impact their spending plans. In general, they are not usually included in econometric models like the MTBE or they are indirectly included insofar as they affect some of the model's variables. In order to evaluate this type of aspect, opinion-based indicators from consumer surveys, such as those conducted by the European Commission, can be consulted. Panel 4 illustrates how one of these indicators, which includes the outlook for unemployment, is related to some extent to the savings ratio. In this respect, the improved future outlook for households suggested by the confidence indicators could have contributed to sustaining consumer growth in recent years.

although higher interest rates and the decline in expectations of rising values tempered demand pressure.

The user cost of this investment increased as a result of higher interest rates and of some moderation in expectations of rising residential asset values, affected by the slowdown in house prices. Further, despite the lower growth in prices, the estimated effort to buy a house continued to increase (see Chart 5.4). The attractiveness of investment in real assets compared with other alternative placements decreased in 2006, as house prices rose less than other assets, such as shares.

Construction activity in the residential sector maintained a high rate.

Despite these signs of moderation, construction activity in the residential sector continued apace, with a significant increase in the stock of housing, which may also have contributed to tempering the rising trend of prices. However, the dynamism may have been due, in part, to the entry into force of the Spanish Technical Building Code, which introduces additional requirements for new houses approved from October 2006, as this might have prompted certain projects to be brought forward. Indeed, since October a slowdown in the approval of new houses has been seen.

Net household borrowing increased once again.

Overall, household demand for consumer goods and services remained relatively buoyant in 2006 relative to disposable income, which made for a decline in the saving ratio. The impact of less saving on the sector's net borrowing was further heightened by the still-high pace of investment in housing. As a result, net household borrowing increased by 0.5 pp of GDP to 2.2%, thereby contributing to the rise in the nation's net borrowing.

There was a strong increase in public investment.

General government demand was geared particularly to investment spending, while final consumption expenditure was somewhat more contained. This latter item continued to slow in real terms in relation to previous years, although it held above real GDP growth. The slowdown was marked by developments in net purchases of goods and services, while the compensation of public-sector employees moved on a somewhat more expansionary path. In any event,

	% of GDP (a)		RATE OF CHANGE (b)					
	2000	2006	2001	2002	2003	2004	2005	2006
<b>HOUSEHOLDS AND NPISHs</b>								
Final consumption expenditure	59.7	57.7	3.4	2.8	2.8	4.2	4.2	3.7
<i>Durable consumption</i>	6.3	5.6	2.0	-3.4	5.8	9.4	5.3	5.3
<i>Non-durable consumption</i>	52.5	51.1	3.4	2.7	2.6	4.2	4.2	3.6
Housing (c)	6.1	9.3	7.5	7.0	9.3	5.9	5.8	6.4
<b>CORPORATIONS</b>								
Private productive investment (d)	12.2	11.9	1.7	-1.1	3.4	7.0	7.4	5.9
<i>Construction</i>	4.9	5.5	5.9	3.1	3.3	11.6	5.4	0.4
<i>Equipment</i>	7.3	6.4	-1.1	-4.2	3.5	3.3	9.2	11.0
<b>GENERAL GOVERNMENT</b>								
Final consumption expenditure	17.2	17.9	3.9	4.5	4.8	6.3	4.8	4.4
Gross fixed capital formation	3.2	3.9	10.2	10.2	4.9	-2.5	7.9	12.3
<i>Construction</i>	2.3	2.9	11.4	10.8	3.7	-7.1	7.9	15.9
<i>Equipment</i>	0.8	0.9	7.0	8.7	8.6	11.7	7.8	2.2
<b>MEMORANDUM ITEM</b>								
Gross fixed capital formation	25.8	30.3	4.8	3.4	5.9	5.0	7.0	6.3
<i>Equipment</i>	8.1	7.4	-0.3	-2.9	4.1	4.4	9.0	9.7
— <i>Machinery</i>	5.7	5.0	-0.2	-2.2	1.9	2.6	8.1	9.6
— <i>Transport</i>	2.4	2.4	-0.6	-4.5	9.4	8.4	10.7	9.9
<i>Construction</i>	13.3	17.8	7.6	6.3	6.2	5.5	6.0	5.9
— <i>Housing</i>	6.1	9.3	7.5	7.0	9.3	5.9	5.8	6.4
— <i>Other constructions</i>	7.2	8.4	7.7	5.6	3.5	5.0	6.2	5.3
<i>Other products</i> (e)	4.4	5.2	5.8	5.0	7.2	4.5	7.5	3.2

SOURCES: INE and Banco de España.

a. Base 2000 National Accounts, current prices.

b. Base 2000 National Accounts, rates of change of volume indices.

c. Excludes investment by sole proprietors.

d. Includes investment by sole proprietors.

e. This investment includes real estate, legal, accounting, consultancy and software services, among others. Given the heterogeneity of these components and the lack of information on them, this portion of investment is not assigned to any sector.

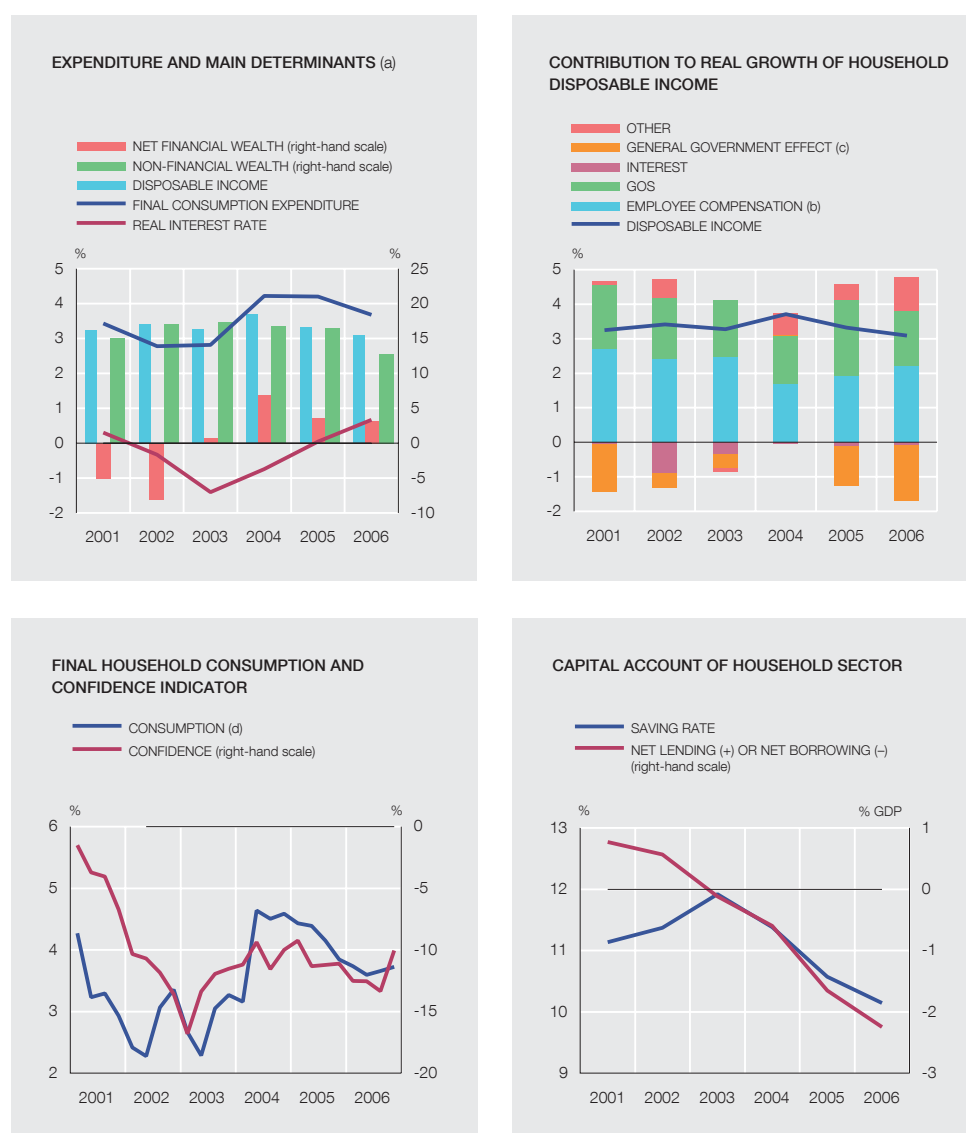
final consumption – over 80% of which is the responsibility of territorial governments – is very closely linked to health and education spending, whose elasticity to the growth of income is high.

General government investment quickened notably in 2006, posting an increase of 17.1% that was driven by the forceful pace of local government investment. In step with the rise in this expenditure, government procurement was very dynamic in 2006, especially in civil engineering works. The contributors to this acceleration in procurement were not only general government, but also certain public corporations in the Spanish Ministerio de Fomento group, whose investment is not recorded in the main as public investment but as that of the non-financial corporations sector. Such investment is part of the Infrastructure and Transport Strategic Plan 2005-2020, with notable volumes accounted for by AENA and ADIF.

And business investment remained very dynamic, especially in capital goods.

Investment by Spanish companies remained dynamic in 2006, with real growth close to 6%, slightly down on the previous year (see Chart 5.5). The momentum of business investment was, for the second year running, underpinned by the capital goods component, while investment in non-residential construction continued on a slowing path. Following the declines recorded in 2001 and 2002, and some subsequent slackness, the recovery in invest-



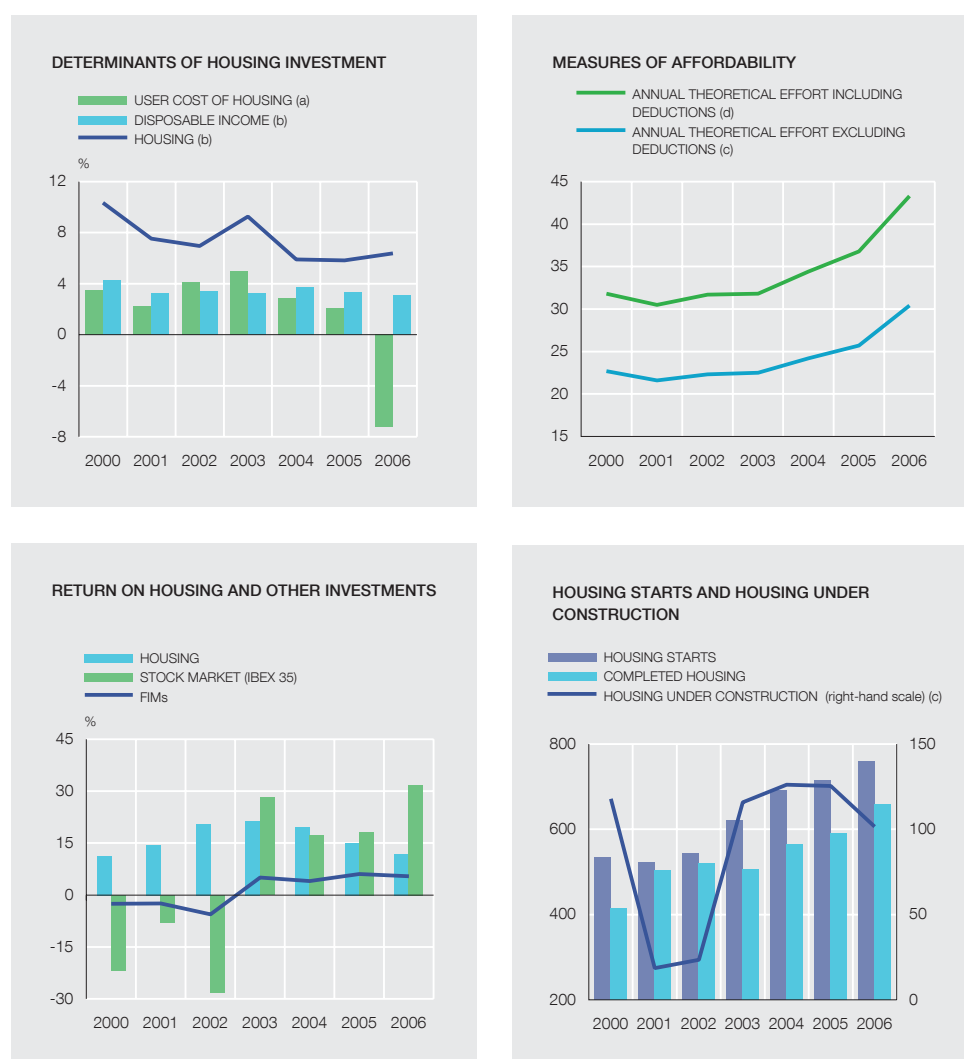


SOURCES: INE and Banco de España.

- a. Real rates of change. In the case of the interest rate, the change therein is shown.  
 b. Gross compensation per employee.  
 c. Includes social benefits, social contributions and taxes on income and wealth.  
 d. Year-on-year growth rate of the real seasonally adjusted series of the volume index of final consumption spending of households and NPISHs.

ment in equipment has been particularly sharp in the past two years and has been reflected in its two components, namely machinery and transport, but to differing degrees. While transport remained robust in the period 2003-2006, the recovery in machinery began later, but more sharply, and it has been the driving force of the expansion in investment in equipment in the past two years. Business investment in capital goods reflects the productive structure of the Spanish economy, whereby it is concentrated in the services sector (which accounts for 70% of that investment) and, to a lesser extent, in the industrial sector (25%) (see Chart 5.5).

Upholding the trend in private productive investment has been the buoyancy of economic activity, which has countered the adverse effect of tighter financial conditions. In particular, the increase in industrial activity has boosted capacity utilisation, which is at a level close to its



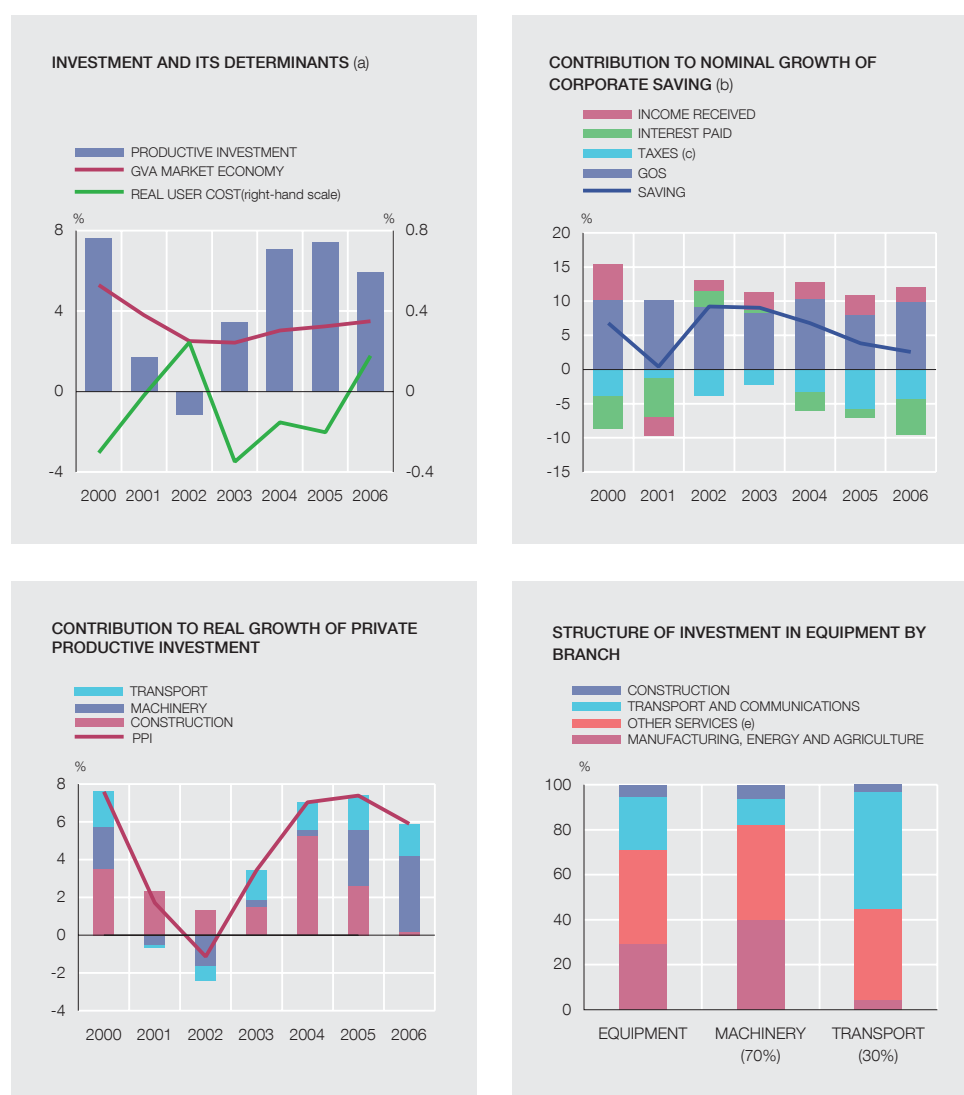
SOURCES: INE, Ministerio de vivienda and Banco de España.

- a. Real change.
- b. Real rates of change.
- c. Estimated gross annual payment required to purchase a standard house as a percentage of annual household disposable income.
- d. Wage approximated by the ETCL annual wage cost.
- e. Annual difference: housing starts less completed housing

all-time high. The user cost of capital in real terms increased in 2006 as a result of the rise in interest rates, although from a broader historical perspective, it remains at a low level.

Corporate results were satisfactory and the sector's net borrowing continued to increase.

Finally, the results of Spanish corporations were fairly favourable during 2006. According to the Non-Financial Accounts of the Institutional Sectors, the gross operating surplus of non-financial corporations quickened, contributing significantly to corporate saving. However, funds generated (saving before distribution of profit) have slowed in the past year as a result of the higher interest burden (stemming from the rise in interest rates and growing indebtedness) (see Chart 5.5). As a result of the growth in business investment, there was a fresh increase in the non-financial business sector's net borrowing to 8.1% of GDP, and an increase in financing received. The increases in the debt ratio and in the interest burden entail greater exposure to changes in financial conditions. Indeed, in the past two years there has been a deterioration in the indicator of financial pressure on investment.



SOURCES: INE and Banco de España.

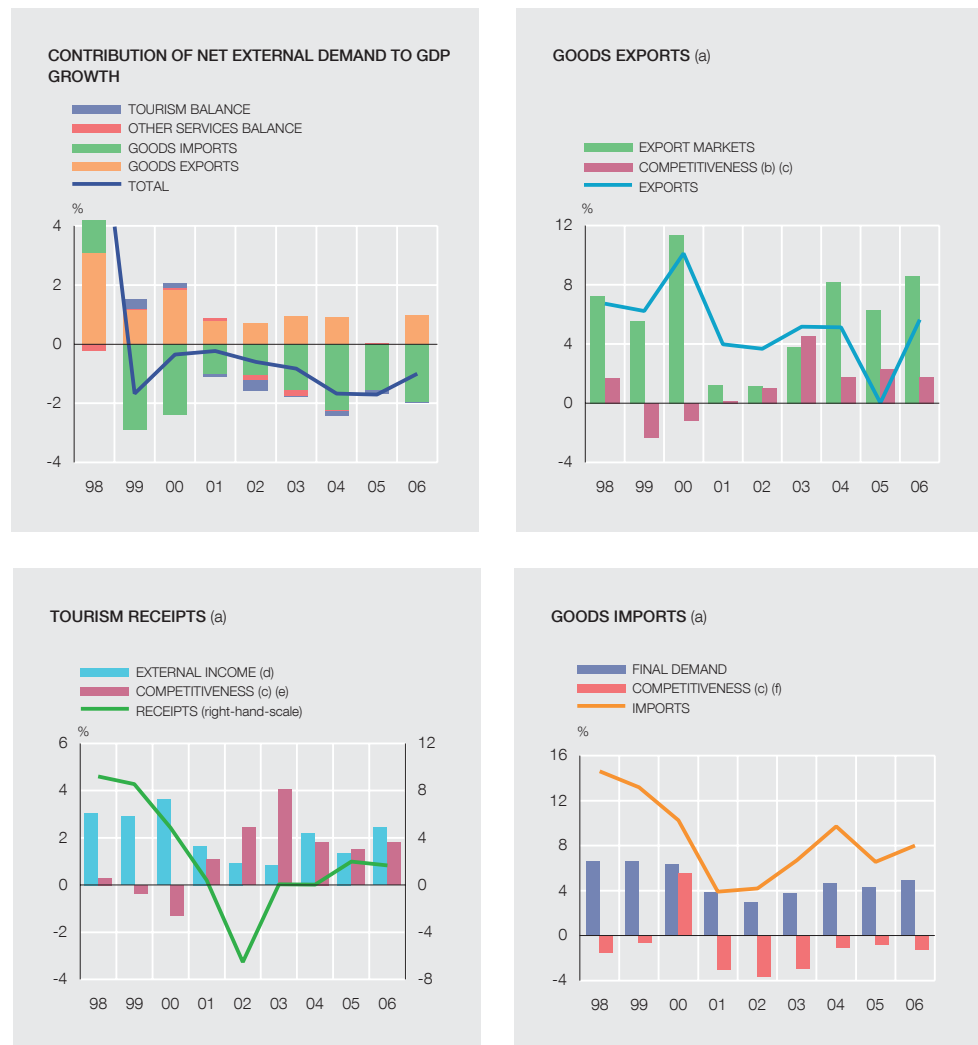
- a. Real rates of change and changes in the real user cost of investment.  
 b. Gross saving before dividend distribution.  
 c. Includes current taxes and other net current transfers.  
 d. 2003 data.  
 e. Includes market and non-market services.

## 2.2 EXTERNAL DEMAND

The pick-up in exports provided for an improved contribution of the external sector to GDP growth.

There was a break in 2006 in the increasingly deteriorating trajectory on which net external demand had been moving since 2002. Its contribution to GDP growth was notably corrected, improving from -1.7 pp in 2005 to -1 pp in 2006. Behind this improvement is the recovery in exports of goods and services, which increased by 6.2% in 2006 in real terms, following several years of moderate rises, offsetting in part the strong momentum of imports (8.4%).

The acceleration in exports in 2006 – both in goods (5.6%) and in services (7.5%) – came about against a highly expansionary international background (see Chart 5.6). The growth in export markets stepped up to a rate of around 8% (among the highest this decade), driven by the ongoing robustness in the south-east Asian and central and eastern European countries, and in some of the main Latin American economies, and by the firming of the economic recovery in the euro area countries, Spain's principal markets.



SOURCES: IMF, OECD, INE and Banco de España.

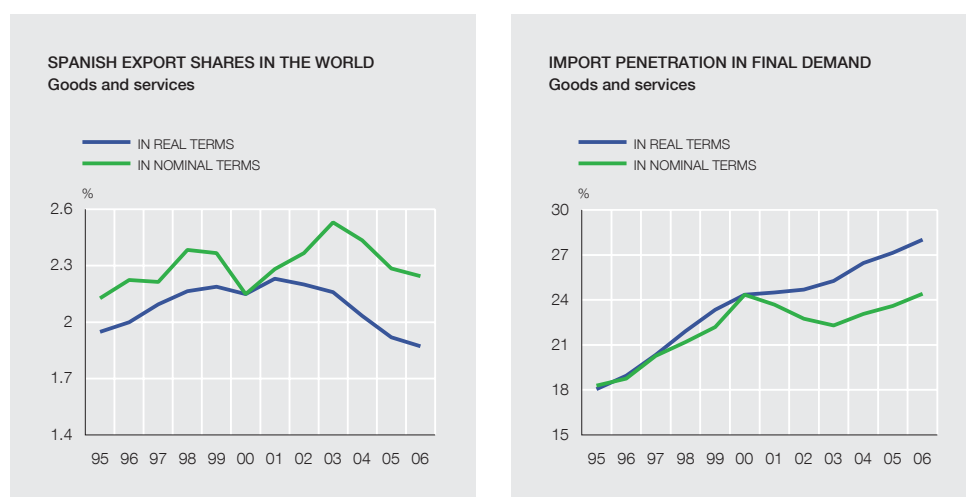
- a. Real year-on-year rates of change.  
 b. Deflator of Spanish exports in relation to rest-of-the-world export prices, exchange rate-adjusted.  
 c. Positive values denote a loss in competitiveness of exports, imports and the Spanish tourism industry, negative values a gain.  
 d. Average of GDP growth of the main countries of origin of tourists to Spain, weighted according to the relative significance of the number of visitors.  
 e. Real effective exchange rate, measured with consumer prices, vis-à-vis OECD.  
 f. Prices of Spanish imports in relation to the producer price index.

The expansion of exports was extensive to all areas...

In this setting, the acceleration in exports was across the board. By geographical area, non-Community sales were the most expansionary (12.1%), with a notable increase in exports to Latin America, the United States and Russia. In contrast, exports to the Asian countries eased off, following the favourable performance in the first half of the year. Sales to the European markets gathered steam as the year unfolded, overcoming the declines witnessed in 2005.

although export shares slipped further, less sharply than in 2005.

The expansion in Spanish exports was less than that in world imports, which led to a fall-off in the share of Spanish products, for the third year running, albeit on an appreciably lesser scale than in previous years (see Chart 5.7). The trajectory of export shares is the same as that seen in other developed countries, which have witnessed a generalised decline in their presence on international markets, as the emerging economies have progressively deployed their supply potential. In Spain's case, along with the unfavourable trend of the price-competitiveness indicators, analysed elsewhere in this chapter, certain specific shortcomings can be seen in the



SOURCES: IMF, OECD, INE and Ministerio de Economía y Hacienda.

structure of exports, which remain excessively concentrated in mature industries and markets with relatively lacklustre demand. In particular, Spanish products have scant projection in Asian markets and depend excessively on the automobile industry where, adding to the sluggishness of demand in recent years, there are growing competitive pressures from the eastern European and emerging Asian economies. However, in the past two years industries such as clothing, pharmaceuticals and consumer electronics have begun to stand out and, if this trend firms, they might provide for greater diversification of exports towards market segments with a high potential for expansion. In 2006, moreover, other industries such as metalworking and capital goods also performed well, spurred by the firming of the industrial recovery in Europe and by the capitalisation process under way in the emerging economies.

Tourism receipts grew at a modest pace, in contrast to the increase in numbers of tourists.

Tourism receipts posted moderate real growth of close to 2% for the second year running, following the methodological revision of how this item is recorded in national accounts and in the balance of payments (see *The Spanish Balance of Payments in 2006* for more details). This result is in contrast to the dynamism of foreign tourist inflows, which were up 4.5%, in line with the increase in worldwide tourism. A further factor is the improvement in the European economies (the source of Spain's main customers) and the geopolitical uncertainty besetting some significant competitors in the "sun and sand" segment, such as Turkey. However, as has habitually been the case in recent years, the increase in numbers of tourists did not feed through with the same intensity to tourism receipts, owing to the structural change world tourism is undergoing. In this respect, the growth of low-cost airlines and access to new travel arrangements are prompting average tourists to travel abroad more frequently, but for shorter stays, with the subsequent reduction in average spending per tourist. Further, in the case of the Spanish economy, the decline in spending per tourist has been accentuated by the momentum that residential tourism and stays in accommodation off the habitual circuits (which poses considerable measurement difficulties in respect of spending) has gathered in recent years.

The behaviour of non-tourist services remained expansionary in 2006.

Exports of non-tourist services quickened in 2006 to 13.7% (compared with 7.3% the previous year), against a background of increasingly buoyant global trade in services. This result reflects the highly favourable performance of passenger and freight transport services, in line with the behaviour of goods exports and of tourist inflows, and of services provided to businesses.

Imports continued to grow sharply.

In 2006 as a whole, imports increased at a notable pace of 8.4% (1.4 pp more than over the course of 2005), underpinned by the strength of final demand and by the take-off in industrial activity. These factors, together with the moderation of relative import prices, contributed to the growing weight of imports as a proportion of final demand, drawing closer to the figures of the euro area countries with a greater propensity to import, which are usually economies that are smaller and, therefore, with a greater degree of openness.

Product by product, imports of non-energy intermediate goods were the most dynamic, in line with the strength of certain industrial activities that are highly dependent on imported inputs. Further, the moderation of prices explains the expansionary behaviour of textile imports and the buoyancy of consumer electronics products, related to the growth of the information society. Conversely, the real-terms increase in capital goods imports slowed to 3.2%, owing to the decline in transport equipment purchases, in contrast to the most sizeable increase the previous year. Meanwhile, machinery imports continued to behave very favourably (especially those related to telecommunications equipment and electrical and precision instruments), which is consistent with the dynamism of investment in equipment.

The expansionary course in recent years of real services imports was interrupted.

Real tourist expenditure grew by 6.9% in 2006 as a whole, far below the rates of over 20% posted in the two previous years; that said, they regained some momentum in Q4, against the background of the appreciating euro. Nonetheless, imports of non-tourist services quickened notably to 10.6% and, as on the export side, the buoyancy of passenger and freight transport services and of services provided to businesses stood out.

### 3 Activity

Activity continued to be dynamic, in line with the estimates of potential growth.

The Spanish economy remained highly dynamic in 2006, in line with the high potential growth estimated for GDP in recent years (see Chart 5.8). This increase in economic growth capacity is associated first, with the bigger build-up in productive capital, the result of the buoyancy of business investment; and further, and above all, with the increase in potential employment, which was in turn the outcome of the decline in the structural unemployment rate (NAIRU) and of the continuing appreciable expansion in the population of working age witnessed in recent years.

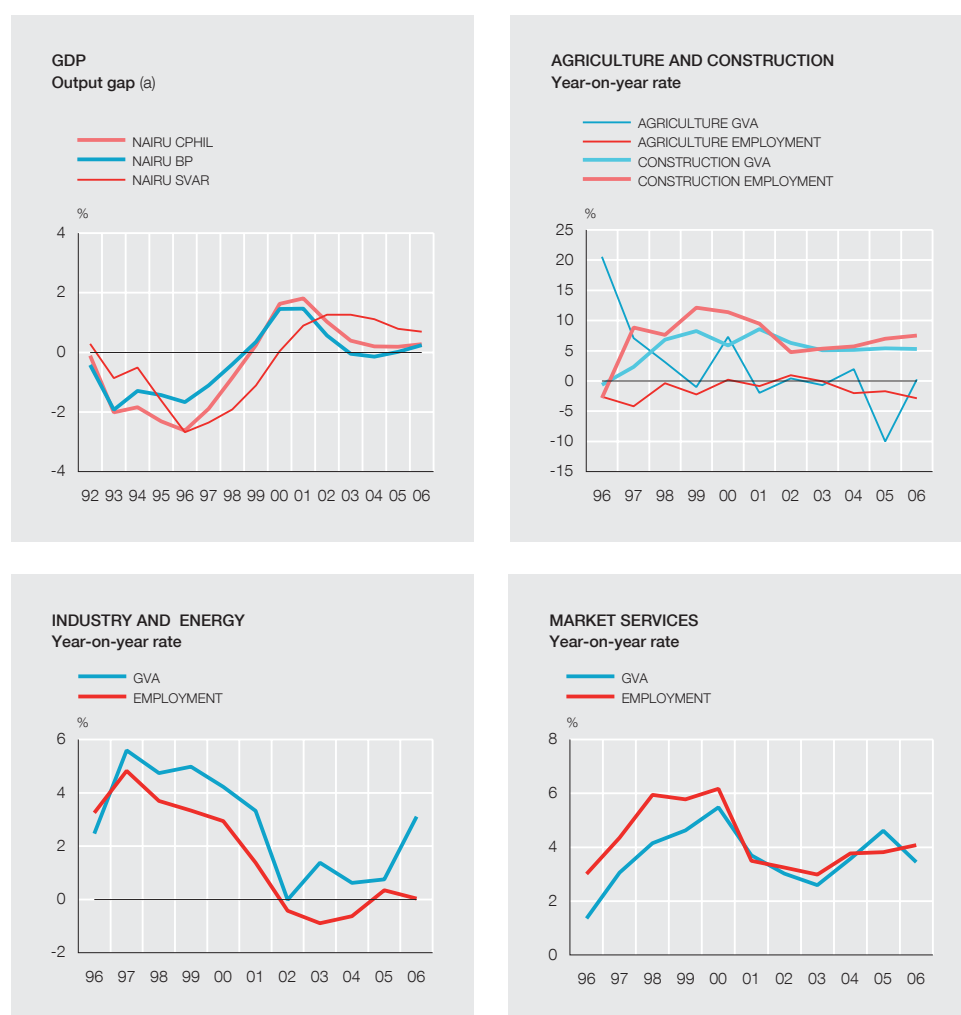
Industrial activity was driven by the recovery in exports.

Activity in the market economy rose by 3.5%, below the increase in the economy as a whole, although this is the highest rate posted by the market branches since 2001. Chiefly behind this momentum, as will be seen later, was the industrial branch, although the role of the agriculture and fisheries branches should also be highlighted. Indeed, considering the 0.4 pp that the agriculture and fisheries branches subtracted from economic growth in 2005, their zero contribution in 2006 should be interpreted as a positive factor. The better performance of agriculture was thanks to somewhat more favourable weather, principally in the winter, although rainfall in the spring, that which is most relevant in respect of agricultural output, was scant.

The year 2006 marked the end of the period of meagre growth for Spanish industry dating back to 2002. This recovery, which is addressed in Box 5.2, actually began in the second half of 2005 and, even though diverse factors contributed to it, chief among these was the pick-up in exports. The outcome was growth in industrial activity of 3.1% in 2006, 2.4 pp up on a year earlier.

The pace of construction eased, but remained very dynamic...

Housebuilding and public works meant that construction activity in 2006 remained immersed in the prolonged upturn dating back to the second half of the 90s. Despite the lesser momentum of non-residential building, gross value added in this branch increased by 5.3%, only 0.1 pp less than in 2005. The consequence of the marked buoyancy shown by this branch in the last decade is that its presence in the Spanish economy as a whole has increased appreciably.



SOURCES: INE and Banco de España.

a. The output gap is defined as the percentage difference between actual GDP and potential GDP. Regarding different estimates of the output gap, see the article "Estimates of the potential growth rate of the Spanish economy", Banco de España, *Economic bulletin*, January 2007.

Indeed, construction accounted in 2006 for 10.9% of nominal GVA and 13.9% of the numbers employed economy-wide, around 4 pp more than in 1995.

while market services slowed.

Market services were the branch which underwent the biggest loss of steam in 2006. Specifically, they declined by 1.2 pp, which lowered their growth rate to 3.4%. This slowdown came about mainly as a result of the lesser momentum of consumption in 2006, which particularly affected the commercial sector.

#### 4 The labour market

Developments in employment closely mirrored those in activity.

Employment quickened once again in the market economy in 2006, maintaining a path very close to that of economic activity. In QNA terms, the rate of net job creation<sup>1</sup> was 3.4%, 0.2 pp up on the 2005 figure, while the rate of change of employment stabilised economy-wide at 3.1% (see Chart 5.9). Apparent labour productivity in the market economy retained the scant momentum of previous periods, posting a rate of change of 0.1%. In terms of the breakdown of this component, the change was due to a slowdown in the capital/employment ratio, de-

1. Measured by the number of full-time equivalent jobs.



From 2001 to 2005 Spanish industry was markedly sluggish because of several factors, including most notably competition from foreign products (particularly more labour-intensive products), which was felt both inside and outside Spain, and less dynamic export markets. The loss of momentum of capital goods investment also had an adverse effect on domestic industrial production. In 2005, growth in industrial production was scant (0.1% according to the Industrial Production Index – IPI) and based almost exclusively on industries with a medium-low technology content, whereas in high or medium-high technology intensive branches – which are essential for boosting growth and competitiveness against a background of economic globalisation – production dropped relative to 2004 (see panel 1).

The recovery in industrial activity in 2006 (with growth of 3.7% according to the IPI) commenced in the second half of 2005, gaining strength as the year unfolded and becoming more widespread. In fact, 63% of industrial groups recorded growth in 2006 while 67% accelerated their output, which is one of the highest figures in the last 25 years. Also, the composition of the recovery in industrial activity was more appropriate in terms of technological intensity since it was based on greater strength in industries with a high and medi-

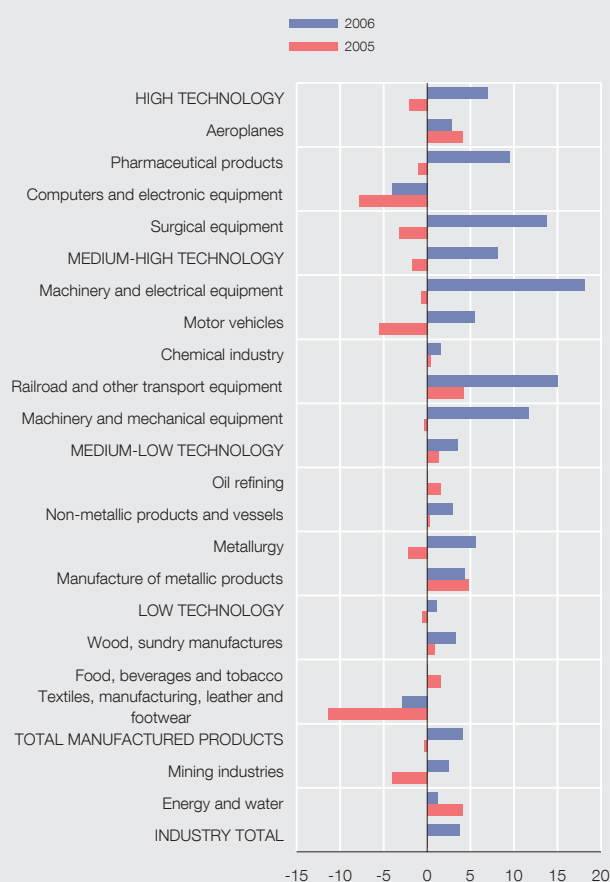
um-high level of technology, in contrast to the contraction one year previously.

