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2010

BANCO DE ESPAÑA
Eurosistema

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ABBREVIATIONS

AIAF	Association of Securities Dealers
BCBS	Basel Committee on Banking Supervision
BE	Banco de España
BIS	Bank for International Settlements
BLS	Bank Lending Survey
BRICs	Brazil, Russia, India and China
CBSO	Central Balance Sheet Data Office
CCR	Central Credit Register
CDSs	Credit default swaps
CEBS	Committee of European Banking Supervisors
CEIPOS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CEMLA	Center for Latin American Monetary Studies
CEPR	Centre for Economic Policy Research
CNE	Spanish National Accounts
CNMV	National Securities Market Commission
CPI	Consumer Price Index
ECB	European Central Bank
ECOFIN	Council of the European Communities (Economic and Financial Affairs)
EDP	Excessive Deficit Procedure
EFF	Spanish Survey of Household Finances
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EMU	Economic and Monetary Union
EONIA	Euro overnight index average
EPA	Official Spanish Labour Force Survey
ESA 79	European System of Integrated Economic Accounts
ESA 95	European System of National and Regional Accounts
ESCB	European System of Central Banks
ESFS	European System of Financial Supervisors
ESRB	European Systemic Risk Board
EU	European Union
EURIBOR	Euro interbank offered rate
EUROSTAT	Statistical Office of the European Communities
FAFA	Fund for the Acquisition of Financial Assets
FASE	Financial Accounts of the Spanish Economy
FDI	Foreign direct investment
FROB	Fund for the Orderly Restructuring of the Banking Sector
FSB	Financial Stability Board
FSF	Financial Stability Forum
GDI	Gross disposable income
GDP	Gross domestic product
GFCF	Gross fixed capital formation
GNP	Gross national product
GVA	Gross value added
HICP	Harmonised Index of Consumer Prices
IASB	International Accounting Standards Board
ICO	Official Credit Institute
IFRSs	International Financial Reporting Standards
IGAE	National Audit Office
IMF	International Monetary Fund
INE	National Statistics Institute
SPEE	National Public Employment Service
LTROs	Longer-term refinancing operations
MFIs	Monetary financial institutions
MiFID	Markets in Financial Instruments Directive
MMFs	Money market funds
MROs	Main refinancing operations
MTBDE	Banco de España quarterly macroeconomic model
NAIRU	Non-accelerating-inflation rate of unemployment
NCBs	National central banks
NPISHs	Non-profit institutions serving households
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of Petroleum Exporting Countries
PPP	Purchasing power parity
QNA	Quarterly National Accounts
SCLV	Securities Clearing and Settlement Service
SDRs	Special Drawing Rights
SEPA	Single Euro Payments Area
SGP	Stability and Growth Pact
SMEs	Small and medium-sized enterprises
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
TFP	Total factor productivity
ULCs	Unit labour costs
VAT	Value Added Tax
WTO	World Trade Organisation
XBRL	Extensible Business Reporting Language

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 (Estonian kroon)
IE	Ireland	EUR (euro)
GR	Greece	EUR (euro)
ES	Spain	EUR (euro)
FR	France	EUR (euro)
IT	Italy	EUR (euro)
CY	Cyprus	EUR (euro)
LV	Latvia	LVL (Latvian lats)
LT	Lithuania	LTL (Lithuanian litas)
LU	Luxembourg	EUR (euro)
HU	Hungary	HUF (Hungarian forint)
MT	Malta	EUR (euro)
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	EUR (euro)
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 (10^9).
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.

CONTENTS

1 Introduction

In 2010, and although GDP fell by 0.1 % over the year on average as a result of the carry-over effects of the previous year's declines in output, the Spanish economy initiated a very sluggish and hesitant recovery amid the sovereign debt crisis in Europe. The situation created poses most considerable future challenges. These involve ensuring the success of the fiscal consolidation programme, the completion of the far-reaching restructuring and recapitalisation of the financial system, and the implementation of structural reforms enabling imbalances to be fully corrected and that would set the economy once more on a path of sustained long-term growth.

2 The sovereign debt crisis

The world economy continues on the path of recovery initiated in 2009, against a background of rising inflation...

The ongoing recovery in the economy continued last year and in 2011 to date, accompanied by a progressive normalisation of the financial markets which, however, were not free from bouts of instability. Of particular note were the episodes on the euro area sovereign debt markets, which have posed the biggest challenge to the common European project since its creation. Inflation has been moving on a rising trend, despite starting from moderate levels in the case of the advanced economies. The acceleration in prices has been largely linked to the cost of commodities and, in the case of the emerging economies, to greater demand-side pressures, too. This tendency has been more evident since December, due to the sharp rise in oil prices resulting from the political instability in the North African and Middle Eastern countries.

… with a marked divergence between the advanced and emerging economies, and considerable heterogeneity across the former

The 5 % increase in world output in 2010, following the 0.6 % decline in 2009, encompasses very different growth rates across the various geographical regions. The emerging economies, which had been less affected by the financial crisis, picked up more rapidly, with a 7.2 % increase in GDP. This headway was largely domestic demand-led and began to be manifest in certain signs of overheating and inflationary pressures. The advanced economies, meanwhile, posted growth rates of around 3 %, largely underpinned by inventories and public-sector support to demand. That said, fragility persisted in certain sectors, such as the real estate and financial industries, and the labour market was lacklustre. Standard indicators continue to show a relatively wide output gap, which helps explain the contained course of core inflation. Yet within this group of economies there have also been significant differences. In particular, the recovery is moving at a slower pace in Europe, with GDP growth of 1.7 % in the euro area in 2010 and of 1.4 % in the United Kingdom, in contrast to the greater dynamism of the United States and Japan (2.9 % and 4 %, respectively; see Chart 1.1). Even within the euro area there were significant differences in economic activity across the Member States, with vigorous GDP growth in Germany and Finland and significant declines in Greece and Ireland.

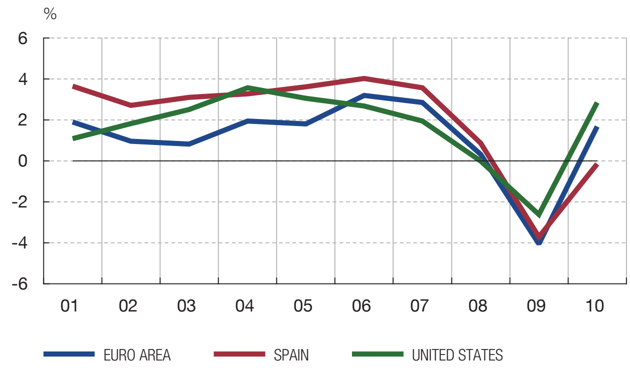
The economic policies adopted also showed divergences, both regarding monetary policy...

Over the course of 2010 there was notable disparity in the economic policy stances applied, reflecting the differences in the cyclical position of the economies in question, the various constraints on their economic policies and the diversity in the assessment of the risks that expansionary measures entail. Regarding monetary policy, the United States adopted further unconventional stimulus measures based on enlarging the Federal Reserve's balance sheet by means of the direct purchase of – essentially government – securities. This quantitative easing strategy, set in train at the outset of the crisis, was added to with a further programme of staggered purchases for a value of $600 billion (QE II) to combat deflationary risks and the signs of weakness that emerged in mid-2010. In the euro

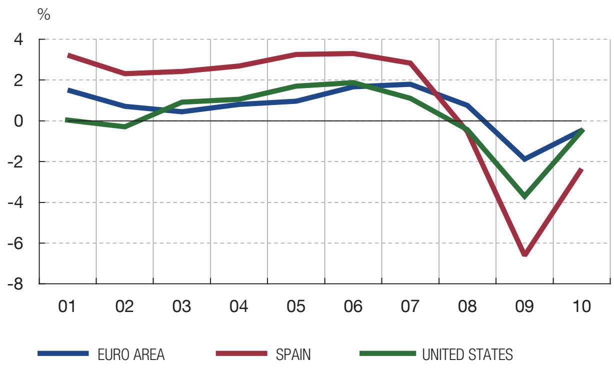
GDP, PRIVATE CONSUMPTION, EMPLOYMENT AND GROSS FIXED CAPITAL FORMATION

CHART 1.1

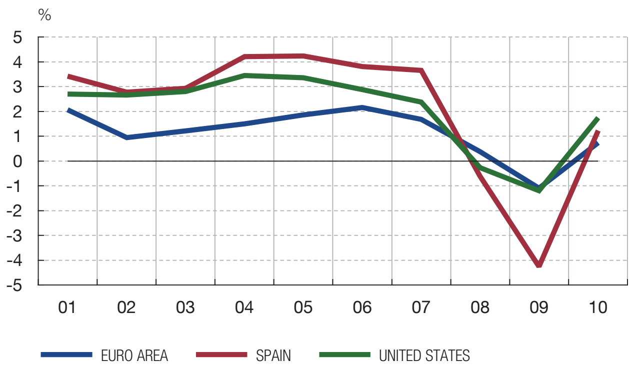
GDP



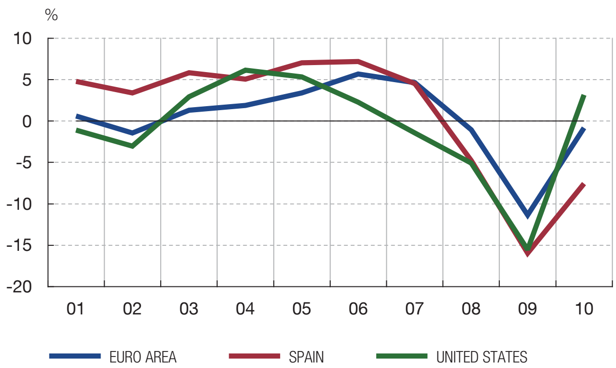
EMPLOYMENT



PRIVATE CONSUMPTION



GROSS FIXED CAPITAL FORMATION



SOURCES: Eurostat and national statistics.

area, monetary policy remained accommodative, but no additional expansionary measures were implemented. Some of the exceptional measures adopted beforehand have gradually been withdrawn; however, given the major tensions on euro area sovereign debt markets, the Securities Market Programme was set up, centred on the purchase of the government bonds of the countries most affected by these tensions so as to preserve the efficiency of the monetary policy transmission mechanism. Conversely, among the emerging economies, adopting a contractionary stance prevailed in response to growing inflationary pressures, a stance which, in some cases, clashed with a reluctance to let the exchange rate float sufficiently freely.

… and, especially, fiscal policy

The differences have proven particularly significant in the fiscal policy arena. In the United States and Japan, the continuing priority was to provide support mechanisms for the recovery, which took the form of new fiscal stimulus plans in both countries. The US budget deficit is thus expected to have stood at around 10 % of GDP at end-2010, with public debt close to 100 % of GDP. Conversely, both in the United Kingdom and in the euro area, vigorous fiscal consolidation processes were undertaken. In the case of the euro area, sovereign debt market tensions clearly put the focus on the risks inherent in a widespread situation of excessive deficits in the Member States, obliging members to take ambitious and swift corrective measures to quell investor doubts over the sustainability of public finances. These doubts, however, did not spread to economies such as the United States or the United Kingdom, despite the large scale of the deficit and public debt in both cases.

The recovery is expected to continue at a moderate rate, against a background of greater inflationary pressures …

The projections available suggest a central scenario for the world economy in which growth will continue to firm over the next two years, at a slightly lower rate than in 2010 but on sounder foundations. This would come about essentially from the application of economic policies whose stance will, broadly, be more contractionary, though not so in the United States. The heterogeneity across geographical areas which characterised the behaviour of GDP last year would be maintained in this scenario.

It is also likely, according to these same projections, that inflationary pressures will increase over the current and the two following years. As in the case of growth, there will be a continuing duality between the emerging economies, where the risk of overheating is higher, and the advanced economies, for which price growth rates are anticipated that, in the absence of second-round effects associated with the rise in commodities costs, would be more contained, in a setting of rather lacklustre employment growth.

… not free from risks

Significant risks surround this central scenario and, though they have tended to diminish, they continue to point to lower growth rates. Such risks include, primarily, those arising from the increase in oil prices, whose ultimate effects on inflation and activity will depend on how long the oil price holds at high levels and how it passes through to the prices of other goods and services, i.e. on the materialisation or not of the so-called indirect and second-round effects. Doubts about the soundness of public finances, the slowness of the return of real estate markets to a normal footing and high private-sector debt in some advanced economies might also check the recovery more than expected. The catastrophes in Japan, too, might have an impact on the world economy which, at present, is still difficult to assess. The pace and pattern of correction of the so-called "global imbalances" remain a source of uncertainty. Finally, as regards the necessary resizing of the financial sector and the restructuring of its regulatory frameworks, there has been progress. Yet the risks that may still arise from the behaviour of the international financial markets should not be underestimated.

There has been further headway in revising international financial regulation, so as to improve prevention and resilience in the face of potential future financial crises

Turning to financial regulation, where the need for far-reaching change became evident with the crisis, the global work led by the G20 has continued, with the Financial Stability Board playing a leading role. Mention should also be made of the recent Basel III Accord, which introduces new capital and liquidity requirements for banking systems. Together, they provide a common reference framework for the deep-seated reforms to national regulatory systems that are needed to correct the weaknesses revealed by the global crisis. The elements of this common framework include most notably enhanced transparency, closer monitoring of developments in the non-regulated financial system and tighter control of the systemic risks generated by financial institutions. This would be done by imposing greater countercyclical capital requirements, limits on the level of leverage and closer surveillance of remuneration arrangements so as to prevent these encouraging excessive risk-taking. Discussions also encompass other aspects such as taxes on financial activity or the establishment of appropriate mechanisms to manage and resolve potential bank crisis episodes. On the whole, this process has evidenced notable international coordination, which must be maintained in the future to ensure the success of the reforms.

Notwithstanding, the international financial markets remain subject to considerable tensions. And these are particularly visible in the euro area sovereign debt markets. Any further episodes of instability here might translate into a tightening of financial conditions that would have unfavourable consequences for corporate and household spending decisions in the economies affected. To properly gauge the scale of this risk, the fundamental reasons behind these tensions should be analysed in detail.

The sovereign debt crisis in Europe began in Greece and spread rapidly to the whole of the area

Tensions in the euro area sovereign debt markets began to brew in late 2009 as a result of investors' growing doubts about Greek public finances. The instability spread initially to the sovereign debt of those economies already perceived to be prone to greater vulnerability. Such perceptions were based on their fiscal position (whether because of the high level of debt or deficit, or because of the pace at which either of these variables was deteriorating), the fragilities in their financial system and the presence of relatively weak foundations for sustaining economic growth. But the problems also reached stock and foreign exchange markets and gave rise to a progressive loss of confidence by international investors which ultimately fed through to bank wholesale funding markets, causing serious liquidity problems to some institutions. As a result, the stability of the financial system of the area as a whole was affected, revealing the tight links between institutions and financial markets within the euro area.

The reluctance of the Greek authorities to request financial support and the doubts expressed by European governments and authorities over the substance and form of any such support were a breeding ground for heightening tensions, which reached a critical point in May. That month saw the approval, finally, of a financial support package for Greece worth €110 billion, strictly conditional upon the Greek authorities adopting an ambitious economic adjustment programme. The funds were contributed by the euro area governments and by the International Monetary Fund. It befell the European Commission and the IMF, in collaboration with the ECB, to supervise compliance with the terms of the agreement. To curb the growing contagion of the tensions, the European Financial Stability Facility was instituted to run to 2013 and be capable of mobilising, along with the EC (through the European Financial Stability Mechanism) and the IMF, funds worth up to €750 billion to provide financial assistance in similar cases and under conditions that could also be equated to those of the Greek programme.

The Irish financial system crisis fanned tensions anew, as did the difficulties in adopting the necessary economic measures in Portugal and concerns over the Greek Treasury's ability to return to the market in 2012 as planned...

These decisions contributed to easing tensions, as did too the publication in July of the results of the banking stress tests conducted under coordination across Europe, which offered a picture of banking system stability. However, over the summer and autumn a new source of tension arose, centred this time on the ongoing deterioration of the position of Irish banks and on the consequences of the situation for Irish public finances. Once again, following an initial phase of some reluctance, the Irish authorities finally and formerly requested financial assistance. Their request was approved and took the form of a conditional programme, like that for Greece, worth €85 billion. In April 2011, Portugal joined the group of countries having to request financial assistance in light of its government's difficulty in carrying out the adjustment and reform plans needed and of the worsening of financial market conditions. On 16 May Ecofin approved the related aid programme. Weeks later, the continuing high sovereign spreads in Greece and the worse-than-expected behaviour of its main macroeconomic variables led to investor nervousness about Greece's ability to return to the markets for funding in 2012, as envisaged in the financial assistance programme. Since the Greek authorities and governments of the rest of the euro area were unable to promptly define the strategy to pursue in light of this eventuality, tensions heightened, fuelled by untimely debates about how realistic certain traumatic scenarios were.

...and they made it necessary to change with relative urgency the fiscal policy stance across the entire area

In all three cases, the macroeconomic adjustment packages on which financial support was conditional envisaged ambitious fiscal consolidation programmes geared to restoring the soundness of public finances and thereby restoring investor confidence. In the rest of the area, the tensions experienced on the sovereign debt markets exerted the same effect.

Fiscal consolidation plans were brought forward and stepped up notably in Spain, with structural reforms being introduced at the same time. In Italy, Germany and other economies in the area, austerity programmes were likewise finalised with a view to their application as from 2011. The sovereign debt crisis prompted not only a need to abandon the expansionary approach with which fiscal policy had responded in Europe to the initial wave of the international financial crisis, but also some urgency to reverse it. The traditional positive effects on growth of an expansionary fiscal policy (Keynesian effects) were exhausted and were rapidly replaced by others that operate to the detriment of activity. These are associated with the increases in long-term interest rates that occur when investors perceive a deterioration in the soundness of public finances and which ultimately prompt a fall-off in private spending (Ricardian effects).

The primary and principal source of the sovereign debt crisis lies in the major imbalances built up in certain Member States…

The euro area sovereign debt crisis is essentially the result of a series of imbalances and mismatches built up in the economies of certain Member States and their sudden emergence and worsening as a result of the global economic and financial crisis. With differing degrees of influence in each case, these imbalances include most notably the continuous losses in the competitiveness of some economies; the excessive size of the financial sector and its excessive accumulation of risks, in other countries; and the high levels of private debt prompted, in certain cases, by an expansionary single monetary policy stance insufficiently offset by the action of the other strands of economic policy in the hands of national authorities. Before the crisis, several Member States had high levels of public debt, accentuated on occasions by the existence of contingent public liabilities linked to the progressive ageing of the population or to the potential need to undertake banking system restructuring. The marked deterioration in budget deficits resulting from the operation of the automatic stabilisers and from the application of discretionary expansionary measures, the loss of extraordinary income linked to certain sectors such as the real estate and financial industries, and the influence of the support programs to financial institutions which it proved necessary to implement in some countries also contributed to undermining market confidence in the soundness of public finances. A further factor weakening confidence lay in growth prospects, weighed down by relatively unfavourable productivity and potential growth developments. As is known, the financial markets have a tendency to overreact to news, whereby it is likely that, in this episode too, investors' response may have been excessive in some cases. But that should not mask the real scope of the problems that have emerged.

… whose effects were exacerbated as a result of a series of weaknesses in the structural design of economic governance in the area

The build-up of these imbalances without any mechanism in place to warn about their potential risks and their possible effects on the area also reveals the existence of weaknesses in the euro area's non-monetary economic policy coordination and surveillance mechanisms, which have acted as amplifiers of the tensions. The sovereign debt crisis has highlighted not only the limitations of the Stability and Growth Pact (SGP) and of national fiscal frameworks in promoting a sufficient degree of fiscal discipline, but also the inadequate attention to the accumulation of macroeconomic imbalances that are not necessarily fiscal in nature, as mentioned in the previous paragraph. Further, the scale of the tensions, their contagiousness and their interrelatedness with the thrust of the discussions on how to address economic governance in the area are by no means unrelated to the absence of powerful formal mechanisms to resolve situations such as those experienced by Greece, Ireland and Portugal, and to the difficulties involved in setting such mechanisms in place amid a crisis.

The tensions on financial markets also influenced the decisions of the ECB…

The tensions on financial markets and, in particular, those created by the increase in sovereign risk, affected the monetary policy transmission mechanism and obliged the ECB to take measures supplementing those it had already adopted in response to the crisis. More specifically, the absence of medium-term inflationary pressures meant that the ECB Governing Council was able in 2010 to retain its expansionary monetary policy stance in the euro area, holding official interest rates unchanged at the minimum level of 1 %. However, to ensure the effective transmission of its decisions, the Eurosystem continued to apply credit support measures, concentrated mainly in the ample provision of liquidity. In addition, the strong tensions on some public debt markets led to the Securities Market Programme being implemented. During the year, nonetheless, the covered bonds purchase programme expired, and repayment fell due of the special longer-term loan operations that had been introduced at the critical points of the international financial crisis. Accordingly, a sizeable portion of the excess liquidity was reabsorbed without giving rise to tensions on interbank markets, which shows how the progressive normalisation of these markets continued apace last year.

… which faces the challenge of bringing financial conditions back onto a normal footing against a background of inflationary risks, slow recovery and tensions on debt markets

In the immediate future, euro area monetary policy will be at a complex juncture that poses significant challenges. The gradual withdrawal of the exceptional measures in place should be carefully calibrated to avoid interfering in the normalisation of financial markets while preventing, too, the maintenance of the measures for too long from reducing the effectiveness of monetary policy, detracting from the ECB's credibility, distorting the relative prices of assets and delaying the reforms needed in certain segments of the European banking sector. At the same time, the rise in commodities prices and the difficulties of assessing their medium-term trajectory are a further complication. This may hamper the adjustment of the monetary policy stance to a scenario in which the consequent risks of indirect and second-round effects that might endanger continuing price stability combine with a slow rate of recovery and, therefore, the slow closure of the output gap, and with a still-uncertain situation on financial markets. Against this background, the ECB Governing Council decided at its April 2011 meeting to raise official rates by 25 bp.

The European institutions likewise face the need to reform economic governance

The challenges for the other European institutions are likewise significant. First, they must successfully overhaul the euro area's economic policy coordination and surveillance mechanisms. As explained in greater detail in Chapter 4 of this Report, the reform targets greater and more effective coordination of national policies, which should move within agreed limits and which will be subject to mutual, rigorous and effective surveillance. The recommendations of the so-called "Van Rompuy Working Group" were, along with the attendant EC proposals, the first steps of a process that should conclude this summer. The measures being considered may be classified under three major headings: those aimed at ensuring greater fiscal discipline, through the strengthening of the SGP; those geared to introducing a new mechanism for monitoring macroeconomic imbalances and competitiveness; and the design of a permanent crisis-management mechanism. Under no circumstances are changes that might require an amendment of fundamental aspects of the EU Treaty envisaged, thereby avoiding the risk of an unwanted stretching out of the reform.

January 2011 saw the start of the European Semester

As part of the reform programme, the EC published in early 2011 the first Annual Growth Report, thus inaugurating the "European Semester" of economic policy coordination. For the first time, the Member States and the Commission will jointly analyse the risks to macroeconomic stability, headway in fiscal consolidation, and the structural reforms and other necessary measures for promoting growth. The European Council's recommendations should be taken into account in preparing the national budgets for 2012 and in the implementation of other national economic policies. Along the same lines, the new "Europe 2020" strategy, aimed at increasing European growth potential, has entailed introduction of a series of emblematic initiatives at the European level, geared to supporting member countries' reform drives.

The governance reforms must be commensurate with the challenges facing the EU, and due attention should be given to the problems the situation in Ireland, Portugal and Greece may pose in the short term

The success of these reforms and their degree of ambition will determine whether the new governance framework is indeed able to withstand the challenges facing the EU. The sovereign debt crisis has highlighted the need to strengthen the European institutional framework and, particularly in the case of the euro area, to attune it to the high degree of integration and economic interdependence attained among its members. A sufficient degree of automaticity and reasonably restrained implementation schedules both for procedures and, where appropriate, for sanctions, will help ensure that the sound working of the mechanisms does not depend on national governments' willingness to meet the commitments entered into.

In this respect, the European Summit on 24-25 March 2011 gave fresh impetus to the legislative reform process that will underpin the new framework for the prevention and correction of fiscal (i.e. a strengthened SGP) and non-fiscal (the creation of the excessive imbalance procedure) imbalances. The Summit also laid down the core principles for a new, permanent crisis management and resolution mechanism that will come into force from 2013 (the European Stability Mechanism), and it approved the "Euro Plus Pact", which enshrines the Member States' political commitment to adopt measures aimed at improving competitiveness, increasing employment, ensuring the sustainability of public finances and reinforcing financial stability in the area. However, more immediately ahead, the situation in Ireland, Portugal and, especially, Greece poses a challenge whose scale should not be underestimated. The transition to this new, reinforced European governance framework is taking place amid the harshest crisis the euro has faced since its creation. If this complex situation is not tackled with the resolve required to overcome it conclusively, the common European project might undergo a setback whose consequences are difficult to foresee and which would jeopardise the success of the efforts made to date.

The European Systemic Risk Board has also started operating in 2011

Another of the structural shortcomings highlighted by the crisis is the absence of macroprudential and eminently pre-emptive economic policies aimed at ensuring the stability of the financial system as a whole and at minimising the effects of instability on the real economy. A consensus has been built around the need to develop a set of early-warning instruments to detect the potential build-up of macroeconomic and financial imbalances capable of leading to large-scale financial crises. The development of macroprudential policy is being addressed through a number of national and international initiatives. These include most notably, within the EU, the institution of the European Systemic Risk Board (ESRB) which, along with the three new European supervisory authorities with a microprudential remit for the banking, securities and insurance sectors, comprise the new European supervisory architecture (the European Financial Supervision System).

At the level of the Member States, the challenges entail fulfilling the fiscal consolidation measures…

The success of the action undertaken at the European level will hinge crucially on whether it is complemented by the measures adopted at the level of the Member States. As regards public finances, the euro area governments have formally undertaken to adopt all the measures needed to meet the fiscal targets envisaged under the excessive deficit procedures. Some countries have adopted additional commitments to speed through the fiscal consolidation foreseen under these procedures and to provide greater guarantees as to the sustainability of their public finances. Such progress towards laying the foundations for a prudent fiscal policy that ultimately provides for the return to a path of balanced and sustainable growth is crucial at the current juncture.

… and adopting the structural reforms needed to promote potential growth and

Now the limits of expansionary demand policies have been reached, structural reforms aimed at increasing the responsiveness of economies to shocks, at making them more flexible and at raising, in the medium term, growth potential and the capacity to achieve employment, along with the restructuring of national financial systems and the reform of their regulatory frameworks

full employment of productive resources should be the chief priority of economic policy action. Along these lines, the Europe 2020 strategy offers a coherent framework to Member States for implementing a co-ordinated and comprehensive programme of structural reforms, which are vital to boost European growth. Finally, it is important that the ongoing restructuring, resizing and recapitalisation of the crisis-hit European banking systems should be satisfactorily concluded. Along with the above-mentioned global regulatory reforms, these should serve to entrench a sound financial system capable of contributing effectively to economic growth through the efficient intermediation of financial flows.

3 The Spanish economy in the face of the sovereign debt crisis

The sovereign debt crisis had a forceful impact on the Spanish economy…

The financial tensions that rocked European markets from May forcefully impacted the Spanish economy. The main channel of transmission was the diminished confidence of the markets, which was quite acute at certain points in the year, coinciding with the bouts of maximum tension in Greece and Ireland. In an economy like Spain's that is strongly dependent on external saving, these episodes translated into a tightening of lending standards, markedly so for the Treasury and credit institutions. Spain's sovereign debt spread against the German benchmark was subjected to various bouts of pressure which saw it widen to close to 300 bp at the most critical points. Difficulties spread also to the banking sector, which for many months found access to the wholesale markets substantially blocked. And this, temporarily, significantly increased Spanish banks' recourse to the Eurosystem.

As in the case of the other euro area countries, the tensions involved an element of overreaction by investors. But it would be mistaken to dismiss the importance of the problems underlying these tensions. The aforementioned weaknesses of the European institutional framework and the doubts generated about the commitment of European governments in general, and of Spain in particular, to tackle structural problems and deteriorating public finances also played a key role in the initial stages of this latest round of financial instability.

… owing to underlying factors that placed our economy in a position of vulnerability

The vulnerabilities that had emerged further to the crisis seriously increased the Spanish economy's exposure to this type of turbulence, at a particularly delicate juncture. The crisis had given rise to a rapid deterioration in public finances, manifest not only in a very high budget deficit level, up to 11.1 % of GDP in 2009 from a surplus of 1.9 % two years earlier, but also in the swift rise in the public debt ratio, despite the fact that general government debt remained far lower than that of other European economies facing similar pressures. Moreover, the surge in the unemployment rate, as a consequence of the depth of the recession in Spain but also of labour market dysfunctionalities, raised doubts about the possibility of reversing the course of public spending in the absence of reforms conducive to reducing unemployment and boosting growth.

During the upturn prior to the crisis, Spain had become very dependent on external financing, a situation that persisted – albeit to a lesser extent in 2010 – and which increased the economy's vulnerability to episodes involving a loss of confidence. These episodes hampered access to the external financing that had been routed through credit institutions, whose role was seriously diminished by the doubts over specific segments of the banking industry, related to the scope of the impact of real estate asset impairment on the soundness of their financial position. Lastly, high household and corporate debt and the cumulative losses in competitiveness, the result of spending excesses during the upturn, were perceived by investors as a check on the recovery of expenditure, whereby the uncertainty spread also to the economy's growth capacity, once the real estate excesses had been corrected.

As the fiscal crisis unfolded, some of these vulnerabilities elicited parallels – in many cases unfounded – with the experiences of the Greek and Irish economies, which had to resort to external financial support conditional upon harsh adjustment programmes overseen by the IMF and the European institutions. The labelling of certain countries on the basis solely of the nature of their difficulties, as opposed to the actual scale and potential scope of such difficulties, has been a further factor amplifying the market tensions that have affected the Spanish economy. These financial strains hampered the ongoing adjustment and resizing of the financial system, eroded the confidence of households and firms, which had embarked on a process of slow deleveraging, and further checked the pick-up in private spending.

4 The adjustment and re-balancing of the Spanish economy, and the turnaround in economic policy

The sovereign debt crisis prompted an abrupt turnaround in the economic policy stance

Economic policy reacted with an abrupt shift in stance in the required direction, which had a key bearing on the course of spending and on macroeconomic developments in Spain during the period analysed in this report. Given the source of the tensions, it was vital to dispel doubts over the trajectory of public finances through a demanding fiscal adjustment plan that would ensure compliance with the goals of the Stability Programme for the 2010-2013 period. In parallel, there was clearly a compelling need to tackle the labour market shortcomings that were hampering the absorption of unemployment and the adjustment to the economy, through the reform of some of the institutional determinants of the labour market. Lastly, in the financial arena, bank restructuring was speeded up, a far-reaching reform of the regulation of savings banks was set in train (providing, inter alia, for the transfer of their financial activity to newly created institutions structured in the form of banks and encouraging the entry of private capital into the sector), unprecedented transparency measures were taken and capital requirements were increased so as to dispel doubts about their solvency, even in scenarios of exceptional tension. All these measures are analysed in greater detail at a later stage, when economic policy challenges are addressed.

The Spanish economy began a slow recovery in 2010

In 2010 the Spanish economy slowly embarked on a course of recovery, posting positive GDP growth rates throughout the year, except in Q3. At the same time, progress was made on the adjustment of the imbalances that had built up during the upturn. The correction of the excess in real estate investment, the reduction in net borrowing abroad and the deflationary path in labour costs and final prices all continued, and were joined by the start of a reduction in the budget deficit. The outstanding balance of private-sector credit stabilised, although the sector's debt held at a high level which continued to influence spending decisions. During the opening months of 2011 the pattern of sluggish recovery continued, and GDP posted a growth rate of 0.3 % in Q1, placing the related year-on-year rate at 0.8 %.

The recovery in 2010 began with some delay and less intensity than that of the euro area countries as a result of the greater scale of the crisis in Spain and of the impact that the necessary process of adjustment is exerting on short-term growth rates. The recovery in output was subject, however, to oscillations during the year as a result of certain temporary measures acting on the path of domestic spending. Specifically, the rise in VAT scheduled for 1 July and the foreseeable end of some of the expenditure-promoting public aid programmes (such as the State Fund for Local Investment and the car scrappage scheme) led some spending decisions to be brought forward to the first half of the year, while the effects of the austerity measures approved in May, chiefly affecting the public components of national demand, were felt in the second half of the year.