An analysis of industrial production, taking into account the categories of goods (see panel 2), clarifies which factors have participated in the recovery in industry. Firstly, the positive contribution of the different types of demand serviced by goods from domestic industry is worth noting in comparison with the drop in output recorded in 2005 in products earmarked for export and gross capital formation. In this respect, there was greater buoyancy than in the previous year in all categories of goods. Exports were the main driver of the upturn in industry in 2006 since they accounted for 43% of growth in industrial production, a figure all the more important bearing in mind that the share of exports in the total is around 36%. As for the other categories of goods, those in demand from the construction sector, services and domestic gross capital formation each contributed around 15% of total growth, whereas products earmarked for final domestic consumption represented approximately 9%.

The industrial expansion in 2006 was not a phenomenon specific to Spain but was closely linked to the performance of the indus-

### 1 INDUSTRIAL PRODUCTION

Growth of production per technological intensity



### 2 CONTRIBUTION TO GROWTH OF INDUSTRIAL PRODUCTION BY MAIN INDUSTRIAL GROUPING



### 3 INDUSTRIAL PRODUCTION

Growth in Spain and in the euro area



SOURCES: Banco de España, Eurostat and INE

trial sector in the euro area (see panel 3), as was the case in the previous five-year periods. Indeed, the linear correlation coefficient between the growth rates of gross value added is quite high with a value of 0.8 in the last 15 years. Together with the renewed vigour of the euro area economy, greater buoyancy in extra-Community trade also boosted growth in manufactured products in Spain.

The increase in industrial value added in 2006 was not reflected in higher job creation. Thus, the rate of growth in employment decreased from 0.3% in 2005 to practically zero in 2006. The most direct consequence of the stagnation in industrial employment was the

higher apparent productivity in most of its branches of activity, with the result that in industry as a whole it climbed 3.1% in 2006 (measured in equivalent jobs) in comparison with the small increase of 0.4% in 2005.

The strong rise in productivity also made it possible for the pace of unit labour costs to ease significantly, meaning that the behaviour of this measure of industrial competitiveness ceased to be more expansionary than in Spain's trading partners, a factor that had been a characteristic of this sector in recent years. This improvement was not reflected in significant price moderation but in a widening of margins.

spite the strong increase in investment, and to a negative contribution by estimated total factor productivity (TFP), in step with its course over the last five years. It is difficult, however, to give an accurate diagnosis of the causes behind this. The TFP estimate may be prone to relatively high measurement errors and may also be affected by changes in the composition of productive factors by sector, level of educational attainment and technological intensity, changes which have no doubt been significant in the Spanish economy in recent years. That might suggest that the ongoing decline in TFP is partly in response to temporary causes, arising from the strong increase in the labour force and from the pattern of growth, although it might also suggest weaknesses as regards the quality of the Spanish economy's productive factors and the characteristics of its business sector (see Box 5.3).

Employment growth was once again concentrated in construction and services.

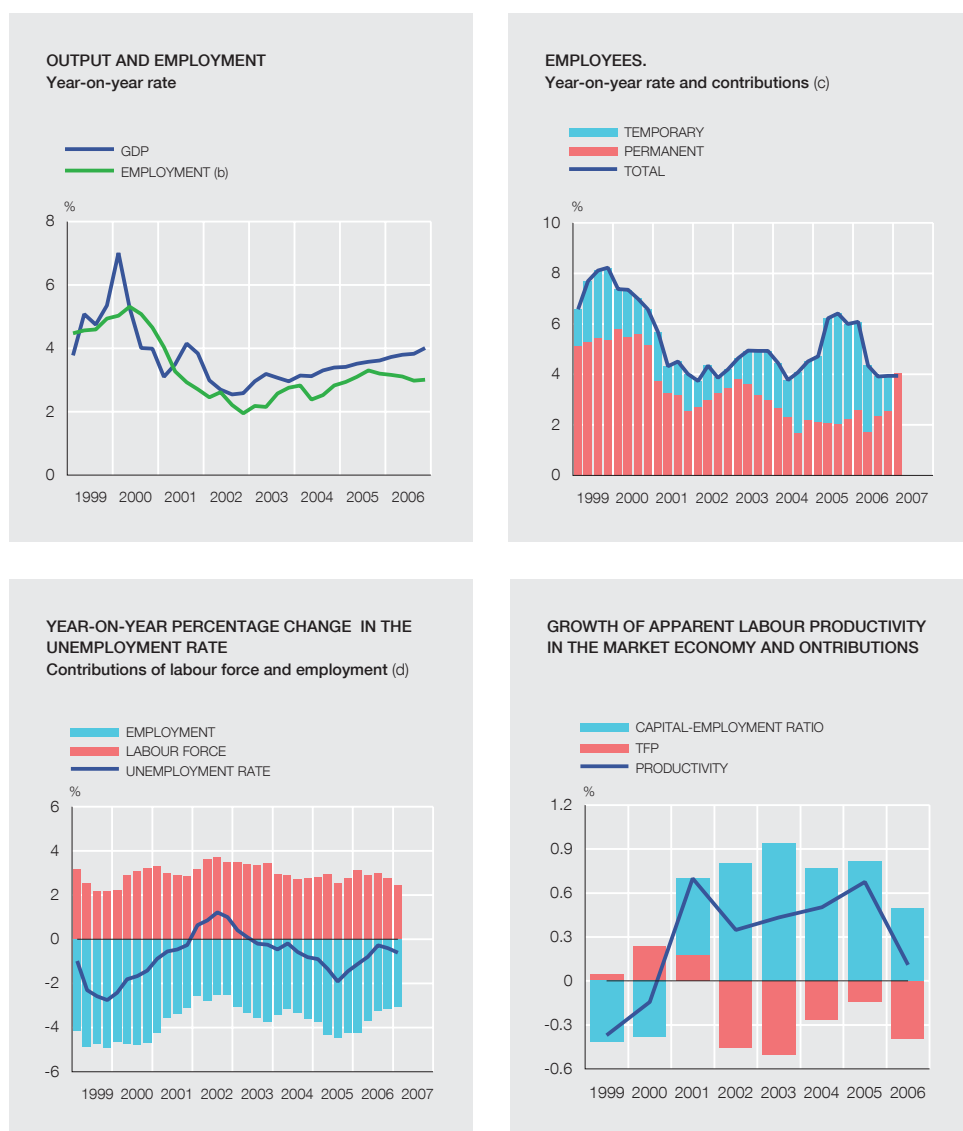
The pattern of growth of employment in 2006 of the sectoral level was very similar to that observed in recent years, meaning that job creation was concentrated in construction and in services. Indeed, in agriculture and in industry, numbers employed trended more negatively than in 2005, with a 2.9% decline in employment in agriculture and zero growth in industry, despite the strong pick-up in activity in the latter. In construction, employment quickened again, posting average growth of 7.5%. It likewise accelerated in market services (4.1%) where, according to the EPA (Labour Force Survey), there was a notable rise in the distributive trade, hotels and restaurants, real estate activities and business services.

The proportion of temporary to total employees dipped slightly in 2006 Q4.

Employment creation in 2006, according to EPA data, was once again sharper among wage-earners with a temporary contract. In the second half of the year, however, there was a recovery in stable employment, linked to the exceptional process of rebates accompanying the conversion of temporary contracts into permanent ones further to the latest labour reform. This would become more patent in 2007 Q1 when the proportion of temporary to total employees fell to 32%, 2 pp less than the 2006 average.

Immigration and female participation upheld the dynamism of labour supply...

As regards labour supply, the vigour of new entries into the labour market was similar in 2006 to that of previous years. This increase was based on the sustained growth of the population of working age and on the fresh increase in the participation rate. On EPA figures, the population aged over 16 grew by 1.6%, and the participation rate rose by almost 1 pp to 58.3%. The contribution of immigration to the increase in the labour supply continued to be decisive. The immigrant population aged over 16 increased by 522,000, a rate of increase of 16.8%, which accounts for two-thirds of the growth in the labour supply in 2006. By sex, the growth of la-



SOURCES: INE and Banco de España.

a. The EPA (Spanish Labour Force Survey) series are linked on the basis of the 2005 Q1 control survey.

b. Seasonally adjusted QNA series. Equivalent employment.

c. EPA.

d. EPA. Link by the Banco de España owing to the change in the operational definition of unemployment in 2001.

e. Compensation per employee in the market economy.

bour market participation was sharper amongst women, whose participation rate increased by 1.4 pp to 48% in 2006, while the male participation rate rose by 0.3 pp to 69.1%.

and unemployment fell once again.

The buoyancy of employment provided for a further reduction in unemployment in 2006, despite the continuing robustness of the labour force. Specifically, numbers of unemployed fell by 3.9%, following the sizeable decline the previous year, and the unemployment rate dipped by 0.7 pp to an average level of 8.5%, the lowest since the end of the 70s (see Chart 5.8). This led, moreover, to the Spanish unemployment rate converging on the average rate of the euro area countries. Long-term unemployment continued to fall, and was down 3.3 pp to 25.6%. The estimates available indicate that the structural component of unemployment has fallen by a similar amount in 2006 and stands still slightly above the actual unemployment rate. However, in historical terms, this development entails a marked reduction in the structural unem-

Spain's business structure is characterised by the small size of firms and low rates of company creation and, particularly, destruction.<sup>1</sup> The differential behaviour of the productivity of these types of firms (small, entrant and exiting firms) may generate composition effects which significantly impact the aggregate productivity growth rate. This Box analyses this matter drawing on the Banco de España Firm Demography Database<sup>2</sup>, which combines statistical information from the Spanish Central Directory of Firms (DIRCE) and the Banco de España Central Balance Sheet Data Office Mercantile Registers (CB). As a result of these data, which are available at individual firm level, it is possible to make a breakdown for accounting purposes of productivity growth and to calculate the contribution of existing firms as well as the entry and exit of firms.<sup>3</sup> Existing firms may contribute to productivity in two different ways: firstly, through their own productivity growth; and secondly, through the reallocation of production resources from less productive firms to more productive ones. The new firms will contribute positively (negatively) to aggregate productivity growth provided that they enter the market with a higher (lower) productivity level than the average of existing firms. Lastly, if exiting firms are among the least (most) productive in the market, their closure will contribute positively (negatively) to aggregate productivity growth.

The analysis of this information shows that in Spain, as in other developed countries, the contribution of existing firms, mainly through their productivity growth, is the engine behind the aggregate growth of this variable (see the first column of the accompanying table). This positive contribution is partially offset by the productivity of business start-ups being lower than the average productivity of existing firms<sup>4</sup>, which is in keeping with a situation where business start-ups begin trading with low productivity levels that rise as the firm gains experience and learning. Finally, there is a negative contribution from exiting firms which is difficult to explain from a theoretical standpoint.<sup>5</sup>

The growth pattern described, which relates to the total for the economy, masks differences from sector to sector. In industry and services, existing firms make the largest contribution to productivity growth; however, in the industrial sector entrants' productivity is approximately the same as existing firms, even from their first year of trading. That suggests that initial investments are relatively high in this sector. The contribution of existing firms in the construction sector is practically zero.

As for differences between firms, there are two highly interesting results according to their size. Firstly, the positive contribution of exist-

1. See Nuñez (2004), "Salida, entrada y tamaño de las empresas españolas" *Boletín Económico*, March, Banco de España. 2. For a more detailed description of this database see López-García y Puente: *Firm Productivity Dynamics in Spain*, Banco de España Working Paper, forthcoming. 3. For a more detailed description of this methodology see Foster, Haltiwanger and Krizan, *Aggregate productivity growth: Lessons from microeconomic evidence*, NBER Working Paper 6803.

4. These results have already been presented in similar empirical studies conducted in Spain. For manufacturing companies see, for example, Jimeno y Sánchez (2006), "La dinámica de la productividad de la industria española" in Segura (ed.), *La productividad en la Economía Española*. 5. This negative contribution should be interpreted with caution given the possibility that less productive exiting firms have fewer incentives to provide their data to the Mercantile Register, which may artificially create a bias in the data towards more productive exiting companies.

#### BREAKDOWN OF PRODUCTIVITY GROWTH PER EMPLOYEE Annual changes in thousands of euros (base 2000). Average 1996-2003

	Economy Total (a)	Industry	Services (b)	Construction
TOTAL GROWTH	-0.14	0.53	-0.24	-0.64
Due to:				
Growth of existing companies (a)	1.29	1.66	1.00	-0.02
With 20 employees or fewer	0.20	0.19	0.25	-0.11
With more than 20 employees	1.09	1.47	0.75	0.09
Reallocation of weights among companies (b)	-0.28	-0.33	-0.15	-0.05
Contribution of entering companies (c)	-0.76	-0.04	-0.90	-0.95
With 20 employees or fewer	-0.65	-0.44	-0.62	-0.57
With more than 20 employees	-0.12	0.40	-0.28	-0.38
Contribution of exiting companies (d)	-0.40	-0.76	-0.19	0.39
With 20 employees or fewer	0.28	0.21	0.28	0.26
With more than 20 employees	-0.67	-0.97	-0.47	0.12

SOURCE: Banco de España Corporate Demography Database.

- a. The contribution is positive when companies increase their own productivity levels.
- b. The contribution is positive when resources are reallocated to companies with above-average productivity levels.
- c. The contribution is positive when entering firms have above-average productivity levels.
- d. The contribution is positive when exiting firms have below-average productivity levels.

ing firms is mostly due to the growth of large firms since small firms contribute much less to the aggregate and sectoral total. Secondly, the productivity of large firms which are entering and exiting the market is higher.<sup>6</sup> This difference in behaviour due to size is particularly important in relation to firms entering the industry.

6. Mergers with and spin-offs from existing firms are counted as entries and exits, usually of large firms.

It is difficult to extract causal relationships from a purely accounting analysis. However, the above results suggest a way in which the business structure inherent to Spain – characterised by the small size of firms – may be slowing productivity growth. Indeed, the biggest contribution to productivity growth is due to growth in existing firms. It is precisely in this group where the differences between large and small firms are greater since the contribution of small existing firms is very low.

ployment rate, or NAIRU, from the levels of over 15% a decade earlier. This fall is connected to the various labour reforms undertaken since the 90s, although more recently there have been additional declines without substantial changes in the labour market institutions, meaning they should be linked to the significant supply-side shock brought about by immigration.

Wages rose in 2006...

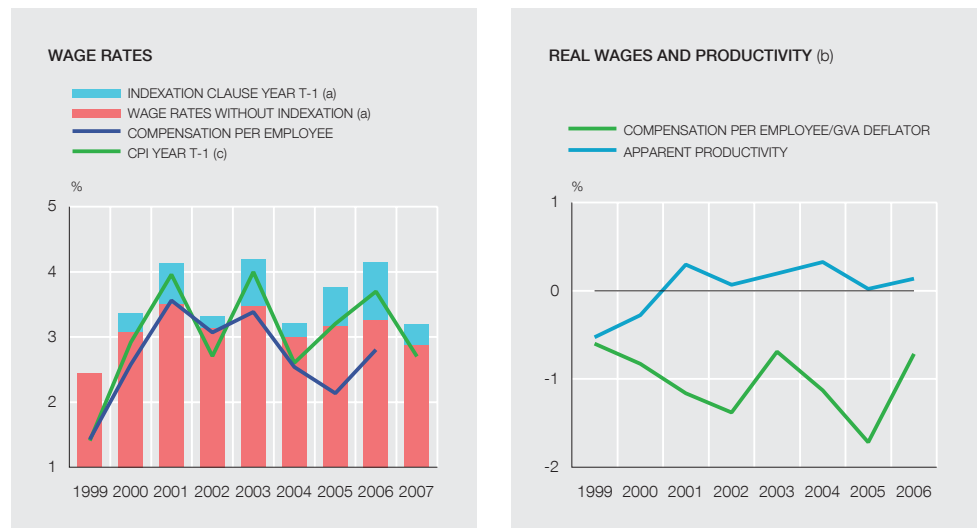
Turning to wage developments, settlements made under collective bargaining agreements stood at 3.2% in 2006, reflecting, at least in part, the rise in inflation in the first half of the year (see Chart 5.10). This wage increase would be above the implicit margin defined in the renewed Interconfederal Agreement for Collective Bargaining (AINC), which in principle relates wage increases above the nominal reference of 2% to increases in productivity, which were – as earlier discussed – low in 2006. In newly signed agreements, the average increase was 3.4%, reflecting with greater intensity the high rate of inflation witnessed in the opening months of the year. The deviation by inflation in 2005 from the official forecasts (1.7 pp) fed through to wage growth in 2006 by means of the activation of the indexation clauses, with an estimated impact of 0.9 pp on labour costs in 2006.

although compensation per employee continued to post more moderate rates.

However, the rise in wage settlements and the effect of the indexation clauses were not fully reflected in the growth rate of compensation per employee in the market economy, which climbed by 0.7 pp to 2.8%, owing to the continuation of significant negative wage drift<sup>2</sup> of more than 1 pp in 2006. This drift is related, in principle, to a composition effect, based on the fact that the new jobs created – in particular to meet the increasing labour supply brought about by immigration and by the progressive incorporation of women into the labour market – are, on average, remunerated with lower wages than those for existing jobs. While the continuation of this negative wage drift in recent years might be adding some wage flexibility to the Spanish labour market, labour institutions and, in particular, the collective bargaining system have remained unchanged in this period, limiting the effect of this greater flexibility on the core of the market.

In real terms, the labour costs borne by companies<sup>3</sup> fell in 2006 (see Chart 5.10), a fact which, as in previous years, contributed to the sound behaviour of employment. However, it should be highlighted that wage moderation in real terms is proving compatible with nominal increases in wages above those recorded in other euro area countries. Moreover, although the growth of compensation per employee in 2006 was similar to CPI growth, wage increases – including indexation clauses – were, for those sectors of the economy covered by collective bargaining, generally higher than actual inflation.

2. Defined as the difference between the increase in compensation per employee on QNA figures, and the increase in wage rates agreed under collective bargaining, including the effect of the inflation-compensating indexation clauses. 3. That is to say, using the value added deflator as a price index.



SOURCES: INE and Ministerio de Trabajo y Asuntos Sociales.

- a. Information on collective bargaining agreements recorded to March 2007.  
 b. Market economy.  
 c. Annual rate of change in December.

## 5 Prices and costs

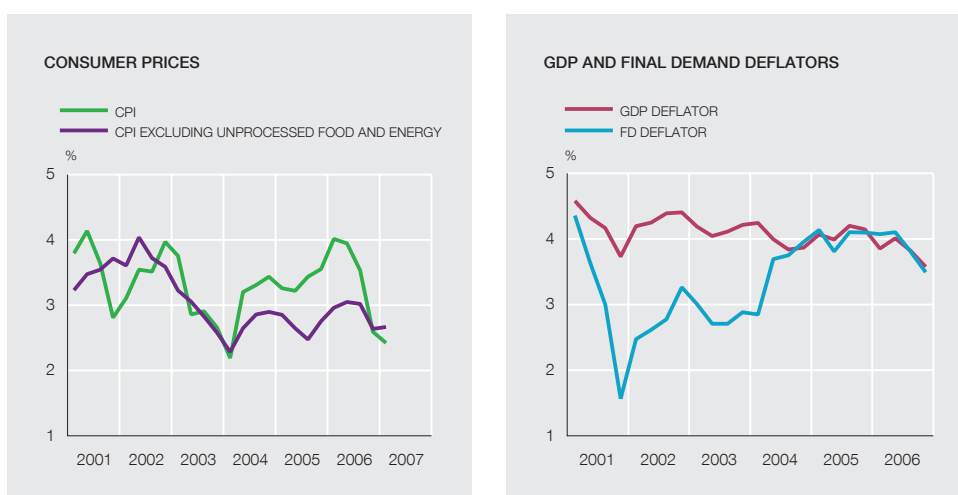
Inflation continued to run at a high level in 2006. In annual average terms, it stood at 3.5% according to the consumer price index (CPI), and at 3.6% in terms of the harmonised index of consumer prices (HICP), with both figures up on previous years. Prices also accelerated to a greater extent than in the euro area, meaning that the inflation differential – measured with the HICP – widened to 1.4 pp for the year on average, the highest figure since the start of monetary union. The inflationary process in 2006 was marked by the greater dynamism of labour costs, by a fresh widening of Spanish corporations' operating margins and, above all, by the increase in import prices, particularly oil. In any event, the pace of the main price indices and deflators progressively diminished during the year as oil prices fell, and this improvement ran into the opening months of 2007.

The CPI moderated as the year unfolded...

The growth rate of the CPI held at around 4% in the first half of 2006, easing off thereafter. As a result, by April 2007 the CPI stood at a rate of 2.4% (see Chart 5.11). The reduction in the inflation rate over the course of the year was sharper in Spain than in the euro area, meaning that the differential in April 2007 stood at 0.6 pp. The CPI excluding unprocessed food and energy increased by 2.9% in 2006, 0.2 pp up on the previous year, although the slowdown in the second half of the year meant that 2006 closed with a year-on-year change of 2.5%, a figure which was unchanged in April 2007.

in line with the course of oil prices.

Developments in the CPI, with significant rises up to the summer and a marked slowdown thereafter, were closely linked to import prices, particularly those of energy products. For the year as a whole, the price of Brent oil was \$11 higher than in 2005 at \$65 per barrel, and it even exceeded its all-time high in the opening days of August. However, in the final months of 2006, cheaper oil and the appreciation of the euro notably reduced the energy component of the CPI. The pass-through of oil price rises to other prices was relatively limited, with the exception of fuel and transport services prices. Compared with the euro area, the more relevant role of fuels in the basket of goods of the Spanish price index and the lesser weight of excise duties on these fuels mean that, in the face of changes in oil prices, changes in fuel prices and, therefore, in price indices are greater in Spain than in the euro area. This accounts for the strong increase in the differential with



SOURCES: INE and Banco de España

a. Year-on-year growth rates.

the euro area in early 2006 and the sharp slowdown subsequently. Regulated energy prices posted higher rates of increase than in the previous year, against the background of dearer oil.

The CPI excluding unprocessed food and energy also posted a lower rate of increase.

The moderation of non-energy import prices, supported by the trajectory of the euro, also bore on the CPI excluding unprocessed food and energy, although the reduction in the growth rate was less than that in the CPI and, moreover, it was concentrated in the last quarter of 2006. In 2006 Q4, processed food prices reflected the easing in the producer and import prices of this type of good. Of particular note was the substantial slowdown in olive oil prices, assisted by the notable increase in domestic production. Conversely, there was an increase in taxes on tobacco, geared to discouraging consumption, which fed through to final prices. The prices of non-energy industrial goods benefited from the moderation of import prices, against a backdrop of stable growth in the domestic prices of such goods, while services prices continued to exhibit considerable rigidity and increased by 3.9% over the year as a whole. Finally, the growth rate of unprocessed food trended upwards to some degree, albeit in a context of considerable variability.

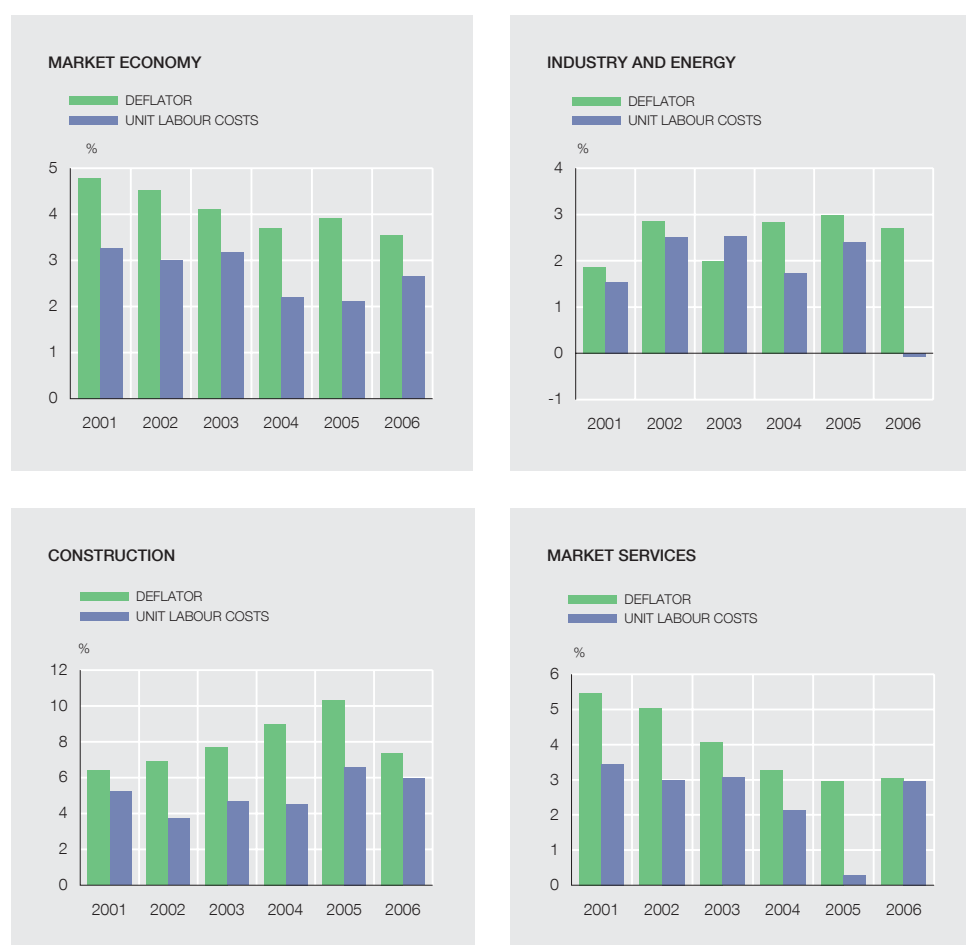
The slowdown in prices spread to all components of final demand.

The final demand deflator increased by 3.9% in 2006 as a whole, slightly below the rate for 2005. This reflected the smaller increases in the construction and export deflators, which offset the trajectory of consumer goods and of other investment goods. The construction deflator reflected the lesser momentum of house prices and of the costs of civil engineering works. Finally, the household final consumption expenditure deflator trended similarly to the CPI, and the capital goods deflator was affected by the dearer domestic prices of this type of good, despite the lower prices of imported products.

Domestic inflation was lower, despite the rise in labour costs and the widening of business margins.

Domestic inflation, proxied by the GDP deflator, increased by 3.8% in 2006, 0.3 pp down on 2005. The GVA deflators for the economy as a whole and for the market economy followed a similar course, with the growth rate easing to 3.5% in both cases. The slowdown in the GVA deflator for the market economy came about against a background of accelerating labour costs per unit of value added, reflecting sharper growth in compensation per employee (see Chart 5.12). Overall, the slowdown in the deflator and the rise in labour costs led margins to widen at a lesser pace than in previous years.





SOURCES: INE and Banco de España.

a. Year-on-year rates calculated using seasonally adjusted base 2000 National Accounts series.

The acceleration in labour costs was due to market services.

The behaviour of unit labour costs (ULCs) was relatively uneven across the different branches of activity. Indeed, the rise in labour costs observed in the market economy as a whole is essentially due to the market services branch, in which higher compensation per employee and lower apparent labour productivity prompted an acceleration of almost 3 pp in labour costs per unit of value added, following the particularly low growth recorded in 2005. The acceleration in labour costs in this sector, however, did not feed through to prices: the GVA deflator in the market services branch held at 3%, unchanged on 2005, whereupon the margins in this sector stabilised. The remaining branches showed lower ULCs growth rates in 2006 than in 2005, meaning that the moderation in the attendant deflators was compatible with a fresh widening of margins.

Some risks persist regarding the behaviour of relative prices and costs vis-à-vis the external sector.

As regards relative prices and costs, price-competitiveness indices worsened once more in 2006, and this was extensive to most indices and geographical areas (see Chart 5.13). Outside the euro area, the losses in price-competitiveness were accentuated by the fresh appreciation of the euro against the dollar and other currencies. In this setting, the most favourable aspect was the moderation of the competitiveness indices measured with manufacturing unit labour costs, which reflect the significant increase in productivity in most industrial activities. This has enabled the sector's profit margins to be restored, after they had fallen off significantly in the early years of the current decade (see Table 5.3).

	Average 1993-1998	1999	2000	2001	2002	2003	2004	2005	2006
<b>TOTAL ECONOMY</b>									
1 Goods and services export margins (1.1/1 .2)	1.0	-1.9	4.4	-1.3	-2.2	-3.1	-0.8	2.1	1.2
1.1 Goods and services export deflator	3.0	0.0	7.3	1.8	0.7	-0.2	1.6	4.3	3.9
1.2 Total economy unit labour costs	2.1	1.9	2.8	3.2	2.9	3.0	2.5	2.2	2.7
2 Total economy unit margin (a)	1.3	0.7	0.6	1.0	1.4	1.1	1.5	1.8	1.1
3 Relative return on exports (1/2)	-0.4	-2.5	3.7	-2.3	-3.5	-4.2	-2.3	0.2	0.1
<b>SPAIN/EU-15</b>									
4 Relative export margins vis-à-vis the EU-15 (4.1/4 .2)	1.3	0.1	2.0	0.5	0.8	0.5	-0.6	1.4	-0.4
4.1 Relative goods and services export deflators	2.1	0.5	3.2	0.9	0.9	0.7	0.6	2.0	1.0
4.2 Total economy relative unit labour costs	0.8	0.4	1.2	0.4	0.1	0.2	1.2	0.5	1.4
<b>MANUFACTURES</b>									
1 Goods export margins	1.8	0.0	3.8	-2.0	-3.6	-4.7	-1.3	0.8	5.1
1.1 Manufactures export prices	3.0	-1.7	4.8	-0.1	-1.0	-1.9	0.6	3.7	4.8
1.2 Unit labour costs in industry	1.1	-1.7	1.0	2.0	2.7	3.0	1.9	2.9	-0.3
2 Unit margin on manufactures (a)	1.8	2.2	1.4	0.1	0.1	-1.2	1.1	0.3	3.2
3 Relative return on exports (1/2)	0.1	-2.2	2.4	-2.1	-3.7	-3.5	-2.3	0.4	1.9
<b>SPAIN/EU-15</b>									
4 Relative export margins vis-à-vis the EU-15 (4.1/4 .2)	0.5	1.3	-1.2	-2.0	-1.8	-2.9	-3.1	-2.5	1.2
4.1 Relative manufactures export prices	2.1	-0.7	0.8	-2.3	-1.0	-0.5	-0.3	1.0	1.6
4.2 Relative unit labour costs in industry	1.7	-2.0	2.0	-0.3	0.8	2.4	2.8	3.6	0.4

SOURCES: Ministerio de Economía, OECD, European Commission and Eurostat.

a. Inverse of employees' share (in industry) in GDP (industrial GVA).

## 6 Net borrowing of the nation and the capital account of the institutional sectors

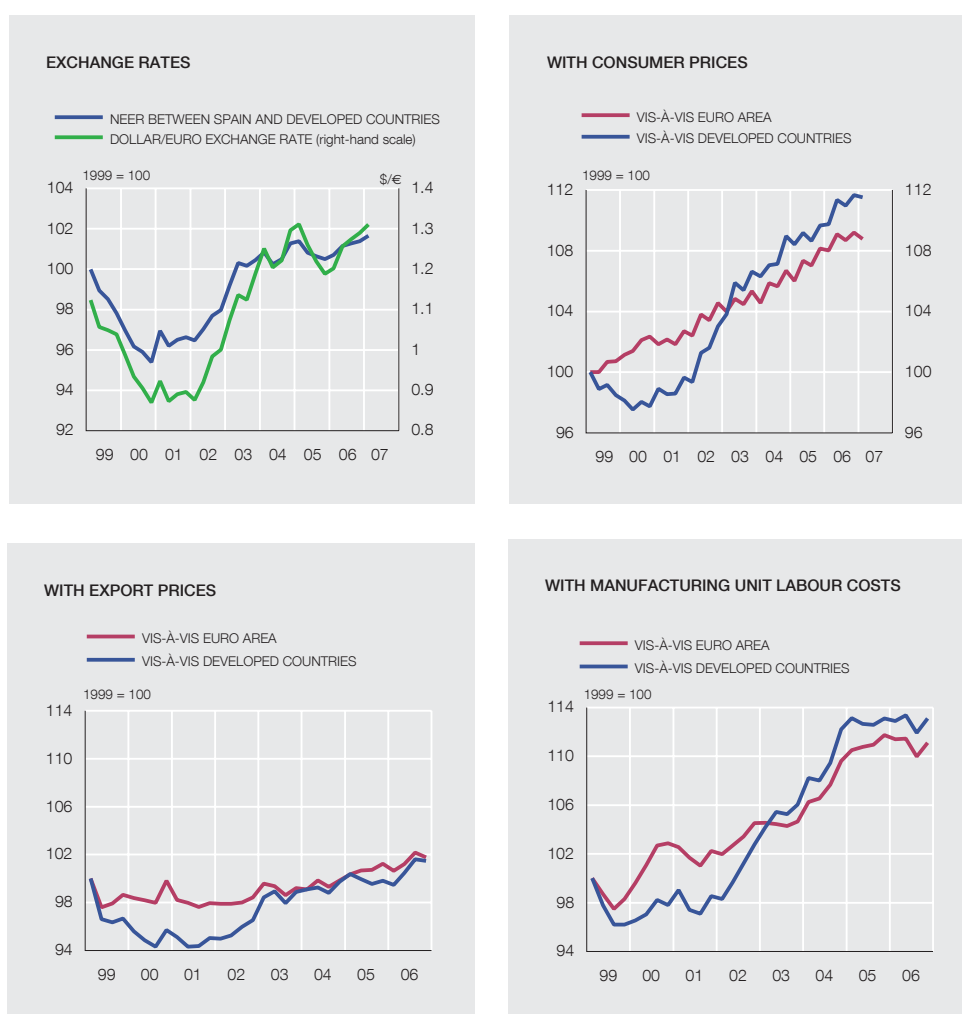
The net borrowing of the nation increased again.

The tourism surplus continues to decline, while the deficit on other services remains stable.

The net borrowing of the Spanish economy continued to increase during 2006, rising to 7.8% of GDP, 1.3 pp up on the previous year. This fresh deterioration in the external balance – which is illustrated in Chart 5.14 – was essentially in response to the increase in the current account deficit, which stood at 8.5% of GDP and, to a lesser extent, to the decline in the surplus on capital transactions, the weight of which in GDP fell by 0.2 pp to 0.7%. In any event, the pace of the increase was less than that seen in previous years owing to the rise in exports and to the improved terms of trade. The weight of the merchandise deficit in GDP increased by 0.6 pp, half that observed in 2005, to 8.1%.

During 2006, and for the sixth year running, the weight of the tourism surplus continued to decline, dipping to 3% of GDP. The diminished capacity of this balance to offset trade imbalances is related to the moderate increase exhibited by receipts in recent years, while the weight of expenditure in GDP has been on a continuously rising path. However, expenditure has not reached the levels seen in other similar-sized economies which, like Spain, are important markets for tourists and, therefore, offer fewer incentives for residents to travel abroad, which suggests that there might still be some further scope for such expenditure to rise.

As to other services, both exports and imports ended the year posting very significant increases (of 17.1% and 15.4%, respectively), prompting a fresh rise in the weight of these transactions in overall external transactions, although their balance remained stable at -1.1% of GDP in nominal



SOURCE: Banco de España.

a. An increase in the index denotes a loss of competitiveness, and viceversa.

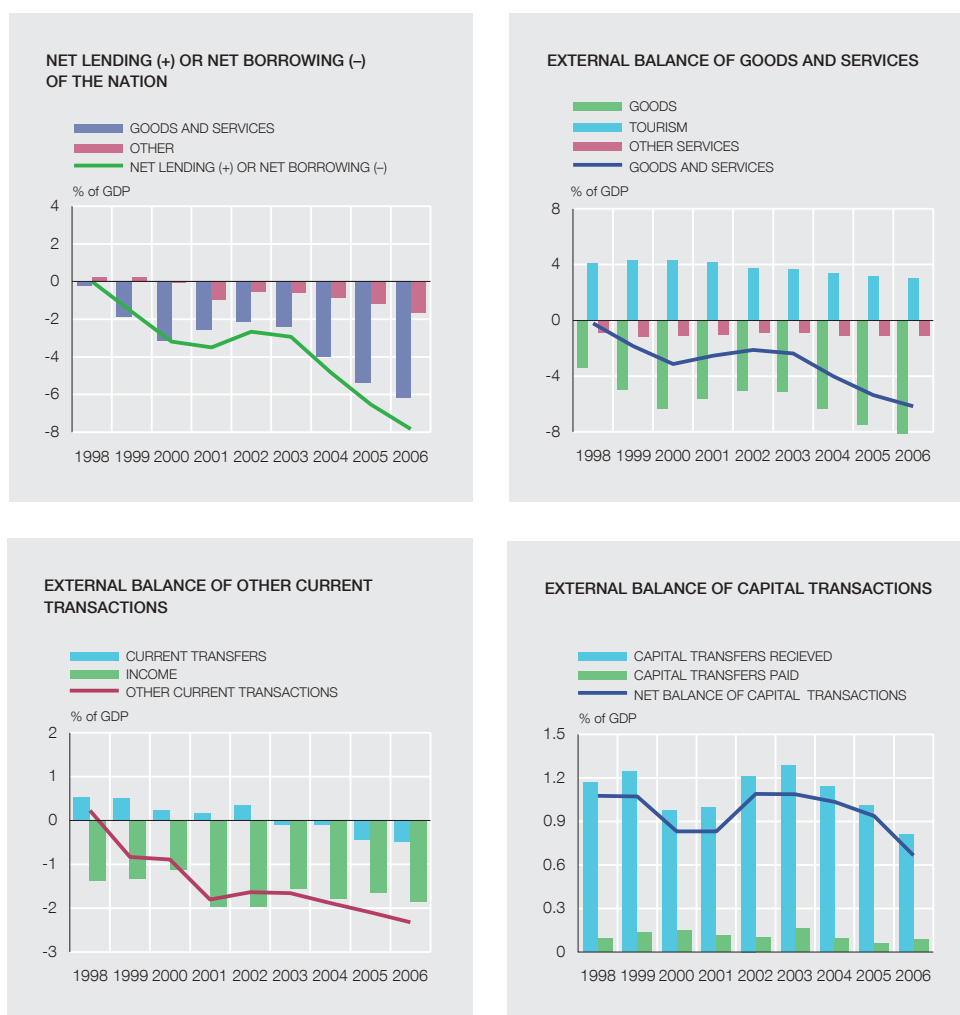
terms for the third year running. Under both headings the behaviour of passenger and freight transport services was very expansionary, as were services provided to businesses.