Despite the gradually improving path referred to, GDP fell by 0.1 % for the year on average, the results of the carryover effect of the declines in output the previous year (3.7 %; see Table 1.1). Overall, domestic demand remained sluggish, influenced by the withdrawal of the public-sector expansionary impulse to aggregate demand, although the impact on

MAIN INDICATORS OF THE SPANISH ECONOMY (a)

TABLE 1.1

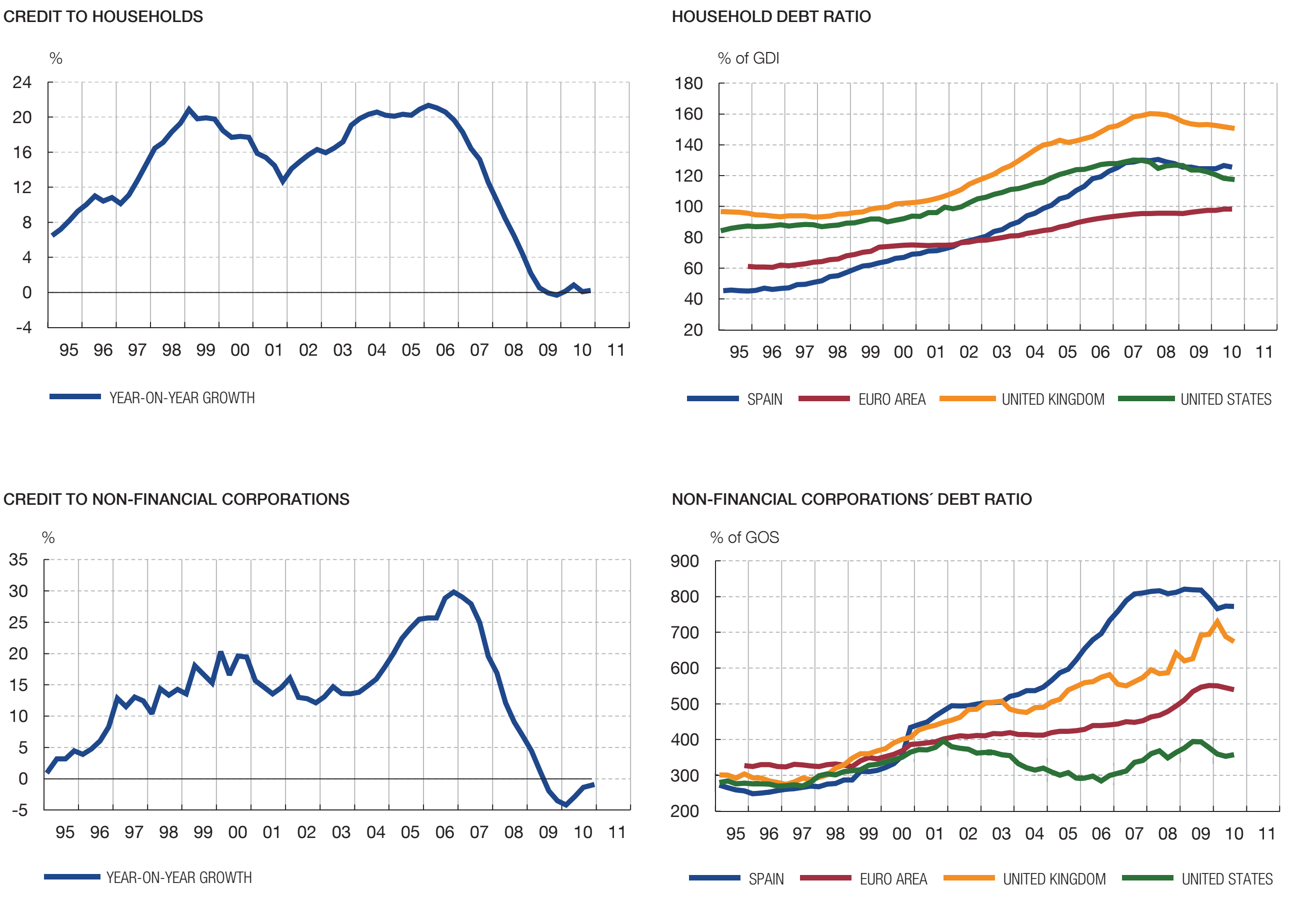
	2005	2006	2007	2008	2009	2010
DEMAND AND OUTPUT (b)						
GDP	3.6	4.0	3.6	0.9	-3.7	-0.1
Private consumption	4.2	3.8	3.7	-0.6	-4.2	1.2
Government consumption	5.5	4.6	5.5	5.8	3.2	-0.7
Gross capital formation	6.5	8.3	4.2	-4.3	-15.8	-7.0
Equipment investment	9.2	9.9	10.4	-2.5	-24.8	1.8
Construction investment	6.1	6.0	3.2	-5.9	-11.9	-11.1
Housing	6.1	6.2	2.5	-10.7	-24.5	-16.8
Other construction	6.2	5.8	4.0	-0.8	-0.1	-7.2
Exports of goods and services	2.5	6.7	6.7	-1.1	-11.6	10.3
Imports of goods and services	7.7	10.2	8.0	-5.3	-17.8	5.4
EMPLOYMENT, WAGES, COST AND PRICES (c)						
Total employment	3.2	3.3	2.8	-0.5	-6.6	-2.4
Employment rate (d)	64.3	65.7	66.6	65.3	60.6	59.4
Unemployment rate	9.2	8.5	8.3	11.3	18.0	20.1
Compensation per employee	3.7	4.0	4.8	6.4	4.1	0.7
Unit labour costs	3.3	3.3	4.0	4.9	1.0	-1.5
GDP deflator	4.3	4.1	3.3	2.4	0.6	1.0
Consumer price index (12-month % change)	3.7	2.7	4.2	1.4	0.8	3.0
Consumer price index (annual average)	3.4	3.5	2.8	4.1	-0.3	1.8
Consumer price differential with the euro area (HICP)	1.2	1.4	0.7	0.9	-0.5	0.4
SAVING, INVESTMENT AND FINANCIAL BALANCE (e)						
Resident sectors: saving (f)	22.9	22.6	21.5	19.9	19.3	19.1
General government (f)	4.5	5.7	6.0	-0.1	-6.6	-5.4
Resident sectors: investment	29.5	31.0	31.0	29.1	24.5	23.0
General government	3.6	3.6	4.1	4.0	4.5	3.8
Resident sectors: domestic net lending (+) or net borrowing (–)	-6.5	-8.4	-9.6	-9.2	-5.1	-3.9
General government	1.0	2.0	1.9	-4.2	-11.1	-9.2
General government gross debt	43.0	39.6	36.1	39.8	53.3	60.1
MONETARY AND FINANCIAL INIDICATORS (i)						
ECB minimum bid rate on MROs	2.0	2.8	3.9	3.9	1.2	1.0
Ten-year government bond yield	3.4	3.8	4.3	4.4	4.0	4.2
Synthetic bank lending rate	3.8	4.6	5.7	6.2	3.8	3.3
Madrid Stock Exchange General Index (DEC 1985 = 100)	1,060.2	1,324.0	1,631.8	1,278.3	1,042.4	1,076.5
Dollar/euro exchange rate	1.2	1.3	1.4	1.5	1.4	1.3
Nominal effective exchange rate vis-à-vis developed countries (h)	100.5	100.7	101.7	103.3	103.5	101.9
Real effective exchange rate vis-à-vis developed countries (i)	108.8	111.6	115.4	119.2	116.1	113.0
Real effective exchange rate vis-à-vis the euro area (i)	107.4	110.1	113.0	114.7	111.0	109.6
Cash and cash equivalents	14.4	11.3	-3.1	-3.3	8.6	-0.2
Liquid assets (l)	11.6	8.4	8.3	9.8	1.0	3.0
Households: total financing	20.9	19.6	12.5	4.4	-0.3	0.2
Non-financial corporations: total financing	21.4	27.9	17.7	7.9	-1.5	1.0

SOURCES: INE, IGAE, AMECO and Banco de España.

a The National Accounts data are calculated on the basis of base year 2000.
b Volume indices. Rate of change.
c Rate of change, except the unemployment rate, which is a level.
d Employment rate (16-64).
e Levels as a percentage of GDP.
f Includes net capital transfers received.
g Annual average levels for interest rates and exchange rates and rate of change for financial assets and liabilities.
h 1999 Q1 = 100.
i 1999 Q1 = 100. Measured with unit labour costs.
j Includes cash equivalents, other bank liabilities and money-market funds.

FINANCING OF HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS

CHART 1.2



SOURCES: INE, ECB, Federal Reserve, UK Office for National Statistics and Banco de España.

activity was softened by the positive contribution of net external demand, an effect in which the thrust of exports was predominant.

Household spending began to rise, driven by the increase in consumption …

Household spending showed its first signs of growth following two years of strong declines, although these were centred exclusively on the consumption component, since residential investment fell off once again. The pick-up in consumption was uneven over the course of the year since the rise in indirect taxation from July and the end of the car scrappage schemes prompted households to bring forward their spending decisions to the first half of the year, which lessened the volume of purchases in the final six months.

… despite the contraction in disposable income and the need to reduce debt

The recovery came about in a setting in which high debt continued to significantly restrain any greater buoyancy in spending and in which disposable income fell as a result of the decline in wage income and the lesser contribution of other sources of income that had underpinned it in the recession. There was a fall in the general government contribution which, although it remained expansionary in step with the situation of cyclical weakness still prevailing, accounted for a lesser amount owing to the withdrawal of the stimuli applied in prior years. Wealth also fell, albeit less sharply than in 2009, in both its financial and real estate components. Against this backdrop, the saving ratio fell sharply in 2010, breaking the upward course on which it had moved for three years, standing at 13.1 % of disposable income for the year on average. Set against the lacklustre spending described, the resort to borrowed funds was flat, although the low rates of credit received were ultimately insufficient to significantly reduce the sector's debt ratios (see Chart 1.2).

The contractionary path of residential investment, by contrast, continued...

Residential investment continued to contract, bringing its cumulative fall since the start of the downturn to almost 50 %, which placed the weight of residential investment at 4.7 % of GDP (4.5 pp down on the peak three years earlier), in line with the historical average. These figures suggest that the bulk of the correction of the real estate overhang in terms of activity has already been made. During the year, some housing demand indicators began to rise owing to the bringing forward of property purchases in the face of the tax changes that were introduced (the rise in VAT in July and the partial elimination of tax deductions effective 2011), but also to the improvement in affordability. This meant that, on available estimates that are not free from uncertainty, the stock of unsold housing ceased to increase in 2010, marking the start of a period of absorption of excess stocks which may be prolonged. House prices declined once again in 2010, and this trend continued into the opening months of 2011, placing the fall from the peak at 15.4 % (19.3 % in real terms). The scale of this decline is still less than that observed in the real estate slump in the 1970s, whereby further declines in house prices should not be ruled out.

... whereas the course of the different components of business investment was uneven

Investment by non-financial corporations during 2010 was uneven by component in a setting of tight lending conditions, excess accumulated capacity and limited headway in ongoing corporate deleveraging. Investment in capital goods picked up slightly following the collapse the previous year, influenced by the need to replace plant, the improvement in export markets and the impact of the plan to stimulate commercial vehicle purchases. By contrast, the component of investment in non-residential construction performed more negatively, as it was affected by the infrastructure investment cuts in the second half of the year.

The net lending capacity of the non-financial corporations sector continued to improve…

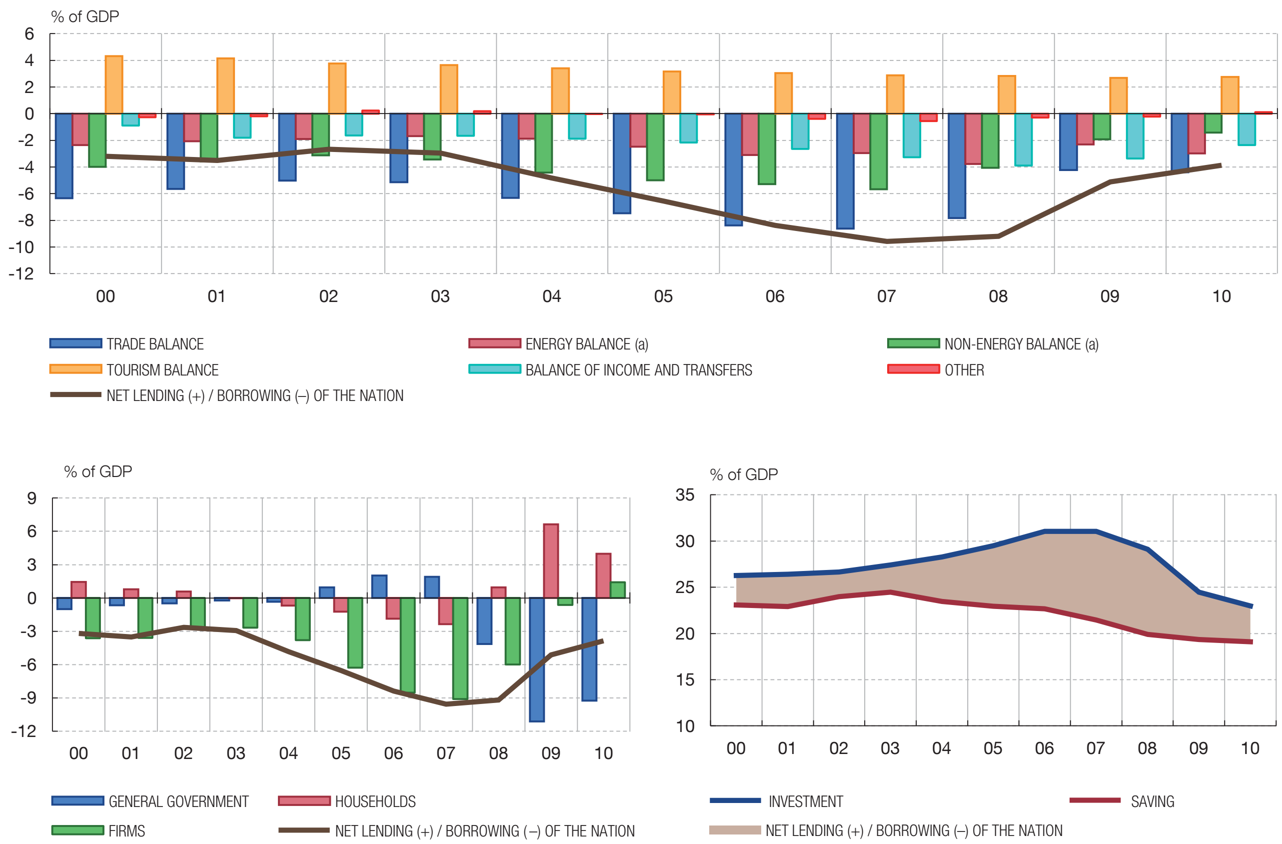
Over the course of 2010 the improvement in the net lending capacity of non-financial corporations continued. The increase in saving, far outweighing that in investment, meant that net lending was equivalent to 0.4 % of GDP for the year on average, an exceptional situation judging by its historical trajectory. This increase in corporate saving was largely based on ongoing staff cuts which allowed for a reduction in unit wage costs, although the significant cut in the interest burden as the lagged result of lower interest rates also contributed. In the case of households, the fall-off in saving, which was sharper than that in investment, led to net lending that was lower than the previous year but positive for the third year running, for an amount equivalent to 4 % of GDP.

…as did the nation's net borrowing, which once again declined

The behaviour of the private sector, along with the cut in the budget deficit, which stood at 9.2 % of GDP, prompted a fresh reduction in the nation's net borrowing to 3.9 % of GDP (see Chart 1.3). This marks a considerable improvement from the levels of maximum external dependence attained in 2007 (close to 10 % of GDP), although behind this are certain risk factors that should be mentioned. From the standpoint of trade with the rest of the world, the headroom for improvement in the trade balance seems somewhat exhausted owing to the adverse impact exerted by the energy bill, amplified in recent months by the hike in oil prices, and a marked decline in the deficit arising on investment income payments. Indeed, the pattern seen in 2010 is illustrative of the challenges that must be addressed in order to further reduce reliance on external saving in the future. A priority will be that exports should be able to continue benefiting from the pick-up in world trade with further adjustments in competitiveness and with the design of ambitious diversification strategies for our markets. It is likewise vital that import dependence be reduced, most particularly in relation to the energy component. It should be borne in mind that the possibility of reducing the income balance deficit, which was cut significantly in 2010, is restricted by the economy's high net debit position vis-à-vis the rest of the world and the current low level of interest rates.

NET BORROWING OF THE ECONOMY

CHART 1.3



SOURCES: INE, Customs and Banco de España.

a The energy and non-energy balance are an estimate of the Banco de España drawing on Customs data.

Job destruction continued for another year, eroding confidence and the capacity for recovery

The economy's capacity to generate jobs was once again weighed down by the ongoing slide in construction activity. This was influenced in 2010 by the fact that civil engineering works ground to a halt, following the cut in public investment under the fiscal austerity plan (see Chart 1.4). Uncertainty over the strength of the recovery, doubts over the scale of the reforms under way and the sluggishness of domestic expenditure further weighed on hiring decisions both in industry and in market services, which continued destroying employment, albeit to a lesser degree.

Labour supply expanded moderately, influenced by the fall-off in the working-age population…

The prolonged deterioration in the labour market altered the dynamics of labour supply, which expanded very moderately (0.2 %), far off the average rate of close to 3 % for the years 2005-2008. Behind this weak increase lies the loss of momentum of the working-age population seen since the previous year, and influenced by the sharp decline in net immigration flows (in the two years spanning 2009 and 2010, these flows were somewhat less than 10 % of the average for the period 2005-2008). This prompted a decline in the foreign working-age population, for the first time since 1990, and a 0.7 % decline in the foreign labour force. Notwithstanding, the participation rate rose slightly owing to the increase in female participation, since the attendant male rate and that of the younger cohorts reacted adversely to the cyclical situation.

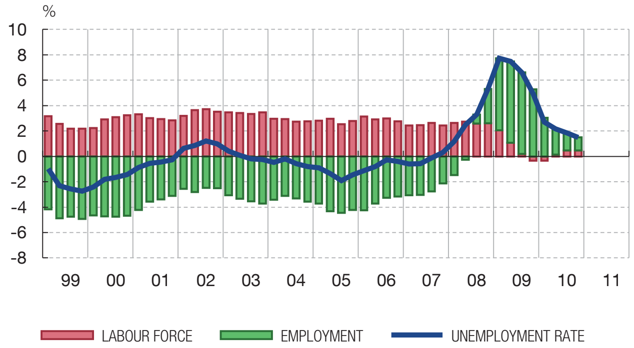
… but unemployment continued to rise, particularly sharply in the long-term component

Despite the check on the increase in the labour force, unemployment continued to rise in 2010, albeit at a more moderate rate than in previous years, and the unemployment rate climbed to 21.3 % in 2011 Q1. Unemployment affected youths, the less-skilled and foreigners more severely. Long-term unemployment rose sharply, accounting for 42.5 % of

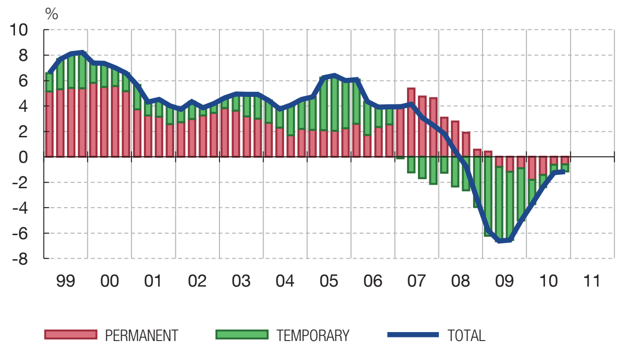
EMPLOYMENT AND UNEMPLOYMENT (a)

CHART 1.4

YEAR-ON-YEAR CHANGE IN THE UNEMPLOYMENT RATE
Contributions of labour force and employment



EMPLOYEES
Year-on-year rate and contributions



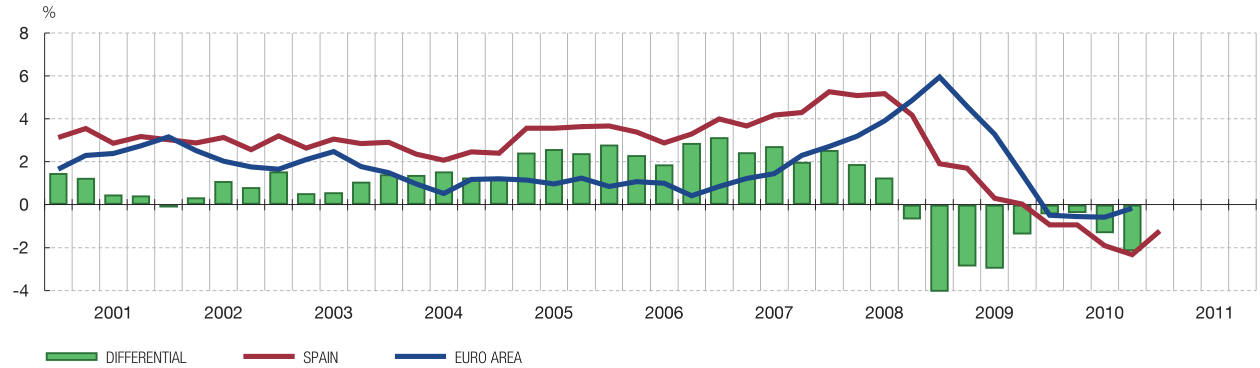
SOURCES: INE and Banco de España.

a The EPA (Spanish Labour Force Survey) series are linked on the basis of the 2005 Q1 control survey and the change in the definition of unemployment in 2001.

LABOUR COSTS

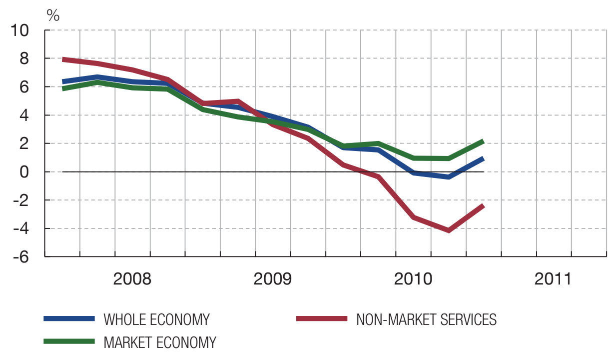
CHART 1.5

SPANISH AND EURO AREA UNIT LABOUR COSTS
Year-on-year rate



UNIT LABOUR COSTS
Year-on-year rate

COMPENSATION PER EMPLOYEE
Year-on-year rate



SOURCES: Eurostat and Banco de España.

a Year-on-year rates with sign changed.

the total for the year on average (46.6 % in Q1 this year). These figures are sufficiently illustrative of the scale of the challenge that bringing back an increasingly larger group into the labour market poses, and it presages a substantial increase in the structural component of unemployment, which demands an energetic economic policy response.

In the setting of labour market weakness, labour costs eased significantly

Against the background of labour market weakness, labour costs eased substantially during 2010. They did so more sharply in the second half of the year, owing to the direct and indirect influence of the cut in public-sector wages (see Chart 1.5). Compensation per employee increased by 0.7 %, in strong contrast to the 4 % increase recorded in labour costs in 2009. A significant portion of the slowdown was due to the change in trajectory of public-sector wages, which declined by 1.8 % (after having increased by 4 % in 2009 and by 7 % over the 2007-2008 period). The remainder was due to the slowdown in compensation per employee in the market economy, which increased at a rate of 1.4 % (compared with the rises of 3.7 % in 2009 and of 5.9 % in 2008, when the sharpest phase of the recession began). Behind this result lay the smaller increase in wage settlements, influenced by the recommendations of the Pact for Employment and Collective Bargaining entered into by the social partners in February 2010, and the absence of inflationary pressures, which in turn provided for a fall in market-economy unit labour costs, for the second year running. Collectively bargained wage settlements in the opening months of 2011 have evidenced a rise which, if it takes root, would jeopardise the improvements in competitiveness needed to reactivate output and employment.

And inflation rose forcefully owing to predominantly temporary factors

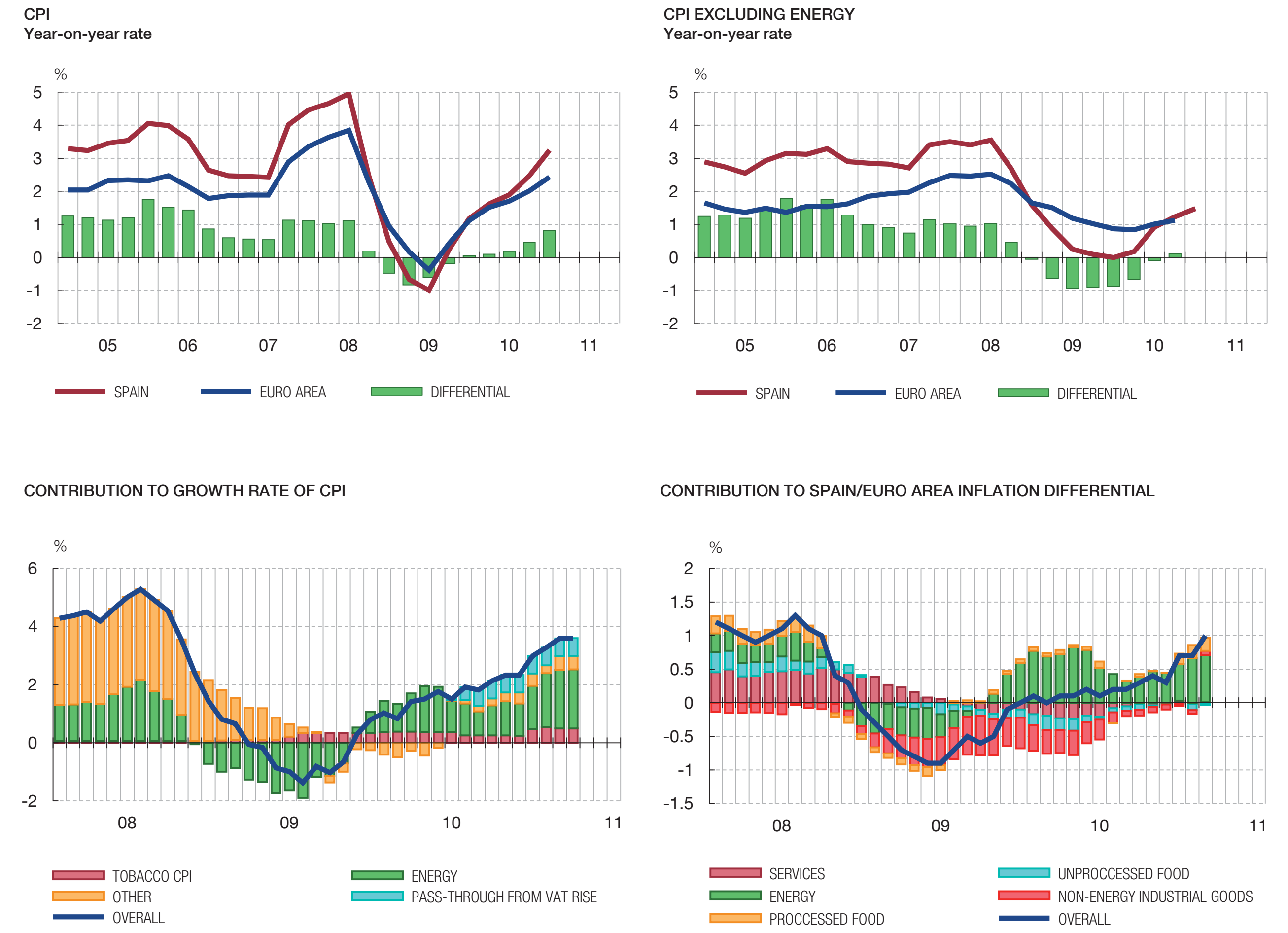
CPI inflation rose in the second half of the year, posting a year-on-year growth rate of 3 % in December 2010 (see Chart 1.6). It has continued on this trajectory to date in 2011, placing the year-on-year rate of change of consumer prices at 3.8 % in April, having been strongly affected by the sharp growth in oil prices in recent months. Much of this increase is due to essentially temporary factors, such as tax changes and regulated prices, and the upward course of commodities prices. They all have a direct and significant effect on price levels and on the inflation rate but, if there are no indirect effects on business costs, their impact will ultimately be stripped out of the year-on-year CPI rate after a year. To ensure the rise in inflation is temporary, it is thus vital that these indirect effects should be limited and that there should be no generalised revision of inflation expectations that ultimately affects final prices in a permanent way, either through the prices producers set or through wage bargaining. Any reluctance to accept the temporary losses in real income that the rise in energy prices and in indirect taxation entails for workers and companies would translate into more persistent inflationary pressures and into diminished possibilities of recovery and job creation.

The outlook for 2011 is one of slow recovery that is not exempt from considerable uncertainty

The outlook for 2011 is one of slow recovery and will involve great dependence on the ability to harness the momentum of the rest of the world through substantial improvements in competitiveness, allowing external demands to provide the support needed for the take-off in activity and employment. The pick-up in domestic demand is conditional upon the level of private-sector debt. This scenario is subject to great uncertainty and potential downside risks, associated with the tensions on financial markets that might continue to adversely affect financing conditions and economic agents' confidence. An added risk is that arising from the hike in oil prices, which may alter the course of recovery in the advanced countries and affect economic and financial agents' confidence. This shock may exacerbate the supply-side factors that have traditionally constrained flexibility and the potential for growth in the economy, and which stem from the interplay of high energy dependence with rigidity in cost and price formation in Spain. An easing in inflation and the adjustment of relative prices are essential prerequisites of recovery (see Box 1.1).

SPAIN/EURO AREA INFLATION DIFFERENTIAL

CHART 1.6



SOURCES: Eurostat and Banco de España.

5 The scale of the challenges and the responsibility of economic policy

The Spanish economy faces a difficult situation, and overcoming it will require ambitious economic policies

As highlighted in the previous sections, the tensions experienced by the Spanish economy were largely due to the vulnerabilities that emerged further to the financial crisis, vulnerabilities rooted in the macroeconomic imbalances that had built up during the long upturn. One year into this new phase of the crisis, linked to sovereign debt, the factors blocking a return to a path of sustained growth have not been fully eliminated and nor have the doubts over the economy's medium and long-term growth capacity, despite the shift in the economic policy stance. That all makes for a difficult situation that poses significant challenges, which include bolstering the recovery while completing the adjustments under way, restructuring the economy and restoring confidence.

In these circumstances, the economic policy response is pivotal and the role of the structural reforms central to seeing through the correction of the imbalances. The future trajectory of the Spanish economy will hinge on how demanding the response proves; and most particularly, on the speed and scale of the recovery and its capacity to generate employment. In the past, the pursuit at critical moments of ambitious reforms was key to promoting ongoing modernisation and real convergence. Within the euro area, the design and implementation of structural reforms is even more important because there is no exchange rate available to generate short-term gains in competitiveness and because the leeway for using expansionary demand-side policies has been exhausted. At the current juncture, there is a timely possibility that the adjustment effort may enable the full adaptation of the economy to the macroeconomic stability requirements that euro area membership entails.

THE ROLE OF PRICE AND WAGE FLEXIBILITY IN THE ADJUSTMENT OF THE SPANISH ECONOMY WITHIN THE EURO AREA

BOX 1.1

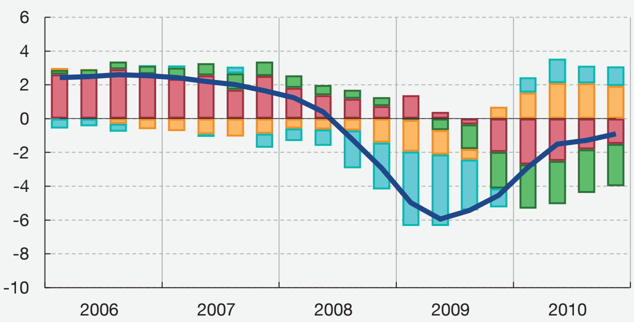
An economy's capacity for adjustment in the face of different shocks depends on a series of structural and institutional characteristics, including most notably the adaptability of prices and wages to changes in their fundamentals. In the case of the Spanish economy, wage- and price-setting mechanisms have given rise to a pattern of adjustment that leads to significant fluctuations in employment and activity, with prices and wages showing more inertia, as demonstrated by various recent papers.[1] In the latest crisis, for instance, the scale of job destruction was far greater than that in other euro area countries where the fall in GDP was of a similar magnitude; subsequently, the difficulties faced by the Spanish economy in generating net employment mean that emerging from the crisis is proving more belated and less intense. Therefore, it is worth questioning to what extent the presence of price and wage rigidities has been a relevant factor in the recession and may hold back the current phase of recovery.

To illustrate the scope of these questions, use is made below of a general equilibrium model (called BEMOD) estimated for the Spanish economy within the Economic and Monetary Union. It reflects the various degrees of nominal and real rigidity existing in Spain and the rest of the euro area, in the form of different values estimated for wage indexation or for the frequency of revision of prices and wages in the face of changes in their determinants, such as marginal cost and the reserve wage, respectively.[2] It should be borne in mind that BEMOD explicitly models no financial aspects other than interest rate movements and, therefore, these results, like all those obtained from highly stylised models, should be

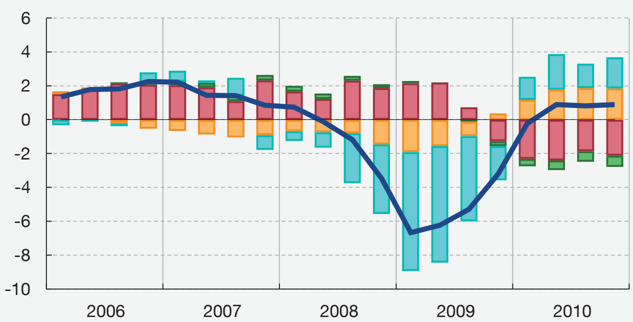
1 For the case of wages, see, for example, P. Cuadrado, P. Hernández de Cos and M. Izquierdo (2011), "Wage adjustments to shocks in Spain", *Economic Bulletin,* April, Banco de España. For price rigidities, a quantification for Spain and other European countries can be found in Dhyne et al. (2006), "Price Changes in the Euro Area and the United States: Some Facts from Individual Consumer Price Data", *Journal of Economic Perspectives.*

2 See the article by Andrés, Hurtado, Ortega and Thomas (2010), "Spain in the Euro: a General Equilibrium Analysis", published in SERIEs, vol. 1.

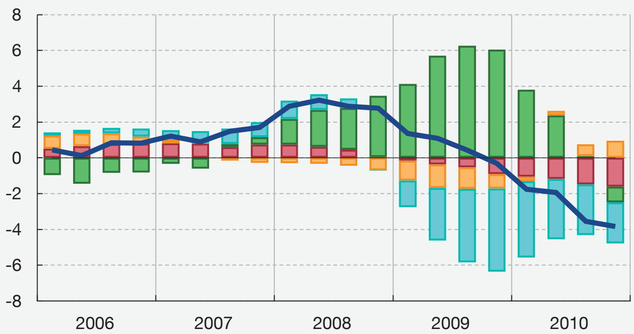
1 YEAR-ON-YEAR RATE OF CHANGE OF REAL GDP: SPAIN



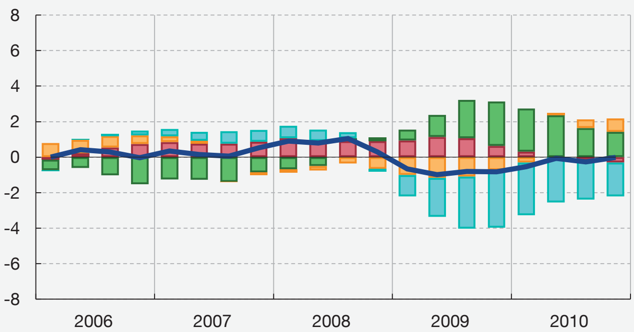
2 YEAR-ON-YEAR RATE OF CHANGE OF REAL GDP: REST OF THE EURO AREA



3 YEAR-ON-YEAR RATE OF CHANGE OF NOMINAL WAGES: SPAIN



4 YEAR-ON-YEAR RATE OF CHANGE OF NOMINAL WAGES: REST OF THE EURO AREA



OTHER SHOCKS: PRIVATE AND PUBLIC DEMAND, PRODUCTIVITY AND FROM THE REST OF THE EURO AREA
INTEREST RATE SHOCKS
DEVIATION OF THE GROWTH OF THE OBSERVED VARIABLE FROM ITS AVERAGE (a)
NATIONAL PRICE AND WAGE SHOCKS
SHOCKS FROM THE REST OF THE WORLD

SOURCE: Banco de España.

a The sum of the contributions of all the shocks envisaged is not equal to the actual growth rate of GDP or of wages, but to the deviation of this rate from its average in the period 1997-2009.

viewed with due caution.[3] In line with recent papers, the model estimates an average duration of prices of less than one year both in Spain and in the rest of the euro area, and of slightly more than one year in wages, as well as a moderate effect of past inflation on prices, which is more significant in the non-tradable sectors than in those exposed to international competition, and similar in both economies. However, the estimated degree of wage indexation is high in Spain and scarcely significant on average in the other European economies.