The income deficit continued to widen at a moderate rate.

Despite the continuing increase in the Spanish economy's external debt, which placed its international investment position with a debit balance of close to 58% of GDP at the close of 2006, the weight of the investment income deficit in GDP widened by only 0.1 pp to 1.8% of GDP. From the standpoint of the Balance of Payments, which allows a more disaggregated analysis of this item, a significant increase can be seen in the deficit balance of income linked to portfolio investment, which remained the main source of financing of the Spanish economy. This result reflects the growing external debt of resident financial institutions, to finance the expansion of credit to households and resident companies. But, at the same time, the external debt of financial institutions is also enabling funds to be routed towards some of the international investment projects of Spanish companies, the returns on which contribute to checking the tendency of the deficit on this caption to widen.

The increase in emigrants' remittances led to a rise in the deficit on current transfers.

Net current transfers ended 2006 with a deficit of 0.5% of GDP, continuing the negative trend of recent years. Receipts once again posted very moderate increases owing to the slowdown in Community funds assigned under EAGGF-Guidance and to the decline in resources under

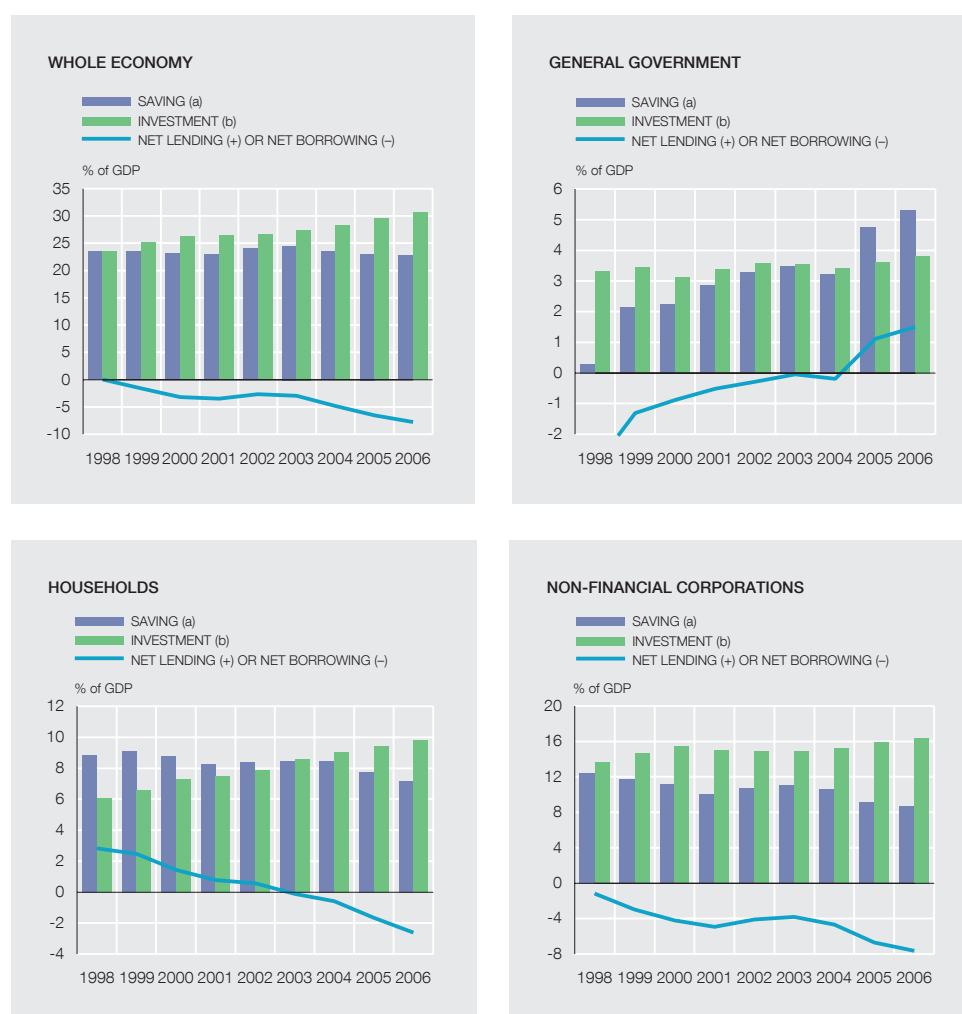


SOURCE: INE.

the European Social Fund. In contrast, expenditure continued to grow at a high rate as a result of the increase in emigrants' remittances, which now account for 0.7% of GDP, in step with the significant rise in the immigrant population in recent years. Finally, the weight of the surplus on capital transactions in GDP diminished by 0.2 pp to 0.7%, owing to the decline seen in Community transfers since the EU enlargement in 2004, a decline which has proven especially appreciable in the case of the ERDF, the biggest item in this category.

The rise in the rate of investment continued to drive the increase in financing requirements.

The increase in the Spanish economy's financing deficit was the outcome of fresh momentum in investment, the share of which in GDP rose by 1.1 pp to 30.6% (a figure amply exceeding that observed in other euro area countries), while the share of gross national saving in GDP fell slightly to 22.8% (see Chart 5.15). All sectors contributed to the dynamism of investment, with increases of 0.4 pp of GDP in gross capital formation on the part of both households and non-financial corporations, and of 0.3 pp in the case of general government. The increase in the national investment rate in 2006 was underpinned more by the equipment and infrastructure components – with a more direct impact on the economy's productive capacity – than by residential investment. That is a favourable feature, since it augurs an increase in the responsiveness of supply and in the ability to check the leakage of demand pressures abroad. From the standpoint of saving, in contrast, there was a slight reduction of 0.3 pp in household saving and a more significant decline (of 1.1 pp) in the proportion of GDP accounted for by non-fin-



SOURCES: INE and Banco de España

- a. Gross national saving.  
b. Gross capital formation.

cial corporations' saving, while government saving rose notably (1 pp). Accordingly, the increase in the nation's net borrowing in 2006 can be explained by the greater debit balance of households, which climbed to 2.2% of GDP, 0.5 pp up on the previous year, and of non-financial corporations, which rose by 1.4 pp to 8.1% of GDP. The 0.7 pp improvement in the budget surplus partly offset the effect on the nation's net borrowing of private-sector saving and investment decisions.



## Financial developments in Spain

Financing conditions became less benign in 2006.

The change in monetary policy stance that began in late 2005 made for a progressive increase in the cost of debt for the private sector during 2006, although the levels reached by this cost reveal that financing conditions continued to be benign. The increases in money market interest rates have been passing through promptly to the price of bank loans, while the issuance cost for non-financial corporations of long-term fixed-income instruments rose to a lesser extent. In contrast, the cost of corporate equity held relatively stable, since the expansionary behaviour of stock market prices was practically offset by the growth of dividends.

Household wealth increased once again, albeit at a lesser pace, ...

Net household wealth continued to expand as a result both of the increase in holdings of real and financial assets and of their rise in value. Its pace, however, was less than in previous years, as a result of the behaviour of house prices. More specifically, property values slowed in a sustained fashion throughout the year, posting a year-on-year growth rate of 9.1% in December, almost 4 pp down on the end-2005 figure. The slowdown was, moreover, fairly widespread as far as the distinction between new and used housing was concerned and also in terms of its geographical distribution. In the opening months of 2007, the growth of this variable dipped by what was practically a further 2 pp, prolonging the orderly normalisation of conditions in this market.

and household debt slowed slightly.

The slowdown in wealth and the increase in the cost of financing contributed to tempering somewhat the rise in household spending and liabilities, although the latter continued to increase at a high rate (of close to 19%). In terms of components, the rate of change of funds for house purchases dipped slightly, but that of the other categories rose. The behaviour of both segments entailed a change in pattern compared with the previous year. The fact that credit outgrew income meant that the rising course of the debt/gross disposable income (GDI) ratio continued for another year. The expansionary effect of this variable on the associated debt service burden added to the impact of the rise in interest rates. Against this backdrop, household net lending capacity contracted once again.

In contrast, corporate debt quickened.

In the case of corporations, in contrast, the normalisation of financing conditions did not prevent greater dynamism in spending on real and financial investment, underpinned by a growing resort to debt transactions. The rate of expansion of funds borrowed by the corporate sector rose to over 28%, which prompted fresh growth in the debt/earnings ratio. This development, along with the rise in the cost of funds, translated into a further increase in the proportion of earnings that are earmarked to cover financial expenses. The favourable behaviour of corporate activity prevented these developments from diminishing net profits, which held at the same level as in 2005.

Greater borrowing requirements boosted activity on financial markets.

The soundness of credit institutions' financial position, underpinned by comfortable levels of profitability and solvency, made it possible for them to continue meeting growing household and corporate demand for credit. Deposits increased notably, but continued to be insufficient to finance the expansion of assets, and it was necessary to resort to fixed-income issues to cover the shortfall. The securities issued were tied in a high proportion to mortgage loans and were once again the main vehicle for channelling the nation's need for funds.

Along these same lines, activity increased on Spanish financial markets. The increase was more marked in the case of the primary markets, particularly the fixed-income markets. In contrast, institutional investors' intermediation of resources was of a lower volume than that of the previous year.



Certain risk factors relating to private-sector debt remain in place.

In sum, the year 2006 saw several favourable developments in connection with the household financial position. House prices continued to slow mildly, in line with a scenario of gradual normalisation of the property market. Further, the rate of expansion of lending for house purchases fell, although the easing in the growth of financing was checked by a fresh surge in consumer loans. The continuing buoyancy of consumption and of residential investment over the medium and long term requires a greater containment of the pace of household debt.

In the case of firms, the increase in debt was partly linked to the rise in corporate acquisitions (see Box 6.1). These operations are a natural response by certain companies to the loss of momentum of the markets in their main business areas. Moreover, they contribute to a greater sectoral and regional diversification of their interests. At the same time, however, they raise the degree of leverage and, in some cases, they add a factor of uncertainty associated with the entry into new areas of activity. In any event, the financial position of firms continued to be sound. And this, along with the still-benign financing conditions, shapes a setting that remains conducive to a sustained increase in private productive investment.

The soundness of credit institutions' financial position continues to be a significant factor of strength that restricts the potential scope of financial risks to the medium-term macroeconomic outlook.

## **1 Financial flows in the Spanish economy**

The Spanish economy's net borrowing increased...

The Spanish economy's net borrowing increased once again, meaning that the debit balance on its net financial transactions stood at 7.8% of GDP (see Chart 6.1). These developments were the result of a fresh rise in the resort by households and firms to other sectors' saving, which was not offset by the increase in the general government surplus.

1.1 HOUSEHOLDS  
driven by the behaviour of households...

Despite less benign financing conditions, household spending on consumption and investment continued to outpace household income, as a result of which their need for funds increased once again up to an amount equivalent to 1.5% of GDP.

The increase in their holdings of financial assets rose to 11.5% of GDP (1.5 pp up on the previous year), while their liabilities-side transactions attained a volume equivalent to 13% of GDP (more than 1 pp above the 2005 figure), although they slowed somewhat (see Chart 6.2), as the annual rate of change of financing grew by 19%, compared with 21% the previous year. This diminished buoyancy is due mainly to the lower rise in the value of household assets, which acts as loan collateral, and to the increase in lending costs. Both factors affected, above all, funds for house purchases which, nevertheless, continued to grow at a brisk pace (close to 20%). In contrast, loans for consumption and other purposes rose by close to 18%, more than 5 pp up on the previous year. The trend of this type of expenditure, which slowed in 2006, suggests an increase in the resort to debt to finance goods and services purchases (see Box 6.2).

1.2 NON-FINANCIAL  
CORPORATIONS

and, especially, of corporations.

Non-financial corporations' financing requirements also increased notably, driven by the vigour of gross capital formation. As a result, the debit balance on their net financial transactions rose to close to 9% of GDP, entailing an increase of almost 2 pp on the previous year.

The sector's demand for funds was further driven by the increase in operations involving the acquisition of financial assets (which accounted for 23% of GDP, 6 pp above the 2005

In step with other euro area countries, corporate acquisitions by Spanish non-financial corporations were notably dynamic in 2006, following the incipient rise seen the previous year. The volume of these transactions rose last year to close to €95 billion, compared with €12 billion and €28 billion in 2004 and 2005, respectively.<sup>1</sup>

As can be seen in panel 1, the vigour of corporate acquisitions was particularly marked in the construction and real estate services sectors, and, to a lesser extent, in telecommunications. Another notable feature in this process is the significance of shareholdings in foreign companies, the amount of which accounted for around half of the total acquisitions last year. Moreover, a sizeable portion of these operations were in activities distinct from that of the acquiring company. This latter phenomenon was particularly significant in the case of construction and real estate services companies, where 55% of the volume of purchases was directed last year at other productive branches.

The boom in these corporate operations has run in parallel with the notable dynamism shown by the financing of non-financial corporations, which was growing at a rate of close to 30% at the end of last year. Accordingly, the flow of funds raised by this sector stood, in net terms, at around €225 billion (see panel 2). Consistent with the sectoral distribution of corporate acquisitions, the momentum behind the raising of borrowed funds proved particularly notable in the construction and real estate services sectors.

The information available suggests that corporate acquisitions have contributed significantly (though this is difficult to quantify accurately)

to the growth of non-financial corporations' debt. A sizeable portion of the acquisitions involving the biggest amounts, on which more information is available, has been financed in a high proportion by fresh credit. Also, the Bank Lending Survey indicates that one of the factors behind the recent expansion in the demand for these liabilities by corporations has been the need to finance this type of investment. Finally, the lack of significant capital-increase operations makes it unlikely that, in aggregate terms, a substantial portion of the funds may have come from the acquiring companies' own funds.

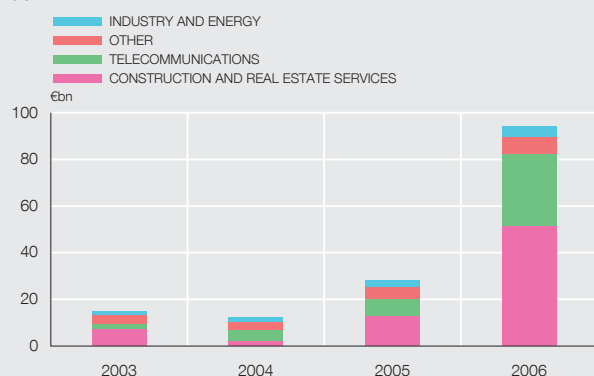
The recent forcefulness of corporate acquisitions has some important consequences. From a macroeconomic perspective, these operations do not entail, at least directly, a new investment in physical capital and, therefore, they do not raise the economy's productive capacity, although indirectly such capacity might increase in the medium term if the change in ownership prompts improvements in management. What is actually taking place is a restructuring of corporate financing sources, taking the form of a higher degree of leverage. Accordingly, there is an increase in the exposure of these corporations to potentially adverse shocks that diminish their fund-generating capacity and to increases in the cost of borrowed funds.<sup>2</sup>

From a microeconomic viewpoint, entry into new business areas or expansion into new geographical markets naturally entails some further factor of uncertainty. However, it also involves greater diversification of the acquiring corporations' activity and, therefore, it reduces their exposure to regional or sectoral shocks.

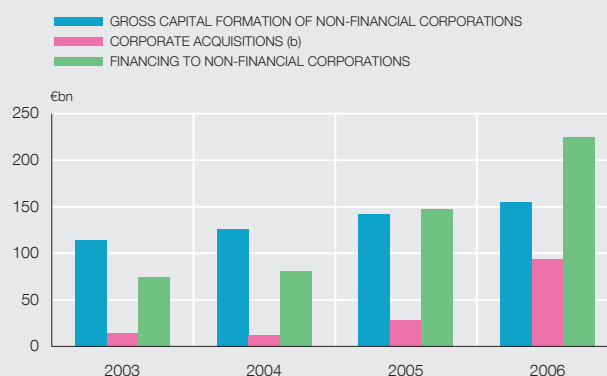
1. These figures are obtained through the aggregation of the value of all corporate acquisitions, included in the Thomson One Banker database, by Spanish non-financial corporations. If the stake has been acquired jointly with financial institutions or foreign non-financial corporations, consideration is given solely to the percentage of the operation corresponding to the Spanish non-financial corporations involved therein.

2. This exposure is less if the operation is carried out through an interposed company (an SPV - Special Purpose Vehicle) and the debt of the latter is backed exclusively by the shares acquired and not by the overall assets of the acquiring non-financial corporation. According to the Thomson One Banker data, at least 30% of acquisitions in terms of volume would have been conducted through an SPV.

1 BREAKDOWN OF CORPORATE ACQUISITIONS BY SECTOR OF ACQUIRING COMPANY



2 CORPORATE ACQUISITIONS AND COMPANY FINANCING

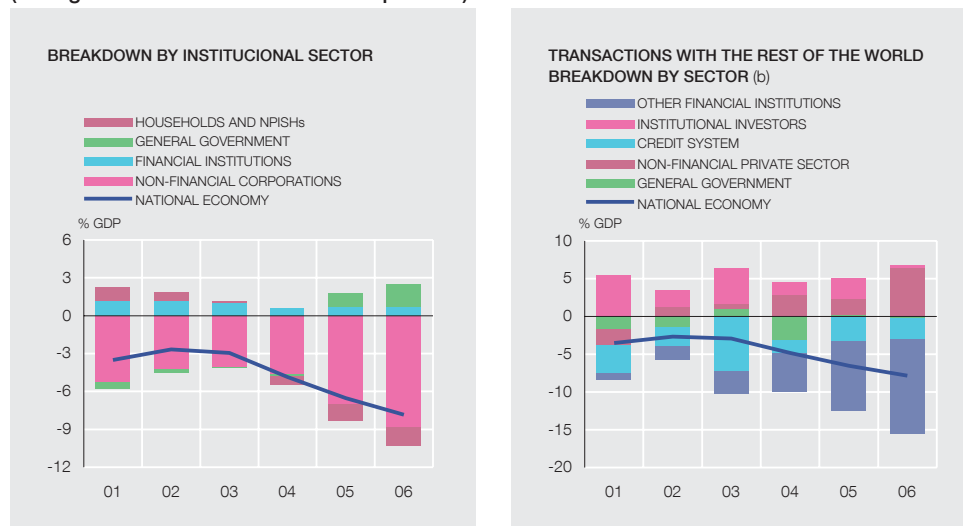


SOURCES: Thomson and Banco de España.

- Corporate acquisitions by Spanish non-financial corporations.
- Flow of corporate acquisitions by Spanish non-financial corporations.
- Change in the balance of financing to the non-financial corporate sector.

## NET FINANCIAL TRANSACTIONS (a) (Changes in and contributions of components)

CHART 6.1



SOURCE: Banco de España.

a. Cumulative four-quarter data.

b. A negative (positive) sign indicates that the rest of the world grants (receives) financing to (from) the counterpart sector.

c. Insurance companies and collective investment institutions.

figure). These consisted essentially of purchases of shares and other equity linked to taking controlling interests in resident and non-resident corporations. Consequently, the *financing gap*, an indicator that approximates the funds needed to cover the difference between gross saving and gross capital formation plus foreign investment of a permanent nature, increased to a greater extent than net borrowing and stood at close to 16% of GDP (11.3% in 2005).

Accordingly, non-financial corporations' liabilities increased once more, up to 32% of GDP (almost 8 pp up on a year earlier). The bulk of these funds was once again in the form of loans from resident institutions. The other items making up debt financing with an explicit associated cost (foreign loans and the issue of fixed-income securities) continued to be of less significance in terms of flows, although they also increased substantially, especially in the case of the resort to securities markets. Overall, the sector's debt quickened notably and the attendant year-on-year growth rate stood at around 28%, compared with 21% in 2005. By contrast, the raising of equity was moderate and slightly lower in terms of GDP (2.3%) than that of the previous year.

The breakdown of bank financing by branch of activity continued to show the marked buoyancy of lending to construction and, above all, property development companies, where the respective year-on-year rates of change were close to 33% and 50%. Increases were smaller in the other sectors, though likewise notable: 21% in other services, and 14% in the case of industry.

### 1.3 GENERAL GOVERNMENT

General government lending capacity increased.

The lending capacity of general government, which was close to 2% of GDP (see Chart 6.3), increased once again. This saving largely reflected the Social Security and central government surplus, since the territorial governments posted a balance slightly in deficit. In net terms, both short- and long-term securities were redeemed, albeit for a small amount (equivalent to 0.2% and 0.1% of GDP, respectively). Accordingly, the sector's deposits, net of credits, rose.

## FINANCIAL TRANSACTIONS OF THE NON-FINANCIAL PRIVATE SECTOR (Changes in and contributions of components)

CHART 6.2



SOURCE: Banco de España.

- a. Excluding mutual funds.
- b. Not including unpaid unaccrued interest, which is included under "other".
- c. Including securitised loans.
- d. These are largely made up of commercial loans.

### 1.4 INVESTMENT AND FOREIGN FINANCING OF THE SPANISH ECONOMY

The financial sector continued to route foreign saving via, above all, the issuance of fixed-income securities...

Financial intermediaries (excluding institutional investors) and, in particular, entities other than credit institutions (including financial vehicle corporations created to hold securitised assets and specialised securities-issuing entities) consolidated their leading role in the channelling of capital from the rest of the world. The funds raised, the volume of which stood at 15% of GDP (3 pp above the 2005 figure), did not only cover the Spanish economy's overspending in relation to its income; they were also needed to meet the increase in net investment abroad by the other resident agents (see Chart 6.1).

Capital inflows continued to take the form mainly of securities other than shares, accounting for an amount at over 21% of GDP, almost 6 pp up on the 2005 figure (see Table 6.1). Mostly, these securities were issued by the financial sector, with mortgage-linked securities once again to the fore. In contrast, funds raised via the interbank market contracted, showing a net outflow for the first time since 2001. Foreign direct investment in Spain also declined to 1.6% of GDP.

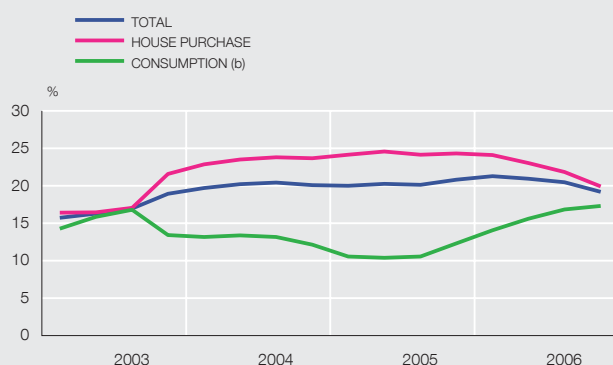
Consumer credit<sup>1</sup>, the outstanding balance of which at the end of 2006 accounted for 27% of the total credit received by households, was very dynamic throughout the year. It posted a year-on-year rate of change of over 17%, when in mid-2005 it stood at around 10%. As can be seen in panel 1, this contributed to softening the slow-down in household liabilities derived from the moderation in the increase in debt earmarked for house purchases. In this same period, however, the sector's current nominal expenditure slowed slightly (see panel 2). As can be seen in panels 2 and 3, although the rate of increase of durable consumption increased somewhat during 2006, the loans associated with such acquisitions were not those which proved most expansionary. Accordingly, these results suggest that the recent momentum of consumer credit reflects rather an increase in agents' propensity to resort to borrowed funds to finance purchases of goods and services than a shift in the composition of such purchases towards items for which indebtedness is more habitual.

The information in the Bank Lending Survey (BLS) is useful for gauging the significance of supply and demand factors in explaining why a growing proportion of consumer spending is being financed through the resort to debt. Panel 4 shows that since late 2004, banks have tended gradually to relax the supply-side conditions governing consumer credit. Contributing to this have been both the growing competition in this type of transaction between deposit institutions and with other financial institutions, and the favourable expectations of the banking sector regarding economic activity in general. There has thus been some expansion in supply, which might respond to banks' need to bolster new business areas now that the main engine of expansion in recent years, namely credit for house purchases, is showing signs of petering out.

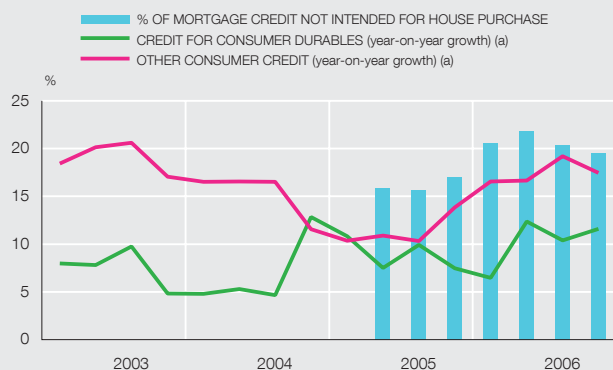
But the BLS also suggests that demand-side factors have also – and even to a greater extent – contributed to the expansion in

1. This Box considers consumer credit in a broad sense, equivalent to the concept of *consumption and other purposes* used in euro area harmonised statistics.

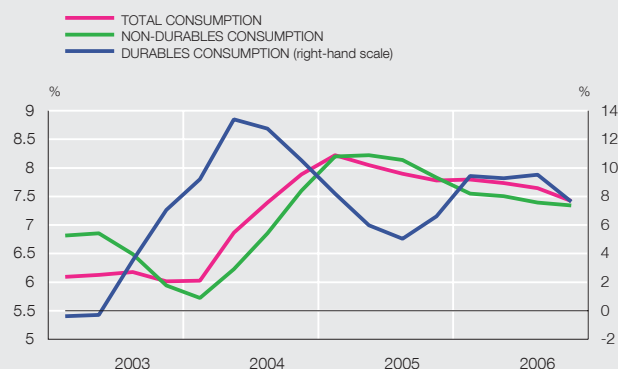
CREDIT TO HOUSEHOLDS AND NPISHs  
(Year-on-year growth) (a)



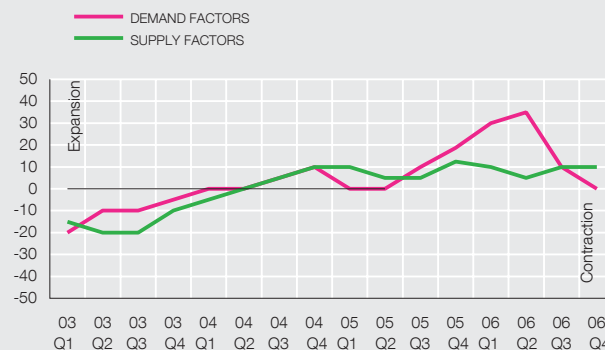
3 CONSUMER AND MORTGAGE CREDIT



2 HOUSEHOLD CONSUMPTION  
(Year-on-year growth)



4 CHANGE IN CONDITIONS OF BANK CONSUMER LOANS (c)



SOURCE: Banco de España.

a. Includes derecognised securitised credit.

b. Includes consumer and other credit.

c. indicator = % of institutions that indicate a considerable increase x 1 + % of institutions that indicate some increase x 1/2 - % of institutions that indicate some decrease x 1/2 - % of institutions that indicate a considerable decrease x 1.

consumer credit (see panel 4). Indeed, the greater propensity of households to take on debt to acquire current goods may have been driven by the accumulation of wealth in recent years as a result of the rise in house values. In this respect, panel 3 confirms that the financing via mortgage loans of spending on consumption and for other purposes has gained in significance since end-2005, meaning that in December 2006 it accounted for around 5% of total credit to households. This percentage is approximately 0.5 pp more than a year earlier, although it remains modest.

The greater opportunities to finance current expenditure decisions through the resort to credit contributes to smoothing the time profile of households' consumption, thus moderating the contractionary effect associated with temporary adverse shocks in their income. However, compared with the debt earmarked for house purchases, this type of liability tends to cause higher increases in the associated debt service burden, given the greater relative cost, and it has a more negative bearing on the sector's financial position, insofar as it does not entail a parallel increase in household assets. Also, an increase in mortgage consumer loans would raise the sensitivity of consumption to changes in property prices.

Resident purchases abroad accounted for a volume equivalent to 17% of GDP, a similar level to that of the previous year. The related breakdown shows purchases of shares and other equity to be prominent, accounting for more than half the total. The dynamism of this item reflects the momentum of corporate operations undertaken by non-financial firms. Indeed, Spanish direct investment in the rest of the world increased, in terms of GDP, by more than 3 pp to 7.3%.

and there was a fresh increase in the debit balance of the international investment position.

The financial transactions discussed in the foregoing paragraphs prompted a fresh increase in the Spanish economy's debit position vis-à-vis the rest of the world which was, moreover, affected by the changes in financial instrument prices and in the exchange rate. Net external liabilities stood at 68% of GDP at the end of the year, compared with 56% in 2005. This rise essentially reflects the behaviour of the financial sector (excluding institutional investors), as a result of their role in routing the resources needed to finance the nation's overspending relative to its income and the purchases of financial assets abroad.

## **2 The Spanish financial markets**

The Spanish financial markets generally followed a similar pattern to that of previous years. There was notable growth in activity on the primary markets and more moderate growth in the secondary markets. At the same time, and for the fourth year running, stock markets prices continued on a growing trend.

### **2.1 PRIMARY MARKETS**

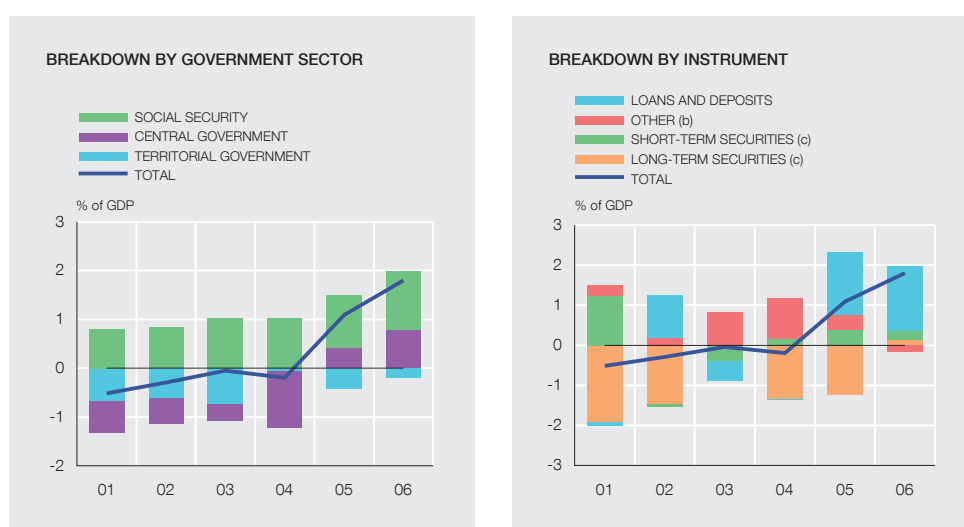
Fixed-income issues grew considerably...

On the primary markets for tradeable securities, the net issuance of fixed-income instruments once again grew at a notable pace (24% in relation to 2005), amounting to €224 billion, almost one-third of the amount recorded in the euro area (see Table 6.2). The distribution by sector revealed the continuing prominence of the financial sector, the result essentially of the high expansion in bank lending. Indeed, approximately half the funds obtained were in the form of securities linked to the mortgage market such as covered bonds and mortgage-backed bonds. The related amounts of these latter instruments are detailed in Table 6.2 under "Other financial intermediaries".

The foregoing item also includes the transactions of the resident subsidiaries of the financial and non-financial corporations specialising in the issuance of securities, which likewise grew at high rates. In contrast, the resources raised by foreign subsidiaries were once again negative in net terms, showing a firming of the shift in this activity to Spain. The issuance of fixed-income securities undertaken directly by non-financial corporations was once again positive, following several years of negative figures, albeit for a moderate amount. The volume of funds

## GENERAL GOVERNMENT NET FINANCIAL TRANSACTIONS (a) Cumulative four-quarter data

CHART 6.3



SOURCE: Banco de España.

- a. A positive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilities.  
b. Includes unpaid accrued interest on bonds and net investment by the Social Security System in assets issued by other general government sectors.  
c. Includes only liabilities-side transactions.

obtained by the sector through the various possible channels amounted to €12 billion, set against net redemptions totalling €2.5 billion in 2005.

In contrast, there was a negative net general government issue (-3 billion), a circumstance not seen since 1970. The breakdown by sub-sector shows a decline in the outstanding balance of State securities and an increase in that of the territorial governments, which maintained the trend of recent years.

and equity issues also rose.

The volume of equity issues practically doubled, although the funds obtained through this channel continued to be small compared with the resources raised through the fixed-income markets. Among the issues undertaken by non-financial corporations, the real estate sector was a leading player.

There was a fresh surge in initial public offerings, the volume of which stood at 2.5 billion, compared with 0.2 billion in 2005. These figures reflect the stock market launch of ten new mid-capitalisation companies. Six of the companies were from the real estate and construction branches.

## 2.2 SECONDARY MARKET ACTIVITY

Activity on the secondary markets also increased, equities in particular.

Activity on the secondary markets also increased, favouring the liquidity of the instruments traded. That said, behaviour across the different segments was mixed (see Table 6.3). The biggest increases were in connection with equities, both in spot operations (stock exchange) and in derivatives transactions (MEFF). In the first case, trades, which grew by 35%, exceeded the €1 billion mark for the first time. Contributing factors here were the favourable trend of prices; renewed activity in the primary market; the strong expansion in takeover bids, which rose to a volume of €100 billion; and the acquisition by non-financial corporations and private equity companies of stakes in listed companies.

On the derivatives markets, trades posted higher growth (almost 60%) and continued to be concentrated in IBEX-35 contracts, although share options and futures also expanded.



**FINANCIAL TRANSACTIONS OF THE NATION**  
Cumulative four-quarter data

TABLE 6.1

% GDP	2003	2004	2005	2006
NET FINANCIAL TRANSACTIONS	-2.9	-4.8	-6.5	-7.8
FINANCIAL TRANSACTIONS (ASSETS)	13.1	13.3	18.2	16.8
Gold and SDRs	0.0	0.0	0.0	0.0
Cash and deposits	0.7	3.2	2.2	5.6
Of which:				
<i>Interbank (a)</i>	0.5	0.7	3.2	3.4
Securities other than shares	6.5	1.8	8.8	-1.2
Of which:				
<i>Credit institutions</i>	3.5	1.0	6.6	-2.0
<i>Institutional investors</i>	3.5	0.3	2.0	0.4
Shares and other equity	4.7	6.8	5.2	9.4
Of which:				
<i>Non-financial corporations</i>	4.5	3.8	3.9	6.9
<i>Institutional investors</i>	1.1	0.8	0.9	1.2
Loans	0.3	0.8	1.1	2.1
FINANCIAL TRANSACTIONS (LIABILITIES)	16.0	18.2	24.8	24.6
Deposits	6.9	1.7	5.7	0.3
Of which:				
<i>Interbank (a)</i>	5.3	5.0	7.2	0.6
Securities other than shares	5.3	12.4	15.8	21.5
Of which:				
<i>General government</i>	-1.0	2.7	0.2	1.3
<i>Credit institutions</i>	3.5	4.6	6.3	7.8
<i>Other non-monetary financial institutions</i>	2.8	5.1	9.3	12.4
Shares and other equity	1.1	2.7	0.7	-0.9
Of which:				
<i>Non-financial corporations</i>	1.3	1.7	0.8	-1.3
Loans	2.8	1.3	2.3	3.5
Other, net (b)	-0.9	-0.6	-0.7	-0.8
MEMORANDUM ITEMS				
Spanish direct investment abroad	3.3	5.8	3.7	7.3
Foreign direct investment in Spain	2.9	2.4	2.2	1.6

SOURCE: Banco de España.

a. These correspond to credit institutions only, and include repos.

b. Includes, along with other items, the asset-side caption showing insurance technical reserves and the net flow of trade credit.

Conversely, on the AIAF market, where private fixed-income securities are traded, activity grew at a moderate rate. In terms of instruments, the biggest increase was in commercial paper, while trades with securities linked to the mortgage market declined slightly. That is in contrast to the buoyancy of the primary markets and points to the greater prevalence of outright purchase transactions to maturity.

On the book-entry public debt market, trading also increased slightly. The highest growth was in spot operations, although the bulk of activity continued to be in repos and sell/buy-back agreements.

The company BME was listed on the stock exchange.