The model enables the various factors behind the fall in activity in Spain and the euro area during the latest crisis to be identified. The top panels in the accompanying chart depict GDP growth in Spain and in the rest of the euro area along with the contributions of the main shocks that made these economies deviate from their historical average growth pattern.[4] Of note at the start of the recession is the sizeable negative contribution of the "rest of the world" item, which captures, above all, the effect of the strong fall-off in world demand and which exerts a greater influence on the rest of the euro area than on Spain, which is less open to the rest of the world. It was also the pick-up in external demand that made a firmer contribution to the economic recovery in 2010 – once again to a greater extent in the rest of the euro area – along with the continuing expansionary stance of monetary policy, with lower interest rates than would be denoted by the estimated response in the model of these rates to inflation and growth (the estimated Taylor rule suggests that, for the observed decline in GDP and inflation, the reduction in interest rates might have been sharper and swifter). The red bars show a broad set of shocks, mainly those related to public demand (which had a very marked positive effect during the public stimulus programmes of 2008 and 2009, and a negative impact with the consolidation measures introduced in 2010) and national private demand (which posted very negative contributions in 2008 and 2009), but also those connected to productivity, and those from the rest of the euro area.[5]

Along with these contributions of various shocks to the crisis, a clearly negative effect on growth was identified in 2009-2010 owing to the insufficient adjustment of prices and wages to the changes in their determinants, even in relation to the above-mentioned gradual response estimated by the model, through a non-immediate resetting of prices and wages and of indexation to past price inflation, which was virtually non-existent in wages in the rest of the euro area, but close to 50 % in the case of wages in Spain. The contributions of the various shocks to wage developments represented in the lower panels of the accompanying chart show that wages grew in Spain above their determinants (the positive shocks are depicted by green bars) from 2008. In the absence of that rigidity, for example, wages would have declined by 1.4 % in 2009, compared with the 4 % growth observed. Given the delayed effect of wages on employment and activity, that would have prompted a positive impulse of 2.6 pp to GDP in 2010. In the rest of the euro area, although wages have outgrown their determinants since 2009, they have done so to a lesser extent than in Spain and their impact on activity is small.

With a view to the recovery phase ahead for the Spanish economy, it is therefore necessary to insist on the advisability of pursuing the required reforms so as to have a greater degree of price and, especially, wage flexibility. In the context of the euro area, the

3 Interest rates are modelled following an estimated Taylor rule where the short-term rates on which the ECB acts change in response to movements in inflation and activity in the euro area as a whole. That said, they may undergo shocks that make them take values above or below these fundamentals.

4 That is to say, the sum of the contributions of all the shocks envisaged is not equal to the GDP or wage growth rate, but to the deviation of this rate from its average value in the model's estimation period (1997-2008).

5 Some of these contributions are very significant individually, but on being grouped together they tend to cancel one another out, hence the relatively small size of the contribution of this set of shocks.

SIMULATION OF A 50% RISE IN OIL PRICES (a)

%

	Accumulated level differences in the second year compared with the baseline scenario			
	Spain		Rest of the euro area	
	Estimated rigidities	Flexible economy	Estimated rigidities	Flexible economy
GDP	-1.59	-1.14	-1.11	-0.93
Employment	-1.12	-0.62	-0.78	-0.57
Consumption deflator	1.74	1.34	1.18	1.01
Nominal wages	0.04	-0.82	-0.21	-0.76

SOURCE: Banco de España.

impossibility of devaluing our currency should be made up for by a degree of price and wage flexibility that provides for the possibility of gains in price-competitiveness. Such flexibility is, moreover, vital in a setting in which further shocks will come about, such as the recent rise in oil prices.

To illustrate how a reduction in these rigidities might help the recovery in the Spanish economy over the coming years, the accompanying table simulates with BEMOD the effects of a rise in oil prices under different scenarios. When the model is used with the degree of rigidity estimated with observed data, it can be seen that, given a persistent increase in oil prices of 50 %, GDP in Spain would decline by 1.6 pp relative to the baseline scenario after two years, and employment by 1.1 pp, also relative to the baseline scenario. In the rest of the euro area, however, the deviations in activity and employment would be only 1.1 pp and 0.8 pp, respectively, due to both their greater observed flexibility and to the lesser weight of energy in their productive processes and in their consumption basket. A simulation has also been performed of what would happen in a scenario of total wage flexibility in which the second-round effects on prices of an inflationary shock are cancelled out, such that both in the Spanish economy and in the rest of the euro area wage indexation disappears and wages are revised each quarter (this counterfactual scenario is rather extreme, therefore the quantifications obtained should be viewed with caution). In this case, the negative impact on GDP and employment in Spain would be smaller, because wages fall in the face of the decline in activity and employment, enabling the outcome of the shock to be a lesser adjustment in employment, and therefore also in GDP. As a result, faced with the same rise in oil prices simulated before, under this scenario of total flexibility 85,000 more jobs would be maintained, that is to say, approximately half the jobs would be destroyed in the second year as would be under the scenario with rigidities. In the case of the rest of the euro area, the differences between the two scenarios are smaller, since the degree of price and wage flexibility prevailing is closer to the counterfactual scenario of wage flexibility.

In the past year there has been a shift in the economic policy stance in three major areas

As indicated, over the past year reforms have been undertaken in three major areas: the restructuring and recapitalisation of the financial system[1]; fiscal consolidation; and structural reforms. The reform drive must persist and further progress must be made in these three closely interconnected areas.

In the financial area, a far-reaching process of write-downs, restructuring and recapitalisation is taking place.

In the financial area, the imbalances accumulated in a part of the banking sector (especially in certain institutions in the savings banks sector) led as early as 2009 to the adoption of measures aimed at prompting substantial write-downs along with the restructuring and recapitalisation of the segment, which is where investors' loss of confidence tended to concentrate. At the core of these imbalances were problems of excessive size, excessive concentration of real estate exposures and high dependency on wholesale market funding. Further compounding these imbalances were the difficulties arising from certain singular features of savings banks that have magnified the perception of these institutions' vulnerability: their particular ownership structure, an insufficiently robust corporate governance model, difficulties in raising top-quality capital on the markets and the complexities which, compared with other credit institutions, arise from a legal framework that sees measures taken at both State and regional government levels.

In 2009 the Fund for the Orderly Restructuring of the Banking Sector (FROB) was created. Its dual aim was to resolve in an orderly fashion potential situations of bank non-viability, and to pave the way for integration processes between viable institutions. In this latter case, financial support from the FROB was conditional upon the submission of an integration plan, containing the business and restructuring plans, which had to be approved by

1 There are more detailed analyses of the Spanish financial system and of its restructuring and recapitalisation in other specialist Banco de España publications such as the Financial Stability Report and the Report on Banking Supervision in Spain.

the Banco de España (Box 1.2 offers greater details on the FROB and on the other measures discussed below).

The process is considered vital to tackle confidence problems that have been exacerbated by the sovereign debt crisis…

The first wave of the sovereign debt crisis in spring last year entailed a widespread loss of investor confidence which, owing to the reasons indicated, particularly affected a group of countries of which Spain was part. Ultimately, these circumstances highlighted the need to speed through integration processes, so as to achieve synergies allowing cost cuts, the idea being to create better managed and more efficient institutions with a greater volume of assets that would be better placed to raise funding on the markets. The reaction was swift and took the form of the approval of a significant number of integration operations, most with the financial support of the FROB, which affected a highly significant portion of the savings bank subsector. As a result, the number of savings banks or groups of savings banks in this subsector has, as at the end of May, fallen from 45 to 18, while the integration plans approved envisage significant reductions in both the number of branches and in staff levels at the institutions involved.

In summer 2010 the highly detailed results of the stress tests conducted in coordination at the European level were published. In Spain's case the tests covered listed banks and all savings banks. The results showed that the Spanish financial system as a whole could withstand relatively unlikely extreme shocks, and that only four groups of savings banks would not, in the event the assumptions materialised, manage to maintain the levels of capitalisation required in the tests.

The restructuring and recapitalisation drive undertaken, along with the write-downs made by the institutions, were an appropriate response to savings banks' problems of excessive size and accumulation of risks, as confirmed by the stress tests. At the same time, savings bank reform legislation was passed in summer 2010, the main aim of which was to improve the governance of these institutions and their ability to raise own funds on capital markets.

These measures were also boosted by others taken at around the same time at the European (the financial support mechanisms and the unconventional monetary policy measures) and Spanish (fiscal consolidation and labour market reform) levels. Tensions began to abate after the summer and investor confidence started to pick up. There was thus a reduction in the risk premia on assets issued by the public sector and by financial institutions, and a gradual resumption of foreign capital flows.

… and later refuelled, again, by the tensions caused by the Irish banking crisis

However, this process was abruptly interrupted in the autumn as a result of the outbreak of the Irish banking crisis. Tellingly, as this episode was centred on the banking sector, it proved particularly harmful to the savings bank restructuring and recapitalisation process. The fact that the two Irish banks that had participated in and passed the aforementioned stress tests were an integral part of the problems substantially weakened investor confidence in the results of the tests. Thereafter, bank funding costs once again began to rise and the difficulties in gaining access to the wholesale markets increased. Spanish credit institutions, and especially savings banks, thus saw how much of the headway made thanks to the previous reformist drive was lost.

In November, the Banco de España imposed a particularly intense transparency exercise on savings banks to obtain a proper picture of their situation. Prior to end-January 2011, it published detailed data on their exposure to the real estate development and construction sector and on the volume of wholesale funding and their liquidity situation, the two factors

SPANISH BANKING SYSTEM BALANCE-SHEET WRITE-DOWNS, RESTRUCTURING AND RECAPITALISATION: THE MAIN STEPS TO DATE

BOX 1.2

This box describes in some detail the main characteristics of the different measures adopted as part of the Spanish banking system balance-sheet write-down, restructuring and recapitalisation process discussed in the main body of the text. The process began with the creation of the Fund for the Orderly Restructuring of the Banking System (FROB), further to Royal Decree-Law (RDL) 9/2009 of 26 June 2009, which had a dual aim: to provide a solution for institutions that ceased to be viable, and to pave the way for integration processes involving viable institutions by promoting their restructuring. The former aim has only been used in one instance (Cajasur), although before the creation of the FROB control was taken over another institution (Caja Castilla-La Mancha) through the participation of the Deposit Guarantee Fund. The overall weight of these two savings banks scarcely exceeded 1 % of the system's total assets. The second aim was instrumented through the subscription by the FROB of convertible preference shares, equity units or contributions to the capital of credit cooperatives, for a maximum term of five years, extendible by a further two years, and earning a minimum return of 7.75 %.[1] The aid was conditional upon the submission of an integration plan approved by the Banco de España. This second arrangement was instrumental in supporting eight savings bank integration processes, in which the FROB committed itself to aid totalling €10.07 billion (around 1 % of GDP).[2] Together with a further four processes which have not required FROB participation, the resulting restructuring has proven far-reaching, as the accompanying table shows.[3] Overall[4], 39 out of a total of 45 savings banks are involved, accounting for 88 % of the assets of this subsector and 32 % of those of the national banking system. The result is a reduction in the number of savings banks or groups of savings banks to 18, with an average size in terms of total assets of €70 billion, almost 2.5 times greater than was previously the case. The integration plans approved also envisage a cut of between 20 % and 25 % in the number of offices and of between 12 % and 18 % in staff. These developments have been accompanied by a substantial balance-sheet write-down drive which, for Spanish deposit institutions as a whole, has amounted to €96 billion (9.5 % of GDP) in the three years from 2008 to 2010, as the accompanying chart shows.

In spring 2010, stress tests coordinated at the European level were conducted. It was considered that the target level of core (Tier 1) capital institutions had to reach following the exercise was 6 % of risk-weighted assets (higher than the figure of 4 % in the regulations then prevailing). In Spain, the exercise was conducted covering 90 % of the system's total assets. The results, which were disclosed in extensive detail in late July, highlighted the resilience of most Spanish institutions since only four groups of savings banks required additional capital, for a total of €1.84 billion, under the adverse scenario. In spring 2011 a similar exercise has been conducted, the results of which are expected to be published in June.

In July last year, the government approved the reform of the savings bank law by means of RDL 11/2010. The aim was to tackle the two structural weaknesses in the sector, linked to its singular legal structure, which have become clearly manifest during the crisis:

1 The return shall be the higher of 7.75 % and the return on 5-year Spanish public debt plus 500 bp at the time of approval of the operation and shall increase by 15 bp each year up to the fifth year, and by 100 bp for each additional year if the operation is extended.

2 These figures do not include the initial Banco Base IPS (Institutional Protection Scheme) project, for which aid totalling €1.49 billion (making for a total of €11.56 billion) was envisaged, and which was finally not granted. The two institutions or groups resulting from this collapsed project have reconsidered their recapitalisation strategies in accordance with the new requirements laid down in RDL 2/2011.

3 Integration processes have also taken place between other institutions in the Spanish financial system (commercial banks and credit cooperatives) in the form of voluntary initiatives aimed at improving efficiency.

4 Taking into account the collapse of the Banco Base IPS project.

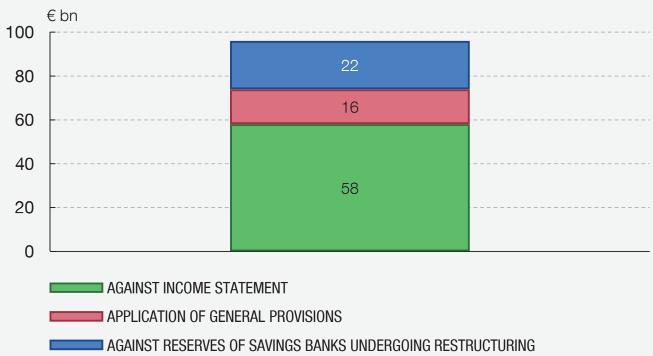
SAVINGS BANK RESTRUCTURING PROCESSES

	Participating institutions	Final institutions	Total assets (€ m) (a)	Assets as % of savings banks total	Assets as % of banking system total (b)
Integration processes with FROB aid	33	9 (4 SIP)	863,353	68.1	24.8
Integration processes without FROB aid	7	3 (1 SIP)	330,263	26.1	9.5
Total restructuring (c)	40	12 (5 SIP)	1,193,616	94.2	34.3
Other	5	5	73,452	5.8	2.1
Total savings banks	45	17	1,267,068	100	36.4

SOURCE: Banco de España.

a Consolidated balance sheet data as at 31.12.2010.
b Sum of national banking instituions' consolidated balance sheets.
c Including the restructuring of CCM, although in this case the traditional DGF framework was used.

PROVISIONS SET ASIDE SINCE JANUARY 2008



SPANISH BANKING SYSTEM BALANCE-SHEET WRITE-DOWNS, RESTRUCTURING AND RECAPITALISATION: THE MAIN STEPS TO DATE (cont'd) BOX 1.2

governance problems and a limited capacity to raise high-quality capital. As regards the former, more restrictive limits were placed on the presence of general government representatives on the governing bodies of savings banks, who were further required to demonstrate their professional suitability. To redress the second shortcoming, a more attractive legal regime was introduced for equity units, and the legal structures through which savings banks may provide their financial services were broadened, allowing them to pursue their financial activity through public limited companies with the category of commercial banks, either through Institutional Protection Schemes (IPSs) or through the creation of a commercial bank to which their financial business would be transferred.

Also in summer 2010, the Banco de España issued a circular (CBE 3/2010) amending the accounting rules for provisioning, with three aims in mind: to recognise the value of different real estate guarantees according to the type of asset involved, but applying substantial precautionary haircuts and shortening the period over which provisioning is made for the risk as a whole; to increase the minimum provisioning charges for foreclosed assets, which depend both on appraisals and on the passage of time; and to encourage the setting of greater prudential margins for the granting of loans. Later (in November), the central bank required savings banks to publish detailed information on their exposures and provisioning, especially exposures to the real estate sector, on the volume of wholesale funding and on their liquidity situation, which they duly did before the end of January 2011. That same month, all banks were formally required to incorporate this information into their 2010 financial statements.

On 18 February 2011, the government approved RDL 2/2011. This legislation increased the minimum capital level required of banks, introducing a new solvency ratio that must be met maintaining common equity Tier 1 capital[5] of at least 8 % of risk-weighted assets, and raising this ratio to 10 % for those institutions in which the relative weight of funding from wholesale markets exceeds 20 % and which have not placed at least 20 % of their capital with third-party investors. The functioning of the FROB was also reformed so that it may be used to recapitalise those institutions that cannot meet these requirements by tapping the markets. Specifically, the FROB is authorised to subscribe ordinary shares under market conditions, which it must sell before five years have elapsed, provided that the institution submits a recapitalisation plan for approval by the Banco de España. In these cases, the FROB shall take a seat on the board of directors of the institution affected. If a savings bank or savings bank integration process by means of an IPS is involved, all lending activity must be transferred to a bank by one of the means provided for in RDL 11/2010. The new requirements have to be met by September this year, although an extension of three months, extendible to six months in the case of market listing processes, may be requested. On 10 March 2011, the Banco de España made known the capital requirements arising from the new regulations, with the result that 12 institutions (two Spanish banks, two subsidiaries of foreign banks and eight savings banks) evidenced additional capital needs for a total amount of €15.15 billion (€14.08 billion of which relating to savings banks). On 14 April the Banco de España approved the strategies for complying with these new capital requirements. In the case of the institutions participating in the original Banco Base IPS, separate strategies have been submitted for the capital requirements of the two institutions or groups of institutions resulting from the collapsed project. On 28th April, within the legally stipulated term, the institutions or groups of institutions that have requested from the FROB, as the primary source, the funds they need to meet these capital requirements, submitted their recapitalisation plans. Thereafter, the measures envisaged in the new RDL 2/2011 have continued to be pursued both by the Banco de España and by the FROB so as to comply with the formalities and schedules laid down.

5 This definition is stricter than the above-mentioned core (Tier 1) capital and is based on the Basel III concept applicable in 2013, with some amendments.

perceived by markets as the main factors of risk of savings banks. In turn, in February 2011 the government approved a Royal Decree-Law whereby the minimum levels of solvency required of all banks were raised and the FROB was authorised to acquire, temporarily and subject to approval by the Banco de España of a recapitalisation plan, shares in the capital stock of those institutions that could not obtain the funds required on the market within the period established. Capital requirements have been raised to a greater degree for institutions in whose capital there is not sufficient participation by third-party investors and which are more reliant on wholesale markets, and it has also been stipulated that recourse to the FROB by a savings bank shall entail the transfer of its business to a bank, which would translate into a substantial change, inter alia, in its corporate governance regime and in its possibilities of gaining access to capital markets.

The aim of this new set of measures, along with the forthcoming publication of the results of the new European stress tests, is to contribute decisively to restoring international investor confidence in our financial system, reducing the risk of an extension of the tensions that might undermine the recovery of the Spanish economy.

Turning to fiscal policy, a demanding budgetary consolidation strategy was defined for 2010 and 2011,…

In the budgetary domain, the government approved a package of deficit-cutting measures for 2010 and 2011 in May, supplementing the 2010 Budget (the withdrawal of some of the extraordinary expansionary measures, in force during the crisis, and a VAT rise from 1 July, among others). The May package involved an additional cut in spending of around 1.5 % of GDP for these two years, whereby the deficit-reduction path was set at 9.3 % of GDP, 6 % of GDP and 4.4 % of GDP in 2010, 2011 and 2012, respectively.

… bringing forward the adjustment drive envisaged for 2013 to the 2010-2011 period. It was based predominantly on structural spending cuts

The consolidation strategy defined by the government brought forward the bulk of the adjustment to the 2010-2011 period, underpinning it with spending cuts, many of which structural, including most notably the cut in public-sector employees' compensation from June 2010, the reduction in public investment, the freeze on public-sector wages and pensions in 2011, and the 10% ceiling on the rate of replacement of public-sector employees. The State budget for 2011 validated these measures, introduced further cuts to other budgetary items and provided for specific tax rises (a tax rise in the State personal income tax tranche for incomes above €120,000 and the elimination of the tax deduction for purchase of the habitual dwelling for incomes above €24,170.2). The Updated Stability Plan for the period 2010-2014, which the government approved on 29 April, confirmed the above-mentioned path of adjustment to 2013 and further set a deficit target for 2014 of 2.1% of GDP, which would be compatible with a public debt/GDP ratio of 68.9%. Accordingly, if the targets of the proposed consolidation plan are met, the deficit will embark on a declining course in 2014.

The public finances outcome at end-2010, entailing a general government deficit equivalent to 9.2 % of GDP and a public debt ratio of 60.1 % of GDP, show that the measures adopted in 2010 have proven effective in reversing the upward trajectory of the budget deficit. They do, however, involve an uneven budgetary adjustment drive across the different tiers of government: while the State cut its deficit by 4.3 pp (to 5 % of GDP), the regional governments' shortfall increased by 1.4 pp (to 3.4 %). The Social Security fiscal position also worsened by 1 pp, posting a deficit of 0.2 %.

The fiscal projections for 2011 and 2012 point to some risks of deviations …

The fiscal projections for 2011 and 2012 by the Banco de España as part of the annual macroeconomic projections exercise suggest some risks of deviations from the consolidation path. The projected reduction in the deficit is based on macroeconomic projections which, if they are not confirmed, might translate into a less favourable performance by revenue. Furthermore, potential deviations at the territorial government level cannot be ruled out.

The fiscal consolidation programme is a centrepiece of the overall economic policy strategy, whose success hinges on a major budgetary effort that is unprecedented in terms of its size and extension to all levels of general government. In meeting these targets it will not be possible to count on the help of other potential sources of improvement that were present during the expansionary phase. On one hand, the extraordinary revenue linked to the real estate boom will not be resuming and, on the other, neither the business cycle, which is following a very gradual pattern of recovery, nor the interest burden, which has already moved onto a rising course, will help improve public finances.

… and averting this will require action by all levels of government and a strengthening of the budgetary stability rules

To prevent the risks of a deviation from the fiscal consolidation path materialising, it is necessary to set in place sound foundations for the reduction of the deficit and the control of medium- and long-term debt, in line with the proposals made in Chapter 2 of this report, which focuses on this matter. It is crucial to involve all levels of government in the fiscal consolidation process, to strengthen the institutional commitment to budgetary stability and the mechanisms for enforcing the rules, to increase the transparency of public finances and to reinforce budgetary planning in the medium term.

Fiscal consolidation must be accompanied by an ambitious structural reform programme

The application of structural reforms providing for enhanced employment generation and growth capacity is crucial for embedding a durable recovery and facilitating fiscal adjustment (see Box 1.3). Supply-side policies that improve the working of the markets for goods, services and factors are vital to pave the way for a durable expansion of activity and employment; and, therefore, to also increase government revenue and, through this means, to promote the medium-term sustainability of public finances. In turn, an appropriate distribution of the adjustment drive between public spending and revenue would contribute to boosting activity and would have positive effects on employment.

The pensions reform approved in March this year has positive effects on the sustainability of public finances and growth potential

The reform of the pensions system, the draft legislation for which was submitted to Parliament in March 2011, is an example of measures that harness the complementarity between the sustainability of public finances and the creation of favourable structural conditions on the supply side. The reform approved in Spain amends certain parameters of the system, raising the legal retirement age and increasing the number of years taken into account to calculate pensions. The combination of both measures could, on one hand, increase participation by more elderly workers and thus raise growth potential; and, on the other, it could enhance the sustainability of the pensions system and contribute to the restructuring of public finances (see Box 2.3).

Labour market reform remains one of the fundamental economic policy measures needed …

The labour market reform approved last year (Law 35/2010 of 17 September 2010) took certain steps towards improving the functioning of the labour market in the medium term. In terms of internal flexibility, one aim of the reform was for companies to be able to change certain aspects of how work was organised (in particular regarding the conditions for setting wages) compared to what was stipulated in industry-, region- and nationwide collective bargaining agreements; that would bring about a more decentralised model, allowing a closer relationship to be established between working conditions and the specific needs of companies. However, this would all be done without yet altering the collective bargaining system. In turn, in the case of hiring mechanisms, changes were made to the modalities already in place in order to boost permanent hiring (facilitating the possibilities of terminating permanent contracts for objective causes and extending the possibility of using employment-promoting contracts), while new limits were added in the case of temporary hires. On the whole, these are so far partial measures that do not alter the key features of the labour framework, such as hiring and collective bargaining arrangements, and they cannot therefore decisively change its present functioning.

Any assessment of the impact of these measures would be premature. The as yet very partial information available points to an increase in employment-promoting contracts which, however, would appear to have crowded out other permanent contracts, while the impact on temporary employment is not yet discernible. Also evident is a greater use of objective dismissals, with lower severance costs, and a greater use by companies of the possibilities to reduce the working day, on a temporary basis. Some time will be needed to accurately ascertain the link between the changes being observed and the effectiveness of the steps taken.

… and it should go ahead with substantial changes to the collective bargaining system …

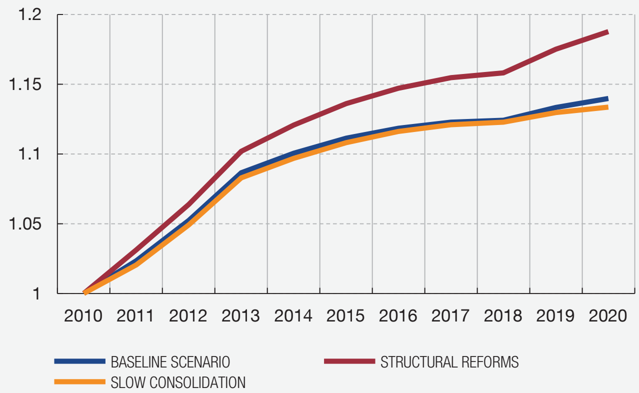
The behaviour of employment continues to be the source of most concern in the economy, and the wage rises observed in the opening months of the year indicate that the measures already taken must be complemented by far-reaching reforms to collective bargaining and

The substantial fiscal consolidation the Spanish economy needs to correct the budgetary imbalances arising from the crisis faces various problems; compounding the difficulties derived from the very scale of the imbalances are further complications due to growth expectations limited by the depth and extension of the crisis and by the impact of population ageing on spending on social policies. These are major obstacles standing in the way of public finances sustainability. In such a situation, a factor of great importance is the complementarity of fiscal consolidation policy and supply-side policies which, by improving the functioning of the markets for goods, services and factors, may lead to an expansion in potential growth, increasing public revenue and allowing certain spending items to be reduced.

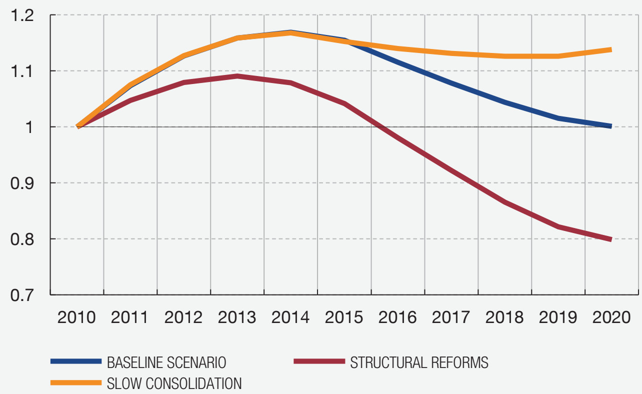
To illustrate the effects that fiscal consolidation and structural reforms have on GDP and public debt in the short and medium term, this box presents simulations performed using a calibrated model for Spain that has two essential ingredients. First, in line with the standard approach in much of the recent economic literature[1], the model incorporates distortions in the labour and product markets, in the form of monopolistic competition, which give rise to a gap between marginal costs and prices and to the inefficient allocation of productive factors. Second, so as to capture the impact on the economy of population ageing, the model's demographic structure is highly detailed, in the form of overlapping generations of households.[2]

1 See, for example, L. J. Christiano, M. Eichebaum and C. L. Evans (2005), "Nominal Rigidities and the Dynamic Effects of a Shock to Monetary Policy", *Journal of Political Economy,* 113 (1), pp. 1-45.
2 For a detailed description of the model and its calibration, see A. Gavilán, P. Hernández de Cos, J. F. Jimeno and J. A. Rojas (2011), "Fiscal Policy, Structural Reforms and External Imbalances: A Quantitative Evaluation for Spain", *Moneda y Crédito,* forthcoming.

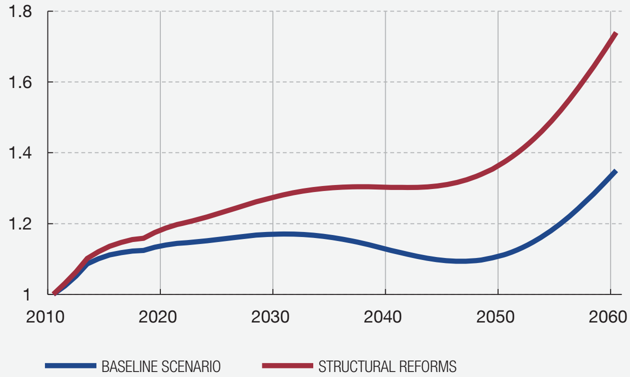
1 GDP PER CAPITA (a) **(2010-2020)**



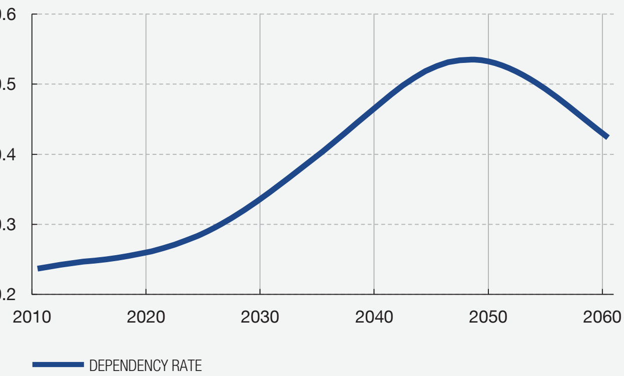
2 PUBLIC DEBT (% of GDP) (a) **(2010-2020)**



3 GDP PER CAPITA (a) **(2010-2060)**



4 DEPENDENCY RATE (b) **(2010-2060)**



SOURCE: Banco de España.

a The variables depicted have been normalised taking their 2010 value.
b The dependency rate is defined as the ratio of the over-65 population to the working-age population (16-64).

Panels 1 and 2 show the response of GDP and of the public debt/GDP ratio from 2010 under different scenarios. The baseline scenario incorporates a public spending trajectory for the period 2009-2013 in line with that established in the April 2011 Stability Programme. It further entails the continuation of the fiscal consolidation process after 2014, whereby the public debt/GDP ratio in 2020 settles at 60 %. This scenario does not, however, consider the introduction of structural reforms. Before addressing the potential impact of these reforms, and to assess the significance of the time path of the adjustment, this scenario is compared with the so-called "Slow Consolidation" scenario, in which the effects of cutting future budget deficits more moderately, again in the absence of structural reforms, are simulated. As can be seen in Panels 1 and 2, a slower fiscal adjustment than that considered in the baseline scenario would entail a significant delay in the stabilisation of the public debt/GDP ratio, without any benefits in terms of short-term growth. These results illustrate the advantages of the strategy of bringing the fiscal adjustment forward.

An assessment follows of the consequences of introducing structural reforms, for instance, those affecting the markets for goods and services. In the "Structural Reforms" scenario, it is assumed these reforms would narrow the prevailing margins between marginal costs and prices in the goods and services and labour markets by 2 pp[3], and that they would increase the growth rate of productivity in the economy by 0.5 pp once the crisis were overcome.[4] As can be seen in panels 1 and 2, the structural reforms considered, by reducing the distortions existing in the markets, would improve the allocation of resources, exert a significant positive impact on activity and make for a swifter improvement in public finances in the short and medium term, widening the fiscal policy room for manoeuvre.

In the long run, the dynamics of activity and of public finances will be notably influenced by the population ageing currently characterising Spain, and most other developed countries. With its highly detailed demographic structure, the model used in this box can capture the impact of this ageing process on spending on pensions and on labour supply, along with other general equilibrium effects on prices and wages. In this setting, the adoption of structural reforms would also have a considerable positive effect since, as shown in panel 3, it would significantly soften the effect of population ageing on growth (see panel 4).

The results presented assume that the cost of financing for all domestic agents (households, corporations and government) is independent of the volume of debt in the economy. However, as was clear in the sovereign debt crisis episodes in 2010, the perception of international lenders may be that an economy's risk of default rises with its volume of debt, and they may demand a growing premium in return. In this case, the advantages of undertaking structural reforms and accelerating fiscal consolidation would be even greater than those resulting from the simulations presented in this box.

3 This reduction in margins is approximately equivalent to one-third of the competitive differences estimated in the literature across different countries. See, for example, J. Andres, E. Ortega and J. Vallés (2008), "Competition and Inflation Differentials in EMU", *Journal of Economic Dynamics and Control,* 32 (3), pp. 848-874, and R. Christopoulou and P. Vermeulen (2008), "Markups in the Euro Area and the US over the Period 1981-2004 – A Comparison of 50 Sectors", *European Central Bank Working Paper Series,* no. 856

4 The positive impact on productivity derived from regulatory improvements in the goods and services and labour markets is empirically documented, for example, in G. Nicoletti and S. Scarpetta (2006), "Regulation and Economic Performance: Product Market Reforms and Productivity in the OECD", in T. Eicher and C. García–Peñalosa (eds.), *Institutions, Development and Growth*, MIT Press, and A. Basanini, L. Nunziata and D. Venn (2009), "Job Protection Legislation and Productivity Growth in OECD Countries", *Economic Policy*, 24 (58), pp. 349-402

active employment policies. The collective bargaining system in Spain concedes to inflation a predominant role among wage-increase determinants. Also, bargaining is carried out at an intermediate level which foments highly uniform wage increases that are barely linked to the specific economic conditions of companies. This furthermore prevents relative wages from acting as a mechanism to allocate resources towards sectors with greater development potential.

A more appropriate design of collective bargaining would help improve the capacity to redistribute employment across sectors, companies and regions, which would provide for a swifter exit from unemployment for the large number of jobless workers. An improvement here is vital, moreover, so as not to jeopardise the gains in competitiveness that have come about during the adjustment phase and so as to lay the foundations for a sound recovery in the economy. The increase in purchasing power that would ultimately ensue as a result of this improvement in the competitive environment would also enable demand to be sustained. In sum, the appropriate functioning of the wage-setting mechanisms is a cornerstone of the capacity for macroeconomic adjustment within the euro area and of the structural change that the economy needs, following the serious shock it has undergone.

… complemented by a far-reaching reform of active and passive unemployment policies

The changes should, moreover, be complemented by a far-reaching reform of active and passive unemployment policies, so as to help prevent the increase in unemployment from becoming structural. In this respect, the incentives of the benefits system should be reconsidered so as to make eligibility conditional upon active job search, complementing this with active policies aimed at enhancing training. The reforms approved in February 2011 are in this direction, although it is once again too soon to assess their effects.

Increasing the quality of human capital requires substantial improvements on the educational front …

Some of the problems in our educational system, such as the high drop-out rates, can be found to be associated with the scant wage dispersion derived from our collective bargaining system, which does not generate the right incentives for prolonging schooling.[2] However, improving human capital also requires significant steps to be taken in the educational system, including lifelong training.

The Spanish economy would be better placed to bring about a change in the productive model that has prevailed over the last business cycle if the design of the educational system and of labour institutions were to appropriately encourage companies' and workers' training decisions, to provide for job mobility across firms and industries, and to increase the capacity for adjustment in the face of the various shocks the economy may undergo, assigning less weight to employment fluctuations over the course of the business cycle.

… and the drive to liberalise and deregulate the markets for goods and services must continue

In recent years there has been a notable drive to liberalise and deregulate the market for goods and services, but there is room to take some of the measures already undertaken further and to launch new reforms.

In the housing market, house rentals as opposed to house purchases should continue to be encouraged. A more balanced market will pave the way for the provision of housing services under more favourable conditions, it will contribute to absorbing the excess capacity in the residential sector and it will provide for job mobility, which is essential for infusing dynamism into the adjustment of the labour market across regions and industries. To this end, the latest initiatives adopted – such as greater legal efficiency in tenancy-related proceedings and the elimination of the tax deduction for incomes above €24,000, equating it to the rental deduction – should be complemented by measures aimed at adding flexibility to the mandatory term of contracts and the control of rental incomes.

The most substantial progress in structural reforms in recent years has been in connection with the liberalisation of the services sector, among others, and with the lessening of administrative burdens, further to the transposition of the Services Directive. However, obstacles remain in respect of the liberalisation of certain activities, such as retailing, where the regional governments can continue to establish administrative authorisation

2 See A. de la Fuente and J. F. Jimeno (2009), «The Private and Fiscal Returns to Schooling in the European Union», *Journal of the European Economic Association*, December, vol. 7, no. 6, pp. 1319-1360.

“for reasons in the general interest”. Such reasons may ultimately interfere in the allocation of productive resources and price-setting. In addition, the reform of professional services should advance along the same liberalising path, given the significance of this sector in Spain and the numerous obstacles in place compared with those in other countries.

Turning to the network industries, there remain segments in telecommunications in which certain rigidities and limited progress in the degree of competition are discernible, specifically in those most closely connected to the new communications technologies (broadband). In the energy industry, the degree of *de facto* competition is also scant and final prices should be more closely aligned to costs in order to bring about by means of incentives a reduction in our energy dependence. In the fuel distribution market, further steps are needed to eliminate the barriers to entry and to the expansion of new operators, in line with the recommendations of the National Competition Board (CNC by its Spanish acronym). As to transport, there is scope for liberalising rail transport, in particular freight.

Lastly, while the general government technology investment drive has increased considerably, the carryover effect of public funding into private investment seems rather limited; accordingly, Spain’s relative lag in technological and scientific production has, overall, scarcely been corrected. In this respect, it would be advisable to improve governance of the public research system and the mechanisms for managing incentives to R+D+i.

1 Introduction

In 2010 the euro area sovereign debt crisis was the fundamental economic event, centred on some of the peripheral countries

The euro area sovereign debt crisis, which was the main source of concern regarding macroeconomic policy implementation in the area, was the outcome of a series of closely interlinked factors. The financial crisis had seen uncertainty and nervousness surge, restricting the channels of funding for the countries that had recently increased their level of debt. Further, there was a generalised deterioration in fiscal positions in most countries, giving rise to an unprecedented increase in public-sector short-term net borrowing. Against a background of financial instability, this prompted greater investor sensitivity to the source of the fiscal imbalances that had built up. As a result, these imbalances began to be viewed as potentially unsustainable in some countries (see Chart 2.1).

These factors were shared by other economies, such as the United States, the United Kingdom and Japan, but the crisis became particularly virulent in the euro area. The shortcomings in euro area governance proved particularly problematic in light of the macroeconomic and fiscal divergences that had arisen, which heightened uncertainty and the lack of confidence in the countries with the biggest imbalances. Moreover, the high financial integration among the euro area countries may have been conducive to the markets perceiving cross-country contagion as a possibility.

The sovereign debt crisis began in Greece and subsequently spread to Ireland and Portugal. Other countries were also affected by the contagion, as a result – to differing degrees in each case – of doubts over their growth prospects, uncertainty about the costs of restructuring their banking systems and the swift rise seen in their budget deficits and public debt, as described in Chapters 1 and 4 of this Report.

The seriousness of the situation requires a resolute economic policy response on several fronts

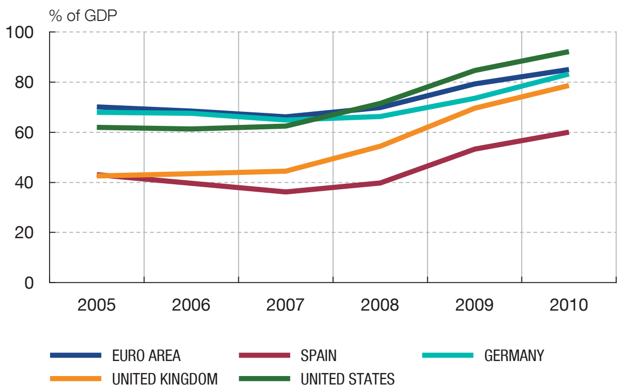
The first pre-requisite for overcoming the euro area sovereign crisis is the follow-through of a fiscal consolidation process, embarked upon already in some countries in 2010, that leads to firm foundations being set in place to reduce the deficit and control debt in the medium and long run, and to the entrenchment of the macroeconomic stability needed to promote economic growth. Equally important for dispelling market doubts is the application of structural reforms that help provide for the recovery in potential growth and the conclusion of the restructuring of financial systems. But such action will not suffice if, as well, the euro area's governance shortcomings that have emerged virulently as the sovereign debt crisis has unfolded are not redressed.

This chapter focuses singularly on analysing the fiscal consolidation challenges that the sovereign debt crisis has posed for Spanish economic policy.[1] First, changes in the fiscal position during the crisis in Spain are described. These illustrate how, despite the surpluses in the previous phase, the fiscal space available to pursue expansionary fiscal policies was limited, and they also reveal the essentially structural nature of the fiscal imbalance built up. Next, debt dynamics are analysed, highlighting the role that economic growth potential and the cost of financing play in the sustainability of public finances. That primarily helps clarify why the swift increase in the fiscal deficit resulted in strong debt market tensions, and, secondly, it allows conclusions to be drawn on how the fiscal adjust-

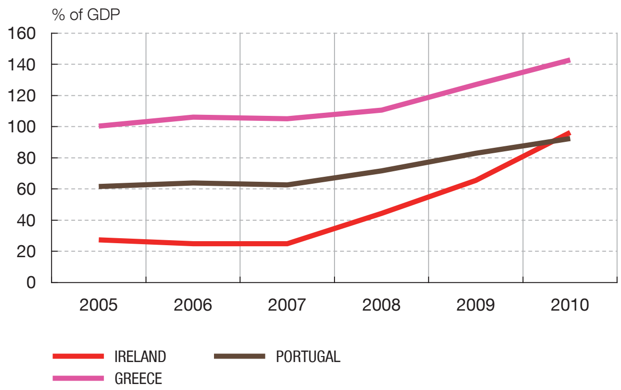
1 With reference to Spain, the recovery in potential growth was the central theme of Chapter 2 in the 2009 *Annual Report*. Resolving the shortcomings of policy coordination in the euro area and the financial system restructuring process are addressed in other chapters in this report.

BUDGET BALANCES AND PUBLIC DEBT COMPARED ACROSS DIFFERENT DEVELOPED COUNTRIES **CHART 2.1**

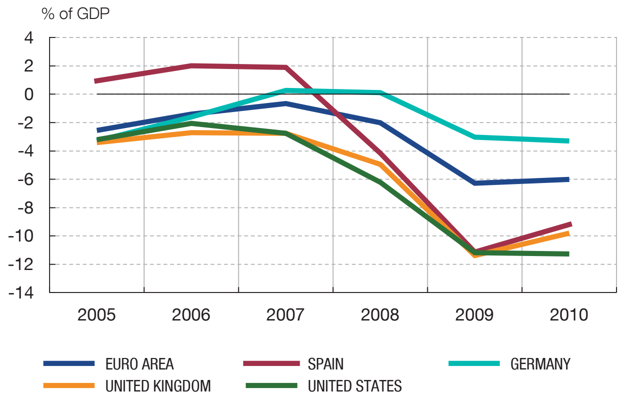
PUBLIC DEBT



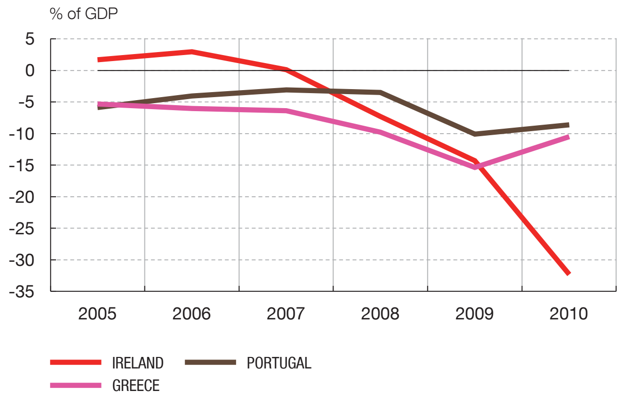
PUBLIC DEBT



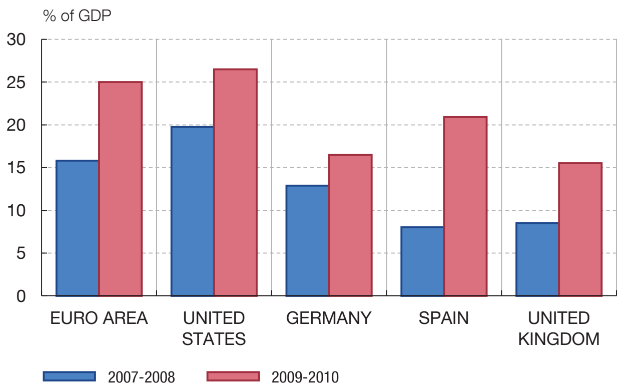
BUDGET DEFICIT (-)/SURPLUS (+)



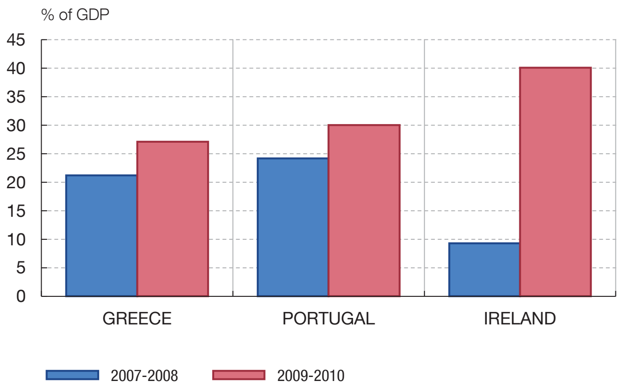
BUDGET DEFICIT (-)/SURPLUS (+)



GENERAL GOVERNMENT NET BORROWING (a)



GENERAL GOVERNMENT NET BORROWING (a)



SOURCES: European Commission, IMF and Banco de España.

a Net borrowing corresponds to the sum of the budget deficit plus adjustments between the deficit and the change in debt plus debt repayment.

DETERMINANTS OF CHANGES IN THE SPANISH GENERAL GOVERNMENT BALANCE (CUMULATIVE PERCENTAGES OF GDP)

CHART 2.2

SOURCES: INE and Banco de España.

ment must be in terms of magnitude, timing and interaction with other policies. Finally, the changes that should be made to the institutional framework and to public spending and revenue policies to ensure that the fiscal adjustment is successful are detailed.

2 The causes of the fiscal deterioration

At the start of the crisis the fiscal situation was favourable, albeit thanks to extraordinary revenue and worrying expenditure dynamics...

In late 2007 Spain had a fiscal surplus of close to 2% and a public debt/GDP ratio of 36%, compared with –0.7% and 66%, respectively, in the euro area as a whole (see Chart 2.1). However, beneath this healthy position lay some worrying public revenue and spending dynamics. Indeed, of the total reduction in the deficit recorded between 1995 and 2007 (8.4 pp of GDP), almost 5 pp are attributable to the business cycle and to the decline in the interest burden, associated above all with the reduction in interest rates. The rest of the adjustment was due to an exceptional increase in tax revenue – with a significant temporary component – linked largely to the excessive real estate expansion, which more than offset the reduction in revenue of approximately 3 pp of GDP arising from discretionary changes in the tax system (see Chart 2.2).[2]

Primary public expenditure (excluding interest payments on public debt), net of unemployment benefits, grew at an annual rate of more than 7%, above trend economic growth. That confirms its procyclical behaviour, something common also to other developed countries.[3] Of note was the growth of spending managed by regional and local government, which at no point in the expansionary phase attained a balanced budget, despite the high increases in tax revenue. Deficiencies in the budgetary framework contributed to this, a matter which is dealt with in greater detail in section 4.

2 See F. de Castro, Á. Estrada, P. Hernández de Cos and F. Martí (2008), "Una aproximación al componente transitorio del saldo público en España", *Boletín Económico,* June, Banco de España.

3 See P. R. Lane, (2003), "The cyclical behaviour of fiscal policy: evidence from the OECD", *Journal of Public Economics,* 87, pp. 2661-2675, and A. Lamo, J. J. Pérez and L. Schuknecht (2007), *The cyclicality of consumption, wages and employment of the public sector in the euro area,* Working Paper No. 757, European Central Bank.

... whereupon the crisis prompted a rapid deterioration in the budget deficit and revealed the size of its structural component

The crisis revealed the latent risks in the public finances situation and highlighted the little leeway available to pursue countercyclical policies. During the economic crisis, the budget deficit rose by more than 13 pp to a peak of 11.1% of GDP at end-2009 (see Chart 2.1). Contributing to the deterioration from 2007 to 2009 was the adverse trend of the business cycle by around 2.5 pp of GDP, whereas close to 4 pp of GDP were associated with the disappearance during the crisis of the extraordinary revenue previously raised (see Chart 2.2). in addition, the measures applied in an attempt to alleviate the effects of the crisis amounted to 3.3 pp of GDP, although more than half of this effect was of a temporary nature. The rest of the increase in the deficit arises from trend growth in expenditure outpacing that of the economy. The rise in the deficit would, therefore, have an eminently structural component, meaning that the cyclically adjusted deficit exceeded 10% of GDP in 2009 and stood at 8.3% of GDP in 2010.

Public debt amounted to 60.1% of GDP in 2010, almost 24 pp above its level in 2007, but still more than 20 pp below the average for the euro area. This increase in debt arose, above all, as a result of the rise in the budget deficit. The impact of the aid to the financial sector, which exceeded 5 pp of GDP in the euro area between 2008 and 2010, amounted to around only 2 pp of GDP in Spain's case.

Compounding the fiscal deterioration were doubts over the growth capacity of our economy and over the cost of restructuring the financial system

In addition to the contagion generated by the Greek and Irish crises and to the worsening fiscal situation in our country, other idiosyncratic factors played a crucial role in spreading the sovereign debt crisis to Spain. Specifically, along with the adverse effects of the economic crisis on the Spanish economy's level of potential output, according to various estimates the growth of this variable in the medium term is also expected to fall by somewhat more than 1 pp, dipping from 3% to a rate below 2%.[4] On the evidence available, this factor is estimated to have played a relevant role in the widening of Spain's spreads.[5] Market doubts also influenced the situation of the financial system, which in other countries had acted as an exacerbating factor of the fiscal situation, in such a way that the strong interrelatedness of macroeconomic, fiscal and financial problems has been particularly significant during the current crisis.

3 The scale of the fiscal adjustment

The fiscal adjustment needed is considerable...

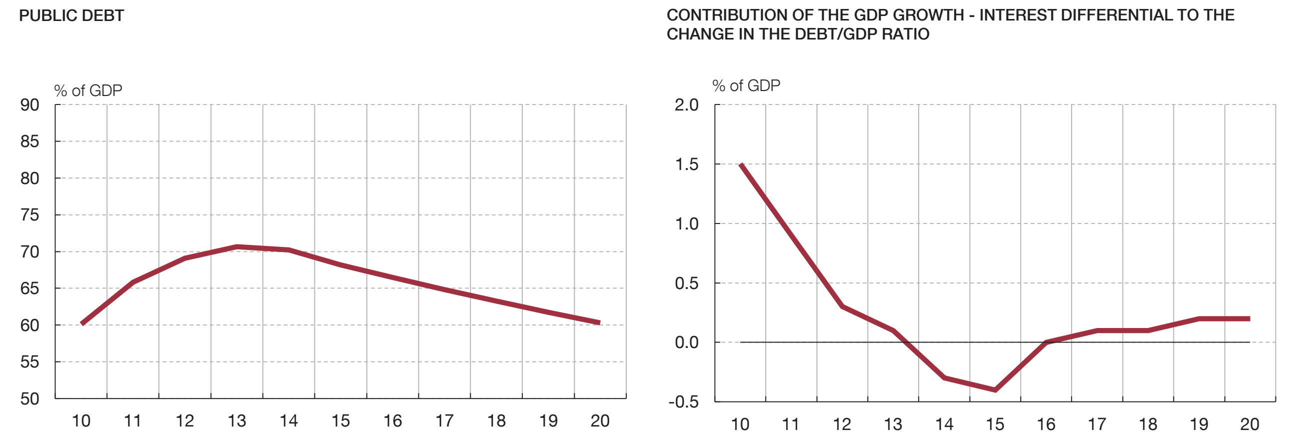
The macroeconomic effects of fiscal policy depend closely on expectations about the stability of the public debt/GDP ratio. The dynamics of this ratio hinge, in turn, on both the fiscal position, measured by the primary fiscal deficit as a percentage of GDP (the public deficit, excluding the interest on public debt), and on macroeconomic developments, via the impact of the nominal interest rate and the nominal GDP growth rate. The level to which the debt ratio tends is given, in short, by the ratio of the primary deficit, in units of GDP, to the difference between the growth rate of nominal GDP and the nominal interest rate. By way of example, this means that, with a nominal growth rate of 4% and nominal interest rate of 3%, it would be necessary to permanently reduce the primary deficit to 0.6% of GDP to stabilise the debt ratio at 60%.

Chart 2.3 plots the course of the public debt/GDP ratio over the coming years under specific assumptions of budget deficit, interest rates and growth rate. Specifically, on the estimates available, the structural fiscal deficit stood at around 8% at end-2010.

4 See P. Hernández de Cos, M. Izquierdo and A. Urtasun (2011), *Una estimación del crecimiento potencial de la economía española*, mimeo.

5 See V. Echevarría, L. Fernández-Caballero and J. J. Pérez (2011), A *note on the role of expectations on growth, public deficit and public debt in the determination of sovereign bond spreads: two case studies,* mimeo, Banco de España.

MEDIUM-TERM SCENARIO FOR THE SPANISH PUBLIC DEBT/GDP RATIO (a) **CHART 2.3**



SOURCE: Banco de España.

a Based on official forecasts of the budget deficit to 2013 (–3 % of GDP that year), assuming that a balanced budget is achieved in 2015, holding unchanged to 2020. Nominal GDP growth and the implied interest rate on debt are the same as those set out in the Banco de España Economic Projections Report to 2012 (3.2% and 3.3%, respectively, in that year) and, subsequently, a progressive increase is assumed in both variables to around 4% in 2015, which holds unchanged thereafter (the right-hand panel of the chart depicts the contribution of the difference between these two variables to the change in the debt ratio as a percentage of GDP). Finally, deficit-debt adjustments hold throughout the period at around 1% of GDP, similar to the average for recent years.

With this starting point and the growth scenario to 2012 included in the Banco de España Projections Report[6], if the output gap is assumed to close in 2015, the stabilising of public debt at around 70% of GDP that year would require an adjustment in the cyclically adjusted primary balance of more than 8 pp of GDP between 2010 and 2015, which is what is simulated in Chart 2.3. That would require strict compliance with the commitments undertaken to reduce the budget deficit to 2013 and, subsequently, a further reduction, until attaining a balanced budget. Given the budget outturn figures for 2010, almost half of this adjustment would have to be made by regional and local government.

Compliance with European commitments will further require resuming at a later date a level of public debt below 60% of GDP. Under the assumption of a zero contribution to the change in debt of the differential between GDP growth and the implicit interest rate on debt[7], attaining a public debt/GDP ratio of 60% in 2020 would mean that, after achieving a balanced budget, for example in 2015, it would be necessary to run a primary surplus of around 2.5% of GDP to 2020 (Chart 2.3).

... and would be even greater under harsher scenarios

If interest rates were higher or economic growth lower, the fiscal adjustment needed would be even greater. Specifically, if the growth rate were 1 pp lower throughout the period 2011-2020 and there were no additional fiscal adjustment, the rate of public indebtedness in 2015 would be 10 pp higher and amount to 85% of GDP in 2020. In this scenario, the adjustment of the average structural balance between 2010 and 2020 to place public debt at 60% in 2020 would be 1.7 pp of GDP[8], compared with around 0.8 pp in the scenario considered in Chart 2.3. and this without having regard to the effort needed to withstand the impact of population ageing on public finances.

6 Published in the Banco de España April 2011 *Economic Bullletin*.

7 By way of reference, the difference between GDP growth and the implied interest rate on debt in the period 2000-2010 provided for an annual average reduction in the debt/GDP ratio of around 0.5 pp of GDP.

8 This is a mechanical calculation that does not take into account the potential interaction between those variables subject to the simulation that remain exogenous.

It is also important to bear in mind that interest rates and the potential growth of the economy depend on debt dynamics. In particular, the higher the level of debt and its attendant growth rate, the higher the interest rate at which such debt will have to be financed and the lower potential growth will be. The estimates available[9] show that an increase of 10 pp of GDP in the debt ratio gives rise to an increase of 50 bp in long-term interest rates and a reduction in real per capita GDP growth of 0.15 pp per year.[10] These effects may, moreover, be greater if specific levels of debt are exceeded. A sharp reduction in the budget deficit and the stabilising of debt would therefore have a significant effect on the interest rates on debt and long-term growth, facilitating their sustainability.

In certain circumstances, the contractionary effects that the fiscal adjustment may exert in the short run can be mitigated

In the short run, the impact of the budget deficit on the growth rate depends on a very broad set of conditions, such as its composition, the starting levels of debt, the behaviour of monetary policy and the exchange rate regime.[11] A high budget deficit is not always a stimulus to economic activity; indeed, it may prove contractionary if it gives rise to an increase in expectations about future interest rates, which is more likely the greater the debt ratio. And the habitually contractionary effects of a reduction in the deficit may be mitigated if the consolidation manages to improve confidence and, therefore, to boost private consumption and investment, which appears to be more likely in the case of fiscal consolidations undertaken at the end of a recession and by means of cuts in government consumption.[12]

Consequently, a timely and well-designed fiscal adjustment may improve growth expectations, contributing, given a specific primary deficit, to the swifter stabilisation of public debt at a less high level. For example, a primary deficit sustained over the long run at 1.2% of GDP would be compatible with a debt ratio of 60% if the difference between the growth rate and the interest rate were 2 pp.

For this to be so, it is crucial that most of the adjustment should be brought forward in time...

Given the variables that influence public debt dynamics, the fiscal adjustment strategy should take into account not only the course of economic activity and the size of the fiscal multipliers, but also the costs of delaying consolidation in terms of risks to credibility and the impact on interest rates and agents' confidence.

Indeed, although the sluggishness of the recovery may have worked in favour of a gradual consolidation strategy, the extreme tension conveyed to the debt markets (see Chart 2.4) made it vital to bring forward the fiscal adjustment by as much as possible, to gain credibility and to reduce the financing costs of public and private debt alike, given the high correlation between the cost of both.

... and focus on public spending

As regards its composition, the fiscal adjustment may be made through various combinations of tax changes and public spending cuts, with different effects not only of a macroeconomic nature in the short run, but also in terms of likelihood of success. Further, the presence of factors that delay and hamper the recovery and long-term growth means that it is most important that the composition of the adjustment should be as conducive as possible to growth.

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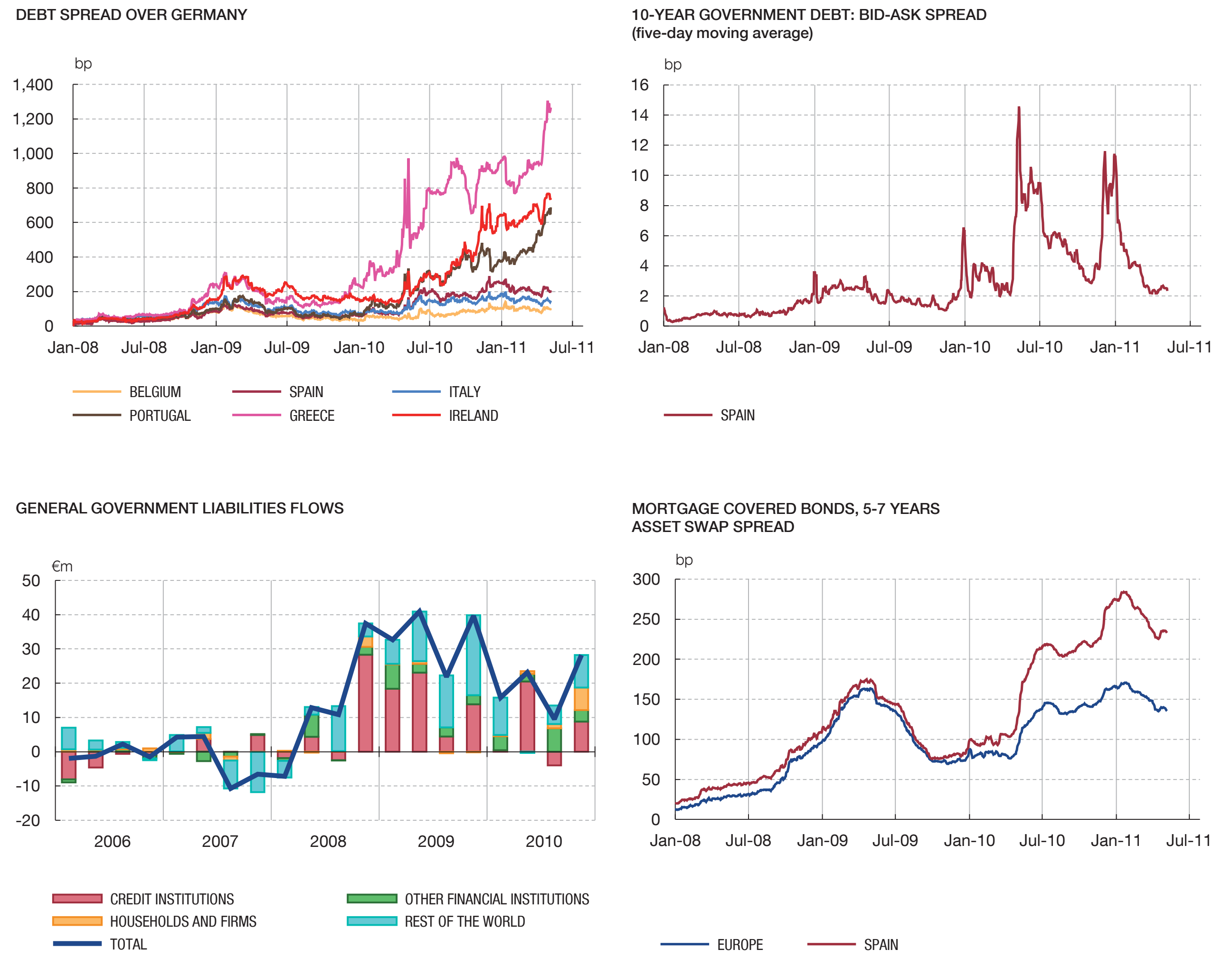
9 See International Monetary Fund, *Fiscal Monitor*, May 2010 and November 2009.
10 See C. Reinhart and K. Rogoff (2009), "The Aftermath of Financial Crises", *American Economic Review,* 99 (2), pp. 466-472.
11 For an overview of these results, see Chapter 3 of the International Monetary Fund (2010), *World Economic Outlook*, October.
12 See P. Hernández de Cos and E. Moral Benito (2011), *Endogenous Fiscal Consolidations*, Working Paper no. 1102, Banco de España.

DEBT MARKET ISSUANCE VOLUME AND PRICE TENSIONS

CHART 2.4



SOURCES: Banco de España and Reuters.

In this respect, the outcome of simulations of different fiscal adjustment strategies based on a calibrated macroeconomic model for the Spanish economy are illustrative (see Table 2.1)[13]. These should not, however, be interpreted as normative proposals, since the adjustment measures needed are contingent upon the nature of the problems of each conjunctural situation. The specific recommendations for the fiscal adjustment strategy in the current circumstances of the Spanish economy are addressed in subsequent sections of this chapter. According to the simulation exercises, a fiscal adjustment based on cuts in public investment would, in principle, exert negative effects on growth in the long run if the plans incorporated capital productivity similar to that observed in recent decades. In the present situation, however, it should be borne in mind that the return on public investments in infrastructure may have been drastically cut, following the period of sharp growth in recent years. In any event, it is the reduction in public-sector employees' compensation (wages and public-sector employment) that has greater positive effects on GDP in the long term, which are also positive in the short term in the case of wages, provided that the public sector wage adjustment passes through to the private sector. On the revenue side, indirect tax, although it has very limited negative effects in the short term, positively affects both

13 For a more detailed analysis of these results, see P. Hernández de Cos and C. Thomas (2011), *Los efectos de la consolidación fiscal sobre el crecimiento a partir de un modelo macroeconométrico,* mimeo.

SIMULATIONS OF THE IMPACT OF PERMANENT ADJUSTMENTS IN REVENUE AND EXPENDITURE ON GDP AND EMPLOYMENT **TABLE 2.1**

	Initial change in the instrument	Year 1 (b)		Year 4 (b)		Long term (b) (c)		
		GDP	Employment	GDP	Employment	GDP	Employment	Taxes on wages pp.
REVENUE								
Taxes on consumption	1.75 pp	-0.1	-0.1	0.0	-0.1	0.7	0.8	-3.5
Taxes on wages	2.18 pp	-0.1	-0.2	-0.3	-0.5	0.1	0.1	-0.6
Corporate income tax	11.83 pp	-0.3	-0.4	-0.7	-0.3	-2.6	-0.4	-2.1
EXPENDITURE								
Net purchases	-13.2	-0.6	-0.9	-0.3	-0.3	0.2	0.5	-3.2
Public investment	-28.2	-0.6	-0.9	-0.4	-0.4	-0.7	0.1	-2.5
Public wages	-13.5	0.4	0.7	1.8	2.5	3.8	4.2	-7.2
Public employment	-13.5	-0.4	-0.7	-0.3	-1.0	1.1	0.2	-4.0

SOURCES: Banco de España, FiMod model simulation (Stähler, Nikolai and Thomas, Carlos, 2011, "FiMod – A DSGE Model for Fiscal Policy Simulations", Banco de España Working Paper No. 1110).

a Each change entails an initial improvement of 1 pp in the general government primary surplus.
b All variables expressed as a percentage change relative to the base scenario, except where a different notation is indicated.
c In the long run, it is assumed the fiscal authority uses the saving on interest payments on public debt brought about through the initial fiscal consolidation to reduce taxes on wage income.

GDP and employment in the long run if the rise in such tax allows a reduction in other less efficient taxes.

The evidence suggests an association between the course of public revenue and public spending and that a larger public sector gives rise to a greater deficit bias[14]; accordingly, public spending cuts are more readily sustainable over time and allow the deficit to be reduced to a greater extent and more permanently than commensurate increases in revenue. Taking a longer view, it is also desirable that the fiscal adjustment should be compatible with a restructuring of public finances in which those items with positive effects on productivity and potential growth, such as spending on education and R+D+I, gain in weight as a proportion of total public spending.

This consolidation strategy is particularly appropriate if the additional consequences of EMU membership are taken into account

Membership of a monetary union attributes a more active stabilising role to fiscal policy, insofar as monetary policy is geared to price stability in the area as a whole. But, as clearly highlighted during the crisis, for it to play this role it is necessary to have an extensive fiscal buffer, building up surpluses during cyclical upturns and reducing the public debt/GDP ratio significantly. From this perspective, fiscal consolidation is also very important for gaining room for manoeuvre in the face of potential future shocks. The new framework for the working of the European Monetary Union, in which the mechanisms for the surveillance and correction of fiscal imbalances will take on greater importance, makes the reinforcement of fiscal discipline necessary.

The fiscal adjustment strategy defined by the government is, broadly, in line with these criteria

In accordance with the latest Stability Programme Update for Spain unveiled on 29 April 2011, the consolidation strategy defined by the government means that more than 70% of the primary structural adjustment required to 2013 will be concentrated in 2010 and 2011.

14 See F. de Castro, J.M. González-Páramo and P. Hernández de Cos (2004), "Fiscal consolidation in Spain: dynamic interdependence of public spending and revenues", *Investigaciones Económicas,* vol. XXVIII.

Further, in the two years spanning 2010-2011, 60% of the adjustment already made or approved resides on the control of public spending, meaning that government consumption and public investment would decline by 1.5 pp of GDP (with a 0.7 pp contribution by employee compensation), and other spending and subsidies would decline by around 1 pp of GDP. The composition of the fiscal consolidation planned for 2012-2014 also resides, to the tune of almost 80%, on spending cuts, due above all to the adjustment of government consumption.

Parallel progress in structural reforms is crucial for the fiscal adjustment

Any measure that increases the Spanish economy's potential growth tends to be conducive to the fiscal adjustment. In particular, supply-side policies aimed at improving the workings of the markets for goods, services and factors may lead to an expansion in activity and in public revenue, and they may therefore help bring about public finances sustainability. Such complementarity comes about through several channels. The lowering of the obstacles to competition and the improved efficiency in the workings of the markets for goods, services and labour have positive effects on productivity. For instance, it has been estimated that an improvement in competition in the product market up to the level of the most competitive country might generate a 2.5% increase in productivity.[15] In parallel are the spending cuts obtained as a result of greater economic activity. For example, the weight of unemployment benefits, which in Spain's case amounted to 3% of GDP in 2010 compared with 1.9% on average for the euro area countries, would diminish. Finally, higher expected growth reduces public debt spreads. Thus, the short- and medium-term effects of a fiscal adjustment, when made separately and conducted along with structural reforms that heighten competition in the market for goods and services and increase labour market flexibility, are very different (see Box 1.3 of Chapter 1 in this Report). Structural reforms, insofar as they lessen the distortions prevailing in labour and product markets, exert a significant positive effect on activity and public finances, mitigating the adverse effects of financial tensions and allowing greater room for manoeuvre for fiscal policy.