On the institutional front, BME – the manager and owner of the Spanish trading, clearing and settlement systems – was listed on the stock exchange in July, following the steps previously taken on other European and US stock markets. This development marks the culmination of

EUR m	2003	2004	2005	2006
NET ISSUANCE BY RESIDENTS (a)	77,578.1	146,570.7	184,373.5	231,291.3
FIXED INCOME	75,801.6	129,008.4	180,141.1	223,660.1
Central government	327.7	6,650.1	3,890.0	-4,789.1
Territorial government	1,784.3	1,533.0	2,792.0	2,055.1
Monetary financial institutions	42,910.9	61,363.6	78,042.4	96,667.6
Other financial intermediaries	31,892.6	59,591.0	95,522.1	128,677.8
Non-financial corporations	-1,113.9	-129.3	-105.4	1,048.7
EQUITIES	1,776.5	17,562.3	4,232.4	7,631.2
Monetary financial institutions	248.2	15,786.9	1,272.4	2,921.2
Other financial intermediaries	62.4	486.3	-4.7	93.8
Non-financial corporations	1,465.8	1,289.1	2,964.7	4,616.1
INITIAL PUBLIC OFFERINGS	417.4	2,557.0	157.1	2,485.4
MEMORANDUM ITEMS				
Net issuance by foreign subsidiaries	12,473.2	-30,336.2	-20,652.3	-6,304.4
Financial institutions	8,325.1	-26,744.3	-15,496.9	-320.4
Non-financial corporations	4,148.1	-3,591.9	-5,155.4	-5,984.0

SOURCES: CNMV and Banco de España.

a. Includes issuance by residents, in both domestic and foreign currency.

the process of demutualisation and privatisation of financial markets and clearing systems in our country.

## 2.3 SECONDARY MARKET

### PRICES

Share prices continued to rise...

Prices remained on a rising course on the equity markets, with this trend being only temporarily interrupted during a bout of instability in mid-2006. This episode was marked by an abrupt fall in traded prices, along with a rise in volatility (see Chart 6.4). Over the year as a whole, the IGBM (Madrid Stock Exchange General Index) posted a gain of 35%, outperforming the Euro Stoxx index for the euro area stock markets (20%) and the US S&P 500 (14%). The soundness of listed companies' actual and forecast earnings, against the background of the favourable economic outlook in Spain, in the euro area and in the rest of the world, contributed to this, as did the renewed surge in corporate operations.

especially in the real estate sector.

Prices rose virtually across the board, although the gains in the indices relating to basic materials, industry and construction (61.8%) and to real estate (111%) were particularly notable. Gains in the oil and energy and banking branches were more in line with those of the market (32% and 27%, respectively), while consumer services increased to a lesser extent (8.6%). During the opening months of 2007 the rising trend of the IGBM continued, being interrupted temporarily from end-February to mid-March during a bout of turbulence that also affected the other main international stock markets. Subsequently, a fresh phase of price increases began, though it was temporarily curtailed in late April as a result of the correction to the valuation of some real estate corporations.

Government bond yields rose and credit risk premia held at low levels.

In step with the actual and foreseeable course of key interest rates in the Eurosystem, yields on government debt markets moved on a rising path at the shortest-dated terms. In the medium- and long-term segments, there were rises until mid-2006, but this process came to a halt during the second half of the year, giving rise to a flattening of the curve. The interest rates

EUR m	2003	2004	2005	2006
Public-debt book-entry market (a)	21,290,331	22,833,682	22,219,946	22,615,358
Spot (b)	2,246,882	2,136,698	2,338,208	2,903,145
Repos and sell/buy-back agreements	18,979,902	20,584,242	19,571,854	19,384,782
Forward (b)	63,547	112,743	309,884	327,432
AIAF fixed-income market	380,197	566,580	872,297	900,202
Commercial paper	261,526	286,468	404,380	481,596
Ordinary and asset-backed bonds and mortgage certificates	86,498	217,368	371,769	324,895
Other	32,173	62,743	96,148	93,711
Stock exchange: fixed-income (b)	74,346	82,790	93,191	93,449
Stock exchange: equities	499,745	643,542	853,971	1,155,682
MEFF derivatives markets (c)	292,539	393,666	583,839	933,973
Fixed-income	138	5	0	0
Ibex 35	268,879	371,494	544,064	883,472
Stock options	12,714	12,014	16,861	22,936
Stock futures	10,808	10,152	22,914	27,565

SOURCES: AIAF, Spanish stock exchanges, CNMV, Federation of European Stock Exchanges, Banco de España and Iberclear.

a. Only includes transactions with 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.

on 10-year bonds thus stood at around 4% in December, up 60 bp on the end-2005 level. The German benchmark bond followed a similar pattern, and the yield spread between the Spanish and German bonds hardly moved, although in the closing months of 2006 and early 2007 it increased slightly.

Finally, the credit risk premia of financial and non-financial corporations held at around their end-2005 levels and, in some cases, they even declined, standing at historically low values at the end of the year. This reflects the favourable assessment the market has made of the financial position of these companies.

### 3 Spanish financial intermediaries

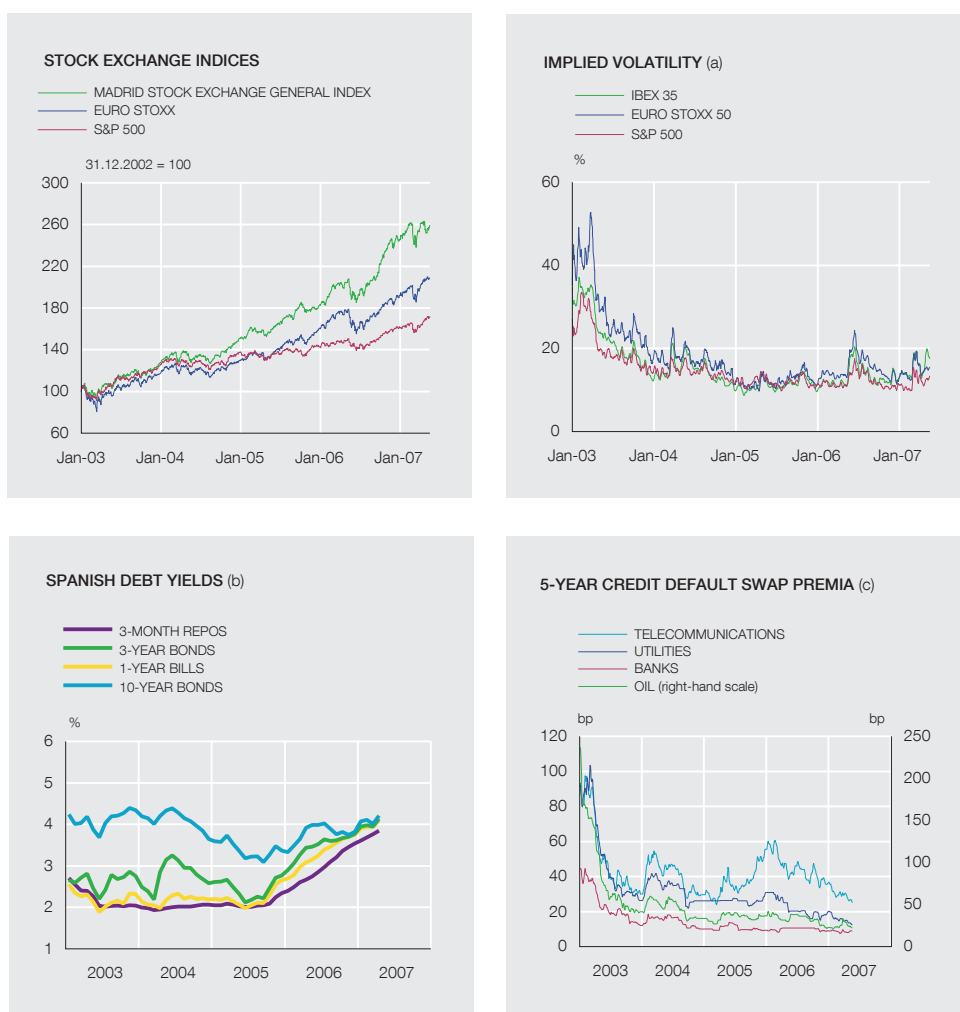
Against a favourable economic and financial background, the year 2006 was once again marked by a sizeable increase in the earnings of Spanish financial institutions (credit institutions, securities companies, fund managers and insurance companies). Activity, however, was mixed, proving notably expansionary in the case of credit institutions and less dynamic in that of institutional investors, whose net volume of resources raised fell in relation to the previous year.

#### 3.1 CREDIT INSTITUTIONS

Institutions' total assets and earnings grew strongly, with some changes in the composition of credit.

The total assets and earnings of credit institutions increased notably (see Table 6.4), driven once again by the buoyancy of credit. Funds lent to the private sector quickened once again, placing the related rate of expansion in real terms at over 21%, an unprecedented level which is increasingly distinct from the actual growth of GDP (see Chart 6.5).

This acceleration was compatible with a lesser increase in resources earmarked for house purchases, which was more than offset by the greater dynamism of the other components. In particular, credit extended to firms rose by 28% during the year, with a notable contribution by the construction and real estate services branches. The weight of the overall risks vis-à-vis the



SOURCES: Madrid Stock Exchange, Bloomberg, Credit Trade, Datastream and Banco de España.

a. Five-day moving average.

b. Monthly averages.

c. Average asset-weighted premia. On 22.6.03 a change came into effect in the contractual terms of European firms. The premia associated with the new contract are lower (by around 10%). Five-day moving averages.

real estate sector in a broad sense (construction, development and house purchases) continued to rise, although the proportion of mortgage-backed loans fell by 0.7 pp to 61% of the total at the end of the year. This is due to the surge in corporate transactions in which these companies participated.

The rate of expansion of loans to individuals for consumption and other purposes also rose during the year. According to the Bank Lending Survey, these developments were mainly due to the increase in the demand for these types of funds, but also to some increase in supply, which likewise took place in the case of credit to companies not intended for real estate activities.

Deposits grew, but were insufficient to finance new lending.

The increase in the return on deposits, prompted by the normalisation of the monetary policy stance, and the changes introduced by the new personal income tax legislation – which eliminated the tax disadvantage facing deposits in relation to mutual funds – gave rise to the greater dynamism of the funds raised from retail customers, enabling the increase in credit to be financed more readily. Nevertheless, since the growth in deposits continued to be insufficient for this purpose, issues of mortgage-backed securities and loan securitisations

**CREDIT INSTITUTIONS**  
**BALANCE SHEET AND INCOME STATEMENT**

TABLE 6.4

	CONSOLIDATED			INDIVIDUAL		
	Dec-05	Dec-06	Y-o-y rate (%)	Dec-05	Dec-06	Y-o-y rate (%)
MAIN BALANCE SHEET ITEMS (% of TA)						
Total assets (EUR bn)	2,533.6	2,905.8	14.7	2,126.1	2,478.4	16.6
Credit	62.0	66.9	23.8	59.5	64.3	26.0
<i>Of which: resident private sector in Spain</i>				55.2	59.5	25.7
<i>Debt securities</i>	15.4	11.2	-16.6	13.4	9.4	-18.1
<i>Other capital instruments and equity interests</i>	4.2	4.5	23.4	5.9	6.1	21.1
<i>Other assets</i>	18.3	17.3	8.3	21.1	20.1	10.9
Liabilities						
Interbank deposits	17.4	15.4	1.6	21.6	19.1	3.0
Customer deposits	48.6	47.9	13.0	50.7	52.2	20.0
<i>Of which: households and non-fin.corps. res. in Spain</i>				30.1	30.0	16.0
<i>Marketable securities</i>	15.3	19.1	43.6	10.4	12.3	37.3
<i>Other liabilities</i>	12.8	11.6	3.8	11.1	10.4	9.5
Equity	6.0	6.0	16.2	6.1	6.0	14.1
INCOME STATEMENT (% of ATA)						
(+) Interest income	4.07	4.30	23.3	3.55	4.02	31.9
(-) Interest expenses	2.34	2.59	29.7	1.89	2.33	43.5
Net interest income	1.74	1.70	14.8	1.65	1.68	18.6
(+) Net commissions	0.79	0.77	13.8	0.58	0.56	12.9
(+) Profits on financial operations and investees	0.40	0.52	52.4	0.14	0.20	68.9
Gross income	2.93	2.99	19.6	2.37	2.44	20.1
(-) Operating expenses	1.52	1.40	7.6	1.24	1.14	7.3
Net income	1.41	1.60	32.5	1.12	1.30	34.3
(-) Write-downs and provisions	0.42	0.48	33.6	0.35	0.42	40.2
(+) Other income	0.16	0.25	86.6	0.09	0.21	172.0
(-) Taxes	0.24	0.34	65.7	0.15	0.22	73.9
After-tax profit	0.91	1.03	32.7	0.72	0.87	41.0
Group net profit	0.86	0.98	33.1			
RATIOS (%)						
Net interbank position/TA (a)	-10.9	-8.5		-9.7	-7.4	
Solvency	11.0	11.2				
Doubtful assets/TA	0.6	0.5		0.5	0.5	
Coverage of doubtful assets	213.5	226.9		245.7	263.4	
Foreign operations/TA	23.6	21.8				
Efficiency (GE/MO)	52.7	47.6		54.6	48.3	
ROE	16.8	19.8		12.0	15.7	

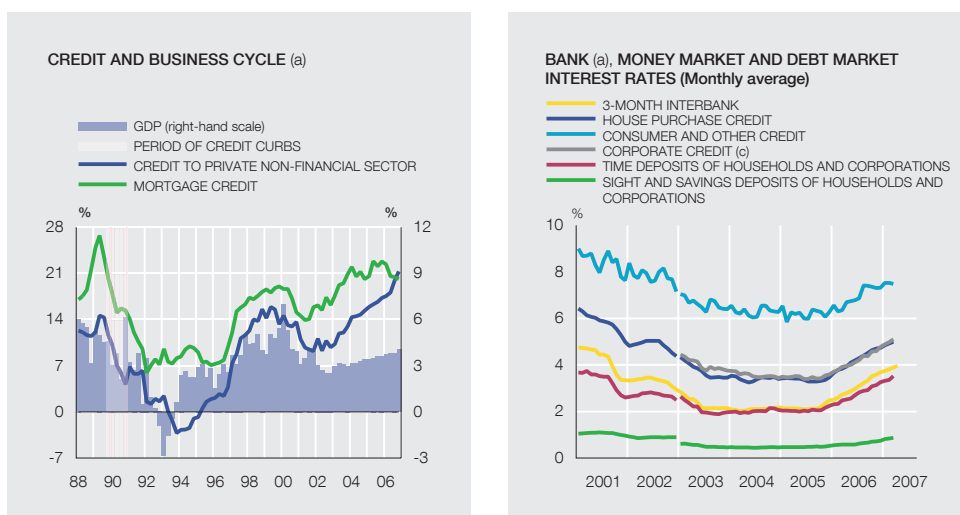
SOURCE: Banco de España.

a. Includes liabilities with central banks.

continued to increase at a high rate. However, resort to the interbank market declined (see Table 6.4).

#### Earnings improved...

The lesser dependence on interbank markets and the increase in dividends received were conducive to a recovery in the net interest income of individual institutions, after several years of decline. The increase in earnings was further boosted by the rise in profits arising on financial transactions and on corporate holdings, and by the decline in operating expenses relative to total assets. Adding to this was the 49% growth in earnings from business abroad, meaning that the return on equity, at the consolidated level, rose from 16.8% in 2005 to 19.8% in 2006.



SOURCES: ECB and Banco de España.

- a. Real year-on-year rates. Base 1995 data to December 1995 and base 2000 data thereafter.  
 b. There is a break, in January 2003, in the series of bank rates owing to changes in the data compilation statistical requirements.  
 c. Calculated as a weighted average of the interest rates on various transactions grouped according to volume. For loans exceeding €1 million, the interest rate is obtained by adding to the NDER (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.

contributing to strengthening the sector's financial soundness...

Spanish institutions' doubtful assets grew by 13% (7 pp up on the previous year), and they did so especially in the case of loans to individuals. Doubtful assets ratios remain, in any event, at low levels (around 0.5% of total assets) and the coverage of doubtful assets with provisions exceeds 200%. Regulatory capital ratios increased slightly and are holding at around 11%. The combined result is a scenario of notable strength in respect of the financial position of credit institutions.

although 2007 poses fresh challenges.

In the second half of the year and in early 2007, there were signs of some change in the trends that have marked credit institutions' activity in recent years. These included most notably the fall in the demand for new loans for house purchases, the main engine of growth of the business in the recent period. The number of new operations arranged moved on a declining course during the year, finally posting an average year-on-year decline of 8%. Moreover, the fact that the decline in the doubtful asset ratio may have run its course and the gradual withdrawal of the benign monetary policy stance will pose fresh challenges for institutions.

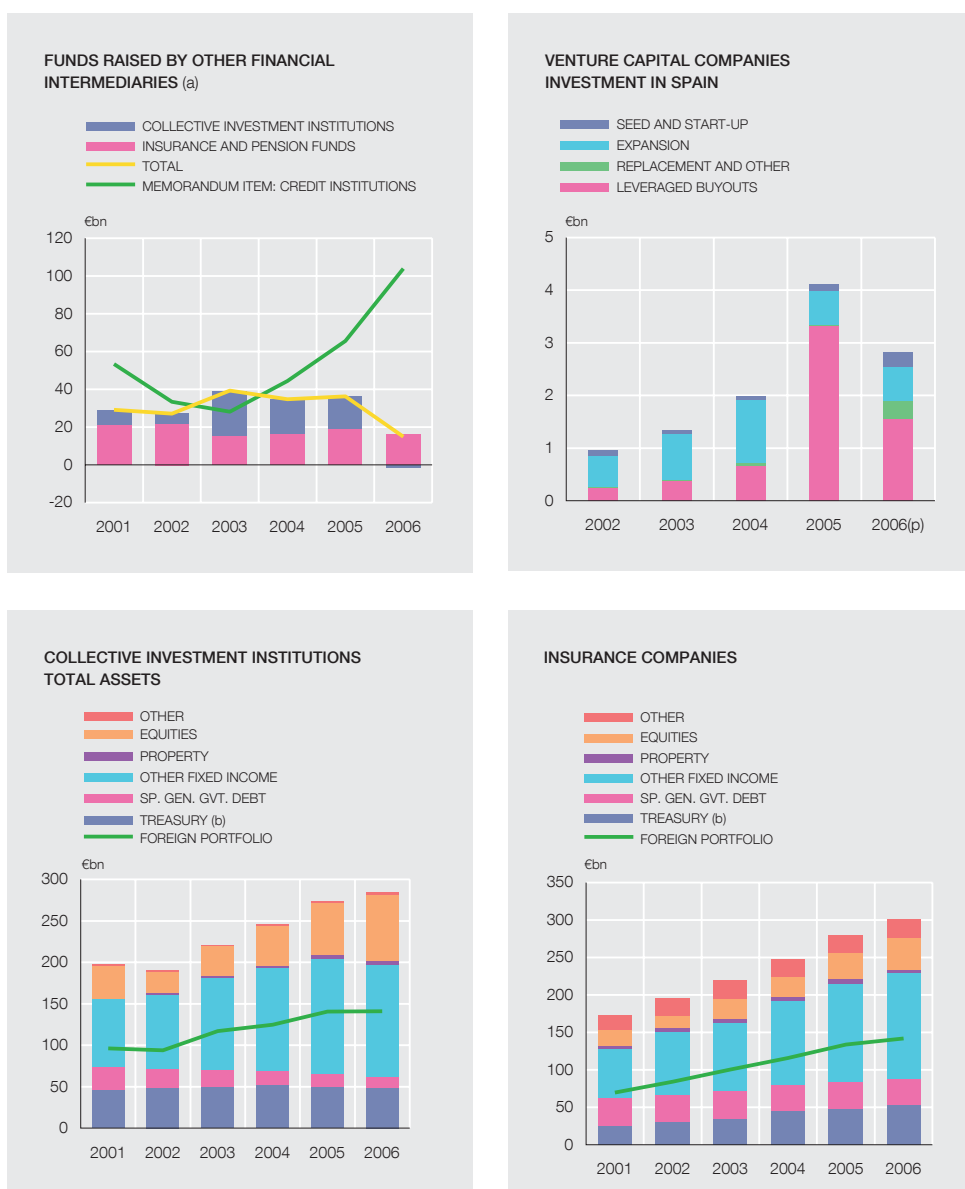
### 3.2 INSTITUTIONAL INVESTORS

Institutional investors raised fewer funds...

The counterpart of the aforementioned increase in bank liabilities was a reduction in the volume of new net resources raised by Spanish institutional investors (see Chart 6.6). This phenomenon was particularly significant in the case of mutual funds, where net redemptions were recorded in the second half of 2006, especially in short-term fixed-income and global funds. However, the total assets of real-estate collective investment institutions (CIIs) and foreign CIIs operating in Spain continued to increase at a rate of over 30%. Net flows received both by insurance companies and by pension funds also declined in relation to the previous year (by around 15% overall), despite the estimated growth of 8% in insurance premia.

although the range of investment instruments available continued to broaden...

New instruments continued to emerge, such as exchange-traded funds (ETFs) and hedge funds. Further, in the case of private equity, the approval in 2005 of new, more flexible regulations, along with the development of this type of activity globally, prompted the registration of new agents pursu-



SOURCES: ASCRI, CNMV and Banco de España.

a. Shares and other equity in CII and reserves of insurance companies and pension funds. In the case of credit institutions, deposits and repos of households and non-financial corporations.

b. Includes cash, deposits and repos.

ing this activity in Spain.<sup>1</sup> Although in 2006 the volume of investment was down on the previous year (see Chart 6.6), the resources raised from residents grew by over 40%, amounting (according to ASCRI<sup>2</sup> estimates) to €1.6 billion (somewhat less than 2% of the total obtained in Europe). As was already the case in previous years, the bulk of this investment was earmarked for purchases of established companies and not for the promotion of new companies with a high technological value.

In institutional investors' portfolio structure there was an increase in the relative weight of equities, partly caused by the trend in prices, and of investments in the property sector and in

1. Specifically, from January 2006 to March 2007 12 private equity management companies, 34 companies and 28 funds were inscribed in the official registers, relating in the latter two cases mainly to simplified-regime entities. 2. Spanish Association of Venture Capital Companies.

private equity companies. In any event, the bulk of these institutions' assets continued to be channelled into money market instruments and into debt.

and their results continued to trend favourably.

Pension and mutual funds obtained average returns of 5.2% and 5.1%, respectively (7.2% and 5% in 2005). Insurance companies increased their net profit, favoured by the lower growth of life assurance provisions, thereby maintaining their return on equity at over 20%. Their financial position is, moreover, very sound, with an aggregate technical provisioning coverage ratio of 115% and the solvency margin 2.9 times the minimum amount required, according to the latest available information relating to Q3 last year.

#### **4 The financial position of the non-financial private sector**

##### **4.1 HOUSEHOLDS**

The debt and debt burden of households continued to grow.

As indicated, spending by Spanish households continued to outgrow their income. As a result, the sector's resort to credit remained high and, consequently, the various indicators of household debt continued to increase (see Chart 6.7). At end-2006, household debt stood at close to 125% of gross disposable income (GDI), more than 10 pp up on the same period a year earlier and approximately 25 pp above the figure for this ratio for the euro area as a whole.

Component by component, despite the fact that debt associated with house purchases slowed moderately, its weight in total household debt increased slightly to 73.4%. The use of mortgage loans to finance other expenses likewise increased somewhat, although its relative weight remains modest. Accordingly, at the end of the year, the outstanding balance of mortgage lending for spending other than housing accounted for somewhat less than 5% of total credit extended to households, around 0.5 pp up on the figure recorded the previous year (see Box 6.2).

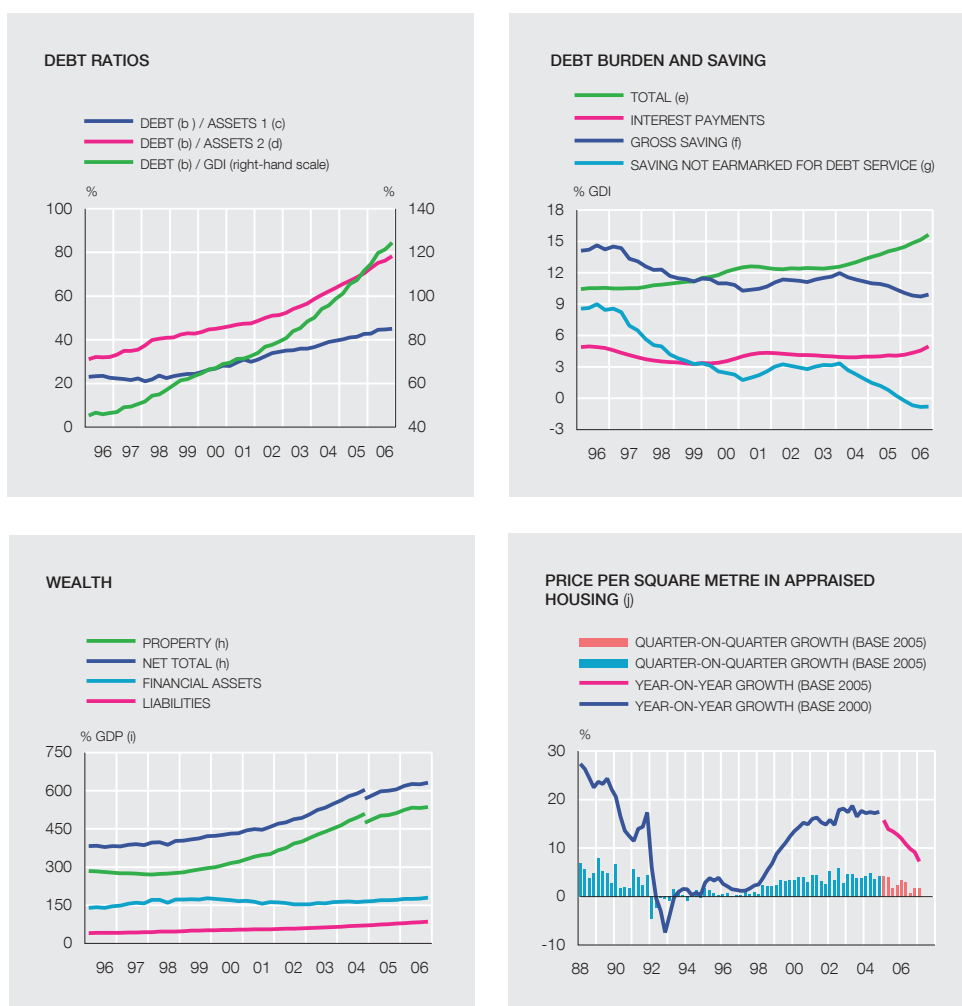
The continuing sharp growth in financing obtained by households, along with the rise in its attendant cost, prompted a fresh increase in the debt burden withstood by households. On the information available on interest payments by the sector and with an estimate of the amounts relating to regular loan principal repayments, this burden stood at close to 16% of GDI, around 1.5 pp up on the previous year's figure. These figures also reflected a further fall-off in saving capacity, once financial charges are stripped out, which held in negative territory throughout the year.

Their net wealth increased and the weight in the portfolio of institutional investment instruments diminished.

As in previous years, the accumulation and rising value of financial and real assets meant that household net wealth continued to increase, accounting for more than 625% of GDP. That contributed to softening the adverse impact of the changes in the foregoing indicators on the sector's spending decisions. However, the rate of increase in the value of net worth was more moderate, as a result of the behaviour of house prices, which held on the gradually slowing path initiated in 2005, growing in December 2006 at around 9%, almost 4 pp less than at the end of the previous year (see Chart 6.7).

In the household portfolio of financial assets, which attained a value equivalent to 180% of GDP, the most liquid low-risk assets continued to account for a notable weight, while the proportion of holdings of shares and other equity increased slightly, chiefly as a result of the trend in stock market prices. The proportions accounted for by investment in insurance and shares in mutual funds both declined, in the latter case as a consequence, at least in part, of the changes in the taxation of saving, which were conducive to shifts out of these products into deposits.





SOURCE: Banco de España.

- a. From 1999, the sectoral National Accounts data correspond to the CNE base 2000. For prior periods, an estimate consistent with this base is used.
- b. Includes bank credit and derecognised securitised credit.
- c. Assets 1 = Total financial assets less "other".
- d. Assets 2 = Assets 1 less shares less shares in FIM.
- e. Estimated interest payments plus debt repayments.
- f. Balance of households' use of disposable income account.
- g. Gross saving less estimated debt repayments.
- h. Calculated on the basis of the estimated changes in the stock of housing, in the average area per house and in the price per square metre. New house price statistic from 2005.
- i. Spanish National Accounts, base 2000.
- j. New statistic from 2005.

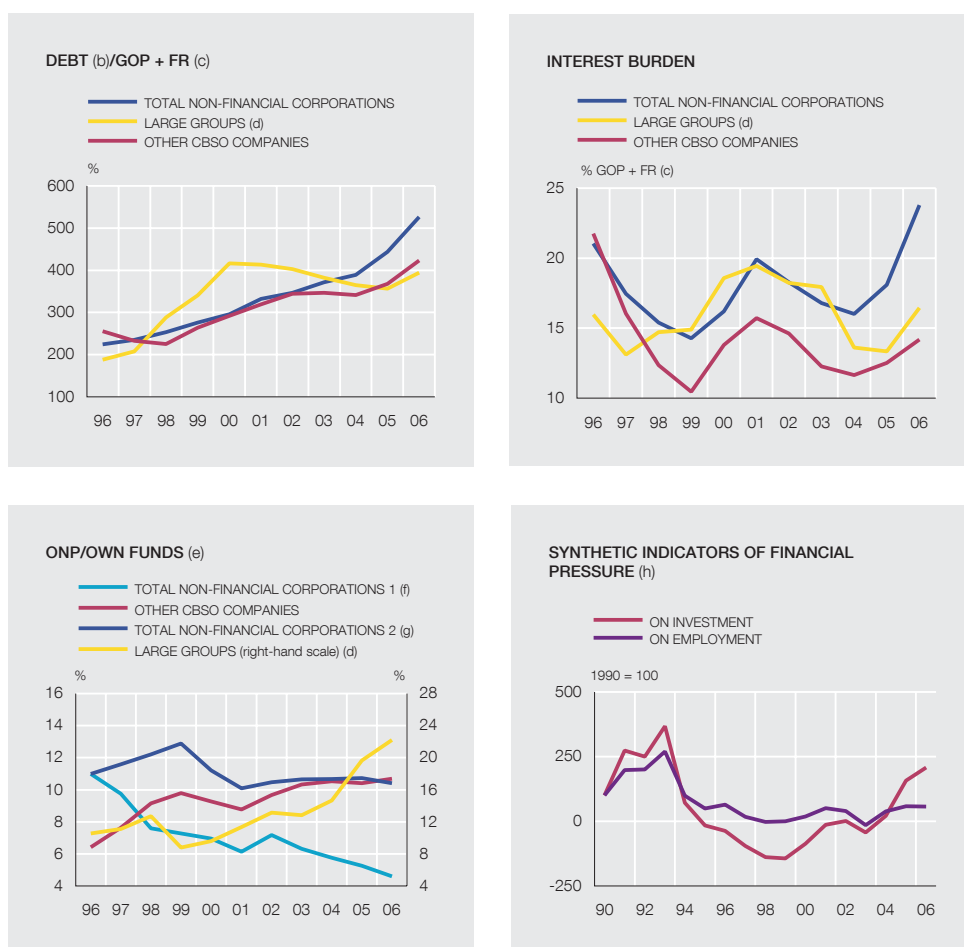
Exposure to potential shocks increased at a somewhat lesser pace.

In sum, despite the fact that the household financial position remains sound, the growing trend of debt and of the cost of financing has prompted fresh increases in the debt burden. These developments, along with the contraction in gross saving, have raised the exposure of the sector to adverse shocks in employment, in asset prices and in interest rates, although the slowdown in credit, linked partly to the lower growth of property prices, is contributing to easing to some extent this increase in exposure.

#### 4.2 NON-FINANCIAL CORPORATIONS

Debt and debt burden ratios continued to increase...

Own funds continued to be the main liability of corporations. Nonetheless, despite the notable rise in stock market prices, the weight of such funds in the balance sheet diminished for the second year running owing to the sharp growth in debt. That made once again for an increase in the ratio of external liabilities to the sum of the gross operating surplus and financial revenue.



SOURCE: Banco de España.

a. Indicators calculated on the basis of CBSO annual and quarterly survey data, except the series "total non-financial corporations", which was obtained from the National Accounts (CNE and FASE). From 1999, the income of the sector corresponds to the CNE base 2000. Previously, an estimate consistent with this base is used.

b. Interest-bearing borrowed funds.

c. Gross operating profit plus financial revenue.

d. Aggregate of all the firms reporting to the CBSO belonging to the groups Endesa, Iberdrola, Repsol and Telefónica. Adjusted for intra-group financing to avoid double counting.

e. For total non-financial corporations,  $ONP = GOS + \text{interest and dividends received} - \text{interest paid} - \text{fixed capital consumption}$ .

f. Own funds valued at market prices.

g. Own funds calculated on the basis of the 1996 figure and cumulative flows since.

h. Indicators estimated on the basis of CBSO annual and quarterly survey data. A value of more (less) than 100 indicates higher (lower) financial pressure than in the base year.

This ratio stood in December 2006 at over 525%, around 80 pp above the end-2005 figure (see Chart 6.8). Among the companies reporting to the Central Balance Sheet Data Office quarterly survey (CBQ), in which the biggest companies predominate, this ratio also increased.

The sharp growth in external funds raised by corporations, along with the increase in their cost, prompted a fresh rise in the ratio of interest payments to profits, which stood at close to 24% at the end of the year, over 6 pp up on the related December 2005 figure. The CBQ information points to a less unfavourable trend in this indicator, owing to the lesser indebtedness of the reporting corporations.

with financial costs subtracting a significant portion from profits.

The increase in the debt burden contributed to tempering the growth rate of ordinary net profit (ONP). While the sector's gross operating surplus increased at a rate of close to 8%,

ONP, which can be estimated by adding to the former net financial revenue and deducting capital repayments, held at the same levels as last year. The notable increase in stock market prices led to a slight reduction in the ratio of the sectoral ONP to own funds valued at market prices, although if the price effects are eliminated from the calculation of the denominator of this ratio, the indicator shows a more stable profile.

CBQ data highlight a better earnings performance by the reporting corporations. The ONP for these companies, though it has slowed notably, grew in 2006 at a rate of over 5%, and ONP as a proportion of capital held stable. This ratio, however, increased for the third year running in the case of the major groups reporting to the CBQ survey, reflecting the more favourable behaviour of their results. Analysts' expectations about the earnings of listed non-financial corporations, among which the biggest companies also predominate, suggest that in the coming quarters such earnings will continue increasing at a notable pace, albeit lower than that of recent years.

The financial position of corporations remains sound, although there are factors of uncertainty.

The sector's doubtful assets ratios remain at very low levels; there have been hardly any changes in the credit ratings of securities-issuing Spanish firms, and credit risk premia are holding at moderate levels. Nonetheless, the joint trend of debt, the debt service burden and profitability meant that, for the third year running, the synthetic indicator of financial pressure on investment, calculated drawing on CBQ data, increased, albeit moderately (the indicator relating to employment held stable). This indicator stood above its historical average, though it did not reach the levels of the early 90s.

Accordingly, although the financial position of the corporate sector is still showing no signs of weakness, the increase in debt and in its cost is raising companies' exposure to adverse shocks. Moreover, the recent corporate acquisitions by certain companies – particularly in the construction branch – add a further factor of uncertainty associated with the entry into new business areas. However, these acquisitions entail greater diversification of the purchasing companies' activity, which reduces their sensitivity to purely regional or sectoral developments.



## 1 Introduction

This chapter of the *Annual Report*, devoted to the management of the Banco de España, is an overall summary of the most notable aspects of the institution's activity in 2006. Some such aspects will be addressed in greater detail in the monographic reports published annually by certain departments of the Bank (Banking Supervision, Balance of Payments, Complaints Service, Central Balance Sheet Data Office, Central Credit Register, Research Activities, Oversight of Payment Systems and Public Debt Market).

## 2 Activities of the Banco de España as a member of the Eurosystem

The institutional framework of the European Union (EU) functioned normally during 2006. Last year saw the continuation of the period of reflection opened at the June 2005 European Council by the heads of State and of Government of the Member States to foster a wide-ranging debate on the future of the EU, following the "no" vote returned in the referenda on the constitutional Treaty in France and the Netherlands.

On the basis of the respective convergence reports of the European Central Bank (ECB) and the Commission, the EU Council proposed that Slovenia adopt the euro as its national currency from 1 January 2007, thus becoming the first of the 10 Member States that acceded to the EU in 2004 to join the Eurosystem.

The ECB raised its benchmark rate by 125 bp during 2006 to 3.5%.

The ECB adhered to a monetary policy aimed at maintaining price stability in the euro area. From January to December 2006, the ECB Governing Council raised the benchmark rate by 125 bp, taking the minimum bid rate on the main refinancing operations to 3.5% in December 2006.

As in previous years, the Banco de España's activity in 2006 as a member of the Eurosystem was intense. The Governor participated in the meetings of the Governing Council and of the General Council of the ECB at which, among others, decisions were taken to change official interest rates, as mentioned in the foregoing paragraph and explained in detail in Chapters 1 and 4 of this *Annual Report*. For the second time in the history of the European System of Central Banks (ESCB), the Banco de España hosted a meeting of the Governing Council, this being the first occasion on which official interest rates were changed outside the official ECB headquarters in Frankfurt.

An extensive group of professionals from the Banco de España participated in various committees, working groups and task forces of the Eurosystem to prepare for the taking of decisions by the governing bodies of the ECB.

The Bank also participated in the ESCB Banking Supervision Committee (BSC), where work continued on the preparation of the six-monthly *Financial Stability Review* and on the publication of the annual reports on the stability of the EU banking sector and on EU banking structures. In 2006 the BSC also published a report assessing the effects that the introduction of a new accounting framework based on International Financial Reporting Standards (IFRSs) might have on financial stability.

There has been further progress in the development and preparation of the new TARGET2 payments platform.

The TARGET payments system continued to contribute to the integration of the euro market, playing a key role in the correct and orderly application of the single monetary policy. As regards the new TARGET2 payments platform, work continued in 2006 on its development and preparation. The system's price structures and modes of participation have been defined, and there has been work on devising its legal and contractual framework, which will come into be-

ing in November 2007. Plans for the migration to the system and for the tests that institutions and central banks will undertake to this end during 2007 have also been developed. Spain's migration will be in the "second window", i.e. on 18 February 2008. In parallel, and in order to harness the benefits that TARGET2 will provide for financial integration, the Governing Council decided to explore, along with market participants, the timeliness and viability of offering a centralised securities settlement service, known as TARGET2-Securities. This initiative would also help reduce the costs of cross-border transactions and lessen the current fragmentation in settlement infrastructures in Europe.

In collaboration with the European Commission, the Eurosystem has continued working on a third initiative in the field of settlement systems, namely the Single Euro Payments Area (SEPA) project, aimed at overcoming the current fragmentation in retail payment processing in Europe, as explained in greater detail in Section 6.2.

With regard to the arrangements for maintaining financial stability foreseen by the Eurosystem, the member central banks conducted a simulation exercise to test their responsiveness in the face of a financial crisis that were to exert systemic effects in several euro area countries. The exercise contributed to improving the current co-ordinated management mechanisms for such eventualities.

The Eurosystem's single list of eligible assets, in force since 1 January 2007, improves transparency and integration in the area.

With regard to monetary policy implementation, the work under way for several years to prepare a single list of eligible assets for Eurosystem credit operations continued during 2006. Having set the single list of eligible assets in place on 1 January and thus eliminated the national lists, the Eurosystem has raised its levels of transparency and has taken a step forward in terms of financial integration in the area.

The ECB continued to analyse progress in this area in the euro area and published the second annual evaluation of the degree of integration of the area's financial markets. The evaluation is based on a set of half-yearly indicators published on the ECB website.

In co-operation with the national central banks, the ECB continued to develop, compile and disseminate a wide range of statistics. In May, in conjunction with Eurostat, it published the annual European accounts by institutional sector for the first time. In September it launched a new on-line statistical data service on the Internet, targeting a wide range of statistical users in the euro area.

The Banco de España was one of the central banks entrusted with measuring the quality of the banknotes in circulation in the euro area.

Under the Eurosystem agreements for the production of euro banknotes, the Banco de España was responsible for the production and distribution of 1,018 million banknotes in 2006. Moreover, it was one of the central banks entrusted with measuring the quality of the banknotes in circulation in the euro area. Further, the Banco de España has set about implementing the Eurosystem agreements on banknote recycling, with the general clauses applicable to the Banco de España ordinary cash service for euro banknotes being published in the Official State Gazette. Finally, the Banco de España has been actively participating in some of the trials to test security features of the second series of banknotes, whose progressive issue is scheduled for the end of the current decade.

### **3 International activities**

One of the strategic aims of the Banco de España is to heighten its international presence and projection, in both quantitative and qualitative terms. The foregoing section referred to its activity within the Eurosystem, so this section will focus on other fora in which the bank participates actively, and on bilateral relations, technical co-operation with other central banks, supervisory agencies and banking regulators, and seminars and conferences organised.

### 3.1 INTERNATIONAL RELATIONS

In the European Union, the Banco de España has continued to participate actively, as part of the Spanish delegation, in diverse Community working groups and committees. Notable here were the Economic and Financial Committee (EFC, which prepares ECOFIN Council meetings) and the Economic Policy Committee (EPC). In the case of the EFC, the main items under discussion in 2006 related to the development and application of the Stability and Growth Pact, financial stability, relations with the International Monetary Fund (IMF) and the contributions to the European Council in relation to the Broad Economic Policy Guidelines. The EPC working agenda focused in 2006 on the oversight of the application of the revised Lisbon strategy, the completion of long-term budgetary projections, analysis of the sustainability of public finances and the furthering of the debate on the means of extracting the maximum benefit from the challenges posed by globalisation.

The Banco de España chaired the BIS Working Group on Institutional Investors, Global Savings and Asset Allocation.

As in previous years, much of the international activity of the Banco de España was in the orbit of the Basel Bank for International Settlements (BIS), which is the main worldwide centre for co-operation between central banks. In addition to regularly attending the governors' meetings and the Annual General Assembly of the BIS, the Bank was active on the Committee on Global Economy, the Committee on the Global Financial System and the Markets Committee, as well as in high-level economists' meetings on matters of particular relevance to central banks and supervisors. In this respect, the Banco de España chaired the Working Group on Institutional Investors, Global Savings and Asset Allocation, whose final report has recently been published.

As regards banking regulation and supervision, the Banco de España has participated actively in the work of the committees reporting to the European institutions and, in particular, to the Committee of European Banking Supervisors (CEBS). As has occurred globally, attention is also shifting in Europe from the transposition to the implementation of solvency regulations (Directive 2006/48). In 2006, the CEBS finalised several guides, including most notably those relating to financial reporting statements (FINREP) and on solvency (COREP) for supervisory agencies, in whose preparation the Banco de España played a very active role. The CEBS has sought to shift the focus towards improved co-operation, not only among banking supervisors, but also with the committees on which securities and insurance and pension supervisors meet. Mention should be made here of the creation of a new committee reporting to the CEBS and to the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), whose aim is to seek convergence in the treatment of financial conglomerates. Moreover, the CEBS has continued to act as an adviser to the European Commission when so required. It has worked on the revision of limits on large exposures, the revision of the definition of own funds and the treatment of commodities derivatives.

The Banco de España has chaired since November the group entrusted with implementing the Basel II Accord, which reports to the BCBS.

Notable among the work developed by the Basel Committee of Banking Supervisors (BCBS) has been the revision of the *Core Principles for Effective Banking Supervision*, the final wording of which was published in October 2006. Mention should also be made of the work to smooth the way for the international implementation of Basel II, through the work of the AIG (Accord Implementation Group), one of the main sub-groups of the BCBS, which has been chaired since November 2006 by the Banco de España. The central issues addressed in 2006 were implementation plans, information exchange between supervisors and validation. The Banco de España also participated in other Basel Committee work relating to accounting aspects affecting credit institutions. Such work included the publication of guides on the use of fair value accounting and on asset valuation. The Bank was also involved in the various studies conducted by the Committee through its Research Task Force.

Elsewhere, the Joint Forum, which co-ordinates banking, securities and insurance supervisors, worked on matters relating to liquidity risk management, analysis of the main regulatory and market differences between sectors, and business continuity principles.

In close collaboration with the Ministry of Economy, the relationship with the International Monetary Fund continued to be strengthened through Spain's representation on the IMF's decision-making bodies, especially on the Executive Board and in the April and September meetings of the International Monetary and Financial Committee. Among the matters addressed for which position notes were drafted were the quota review process under way, the updating of the IMF's supervisory function, the reinforcement of the institution's role in emerging economies (essentially through the creation of a new contingent financing instrument), the sustainability of its finances and the need to find new sources of financing as a result of the strong decline seen in the volume of credit granted.

Formerly a collaborating member, the Banco de España is now an associate member of the ASBA and has heightened its involvement in the Association's activities.

As regards the Centre for Latin American Monetary Studies (CEMLA), the main forum for co-operation among Latin American central banks, the Bank participated in its meetings of Governors, its Alternates Committee and its Audit Committee. Matters of particular importance for CEMLA were addressed in 2006, including most notably the amendment of its statutes, the preparation of an organisational manual and the review of administrative regulations. Also of note was that the Assembly of the Association of Supervisors of Banks of the Americas (ASBA) approved a change in status for the Banco de España from collaborating member to associate member, which will entail greater involvement by the Bank in the Association's activities.

The Bank continued strengthening its collaboration with the multilateral development banks, namely the World Bank, the Asian Development Bank and the Inter-American Development Bank. And bilaterally, it is co-operating more closely with other central banks and banking supervisors through both high-level and specialist meetings. Of note in 2006 were the meetings with the Bank of England, the Bank of Canada, the Central Bank of Brazil and The Central Bank of China.

In conjunction with the Ministry of Economy, the Bank participated in meetings of the Paris Club and in working groups of the Organisation for Economic Co-Operation and Development (OECD).

Technical co-operation with other central banks and international agencies increased by 42% relative to 2005.

The provision of technical co-operation and the subsequent transfer of knowledge this involves have become irreplaceable components of the external projection of the Banco de España. Compared with the preceding year, 2006 saw a 42% increase in the activity deployed in this field. Work in the Latin American area remains most notable. There, the Banco de España is in the process of becoming a benchmark for many central banks and banking supervisors. The dual means of stimulating, on one hand, the demand for co-operation from those institutions interested and, on the other, of supplying know-how and training through the increasingly frequent organisation of seminars and courses by the Bank has proven most appropriate in this region. However, in other geographical areas where there is no common language and cultural factor, a co-operative model has been pursued. As a result, the Banco de España has combined its efforts with those of other central banks and supervisory agencies, working on projects habitually co-ordinated within the Eurosystem and structured around the facilities granted by the European Union (TACIS, PHARE, CARDS, etc.).

It is also important to highlight the Bank's growing collaboration with various agencies for the provision of technical assistance in the international arena, especially with CEMLA, the Central American Monetary Council, the International Monetary Fund, the World Bank, the BIS



Financial Stability Institute and the Latin American Reserves Fund. Likewise, the Bank has stepped up co-operation with the Spanish National Securities Market Commission, the Latin American Institute of Securities Markets, and other institutions and foundations. Although the co-operation provided spans practically all aspects of central banking activity, the areas of financial reporting, operations and statistics have proven to be of most interest for recipient institutions.

### 3.2 CONFERENCES, MEETINGS AND SEMINARS ORGANISED BY THE BANCO DE ESPAÑA

*The Conference on Central Banks in the 21st Century* in June addressed the challenges facing monetary policy, payment systems and financial stability.

In 2006, the Banco de España's activity in organising international conferences and seminars was once again notable. Such activity contributes decisively to establishing the Bank's external prestige, especially in Latin America, and to disseminating its knowledge in central banking and financial supervision matters.

A particularly prominent event was the *Conference on Central Banks in the 21st Century*, organised further to the European Central Bank Governing Council meeting held in Madrid in June and an integral part of the commemoration of the 150th anniversary of the adoption of the name Banco de España. The conference gathered together a select group of senior officials, central bankers, academics and representatives of banking and financial institutions. It reviewed changes in the role played by central banks in the recent past and the challenges they must face, especially in respect of monetary policy, payment systems and financial stability.

It is also important to underscore the role played by conferences and seminars whose goal is to make the European reality more familiar to other regions. In this respect, the Banco de España, along with the European Central Bank, organised in Madrid the third *High-Level Seminar*, a gathering of the governors of most European and Latin American central banks which was preceded by a technical workshop organised jointly with the Bank of Mexico. Mention may also be made of the conference organised in conjunction with the China Banking Regulation Commission, in Shanghai, on *Bank Restructuring Experiences*, and the seminar organised in Toledo with the IMF, addressed to Middle Eastern and North African countries, on *Central Bank Modernisation and Banking Reforms*.

Other activities of note in 2006 were the presentation of the World Bank report on poverty reduction and growth in Latin America and the presentation of the IMF report on global financial stability. The year also saw the eighth CEPR (Centre for Economic Policy Research) European Summer Symposium in International Macroeconomics at Roda de Bará. On this occasion, the key topics on the agenda were the optimal mix of monetary and fiscal policies, financial market stability, the cyclical behaviour of the labour market and the effects of globalisation.

*The Conference on Financial Integration and Stability in Europe* analysed the relationship between these two variables.

The Banco de España was the venue for the international conference on *Financial Integration and Stability in Europe* co-organised by the Bank itself, the European Central Bank and the Frankfurt Centre for Financial Studies. The conference focused on analysing the relationship between financial integration and financial stability and on recent progress in both fields, and was attended by high-level government officials, central bankers, experts and academics.

The Bank was once again responsible for organising the *Seminar on the Validation of Advanced Credit Risk Models and the Process of Implementation of Basel II*, aimed at supervisors in the Latin American region. This year an invitation was also extended to supervisors from other countries where Spanish banks are present. The objective was to divulge the Spanish supervisor's experience in this area and to promote an exchange of opinions on the best means of facing the process of transition towards Basel II.

## 4 Economic analysis and research

Research activities have been extended to new departments and areas of analysis.

In 2006, analysis and research into the Spanish economy and its international environment continued to be conducted by several departments of the Banco de España, with the aim of advising the Bank's governing bodies so they may comply with the functions entrusted to them and of helping to improve general awareness of the areas of interest to the institution.

Research work continued in 2006 in those departments traditionally involved in research, and there was also a broadening and co-ordination of research in other departments and areas of analysis.

The results of such research in 2006 included most notably the publication of 39 working papers and 8 occasional papers. A total of 67 papers were published by Banco de España staff in academic journals and in specialist books, 27 of these in anonymously refereed journals.<sup>1</sup> The publications in question included the *Economic Journal*, *Journal of the European Economic Association*, *European Economic Review*, *Journal of Public Economics*, *Journal of Financial Economics*, *Journal of Empirical Finance*, *International Journal of Forecasting*, *Journal of Money, Credit and Banking*, *Journal of Banking and Finance*, *Economics Letters*, *Emerging Markets Review*, *Economía* and *International Journal of Central Banking*. During 2006, another 25 papers shortly to be published were accepted by anonymously refereed journals, 24 of them international and one national.

### 4.1 PRIORITY AREAS OF ANALYSIS

The Banco de España research agenda prioritises contributions to knowledge of the functioning of the Spanish economy within the framework of its membership of EMU (Economic and Monetary Union). In relation to these tasks, the main areas of analysis during 2006 were as follows: i) households' financial decisions and the housing market; ii) the determinants of productivity in the euro area; iii) the macroeconomic implications of external deficits in a monetary union, and iv) the strengthening of instruments for modelling and forecasting the behaviour of the Spanish economy.

Research focused on the Spanish economy and its environment, the international economy, financial stability and other banking issues.

Along with analysis of the Spanish economy and its most immediate environment, research at the Banco de España also encompasses matters relating to the international economy, financial stability and other banking issues.

As regards the international economy, research focuses on matters of economic importance for Spain as an increasingly active participant in the global economy. During 2006, research delved further into the analysis of fiscal, financial, banking and financial stability aspects of the emerging countries, particularly Latin America and China. International trade matters also began to be tackled and the empirical and theoretical analysis of issues relevant to the international financial architecture was further developed.

In connection with financial stability and other banking issues, research focused on i) the analysis of the procyclicality of Basel II; ii) the development of an efficient tool for conducting stress testing at deposit institutions, and iii) the study of the relationship between banking competition and financial stability, and the study of the role of banks in corporate fragility and in the credit market, among other matters.

### 4.2 RELATIONS WITH THE ACADEMIC COMMUNITY

In addition to organising conferences, meetings and seminars (see Section 3.2), the Banco de España uses another three channels for relating to the academic community and to the units devoted to analysis and economic research at other central banks and international institutions.

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1. More details of these publications are given in the Banco de España *Research Memorandum 2006*, which can be viewed at [www.bde.es](http://www.bde.es). This memorandum also gives further details of other research by the Banco de España in that year.

Firstly, the analysis and research papers produced by the Banco de España are submitted to and discussed at national and international academic seminars, congresses and conferences, and they are published through the profession's usual channels. Likewise, at the economic research seminars organised by the Banco de España, of which around 40 were held in 2006, researchers from other institutions presented their papers to Bank staff.

Secondly, the Banco de España contributed to the research networks organised within the Eurosystem for the analysis of the euro area economy. A case in point in 2006 was the Wage Dynamics Network. As in previous years, it also participated actively in the CEMLA Central Bank Researchers' Network.

Finally, there are regular external visitors' and fellows' programmes to boost projects that may be considered strategic in different areas of analysis and research.

#### 4.3 DISSEMINATION AND COMMUNICATION

As mentioned above, the three main channels for the dissemination and communication of the Banco de España's research findings are the Working Paper and Occasional Paper series and the monthly *Boletín Económico* which, along with regular articles on the economic situation, includes summaries of research conducted or underway. Together with these publications, the review *Estabilidad Financiera*, launched in 2001, continued to serve as a channel of communication and discussion between the Banco de España and the Spanish financial sector on prudential regulation and supervision issues, including also the dissemination of research findings in these areas.

### 5 Banking supervision and regulation

#### 5.1 SUPERVISORY MEASURES

As at 31 December 2006, a total of 494 entities were subject to supervision by the Banco de España, 353 of which were credit institutions (see Table 7.1). As the supervisor on a consolidated basis of groups that have a Spanish credit institution at their helm, the Bank is also the supervisor of 115 foreign credit institutions.

The process of pre-validation of institutions' advanced internal models characterised supervisory activity.

The year 2006 was characterised by the assignment of sizeable human and technical resources to the supervisory pre-validation of the advanced internal models that may be used in accordance with the future solvency rules (Basel II). This drive to validate and review institutions' parallel calculations has also run into the current year. Like the Banco de España itself, the financial groups currently immersed in validation are assigning considerable resources to these processes, the initial stage of which will be completed in December 2007.

The Bank has continued reviewing the quantitative and qualitative aspects of the institutions' models, having regard to the multiple variables and circumstances surrounding them. Teams of bank examiners have analysed the adjustments to the institutions' procedures, the calculation methodology and organisation. Similarly, headway has been made in reviewing technological environments and database construction, along with the review of use tests and corporate governance.

The new accounting framework instituted in December 2004 under International Financial Reporting Standards has now been in place long enough to consider the adaptation process to have finalised with notable success. Current efforts will be focused on the implementation of the new solvency rules, which will require an additional drive in training and the adaptation of supervisory methods.

The Banco de España conducted 177 on-site inspections in 2006.

The ongoing supervision process that the Banco España applies to the institutions referred to in Table 7.1 involves a system for the permanent monitoring and analysis of each institution's situation, reinforced by an intensive programme of on-site inspections. A total of 177 inspec-

## INSTITUTIONS SUPERVISED BY THE BANCO DE ESPAÑA

TABLE 7.1

	31.12.2006
	494
CREDIT INSTITUTIONS	353
Banks	73
Savings banks	47
Credit co-operatives	83
Branches of foreign credit institutions	70
Specialised credit institutions	79
Official credit institutions	1
OTHER	141
Mutual guarantee and reguarantee companies	25
Currency-exchange bureaux	59
Appraisal companies	57

## INSPECTION VISITS IN 2006

TABLE 7.2

	COMPLETED AS AT 31.12.2006	IN PROGRESS AS AT 31.12.2006
TOTAL	81	96
CREDIT INSTITUTIONS	69	80
Banks	36	37
Savings banks	11	21
Credit co-operatives	10	12
Branches of EU credit institutions	1	2
Specialised credit institutions	11	8
OTHER	12	16
Mutual guarantee and reguarantee companies	7	5
Currency-exchange bureaux	3	5
Appraisal companies	2	6

tion visits were made in 2006, 96 of which were under way as at 31 December, according to the details indicated in Table 7.2.

Under the scheduled arrangements for supervisory activities, inspection visits may be either of an overall scope or confined to specific aspects.

The Banco de España sent 97 recommendation and requirement letters to supervised institutions.

Supervisory activity in 2006 involved the sending of 97 recommendation and requirement letters to credit institutions and other entities supervised by the Banco de España, these being either the institutions ultimately addressed or the parents of consolidated groups, in accordance with the breakdown in Table 7.3.

The letters sent to supervised institutions contained a total of 423 observations on various aspects relating to the matters set out in Table 7.4.

## REQUIREMENT AND RECOMMENDATION LETTERS TO SUPERVISED INSTITUTIONS

TABLE 7.3

	2006
<b>CREDIT INSTITUTIONS</b>	
Banks	24
Savings banks	14
Credit co-operatives	20
Branches of EU credit institutions	4
Branches of foreign credit institutions	5
Specialised credit institutions	13
<b>OTHER</b>	
Mutual guarantee and reguarantee companies	4
Currency-exchange bureaux	8
Appraisal companies	5

## SUBJECT MATTER OF LETTERS SENT TO SUPERVISED INSTITUTIONS

TABLE 7.4

<b>TOTAL</b>	<b>423</b>
Accounting for credit risk, borrower weakness and increased coverage requirements	96
Quality of credit risk controls (granting and monitoring procedures, etc.)	49
Shortfall in provisions for other risks	15
Deficiencies in information reported to the CCR	22
Failure to comply with rules on transparency and customer relations	31
Capital market activities	18
Solvency ratio	30
General quality of internal control	84
Requirements for authorisation of non-credit institutions	13
Other	65

34% of the recommendations made by the Banco de España referred to credit risk.

As usual, credit risk, in its different forms, was the main subject of the recommendations, accounting for 34% of the total. Notable here were the reprimands made by the Bank on the quality of the controls established in credit risk procedures. In particular, the bank conveyed through these letters its reflections to institutions on the risks of mortgage portfolios.

The second most common group of recommendations (84, almost 20% of the total) referred to the internal control of the entities, which generally encompasses the need for proper management of overall risks and improved internal control procedures. All these matters are aspects of continuous interest as far as the Banco de España's supervision is concerned, which ties in with the concern shown also by the new regulations - the new solvency rules and the Markets in Financial Instruments Directive (MiFID) - being incorporated into Spanish law for internal control, risk management systems and corporate governance. The strict oversight of compliance with solvency rules gave rise to 30 requirements and recommendations.

In 2006, it was not necessary to take any precautionary measures in relation to the supervised institutions.

## 5.2 IMPOSING OF SANCTIONS

17 cases were opened against supervised institutions and 46 against their managers or directors in 2006.

As regards sanctioning proceedings initiated in 2006, 17 cases were opened against supervised institutions and, in conjunction with these, 46 cases against the directors or managers of those institutions. Specifically, and with regard to the different types of institutions on which sanctions were imposed, sanctioning proceedings were initiated against 1 bank, 1 branch of a Community credit institution, 1 specialised credit institution, 2 appraisal companies, 5 currency exchange bureaux, 2 unauthorised currency exchange bureaux, and, finally, 5 proceedings were initiated for failure to comply with the ECB minimum reserve requirement.

The foregoing figures are similar to those of previous years and add firmness to the recent trend in respect of disciplinary procedures not only for supervised institutions that have committed some type of administrative infringement, but also for individuals holding managerial posts and directorships in such institutions. The above-mentioned information also continues to show, as in previous years, how the Banco de España brought sanctioning proceedings against practically all types of supervised institutions, such as banks, branches of credit institutions, specialised credit institutions, appraisal companies and currency exchange bureaux.

18 sanctioning proceedings against institutions were resolved, with 59 sanctions being imposed, and another 56 against managers and directors, entailing 171 sanctions.

Turning to the sanctioning proceedings resolved during 2006, 18 against supervised institutions and 56 against managers or directors thereof were resolved. As for the type of infringements found to have been committed in the proceedings resolved in this period, the competent authorities imposed sanctions, on one hand, on supervised institutions for the commission of 13 very serious infringements, 33 serious ones and 13 minor ones and, on the other hand, on senior managers and directors of such institutions for 39 very serious infringements and 132 serious ones, it having been resolved that there was no case to answer on 2 occasions. Also imposed were 5 sanctions due to non-compliance with the ECB minimum reserve ratio.

The process of regularisation of currency exchange bureaux concluded, with 347 inactive establishments being deregistered.

Along with strictly sanctioning activity, and as a result of the evident parallels and similarities with such activity, this section includes the initiation, processing and resolution of proceedings for the withdrawal of authorisation brought against different supervised institutions. In this respect, 1 case for the withdrawal of authorisation for the professional pursuit of currency exchange in an establishment open to the public was initiated and resolved in 2006. This case marked the close of the process of regularisation initiated in 2004 in this market sector, which has enabled the deregistration of 347 inactive establishments which were no longer pursuing the currency exchange activity for which they originally received authorisation and which were still inscribed in the official registers of the Banco de España.

The sanctions for very serious infringements imposed during this period included most notably the following:

- regarding the legal regime of qualifying holdings, one specific sanctionable conduct involved the acquisition of or increase in a qualifying holding in violation of the provisions laid down in Part VI of the Law on Discipline and Intervention of Credit Institutions;
- in the case of appraisal companies, the very serious infringements consisted, in three cases, of not having the organisation, resources and internal control systems required by regulations; in three instances, of failure to hold the minimum required percentage of fully paid capital (i.e. the amount of own funds falls below such required minimum paid-in capital); in another case, of the insufficiency of coverage in respect of the civil liability insurance required by sectoral rules, and finally, in the last case, of the resistance to, and refusal and obstruction of, the inspection tasks entrusted to the Banco de España;

- finally, in the case of currency exchange bureaux, the very serious infringements related, on two occasions, to non-compliance with legal obligations concerning the external audit of the annual accounts; on one occasion, to keeping accounting records with fundamental irregularities preventing the entity's net worth and financial position from being known, and finally, in another case, to the failure to report data or documentation that have to be sent to the competent administrative body or are required by it in the performance of its functions, or the lack of veracity in such data or documentation, when this prevents the net worth and financial position of the establishment from being known.

Most serious infringements related to solvency, the reporting of information to the Banco de España, the recording of transactions and transparency.

Serious infringements include a varied range of conduct that largely depends on the nature of the institution concerned, although a substantial number of them are closely related to the general compliance of the activities they pursue with the applicable regulations, as regards, inter alia, the solvency of the institutions, the proper reporting of information to the Banco de España as a fundamental element in supervisory activity, the proper recording of their transactions and transparency in their customer relations.

Sanctions for minor infringements which, according to the provisions of Law 26/1998, cannot be imposed on directors and managers of institutions, are restricted, by their very nature, to isolated or insignificant breaches of the law that cannot be classified as very serious or serious infringements.

### 5.3 REGULATORY CHANGES

Law-making activity focussed on preparing the future transpositions of the Capital Adequacy Directive and the Markets in Financial Instruments Directive.

There were scarcely any significant changes in Spanish law in 2006 as regards the organisational and disciplinary rules to which credit institutions and other financial intermediaries supervised by the Banco de España are subject. However, that does not infer that 2006 was a relatively inactive year in terms of banking regulation. Rather, it was a year of intense work both for the regulator, in terms of promoting and preparing future regulations, and for financial institutions, which have already begun the necessary adaptation of their systems, strategies and procedures to the forthcoming regulations that will result from the transposition to Spanish law of both the so-called Capital Adequacy Directive and the Markets in Financial Instruments Directive (MiFID) referred to at the end of this chapter.

Notable among the main regulatory changes in the domestic arena were the following:

- Changes in the specific legal framework for credit institutions.

Of particular importance in this area was Circular 2/2006 of 30 June 2006 (Official State Gazette of 8 July), amending Circular 5/1993 of 26 March 1993 on the determination and control of minimum capital. This Circular, published under Law 5/2005 of 22 April 2005, on the supervision of financial conglomerates and implementing regulations, regulates the minimum information these groups must report to the Banco de España and also introduced significant changes in the eligibility of specific elements of capital, in particular considering as such, with certain limits, portfolio gains and the general provision for loan losses.

The year also saw the publication of Circular 1/2006 of 24 February 2006 (Official State Gazette of 25 February), aimed at institutions affiliated to a deposit guarantee fund, amending Circular 4/2001 of 24 September 2001 on the reporting of the balances making up the base used for calculating the contributions to deposit guarantee funds, and the scope of the amounts guaranteed. Its purpose was to



adapt the content of the Circular to the new criteria governing the valuation and presentation of financial statements further to the entry into force of the new accounting regulations, without altering either the base for calculating the contributions or the scope of coverage.

- Regulatory changes which, while specific to other financial institutions, have a particular influence on the activities pursued by credit institutions.

First, the changes arising from Law 26/2006 of 17 July 2006 (Official State Gazette of 18 July) on private insurance and reinsurance mediation, which includes not only new principles but also new mediation forms and operators. Notable among the latter, for these purposes, is the use of credit institutions' distribution networks under the name of bancassurance operators.

Also noteworthy are the changes relating to the marketing and provision of investment services, further to the enactment of Ministerial Order 1199/2006 of 25 April 2006 (Official State Gazette of 26 April) on hedge funds and funds of hedge funds), supplemented by CNMV Circular 1/2006 of 3 May 2006.

- Legal changes which, while not arising in the context of regulation of financial institutions, have a particular impact on the activity of credit institutions.

These include most notably changes relating to the rules on the prevention of money laundering, in particular those in Ministerial Order 1439/2006 of 3 May 2006 (Official State Gazette of 13 May) regulating the reporting of movements in payment instruments; and in Ministerial Order 2619/2006 of 28 July 2006 (Official State Gazette of 10 August), aimed at subject persons who engage in currency exchange or cross-border transfer activities. Both ministerial orders introduce new measures relating to client identification, to the reporting of movements of means of payment and to the establishment of internal control procedures.

In contrast to this apparent regulatory lull in the domestic financial legal framework, the year 2006 saw significant regulatory changes at the Community level. These changes were most significant in two particular financial aspects:

- First, and concerning the solvency of financial institutions, two key regulations were enacted, namely: Directives 2006/48/EC and 2006/49/EC of the European Parliament and of the Council, substantially amending the rules on the capital adequacy of investment firms and of credit institutions. These Directives incorporate the so-called New Capital Accord (Basel II) into the Community body of law, which entails, in many aspects, a new approach regarding the requirements and caveats affecting the solvency of credit institutions.
- Regarding the provision of investment services, and in application of the so-called Lamfalussy Process, the respective regulations were enacted to implement Directive 2004/39/EC of the European Parliament and of the Council (MiFID), which have yet to be transposed to Spanish legislation. These regulations finalised, in particular, the organisational and operational requirements to be met by investment firms and other institutions, including banks, which provide services of this nature.



## 5.4 FINANCIAL AND PRUDENTIAL REPORTING

### 5.4.1 Impact of the Accounting Circular

Bearing in mind that accounting regulations were amended in 2005 to adapt them to the International Financial Reporting Standards adopted by the European Union, the Banco de España, after having processed and edited the information reported by institutions, compiled and published in the first half of 2006 a study on the impact of Accounting Circular 4/2004 on the balance sheet and income statement of Spanish deposit institutions.

### 5.4.2 Preliminary consultative process on the future Solvency Circular

In late 2006, the Banco de España initiated an exceptional and informal preliminary public information procedure on the content of the future Solvency Circular, which will replace Circular 5/93 currently in force. This consultative process, undertaken in anticipation of the conclusion of the process to transpose the new Capital Adequacy Directive to Spanish law, is aimed at the smooth implementation of the new regulation, which will come into force in 2008, enabling institutions to speed their preparations. To this end, the consultative process is open and dynamic; that is to say, the contents of the future circular will be subjected to consultation as and when they become available, without awaiting the completion of the circular as a whole.

This consultative process, ahead of the publication of the circular and which was previously conducted on the occasion of the accounting change involving the adoption of International Financial Reporting Standards, also aims to crystallise what are today considered as best financial regulation practices. These improvements have received considerable support in recent years from the European Commission under the Financial Services Action Plan.

The preliminary consultation has been accompanied for the first time by a study on the impact of the new capital regulations in three areas

A novel feature compared with previous regulatory processes under the remit of the Banco de España, and one which is likewise in line with best international financial regulation practices, is that this present process is accompanied, for the first time, by a study on the impact of the new capital regulations, focusing on three areas: the financing of SMEs, the securitisation market and the procyclicality of the new Accord. This marks the first step in introducing cost-benefit analysis into banking regulation, and will map out the future road to follow, given that it is the intention of the Banco de España that new regulations for which it is responsible should be accompanied by this type of study.

On launching this informal process, the chapter on credit risk (where the biggest volume of the additions to the new regulation is concentrated) and that on rules governing periodic capital adequacy reporting to the Banco de España and the returns in which such information must be submitted were subjected to public consultation. In the case of these returns, the consultative process is particularly important in that institutions must make a considerable data programming effort, and disclosing these returns a year ahead of the envisaged date of entry into force should enable them to better plan their IT resources.

### 5.4.3 XBRL activity

All credit institutions used XBRL language to report their financial information to the Banco de España

The use of XBRL (eXtensible Business Reporting Language) for sending public financial information to the Banco de España (balance sheet, income statement, statement of changes in equity and cash flow statement) became extensive to all credit institutions in 2006, after a pilot group of eight institutions had begun to follow this practice in 2005. The last institutions to adopt XBRL were the specialised credit institutions, whose first transmission was of the data as at December 2006.

Further, the Banco de España set up a mixed working group with the associations of credit institutions so that the latter might disclose the financial statements of their associates in XBRL language on their respective websites. To help bring this about, the Bank provided the associations with the technical support they needed. The first financial data to be published in this language are those as at January 2007.

As to the taxonomy of these financial statements, a new version was published during the year in order to improve on that initially published.

Owing to the fact that the Banco de España also intends to request that all the prudential returns that institutions are to send should be in XBRL language, intensive work was under way last year on the preparation of an initial version of the taxonomy of the returns that should be used when the Capital Accord (Basel II) is introduced into Spain. The taxonomy was published jointly with the draft returns on the preliminary consultation page on the Banco de España website. These returns, and their taxonomy, are naturally based on those approved by the Committee of European Bank Supervisors (CEBS), and are known as COREP (Common RE-Porting) returns, in order to smooth convergence with the other European supervisors on this issue.

During the year there were meetings with the sector to disseminate the XBRL COREP project and, finally, the first taxonomy draft was published on the Bank's website, so that both institutions and suppliers of IT applications might begin to work on the development of the new returns in XBRL language. Although such returns may undergo changes, these should be minimal bearing in mind that they are based on the COREP returns.

## 5.5 CENTRAL CREDIT REGISTER

Using data from its Central Credit Register (CCR), the Banco de España compiles individualised information on the credit exposure of reporting institutions (basically credit institutions) to their customers. This information is used by the institutions themselves for granting and monitoring exposures and, in conjunction with the accounting statements of credit institutions, by the Banco de España itself, maintaining the confidentiality of the individual data, as a source for work connected with its supervisory and statistical functions.

The number of direct and indirect exposures increased by 10% last year, and the amount thereof by 27.1%

The activity of the CCR grew significantly once again in 2006, in step with the growth in lending. As at December 2006, the number of direct and indirect exposures (the latter arising from guarantees of or collateral on direct exposures) reported totalled 31 million (10% up on the same month a year earlier), with their total amount rising to €3.9 trillion (27.1% more), corresponding to 16.8 million different borrowers (up 6.8%). The CCR sent a total of 269.2 million reports to institutions during 2006 on borrowers reported by these institutions (9% up on 2005) and, on the express request of the institutions themselves, 6.2 million reports on potential new customers (up 16.4%). Borrowers directly requested of the CCR a total of 90,648 reports (up 17.8%), 50.6% of which were requested at branches and the remainder in Madrid (14% at central headquarter windows and 35.4% by post).

The number of claims lodged by borrowers through the CCR in relation to data reported to the latter rose from 177 in 2005 to 328 in 2006, an increase of 85.3%.

As concerns the exchange of quarterly information with six other European credit registers (Austria, Belgium, France, Germany, Italy and Portugal) on exposures to legal persons, in 2006 Q4 the CCR received data relating to September 2006 on 2,934 Spanish borrowers (a 23% increase on the data for the same quarter in 2005), with total exposures of €184,538 million (up 39.6%). In the same period the CCR sent data on 1,381 borrowers resident in the other countries (up 32%) with overall exposures of €64,490 million (up 160.7%).

The annual report of the Central Credit Register was published for the first time in 2006

An annual report in Spanish issued by the Central Credit Register was published for the first time in 2006 with the aim of contributing to promoting financial stability, improving the management of credit risk and credit concentration, and heightening transparency in respect of supervised institutions and of the general public.

## 5.6 OPTIMISATION OF PROCESSES

As part of the Process Optimisation Project launched by the Directorate General Banking Regulation in 2005, the indicators to be used by those responsible for the various units involved were specified in 2006. Their computerisation was initiated, so that those responsible may have automatic access to the information deemed essential for management control. This has required a detailed revision of the processes that this Directorate General conducts.

## 6 Operational functions

### 6.1 MANAGEMENT OF THE BANCO DE ESPAÑA'S ASSETS

The 5.1% increase in Spain's liquidity requirements in 2006 were covered by interbank financing

Spain's liquidity requirements increased by 5.1% in 2006. This increase was covered by funds from other euro area institutions, since the average outstanding balance of loans granted by the Eurosystem to institutions in Spain fell during the year, from €28,592 million in 2005 to €23,916 million in 2006. The increase in this interbank financing, which was reflected in a rise in the average outstanding balance of intra-Eurosystem accounts of €6,968 million, amply offset the reduction in monetary policy loans.

During the year the demand for euro banknotes continued to expand, leading to an increase in the size of the Banco de España's balance sheet, which translated into an increase in euro-denominated investments on the asset side. In addition, the Banco de España continued with the process of shoring up its financial situation, replacing non-interest-earning assets with other current-yield assets. It sold 1.3 million troy ounces of fine gold (41 tonnes) under the Central Bank Gold Agreement. The proceeds of the sale were reinvested in euro-denominated fixed-income bonds and the book profit was assigned to increasing the Bank's capital. The average balance of the euro-denominated fixed-income portfolio rose to €52,812 million. The holdings of foreign currency assets remained at similar levels to those at end-2005. The average balance in 2006 was €7,827 million.

Among the items not manageable by the Banco de España in 2006, the annual repayment of euro-denominated credit to general government continued to decline gradually in terms of its relative weight in the balance sheet total.

As at 31 December 2006, manageable assets in euro, foreign currency and gold totalled €76,467 million.