4 The foundations of a fiscal stability programme for Spain

4.1 THE BUDGETARY FRAMEWORK AND FISCAL RULES

The institutional framework of budgetary policy in the European countries is being reconsidered, assigning greater importance to the rules that control the growth of public spending

The economic literature shows that countries that have more demanding budgetary frameworks tend to evidence greater fiscal discipline. Further, the experiences of some of our neighbours showed that the most successful frameworks of fiscal rules are those that combine a budget deficit rule with explicit ceilings on public spending (see Box 2.1). In this respect, most EU countries have enhanced the quality of their fiscal frameworks, as a result above all of the application of the Stability and Growth Pact (SGP) and its extension to an additional set of national fiscal rules. Moreover, among the new features seeking to reinforce fiscal discipline in the euro area, the reform of the SGP currently under discussion includes the need to properly develop these national fiscal frameworks and the application of a prudent public spending growth rule when assessing countries' fiscal developments.

In Spain, the budgetary stability legislation should be strengthened by extending a spending ceiling to all tiers of government. This ceiling should also be more accurately defined

Spain has budgetary stability laws that set limits on the deficit that all levels of general government, and public bodies, may incur. In particular, central, regional and local government and the Social Security system have to post a balanced budget or run a surplus over the course of the business cycle, in terms of financing capacity. However, only central government is subject to a ceiling on annual spending approved by Parliament before the budget is drawn up.

15 On the effects of the regulation of goods and services markets and of labour market institutions on productivity, see, respectively, G. Nicoletti and S. Scarpetta (2006), "Regulation and Economic Performance: Product Market Reforms and Productivity in the OECD", in T. Eicher and C. García-Peñalosa (eds.), Institutions, Development and Growth, MIT Press, and A. Basanini, L. Nunziata and D. Venn (2009), "Job protection legislation and productivity growth in OECD countries", Economic Policy, 24 (58), pp. 349-402.

The experiences of some of our European peers (Denmark, Sweden, Finland and Switzerland) show that the most successful fiscal rule frameworks are those that combine a budget deficit rule with explicit public expenditure ceilings.[1] Their usefulness lies in the fact that they are directed at the habitual source of budget deficits. Specifically, the ex-ante setting of a maximum amount of spending disciplines the drawing up of budgets for each unit of spending; these, therefore, have less room to exert upward pressure through individual demands. Further, the presence of a spending ceiling enables the rise in revenue in better-than-expected cyclical situations to be saved, ex post. Also, if the rule is well-defined and transparent, it provides for identification of the spending components that generate the deviations.

1 See G. Ljungman (2008), Expenditure Ceilings – A Survey, IMF Working Paper no. 282.

A spending rule is under discussion at the European level as part of the proposals to reform the SGP. According to the EC's proposal, its adoption would mean that, if a country failed to meet its medium-term fiscal target[2], fiscal policy would only be qualified as prudent if the increase in spending were lower than the economy's nominal potential growth, this being adjusted for discretionary measures on revenue.[3]

2 The medium-term objective of the SGP is defined individually for each country; but generally, it requires that countries attain and maintain a structural public balance that is in equilibrium.

3 This means that spending growth might exceed the economy's potential growth if a fiscal reform that is to increase revenue is anticipated (and the opposite in the case of a tax cut). The extra permitted spending growth above potential will be equal to the amount of revenue raised by the tax increase.

EX POST SIMULATION FOR THE 1998-2007 PERIOD OF THE APPLICATION OF A SPENDING RULE SIMILAR TO THAT PROPOSED BY THE EUROPEAN COMMISSION (a) (b)

Countries	Actual average growth in nominal primary spending (1998-2007)	Average growth of potential real GDP (c)	Average maximum growth in nominal primary spending compatible with the spending rule (1998-2007) (d)	Number of years with actual spending growth above the spending rule (e)	Actual general government budget balance in 2007	General government balance that would have been posted in 2007 had spending been compatible with the spending rule (f)
Belgium	4.5	2.4	3.6	7.0	-0.4	3.4
Germany	1.5	1.7	2.4	3.0	0.3	-3.5
Estonia	12.5	6.1	11.7	7.0	2.5	4.9
Ireland	11.6	5.5	7.5	7.0	0.0	11.2
Greece	9.3	2.9	6.5	9.0	-6.7	3.0
Spain	7.8	3.0	5.9	8.0	1.9	8.2
France	3.9	2.2	3.0	7.0	-2.7	1.2
Italy	4.4	1.9	3.6	7.0	-1.5	1.8
Cyprus	9.4	4.3	7.6	7.0	3.4	9.3
Luxembourg	7.2	4.0	6.6	6.0	3.7	5.7
Malta	4.7	2.2	4.0	5.0	-2.3	-0.2
Netherlands	5.5	1.7	4.6	6.0	0.2	3.4
Austria	3.2	2.2	2.7	6.0	-0.6	1.3
Portugal	6.4	1.9	5.3	7.0	-2.8	1.1
Slovenia	9.5	3.7	9.1	7.0	0.0	1.8
Slovak Republic	6.9	4.6	8.6	6.0	-1.8	-8.3
Finland	4.0	2.7	3.1	7.0	5.2	9.1

SOURCES: European Commission and Banco de España.

a The simulation is performed year by year, although columns 1, 2 and 3 show average growth.
b According to the National Accounts information available in December 2010.
c Average potential growth for the period 2004-2010 according to the report "The impact of ageing on public expenditure: projections for the EU25 Member States", Report of the Economic Policy Committee and the European Commission (2006).
d The simulated spending rule is defined as a ceiling on annual nominal primary expenditure growth equivalent to the sum of potential real GDP growth and the actual growth of the GDP deflator, adjusted by the existence of discretionary tax measures. Moreover, if the country has not in the year under analysis attained the medium-term fiscal objective, according to the EC's available estimates as at December 2010 of the cyclical adjusted balance corrected by the effect of the rule, the maximum ceiling on spending growth is reduced by 1%.
e The column indicates the number of years in which actual spending was higher than the maximum ceiling in the period running from 1998 to 2007.
f The budget balance that would have been obtained in 2007 if the estimated maximum spending ceiling had been observed in each year of the period.

The accompanying table illustrates the workings of a rule of this type.[4] Specifically, it shows the budget balance that the euro area countries would have obtained in 2007 had a similar rule to that proposed by the EC been applied each year over the 1997-2007 period. To do this, the fiscal data for 1997 are taken as the starting point and, if a country has not reached the medium-term fiscal target set by the SGP, primary public spending growth is set at 1 pp below the economy's nominal potential growth.[5] In this exercise, once the country attains the medium-term target, the increase in primary spending equals the economy's nominal potential growth.[6] it can be verified that strict compliance with this rule would have led to a much healthier situation in most of the countries during the decade prior to the economic crisis. Indeed, Germany is the only country in which its application would not have led to an improved fiscal situation, given that in the period analysed, it posted average primary expenditure growth of 1.5%, almost 1 pp below that required by the rule (2.4%). In Spain, the application of such a rule would have provided for saving on the extraordinary revenue arising from the real estate expansion, and it would have allowed a fiscal surplus in 2007 almost 6 pp of GDP higher than actually observed. This is the outcome of the fact that average primary spending growth for the period was significantly higher in Spain than that deriving from the application of the rule (7.8%, compared with 5.9%, respectively).

Defining a spending rule is not, however, free from difficulties. Firstly, a variable allowing the permitted spending growth to be anchored must be chosen. If the starting point is a balanced budget and, given that public revenue evidences approximately unit elasticity with respect to the economy's nominal GDP, the spending ceiling should be set on the basis of the growth of this variable. Evidently, if the starting point is a budget deficit, the return to a balanced budget will require spending growth below nominal growth until such equilibrium is attained. To prevent the change in public spending from being pro-cyclical, nominal GDP should be replaced by the economy's potential nominal GDP. In this way, in an economic upturn, characterised by GDP growth above potential, public spending should grow below actual GDP growth, while the opposite will occur in recessions. In any event, it should be stressed that the economy's potential growth is not an observable variable and its estimation is controversial. As a result, with a view to its application in the spending rule, a prudent estimate of potential output must be recommended.

Potential GDP growth is normally estimated only in real terms; accordingly, the definition of the nominal component is additionally required. In this connection, resort can be had to using the annual growth of the GDP deflator. However, if spending growth is allowed to accommodate any increase in the deflator, this might enable very high increases in spending as a result of the existence of likewise very high inflation. To avoid this problem, one option is to set a ceiling on the increase in the deflator incorporated into the rule (e.g. that compatible with the ECB's definition of price stability).

The rule should make explicit the spending components subject to it. On occasions, so as to prevent the ceiling from entailing a reduction in productive spending, the exclusion of investment spending has been proposed. Nonetheless, this rule is more difficult to oversee and easier to circumvent, since in practice the distinction between current and investment expenditure is not clear. In this respect, both the United Kingdom and Germany have recently abandoned this type of golden rule. The national fiscal rules in place often exclude interest payments.[7] Finally, it is occasionally proposed that spending on unemployment benefits be excluded from the rule, so as to avoid, once again, a procyclical bias. However, it is argued that its exclusion adds complexity to the rule and may leave out increases in spending arising from a structural rise in unemployment, which will not be corrected by the cyclical trend.

The spending rules should also make explicit the correction mechanism for potential deviations that may arise, in which connection their fit in the multi-year budgeting horizon may prove particularly appropriate.

In sum, spending rules have proven to be a very useful instrument for ensuring fiscal discipline, but their definition can greatly condition their effectiveness. Broadly, to maximise their effectiveness, they should: cover all public spending, including fiscal expenses; be applicable to all tiers of government; be part of a medium-term budgetary framework; be subject to a deviation-correction mechanism; and be anchored in prudent estimates of the economy's potential growth and inflation.

4 See L. Fernández-Caballero, P. Hernández de Cos and J. Pérez García (2011), *El marco de reglas fiscales en España,* mimeo.

5 Each country's potential growth is calculated as the sum of potential real GDP growth according to the European Union's Economic Policy Committee's 2006 estimates for the period 2004-2008 plus the GDP deflator observed for each year.

6 In keeping with footnote 3, the spending ceiling is raised/lowered by the estimated amount of the discretionary tax measures each year.

7 Set against growing public indebtedness as at present, this exclusion may give rise to a lower level of fiscal effort, or the opposite would occur in a situation of diminishing public debt/GDP ratios.

Given the effectiveness of these limits on spending growth - which have enabled the State's budgetary deviations to be reduced, setting aside the exceptional period of economic crisis[16] - and, above all, the decentralised nature of public spending in Spain, this type of rule should be extended to regional and local government, in particular to the former, where spending overruns compared with budget projections have been systematic and exceeded 3% per annum between 1984 and 2007. Further, even in the case of the ceiling on State spending, its definition may be better defined so that it is not only in terms of budgetary accounting, but also in National Accounts terms, and that it is anchored in a macroeconomic indicator, such as the trend growth of nominal GDP.

In this respect, Spain's recently updated Stability Programme commits to including a spending rule in the Budgetary Stability Law, of similar characteristics to the European Commission's recent proposal (see Box 2.1). Under this rule, budgeted and actual general government spending may not exceed the medium-term reference growth rate of the Spanish economy. Moreover, spending may only exceed that set under this rule if permanent revenue-increasing measures are adopted; in turn, regulatory changes entailing permanent losses in revenue will automatically lead to a downward revision of the spending threshold. The spending rule will be directly applicable to central and local government, and the government will pursue its adoption by the regional governments.[17]

Moreover, the mechanisms for enforcing the rules should be strengthened...

The fiscal rules should include appropriate mechanisms to enforce their application or, in the event of a breach, to correct this. In Spain's case, the Stability Law allows deviations from the limits set whereby, if they arise, the level of government responsible is obliged to submit a plan for their correction, which in the case of the regional governments should be approved by the Fiscal and Financial Policy Council. It is further established that, if as a result of this breach Spain is sanctioned under the SGP, the level of government responsible will pay the commensurate portion of the sanction. In addition, the Stability Law allows central government to make authorisations for the issuance of regional government public debt conditional upon compliance with these objectives. Such conditionality is, in fact, that which has been applied over the past year, and its use should be viewed most favourably, despite it not being automatically applicable. In this respect, it should be recalled that greater automaticity in the setting of specific sanctions is one of the aims of the reform of the Stability Pact. Under Spanish legislation there is, however, no possibility of establishing sanctions, beyond those mentioned arising from non-compliance with the SGP. Looking ahead, such a possibility might be considered as an additional disciplining mechanism, although the evidence shows that it is not easy to define these in a way that makes their application effective.

... and the transparency of public finances should be increased, especially at the regional and local government level

Another key element of fiscal rules is transparency, as acknowledged in the Budgetary Stability Law. Accordingly, although the dissemination of data on State activity is abundant, detailed and with relatively short lags, this was not the case for most regional and local governments until recently. That limited the ability to exert timely control over their activity and accountability, and it is particularly dangerous at times such as the present, when a lack of information might result in a lack of market confidence.[18]

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16 See T. Leal and J. Pérez (2009), *Análisis de las desviaciones presupuestarias aplicado al caso del presupuesto del Estado,* Documentos de Trabajo, no. 0933, Banco de España.

17 Moreover, the Stability Programme, in line with the proposed reform of the Stability Pact (which seeks to set greater store by public debt in the European fiscal surveillance procedure), mentions that stricter rules will be set for indebtedness, extending the monitoring thereof. This will refer not only to compliance with the rules on debt as defined in the Excessive Deficit Protocol, but also to other financial liabilities.

18 See T. Leal, D. Pedregal and J.J. Pérez "Short-term monitoring of the Spanish government balance", SERIEs-Journal of the Spanish Economic Association, 2, pp. 97-119.

To redress these shortcomings, in late 2010 the government began to publish information on the regional governments' budget outturn, individually and overall, on a quarterly basis (see Table 2.2). In any event, the regular publication of the budget outturn of regional governments as a whole, and on an individual basis, with the same periodicity, degree of detail, lag and accessibility as the State outturn, would be welcome. It would also be desirable to have some information, perhaps of a more aggregated nature, for the main cities, given their relative size compared with most of the regions. The latest Eurostat proposals to strengthen the Stability Pact statistically are, indeed, geared to increasing transparency.

Greater importance should be given to medium-term budgetary planning

Medium-term budgetary planning, necessitating the regular analysis of the structural dynamics of the various public revenue and spending captions and enabling those areas where room for rationalisation and adjustment is greater to be identified, may prove particularly appropriate when adjustment measures going beyond a temporary correction of imbalances are required. Indeed, the application of binding budgetary frameworks spanning several years is indicated in the literature as a positive factor in the application of fiscal adjustment plans, with the Netherlands a successful case in point in this connection.

In some cases, the full or partial delegation of fiscal policy decisions to an independent agency has also been discussed recently at the international level as a means of increasing discipline, although the attendant design and effectiveness of such a mechanism is not free from controversy (see Box 2.2).

For fiscal discipline, defining an appropriate framework for local and regional government is vital

In a highly decentralised system such as Spain's, achieving fiscal discipline comes up against the traditional problems of inter-government coordination. In this respect, in addition to extending fiscal rules to the lower tiers of government, the Stability Law includes a clause that establishes that the State shall not be responsible for financing the deficits or public debt of the lower levels of government.[19] This clause seeks to prevent the cost of inappropriate fiscal behaviour in one region from passing through to the rest or to central government, and its presence enables the capital markets to continue to exert a significant disciplining effect on the basis of distinguishing between the risk premia on the debt of the different governments.

In addition, achieving fiscal discipline also depends on some correspondence between the level of accountability governing regions' spending and their fiscal autonomy (fiscal co-responsibility), this being understood as the ability of the regions to generate revenue to fund such spending. Without this autonomy, the regions depend excessively on inter-governmental transfers, distorting the relationship that should exist between taxation and public spending. That makes it more unlikely that citizens will penalise the undisciplined behaviour of the authorities, the appearance being that regional spending is funded, at least in part, by non-residents in the region. Indeed, the empirical literature finds a positive relationship between the level of transfers received by the regions and their levels of public spending and budget deficit.[20] In Spain, although there has been a gradual increase in fiscal co-responsibility, this has only reached a scale and, above all, acquired significant characteristics in the latest financing arrangements: in these, the State guarantees on revenue growth were eliminated, the weight of tax receipts as a

19 Specifically, the Single Additional Provision of the Budgetary Stability Law states that "the State shall not assume nor be accountable for the commitments of the regional governments, the local governments and the bodies linked or reporting to them,...".

20 For the case of Spain, see I. Argimón and P. Hernández de Cos (2011), "Fiscal Rules and Federalism as Determinants of Budget Performance: an Empirical Investigation for the Spanish Case", Public Finance Review, 3 February.

AVAILABILITY ON THE INTERNET OF INFORMATION FOR THE YEAR AS AT DECEMBER 2010 ON THE BUDGET OUTTURN FOR GENERAL GOVERNMENT, THE STATE, THE SOCIAL SECURITY SYSTEM AND THE REGIONAL GOVERNMENTS

TABLE 2.2

	Coverage	Frequency	Publication lag	First year available	Accounting framework
STATE	Revenue and expenditure	Monthly (a)	Approximately one month	Cash basis: Jan 1988 Nat. Acc.: Jan 1995	Nat. Acc., Cash basis
SOCIAL SECURITY					
Social Security System	Revenue and expenditure	Monthly (a)	Approximately one month		Cash basis
National Public Employment Service	Revenue and expenditure	Monthly (a)	Approximately one month	January 1984 (b)	Cash basis
REGIONAL GOVERNMENTS	Revenue and expenditure	Quarterly	Two months	2010 Q4	Budget
	Since December 2010 the budget outturn figures have been published uniformly on a quarterly basis for the regional governments, in aggregate form and individually.				
Other regularly published data (c):					
Andalusia	Revenue and expenditure	Quarterly	Approximately one month	2008	Cash basis
Aragon	—	—	—	—	—
Asturias	—	—	—	—	—
Balearic Islands	—	—	—	—	—
Canary Islands	Revenue and expenditure	Quarterly	Approximately one month	1990	Cash basis
Cantabria	Revenue and expenditure	Monthly	Approximately one month	2006 (half-yearly from 2001 to 2005)	Cash basis
Castile-La Mancha	Revenue and expenditure	Quarterly		1999	Cash basis
Castile-León	Revenue and expenditure	Monthly	Approximately one month	November 2009 (quarterly from 1991)	Cash basis
Catalonia	Revenue and expenditure	Monthly	Approximately twomonths	2007	Cash basis
Extremadura	—	—	—	—	—
Galicia	Revenue and expenditure	Quarterly	Approximately four months	2002 Q1	Cash basis
La Rioja	—	—	—	—	—
Madrid	Expenditure	Monthly	Approximately two months		Cash basis
Murcia	—	—	—	—	—
Navarre	—	—	—	—	—
Basque Country	Revenue and expenditure	Quarterly	Approximately two months	2004 Q2 (annual from 2000)	Cash basis
Valencian Community					
GENERAL GOVERNMENT	Revenue and expenditure	Quarterly	Approximately three months	2000	Nat. Acc.

SOURCES: IGAE, Administración de la Seguridad Social, Economics and Statistics Offices and Official Gazettes of each of the regional governments.

a The publication of the December figure for the State, Social Security System and National Public Employment Service has a lag of over one month.
b The Social Security System and National Public Employment Service figures prior to this date were published quarterly.
c Search made on public services as at 10 December 2010. The sources consulted were the websites of the Economics and Statistics Offices and Official Gazettes of each of the regional governments.
d Initial publications on the Canary Islands budget outturn only included revenue.

In the ongoing reform of euro area economic governance rules and institutions, changes to the institutional framework for fiscal policy decisions are a priority. In this respect, two recommendations currently under consideration[1] are to reinforce the independence of European fiscal policy supervision, through the creation of an independent European fiscal agency under the control of the Eurogroup, and to broaden national fiscal frameworks through the creation of independent budget offices or fiscal oversight agencies in all the member countries.

The taxonomy of these independent fiscal agencies distinguishes two main types.[2] First, there are *fiscal councils* with an analytical or forecasting role, which act as reference points, counterweights or guarantors of orthodox fiscal policy conduct and of compliance with the existing fiscal rules. Second, there are *independent fiscal authorities* which can influence budget balance directly by controlling some operational fiscal policy instrument.

The main theoretical reason for delegating a public decision to an independent authority is the existence of time inconsistency, i.e. a situation where short-term decisions are taken without considering their long-term consequences. In the case of monetary policy, *inflation bias* can be reduced by delegating control of operational monetary tools to an independent central bank with a clear price stability objective.

In the case of fiscal policy there may be a *deficit bias*, especially in the context of a monetary union[3], but the delegation of fiscal instruments is less common, given the limited consensus regarding the optimal levels of public spending and revenue. However, an example of delegation of fiscal levers to non-government authorities occurs in the management of sovereign wealth funds. In democratic countries, these funds are used to smooth public spending and taxes over time, and they are governed by a framework similar to the delegation of monetary policy, as summarised in the IMF's "Santiago Principles".[4] Under these principles, sovereign funds should have a mandate that defines their objectives and confers them operational independence from the Finance Ministry, subject to rules of transparency in their conduct. Further, central banks usually act as guarantors of the independence of sovereign funds: for instance, a division of the Norgesbank manages the Norwegian funds, while the Central Bank of Chile appoints the management committees of the Chilean funds.

In the euro area, the role of the European Commission in the application of the Stability and Growth Pact (SGP) can be seen as an example of delegation of fiscal responsibilities to a supranational agency. Nonetheless, the operation of the SGP has been complicated by a lack of effective tools to ensure fiscal discipline *ex ante*, as opposed to sanctioning indiscipline *ex post*; moreover, the empirical evidence suggests that an independent fiscal agency should be a national body, given the importance of specific knowledge of domestic fiscal conditions. Consistent with these arguments, many economists have proposed designs for possible independent fiscal authorities that would be mandated to ensure budget balance, and would be delegated effective operational control of some fiscal instruments to achieve this. Proposed instruments include changing VAT or income tax rates, without Parliamentary intervention, when budgetary or economic circumstances so require, or imposing across-the-board spending cuts if legislators approve a budget inconsistent with the mandated deficit level.[5]

However, in practice most independent fiscal bodies today take the form of advisory councils. Their mandates range from the preparation of budgetary and macroeconomic forecasts to the evaluation of government policy proposals. Historical evidence suggests that these councils may reduce deficit bias if they intervene directly in the budgetary process with their own normative recommendations, and that they can reinforce the impact of fiscal rules, laws or objectives.[6] Examples come from the United States, where Congressional Budget Office forecasts were used to calculate the fiscal adjustments needed to offset new spending programmes; from the Netherlands, where party platforms are based on the macroeconomic forecasts of the fiscal council, which also evaluates the fiscal agreements of coalition governments; and also from Chile, where two mutually independent panels monitor the maintenance of a structural surplus of 1% of GDP over the economic cycle. Another relevant role played by some independent fiscal agencies is to act as a neutral referee between central and regional governments, as stipulated, for example, by a recent reform in Australia.[7]

In Spain's case, one new institutional feature this year is the establishment of the OPCG (Parliamentary Budgetary Office)[8], which is intended as an advisory body for Parliament, designed to monitor and verify budget implementation. The specific role of the OPCG has still to be defined in detail.

1 ECB (2010), "Reinforcing Economic Governance in the Euro Area", June.
2 See X. Debrun, D. Hauner and M. Kumar (2009), "Independent fiscal agencies", Journal of Economic Surveys, 23 (1), pp. 48-81, and L. Calmfors and S. Wren-Lewis (2011), What should fiscal councils do?, CESifo WP3382.
3 See A. Velasco (1999), "A Model of Endogenous Fiscal Deficits and Delayed Fiscal Reforms", in J. Poterba and J. Von Hagen (eds.), Fiscal Institutions and Fiscal Performance, University of Chicago Press, and R. Beetsma and R. Bovenberg (1999), "Does monetary unification lead to excessive debt accumulation?", Journal of Public Economics ,74, pp. 299-325.
4 International Working Group of Sovereign Wealth Funds (2008), Generally Accepted Principles and Practices, October.
5 See J. Von Hagen and I. Harden (1995), "Budget processes and commitment to fiscal discipline", European Economic Review, 39, pp. 771-779; S. Wren-Lewis (2002), Fiscal policy, inflation, and stabilisation in EMU, mimeo, University of Exeter; L. Calmfors (2003), "Fiscal policy to stabilise the domestic economy in the EMU: what can we learn from monetary policy?", CESifo Economic Studies, 49 (3), pp. 319-353, and C. Wyplosz (2005), "Fiscal policy: institutions versus rules", National Institute Economic Review, 191, pp. 70-84.
6 See Debrun et al. (2009), op. cit., and Calmfors and Wren-Lewis (2011), op. cit.
7 Council of Australian Governments (2010), Charter, "COAG Reform Council", 30 June 2010.
8 Law 37/2010 of 15 November 2010 on the creation of the Parliamentary Budgetary Office.

MAIN FEATURES OF THE NEW FINANCING ARRANGEMENTS FOR THE ORDINARY-REGIME REGIONAL GOVERNMENTS

TABLE 2.3

TAXES TRANSFERRED (percentages transferred under previous arrangements in brackets)	% transferred	Normative capacity
DIRECT TAXES		
Personal income tax	50 (33)	Yes
Estate duties	100 (100)	Yes
INDIRECT TAXES		
VAT	50 (35)	No
Manufacturing duties	58 (40)	No
Retail sales of hydrocarbons	100 (100)	Yes
Electricity	100 (100)	No
Transfer tax and stamp tax	100 (100)	Yes
Car registration	100 (100)	Yes
Gaming tax	100 (100)	Yes
GUARANTEE FUND		
Amount in base year: the regional governments contribute 75% of taxes transferred in normative terms and the State contributes an amount of around 0.8% of GDP.		
The Fund is distributed by regional government on the basis of adjusted population (population 30%, equivalent protected population 38%, population over 65 8.5%, population 16 and under 20.5%, surface area 1.8%, dispersion 0.6%, island status 0.6%).		
In future years the regional government contribution changes in step with tax takings, the State contribution according to the ITE (a) and the adjusted population is re-calculated year by year.		
SUFFICIENCY FUND		
Amount in base year: net borrowing of each regional government (including share in the additional State contribution to the system, around 0.7% of GDP), less financing by taxes transferred in normative terms and less net share in the Guarantee Fund.		
In future years, the Fund changes according to the ITE (a).		
REGIONAL CONVERGENCE FUNDS		
Two new funds are created: the Competitiveness Fund (0.2% of GDP in the base year) and the Cooperation Fund (0.1% of GDP in the base year).		
The Competitiveness Fund is annually distributed among the regional governments on the basis of adjusted per capita financing below the average or below their fiscal capacity, on the basis of their relative adjusted population.		
The Competitiveness Fund is annually distributed among the regional governments whose per capita GDP is below 90% of the average, whose population density is less than 50% of average density or, given population growth that is lower than 90% of the average, whose population density per square kilometre is lower than the figure resulting from multiplying the average density of the ordinary-regime regional governments by 1.25.		
In future years both funds will change in step with the ITE (a).		

SOURCE: Banco de España.

a The ITE comprises State takings for the year (excluding tax resources transferred to the regional governments), personal income tax, VAT and excise duties on beer, wine and fermented beverages, on intermediate products, on alcohol and derivative beverages, on hydrocarbons and on tobacco products.

proportion of total regional government revenue increased, with the dependence on State transfers diminishing, and regulatory powers over taxation were increased (see Table 2.3).

However, some elements have still to be resolved. The first arises from the lack of stability of the system, which has given rise to high incentives for the regional governments to promote negotiation processes as a means of increasing the volume of financing acquired. Also contributing to this instability of the financing agreements is the complexity of the arrangements, which hampers anticipating how they may unfold over time and, indeed, setting a specific annual amount, which only depends on actual tax receipts with a time lag. The second element, associated with the first, arises from the way in which the regional governments' guaranteed spending is determined, since in negotiations it has always been chosen to take the previous financing level as the base figure. That offers assurances to all the regional governments that, in the year taken as the base, they will see no decline in their resources. Looking ahead, it would be desirable, on one hand, to have a more stable financing system and, on the other, to use some objective method of calculating the regional governments' actual spending needs. Such a method would assess current effective spending, it would add greater objectivity to the system and it would eliminate the incentives to periodically reconsider agreements that take the previously attained level of financing as their basis.

4.2 PUBLIC SPENDING

To ensure fiscal stability, pensions reform is pivotal...

Taking the long view, the key factor for fiscal sustainability in Spain and in other developed countries is the impact on public finances of population ageing, which will push both pensions spending and health care and dependency spending upwards. Accordingly, ensuring the long-term sustainability of public finances involves, first, reforming the pensions system. This reform is particularly appropriate in the short term, since significant positive effects in terms of confidence may ensue from it, whereas its repercussions on demand are very limited. And regard should be had to its positive influence on the economy's potential growth, via the increase in participation rates, in particular those of the oldest cohorts.

... and must act on the actual retirement age and on the commensurateness of contributions to pensions, as the recent draft reform proposes

Since the increase in spending is due essentially to the rise in life expectancy and to the subsequent impact on the dependency ratio, the sustainability of the system necessarily entails raising the retirement age, restricting early retirement and encouraging a longer working life. The same considerations, along with reasons relating to fairness and encouraging participation in the labour market, also advise moving towards the proportionality of contributions paid in throughout working life to the pension received, in which connection the number of years of contributions for the calculation of the amount of the pension (the regulatory base) must be raised significantly, which would bring us closer into line with other European countries (see Table 2.4).

The draft legislation on the reform of the public pension system submitted by the government to Parliament in March 2011 marks progress in both directions, and on the projections available, it will bring about a significant saving on the increased expenditure envisaged (see Box 2.3).

The introduction of a factor of sustainability is particularly important...

The reform also includes a factor of sustainability as from 2027, which should be instrumental in the revision every five years of the fundamental parameters of the system in terms of the differences between the trend of life expectancy for the population at the age of 67 from the year 2027 to the year in which the revision is made. The prompt definition of this factor of sustainability and the bringing forward of its application from the envisaged date (2027) are particularly important, and should avoid successive rounds of negotiations on the adaptation of the parameters, which are so difficult to agree on.

Some European countries have already introduced similar measures (see Table 2.4). In some (Finland, Italy and Portugal), the factor of sustainability depends on changes in life expectancy, whereas in Germany the deciding factor is the ratio of pensioners to workers paying contributions. In the cases of Finland and Italy, it only affects the calculation of new pensions; in Germany's case, meanwhile, the factor of sustainability affects new pensions and the way in which previous pensions are updated. In most cases, the adjustment of the social security system parameters is automatic, except in Austria, where changes in life expectancy are only taken as an indicator of the need to activate the adjustment.

In March 2011, the government submitted to Parliament the draft law on the reform of the public pensions system, containing proposals to amend some of its main parameters. Firstly, the retirement age is to be generally raised to 67 (compared with 65 at present). The extension will be progressively applied in the period from 2013 to 2027, at a rate of one month per year up to 2018 and two months a year from 2019. However, workers who have contributed to the system for 38 years and six months may continue to retire at the age of 65.

The reform also states that, from the age of 63, there is a possibility of taking early retirement provided 33 years' contributions have been made. In each case an annual reduction factor of 7.5% for each year ahead of the new ordinary retirement age shall be applied, although in these cases no top-up to the minimum pension will be applicable. The only exception to this rule has it that the minimum age (63) may be reduced to 61 in crisis situations.

The second notable feature of the reform is the lengthening of the period used to calculate the amount of the pension (the "regulatory base") from 15 to 25 years (immediately prior to retirement). This will be progressively phased in at a rate of one year per annum from 2013 to 2022. 37 years' contributions will be necessary to qualify for 100% of the regulatory base of the pension, whereby the first 15 years of contributions will entitle pensioners to 50%, while the remaining 50% will be obtained proportionately between 15 and 37 years' contributions, the calculation being made monthly. In this case a transitional period has also been set, commencing in 2013 and concluding in 2027. It is further established that, in the event of gaps in contributions, those relating to the first 24 months shall be topped up with the minimum contribution base, and those exceeding 24 months, with 50% of the base. That is in contrast to the current legislation, where all gaps are supplemented with the minimum base.

The reform introduces a sustainability factor as from 2027, with the aim of maintaining the proportionality of contributions to expected system benefits. In this connection, every five years the system's fundamental parameters will be revised on the basis of the differences observed between the population's life expectancy at the age of 67 as at the year in which the revision is made and life expectancy at 67 in 2027, using to this end the projections made by the competent government agencies. Finally, under certain conditions, the reform enables women who have interrupted their working life to have a baby or to adopt to bring forward their retirement age ahead of 67, by a proportion of nine months per child, for a maximum of two years. New incentives are also provided to prolong working life,

together with greater safeguards for university and vocational training programmes, so that the entities and companies funding such programmes will have to contribute to the Social Security system for programme beneficiaries.

As regards the potential impact of this reform, information from the MCVL (Continuous Survey of Working Life) shows that a significant proportion of individuals retire at present having contributed for more than 38 years and six months. Under the new regulations, these individuals may continue to retire at 65 and, therefore, they would not be affected by the higher retirement age. In particular, since 1998 the percentage of individuals who have retired at the age of 65 or less and with years of contribution more than or equal to 39 years has held relatively stable at a figure close to 50%.

In terms of the breakdown by sex, this percentage is higher in the case of men (around 61%) than in that of women (20% in 2009). The percentage in the case of women can be seen to be on a mildly growing trend, rising from 12% in 1998 to 20% in 2009; accordingly, in the future, the increase in female participation might exert slight upward pressure on this percentage, raising the number of people who might take retirement at 65.

With regard to skills, the group of highly skilled workers evidences a slightly lower percentage than the rest, due possibly to the fact that a higher level of educational attainment is associated with entering the labour market at a later age. Looking ahead, insofar as this high-skills group continues to increase, there might be a reduction in the percentage of people who can take retirement at 65.

In sum, no clear trends are apparent in changes in the percentage of individuals who, aged 65 or less, and with 39 years' contributions or more, have retired in recent years. With a view to the future, if these percentages hold, the increase in the legal age of retirement by two years, from 65 to 67, would give rise to an impact of around 1.1 years on average on top of the actual retirement age. In any event, the increase in the female participation rate might drive this percentage upwards, while the presumed increase in the population's level of educational attainment would have the opposite effect.

As to how the average pension will be affected by the increase in the number of years' contributions taken into account in calculating the regulatory base and the new treatment accorded to gaps in contributions, information drawn from the MCVL can be used to estimate the impact that would arise from these changes had the new regulations (those corresponding to the final year of the transitional period, 2022) been applied to actual retirements in 2008. To do this, the regulatory bases of the generation that was born in 1943 and which retired in 2008 are estimated. For this group it is obtained that the application of the reform would have brought about an average reduction in pensions of 4.7%. This reduction cannot, however, be taken as an estimate of the impact of the reform on future pensions since, among other matters, individuals might change their behaviour, increasing for instance their participation in the labour market, as a result of the reform.

Calibrating the long-term effects of such a far-reaching reform of the parameters of the pensions system is a complex task and one subject to the uncertainty of the many assumptions that must be made. Possible exercises include estimates with a general equilibrium model, calibrated for the Spanish economy, with overlapping generations of economic agents that take optimal consumption, saving, work and investment decisions. These estimates are comparable with those made by the European Commission's Economic Policy Committee, which show an increase in contributory pension spending of 6.3 pp of GDP between 2009 and 2060, insofar as they are based on the same population projections to 2060 (those made by Eurostat and which are known under the name of EUROPOP 2008) and the same projection on total factor productivity, which is a determinant of the future course of GDP and, therefore, of the sustainability of the Social Security system.

Specifically, a simulation has been made of the impact on future pensions spending of the estimated increase in the effective retirement age, the extension of the calculation period determining the regulatory base and the modification of the scale of percentages according to the number of years' contributions. The results of the simulations show that the effect of these changes might entail a saving of around 40% on the projected increase in pensions spending relative to GDP from 2009 to 2060 (see accompanying table). Consequently, the reform is a major step towards easing the effects of population ageing. The results are in line with those estimated in other papers, including the government's official estimate. Moreover, these effects of the reform might become wider following the activation of the sustainability factor, which would contribute to reducing pensions spending further if its application were to infer new changes to the system's parameters such as, for instance, increases in the number of years used to calculate the pension and/or the putting back of the effective retirement age.

THE IMPACT OF THE REFORM ON FUTURE PENSION SPENDING. A COMPARISON OF EXISTING ESTIMATES (%)

	Increase in the retirement age (1)	Lengthening of calculation period (2)	Change in scale (3)	Total effect (1) + (2) + (3)	Sustainability factor
2009-2050 period					
Government	15	15	8	38	15
Díaz-Saavedra et al. (2010= (Δ ret. 1.4 years) (b)	—	—	—	38	—
De la Fuente and Doménech (2011)	—	—	—	40	—
Banco de España model (Δ ret. 1 year) (c)	14	26	11	43	—
2009-2060 period					
De la Fuente and Doménech (2011)	—	—	—	39	—
Banco de España model (Δ ret. 1 year) (c)	7	22	10	37	—

SOURCE: Banco de España.

a The results show the saving from each reform expressed as a percentage of the envisaged increase in spending without reform.
b The estimates of Díaz-Saavedra et al. (2010) include (1) and (2), but not (3). In these, the increase in the simulated retirement age is 1.4 years.
c In this model, the minimum frequency is annual. Accordingly, to approximate the estimated raising of the retirement age by 1.1 years, an increase of one year in the retirement age is simulated. Moreover, it should be borne in mind that the total effect of the reforms, i.e. the sum of (1), (2) and (3), is not equal to individual sum of each reform, owing to the interactions between them.

...whereas, with a view to enhancing transparency and system incentives, it would be desirable to move towards the proportionality of contributions to pensions

Some countries (Sweden, Italy and certain central and eastern European countries) have opted for more extensive reforms, such as the transition towards a system which, being unfunded, is based on the defined contribution principle. Under this principle, pensions are proportionate to the contributions made by each individual over the course of their working life, they are duly updated on the basis of demographic and economic developments, and they depend on their age at the time of retirement. This rule entails greater transparency in the calculation of pensions, which encourages labour participation, lengthens working life and, in this way, ultimately raises the ratio of pensions received to wages.

The dynamics of health spending are also worrying...

The estimates available presage a strong increase in health spending as a result of population ageing, of around 1.6 pp of GDP to 2060.[21] An analysis of public spend-

21 See European Commission and CPE (2009), "The 2009 Ageing Report: economic and budgetary projections for the EU-27 Member States (2008-2060)", European Economy, no. 2/2009.

PENSION SYSTEMS IN THE EU-15 — **TABLE 2.4**

RECENT REFORMS TO PENSION SYSTEMS IN THE EU-15

	Reforms to system parameters						Structural reforms	
	Calculation of pensions							
	Retirement age	Incentives to carry on working	Measure	Updating of contribution bases	Updating of the pension	Sustainability factor	Defined contribution	Notional accounts
Germany	X	X			X	X		
Austria	X	X	X	X				
Belgium	X	X		X				
Denmark	X	X				X		
Spain (a)		X						
Finland		X	X	X	X	X		
France	X	X	X	X		X		
Greece	X		X					
Netherlands								
Ireland		X						
Italy	X	X	X		X	X		X
Luxembourg			X					
Portugal	X	X	X	X	X	X		
United Kingdom	X	X			X			
Sweden			X			X	X	X

DESCRIPTION OF SUSTAINABILITY FACTORS IN PLACE IN EU-15 PENSION SYSTEMS

Germany	The degree of indexation of the pension to wage growth will be adjusted on the basis of the difference between the change in the number of contributors to the system and the increase in the number of pensioners.
Denmark	Increases in life expectancy at the age of 60 will translate as from from 2005 into the retirement age being put back so that the average number of years pension collection will remain set at 19.5 years. The new estimates, which will be updated every 5 years, will come into force 10 years after.
Finland	The amount of the pension is adjusted on the basis of the changes that arise in life expectancy as from 2010.
France	The reference period used to calculate the amount of the pension is adjusted on the basis of the the increases that arise in life expectancy at 60, so that the relationship between the reference period for the calculation of the pension and the number of expected years in retirement holds constant.
Italy	The amount of the pension depends directly on "transformation coefficients", which in turn depend on life expectancy. These shall be revised every ten years.
Portugal	The amount of the pension will be adjusted according to the relationship between life expectancy at 65 in 2006 and life expectancy at that same age in the year immediately prior to retirement .
Sweden	The amount of the pension will be adjusted on the basis of life expectancy as at the age at which retirement becomes effective, with no distinction by sex.

SOURCES: CPE, European Commission and Banco de España.

a Measures forming part of the draft pension system reform submitted to Parliament by the government in March 2011 are not included.

ing by function in the decade prior to the crisis reveals the strong growth of this item, with annual rates close to 9% between 1997 and 2007, and exceeding 20% of total public spending. A breakdown of the annual average growth of per capita health care spending shows, moreover, that the contribution of the non-demographic factors (associated, inter alia, with supply-side elements) is estimated to be very high; consequently, extrapolating past behaviour to the future, the increases in health spending in the long run might exceed those arising from the purely demographic effect.

HEALTH CARE SECTOR REGULATION INDICATORS AND ESTIMATE OF THE POTENTIAL IMPACT OF REGULATORY CHANGES ON EFFICIENCY

TABLE 2.5

	Value of the indicator (a)		Elasticity of changes in regulation on efficiency (b)
	Spain	Maximum in the OECD	
Price regulation	5.30	5.90	0.011
Control of access to specialists	6.00	0.00 (c)	-0.005
Control of objectives	2.80	5.70	0.009
Price mechanisms	1.30	3.10	0.020
Development of private coverage	3.00	6.00	0.003

SOURCE: Hernández de Cos and Moral Benito (2011), drawing on OECD data.

a All the indicators range from 0 (minimum) to 6 (maximum).
b Obtained using the regression of an estimated level of efficiency for each country on the basis of 20 health care policy indicators considered by the OECD. The table shows only indicators and their estimated elasticity in cases in which this is significant.
c In the case of this indicator, given that estimated elasticity is negative, the value in the table is the minimum, not the maximum, in the OECD countries.

... although gains in efficiency in this sector can be achieved

The improved efficiency of health spending might provide for cost savings by bearing on certain regulatory factors[22], including most notably price mechanisms (little used in Spain), the regulation of supplier prices and a degree of competition in the provision of services (see Table 2.5).[23]

Public-sector employee compensation should play a key role in the fiscal adjustment...

In Spain, the general government sector employed somewhat more than 15% of all wage-earners in 2009, with total gross wages amounting to close to 20% of economy-wide employee compensation, on average, in the period 1999-2010. in terms of public spending, the significance of this variable is even greater, since it accounts for around 26% of the total. In the ongoing fiscal adjustment, and according to the latest Stability Programme Update, the contribution of the cut in this total gross wage bill between 2009 and 2014 might account for around 30% of the total reduction in the budget deficit.

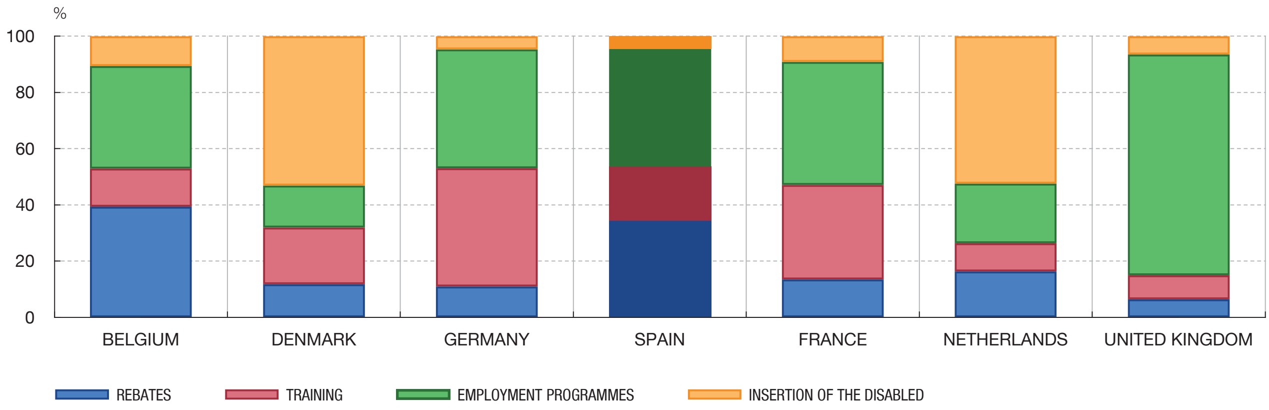
Employee compensation has played a dual role in other countries' successful consolidation strategies, helping make the adjustment durable and reducing its effect on economic activity in the short term. The interaction between public- and private-sector wages is the main channel through which the cushioning or offsetting of the potential restrictive effect of the containment of public-sector employee compensation on GDP is instrumented. In the case of the Spanish economy, the evidence indicates that the multiplier effect on activity of a reduction in employee compensation is positive even in the short term.[24] Using this relationship between public- and private-sector wages may be particularly relevant in a context in which the growth of the economy requires significant gains in competitiveness. For this to be possible in the current circumstances, the reform of collective bargaining is vital.

In any event, it should be borne in mind that, when aggregate fiscal adjustment needs are considerable, measures based on restricting public-sector total gross wages face certain limits, given their potential impact on the efficiency and sufficiency of services. In this respect, in terms

22 These results should be viewed with caution given that they do not always prove robust to the measure of health care spending efficiency used. See P. Hernández de Cos and E. Moral Benito (2011), *Eficiencia y regulación en el gasto sanitario en los países de la OCDE,* mimeo.
23 Specific recent regulatory decisions by the government attempt to influence the reduction in prices and distribution margins. For example, Ministerial Order SPI/3052/2010 of 26 November 2010, determining sets of drugs and their reference prices, and also regulating specific aspects of the reference price system, and Royal Decree 8/2010 of 20 May 2010, adopting extraordinary measures for the reduction in the budget deficit (Chapter 5, health measures).
24 See F. De Castro and P. Hernández de Cos (2008), "The economic effects of fiscal policy: the case of Spain", Journal of Macroeconomics, 30, pp.1005-1028.

BREAKDOWN OF PUBLIC SPENDING ON ACTIVE EMPLOYMENT POLICIES IN SPAIN AND SELECTED EU COUNTRIES IN 2008

CHART 2.5



SOURCE: Eurostat.

of restricting public-sector employment, consideration must be given to the fact that, according to the MAP (General Government Ministry), the main weight of public employment in Spain is concentrated in activities that are complementary to the private sector (Justice, Security Forces, general administration) or potentially substitutive of private activity, but which are considered basic public services (education and health, almost 45% of the total).[25] The staff employed in public corporations account for less than 5% of total public-sector employment in Spain.

As regards compensation per employee, the estimates available show there is some leeway for the adjustment, given that significant positive wage differences are observed between compensation per employee in the public sector as opposed to the private sector, even when controlling for individual characteristics.[26] These differences would be chiefly concentrated in the lower-skilled strata.

... while public investment projects should be rationalised...

Turning to public investment, it should be borne in mind that the growth of non-residential public productive capital was close to 4.5% on average between 1994 and 2007, which allowed the gap between Spain and the other euro area countries in terms of the public capital/population ratio to be reduced by more than 20 pp to 85% of the average for the euro area at end-2009. Likewise, the public investment/GDP ratio in 2009 stood at 4.4% of GDP in Spain (2.8% on average in the euro area); accordingly, the weight of this variable could be reduced without harming the necessary process of convergence.[27] The reduction in the European funds that were used in the past to fund a significant portion of this public investment also makes it necessary to rationalise future investment projects to some extent. In this connection, it should be borne in mind that the positive effects of public investment on productivity appeared to arise only from specific components, such as infrastructure, and these may moreover be cut significantly as from certain thresholds.

...as should public transfers and subsidies, whose weight in public spending is high

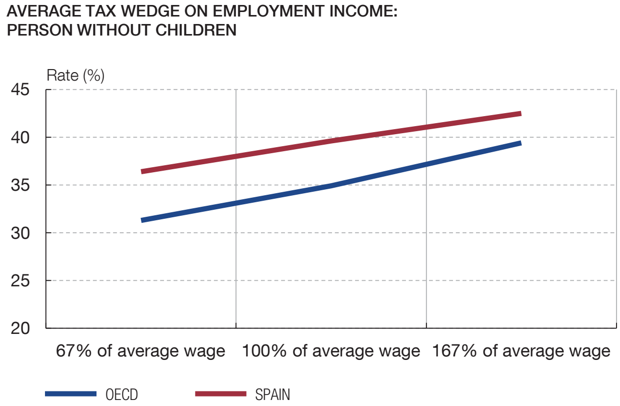
The weight of some spending items, in particular other transfers and current payments, capital transfers and subsidies, is high, accounting in 2010 for almost 9% of total public

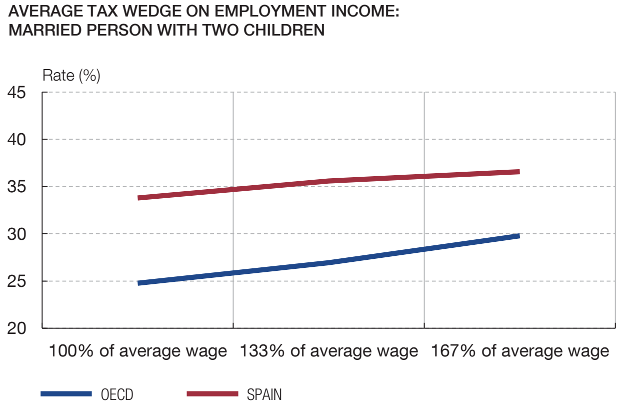
25 For a classification of public-sector activities that are substitutive of or complementary to private activities, see R. Fiorito and T. Kollintzas (2004), "Public goods, merit goods, and the relation between private and government consumption", European Economic Review, 48, pp. 1367-1398.

26 J. I. García-Pérez and J. F. Jimeno (2005), Public sector wage gaps in the Spanish regions, Documentos de Trabajo, no. 0526, Banco de España. See also R. Giordano and D. De Palo (2011), *The public sector pay gap in selected euro area countries,* mimeo, Banca d'Italia.

27 Moreover, it should be taken into account that much of the investment in infrastructure is by the corporate public sector or funded (at least in part) by the private sector.

AVERAGE TAX WEDGE ON EMPLOYMENT INCOME (a) CHART 2.6





SOURCE: OECD (2011), *Taxing Wages 2010, OECD Publishing.*

a The average tax wedge on employment income for each standard individual is obtained as the sum of personal income tax derived from employment income plus social security contributions borne by the employer and the worker, on one hand, and the related gross average wage of private-sector full-time employees, on the other.

spending and around 4% of GDP. Currently, more than half the subsidies and transfers are aimed at public and private companies, which include most notably infrastructure and transport companies, along with those aimed at promoting employment and at international cooperation. There would therefore be room for rationalisation in this field, on the basis of effectiveness criteria and bearing in mind the potential distortionary effects that this type of transfer generates. In this area, the latest Stability Programme Update considers significant reductions in this type of spending of around 1.8% of GDP in the 2014 horizon.

Lastly, employment policy should be reorganised, giving greater weight to the so-called "active policies"

The weight of spending on unemployment benefits rose to 3% of GDP in 2010, a significantly higher level than the European average, as a result of Spain's high unemployment rate. Conversely, active employment policies accounted in 2008 for only 0.6% of GDP, below the EU average (see Chart 2.5). This difference is even greater when analysed in terms of spending per unemployed person. The breakdown of spending on active policies shows, moreover, that almost 35% of active policy expenditure in Spain was earmarked for the concession of Social Security rebates (compared with 23% in the EU), while spending on training accounted for only 19% (36% in the EU).

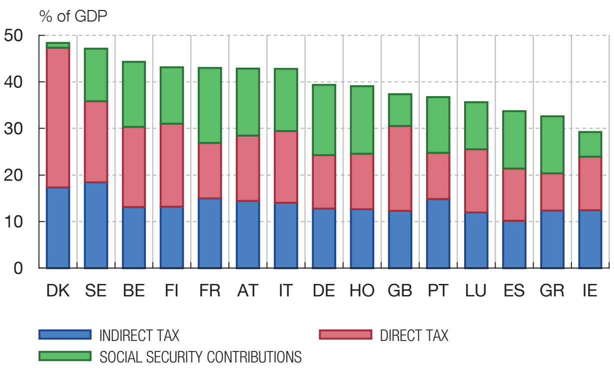
Against a background of high unemployment levels, employment policies should be chiefly aimed at preventing this increase in joblessness from becoming structural. To do this, it should be borne in mind that the available empirical evidence shows that the effectiveness of Social Security rebates is very limited, whereas unemployment benefits have negative effects on unemployment exit rates, lengthening the duration of unemployment and increasing the likelihood of it becoming structural. In this respect, active and passive employment policies should be reorganised and greater control maintained over effective job search by workers. Active policies should reduce the funds currently assigned to rebates, which should be confined to the groups facing most employability difficulties, in line with the reform approved in 2010. Also, these funds should be earmarked to a greater extent for training, with highly specific technical content.[28]

28 See C. Alonso-Borrego, A. Arellano, J.J. Dolado and J.F. Jimeno (2004), *Eficacia del gasto en algunas políticas activas en el mercado laboral español,* Documento de Trabajo no. 53, Fundación Alternativas, Madrid.

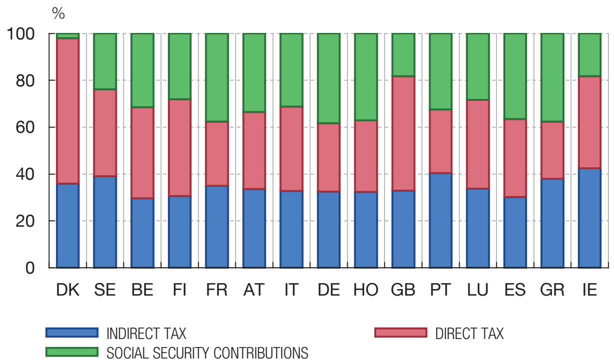
TAX STRUCTURE IN SPAIN AND IN THE EU-15 (a)

CHART 2.7

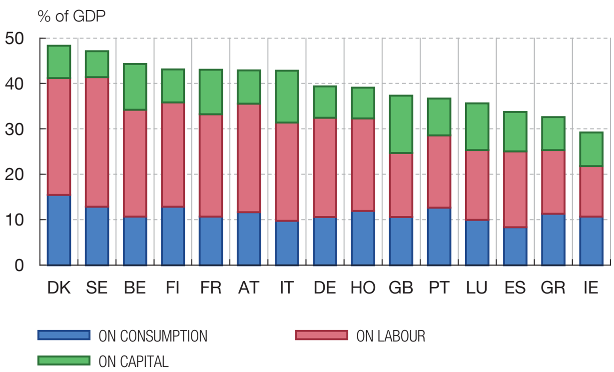
REVENUE AS A % OF GDP IN 2008



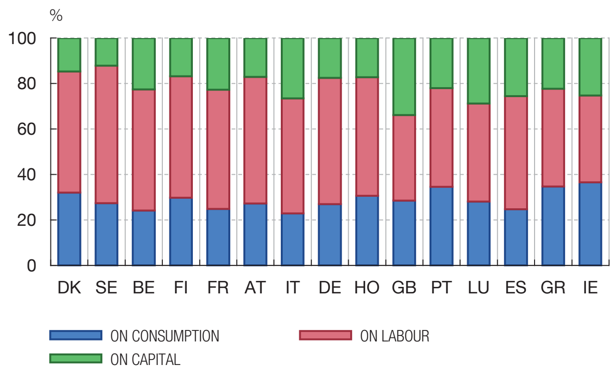
WEIGHTS RELATIVE TO TOTAL TAXES IN 2008



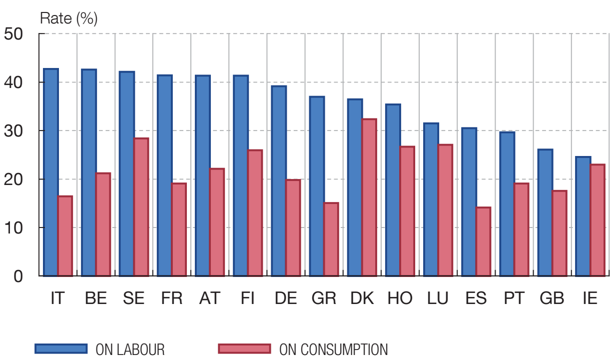
TYPOLOGY OF TAXES IN 2008



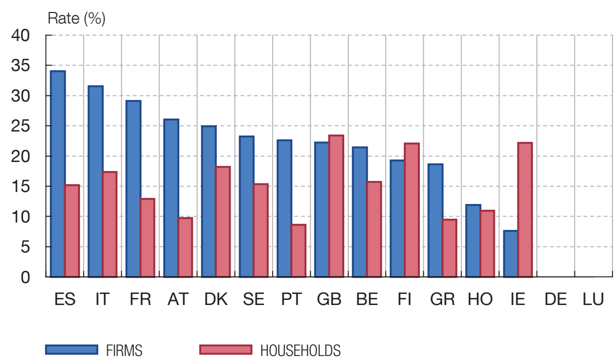
WEIGHTS RELATIVE TO TOTAL TAXES IN 2008



IMPLIED RATES ON LABOUR AND CONSUMPTION IN 2008 (b)



IMPLIED RATES ON CAPITAL INCOME IN 2008 (c)



SOURCES: *Taxation trends in the European Union* - 2010 Edition (Eurostat)

a The data for Portugal and Greece are for 2006.

b The implied rates on consumption are calculated as the ratio of the sum of revenue from taxes on consumption (VAT, taxes on energy, taxes on tobacco and alcohol, and other taxes on specific consumption) to household final consumption in national territory. The implied rates on labour are calculated as the sum of all direct taxes and social security contributions, paid both by wage-earners and employers, that are levied on employment income, divided by the total compensation of wage-earners who work in national territory.

c The implied rates on firms' capital are obtained as the ratio of all tax revenue arising from taxes levied on business income and on capital, on one hand, to the sum of firms' net operating surplus, interest, dividends and other net property income received, on the other. The implied rates on households' capital are calculated as the ratio of the sum of taxes on households' capital income and the returns on business activities, on one hand, to the sum of imputed income, the net operating surplus and households' and not-for-profit private institutions' mixed income, mixed income of the self-employed, and interest, dividends and other net property income received by households and not-for-profit private institutions.

WEIGHT OF FISCAL EXPENSES IN THE MAIN SPANISH TAXES

CHART 2.8

FISCAL EXPENSES: PERCENTAGE OF GROSS REVENUE OF EACH TAX (a)

FISCAL EXPENSES

SOURCES: 2010 State Budget (Report on tax benefits) and IGAE (National Audit Office).

a Gross revenue is the sum of actual revenue and of fiscal expenses.

4.3 PUBLIC REVENUE

Given the scale of the fiscal adjustment needed, having to introduce tax changes to accompany the foregoing spending cuts cannot be ruled out. Further, it should be taken into account that a significant portion of the fiscal deterioration has been due to the reduction in revenue, which will not foreseeably be reversed in the medium term to pre-crisis levels. These changes should take into consideration the role that the level and structure of taxation play in respect of the economy's potential growth and competitiveness. Nor should it be forgotten that another function of tax systems is to contribute to the redistribution of income among the different agents. The change in the size and composition of public spending programmes should, therefore, be complemented with tax reforms which, along with being compatible with the goals of fairness that should be established, combine an increase in tax-raising capacity with improved efficiency.

On the revenue side, measures could include increasing indirect taxation and reducing fiscal expenses

In keeping with these criteria, when tax increases are necessary, they should be in the form of taxes that have fewer distortionary effects on growth and the allocation of resources. Examples of such taxes are those on real estate and on consumption. Currently, Spain's lower tax pressure relative to other developed countries is due to the lower weight of those taxes considered less distortionary, in particular indirect taxes (see Charts 2.6 and 2.7).

VAT rates, even after being raised in 2010, remain below the average for the OECD countries. Moreover, the ratio of VAT revenue to that which would be obtained were the standard rate to be applied to all consumer spending stands in Spain at 56%; accordingly, one option to increase revenue might be to broaden the base of the tax. Along the same lines, the weight of excise duties in general, and of environmental levies in particular, is significantly lower than in other developed countries.

So-called "fiscal expenses", arising from the presence of deductions and exemptions on different taxes, represent a major cost in terms of revenue-raising, they add complexity to the tax structure and in some cases they exert significant adverse effects on efficiency and even on fairness (see Chart 2.8). They should therefore be rationalised. Specifically, according to information provided by the State budget on tax benefits, fiscal expenses in Spain account for around 42% of VAT revenue raised, for almost one-third of personal income tax revenue and for one-fifth of corporate income tax revenue. The source of these fiscal expenses is highly diverse. In the case of VAT, the biggest portion arises from the application of low rates to specific goods, while under personal income tax, they are associated above all with exemptions/deductions on employment income, but also with the preferential treatment that investment in housing[29] and contributions to pension schemes receive. Under corporate income tax, fiscal expenses correspond to various incentives in respect of investment, the promotion of SMEs and the development of R+D projects.

In sum, public revenue and spending policies should urgently redress public finances and contribute to economic growth in the medium term

In sum, the fiscal policy priority in the coming years should be a vigorous adjustment that provides for public finances to be redressed swiftly and soundly. In parallel, the spending- and revenue-side measures ultimately adopted should strengthen the contribution of fiscal policy to the economy's potential growth, which will require greater efficiency in public policy action.

29 Here it should be recalled that the habitual dwelling deduction was eliminated for taxpayers exceeding a specific income threshold. In addition to this marking significant progress in tax neutrality between house-purchase versus house-rental decisions, it will also entail a gradual reduction in the current fiscal spending derived from this personal income tax deduction.

1 Introduction

In 2010, the world economy made progress in emerging from the crisis and grew by 5%, underpinned by the buoyant emerging economies, whereas the recovery in the advanced economies was more gradual

In 2010, as a whole, the world economy continued the process of recovery and financial normalisation with which it had ended 2009 and grew by 5%, following the contraction of 0.5% posted in the previous year. The emerging economies, whose fundamentals had scarcely been affected by the crisis, recovered more strongly and grew by 7.3%, which accounted for more than three quarters of world growth. The more gradual upturn of 3% experienced by the developed economies varied notably across countries, the United States and Japan being the most buoyant economies in this group. However, in most cases – the United Kingdom, the euro area and Japan – activity has still not returned to its pre-crisis levels as seen in Chart 3.1.

In the developed economies the recovery was subject to fluctuations and uncertainties throughout the year. The sovereign debt crisis in the euro area and doubts about the soundness of the upturn in the United States seriously affected confidence and markets around the second quarter. It was only with the support from fresh monetary and fiscal stimuli in the United States that confidence in the recovery was restored in the last four months of the year. Notwithstanding this, the risks to the recovery remained high and included, most notably, the upward trend in commodity prices, triggered by the strong growth of the emerging economies, and the ongoing sovereign debt problems in Europe. Furthermore, at the beginning of 2011 major shocks occurred – there was a wave of instability in the Arab world and an earthquake with grave consequences in Japan – which have exacerbated certain of these risk elements.

Inflation rates have risen from very low levels, driven higher by the upswing in commodity prices

During 2010, ongoing wide output gaps, weak labour markets and the process of reorganisation of public and private balance sheets constrained the expansion of domestic demand in the developed economies and eased inflationary pressures. However, increases in commodity prices, which intensified in 2011, have lifted inflation from average rates of approximately 1% in mid-2010 to the present level of more than 2%. In the emerging economies, inflationary pressures have been stronger and in certain cases – mainly in Asia – inflation rates have exceeded their pre-crisis levels.

International trade returned to a normal footing and international capital flows picked up

The recovery was accompanied by the normalisation of international trade, which in 2010 increased by 12% in volume and exceeded its pre-crisis levels. Noteworthy were the buoyancy of the trade of (and between) emerging countries and the fact that global imbalances once again widened, albeit moderately. The return of financial flows towards emerging economies has been very strong, accentuating the risks of some of them overheating. The reorganisation of international financial flows reflects the adjustment of the global financial system to a situation in which the outlook for emerging economies is better than that for advanced economies, while the latter continue to correct the excesses which led to the crisis.

Economic policies continued to play an essential role as a support for activity

Economic policies continued to play an essential role as a support for activity. In fact, uncertainty about the recovery and the financial situation led to the postponement of the exit strategies from expansionary monetary policies, which were anticipated at the beginning of the year, and there was even some further loosening in the United States and Japan. In the fiscal arena, there was a pronounced difference in behaviour between the fiscal consolidation in Europe - prompted by sovereign debt problems in the euro area - and fresh fiscal stimuli in Japan and the United States.

MAIN MACROECONOMIC INDICATORS

TABLE 3.1

	2008	2009	2010	2010 Q1	2010 Q2	2010 Q3	2010 Q4
UNITED STATES							
GDP (a)	0.0	-2.6	2.9	2.4	3.0	3.2	2.8
CPI (a) (f)	3.8	-0.4	1.6	2.4	1.8	1.2	1.3
Current account balance (% of GDP)	-4.7	-2.7	-3.2	-3.0	-3.4	-3.4	-3.1
General government balance (% of GDP)	-6.3	-11.3	-10.6	-10.7	-11.1	-10.4	-10.3
JAPAN							
GDP (a)	-1.2	-6.3	3.9	5.6	3.1	4.9	2.2
CPI (a) (f)	1.4	-1.4	-0.7	-1.2	-0.9	-0.8	0.1
Current account balance (% of GDP)	3.2	2.8	3.1	3.3	3.4	3.5	3.6
General government balance (% of GDP)	-4.1	-10.2	-9.6	-7.4	-7.1	-7.3	-7.5
EURO AREA							
GDP (a)	0.3	-4.1	1.8	0.8	2.0	1.9	2.0
CPI (a) (f)	3.3	0.3	1.6	1.1	1.5	1.7	2.0
Current account balance (% of GDP)	-0.7	-0.4	0.2	-0.4	-0.3	-0.4	-0.6
General government balance (% of GDP)	-1.9	-6.3	-6.5	—	—	—	—
UNITED KINGDOM							
GDP (a)	-0.1	-4.9	1.3	-0.3	1.6	2.5	1.5
CPI (a) (f)	3.6	2.2	3.3	3.3	3.4	3.1	3.4
Current account balance (% of GDP)	-1.6	-1.7	-2.5	-2.6	-2.1	-2.4	-2.9
General government balance (% of GDP)	-3.6	-8.6	-8.9	-7.3	-9.5	-7.9	-10.7
CHINA							
GDP (a)	9.6	9.2	10.3	11.9	10.3	9.6	9.8
CPI (a) (f)	5.9	-0.7	3.3	2.2	2.9	3.5	4.7
Current account balance (% of GDP)	9.3	4.9	5.2	4.5	5.4	7.2	5.3
General government balance (% of GDP)	-0.8	-2.8	-1.6	6.5	4.6	-1.0	-11.8
LATIN AMERICA (b) (c)							
GDP (a)	4.3	-2.0	6.3	5.9	7.9	6.0	5.3
CPI (a) (f)	7.8	6.4	6.4	6.1	6.6	6.3	6.7
Current account balance (% of GDP)	-0.6	-0.3	-0.7	-0.1	-0.4	-0.6	-0.7
General government balance (% of GDP)	-0.5	-2.9	-2.2	-2.7	-2.5	-2.1	-2.0
NON-EURO AREA EU MEMBER STATES THAT JOINED EU IN 2004 OR 2007 (b) (d)							
GDP	4.4	-3.4	1.9	0.6	2.0	2.1	2.8
CPI (a) (f)	6.4	3.6	3.1	3.0	2.7	3.1	3.7
Current account balance (% of GDP)	-7.4	-2.7	-2.6	-1.0	-2.0	-4.4	—
General government balance (% of GDP)	-3.6	-6.9	-6.4	—	—	—	—
PRO-MEMORIA: GDP GROWTH (e)							
World	2.5	-1.0	5.0	5.1	5.3	5.0	4.6
Developed countries	0.1	-3.5	2.6	2.1	2.7	3.0	2.4
Emerging countries	5.7	2.1	7.9	8.7	8.6	7.3	7.1
PRO-MEMORIA: INFLATION (e)							
World	4.5	2.9	3.3	3.0	2.8	3.0	3.6
Developed countries	1.6	0.1	1.5	1.6	1.1	1.3	1.7
Emerging countries	8.1	5.2	6.2	4.7	4.8	5.1	5.7

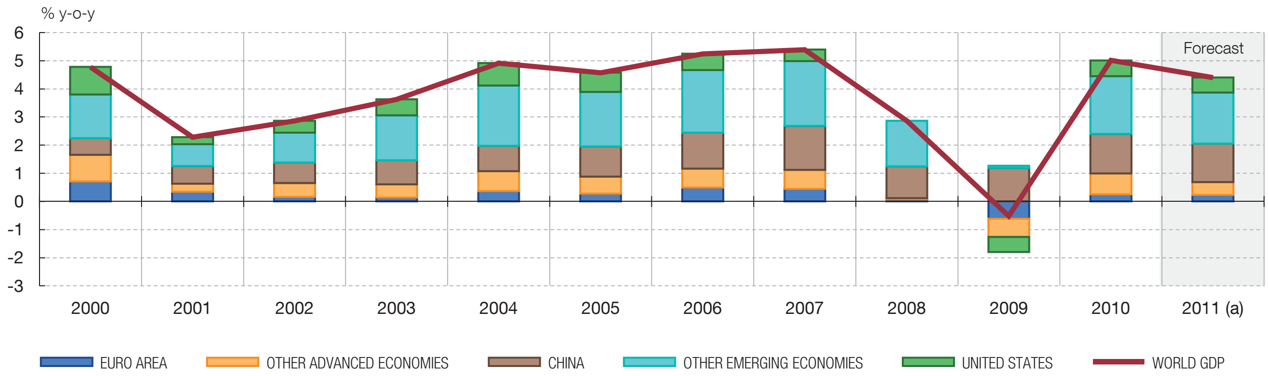
SOURCES: Banco de España, IMF and national statistics.

a Annual percentage change.
b The aggregate for the different areas has been calculated using the weight of the countries making up such areas in the world economy in the previous year, in PPP. Based on IMF information.
c Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
d Latvia, Lithuania, Czech Republic, Hungary, Poland, Bulgaria and Romania.
e Quarterly data based on a sample of countries representing 90% of world GDP.
f Quarterly CPI corresponds to the average for the quarter.