#### 6.1.1 Management of ECB reserves

The Banco de España manages \$4,262 million of ECB reserves

During 2006 the Banco de España continued managing a portion of the European Central Bank's foreign reserves. Until the end of 2005, the attendant management remit was conferred in identical terms upon all euro area central banks. Since January 2006, the NCBs have the discretion to choose whether to manage a portion of the ECB portfolio (whether in US dollars or yen) or not. The initial assignment for the Banco de España in this new stage was \$4,262 million.

### 6.2 MANAGEMENT OF PAYMENT SYSTEMS

Large-value payments settled through the SLBE grew by 37% in 2005

With the recent reform having been completed, the Spanish payment system is based on two pillars: the Banco de España Settlement Service (SLBE) for large-value payments and the National Electronic Clearing System (SNCE) for processing retail payments.

As regards large-value payments, the SLBE is a real-time gross settlement system managed by the Banco de España, and is the Spanish component of the TARGET system, the operational mainstay of the European System of Central Banks. During 2006, the first full year following the aforementioned reform, the growth of the number of SLBE transactions stood at 37%, numbering almost 11 million, for an amount of over €82 trillion.

As TARGET2, the new generation of the TARGET system, is scheduled to come on stream in the near future, the SLBE has not undergone substantial changes in terms of its design and operations. The main efforts of the Banco de España in this area have been directed at prepar-

ing the migration of the Spanish banking community, which will foreseeably take place in the first quarter of 2008.

The Banco de España continues to oversee the SNCE following the transfer of its management to the system's participants

As regards the SNCE, and now the system's management has been transferred to its participants through Iberpay (the Spanish Payment Systems Company), the Banco de España has continued to oversee the system and has begun the process of ratifying its new regulations, as envisaged under Law 41/1999. During 2006, the SNCE continued to grow steadily, processing a total of 1,351 million operations initiated with various payment instruments, principally direct debits, transfers, cheques, promissory notes and trade bills. The amounts processed also grew, rising to €1.9 trillion.

As concerns retail payments, and in parallel with the work at the Community level geared to the creation of a Single Euro Payment Area (SEPA), the Banco de España has been working alongside the national banking community and other involved sectors on the developments needed for a project on such a scale, of such importance and with such a demanding schedule. Initiatives are structured around two key milestones. The first will take place in January 2008, when European citizens should be able to have access to pan-European payment instruments, along with domestic ones, when performing their transactions. The second milestone, which will mark the culmination of the project in late 2010, will see most retail payments being made with pan-European instruments and full operational compatibility between the different infrastructures for processing these types of transactions.

#### 6.2.1 Oversight of payment systems

The annual report on payments systems oversight was published for the first time in 2006

The Banco de España considers that payment systems oversight is an important tool for promoting the sound functioning of such systems. Accordingly, after publishing a document with its functions and responsibilities in this area and systematising its development, the Bank published its first annual report on oversight in 2006.

With this annual report, the Banco de España seeks to give greater transparency to oversight and to key events and developments in national payment systems. In addition to reviewing the extent to which goals and proposed action plans for the future have been met, the report details the oversight activities carried out during the year. These include most notably the regular monitoring of Spanish payment systems, the exhaustive analysis of the Spanish component of the new TARGET2 system and the initiatives geared to ensuring payment system business continuity.

During 2006 the bank continued to use various instruments for its oversight task. These included, firstly, the application of international standards, mainly those of the BIS and IMF, given their great usefulness in verifying the soundness and efficiency of payment systems; and, secondly, co-operation with other institutions at both national and international level. In this respect, the Protocols entered into for co-operation and information exchange both in normal circumstances and in crisis situations are particularly important.

#### 6.3 BANKNOTE MANAGEMENT

In 2006 banknote issuance grew by 16% and banknote withdrawal by 12% with respect to 2005

As an integral part of the Eurosystem, the Banco de España issues euro banknotes and also withdraws them from circulation. In 2006, the Banco de España delivered 2,137 million banknotes to credit institutions, up 16% from the previous year. At the same time, the number of banknotes withdrawn (deposited with the Bank by these same institutions owing to a surplus of cash in their tills) grew by 12% relative to 2005 to 2,291 million banknotes for the year. Overall, and markedly so in the 10- and 20-euro denominations, the difference in favour of withdrawn banknotes has been maintained, which translates statistically into a "negative net issue".

In 2006 more than 2,280 million banknotes were counted, sorted and processed, an increase of 14% on the previous year. This activity is decentralised and carried out at the Bank's different branches using mechanised systems and high-technology machinery.

With regard to coins, the Banco de España places into and withdraws from circulation euro coins issued by the Spanish State, acting as its financial agent. In 2006, on behalf of the Treasury, it placed 1,452 million coins into circulation and withdrew 186 million. Although there was a net positive issue overall, this represented a slightly lower percentage (12.7% less) than the previous year.

Peseta banknotes and coins with a value of almost €40 million were exchanged in 2006

In 2006, 1.2 million peseta banknotes and 16 million peseta coins, with respective values of €36 million and almost €4 million, were exchanged.

6.3.1 European framework for banknote recycling

In December 2004, the ECB agreed on a general Framework for the Eurosystem as a whole, in order to establish harmonised rules to help credit institutions meet their obligations in combating counterfeiting, to ensure the quality of banknotes in circulation and to regulate banknote recycling in the euro area. For the application of this Framework in Spain, the Banco de España approved the document "General Clauses for the Application of the Banco de España Ordinary Cash Service for Euro Banknotes" (Official State Gazette of 23.11.2006). This regulates the conditions to be met by the credit institutions to which the Banco de España provides a wholesale banknote delivery service, and it lays down the cash service conditions these institutions will receive in exchange for complying with the rules. The clauses entered into force on 31 December 2006, with institutions being given four years in which to implement them.

## 7 Statistics

### 7.1 THE STATISTICAL FUNCTION OF THE BANCO DE ESPAÑA

The main statistics compiled and disseminated by the Banco de España under the Law of Autonomy relate to financial institutions and markets and to interest rates, although the underlying information for some of the statistics included in these areas is drawn from other supervisory agencies [the Spanish National Securities Market Commission (CNMV), and the Spanish Directorate General of Insurance (DGS)]. The statistics compiled and disseminated under the National Statistical Plan (2005-2008) are the Balance of Payments and the International Investment Position, the Financial Accounts of the Spanish Economy, the Survey of Household Finances and Public Debt according to the Excessive Deficit Protocol (EDP). By means of its Central Balance Sheet Data Office, the Banco de España also compiles and disseminates information on the balance-sheet position and results of non-financial corporations based on questionnaires completed voluntarily by the reporting firms. The aforementioned statistics are published in the *Boletín Estadístico*, in monographic publications and on the Bank's website.

The Banco de España also compiles information on the units subject to supervision and on all sectors in order to prepare the Balance of Payments and International Investment Position. These compilation activities, and the preparation of the aforementioned statistics, do not fully define the statistical function of the Banco de España. The Bank also uses statistics produced by other national (INE, IGAE, ministries, CNMV, DGS, etc.) and international agencies and supervisors as a source for its statistical work, making it available to the Bank's own analysts and to experts in general. These activities are complemented by the active participation of Banco de España representatives in international statistical fora [within the ESCB, the European Commission (i.e. Eurostat), the European Committee of Central Balance Sheet Data Offices, the IMF, the BIS, the OECD, etc.], and in the maintenance of databanks and databases, which make it possible to study the changes over time in all the variables.

7.2 MAIN CHANGES  
INTRODUCED DURING 2006

in 2006, the statistics for which the Banco de España is responsible were updated in accordance with generally accepted quality levels and the data released on pre-announced dates, in accordance with the calendar that began to be published on the Bank's website in May 2005. Each of the updates referred to incorporates the methodological changes and improvements outlined in the related publications. They include most notably the following.

7.2.1 Monetary and financial  
statistics

During 2006, regarding the work conducted on monetary and financial statistics in relation to the functions referred to under the Law of Autonomy:

The statistics on credit  
institutions have been revised  
as a result of the adaptation to  
IFRSs

1. There has been a far-reaching revision of Chapter 4 of the Boletín Estadístico on the statistics of credit institutions drawn from prudential returns, as provided for in Circular CBE 4/2004, which adapts the accounting statements of credit institutions to IFRSs. Among other things: a) the statistics are more detailed than those shown in relation to these institutions in Chapter 8, devoted to Monetary Financial Institutions and their different groupings (including credit institutions), prepared drawing on the specific accounting statements on which euro area statistics are based, and b) the start of the time series of this statistic is 1962, in which year the Law on the Nationalisation and Reorganisation of the Banco de España was promulgated.
2. The second phase of the implementation of the Centralised Securities Database (CSDB) has continued at a sound pace. The CSDB will, inter alia, offer security-by-security information on the key characteristics of all securities issued by the different institutional groupings of the euro area countries and on securities they hold, even though they have been issued by non-residents in the euro area.
3. The drafting of the ECB's first Regulation and first Guideline on investment funds has concluded, and will be approved in 2007, paving the way for the compilation, for the first time, of harmonised statistics for this significant group of financial intermediaries.

In relation to the statistics included in the National Statistical Plan, the following work, inter alia, was carried out in 2006:

The Survey of Household  
Finances will be published in  
2007

1. Revision of Chapters 11 to 14 of the Boletín Estadístico, on general government and the related sub-sectors, eliminating the tables which are already disseminated in Chapter 1 of the Financial Accounts of the Spanish Economy and on the websites of INE or IGAE, for which a link is provided in the Boletín, and improving and extending the statistics prepared by the Banco de España.
2. Culmination of data gathering and editing work for the Survey of Household Finances for the period 2005-2006. The Survey will be published in 2007.

The database for the  
sectorisation of the Spanish  
economy has been revised

3. Overhaul of the database for the sectorisation of institutional units to provide for their use by reporting units and statistics compilers, both within and outside the Banco de España. The sectorisation database is disseminated on the Bank's website at [www.bde.es](http://www.bde.es) under the heading "Sectorisation of the Spanish economy".



7.2.2 Balance of payments and international investment position statistics

In addition to meeting the new ECB reporting requirements in respect of the preparation of euro area statistics (including most notably the requirements for the preparation of the rest of the world account), the main changes in this area were as follows:

The procedure for calculating workers' remittances has been revised to correct for understatement

1. The revision of the calculation procedure for payments under the heading "Workers' remittances". The econometric model used for this revision enabled an initial evaluation to be made of the understatement in the data, of the information that the register of cross-border economic transactions continues to provide and of the data which currency exchange bureaux managing cross-border transfers report to the Banco de España under the provisions of Circular 6/2001. The revision, which was incorporated into the balance of payments data for the period 2001-2005, has managed to reflect more accurately the country of destination of these transactions; accordingly, it has been possible to begin to disseminate a geographical breakdown of these transactions.
2. The application of the accrual principle has been extended to unrequited transfers between Spain and the EU and to all income arising on portfolio investment. In the first instance, information provided directly by the related ministries has been used. As regards portfolio investment income, where this principle was applied exclusively to income payments arising on interest on general government euro-denominated medium and long-term bonds, use has been made of the information on international investment position stocks, broken down security-by-security, and the most representative interest rates. The implementation of the CSDB, mentioned above, will enable the quality of these calculations to be enhanced in the future, applying to the different holdings of securities the interest rates relating to the specific securities in question.
3. Work has continued on improving the estimates of revenue in the "Travel" heading and on incorporating into the balance of payments and the international investment position the data on direct investment transactions and stocks drawn from the investment register kept by the Directorate General for Trade and Investment of the Ministry of Industry, Trade and Tourism. This work, which yielded its first fruits in 2006, should be completed in 2007.

The system of compiling data for the balance of payments is being revised

4. The pace of the preparatory work for revision of the information system currently used in compiling the balance of payments was stepped up in 2006. This work is aimed at adapting the information system to the changes that will affect it in 2008 (raising of the cross-border transaction reporting threshold to €50,000 and entry into force of TARGET2 and other systems for interconnecting euro area settlement systems) and at preparing it for the revision of the Balance of Payments Manual, the drafting of which is at an advanced stage. In this respect, the working group set up with resident credit institutions made headway in developing a procedure for identifying international transactions in TARGET2 and there was progress in the work done in collaboration with the INE to set in train a survey on international trade in services intended to serve as the main basis for most of the services headings in the balance of payments from 2008 onwards.

7.2.3 Results of non-financial corporations according to the Central Balance Sheet Data Office

During 2006 the Central Balance Sheet Data Office again worked together with the Asociación XBRL España (Spanish XBRL Association) on accounting taxonomies and on the national and international implementation of the new international financial reporting standards (IFRSs). This task is linked to the adoption of the XBRL language and to the efforts being made by the Bank

concerning the credit institutions that send their accounting statements to it and the non-financial corporations that report to the Central Balance Sheet Data Office. The Banco de España played an active role in creating a standard format for the European Central Balance Sheet Data Offices based on IFRSs and participated in the preparation of a new Spanish chart of accounts, co-ordinated by the ICAC.

Approximately 1,000 new firms have started to report to the annual database (CBA) of the Central Balance Sheet Data Office in recent years

The Central Balance Sheet Data Office made further progress in the recording of transactions derived from the application of the Kyoto Protocol, examined the impact of the use of IFRSs on Spanish listed groups and started to use in its publications a new set of indicators of the financial position of non-financial corporations. Further, in 2006 the number of reporting corporations continued to increase, to the point that at the cut-off date the annual database (CBA) contained approximately 9,000 corporations (compared with 8,000 some years ago), whose GVA accounted for more than 30% of the sector total. The quarterly database (CBQ) had more than 800 large corporations at the cut-off date, the GVA of which amounted to approximately 15% of the sector total. The database set up by the Central Balance Sheet Data Office using a selection of small firms with consistent data furnished to it by mercantile registers (CBB) now exceeds 400,000 firms, whose GVA amounts to more than 12% of the sector total.

## **8 Complaints Service**

In 2006 the Complaints Service started to publish quarterly reports on its activity

In 2006 the Complaints Service continued the modernisation and resizing work undertaken in 2005 in response to the increasing claims and complaints received and the greater complexity and diversity of the cases coming before it. The most significant change in the year was that the Complaints Service commenced publication of quarterly reports on its activity, with statistical analyses of the work completed in the reporting quarter. These reports aim to offer users and financial institutions more up-to-date information on the matters submitted to the Service for its consideration and to set out the new criteria applied in dealing with complaints, claims and enquiries.

In addition, the format and content of the Complaints Service's annual report were substantially improved by modifying its structure and expanding and improving the statistical information, which was completed through the inclusion of explanatory boxes to aid comprehension. Also, new sections were added to inform of the contents available on the Bank's website and of activity in the international area.

The criteria used for resolving complaints are published on the Internet

Also included in this section of the Banco de España website are the duly revised and updated criteria used in resolving complaints and claims, as well as warnings to the users of financial services on matters of interest or significance in this field.

The receipt of enquiries by e-mail, a service inaugurated in the previous year, increased notably (by 262%), indicating the interest awakened in the public by this new channel for resolving queries on financial matters of a general nature. The most frequent topics are those relating to lending transactions, loans and credits, particularly the interest and fees applicable to them, and those relating to deposits of all types. Late 2006 saw an increase in the types and complexity of queries directed to the Complaints Service, reflecting the greater financial maturity of those using the Service.

The number of telephone enquiries also increased significantly as a result of the increasing popularity of the telephone enquiry service in 2006.

The Complaints Service's work in the international area was highly significant, since Spain was elected to sit on the Steering Committee created as a result of the work in the previous year by the working group formed by members of the Finnet network. The remit of Finnet is the



out-of-court resolution of consumer disputes over financial services in the European Union and the European Economic Area, for the purpose of reviewing the work carried out by the latter and adopting measures to strengthen and develop it. The Steering Committee is entrusted with putting into practice the plan to reorganise and strengthen activity, which seeks to increase awareness of Finnet and of its work in the out-of-court resolution of cross-border financial disputes.

Outside Europe, the Complaints Service participated in training workshops organised within the framework of the activities of the Banco de España's Technical Co-operation Committee.

## 9 External communication

The Banco de España, as an institution belonging to the ESCB and in the framework of the functions assigned to it by the Law of Autonomy, applies a communication policy aimed primarily at informing Spanish society of its activities and ensuring the confidence of citizens in the institutions and in the financial system as a whole. In this respect, external communication is for the Banco de España a necessary complement to its obligatory functions under the legal framework and ECB membership.

### 9.1 MEDIA RELATIONS

Under the communication strategy established by the Bank, media relations in 2006 focused on enhancing knowledge of its activities among information professionals, since these play an essential part in the process by which that knowledge reaches the general public. In this respect, the Bank continued the regular informative meetings in which the work of its various departments, such as the release of the first Annual Report of the Complaints Service, is alternated with current issues, such as, for example, the economic effect of immigration in Spain.

The press coverage of the Banco de España in 2006 was marked by the 150th anniversary of the Bank under that name (see Section 9.2.1). The various events scheduled to celebrate the occasion afforded it special visibility in the media.

The other high spot in the media attention given to the Banco de España concerned the expiry of the terms of its Governor and Deputy Governor and the appointment of the new incumbents. Particularly notable was the coverage of the investiture ceremony held at the Bank on 18 July, which was attended by the Deputy Prime Minister and Minister of Economy and Finance, Pedro Solbes, along with other authorities and renowned figures from the economic and financial world.

Media demand for interviews with senior Bank officials remained considerable in 2006. In total, Banco de España representatives granted 20 interviews in and outside Spain on diverse current issues.

Members of the Bank's governing bodies participated in more than 40 national and international fora which received wide media coverage

Along with dissemination of the Bank's regular publications, the public speeches made by its management and, especially, the Governor's regular appearances before Parliament (in June and October) and the Senate (November) were once again a fundamental channel for communicating the institution's views on the economic situation and the financial system. In 2006 the members of the bank's governing bodies participated in more than 40 national and international fora, most of which were widely covered by the media.

Finally, the trend continued towards greater involvement of the branch network in the Banco de España's communication activities under the Bank's plan to promote relations with local and regional media. In this respect, the branch managers gave 16 interviews to local media and organised numerous school visits to the branches in the 22 cities of the branch network.

9.2 INSTITUTIONAL  
COMMUNICATION PROGRAMME  
9.2.1 150th anniversary of the  
name Banco de España

The commemorative  
programme included historical  
exhibitions, the issuance of a  
stamp and other educational  
and cultural initiatives

In 2006, the Banco de España's institutional communication programme focused basically on celebrating the 150 years of the Bank's history since, on 28 January 1856, the Law of Banks of Issue renamed the Banco Español de San Fernando as the Banco de España. It was decided to commemorate the 150 years of existence under this name through a series of cultural, educational and historical initiatives accrediting the important role played by the Banco de España in the Spanish economy. For this purpose, a commemorative programme was organised and an anniversary logo designed to celebrate this event.

The first event in the commemorative programme took place on 28 January when the post office issued a commemorative stamp with a motif based on the drawings of the new facade of the Banco de España building by the architect Rafael Moneo.

On 30 January the exhibition on the history of the main building of the Banco de España was inaugurated. Through 380 illustrations viewed by more than 24,000 visitors, it depicted the successive stages of construction of the Plaza de Cibeles building, giving pride of place to the six projects submitted for the construction of the new chamfered corner, particularly that submitted by Rafael Moneo, finally chosen as the winning entry.

On 9 May the King and Queen of Spain inaugurated an exhibition on the history of the Banco de España from the creation of the Banco de San Carlos in 1782 to the present day. It put on show documents and articles illustrating the salient events in the Bank's history, banknotes and coins issued, portraits of important people in Spanish life and in the Bank, and the paintings from its collection that best illustrate this extensive period. The exhibition was visited by more than 14,000 people.

The Banco de España organised an international conference in which central bank experts and academics debated the role of central banks in the 21st century. It took place on 8 and 9 June, coinciding with the meeting of the ECB Governing Council, which, for the second time, was held in Madrid. On 14 November, under the patronage of the Madrid regional government's Council of Culture and Sport, a memorable concert was held in the National Auditorium of Music in Madrid for employees, whose work has contributed to the smooth running of the Banco de España.

9.2.2 Educational initiatives  
The launch of the virtual  
classroom, an educational  
portal for young people,  
is aimed at heightening people's  
awareness of the Banco de  
España and of its mission  
as a guarantor of stability

A 150th anniversary initiative whose impact will last long after the commemoration was the launch of the Banco de España's virtual classroom, an educational portal for young people developed by a multidisciplinary team in co-operation with IBM and the Complutense University of Madrid. The virtual classroom's aim is to heighten awareness of the Banco de España and spread word of its mission as a guarantor of the stability of prices, payments and the financial system. The portal, which was presented to the media on 16 November, combines rigour of content with the entertainment of games, and uses simulation as a learning tool. The favourable reception from the educational community, which the Bank addressed directly via an information campaign was confirmed by the number of visits to the website's pages and files, which one month after the launch date amounted to nearly 30,000.

On the virtual classroom launch date, the Banco de España announced the first of a series of school competitions under the name "The Banco de España and economic stability" (2006/2007) for upper secondary level. The participating teams, basing themselves on the educational portal, will compete in two trials: one consisting of multiple-choice questions and the other a descriptive essay. The winning team will obtain a diploma and 12 computers, of which three will be for the school.

### 9.2.3 Information to the public

The Banco de España's commitment to providing reliable and accurate information to different user groups means that its website is the most efficient channel of communication. The Bank has thus opted to continuously improve and update the contents of this powerful tool. The website statistics indicate that in December there were over 2,200,000 visits to pages and files. Notable in this respect is the Bank Customer's Portal, which also received a large number of visits. This portal, which aims to serve as a guide for consumers in their relationships with credit institutions, underwent exhaustive format and content redesign work in 2006, which concluded at the beginning of this year.

Telephone and e-mail requests by the public to the statistical information service numbered nearly 5,300 in 2006. The most frequently requested information was the daily interest and exchange rates.

In line with the Banco de España's intention to become a more familiar sight for the different social groups, it distributed 18,000 brochures and other informational items (8,000 units) in the conferences and seminars held at the Bank and in the 10,000 visits to the Madrid headquarters and branch network by the public, professionals, students and others. Simultaneously with these actions, the Communication Department continued its institutional relations programme with visits to the Banco de España building, where numerous representatives of the media, universities, businesses and government institutions were received in 2006.

### 9.3 CO-OPERATION WITH THE ESCB

The word "Eurosistema" has been included in the Banco de España logo

In addition to helping to define and put into practice the Eurosystem communication strategy through its membership of the External Communication Committee and through dissemination via the Internet of ECB press releases and communications, the Banco de España pursued several initiatives under the Eurosystem Communication Plan. These included most notably the incorporation of the word "Eurosistema" in the Banco de España logo as a result of the agreement between the European Central Bank and the national central banks in September 2005, and the preparation of a campaign to raise people's awareness of the security features of euro banknotes in 3,500,000 brochures to be distributed to the public through the branch networks of credit institutions from September 2006. Also, 1,200 ECB brochures were distributed via the Banco de España branch network in 2006.

## 10 Internal organisation and administration

### 10.1 HUMAN RESOURCES POLICIES

The Banco de España's total workforce at 31 December 2006, including temporary employees, amounted to 2,724. The branch workforce increased by 0.7% with respect to 2005 and that of central services was unchanged.

Following the trend of previous years, the number of employees in the most highly qualified group increased to 55% of the total workforce.

The percentage of female employees in the Bank as a whole remained at 35%, although notably, with the appointment of women to the posts of Director-General and Associate Director-General, the Banco de España now has a female presence in senior management positions for the first time in its history.

2006 was a very active year for the signing of agreements with the employees' legal representatives, in the form of the collective labour agreement and other specific ones of general scope.

The 2006 collective labour agreement represented a step forward in the reconciliation of work obligations and family life

The 2006 collective labour agreement was notable for the significant headway made in reconciling work obligations and family life, achieved through the incorporation of measures in line with the government's Plan Concilia.

In April 2006 the Banco de España ceased to belong to the Social Security system for the purpose of the provision of healthcare for ordinary and work-related reasons in Madrid. In or-

der to ensure that its employees have access to healthcare in addition to that provided by the public health service, an agreement was reached by the Bank with a private insurance company on a healthcare policy with similar characteristics to those of the one taken out for the branches. Furthermore, the coverage of occupational risks was arranged with an accident insurance company.

Students on work experience contracts continued to be received by the Bank from Colegio Universitario de Estudios Financieros (CUNEF), Universidad Complutense de Madrid and Centro de Estudios Monetarios y Financieros (CEMFI).

Moving on to training, in addition to continuing with the activities pursued in 2005, new courses were introduced to provide both technical training and skills training. The latter basically focused on enhancing the participation of bank employees in the international environment.

Further, it was decided to resume the management-tool training in the area of organisation management, which had started in 2004 with the department directors. As in the past, this training took place in a business school of international repute. Those chosen to receive training this time were the department directors' direct subordinates.

The number of hours of training per employee in 2006 was increased with respect to 2005, exceeding 45 hours on average. Importantly, the general assessment of training by employees was very positive and, according to the questionnaires on the level of satisfaction, 94% of those attending training sessions would recommend them to other bank employees.

## 10.2 ADMINISTRATION AND PROPERTIES

The new building designed by Rafael Moneo completes the facade of the Banco de España's central headquarters in Madrid

In a ceremony attended by the King and Queen of Spain in May 2006, the new building designed by Rafael Moreno was inaugurated, completing the facade of the Bank's central headquarters in Madrid. The construction work was completed on schedule and within the approved budget. Apart from completing the facade so that it now runs completely around the city block occupied by the Bank, the new building features purpose-designed facilities equipped with leading-edge technology which are ideal for high-level international meetings.

The work-space refurbishing programme in central services managed to recoup office space and, therefore, the occupants of the offices leased in a building in Plaza del Rey, Madrid, were able to be accommodated in the central headquarters.

Also, new fully equipped classrooms were built for use in human resources development and a new operations and markets room will improve the operability of the Bank's facilities.

In 2006 the installation of advanced audiovisual systems in six meeting rooms was completed. These will enable videoconferences between the two Madrid buildings and with other external venues. It is planned to extend these systems to other rooms in 2007.

## 10.3 CORPORATE DOCUMENT MANAGEMENT

The Banco de España is fully aware of recent initiatives in electronic administration and is engaged in a major project to modernise its document processing through the implementation of corporate document management. This project commenced in 2004 and the preparatory work for defining the model suited to the Bank's needs was finished in 2005 and implemented in pilot units. In 2006 the implementation was analysed and assessed and the required measures taken to extend it to all administrative units.

Since 2006 various administrative units have adopted the system and all internal communications (electronic documents used for official internal correspondence between different admin-

istrative units, as defined in Internal Circular 1/2006) are processed using the GDC (Gestor Documental Corporativo -- Corporate Document Manager) computer application. This tool has standardised the processes of drafting, registering, sending, receiving, filing and retrieving internal communications and is being used by all Bank administrative units and employees in central services and in the branch network. Since it came into operation on 1 April 2006 until 31 December of that year, more than 21,000 internal communications have been processed, which represents a significant saving in resources, management time and speed of delivery.

#### 10.4 INFORMATION SYSTEMS

The Banco de España's main task in the information systems area in 2006 related to management of the annual systems plan consisting of 126 projects. Particularly notable among them because of the effort involved and its importance for the Bank is the adaptation of software to TARGET2. 2006 was also the first year of the plan for migration of the whole of the central environment, where the Bank's critical applications reside, changing the database and the Adabas/Natural programming tools to Cobol/DB2. Furthermore, all applications have been adapted to the requirements of the data protection law.

Also, more up-to-date software versions have been installed, server hardware has been modernised with more powerful and reliable models and a contingency plan has been developed for distributed applications which enables all the Bank's operating processes to be recovered in two hours, similar to that in place for the central environment.

In the Internet/Intranet environments, a new search engine has been implemented to enable intelligent searches, document management has been strengthened through the inclusion of internal communications in an automated system (as described in Section 10.3) and tools have been provided for developing applications and putting them into operation via the Internet.

With regard to computer security, the Bank continued investing in improvement plans and in increasing the system's robustness, and has finished implementing the electronic signature and the validation of certificates, which will be available to all users.

The Bank's user help desk was extremely busy attending to more than 41,000 calls, its service being rated as excellent by users. Also, the computers of 690 users were renewed and fully depreciated computers were donated to NGOs and to bank employees.

In process management, the re-engineering of the General Secretariat was undertaken and support was provided to the activities aimed at improving the Directorate General Banking Regulation, whose plan had been previously defined. Also, the Bank's Business Continuity Plan was completed and all the methodology for the Bank's risk management was arranged.

#### 10.5 CONTROL, BUDGET AND ACCOUNTING

The process of capitalisation of the Bank was completed and, as a result, total own funds increased to €2 billion

The process of capitalisation of the Banco de España initiated in 2005 was completed with the addition of €500 million to reserves. This raised total own funds to €2 billion, in conformity with the European Central Bank's repeatedly expressed criterion that the own funds of Eurosystem national central banks should be maintained and strengthened.

The firm Deloitte SL was appointed as the new auditor following a selection process

In accordance with the good practices for the selection of external auditors approved by the Governing Council of the European Central Bank, in 2006 the Banco de España carried out a new auditor selection process and designated the firm Deloitte, SL to carry out this function, following Recommendation ECB/2006/18 of the European Central Bank of 13 November 2006 and Decision 2007/97/EC of the Council of the European Union of 12 February 2007.

In the financial accounting area, following the guidelines of the ESCB, in 2006 the criteria for inter-period allocation of gains and losses on financial income and expenses were changed and, as a result, accrued interest denominated in foreign currency began to be recorded daily instead of at the end of each month. Also, the gains or losses on forward transactions in foreign currency and on interest rate futures will now be treated as realised.

In cost accounting, the Banco de España improved its systems further in 2006, particularly in the area of the cost attributable to functions, and adapted its accounting criteria to the Eurosystem's common cost methodology in order to harmonise the information in this field.

Internal control made more intensive use of IT in order to capitalise more fully on the possibilities offered by it.

#### 10.6 INTERNAL AUDIT

According to the Statute approved by the Executive Commission on 28 November 2001, the aim of internal auditing is to evaluate the risks associated with the Bank's activities and the effectiveness and efficiency of the risk management and control systems in place.

The internal audit function is performed by the Department of the same name, which reports directly to the Governor. In addition, the Internal Audit Department must afford the Audit Committee of the Governing Council all such assistance as it may request and provide it with any information it may need.

The Internal Audit Department and its audit staff shall adhere to the principles of objectivity, impartiality, confidentiality and absence of conflict of interests, and act in keeping with the principles, standards and procedures laid down in the Internal Audit Manual authorised by the Deputy Governor on 17 December 2004 and reported to the Executive Commission that same day.

The Internal Audit Department's audit activity is subject to an Annual Plan approved by the Governor/Deputy Governor and reported to the Executive Commission. Under the plan for 2006, the main audits performed by the Internal Audit Department related to the following: the annual accounts of the Banco de España; the report envisaged in Law 44/2002 on Financial System Reform Measures; the Spanish Personal Data Protection Organic Law; compliance with Article 17 of the Security Measures Regulation; wages; administration of CBSO computer security; art collection; counting the strategic reserves deposited by the European Central Bank; volume of production of euro banknotes; accounting for intra-Eurosystem accounts; business continuity plan and operating procedure; TARGET2; ordinary inspection of the Bilbao, Oviedo, Santander, Valencia and Zaragoza branches and extraordinary inspection of the Las Palmas branch.

ANNUAL ACCOUNTS OF THE BANCO DE ESPAÑA  
2006

## 1 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, approved by a Resolution of the Governing Council of 28 March 2000 (Official State Gazette (BOE) of 6 April). Pursuant to the provisions of that article, the accounts have been prepared in accordance with the accounting guidelines and instructions of the European Central Bank (ECB)<sup>1</sup> established under Article 26.4 of the Statute of the European System of Central Banks (ESCB)/ECB relating to standardisation of Eurosystem accounting principles and practices, and, whenever they are not applicable, in accordance with internal accounting policies. These internal policies follow generally accepted accounting principles, adapted to the special characteristics of the operations and functions of a central bank.

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 analysed and examined by the Audit Committee appointed for the purpose by the Bank's Governing Council. The accounts have also been audited by independent external auditors, as stipulated by Article 29 of the Bank's internal rules and 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 Economy and Finance, 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 are expressed in millions of euro. Those relating to 2005 are presented solely for comparison with 2006. Due to rounding, on occasions the totals included in the balance sheet, profit and loss account and notes on the annual accounts may not equal the sum of the individual figures.

This document presents the accounts for the year 2006. Section 2 includes the balance sheet and profit and loss account; Section 3 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 4, 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 those amounts.

Finally, Annexes 1 and 2 include the reports of the external auditors and of the Bank's Audit Committee on the annual accounts presented in the preceding sections.

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1. Guideline of the European Central Bank of 5 December 2002 on the legal framework for accounting and financial reporting in the ESCB (ECB/2002/10), as amended. With effect from 1 January 2007, this Guideline has been revoked and replaced by Guideline ECB/2006/16.



## 2 Balance sheet and profit and loss account

BALANCE SHEET OF THE BANCO DE ESPAÑA AS AT 31 DECEMBER 2006

EUR m

	NOTE NUMBER	2006	2005
<b>ASSETS</b>			
<b>1. Gold and gold receivables</b>	<b>1</b>	<b>6,467.38</b>	<b>6,399.79</b>
<b>2. Claims on non-euro area residents denominated in foreign currency</b>		<b>3,855.62</b>	<b>8,192.89</b>
2.1. Receivables from the IFM	2	674.33	1,067.17
2.2. Balances with banks and security investments, external loans and other external assets	3	3,181.29	7,125.72
<b>3. Claims on euro area residents denominated in foreign currency</b>	<b>4</b>	<b>1,176.98</b>	<b>2,331.17</b>
<b>4. Claims on non-euro area residents denominated in euro</b>		<b>912.78</b>	<b>1,926.30</b>
4.1. Balances with banks, securities investments and loans	5	912.78	1,926.30
4.2. Claims arising from the credit facility under ERM II		—	—
<b>5. Lending to euro area credit institutions related to monetary policy operations denominated in euro</b>	<b>6</b>	<b>21,865.81</b>	<b>31,930.55</b>
5.1. Main refinancing operations		18,695.60	29,377.70
5.2. Longer-term refinancing operations		3,169.93	2,552.72
5.3. Fine-tuning reverse operations		—	—
5.4. Structural reverse operations		—	—
5.5. Marginal lending facility		—	—
5.6. Credits related to margin calls		0.29	0.13
<b>6. Other claims on euro area credit institutions denominated in euro</b>	<b>7</b>	<b>1.98</b>	<b>3.82</b>
<b>7. Securities of euro area residents denominated in euro</b>	<b>8</b>	<b>29,396.07</b>	<b>46,401.37</b>
<b>8. General government debt denominated in euro</b>	<b>9</b>	<b>7,416.32</b>	<b>7,979.12</b>
<b>9. Intra-Eurosystem claims</b>	<b>10</b>	<b>29,834.73</b>	<b>17,425.78</b>
9.1. Participating interest in ECB		432.70	432.70
9.2. Claims equivalent to the transfer of foreign reserves		4,326.98	4,326.98
9.3. Net claims related to the allocation of euro banknotes within the Eurosystem		—	—
9.4. Other claims within the Eurosystem (net)		25,075.06	12,666.11
<b>10. Items in course of settlement</b>		<b>2.71</b>	<b>0.85</b>
<b>11. Other assets</b>		<b>36,880.40</b>	<b>2,269.24</b>
11.1. Tangible and intangible fixed assets	11	210.72	203.97
11.2. Other financial assets	12	34,090.77	69.18
11.3. Off-balance sheet instruments revaluation differences	13	201.33	—
11.4. Accruals and prepaid expenses	14	1,511.27	1,100.82
11.5. Sundry	15	866.31	895.26
<b>TOTAL ASSETS</b>		<b>137,810.78</b>	<b>124,860.88</b>

	NOTE NUMBER	2006	2005
<b>LIABILITIES</b>			
<b>1. Banknotes in circulation</b>	<b>16</b>	<b>62,864.84</b>	<b>56,558.34</b>
<b>2. Liabilities to euro area credit institutions related to monetary policy operations denominated in euro</b>	<b>17</b>	<b>20,558.76</b>	<b>16,531.07</b>
2.1. Current accounts (covering the minimum reserve system)		20,558.13	16,531.07
2.2. Deposit facility		—	—
2.3. Fixed-term deposits		—	—
2.4. Fine-tuning reverse operations		—	—
2.5. Deposits related to margin calls		0.64	—
<b>3. Other liabilities to euro area credit institutions denominated in euro</b>		<b>—</b>	<b>—</b>
<b>4. Debt certificates issued</b>		<b>—</b>	<b>—</b>
<b>5. Liabilities to other euro area residents denominated in euro</b>		<b>17,503.08</b>	<b>15,627.89</b>
5.1. General government	18	15,057.47	13,277.69
5.2. Other liabilities	19	2,445.62	2,350.20
<b>6. Liabilities to non-euro area residents denominated in euro</b>	<b>20</b>	<b>126.59</b>	<b>28.08</b>
<b>7. Liabilities to euro area residents denominated in foreign currency</b>		<b>2.07</b>	<b>3.55</b>
<b>8. Liabilities to non-euro area residents denominated in foreign currency</b>		<b>154.14</b>	<b>126.29</b>
8.1. Deposits, balances and other liabilities	21	154.14	126.29
8.2. Liabilities arising from the credit facility under ERM II		—	—
<b>9. Counterpart of special drawing rights allocated by the IMF</b>	<b>22</b>	<b>341.12</b>	<b>361.52</b>
<b>10. Intra-Eurosystem liabilities</b>	<b>23</b>	<b>24,113.87</b>	<b>23,667.70</b>
10.1. Net liabilities related to the allocation of euro banknotes within the Eurosystem		24,113.87	23,667.70
10.2. Other liabilities within the Eurosystem (net)		—	—
<b>11. Items in course of settlement</b>	<b>24</b>	<b>205.57</b>	<b>240.86</b>
<b>12. Other liabilities</b>		<b>548.05</b>	<b>457.35</b>
12.1. Off-balance-sheet instruments revaluation differences	25	—	12.31
12.2. Accruals and income collected in advance	26	238.25	123.31
12.3. Sundry	27	309.80	321.73
<b>13. Provisions</b>	<b>28</b>	<b>2,651.57</b>	<b>2,706.65</b>
<b>14. Revaluation accounts</b>	<b>29</b>	<b>5,293.55</b>	<b>5,786.33</b>
<b>15. Capital and reserves</b>		<b>1,500.00</b>	<b>4.54</b>
15.1. Capital	30	1,000.00	1.37
15.2. Reserves	31	500.00	3.17
<b>16. Profit for the year</b>	<b>32</b>	<b>1,947.57</b>	<b>2,760.72</b>
<b>TOTAL LIABILITIES</b>		<b>137,810.78</b>	<b>124,860.88</b>

	NOTE NUMBER	2006	2005
1. Interest income	1	3,493.02	2,449.71
2. Interest expense	2	1,442.89	865.40
<b>3. Net interest income (1-2)</b>		<b>2,050.13</b>	<b>1,584.31</b>
4. Realised gains/losses arising from financial operations	3	453.04	817.24
5. Write-downs on financial assets and positions	4	239.54	189.63
6. Transfer to/from provisions for foreign exchange rate and price risks	5	-1.36	1.16
<b>7. Net result of financial operations, write-downs and risk provisions (4-5-6)</b>		<b>214.86</b>	<b>626.44</b>
8. Fees and commissions income		15.43	11.91
9. Fees and commissions expense		6.25	4.19
<b>10. Net income from fees and commissions (8-9)</b>	<b>6</b>	<b>9.17</b>	<b>7.72</b>
11. Income from equity shares and participating interests	7	20.22	18.83
12. Net result of pooling of monetary income	8	21.23	11.36
13. Other income and losses	9	81.73	1,026.39
<b>14. TOTAL NET INCOME (3+7+10+11+12+13)</b>		<b>2,397.34</b>	<b>3,275.04</b>
15. Staff costs	10	204.63	195.54
16. Administrative expenses	11	111.18	102.98
17. Depreciation of tangible and intangible fixed assets	12	33.97	27.15
18. Banknote production services	13	89.48	52.36
19. Other expenses		2.26	2.41
<b>20. TOTAL OPERATING EXPENSES (15+16+17+18+19)</b>		<b>441.52</b>	<b>380.44</b>
21. Transfers and additions to other funds and provisions	14	8.26	133.88
<b>22. PROFIT FOR THE YEAR (14-20-21)</b>	<b>15</b>	<b>1,947.57</b>	<b>2,760.72</b>

Countersigned by  
The Governor,



MIGUEL FERNÁNDEZ ORDÓÑEZ

The Comptroller,



ANTONIO ROSAS

### 3 Notes on the accounts

#### 3.1 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 and consistency and comparability.

##### 2 BASIS OF ACCOUNTING

The accounts have been prepared on a historical cost basis, modified as necessary to include market valuation of marketable fixed-income securities, gold and the foreign currency position. Futures shall be valued daily at market price and significant participating interests at underlying book value.