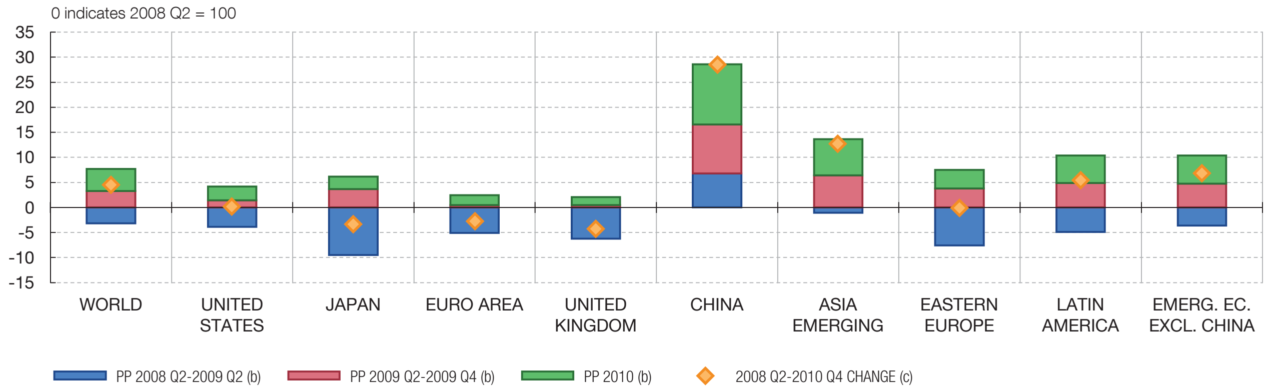
GDP

CHART 3.1

CONTRIBUTIONS TO YEAR-ON-YEAR WORLD GDP GROWTH



CHANGE IN LEVEL OF GDP AFTER THE FINANCIAL CRISIS



SOURCE: IMF World Economic Outlook, April 2010, national statistics, Datastream and JP Morgan.

a IMF forecasts.
b Contribution in pp to the change in GDP for the period.
c Rate of change of GDP between 2008 Q2 and 2010 Q4.

Emerging from the crisis will be a slow process and inflationary risks will become more important

The outlook for the global economy is one of a gradual recovery, although it will be hampered by the adjustments which are still pending in the developed economies and subject to notable uncertainty. The deterioration of public finances and the upward trend in commodity prices will reduce the authorities' margin for manoeuvre and may undermine confidence again. In parallel, the global economy remains immersed in a process of profound structural change characterised by the increasingly important role of emerging economies as engines of economic growth (see Box 3.1) and a new framework of international cooperation in the formulation of economic policies.

2 Economic and financial developments

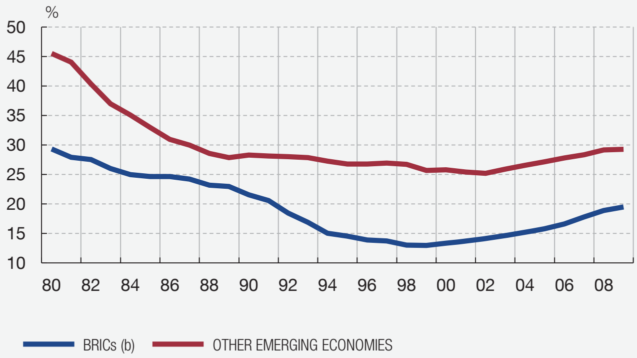
In 2010 Q1, global economic activity continued to pick up, more sharply in the emerging economies...

At the beginning of 2010 global economic activity continued to recover against a backdrop of moderate inflation, carrying on the trend that began in the second half of 2009. World GDP increased at a year-on-year growth rate of 5.1% in Q1, boosted mainly by the emerging economies, which grew by 8.7% year-on-year (see Chart 3.2). For their part, the advanced economies expanded by 2.1% year-on-year (3.1% in annualised quarter-on-quarter terms), supported by stockbuilding and private consumption; the external sector's contribution to growth was negative despite the recovery of exports. The upturn was more robust in the United States and Japan, which posted annualised quarter-on-quarter growth of 3.7% and 6%, respectively, and more moderate in the United Kingdom. In any event, The emerging economies have become increasingly important actors in the global economy, raising their share of world GDP, trade and financial flows. This process strengthened from the turn of the century and intensified further during the financial crisis. Also as a result of the crisis, there have been significant changes in the governance of international economic institutions, which have crystallised into greater participation by the emerging countries, more in line with their relative weight in the world economy. Within the group of emerging economies, these trends have been particularly strong in the most systemically important countries (Brazil, Russia, India and China, collectively known as the BRICs).

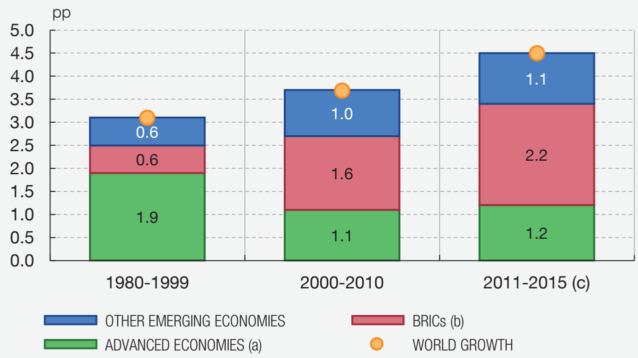
Traditionally, the medium- and low- income economies (included here in the category emerging economies), which account for most of the world's population, have recorded similar growth rates to the advanced countries, which has limited real convergence between these two groups of countries. However, in the last decade the advanced economies have grown by about 2% and the emerging economies by somewhat more than 6%, a disparity that, according to IMF long-term forecasts, will be sustained over the period 2011-15. This progress has enabled these countries to improve their living standards significantly, and has been reflected in an increase in the human development index and in a sharp rise in per-capita GDP (of 28.3% between 2000 and 2009). Within the emerging economies, the four BRIC countries are among those that have grown most (by 8% on average between 2000 and 2010, a rate that is expected to be sustained between 2011 and 2015), and those that have converged most rapidly with the developed countries (see Chart 1). This strong growth over the last ten years has led to a significant increase in the share of the emerging economies in world output, from one third in 1980 to almost one half now, a level that will be clearly exceeded in 2015 (53% of world GDP). The BRICs' share of world GDP rose from 12% in 1980 to 25% in 2010, and could reach 29% in 2015, with China accounting for the largest part of the increase. Given their strong relative growth rate and the increase in their share of the world economy, the contribution of emerging economies to world growth

1 See, for more details, "El creciente peso de las economías emergentes en la economía y gobernanza mundiales: los países BRIC", *Documentos Ocasionales*, No. 1101, Banco de España.

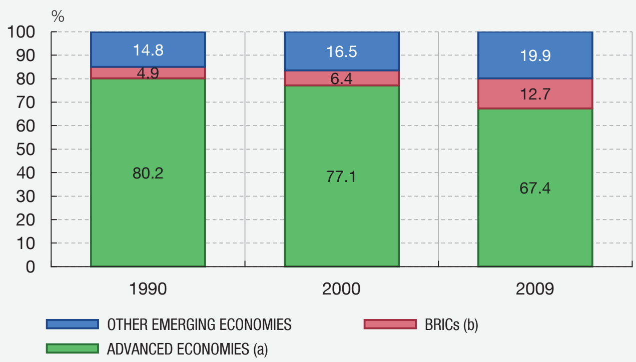
1 GDP PER CAPITA
(100 = advanced economies)



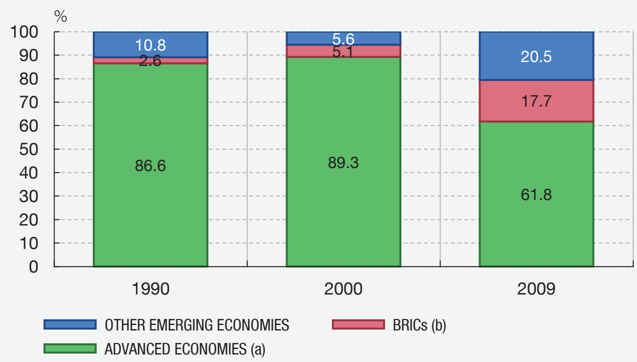
2 CONTRIBUTIONS TO GROWTH



3 SHARE IN WORLD TRADE
(EXPORTS PLUS IMPORTS)



4 SHARE OF DIRECT INVESTMENT INFLOWS



SOURCES: IMF, World Bank and UN.

a Current IMF definition
b Brazil, Russia, India and China.
c IMF estimates in WEO, October 2010.

has also increased substantially; in the last decade these countries have accounted for more than half of world growth (see Chart 2).

This progress has been made against a background of greater integration in the world economy of the emerging economies, which have also become the main beneficiaries and engines of globalisation. This process has been accompanied by a gradual improvement – albeit uneven across countries – in the institutional and macroeconomic framework of these economies, which has helped them to avoid the most negative effects of the crisis and to draw a dividing line from their own past.

The integration has taken place in both the trade and financial spheres, although it has been more pronounced in the former. The emerging economies increased their degree of openness to trade significantly from 2000 and are playing an increasingly important role in world trade (see Chart 3). The higher degree of openness of the developing economies largely reflects greater trade between the emerging regions themselves. Such trade increased from 25.1% of the total external trade of these economies in 1990 to 37.6% in 2009. The foreign trade of these countries is basically centred on raw materials, the BRIC countries being particularly important here, either as net exporters (Brazil and Russia) or as net importers (China and India). Notwithstanding the bias towards trade in raw materials, China (in manufacturing), India (in services) and other emerging economies (in particular in Asia) are rapidly increasing the technological content of their exports.

As in the case of trade, the financial integration of the emerging economies has intensified in recent decades. Direct investment has played a notable role in this process. While in 1990 direct investment flows were practically confined to the advanced economies (99% of outflows and 87% of inflows), in 2009 the developing economies received 38.2% of all direct investment inflows (see Chart 4) and were responsible for 15% of all outflows. Around half of the inflows and outflows of direct investment in the emerging economies correspond to the BRICs, with China standing out as the second largest recipient of direct investment inflows. The increase in the share of other capital flows has been less pronounced, partly due to the restrictions on the openness of the capital account that persist in some important countries, although Brazil and other Latin American and Asian countries play an important role in international flows of portfolio and fixed income investment. Moreover, the favourable outlook for growth in the short and medium-term and lower macroeconomic volatility have reduced the perception of risk traditionally associated with the emerging economies and may contribute to a reorientation of international capital flows towards these economies in the coming years. This process is not risk-free, given the volatility and institutional fragility that still characterise many of these economies.

The growing weight of the emerging economies on the international stage means that the main actors are no longer limited to the G7 countries. Indeed, the financial crisis has led to an increase in the weight of these economies in global financial institutions. Factors contributing to this change have been the relatively favourable behaviour of the emerging economies during the crisis and the need to involve them in the economic policy responses required to overcome it. The changes in world economic governance over the last three years have taken place in numerous spheres: the G20's acquisition of preeminence over the G7, the creation of the Financial Stability Board, with the participation of the emerging G20 countries, and the increase in their weights and voting power in the World Bank and IMF in 2010. Furthermore, the summits of heads of state of the so-called BRICs have begun to become institutionalised, reflecting the greater institutional links between emerging economies, with the aim of presenting a common front at the global level.

The result of these macroeconomic, trade and financial developments will be a world economy that is increasingly more globalised, multipolar and independent than it was at the end of the 20th century. Global governance structures, in which the emerging economies have acquired greater prominence, are adapting to this new situation, and mechanisms are taking shape to coordinate all the important actors, so as to ensure that growth in the world economy is more balanced and sustainable. However, this reshaping of global governance structures is neither free of difficulties nor of challenges, starting with the active and constructive involvement of the systemic emerging countries in the most important areas of international economic relations, such as global imbalances, financial reform, trade agreements and efforts to combat climate change.

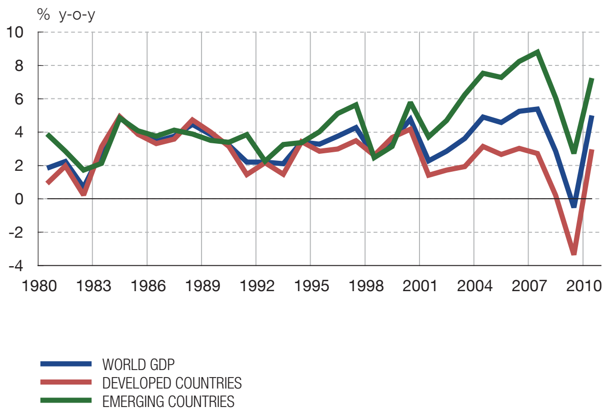
growth in the developed economies continued to be underpinned by stimulus policies and its foundations remained fragile: employment was weak and unemployment rates were high (see Chart 3.3); indebtedness was still excessive in the non-financial private sector; restructuring was still needed in financial systems and activity in real estate markets was minimal.

In the emerging economies the recovery was gaining momentum in early 2010, particularly in China, which posted growth of approximately 10% year-on-year in Q1, and in the rest of emerging Asia and Latin America, which expanded by rates of around 8.5% and 6%, respectively. This buoyancy was driven by strong domestic demand and, in particular, by investment, a growth pattern that indicated a certain independence from developed econo-

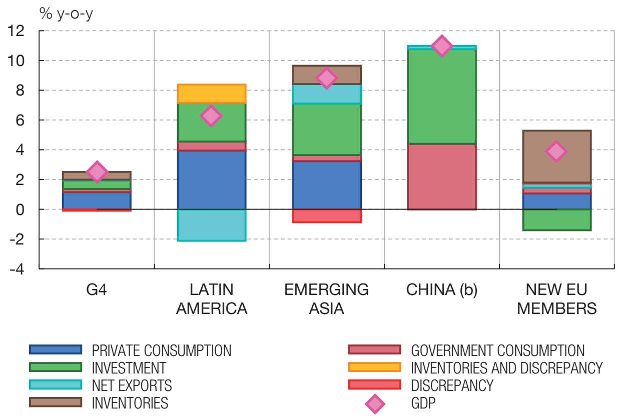
GLOBAL ECONOMIC ACTIVITY

CHART 3.2

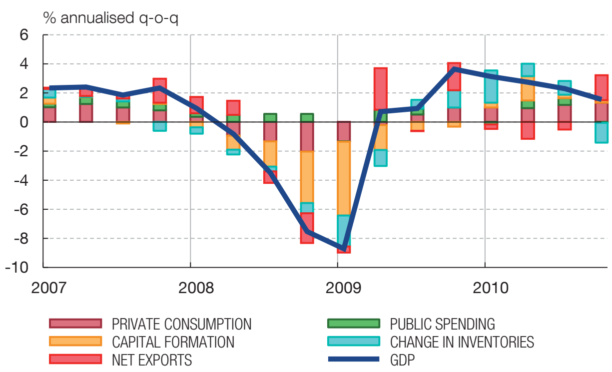
GROWTH IN WORLD GDP



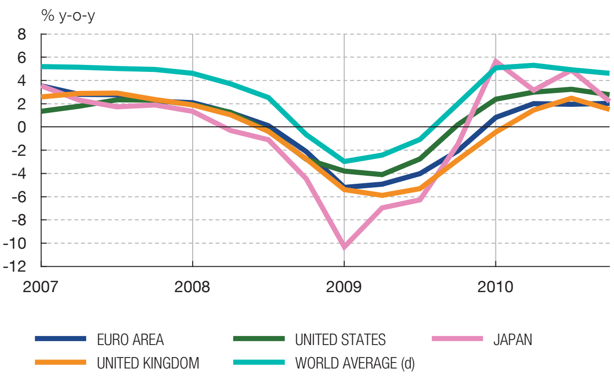
CONTRIBUTIONS TO GDP GROWTH IN 2010 (a)



CONTRIBUTIONS TO GDP GROWTH IN MAIN ADVANCED ECONOMIES (a) (c)



GDP GROWTH IN MAIN DEVELOPED COUNTRIES



SOURCES: IMF, Datastream, JP Morgan, Eurostat, national statistics and Banco de España.

- **a** G4: United States, Japan, United Kingdom and euro area. Latin America: Argentina, Brazil, Chile, Colombia, Venezuela, Peru and Mexico. Emerging Asia: India, Hong Kong, South Korea, Thailand, Indonesia, Philippines, Taiwan and Singapore. New EU members: Poland, Hungary, the Czech Republic, Latvia, Lithuania, Bulgaria and Rumania.
- **b** In China, the government consumption component represents total consumption (government and private).
- **c** Contribution, in percentage points, to the annualised quarterly change in GDP.
- **d** In-house calculations based on data for 57 countries that represent 90% of world GDP. The aggregates have been calculated using the weight of the countries in the world economy in the previous year, in PPP, according to IMF information.

mies, in the absence of fresh shocks (see Chart 3.2). In Eastern Europe, by contrast, where the crisis had hit harder, the expansion was more moderate. The increase in trade between emerging economies, especially the Asian economies, was also faster (see Chart 3.3).

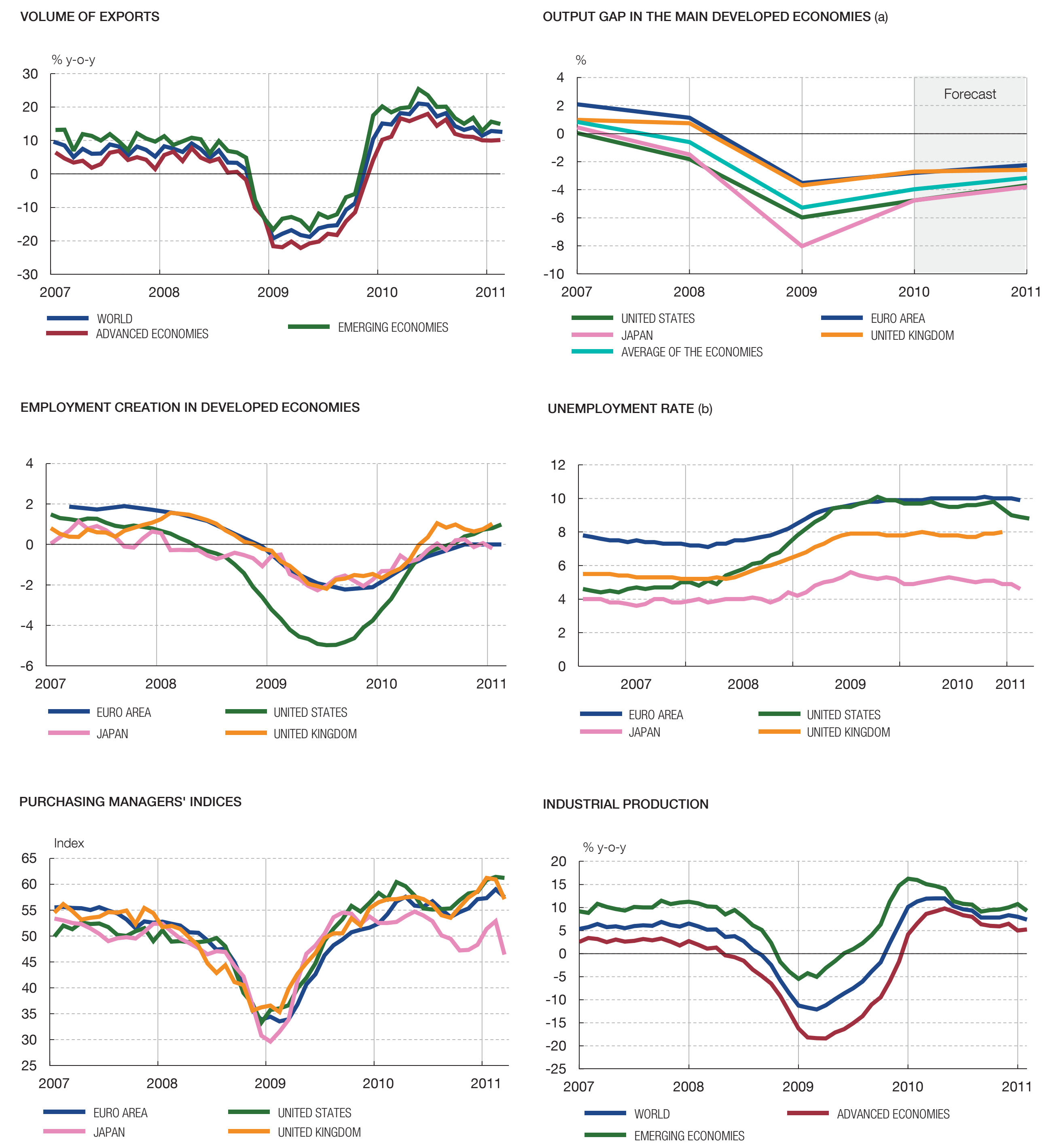
… and was accompanied by an improvement in the financial environment, which was not without weaknesses

The performance of financial markets continued to improve at the beginning of 2010, in line with the trend that began half way through the previous year (see Chart 3.4). The early months of the year were marked by the recovery of the appetite for risk and lower volatility, which returned to its levels prior to the bankruptcy of Lehman Brothers. This favourable environment gave rise to stock market gains, a rise in long-term interest rates and a narrowing of the spreads on corporate and emerging sovereign bonds. The increase in profits and the notable level of issuance on capital markets improved the corporate sector's financial capacity despite weak bank lending (see Chart 3.5).

However, there were underlying weaknesses behind this favourable performance. The advanced economies' financial systems – still immersed in restructuring processes – had not

ACTIVITY INDICATORS

CHART 3.3



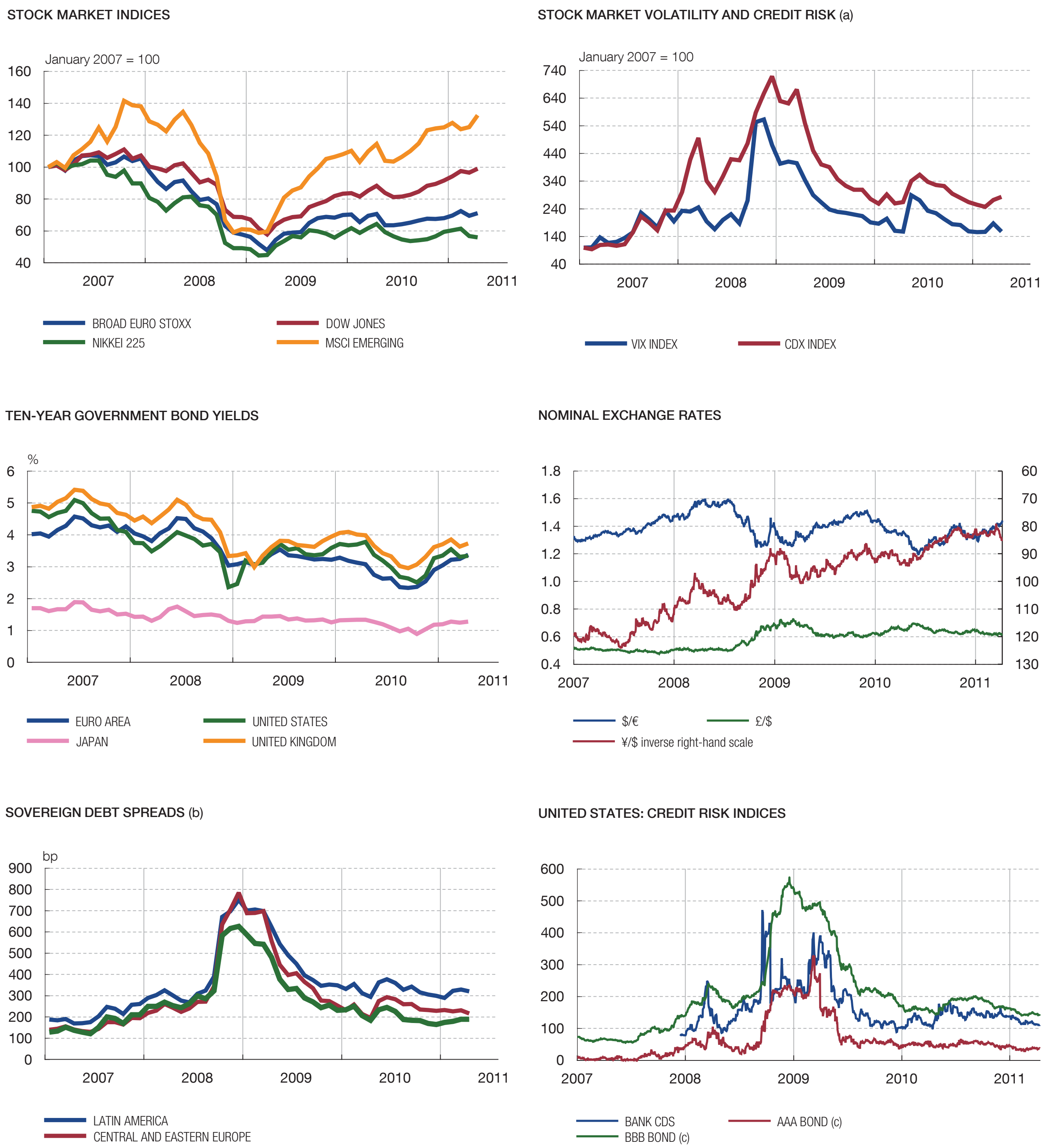
SOURCES: Datastream, CPB Netherlands Bureau for Economic Policy Analysis, IMF (WEO) and Banco de España.

a IMF forecasts.
b Percentage of labour force.

resumed their role as intermediaries in the financing of firms and households, and credit continued to adjust. As for the bank deleveraging and recapitalisation processes, vulnerabilities remained on the liabilities side, with substantial volumes of short-term financing, and there were still troubled segments in the financial system in some countries. Furthermore, since end-2009 problems had been incubating on the sovereign debt markets, which would ultimately affect confidence in banking systems.

INTERNATIONAL FINANCIAL MARKETS

CHART 3.4



SOURCES: Datastream and Bloomberg.

a VIX index (volatility of the Standard & Poors 500 index) and 5-year US CDX investment grade credit risk index.
b EMBI+ for Latin America and EMBI Global for Asia and Central and Eastern Europe.
c Industrial corporate bonds. Differentials vis-à-vis swaps.

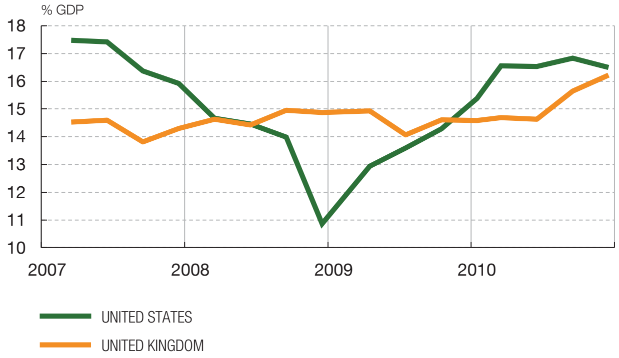
In May, the European sovereign debt crisis unleashed a bout of instability on global markets and activity in the advanced economies began to show signs of weakness

Growing instability on certain European sovereign debt markets peaked in May when the turmoil associated with fiscal difficulties in Greece, after spreading to the euro area, affected global markets, including emerging ones, which had been the most resilient until that time. World stock markets recorded considerable losses and there was a sharp increase in volatility, although not as extreme as that in September 2008. Furthermore, the process of issuance returning to normal on fixed-income markets came to a halt. Investors' search for

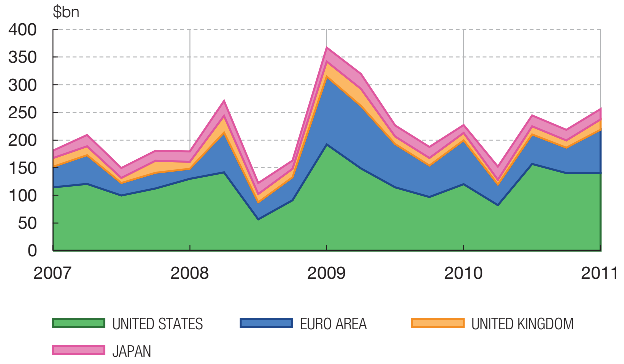
FINANCING CONDITIONS

GRÁFICO 3.5

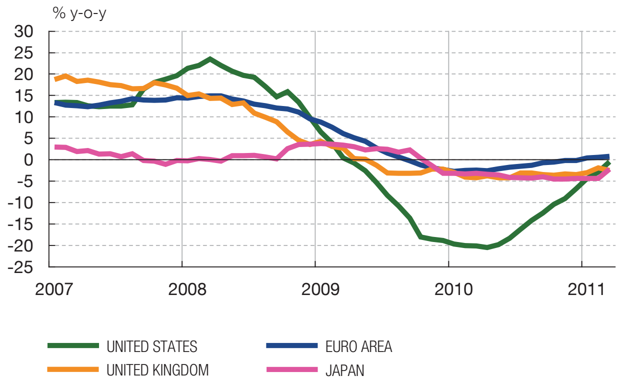
NON-FINANCIAL CORPORATE SECTOR PROFITS (a)



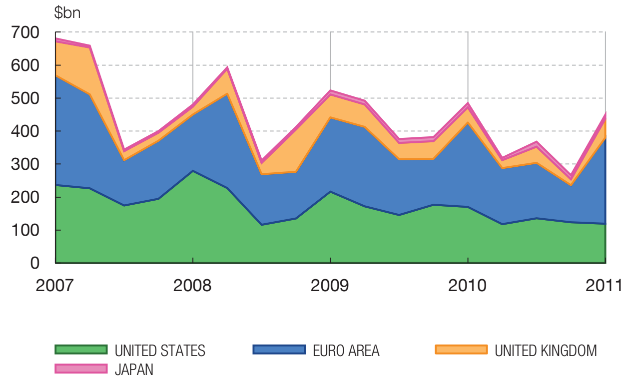
NON-FINANCIAL CORPORATE SECTOR DEBT ISSUANCE (EXCLUDING SECURITISATION)



BANK CREDIT TO NON-FINANCIAL CORPORATIONS



BANKING SECTOR DEBT ISSUANCE



SOURCES: Datastream, Bureau of Economics, Federal Reserve, ECB, Bank of England, Banco de España, Bank of Japan and Dealogic.

a Pre-tax corporate earnings + fixed capital consumption.

safe havens resulted in a fresh decrease in US bond yields – and in those of other advanced economies – with the result that the ten-year yield dropped to levels of around 2.5% in summer, approaching the lows recorded after the bankruptcy of Lehman Brothers. The dollar and yen also appreciated strongly; at the beginning of June the dollar traded against the euro at its highest levels since 2006 ($1.21/€), as shown in Chart 3.4. In this scenario, banks' financing conditions tightened at the same time as their credit risk deteriorated.

The unfavourable impact on financial markets was accentuated by the signs of a slowdown in the US economy, which emerged during the second quarter of the year. This change was determined largely by the downturn in the housing market, which occurred when part of the tax relief it enjoyed ended. Furthermore, on the labour market, employment showed signs of renewed weakness, while the unemployment rate reached levels of approximately 9.5% and the labour force fell owing to a discouragement effect.

Throughout the summer markets stabilised, while uncertainty about the economy prompted a fresh round of monetary and fiscal stimulus in the United States…

The response of the European authorities to the Greek crisis, the results of the stress tests of European banks released in July and the publication of business and bank profits, mainly in the United States, contributed to the stabilisation of financial markets over the summer, although doubts remained about the recovery. US GDP growth in Q2 (1.7% in annualised quarter-on-quarter terms), which was published in July, confirmed the loss of economic momentum and the weakness of private consumption. The lack of vigour spread to other economies such as Japan's, while the United Kingdom recorded a recovery (that turned out to be temporary) following several quarters of sluggishness, which was led by buoyant private consumption.

The signs of economic weakness prompted an expansionary turn in the economic policy stance in the United States. Following the gradual (and passive) withdrawal of support for liquidity and financing during the first half of the year, the Federal Reserve pre-announced at the end of August a fresh phase of non-conventional monetary expansion, which began to be implemented in November. In addition to the monetary impulse, in December a new substantial fiscal stimulus package was introduced. Japan also implemented a new fiscal programme in that period, albeit on a more modest scale. These two cases contrast with the fiscal adjustment introduced in Europe, including the United Kingdom, as a result of the sovereign debt crisis in certain countries in the euro area (see Section 3.1).

... which contributed to improving the economic outlook and anchoring the confidence of financial markets, although it triggered strong movements in exchange rates

The stimulus measures in the United States prompted a notable improvement in the economic outlook at the same time as they contributed to anchoring the confidence of the financial markets, despite representing a serious setback for fiscal consolidation. The easing of financial tensions was reflected in a stock market rally and an improvement in credit and financing markets in the last stretch of the year. This trend was particularly pronounced in the emerging markets, where capital inflows notably stepped up at the end of summer, coinciding with the new expansionary turn in US monetary policy. This situation unleashed strong tensions in exchange rates due to the dollar's tendency to depreciate against most currencies; in particular, the euro returned to levels of approximately $1.40.

The new strains which appeared in autumn in the euro area did not have a significant impact on international markets

Coinciding with the fresh stimulus in the United States, US long-term bond yields increased to around 3.5% at end-2010, mainly reflecting better expectations for growth. This rise in long-term rates contributed to easing strains in exchange rates and capital flows to emerging economies, alleviating monetary policy dilemmas in these countries at a time when inflationary pressures were increasingly evident. In this context, the triggering of a new episode in the sovereign debt crisis in the euro area in November, caused by problems with banks in Ireland, had a very limited impact on international financial markets in comparison with the episode in May.