Transactions in assets and liabilities are generally recorded on the settlement date. However, since 2 November 2006 the Banco de España has applied the so-called economic approach<sup>2</sup>, and, within it, the alternative method. Under this method, forward transactions in foreign currencies and in gold are booked at the spot settlement date (usually the trade date plus two days), unless a period-end falls between the trade date and the spot settlement date, in which case they have to be recognised at the trade date.

The specific valuation criteria applied to the various assets and liabilities were the following:

##### Gold

Gold is recorded at acquisition cost<sup>3</sup>, which is determined by the cash amount paid in the transaction including any related expense.

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 in subsequent revaluations.

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.

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2. Defined in the Guideline of the European Central Bank of 5 December 2002 on the legal framework for accounting and financial reporting in the ESCB (ECB/2002/10), as amended. With effect from 1 January 2007, this Guideline has been revoked and replaced by Guideline ECB/2006/16. 3. As at 31/12/1998 its acquisition cost was adjusted to the market price then prevailing and the unrealised gains were credited to revaluation accounts. These gains are subsequently credited to profit and loss when the asset is sold or, alternatively, they are used to offset unrealised losses subsequently arising on those assets.

## Foreign currencies

Since the entry into effect on 2 November 2006 of the so-called alternative economic approach, spot purchases or sales of foreign currencies are recorded at the settlement date, affecting the foreign currency position from that date. Also in application of this approach, gains and losses on the spot sale of foreign currencies are similarly considered to be realised from the settlement date. Meanwhile, foreign exchange forward purchase and sale transactions shall be recognised in off-balance-sheet accounts at the spot date of the transaction, affecting the foreign currency position as at that date. The gain or loss on the transaction shall also be considered to be realised on that date.

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. When 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 trade date. Transactions in a foreign currency that do not modify the overall position therein have no effect on the book value of such position.

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

In application of the aforementioned economic approach, accrued interest denominated in foreign currency is recorded on a daily basis using the mid-market rate on each day. If the rate on the relevant day is not available, the latest mid-market rate available shall be applied. Accrued interest receivable or payable denominated in foreign currency shall form part of the foreign currency position.

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 in subsequent revaluations.

## 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 position in the International Monetary Fund (IMF) are valued at the year-end SDR market exchange rate by the same methods used for other currencies.

## Securities

Since 15 June 2006, the Banco de España holds two separate securities portfolios: a trading portfolio and a held-to-maturity portfolio.

In both cases, the securities are recorded at acquisition cost<sup>4</sup>, which is determined by the cash amount paid, less any accrued gross coupon.

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4. As at 31/12/1998 the acquisition cost of securities was adjusted to the market price prevailing at that time, crediting unrealised gains to revaluation accounts and debiting unrealised losses to the profit and loss account. Gains are subsequently credited to the profit and loss account when the related security is sold or, alternatively, are used to offset unrealised losses subsequently arising on the same security.

The cost of securities sold or redeemed is determined by the average book price of the security in question. The securities in the held-to-maturity portfolio may not be sold except in exceptional circumstances and with the authorisation of the Executive Commission.

Trading portfolio 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.

Securities within the held-to-maturity portfolio are not subject to any periodic valuation.

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. These accruals are recorded daily, except in the Spanish public debt book-entry portfolio, in which they are made monthly.

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 Bank's balance sheet 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 recorded according to the valuation rules set forth in the preceding two paragraphs.

Automated security loans (contracts empowering a depository of securities to lend them to a third party in overnight transactions, subject to certain contractual limitations) are not recorded in the balance sheet. The only item accounted for is the income, which is recorded in the profit and loss account. Transactions outstanding at year-end are recorded off-balance-sheet.

#### Doubtful debtors

Where there is any reasonable doubt about 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 that granted to the Social Security System pursuant to transitional provision six of Law 41/1994 on the State budget for 1995, are valued at their nominal amount.
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. The participating interest in Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros S.A. is valued at its underlying book value.
Tangible and intangible fixed assets	<p>Fixed assets are generally valued initially at cost, defined as the amount of the monetary disbursements made or committed to, including any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the intended manner, such as transport, installation, professional fees for legal services, non-refundable taxes and the fair value of other consideration given.</p> <p>Trade discounts and those for defects in assets received are recorded as a reduction in the cost of the related assets. Cash discounts and those for late delivery are recorded in the profit and loss account under other income or, where appropriate, as a reduction in expenses, and do not affect the acquisition cost of the asset purchased.</p> <p>Fixed assets are deemed not to include those assets which, although meeting the conditions to be classed as such (i.e. they are non-financial assets owned by the Bank that are intended be used for a period exceeding 12 months and contribute directly or indirectly to fulfilling its objectives and/or to the probable generation of income in the future and, in addition, their cost can be reliably assessed), do not generally exceed the amount of €600 (€6,000 in the case of buildings, structures and plant in buildings), although there may be exceptions.</p> <p>Only extensions, replacements, rehabilitations and improvements that exceed €6,000 are capitalised, provided also that the elements replaced can be removed from the balance sheet.</p> <p>After initial recognition, fixed assets are valued at acquisition cost less accumulated depreciation or amortisation and any impairment losses.</p> <p>The acquisition cost of a fixed asset, net of its residual value, is depreciated or amortised systematically during its useful life on a monthly basis from the month following that in which it was recognised in the accounts. Generally, all depreciable/amortisable fixed assets are estimated to have a residual value of zero unless there is a deep, liquid market for assets similar to the one whose residual value may be received. Land, the art collection and fixed assets under construction are not depreciated.</p> <p>The depreciation/amortisation rates and estimated useful lives applied to the various fixed assets in 2006 were as follows:</p>

	Depreciation /Amortisation Rate (%)	Useful life (years)
Buildings and structures	2	50
Renovation work	4	25
Plant in buildings (a)	10	10
Security-related plant in buildings	20	5
Furniture and fittings	10	10
Office machines other than computer equipment. For the handling of banknotes and coins	10	10
Office machines other than computer equipment. Other office machines	20	5
Computer equipment	25	4
Transport equipment. Cars and motor bikes	25	4
Transport equipment. Trucks and buses	10	10
Libraries	10	10
Other tangible fixed assets	20	5
Computer applications	20	5
Industrial property	—	Number of years of exclusive use

a. Except security-related plant in buildings, which will have a useful life of five years (20%).

An asset is impaired when its book value exceeds the recoverable value. In this case, and only if the amounts are significant, an impairment loss is recognised by simultaneously reducing the item's book value and modifying its depreciable/amortisable base.

#### Banknotes in circulation

The ECB and the national central banks (NCBs), which together comprise the Eurosystem, have issued euro banknotes since 1 January 2002<sup>5</sup>. The total value of euro banknotes in circulation is recorded by allocating to each Eurosystem NCB, on the last working day of each month, an amount based on the banknote allocation key<sup>6</sup>.

The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation, whereas the remaining 92% has been allocated to the NCBs and divided amongst them 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<sup>7</sup>, are disclosed under the sub-item “*Intra-Eurosystem: Net claims/liabilities related to the allocation of euro banknotes within the Eurosystem*” (see “*Intra-Eurosystem balances*” in this Section on accounting policies).

From 2002 until 2007, the intra-Eurosystem balances arising from the allocation of euro banknotes are adjusted in order to avoid significant changes in the relative income positions of the NCBs that initially formed part of the Eurosystem 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

5. 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, as amended. 6. The banknote allocation key is that which results from applying 92% to the Eurosystem subscribed capital key (the other 8% is attributed to the ECB). 7. 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, as amended.



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 are being reduced in annual stages and will continue to be so until the end of 2007. However, the entry of Slovenia in the Eurosystem on 1 January 2007 entails a new adjustment of this type, which will affect the period 2007-2012.

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

In accordance with ECB Decision of 17 November 2005 (ECB/2005/11) on the distribution of the income of the ECB on euro banknotes in circulation to the national central banks (NCBs) of the participating Member States, this income arising from the 8% share of euro banknotes allocated to the ECB belongs to the NCBs and shall be distributed to them annually<sup>8</sup>. This Decision stipulates however that the ECB's Governing Council may decide before the end of the financial year to transfer part or all of this income to an ECB provision for foreign exchange rate, interest rate and gold price risks. The ECB Governing Council may also decide before the end of the financial year not to distribute part or all of this income if it expects that the ECB will incur a loss or that its net profit for that year may be less than the amount of seignorage income on its euro banknotes in circulation. Finally, the distribution of this income may be reduced in accordance with any decision by the ECB's Governing Council in respect of expenses incurred by the ECB in connection with the issue and handling of euro banknotes.

#### 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 and the net balance resulting from the transfers issued and received by TARGET<sup>9</sup> among the national central banks of the ESCB, including the ECB. They also arise from the balances vis-à-vis the ECB resulting from allocation of euro banknotes within the Eurosystem, from the outcome of the contribution and allocation of monetary income and from the positions vis-à-vis the ECB owing to the deferral of sundry receipts and payments.

In the case of TARGET operations, the resulting balance is included as an asset or liability, as appropriate, under the sub-item "*Other claims/liabilities within the Eurosystem (net)*". Intra-ESCB balances arising from the allocation of euro banknotes within the Eurosystem are included, depending on their net amount, as an asset or liability under "Net claim/liability related to the allocation of euro banknotes within the Eurosystem" (see "Banknotes in circulation" in this Section 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.

<sup>8</sup>. Decision ECB/2002/9 of 21 November 2002, which previously regulated this matter, stipulated that the distribution of this income to national central banks was to be quarterly. <sup>9</sup>. Trans-European Automated Real-time Gross settlement Express Transfer system.

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, together with the accrued coupons, according to the internal rate of return method.

#### Pension Scheme

The Pension Scheme is a defined-contribution occupational scheme, while the Fund is external and closed-end. Contributions made by the Banco de España on behalf of the employees who, having joined the Bank after 1/2/1986, are eligible to and do participate in the Scheme, are established at 7.5% 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<sup>10</sup>

Foreign exchange forward currency positions, which comprise 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.

As a general rule, 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. Specifically, in application of the economic approach, the gains and losses on positions in interest rate futures are considered to be realised at the time when they are settled net each day. In the case of futures denominated in foreign currency, such settlements shall affect the foreign currency position on the day on which they take place.

#### 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.

### 3.2 Notes on the balance sheet

#### 1 GOLD AND GOLD RECEIVABLES

The Banco de España's gold holdings amount to €6,467.38 million, consisting of 13.399 million troy ounces<sup>11</sup> of fine gold valued at €482.69 per ounce. The value of these holdings is €67.58 million more than in 2005, basically as a result of the rise in the market price (at end-2005 the price per ounce was €434.86) and despite the sales during the year (1.318 million troy ounces) under the gold agreement between central banks of 8 March 2004.

#### 2 CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY.- RECEIVABLES FROM THE IMF

This sub-item has three components:

- a The position in the International Monetary Fund (IMF) in the reserve tranche. This is the euro equivalent of the SDRs relating to the foreign currencies assigned to the IMF due to Spain's initial quota and successive increases in it and due to the net financing granted to the IMF. Spain's IMF quota was not changed in 2006 and remained at SDR 3,048.90 million.
- b Special drawing rights (allocations). These represent the euro equivalent of the successive allocations of this currency by the IMF. The changes in allocations are

<sup>10</sup> 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 11.3 on the assets side and 12.1 on the liabilities side, depending on their sign. <sup>11</sup> One troy ounce is equal to 31.1035 grams.

mainly due to loan agreement transactions with third countries and to interest receipts or payments resulting from positions vis-à-vis the IMF.

- c Other claims on the IMF. These reflect the amount that the Banco de España has provided to the IMF as a contribution to the Poverty Reduction and Growth Facility. This fund is used to finance low-interest loans to the poorest countries. The Banco de España has undertaken to contribute a maximum of SDR 425 million to this fund.

The breakdown in 2005 and 2006 is as follows:

EUR m	Type of asset	2006	2005	Change
	Reserve tranche position	302.75	636.39	-333.65
	Special drawing rights (allocation)	254.20	280.81	-26.61
	Other claims on the IMF	117.38	149.96	-32.58
	TOTAL	674.33	1,067.17	-392.84

The overall amount of claims on the IMF decreased by €392.84 million with respect to the balance at end-2005. The decrease, basically in the *Reserve tranche position* account, arose from net repayments by the IMF of loans to third countries (Argentina, Turkey, Serbia, Indonesia, Ukraine, Bulgaria) which have fulfilled their obligations. Of this amount, €328.57 million related to the net decrease in amounts denominated in foreign currencies and the remaining €64.27 million to the change in market foreign exchange rates between the two years.

SDRs are valued at the year-end market rate, calculated by the ECB for all the Eurosystem national central banks, of €1 = SDR 0.875964. SDRs are defined in terms of a basket of currencies. Its value is determined as the weighted sum of the exchange rates of the four major currencies: the US dollar, the euro, the yen and the pound sterling. The interest rate, which is updated weekly, remained between 3% and 4% during the year.

### 3 CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY.- BALANCES WITH BANKS AND SECURITY INVESTMENTS, EXTERNAL LOANS AND OTHER EXTERNAL ASSETS

This sub-item includes deposits, debt security investments in the trading portfolio and other claims on non-euro area residents denominated in foreign currency. Their total amount as at 31.12.2006 was €3,181.29 million, with the following breakdown:

EUR m	Type of asset	2006	2005	Change
	Deposits	873.17	1,355.72	-482.55
	Security investments (a)	2,306.77	5,768.63	-3,461.85
	Other	1.35	1.38	-0.03
	TOTAL	3,181.29	7,125.72	-3,944.43

a. As at 31 December 2006, repurchase agreements were constituted over part of the USD-denominated securities portfolio with a market value of USD 1,920.81 million, under automated security lending contracts with the depositories of these securities.

As at 31 December 2006, 99.8% of these assets were denominated in US dollars. The equivalent value in euro of this US dollar amount was transferred to the balance sheet at the year-end market exchange rate (€1 = USD 1.3170).

The decrease in the balance of this sub-item (€3,944.43 million) was due to the net effect of the factors listed in the following table:

EUR m		
	Reason for change	Amount
	Net purchase/sale	-3,121.03
	Adjustment to market exchange rates as at 31 December	-826.26
	Adjustment to market prices as at 31 December	-3.88
	Accrued interest receivable	7.57
	Other	-0.83
	<b>TOTAL</b>	<b>-3,944.43</b>

The main reason for the decrease in this sub-item was the decline in the balance of trading portfolio securities (€2,794.50 million) as a result of the replacement of part of this portfolio with held-to-maturity securities recorded under asset sub-item 11.2 (Other assets. Other financial assets).

**4 CLAIMS ON EURO AREA  
RESIDENTS DENOMINATED IN  
FOREIGN CURRENCY**

This balance sheet item may include balances with banks and security investments. As at 31.12.2006, the only balances held were deposits at monetary financial institutions amounting to €1,176.98 million. This balance decreased by €1,154.19 million with respect to 2005 because of placements in financial centres outside the euro area.

**5 CLAIMS ON NON-EURO AREA  
RESIDENTS DENOMINATED IN  
EURO.- BALANCES WITH BANKS,  
SECURITY INVESTMENTS AND  
LOANS**

This balance sheet sub-item includes the balance of current accounts at correspondents and trading portfolio securities denominated in euro. Of the total of this sub-item (€912.78 million), substantially all (€912.18 million) relates to fixed-income securities issued in euro by international agencies, which nevertheless decreased by €1,013.56 million with respect to the balance as at 31.12.2005 due to the progressive replacement of a portion of the trading portfolio by the aforementioned held-to-maturity portfolio created in 2006.

**6 LENDING TO EURO AREA  
CREDIT INSTITUTIONS RELATED  
TO MONETARY POLICY  
OPERATIONS DENOMINATED IN  
EURO**

This item includes the amount of the euro-denominated lending to euro area credit institutions through which monetary policy is implemented. The breakdown by type of transaction is as follows:

EUR m				
	Type of operation	2006	2005	Change
	Main financing operations	18,695.60	29,377.70	-10,682.10
	Longer-term refinancing operations	3,169.93	2,552.72	617.21
	Fine-tuning reverse operations	—	—	—
	Structural reverse operations	—	—	—
	Marginal lending facility	—	—	—
	Credits related to margin calls	0.29	0.13	0.15
	<b>TOTAL</b>	<b>21,865.81</b>	<b>31,930.55</b>	<b>-10,064.74</b>

Its balance as at 31 December 2006 is 31.52% lower than in 2005, since the average daily flow of financing extended during the year fell by 16.35% (€23,916.45 million in 2006 against €28,592.20 in 2005).

85.96% of the annual average balance of daily financing was extended through “Main refinancing operations” and another 14.00% was granted under “Longer-term refinancing operations”. Only 0.04% was financed through other instruments.

- a. Main refinancing operations
- These operations play a pivotal role in achieving the aims of steering interest rate, managing market liquidity and signalling the monetary policy stance. They are executed through liquidity-providing reverse transactions with a weekly frequency and a maturity of one week, by means of standard tenders.
- The balance of this sub-item was €18,695.60 million as at 31.12.2006. This was €10,682.10 million less than at 31.12.2005, as a result of the preference of monetary financial institutions for external financing, as reflected in the intra-Eurosystem position arising from TARGET transactions.
- b. Longer-term refinancing operations
- These operations aim to provide counterparties with additional longer-term refinancing. They account for a limited part of the overall refinancing volume and are executed through liquidity-providing reverse transactions with a monthly frequency and a maturity of three months, by means of standard tenders.
- The balance of this sub-item was €3,169.93 million as at 31.12.2006, showing an increase of €617.21 million with respect to the previous year.
- c. Fine-tuning reverse operations
- The purpose of these operations is to smooth the effects on interest rates caused by unexpected market fluctuations. Owing to their nature, their frequency is not standardised.
- Their balance at end-2006 was zero, as it was at the previous year-end, although five fine-tuning reverse operations took place in the Eurosystem during the year. Financing was obtained by Spanish credit institutions in four of them.
- d. Structural reverse operations
- The Eurosystem is able to engage in reverse open-market transactions through standard tenders to adjust its structural liquidity position vis-à-vis the financial sector.
- The end-2006 balance was zero, as it was at the previous year-end. No structural reverse operations took place during the year.
- e. Marginal lending facility
- Counterparties may use the marginal lending facility to obtain overnight liquidity from national central banks at a pre-specified interest rate against eligible assets. This interest rate is penalised with respect to the intervention rate set in the weekly tenders or in main refinancing operations.
- The end-2006 balance was zero, as it was at the previous year-end. Very few of these transactions were carried out during the year.
- f. Credits related to margin calls
- Under Eurosystem rules for monetary policy management, all operations providing liquidity to the banking system must be backed by adequate underlying assets accepted by the system as eligible for use as collateral. If, after daily valuation, the market value of the assets used as loan collateral has fallen below the lower trigger point set for each security, the counterparty must provide additional assets or cash (see Note 17). If the market value of the underlying assets, following their revaluation, exceeds the amount of the financing obtained from the national central bank plus the variation margin, the counterparty may withdraw an amount of underlying assets equal to that excess (or receive this difference as a cash payment in its account).
- In the national central banks that make margin calls by debiting or crediting the accounts of credit institutions, as is the case for the Banco de España, these debits or credits are the balancing entries of the asset-side or liability-side accounts reflecting the changes in these margins. These balance sheet accounts are remunerated at the interest rate applied in main refinancing operations.

As at 31.12.2006 this sub-item had a balance of €0.29 million, up €0.15 million with respect to the previous year.

7 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 €1.98 million as at 31.12.2006, which includes the amount of the correspondent accounts in euro with euro area credit institutions, is €1.85 million lower than in 2005.

8 SECURITIES OF EURO AREA  
RESIDENTS DENOMINATED IN  
EURO

This item includes the trading portfolio, which consists entirely of euro-denominated fixed-income securities issued by euro area residents, as follows:

EUR m				
	Type of security	2006	2005	Change
	Issued by general government	25,741.27	43,893.39	-18,152.12
	<i>Domestic portfolio of Spanish book-entry State debt</i>	6,240.97	10,245.79	-4,004.82
	<i>Non-Spanish</i>	19,500.30	33,647.60	-14,147.30
	Issued by monetary financial institutions	3,654.80	2,507.98	1,146.82
	<i>Spanish</i>	1,112.29	888.84	223.45
	<i>Non-Spanish</i>	2,542.51	1,619.14	923.37
	TOTAL	29,396.07	46,401.37	-17,005.30

The balance of this item as at 31.12.2006 was €29,396.07 million<sup>12</sup>, of which 87.6% (€25,741.27 million) relate to securities issued by general government and the remainder (€3,654.80 million) to fixed-income securities of euro-area monetary financial institutions. Of the securities issued by general government, €19,500.30 million were non-domestic and €6,240.97 were book-entry State debt.

Overall, the securities of euro area residents denominated in euro decreased by €17,005.30 million in 2006. Specifically, non-Spanish general government fixed-income securities declined by €14,147.30 million and book-entry State debt by €4,004.82 million, while securities issued by monetary financial institutions rose by €1,146.82.

The replacement of part of this portfolio by the held-to-maturity portfolio created in 2006, recorded under asset-side sub-item 11.2 (Other assets.- Other financial assets), as securities were redeemed or sold, partly explains the decrease in these securities. Specifically, the changes were for the reasons reflected in the following table:

EUR m		
	Reason for change	Amount
	Net sales of securities	-17,059.15
	Net unrealised gains at year-end	-64.03
	Accrued implicit interest	117.88
	TOTAL	-17,005.30

<sup>12</sup>. As at 31 December 2006, repurchase agreements were constituted over part of the euro-denominated securities portfolio with a market value of €91.21 million, under automated securities lending contracts with the depositories of these securities.

It should be noted that all purchases of debt issued by general government are in the secondary market, none being direct subscriptions of security issues.

## 9 GENERAL GOVERNMENT DEBT DENOMINATED IN EURO

### a. State

This sub-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 of December 1993 on the State budget for 1994. They are being repaid on a straight-line basis over twenty-five years by means of yearly payments as from 1999, inclusive.

The outstanding balance as at 31 December 2006 of the loans granted to the State amounted to €6,415.85 million, broken down as follows:

EUR m	2006	2005	Change
Treasury. Law 3/1983 special account	1,757.26	1,854.89	-97.63
Treasury. Law 4/1990 special account	4,168.78	4,516.18	-347.40
Treasury. Credits arising from subscription for participating interests, contributions and quotas in international agencies	489.80	530.62	-40.82
<b>TOTAL</b>	<b>6,415.85</b>	<b>6,901.69</b>	<b>-485.84</b>

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 (€1,000.47 million) corresponds to the outstanding amount of a loan granted to the Social Security System under Law 41/1994 of 30 December 1994 on the State budget for 1995. This loan includes the principal of another loan granted to this institution, which was not paid on its maturity, of €1,539.19 million. The repayment of this 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 State, referred to above.

The reduction in the balance of this sub-item (€76.96 million) corresponds to receipt of the seventh repayment instalment on the aforementioned loan.

## 10 INTRA-EUROSISTEM CLAIMS

This item includes the amounts of the following sub-items:

EUR m	2006	2005	Change
Type of asset			
Participating interest in the ECB	432.70	432.70	—
Claims equivalent to the transfer of foreign reserve assets to the ECB	4,326.98	4,326.98	—
Net claims related to the allocation of euro banknotes within the Eurosystem	—	—	—
Other claims within the Eurosystem (net)	25,075.06	12,666.11	12,408.96
<b>TOTAL</b>	<b>29,834.73</b>	<b>17,425.78</b>	<b>12,408.96</b>

### a. Participating interest in the ECB

As at 31.12.2006 the fully paid-up subscription of the Banco de España to the capital of the ECB amounted to €432.70 million, which is equal to a share of 7.7758% in such capital. This percentage, unchanged in the year, corresponds to the Banco de España in accordance with



the capital key established using European Commission data on the basis of Spain's population and GNP relative to those of the total ESCB countries.

As post-balance-sheet events, it should be mentioned that on 1 January 2007 the ECB capital key changed because two new members (Bulgaria and Romania) joined the ESCB. Based on the Council Decision of 15 July 2003 on the statistical data to be used for the adjustment of the key for subscription to the capital of the European Central Bank, that of the Banco de España decreased from 7.7758% with 25 countries to 7.5498% with 27 countries. However, despite the decrease in Spain's key in percentage terms, the asset-side sub-item "9.1. Participating interest in the ECB" increased in January 2007 by €2.22 million with respect to December 2006 to the figure of €434.92 million, as a result of the rise in the Banco de España's relative weight in the capital of the ECB following the review of GDP and population data conducted on the occasion of the aforementioned admission of the new members of the ESCB.

b. Claims equivalent to the transfer of foreign reserve assets to the ECB

These represent ECB's debt to the Banco de España arising from the transfer of foreign reserve assets to the ECB. The claims are denominated in euro at a value fixed from the time of their transfer. They are remunerated at the latest available marginal rate for the Eurosystem's main refinancing operations, adjusted to reflect a zero return on the gold component. Their end-2006 balance amounted to €4,326.98 million, the same as at the previous year-end.

As post-balance-sheet events, it should be mentioned that the adjustments to the capital key and the resulting changes in the NCBs' participating interests in the subscribed capital of the ECB made it necessary to also adjust the assets that the ECB credited to the NCBs for their contributions of external reserve assets to it. Despite the decrease in the Banco de España's capital key, its asset-side balancing entry of the external reserves transferred to the ECB (asset sub-item 9.2) increased in January 2007 by €22.20 million with respect to December 2006 to a figure of €4,349.18 million, as a result of the rise in the Banco de España's relative weight in the capital of the ECB and, consequently, in the reserves it has to transfer to each NCB.

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

In accordance with Eurosystem rules, since the accounts making up this sub-item have a net credit balance, this information is presented on the liabilities side of the balance sheet.

d. Other claims within the Eurosystem (net)

The balance of €25,075.06 million as at 31.12.2006 represents the sum of three components: 1) the position of the Banco de España vis-à-vis the ECB in respect of the transfers issued and received through TARGET by the ESCB national central banks, including the ECB, plus the balances held with Eurosystem central banks through correspondent accounts; 2) the position vis-à-vis the ECB in respect of the pooling and allocation of monetary income within the Eurosystem pending settlement (see "*Net result of pooling of monetary income*" in Note 8 on the profit and loss account); and 3) the Banco de España's position vis-à-vis the ECB in respect of any amounts receivable or refundable, basically in respect of the dividend relating to euro banknotes issued by the ECB.

Regarding the first component, the end-2006 balance of the transfers via TARGET amounted to €25,053.82 million, while the correspondent accounts showed a balance of €0.01 million. From 30 November 2000, the balances arising from TARGET transfers vis-à-vis the Eurosystem banks, and vis-à-vis the rest of the European Union banks have been netted and replaced by a single balance vis-à-vis the ECB. The remuneration of the debit position vis-à-vis the ECB is calculated daily at the marginal interest rate on ESCB main refinancing operations.



The second component, i.e. the position vis-à-vis the ECB in respect of the pooling and allocation of monetary income among the Eurosystem national central banks, had a debit balance of €21.23 million at end-2006.

Finally, in regard to the position vis-à-vis the ECB relating to the distribution of income arising from the seignorage of euro banknotes issued on its behalf by the NCBs, until 17.11.2005 the ECB made the quarterly payment on account of banknote seignorage income. However, following approval of the Decision of the European Central Bank of 17 November 2005 on the distribution of the income of the European Central Bank on euro banknotes in circulation to the national central banks of the participating Member States (ECB/2005/11), the income on euro banknotes in circulation earned in each financial year is distributed by the ECB on the second working day of the following year, although the ECB Governing Council may decide before the end of the financial year not to distribute part or all of this income (see "Banknotes in circulation" in Section 3.1.2). This year the ECB Governing Council decided to retain the 2006 banknote seignorage income in order to increase the provision for foreign exchange rate, interest rate and gold price risks set up in 2005 and therefore the balance of this component at end-2006 was zero.

# 11 TANGIBLE AND INTANGIBLE ASSETS

The balance of this sub-item amounted to €210.72 million at end-2006, of which €470.47 million related to cost and €259.74 to accumulated depreciation.

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

EUR m	2006	2005	Change
<b>TANGIBLE FIXED ASSETS</b>	<b>384.63</b>	<b>373.03</b>	<b>11.60</b>
Land and unbuilt plots	4.52	4.54	-0.02
Buildings, structures and renovation work	78.78	77.30	1.48
Plant in buildings	124.00	118.37	5.62
Furniture and fittings	30.76	28.12	2.64
Office machines other than computer equipment	42.87	42.75	0.11
Computer equipment	45.13	44.57	0.56
Transport equipment	8.81	8.70	0.12
Libraries	8.67	8.02	0.65
Other tangible fixed assets	3.21	3.04	0.17
Art collection	37.88	37.62	0.26
<b>INTANGIBLE FIXED ASSETS</b>	<b>34.63</b>	<b>31.16</b>	<b>3.47</b>
Computer applications	34.57	31.16	3.41
Industrial property	0.05	0.00	0.05
<b>FIXED ASSETS IN PROGRESS</b>	<b>51.21</b>	<b>36.70</b>	<b>14.51</b>
Buildings, plant in buildings and other structures under construction	48.77	35.14	13.63
Computer applications under development	1.74	1.43	0.32
Other fixed assets in progress	0.70	0.13	0.56
<b>TOTAL</b>	<b>470.47</b>	<b>440.89</b>	<b>29.58</b>

EUR m

Accumulated depreciation or amortisation	2006	2005	Change
TANGIBLE FIXED ASSETS	-234.84	-212.03	-22.81
Buildings, structures and renovation work	-26.52	-24.95	-1.57
Plant in buildings	-106.77	-86.87	-19.90
Furniture and fittings	-18.92	-18.27	-0.65
Office machines other than computer equipment	-35.17	-33.87	-1.30
Computer equipment	-34.46	-32.09	-2.38
Transport equipment	-4.31	-4.18	-0.14
Libraries	-6.11	-5.66	-0.45
Other tangible fixed assets	-2.56	-2.28	-0.28
Art collection	0.00	-3.86	3.86
INTANGIBLE FIXED ASSETS	-24.90	-24.89	-0.01
Computer applications	-24.86	-24.89	0.03
Industrial property	-0.04	0.00	-0.04
TOTAL	-259.74	-236.92	-22.82

The increase in fixed assets in 2006 was basically due to the construction of the remaining portion of the Bank's headquarters in Madrid and to the development of computer applications.

Regarding the increase in accumulated depreciation and amortisation (€22.82 million), a large part of it (€19.90 million) relates to plant in buildings. 78% of this amount arose from the change in depreciation rates when the estimated useful life of these assets was modified in application of the harmonised criteria established in the common Eurosystem cost methodology approved by the ECB's Governing Council at its meetings on 22 July 2004, 15 February 2005 and 6 April 2006.

## 12 OTHER FINANCIAL ASSETS

The balance of this sub-item at end-2006 (€34,090.77 million) includes the Banco de España's held-to-maturity portfolio and other financial investments.

To ensure stable returns throughout the cycle, on 15 June 2006 the Executive Commission authorised the creation of a held-to-maturity portfolio. This portfolio, which is valued at amortised cost, enables more stable yearly profits to be achieved because it is not subject to the annual recognition of unrealised gains and losses.

The Banco de España's held-to-maturity portfolio had the following balances at end-2006:

EUR m

Held-to-maturity portfolio securities	2006
In foreign currencies	4,164.92
<i>Issued by non-euro area residents</i>	4,164.92
<i>Issued by euro area residents</i>	0.00
In euro	29,878.21
<i>Issued by non-euro area residents</i>	3,702.55
<i>Issued by euro area residents</i>	26,175.65
TOTAL	34,043.12

This sub-item also includes €47.64 million of other financial investments relating basically to the Banco de España's participating interests in Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A. and the Bank for International Settlements. The decrease of €21.54 million in these financial assets was basically due, firstly, to the sale of some of the shares of Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A. as a result of the public offering conducted when this company was floated on the stock exchange (€13.45 million), with a gain of €107.79 million being recorded on this transaction (see Note 9 on the profit and loss account) and, secondly, to a diminution in the underlying book value of these shares following the distribution of dividends with a charge to reserves (€8.27 million).

13 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 the position is a creditor one, it is recorded under the same heading in liability sub-item 12.1. Its balance of €201.33 million as at 31.12.2006 is the net value of the swap transactions outstanding at that date.

14 ACCRUALS AND PREPAID  
EXPENSES

The main components of this sub-item, the balance of which amounts to €1,511.27 million, are as follows:

EUR m	2006	2005	Change
ACCRUED INTEREST ARISING FROM SECURITIES ACQUISITIONS AND ACCRUED COUPON INTEREST RECEIVABLE	1,225.33	920.84	304.50
Trading portfolio	560.28	920.84	-360.55
<i>Denominated in foreign currency</i>	20.59	31.93	-11.34
<i>Denominated in euro</i>	539.69	888.91	-349.22
Held-to-maturity portfolio	665.05	0.00	665.05
<i>Denominated in foreign currencies</i>	34.68	0.00	34.68
<i>Denominated in euro</i>	630.37	0.00	630.37
OTHER ACCRUED INTEREST RECEIVABLE	270.98	168.94	102.05
On forward foreign exchange transactions	0.00	0.00	0.00
On swaps	0.00	-9.98	9.98
On deposits and other assets denominated in foreign currency	70.48	64.92	5.57
On claims equivalent to the transfer of foreign reserves to the ECB	105.00	77.24	27.75
On other intra-Eurosystem claims arising from TARGET transactions	69.57	25.01	44.56
Other	25.93	11.74	14.19
ACCRUED COMMISSIONS RECEIVABLE AND PREPAID EXPENSES	12.28	11.05	1.23
ACCRUED DIVIDENDS RECEIVABLE	2.67	0.00	2.67
TOTAL	1,511.27	1,100.82	410.44

As can be seen from the foregoing table, the most significant accounts are accrued interest arising from securities acquisitions and accrued coupon interest receivable denominated in euro arising from trading portfolios (€539.69 million) and from held-to-maturity portfolios (€630.37 million).

Also, in 2006 the accrued interest arising in securities transactions was reclassified in the balance sheet from asset sub-item 11.5 "Other assets. Sundry" to asset sub-item 11.4 "Other

assets. Accruals and prepaid expenses". For comparison purposes, the amounts of this caption relating to 2005 have also been reclassified.

15 OTHER ASSETS.- SUNDRY

The most significant components are the transfer made to the Treasury on 2 November 2006 of €695.07 million, equivalent to 70% of the Bank's distributable profits earned to 30 September 2006, which was €39.04 million lower than in the previous year, and the home loans and repayable advances granted to employees of the Bank, the balance of which, at €157.71 million, was up by €11.15 million.

16 BANKNOTES IN CIRCULATION

The balance of banknotes in circulation (€62,864.84 million) represents the Banco de España's share in the total euro banknotes in circulation (see "*Banknotes in circulation*" in the notes on accounting policies) according to the Eurosystem euro banknote allocation key (10.0065%<sup>13</sup> of the total issue by all the central banks) after deducting those corresponding to the ECB (8% of the total). This balance was €6,306.50 million higher than in the previous year because of the greater volume of euro banknotes in circulation in the Eurosystem.

17 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 €20,558.76 million at end-2006, €4,027.69 million more than in the previous year. This increase basically took place in the sub-item "*Current accounts (covering the minimum reserve system)*", which includes the different types of deposits held by credit institutions at the Banco de España, in which they maintain the minimum reserves required for monetary policy implementation purposes. The average balance of these deposits increased from €15,064.76 million in 2005 to €17,224.09 million in 2006.

Also included in this item are the deposits placed by credit institutions in relation to the deposit facility, fixed-term deposits, fine-tuning reverse operations and deposits related to margin calls. As at 31.12.2006 there were only deposits of the latter type, in the amount of €0.64 million. However, during 2006 Spanish credit institutions participated in five liquidity absorbing operations through the placement of fixed-term deposits.

18 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-end was €15,057.47 million, which breaks down as follows:

EUR m			
	2006	2005	Change
Central government (State)	4,388.29	3,756.92	631.37
<i>Treasury current account</i>	99.74	300.20	
<i>Other central government agencies and similar bodies</i>	4,288.55	3,456.72	
Territorial government	165.22	133.76	31.46
<i>Regional (autonomous) governments, administrative agencies and similar bodies</i>	160.34	128.19	
<i>Local government</i>	4.87	5.57	
Social security funds	10,503.96	9,387.01	1,116.95
<i>Social Security System</i>	9,465.53	8,821.78	
<i>Other</i>	1,038.43	565.24	
TOTAL	15,057.47	13,277.69	1,779.78

13. After Slovenia joined the Eurosystem on 1 January 2007, the banknote allocation key is 9.9925%.

The increase in the balance of this sub-item (€1,779.78 million) was basically due to the rise in the balances held by social security funds and, to a lesser extent, by central government agencies other than the Treasury.

19 LIABILITIES TO OTHER EURO  
AREA RESIDENTS DENOMINATED  
IN EURO.- OTHER LIABILITIES

Included here are the current accounts of financial institutions other than credit institutions, such as the Deposit 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 non-administrative public and autonomous agencies of the State, the current accounts of employees and pensioners and other accounts of legal entities classified in “*Other resident non-financial sectors*”.

The balance at end-2006 was €2,445.62 million, and its increase of €95.41 million on end-2005 was basically due to the increase in the balances of the current accounts of State agencies (€118.18 million).

20 LIABILITIES TO NON-EURO  
AREA RESIDENTS DENOMINATED  
IN EURO

This item basically includes the treasury accounts of non-EU countries, central banks and monetary authorities and of international agencies to which reserve management services are provided, and the euro accounts held by non-euro area central banks. The balance of €126.59 million was €98.51 million higher than a year earlier, basically due to the increase in reserve management activity on behalf of third parties.

21 LIABILITIES TO NON-EURO  
AREA RESIDENTS DENOMINATED  
IN FOREIGN CURRENCY.-  
DEPOSITS, BALANCES AND  
OTHER LIABILITIES

This sub-item basically includes the foreign-currency balances of non-euro area central banks, which amounted to €154.14 million at 2006 year-end. It also includes collateralised inward deposits recorded in respect of reverse transactions conducted under repurchase agreements, the balance of which was zero as at year-end and €125.79 million as at 31.12.2005. Overall, the total balance of this sub-item increased by €27.86 million.

22 COUNTERPART OF SPECIAL  
DRAWING RIGHTS ALLOCATED BY  
THE IMF

This item of €341.12 million shows the amount of the special drawing rights allocated to Spain by the IMF in proportion to its quota. The total amount of this item decreased by €20.41 million with respect to the previous year, due to the variation in the exchange rate.

23 INTRA-EUROSISTEM  
LIABILITIES

This item, which as at 31.12.2006 had a balance of €24,113.87 million, comprises the following two sub-items:

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

This sub-item, the balance of which amounted to €24,113.87 million at end-2006, 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 section on accounting policies).

b. Other liabilities within the  
Eurosystem (net)

This sub-item had a net debit balance in 2006. Therefore, the explanation is given in note 10.d above.

24 ITEMS IN COURSE  
OF SETTLEMENT

Included here are various items which as at 31.12.2006 were in the course of settlement: transfer instructions pending execution, transfers sent to deposit institutions but not yet reimbursed, transfers pending payment, etc.

Of the total balance of this item (€205.57 million) at year-end, €135.93 correspond to transfers ordered by credit institutions pending payment at year-end, and €67.89 million relate to transfers received on 29 December 2006 by the Sistema Nacional de Compensación Electrónica (National Electronic Clearing System) that have been settled and are pending payment.

The decrease with respect to 2005 (€35.29 million) was basically due to the aforementioned transfers ordered and pending payment at year-end (€31.71 million).

25 OFF-BALANCE-SHEET  
INSTRUMENTS REVALUATION  
DIFFERENCES

This sub-item includes the amount of the net creditor position arising from foreign-exchange forward and swap transactions valued at the exchange rates prevailing at the end of the year. When the position is a debtor one, as in 2006, it is recorded under the same heading in asset sub-item 11.3 (see Note 13 on the balance sheet).

26 LIABILITY ACCRUAL  
ACCOUNTS AND INCOME  
COLLECTED IN ADVANCE

This sub-item includes interest accrued but not yet paid, expenses accrued but not yet paid and deferred income.

As at 31.12.2006, its balance amounted to €238.25 million, the main component being interest accrued but not yet paid (€231.17 million). The increase in 2006 (€114.95 million) mainly resulted from the higher interest incurred on intra-Eurosystem accounts relating to the adjustment of banknotes in circulation.

27 OTHER LIABILITIES.- SUNDRY

This includes other liabilities not classifiable above.

As at 31.12.2006 the balance of this sub-item amounted to €309.80 million and its main component was the "Banco de España employee social welfare scheme (*Mutualidad de empleados*).- Contributions payable" (€234.23 million). The decrease of €11.93 million in this sub-item with respect to the previous year arose basically from the decline in the aforementioned debt by €30.93 million. The rest of the variation related to increases in several captions, including most notably those relating to expenses and investments payable (€4.93 million) and to the amounts received on account of the subscription of public debt (€3.57 million).

28 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:

EUR m	2006	2005	Change
For exchange rate and interest rate risks	2,421.95	2,423.30	-1.36
For exchange of withdrawn peseta banknotes	89.61	125.70	-36.09
For early and regular retirement	66.28	84.96	-18.67
For death and retirement assistance	69.98	69.02	0.96
For sundry liabilities and charges	3.75	3.67	0.08
<b>TOTAL</b>	<b>2,651.57</b>	<b>2,706.65</b>	<b>-55.09</b>

The most important provision is that "For exchange rate and interest 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. Subsequently, on 14 April 2004 the Executive Commission resolved to extend the purpose of this provision to include the coverage of interest rate risk. The balance of this provision as at 31.12.2006 amounted to €2,421.95 million. This resulted from the use of a portion of the provision and from an addition to it, both explained in Note 5 on the profit and loss account.

The main decreases were in the provision recorded for the exchange of peseta banknotes withdrawn from circulation (€36.09 million) and in the provision for payments to early and regular retirees (€18.67 million), as a result of the use of these provisions for their intended purpose.

## 29 REVALUATION ACCOUNTS

This item includes the revaluations arising from unrealised gains on financial assets and liabilities. The breakdown is as follows:

EUR m			
Type of account	2006	2005	Change
Gold	5,208.90	5,017.56	191.33
Foreign currency	20.35	552.03	-531.68
Securities	46.50	180.83	-134.33
<i>Issued in foreign currency by non-euro area residents</i>	<i>5.77</i>	<i>9.65</i>	<i>-3.88</i>
<i>Issued in euro by non-euro area residents</i>	<i>0.00</i>	<i>3.14</i>	<i>-3.14</i>
<i>Issued in euro by non-euro area residents</i>	<i>40.73</i>	<i>168.05</i>	<i>-127.32</i>
Other	17.81	35.90	-18.09
TOTAL	5,293.55	5,786.33	-492.77

The revaluation accounts decreased by €492.77 million in 2006. The main change was in foreign currencies, the unrealised gains on which decreased by €531.68 million due to the depreciation of the US dollar and SDR against the euro. The gold revaluation account increased by €191.33 million due to the increase in its market price in euro. Finally, the main change in the securities revaluation accounts took place in euro-denominated securities, which decreased by €130.46 million (of which €107.96 million related to the book-entry State debt portfolio) because securities prices were pushed down by the trend in interest rates.

## 30 CAPITAL

As at 31 December 2006 the capital of the Banco de España amounted to €1,000 million, of which €1.37 million were constituted pursuant to Royal Legislative Decree 18/1962 of 7 June 1962 and €998.63 million as a capital increase carried out in 2006. This capital increase resulted from the approval by the Council of Ministers on 28 July 2006 of the proposal submitted by the Governing Council of the Banco de España in application of Law 192/1964 that a portion of the 2005 profits, which were retained as permitted by the resolution of the Council of Ministers of 29 July 2005 and by Royal Decree 1198/2005 on the regime governing the payment of Banco de España profits into the Treasury, be used to increase capital at the Bank within the limits authorised by the thirty-eighth additional provision of Law 30/2005 of 29 December on the State Budget for 2006, i.e. until the capital of the Banco de España reaches the figure of €1,000 million.

## 31 RESERVES

Included in this sub-item is, first, 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 (€3.17 million) and, second, the portion of 2005 profit taken to reserves (€496.83 million), authorised by the Council of Ministers on 28 July 2006 in application of the legal provisions cited in the previous note which affect the increase in reserves. This increase raised the reserves of the Banco de España to €500 million.

## 32 PROFIT FOR THE YEAR

The net profit for 2006, after deducting the transfer to the Beneficent-Social Fund (€4.36 million), amounted to €1,947.57 million, down 29.5% on 2005. Of this amount, €695.07 million was paid to the Treasury on 2 November 2006, in accordance with Royal Decree 1198/2005 of 10 October 2005 and with the Council of Ministers resolution of 22 September 2006 on distributable profit (see Note 15 to the profit and loss account).

During the year, the following amounts were also paid to the Treasury out of 2005 profits:

- a On 1.3.2006, €404.62 million, which, together with the payment in November 2005, amounted to 90% of the €1,265.26 million of distributable profit for that year.
- b On 18.8.2006, once the balance sheet and profit and loss account for the year 2005 had been approved by the Council of Ministers, €126.53 million, representing the rest of the distributable profit for 2005, were paid to the Treasury.

The details of the various components of the profit for 2006 and the reasons for the changes in them with respect to 2005 are given in Section 3.3 below on the profit and loss account.

### 3.3 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 2006 and 2005, as follows:

EUR m and %					
	Interest income			Average investment in 2006	Average yield in 2006
	2006	2005	Change		
Foreign currency	456.48	359.73	96.75	9,107.62	4.9
Securities	272.94	178.00	94.94	5,249.86	5.1
Deposits and other assets	183.54	181.73	1.81	3,857.75	4.7
Euro	3,036.54	2,089.97	946.57	103,503.66	2.9
Securities	1,572.55	1,061.63	510.92	51,824.25	3.0
Monetary policy operations	678.06	604.34	73.72	23,916.45	2.8
Intra-Eurosystem accounts	784.18	422.51	361.67	27,762.96	2.8
Claims equivalent to the transfer of foreign reserves to the ECB	105.00	77.24	27.75	4,326.98	2.4
Intra-Eurosystem accounts	679.18	345.27	333.92	23,435.98	2.9
Other assets	1.75	1.49	0.26	—	—
<b>TOTAL</b>	<b>3,493.02</b>	<b>2,449.71</b>	<b>1,043.31</b>	<b>112,611.28</b>	<b>3.1</b>

Of the €456.48 million of interest on foreign-currency investments, €272.94 million (59.79%) arose from investments in fixed-income securities denominated in US dollars, which had an average balance of USD 5,249.86 million and an average yield of 5.1% in 2005, compared with USD 4,214.51 million and 4.2%, respectively, in 2005. Also, of the balance included under “Deposits and other assets” (€183.54 million), most (€133.15 million) is in the form of term deposits and the rest in other investments denominated in US dollars (repos, etc.) and in SDRs.

The increase in euro-denominated interest income (€946.57 million) was due to the higher average return (2.9% in 2006 compared with 2.3% in 2005) and to the higher average investment (€90,074.53 million in 2005) resulting the rise in the securities portfolio, the average balance of which was up from €40,687.83 million in 2005 to €51,824.25 million in 2006, and in intra-Eurosystem balances relating to TARGET transactions, which were up from €16,467.52 million in 2005 to €23,435.98 million in 2006.

#### 2 INTEREST EXPENSE

This item includes interest expenditure on the following liabilities:



EUR m and %					
	Interest expense			Average financing in 2006	Average cost in 2006
	2006	2005	Change		
Remuneration of minimum reserves and other monetary policy deposits	494.22	315.01	179.21	17,242.68	2.8
General government deposits	315.06	208.66	106.40	11,544.91	2.7
Intra-Eurosystem liabilities- Net liabilities related to allocation of euro banknotes within the Eurosystem	499.43	270.97	228.46	17,527.86	2.8
Liabilities denominated in foreign currency	132.22	70.75	61.47	5,765.83	2.3
Other liabilities denominated in euro	1.96	0.00	1.96	—	—
<b>TOTAL</b>	<b>1,442.89</b>	<b>865.40</b>	<b>577.49</b>	<b>52,081.29</b>	<b>2.7</b>

The increase in the expense compared with the previous year (€577.49 million) was due to the higher average balance incurring interest (€42,683.49 million in 2005) and the higher average cost (2.7% in 2006 against 2.1% in 2005). Of the increase in the average amount of financing (€9,397.80 million), €4,630.21 relate to intra-Eurosystem balances related to allocation of euro banknotes, €2,170.44 to the minimum reserves incurring interest and other monetary policy deposits, and €1,276.27 million to social security deposits.

### 3 REALISED GAINS/LOSSES ARISING FROM FINANCIAL OPERATIONS

This item includes the profits and losses arising from dealing in financial assets. In 2006 the gains in this connection amounted to €453.04 million, arising from the following sources:

EUR m			
	2006	2005	Change
Sale of gold	500.03	585.00	-84.97
Sale of foreign currency (exchange gains)	87.74	164.21	-76.47
Sale of securities (price losses)	-134.80	70.01	-204.81
<i>Foreign currency</i>	<i>-22.62</i>	<i>-33.84</i>	<i>11.22</i>
<i>Euro</i>	<i>-112.18</i>	<i>103.85</i>	<i>-216.03</i>
Other gains/losses	0.08	-1.98	2.06
<b>TOTAL</b>	<b>453.04</b>	<b>817.24</b>	<b>-364.20</b>

As shown in the above table, the main components of the gains and losses arising from financial operations in 2006 were as follows:

- Gains of €500.03 million on the sale of 41.01 tonnes of gold.
- The net gains arising from exchange rate differences on the sale of foreign currency amounted to €87.74 million, substantially all from sales of US dollars (€70.66 million) and of SDRs (€17.07 million).
- The net price-related losses arising from the sale of foreign securities amounted to €22.62 million and related in full to the sale of securities denominated in US dollars.

- €112.18 million of losses on the sale of euro-denominated fixed-income securities.

Compared with the previous year, the total net realised gains arising from financial operations decreased by €364.20 million, basically due to the following:

- Lower gains on the sale of gold: €84.97 million less than in 2005.
- Losses on the sale of securities, as compared with gains in 2005 (variation of €204.81 million), which arose basically from the sale of euro-denominated securities in 2006 (€216.03 million), offset slightly by lower losses on sales of securities denominated in foreign currencies (€11.22 million). The losses on the sale of euro-denominated securities were essentially related to the rise in interest rates and the consequent fall in prices. In the case of securities denominated in foreign currencies, although the difference between the cost per books and the sale price was slightly less negative in 2006, the losses were lower in that year basically because of the lower volume of sales, down from €21,439.26 million in 2005 to €12,955.65 million in 2006.
- Decrease in net gains on sales of foreign currencies (exchange rate gains) with respect to the previous year (€76.47 million), particularly in the sale of US dollars, which were due also to the lower volume of sales.

#### 4 UNREALISED LOSSES ON FINANCIAL ASSETS AND POSITIONS

This item includes the loss arising in the currency position derived from the exchange rate depreciation, as well as that arising from depreciation of securities prices, for that portion that cannot be offset by unrealised gains from previous years. The breakdown in 2006 and 2005 is as follows:

EUR m			
	2006	2005	Change
Foreign currency (exchange rate losses)	2.71	0.02	2.69
Securities (price losses)	236.83	189.55	47.28
<i>Foreign currency</i>	6.26	22.32	-16.06
<i>Euro</i>	230.57	167.23	63.34
Other	—	0.06	-0.06
<b>TOTAL</b>	<b>239.54</b>	<b>189.63</b>	<b>49.91</b>

Unrealised losses in 2006 amounted to €239.54 million, of which 98.87% were on securities. Specifically, unrealised losses on euro-denominated securities amounted to €230.57 million, of which €226.57 million related to trading portfolio securities issued by euro area residents. Unrealised losses on securities denominated in foreign currency amounted to €6.26 million.

#### 5 TRANSFERS TO/FROM PROVISIONS FOR FOREIGN EXCHANGE RATE AND PRICE RISKS

Pursuant to the resolution adopted by the Executive Commission on 26.01.2007, in 2006 provisions for an amount of €239.54 million were reversed to income to cover the unrealised losses on financial assets and positions recorded in that year. Also, a transfer of €238.18 million was made to raise this provision to the level considered appropriate for the risks to be covered.

#### 6 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, settlement service for securities transactions, etc.). It may be broken down as follows:

	EUR m					
	Income			Expenses		
	2006	2005	Change	2006	2005	Change
Foreign operations	0.30	0.34	-0.03	2.86	2.42	0.44
Domestic operations	15.12	11.57	3.55	3.40	1.77	1.63
<b>TOTAL</b>	<b>15.43</b>	<b>11.91</b>	<b>3.52</b>	<b>6.25</b>	<b>4.19</b>	<b>2.07</b>

The higher net fee income in 2006 (up 18.8%) was due above all to the fees and commissions received on securities transactions (€2.08 million) under the correspondent central banking model (CCBM) used for managing the custody of collateral on monetary policy operations, and to the fees and commissions received from member institutions of the Settlement Service (€1.62 million).

## 7 INCOME FROM EQUITY SHARES AND PARTICIPATING INTERESTS

This item includes the participating interest of the Banco de España in the profit of the ECB and the dividends on other shares and participating interests.

Of the total amount of €20.22 million recorded, €17.54 million was dividend income from the participating interest in Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistema Financieros, SA (BME) and €2.68 million from interests in international agencies. In 2006 the ECB Governing Council decided to retain the banknote seignorage income in order to increase the provision for foreign exchange rate, interest rate and gold price risks set up in 2005 and, accordingly, as that year, the Banco de España did not receive income from the ECB in this connection. In 2006 the Banco de España did not receive an ordinary dividend from the ECB either.

The slight increase with respect to the previous year (€1.4 million) is due basically to the higher dividends received on the participating interest in BME.

## 8 NET RESULT OF POOLING OF MONETARY INCOME

The amount of each Eurosystem NCB's monetary income is determined by calculating the annual income generated by the earmarkable assets held against the liability base. The liability base consists of the following items: banknotes in circulation; 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 earmarkable assets include the following items: lending to euro area credit institutions related to monetary policy operations; intra-Eurosystem claims equivalent to the transfer of foreign reserve assets to the ECB; net intra-Eurosystem claims resulting from TARGET transactions, whenever they have a debit balance; net intra-Eurosystem claims related to the allocation of euro banknotes in the Eurosystem; and a limited amount of each NCB's gold holdings, in proportion to its capital key. The gold is considered to generate no income. If the value of a NCB's earmarkable assets exceeds or is less than the value of its liability base, the difference will be offset by applying to it the average rate of return on the NCB's total earmarkable assets.

The monetary income pooled by the Eurosystem is to be allocated among NCBs according to the ECB subscribed capital key. The difference between the monetary income pooled by the Banco de España in 2006, amounting to €1,604.41 million, and that reallocated to it, amounting to €1,625.64 million, is the net result arising from the calculation of monetary income (€21.23 million). This result was €9.87 million higher than in 2005.

## 9 OTHER INCOME AND LOSSES

This includes the income and losses that cannot be included in other items, along with other diverse income of an exceptional nature. It may be broken down as follows:

EUR m	2006	2005	Change
Extraordinary profit	2.49	1,057.91	-1,055.42
Employee social welfare scheme	-29.17	-32.23	3.07
Sundry	108.41	0.71	107.70
<b>TOTAL</b>	<b>81.73</b>	<b>1,026.39</b>	<b>-944.66</b>

As can be seen, this item decreased by €944.66 million with respect to the previous year, basically due to the Executive Commission's resolution of 3 February 2006 to credit €1,032.97 million to profit and loss in 2005 for the peseta banknotes withdrawn from circulation upon the introduction of the euro and not yet exchanged as at 31.12.2005, and, to a lesser extent, to the gain of €24.79 million on the sale of the buildings of branches closed in 2004, which were recognised in 2005. This decrease was partly offset by the gain on the sale in July 2006 of a portion of the shares of Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A., which amounted to €107.79 million.

## 10 STAFF COSTS

The increase of 4.6% in staff costs (€9.09 million) is basically due to: a) the economic improvements included in the Collective Agreement for 2006, estimated at €5.13 million, and b) changes in staff size and structure, wage drift due to promotions, years of service, etc., totalling €3.96 million.

## 11 ADMINISTRATIVE EXPENSES<sup>14</sup>

This item includes expenses arising from the purchase of current assets and of diverse services received during the year, as follows:

EUR m	2006	2005	Change
Office expenses	62.66	56.84	5.82
Property expenses	20.49	18.90	1.59
Transport and communications	7.21	7.04	0.17
Surveillance and security	6.45	6.13	0.33
Training and grants	2.61	3.24	-0.63
Sundry operating expenses	10.97	9.90	1.08
Local taxes	0.79	0.93	-0.14
<b>TOTAL</b>	<b>111.18</b>	<b>102.98</b>	<b>8.20</b>

As can be seen in the above table, the most important components were office expenses - including IT costs- and those relating to premises, which amounted to €62.66 and €20.49 million, respectively.

The increase in administrative expenses in 2006 was due primarily to the services price adjustment at rates of around 3.7% (the CPI for 2005). Additionally, stripping out this effect from the figures, there was a notable increase in billings for IT services, largely attributable to the development of TARGET2 software and the conversion of ADABAS data-

<sup>14</sup>. 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.

bases to DB2. Property expenses grew basically because of the increase in building maintenance expenses, including most notably the restoration of the roof and the cleaning of the facade of the building in Plaza de Cibeles, Madrid, and the cleaning of the facade of the Seville branch. Finally, the increase in sundry operating expenses was due, among other things, to the expenses derived from the events organised to celebrate the 150 anniversary of the Banco de España under that name. By contrast, decreases were recorded in expenses for non-IT services, rental of premises and training, promotion and recruitment.

“Sundry operating expenses” include €62,690.87 (including VAT) relating to the fees of the external auditors Deloitte, S.L. for the audits in 2006 of the Bank’s annual accounts and of certain aspects of the Bank’s management of European Central Bank reserves. In 2006 no services were received from or amounts paid to other firms in the group.

## 12 DEPRECIATION OF FIXED ASSETS

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

EUR m	2006	2005	Change
Depreciation of buildings, structures and renovation work	1.61	1.64	-0.03
Depreciation of plant in buildings	19.69	6.26	13.43
Depreciation of furniture and fittings	1.35	0.95	0.40
Depreciation of office machines other than computer equipment	1.43	6.33	-4.90
Depreciation of computer equipment	5.93	5.77	0.16
Depreciation of transport equipment	0.94	1.09	-0.15
Depreciation of libraries	0.45	0.44	0.01
Depreciation of other tangible fixed assets	0.28	0.26	0.03
Amortisation of intangible fixed assets	2.27	4.42	-2.15
<b>TOTAL</b>	<b>33.97</b>	<b>27.15</b>	<b>6.82</b>

The increase in accumulated depreciation and amortisation of fixed assets was because the change in depreciation rates and other criteria relating to the useful life of certain assets as a result of the harmonisation of Eurosystem financial and cost accounting methodology led to a significant rise in the expenses booked in 2006 (see Note 11 on the balance sheet).

## 13 BANKNOTE PRODUCTION SERVICES

This amount (€89.48 million) corresponds to payments made by the Banco de España to purchase banknotes from the National Mint. The increase with respect to the previous year (€37.12 million) was attributable to the lower volume of euro banknotes acquired by the Bank in the reporting year (€1,038 million in 2006, against €489 million in 2005), although the effect of the greater production was partly offset by the decrease in unit prices.

## 14 TRANSFERS AND ADDITIONS TO OTHER FUNDS AND PROVISIONS

The net balance of transfers and applications to other funds and provisions in 2006 amounted to €8.26 million, compared with €133.88 million in 2005. This change (€125.63 million) is primarily due to the recording in 2005 of a provision of €122.50 million for exchange of the peseta banknotes that may be presented in the future and to the smaller amount set aside in 2006 for death and retirement assistance provided for in Article 190 of the Banco de España Conditions of Employment.

Since the Banco de España provides financial services, it is not an institution with a high environmental risk. In 2006 it was not considered necessary to record any provision for environmental liabilities and charges.

## 15 PROFIT FOR THE YEAR

As detailed and explained in the preceding notes, the net profit for 2006 amounted to €1,947.57 million, down 29.5% on the previous year. The distributable profit is determined by application of the Council of Ministers resolution of 22 September 2006 authorising the Banco de España to exclude from payment to the Treasury the “income arising from the net gains on the sale of gold, up to the limit of €500 million”. After applying this authorisation, the distributable profit of the Banco de España amounts to €1,447.57 million.

In application of this resolution and of Royal Decree 1198/2005 of 10 October 2005, the payments to the Treasury of distributable 2006 profit of the Banco de España are as follows:

EUR m	
1 Total profit for 2006:	1,947.57
<i>Profit excluded from distribution</i>	<i>500.00</i>
<i>Total distributable profit</i>	<i>1,447.57</i>
2 Payments to the Treasury:	
<i>On 2.11.2006. 70% of distributable profit as at 30.09.2006</i>	<i>695.07</i>
<i>On 1.3.2007. Difference between the above amount and 90% of distributable profit as at 31.12.2006</i>	<i>607.74</i>
3 Distributable profit payable to the Treasury:	
<i>At date of approval of the 2006 accounts</i>	<i>144.76</i>

#### 4 Specific information required by Article 4.2 of the Law of Autonomy of the Banco de España of 1 June 1994

##### **Contributions made by the Bank to the Deposit Guarantee Funds**

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 2006 the Banco de España made no contributions whatsoever to these Funds.

##### **Loss of profit**

The table below shows the loans outstanding in 2006 with interest rates below the reference rates used, in order to estimate the loss of profit for the year pursuant to the provisions of Article 4.2 of Law 13/1994 of 1 June 1994 of Autonomy of the Banco de España.

EUR m and %				
Type of credit/loan	Estimated average balance in 2006	Interest rate received	Reference interest rate	Estimated loss of profit
Net State debt	6,670.53	0.00%	2.82%	187.82
Loans to the Social Security System	1,076.80	0.00%	2.82%	30.32
Housing loans and repayable advances to employees	152.12	1.09%	2.82%	2.63
<i>Housing loans</i>	<i>127.35</i>	<i>1.30%</i>	<i>2.82%</i>	<i>1.93</i>
<i>Repayable advances</i>	<i>24.77</i>	<i>0.00%</i>	<i>2.82%</i>	<i>0.70</i>
TOTAL	7,899.45	0.02%	2.82%	220.76

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 less 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 reference rate used to estimate the loss of profit in all these loans is the daily average of the marginal interest rate on main refinancing operations conducted during the year.





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*Translation of a report originally issued in Spanish based on our work performed in accordance with International Standards on Auditing and of annual accounts originally issued in Spanish and prepared in accordance with the internal accounting rules and principles of the Banco de España, which are indicated in Note 3.1 to the accompanying annual accounts and are based on the accounting regulations established for the member central banks of the European System of Central. In the event of a discrepancy, the Spanish-language version prevails.*

### AUDITORS' REPORT ON 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 at 31 December 2006 and the related profit and loss account and notes to the accounts for the year then ended.

#### *Responsibility for the annual accounts*

The Executive Commission of the Banco de España is responsible for organising the Bank and appointing its general directors. Under the Internal Rules of the Banco de España, the Directorate General Services is responsible for preparing the annual accounts in accordance with the internal accounting rules and principles of the Banco de España, which are indicated in Note 3.1 to the accompanying annual accounts and are based on the accounting regulations established for the member central banks of the European System of Central Banks. This responsibility, which is exercised through the Control, Budget and Accounting Department, includes the supervision of operations and, therefore, the design, implementation and maintenance of the relevant internal controls required for the preparation and adequate presentation of the annual accounts that are free from material misstatement due either to fraud or error; the selection and application of appropriate accounting rules; and the performance of the estimates considered to be reasonable in the circumstances. Pursuant to Article 21.g) of Law 13/1994, of 1 June, on the Autonomy of the Banco de España, these annual accounts are prepared by the Governing Council of the Banco de España.

#### *Responsibility of the auditor*

Our responsibility is to express an opinion on the annual accounts taken as a whole based on our audit work performed in accordance with International Standards on Auditing, which require that we comply with certain ethical requirements and that we plan and perform the audit to obtain reasonable assurance that the annual accounts are free from material misstatements or irregularities.



An audit entails the performance of procedures designed to obtain evidence supporting the amounts and disclosures contained in the annual accounts. The procedures selected depend on the auditor's judgment, which includes the assessment of the risks of the occurrence of material misstatement or irregularities in the annual accounts due either to fraud or error. In assessing these risks, the auditor considers the internal control system applicable to the preparation and adequate presentation of the annual accounts by the entity, in order to design audit procedures that are appropriate in view of the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control system. An audit also includes the evaluation of the adequacy of the accounting policies used and of the reasonableness of the accounting estimates made by the entity, as well as an assessment of the overall presentation of the annual accounts. We consider that the evidence we have obtained is sufficient and adequate to provide a basis on which to express our audit opinion.

#### *Comparative information*

For comparison purposes, the accompanying annual accounts present, in addition to the 2006 figures for each item in the balance sheet and profit and loss account, the figures for 2005. Our opinion refers only to the 2006 annual accounts. On 30 May 2006, other auditors issued their auditors' report on the 2005 annual accounts in which they expressed an unqualified opinion.

#### *Opinion*

In our opinion, the accompanying annual accounts for 2006 present fairly, in all material respects, the net worth and financial position of the Banco de España at 31 December 2006 and 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 internal accounting rules and principles of the Banco de España, which are indicated in Note 3.1 to the accompanying annual accounts and are based on the accounting regulations established for the member central banks of the European System of Central Banks.

DELOITTE, S.L.

  
A stylized handwritten signature in black ink, consisting of several loops and a long horizontal stroke at the end.

Miguel Angel Bailón  
31 May 2007

## 2 Report of the Audit Committee

We the undersigned, Ángel Luis López Roa, Jesús Leguina Villa and Ana María Sánchez Trujillo, are members of the Governing Council of the Banco de España and of the Audit Committee appointed by the Governing Council. In accordance with Article 29 of the Internal Rules of the Banco de España, we were given the task of reviewing the accounts of the Institution for the year 2006.

As required by the aforementioned precept, the Audit 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 2006, prepared by the Directorate General Services of the Banco de España; 2) studying the audit of the balance sheet and profit and loss account of the Banco de España for 2006, 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, Budget 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 2006 give a true and fair view of the net worth and financial position of the Banco de España.

Madrid, 24 May 2007.



ANA MARÍA SÁNCHEZ TRUJILLO



ÁNGEL LUIS LÓPEZ ROA



JESÚS LEGUINA VILLA

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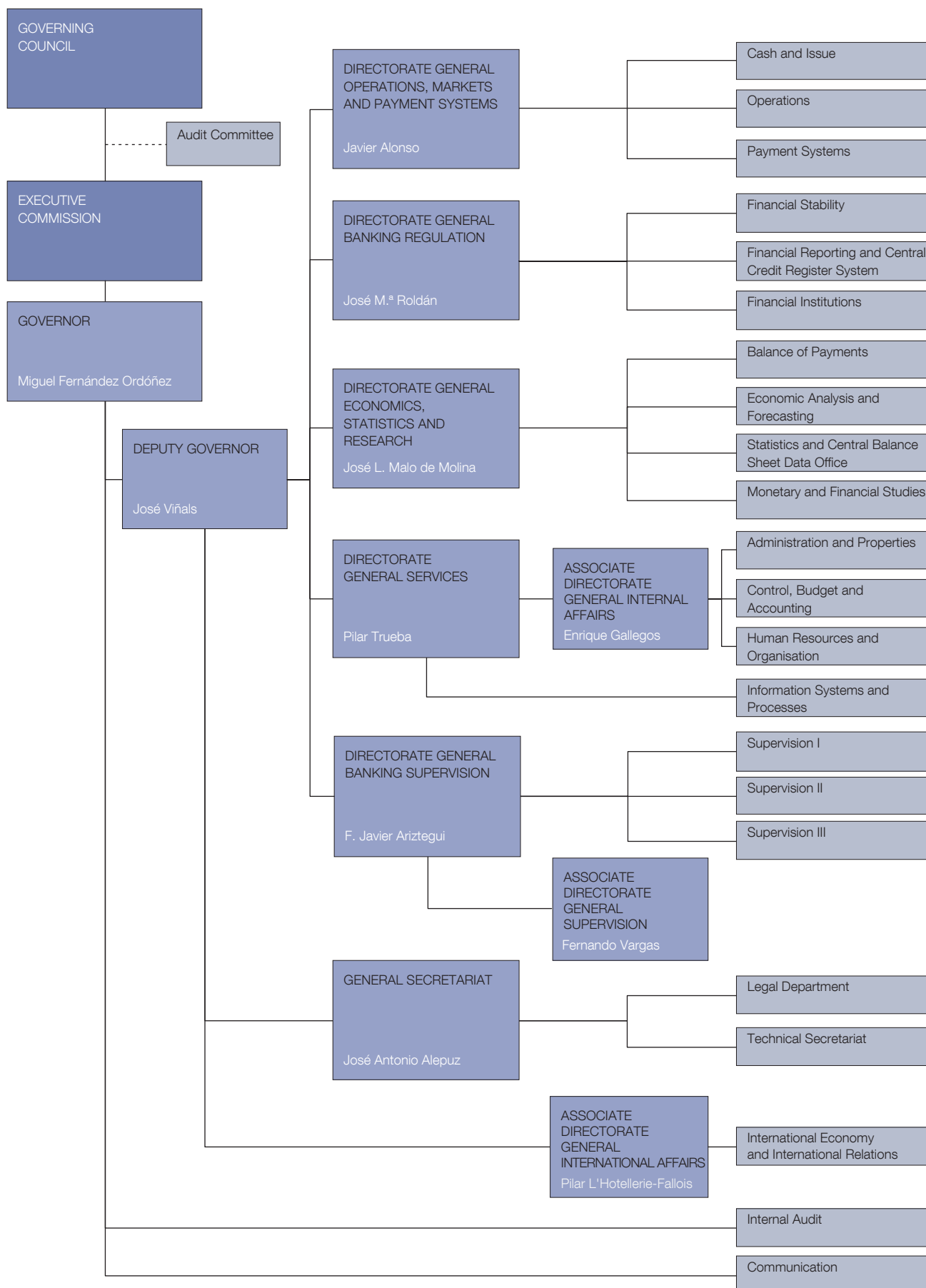
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COMPOSITION OF THE GOVERNING BODIES  
OF THE BANCO DE ESPAÑA



## ORGANISATION CHART



## Governing Council

GOVERNOR	Miguel Fernández Ordóñez
DEPUTY GOVERNOR	José Viñals
COUNCIL MEMBERS	Jesús Leguina Ángel Luis López Roa Guillem López José María Marín Vicente Salas Ana M <sup>a</sup> Sánchez Trujillo
DIRECTOR-GENERAL OF THE TREASURY AND FINANCIAL POLICY	Soledad Núñez
VICE-PRESIDENT OF THE NATIONAL SECURITIES MARKET COMMISSION	Carlos Arenillas
DIRECTORS-GENERAL OF THE BANK (Without a right to vote)	José Luis Malo de Molina F. Javier Aríztegui José María Roldán Pilar Trueba Javier Alonso
SECRETARY (Without a right to vote)	José Antonio Alepuz
REPRESENTATIVE OF THE BANK'S PERSONNEL (Without a right to vote)	Luciano Murias

## Executive Commission

GOVERNOR	Miguel Fernández Ordóñez
DEPUTY GOVERNOR	José Viñals
COUNCIL MEMBERS	Ángel Luis López Roa Vicente Salas
DIRECTORS-GENERAL (Without a right to vote)	José Luis Malo de Molina F. Javier Aríztegui José María Roldán Pilar Trueba Javier Alonso
SECRETARY (Without a right to vote)	José Antonio Alepuz

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