In the final stretch of 2010, world growth moderated slightly, although the US economy picked up

Overall, the world economy ended 2010 with a growth rate that was slowing slightly (close to 4.5% in annualised quarter-on-quarter terms) and a favourable outlook. The emerging economies remained notably robust, growing by 7.1% year-on-year in that period. For their part, the developed economies also experienced a slight deceleration and expanded by 2.4% year-on-year (with an annualised quarterly growth rate of 1.5%), partly owing to the fall in inventories. In the United Kingdom and Japan growth decelerated and negative quarter-on-quarter growth rates were recorded on account of the fall in private demand. However, in the United States activity rose in the last part of the year and GDP increased by 3.1% in annualised quarter-on-quarter terms in Q4, supported by private consumption and the favourable contribution from the external sector. In any event, output gaps in the major developed economies were still negative at the end of 2010 and unemployment rates held at historically high levels (see Chart 3.3).

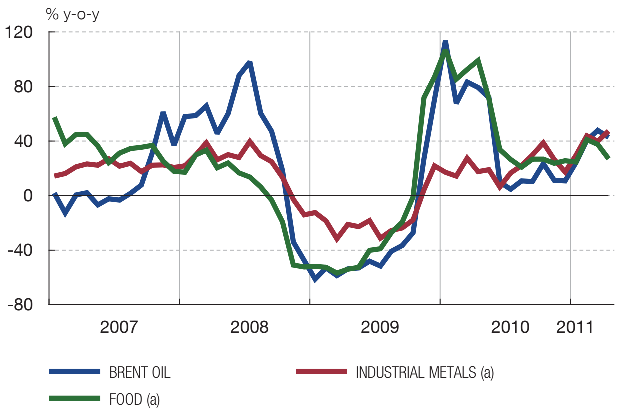
Despite the substantial negative shocks in the early months of 2011, the outlook remains favourable

In the early months of 2011, the main trends discussed have firmed: the recovery in the United States, strengthened by the revival of the labour market and the normalisation of financial markets. The ongoing problems in the euro area – with the bailout of Portugal in April – have not significantly affected global markets, while the political crisis in the Arab countries and the earthquake in Japan are having a global impact, since they contribute to

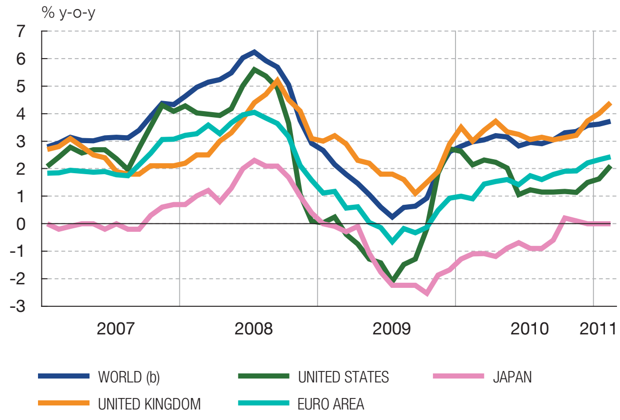
INFLATION AND COMMODITIES

CHART 3.6

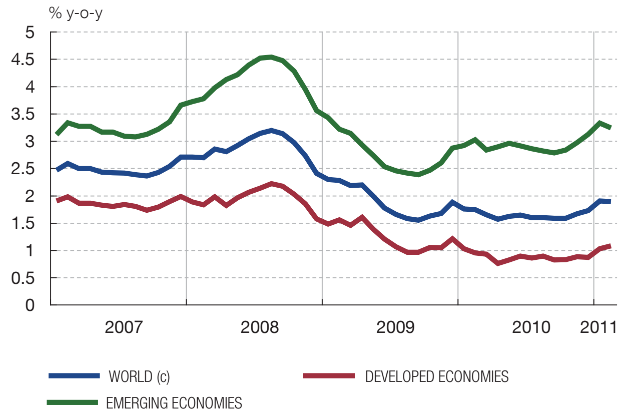
COMMODITY PRICES



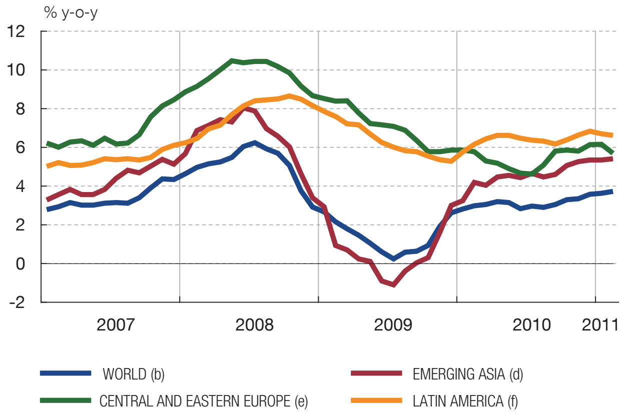
CONSUMER PRICES IN DEVELOPED ECONOMIES. OVERALL INDEX



CONSUMER PRICES: CORE INDEX



CONSUMER PRICES IN EMERGING ECONOMIES: OVERALL INDEX



SOURCES: Datastream, Goldman Sachs, national statistics and Banco de España.

a CRB indices.
b Aggregate calcuated on the basis of data for 57 countries representing 90% of world GDP.
c Aggregate calculated on the basis of data for 45 countries representing 83% of world GDP.
d India, China, Hong Kong, Indonesia, South Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.
e Russia, Ukraine, Turkey, Poland, Czech Republic, Hungary, Estonia, Latvia, Lithuania, Bulgaria and Croatia.
f Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

the rise in commodity prices but without having seriously compromised the confidence in the recovery.

Inflationary pressures only began to become widespread towards the end of the year, driven by the notable rise in commodity prices

Price developments remained contained in the first half of 2010, but inflation posted widespread rises after the summer (see Chart 3.6). The main factor behind this increase was the rise in commodity prices (agricultural products, metals and oil), which held on a rising trend throughout the year, that was only briefly interrupted in Q2, and gained strength in the final quarter (see Chart 3.6). In 2010, as a whole, the overall index increased by 24%, with notable rises in food (28%) and oil (23%) prices. This trend, which was the result of growing demand from emerging countries, continued in the early months of 2011 and was strengthened in certain cases by cyclical supply factors (see Box 3.2).

Inflationary pressures were more pronounced in the emerging economies than in the advanced economies. In the United States inflation reached 1.5% year-on-year at end-2010, which was lower than in the euro area (2.2%), whereas in Japan it held at negative

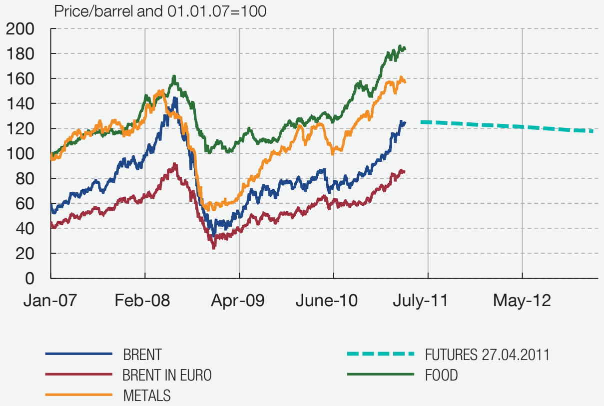
Commodity prices rose sharply from mid-2010 and in many cases were higher in early 2011 than in 2008 (see Chart 1). This general rise poses significant challenges for the developed economies, owing to the potential impact on inflation and the risk to the economic recovery.

The dominant factor in the general rise in commodity prices is the increase in world demand, stemming principally from the emerging economies (in particular, from China) and, to a lesser extent, from the recovery in the developed economies. As a result of this increase, the world demand for many commodities (including foodstuffs) is at an all-time high. Behind these developments lie cyclical factors, and also structural ones, relating to changes in consumption habits. In the case of oil, the International Energy Agency (IEA) expects the demand for oil in 2011 to be more than 89 million barrels per day (mbd), as compared with 86 mbd in 2008. The emerging economies are responsible for the increases in the demand for oil in recent years, given that energy efficiency improvements and the severe economic crisis in the advanced economies have significantly reduced their demand (see Chart 2).

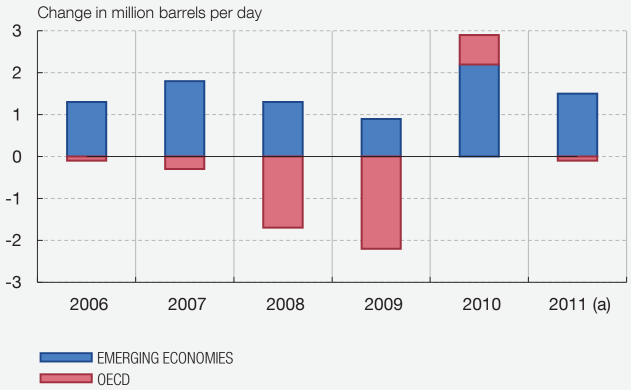
At the same time, various supply-side factors have also temporarily affected the prices of some commodities. Notable in the case of foodstuffs have been poor harvests, primarily due to adverse weather conditions, which have led to export restrictions in some countries. In the case of oil, since the beginning of the year, political tensions in various producing countries in North Africa and the Middle East have generated fears of a significant reduction in production.

Moreover, the upward trend in prices may have been exacerbated by an increase in financial flows into commodity markets, against

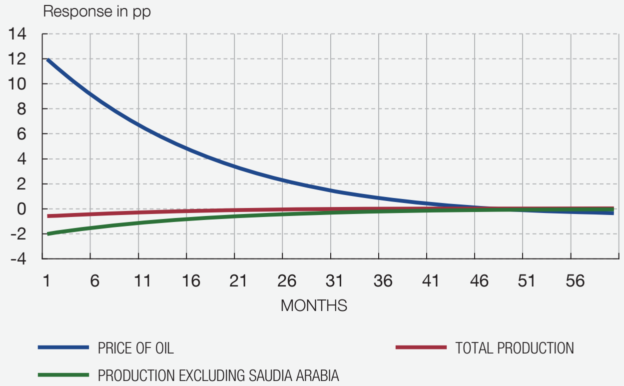
1 OIL AND OTHER COMMODITY PRICES



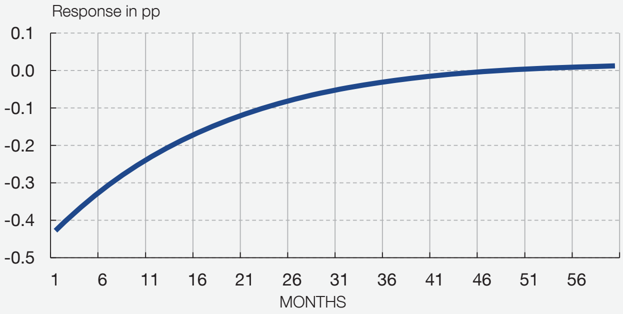
2 CHANGE IN DEMAND FOR OIL



3 RESPONSE OF OIL PRICES AND OF TOTAL OIL PRODUCTION TO A SUPPLY SHOCK (b)



4 RESPONSE OF GDP IN THE DEVELOPED ECONOMIES TO A SUPPLY SHOCK (b)



SOURCES: International Energy Agency, Bloomberg, Datastream and Banco de España.

a Forecast according to the International Energy Agency.
b The shock simulated relates to a 2% reduction in global production excluding Saudi Arabia.

a background of abundant liquidity at the global level and of a higher relative preference on the part of investors for this type of assets. However, the evidence on the causality between flows and prices in these markets is not conclusive. The question is even more complex in the case of those commodities that have relatively high storage costs, such as oil, in which investments are made in futures and options markets. The channels through which the prices of these financial instruments may affect spot prices are not clear.

Higher commodity prices have effects on inflation and activity. As regards inflation, the pass-through of the rise in international prices for commodities to their domestic prices depends on exchange rate fluctuations against the dollar (the reference currency for most commodity prices), duties and taxes, the ability of importers to mitigate the increase by lowering their margins and transport and distribution costs. For their part, changes in domestic commodity prices may affect consumer prices through various channels. First, an increase in commodity prices has direct effects on the CPI, which will be all the larger the greater their weight in the representative consumption basket. Second, there will be indirect effects, in the form of increases in production and distribution costs, which are more important in the case of energy. Finally, the so-called "second-round effects", which reflect the incorporation of the initial rise in prices into price and wage formation processes, so that the original shock is eventually passed through to inflation expectations and underlying inflation. The various studies that have analysed the impact of a rise in oil prices on inflation in the developed economies generally find relatively moderate effects, which principally stem from the direct impact of the higher cost of commodities on inflation. Thus, a 10% increase in the price of oil would involve a rise in the euro area CPI of some 0.2-0.4 pp.[1]

At the same time, higher commodity prices have a contractionary impact on the net importing economies via three main channels. First, relative prices change, causing households and firms to spend a higher proportion of their income on goods derived from such commodities, to the detriment of other products. Second, firms' production costs rise. And third, they may give rise to a contractionary monetary policy response. In the net exporting economies, by contrast, the impact is expansionary, through the increase in the terms of trade. However, it should be pointed out that the impact on activity will be very different depending on whether the rise in commodity prices is due to a sudden reduction in supply or to an increase in demand, owing to higher global economic growth.[2]

The recent tensions in the Arab countries make consideration of a scenario of reduction in the world supply of oil pertinent. The model used includes the consumption and production decisions of oil importers and exporters, taking into account, in particular, the different and strategic role of Saudi Arabia as the "dominant producer", i.e. the only country with surplus production capacity.[3] The results show that, given a fall in the supply of a producer equivalent to 2%[4] of the world market, the oil price would increase by 12% (see Chart 3). In response to this rise, Saudi Arabia would increase its oil production to make up for part of the fall in supply, so that the fall in world production would be smaller (0.5%). The initial impact on the GDP of the developed economies would be -0.4 pp, a fall that would be progressively absorbed and disappear after three years (see Chart 4). Accordingly, the effects on the activity of the developed economies of an oil supply shock would be moderate, in line with the results in the literature.[5]

1 See, for example, Rolf Strauch et al. (2010), "Energy markets and the euro area macroeconomy", *Occasional Paper Series,* No. 113, ECB or Luis J. Álvarez et al. (2011), "The Impact of Oil Price Changes on Spanish and Euro Area Consumer Price Inflation", *Economic Modelling*, No. 28, pp. 422-431.

2 For an in-depth discussion of the different responses of the economy and oil prices to changes in world supply and demand, see Anton Nakov and Galo Nuño (2010), "Un modelo sencillo para analizar las causas y consecuencias de las variaciones en el precio del petróleo", *Boletín Económico*, February, Banco de España, pp. 67-78.

3 For a technical description of the model used, see Anton Nakov and Galo Nuño (2009), "Oilgopoly: a general equilibrium model of the oil-macroeconomy nexus", *Documentos de Trabajo*, No. 0932, Banco de España.

4 As a reference, Libya represents 1.8% of the world oil market and during the crisis its market share fell by 75%.

5 The cited paper by Strauch et al. (2010) presents values of 0.2-0.4 pp, for a broad range of models, in response to a rise of 10% in oil prices. Some authors also stress that the impact of oil price shocks on GDP has been diminishing on account of the lower rigidities in labour markets, lower oil consumption per unit of GDP and the improvement in the conduct of monetary policy. In this connection, see O. Blanchard and J. Gali (2007), "The Macroeconomic Effects of Oil Shocks: Why are the 2000s So Different from the 1970s?", *NBER Working Paper* No. 13368.

rates, although in the closing months of the year it moved into positive territory. By contrast, in the United Kingdom, it climbed to 3.7%, and breached 4% at the beginning of 2011. The performance of core inflation was more stable and moderate, in line with the persistently wide output gap and surplus capacity. Similarly, inflation expectations remained firmly anchored. By contrast, in the emerging economies inflation rose to 5.6% at end-2010, reflecting the higher weight of food and energy in their consumption baskets (although subsidies tend to mitigate fluctuations in final prices), strong private demand and narrower output gaps, which in Asia and certain Latin American economies had already closed. By region, inflation at end-2010 stood at 6% in Eastern Europe, 6.9% in Latin America and 5.1% in emerging Asia. Core inflation also showed a slight upward trend (in China and Brazil, in particular) and inflation expectations rose in some economies. The rising trend in inflation continued into the early months of 2011, as a result of the continuous upswing in commodity prices: in February inflation was 2.1% in the advanced economies and 5.7% in emerging economies, and in many Asian and some Latin American countries it has breached its pre-crisis rates. This situation has prompted a notable change in the monetary policy outlook, in particular in the developed economies, as described below.

3 Economic policies

At the beginning of 2010, gradual economic recovery and financial normalisation presaged a progressive withdrawal of the support given as a result of the crisis, albeit at different paces in the developed and emerging countries (more gradually in the former and more decisively in the latter). However, several events altered these prospects and contributed to accentuating the differences in the conduct of economic policies between emerging and developed countries, and also among the latter.

3.1 ECONOMIC POLICY DIVERGENCE IN THE DEVELOPED ECONOMIES

The main developed economies began the year with the intention of exiting their extraordinarily expansive policies, which were implemented in response to the crisis. The challenge they faced consisted of reducing public support, which was leading to inflationary risks and doubts about the sustainability of fiscal positions, without harming the recovery.

At the beginning of 2010, a progressive exit from non-standard monetary policy measures in the developed economies was anticipated, against a backdrop of withdrawal of the stimuli introduced as a result of the crisis

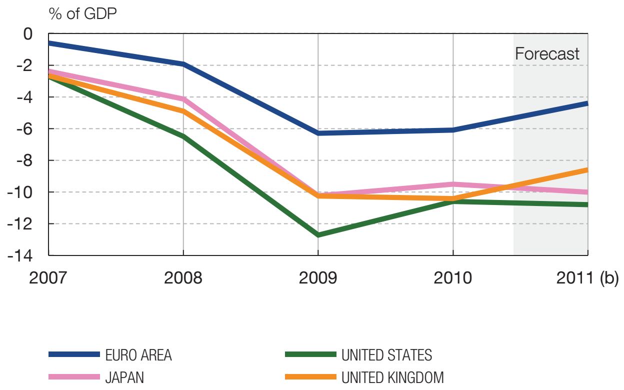
In the monetary policy area, the debate centred on how and in what sequence non-standard measures would be withdrawn and when official interest rate rises would begin. The improvement in the financial and banking situation led to a natural unwinding of the use by financial institutions of certain assistance. Thus, in Q1, most of the extraordinary liquidity facilities in the United States and in the United Kingdom expired and the asset purchase programme of the Federal Reserve and the Bank of England was completed. In the euro area too certain measures, such as the covered bond purchase programme and special longer-term refinancing operations, came to an end. In contrast, the Bank of Japan continued to introduce new measures, against the backdrop of persistent deflation. Nevertheless, uncertainty about the strength of the recovery and the absence of inflationary pressures led to the postponement of when interest rate rises were expected – even in the United Kingdom, despite its higher inflation – a trend that was to continue throughout the year. Official rates were raised in other developed economies that were further ahead in the cycle (Sweden, Australia and Canada).

The sovereign debt crisis in the euro area and uncertainty about the recovery in the United States opened up a widening gap between the economic policies of the developed economies

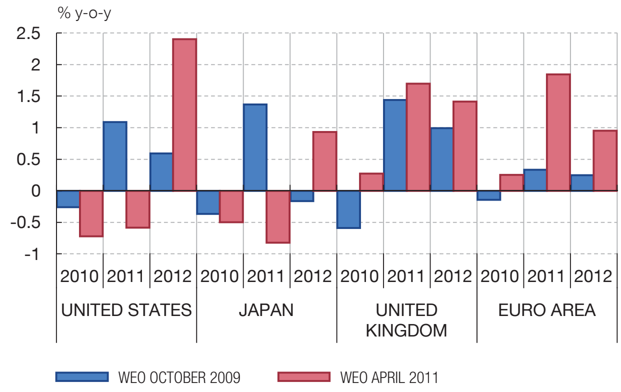
In spring the uncertainty surrounding the euro area sovereign debt crisis and doubts about the strength of the recovery in the United States delayed the withdrawal of monetary stimulus and led to divergence in economic policy stances. Overcoming the sovereign debt crisis became a necessary priority in the euro area, whereas in the United States – and in a slightly different context, in Japan – concerns centred on avoiding a possible double-dip in activity and, even, the risk of deflation.

FISCAL POLICY IN DEVELOPED ECONOMIES

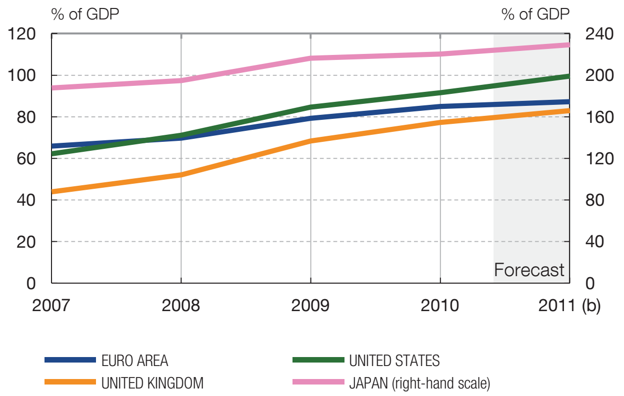
CHART 3.7



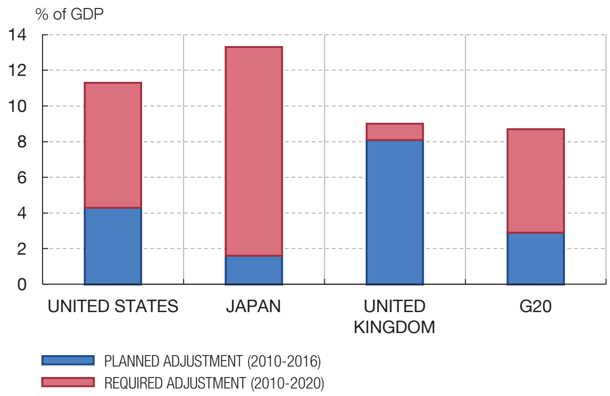
CHANGES IN THE STRUCTURAL FISCAL BALANCE (2009-2012)



GOVERNMENT DEBT



PLANNED AND REQUIRED FISCAL ADJUSTMENT (c)



SOURCES: IMF, Datastream, Bloomberg, Federal Reserve Bank of Cleveland and Banco de España.

a Percentage of GDP. Surplus (+) or deficit (-).
b IMF forecasts.
c Necessary adjustment of the primary structural balance in 2010-2020, to stabilise the debt-to-GDP ratio in 2030 at 60% (200% in Japan).

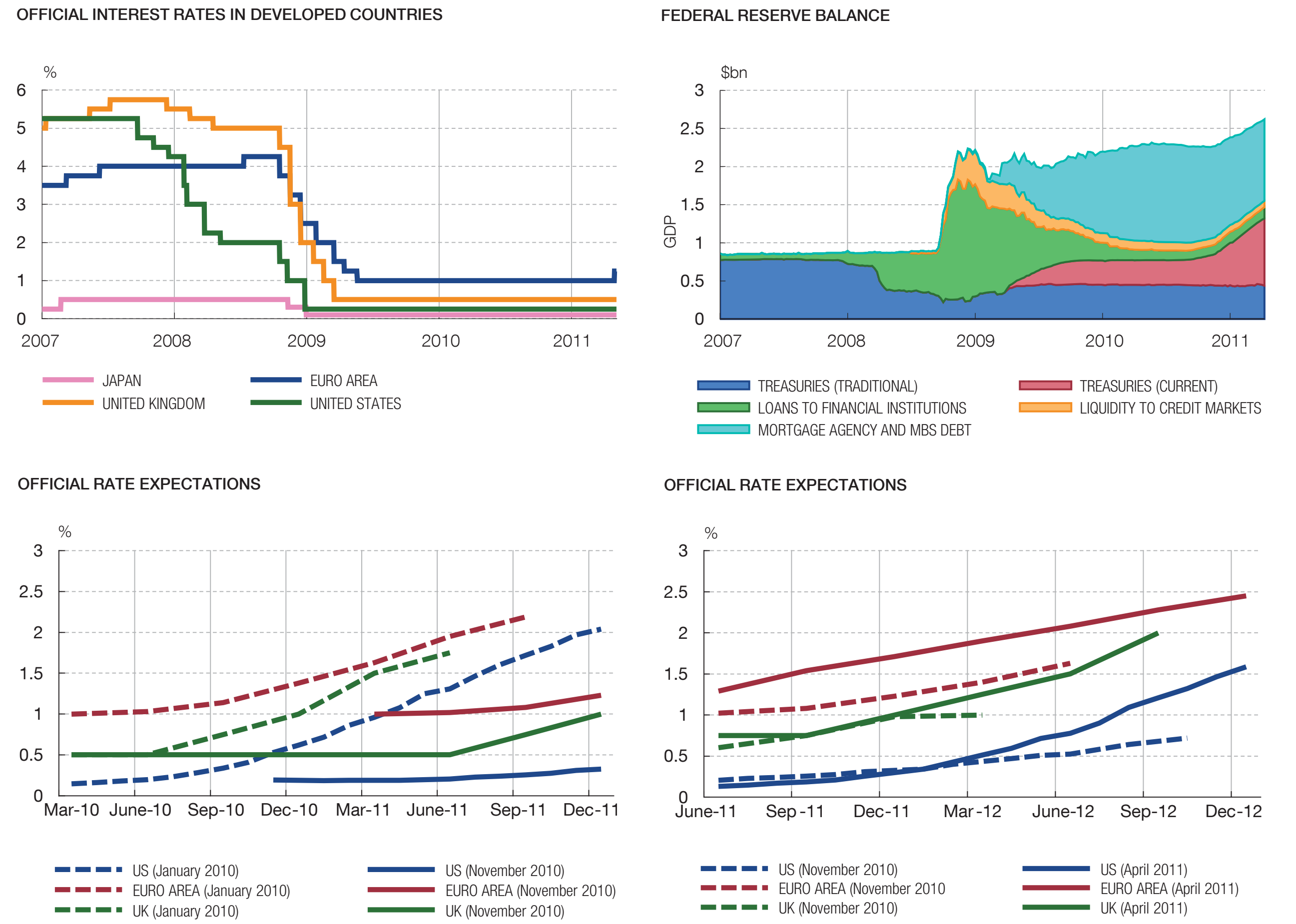
In the fiscal sphere, the euro area sovereign crisis accelerated the adjustment in Europe, while in the United States and Japan new fiscal stimulus plans were introduced towards the end of the year

The notable deterioration in fiscal variables in 2009 called for a gradual, but decisive, withdrawal of the fiscal stimulus (see Chart 3.7). However, public debt increased further in 2010 (by around 8 percentage points (pp) of GDP in the advanced economies as a whole), while fiscal deficits barely declined, standing at around 10% of GDP in the United States, Japan and the United Kingdom, and 6% in the euro area. The tensions prompted by the sovereign crisis in May led to an acceleration of fiscal adjustment in the euro area countries (see Chapter 4) and also in the United Kingdom (see Chart 3.7). In the latter country, the new government introduced a drastic fiscal adjustment (based on spending cuts and tax measures, including an increase in VAT of 2.5 pp and a new tax on banks), which will reduce the structural deficit by more than 8 pp of GDP over the next five years.

In marked contrast, activity doubts in the United States and Japan led to fresh fiscal expansion plans towards the end of the year. The main measure in the United States was the approval in December of a new fiscal package, of more then $800 billion (almost 6% of 2010 GDP) for the next 10 years, notable being the extension of tax cuts that were due to expire and of unemployment benefits. This plan may raise the structural deficit by between 1.5 pp and 2 pp of GDP, in 2011 and 2012, and delay the start of fiscal consolidation. For its part, Japan introduced a new fiscal package of around 1% of GDP in October and fol-

MONETARY POLICY IN DEVELOPED ECONOMIES

CHART 3.8



SOURCES: Bloomberg, Reuters Survey, Datastream and Federal Reserve Bank of Cleveland.

lowing the earthquake in March 2011 approved a supplementary budget of a similar amount for the reconstruction work.

As regards monetary policy, there was a new phase of quantitative easing in the United States

In the monetary policy sphere, the weakening of activity led to the possibility of new non-standard monetary policy easing in the United States and in the United Kingdom in the summer. This was not the case in the euro area, which did however continue to provide ample liquidity to the financial system and put in place a government bond purchase programme for the countries most affected by the sovereign tensions, to restore the transmission mechanism. Official interest rates remained unchanged in all cases during 2010, although in the first few months of 2011, in the face of the rise in inflation, the date on which the markets expected official interest rate rises to begin moved forward (see Chart 3.8). In fact, the upward cycle in the euro area began in April, with a rise in interest rates of 25 basis points (bp), to 1.25%.

The second phase of quantitative easing in the United States (known as QE II) was announced in August and commenced in November. It consists of the staggered purchase by the Federal Reserve System of $600 billion of Treasury bonds, to be completed in June 2011, along with the reinvestment of another $300 billion of balance sheet assets reaching maturity. The intention was to ease monetary and financial conditions, by reducing long-term interest rates and increasing the prices of a range of financial assets, in order to improve the outlook for agents and to increase their inflation expectations. Notwithstanding the debate on the effectiveness and risks of QE II, subsequent developments appear to indicate that it has contributed to this objective, although long-term interest rates rose sharply following the start of the programme, the initial downward movement having occurred in advance. For its part, in October the Bank of Japan extended its lending facilities and its programme for the purchase of financial assets (including government securities), with a new fund equivalent to 1.1% of GDP. After the earthquake in March, it doubled the volume of purchases and injected massive amounts of liquidity. In the United Kingdom, the possibility of an extension of non-standard measures eventually disappeared, owing to the risk that agents' expectations would become unanchored, given that inflation has been standing at more than one percentage point above target for the last two years.

The economic policy divergence reflects both differences in the economic situation and in the assessment of medium and long-term risks

There are many reasons for the divergence in the economic policies of the main developed economies: differences in diagnosis, strategy and priorities in the presence of inflationary risks and economic weakness, and different degrees of freedom to design policies. However, in an increasingly integrated global economy, in which the policies of the largest countries have implications for the rest, these divergencies may generate tensions and reactions by other countries, as has already happened in the monetary and foreign-exchange arena after QE II in the United States, undermining the international coordination efforts that were established after the crisis (see Section 4.3).

3.2 ECONOMIC POLICY DILEMMAS IN THE EMERGING ECONOMIES

Expectations of strong economic growth in the emerging countries were confirmed

The emerging economies avoided the impact of the crisis more successfully than the developed ones. Their recovery has been more rapid, assisted by robust economic fundamentals, less need to deleverage than in the developed economies and zero or low exposure of their financial systems to problematic assets. The situation in the EU Member States that joined the EU in 2004 and 2007 has been different. Most of them were hit hard by the crisis and their recovery has been weaker, owing to the larger imbalances and financial vulnerabilities accumulated during the years leading up to the crisis, as well as their close economic links to the euro area.

2010 saw sizeable capital inflows, that were especially large in certain countries

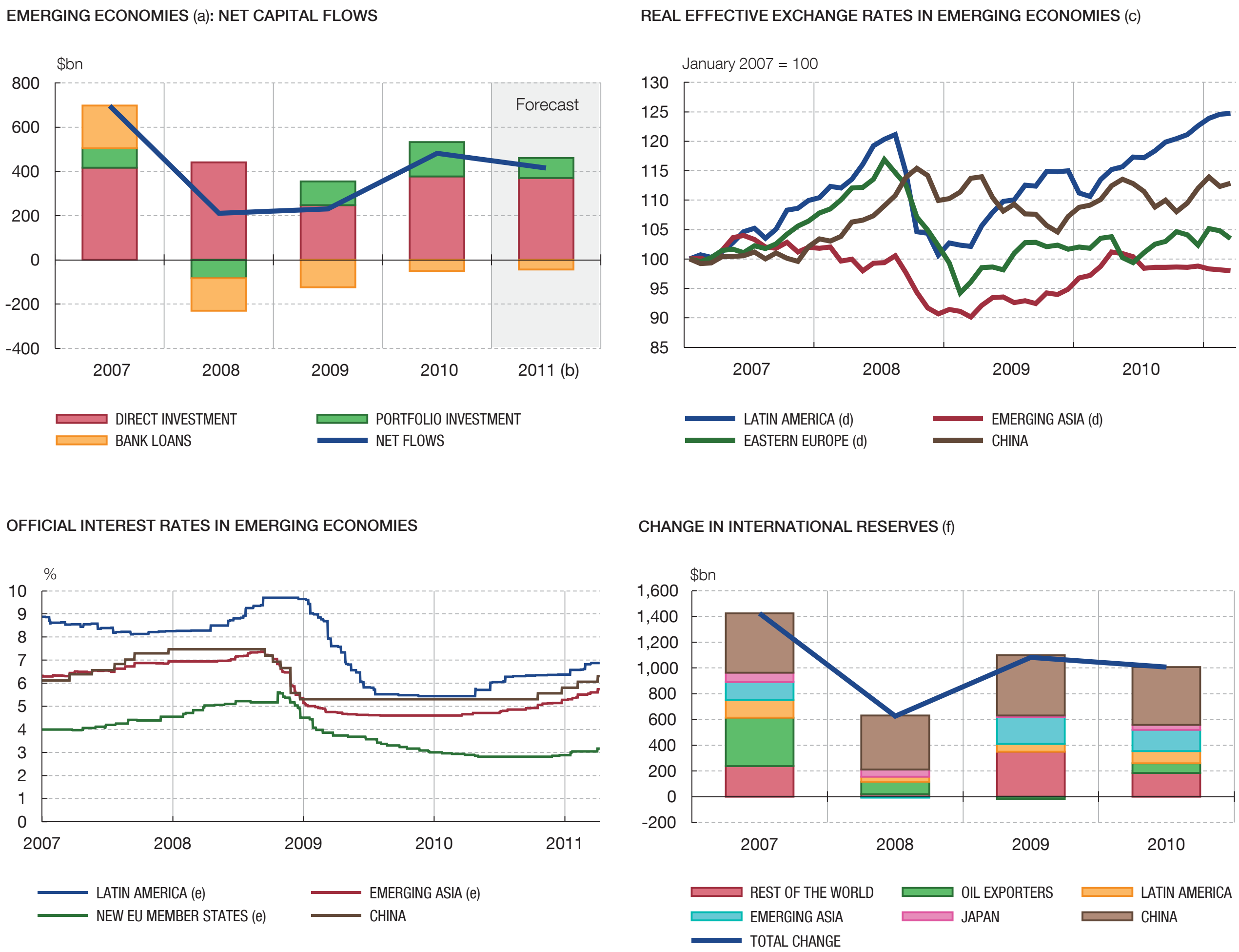
The combination of improved growth prospects in the emerging economies, renewed appetite for risk in global financial markets and the persistence of very low interest rates in the developed economies led to a resurgence of capital flows towards the emerging countries during 2010. In Asia and Latin America these flows exceeded their pre-crisis levels (see Chart 3.9). These flows intensified after the summer, given the expectations of further monetary stimulus in the United States, creating significant difficulties for macroeconomic management and the fear of excessive exchange-rate appreciation. A significant portion of these larger flows towards the emerging economies is possibly permanent in nature, being the result of a global reallocation of capital, associated with better growth prospects and reflecting the weight and growing importance of these regions in the world (see Box 3 .1). However, the capital inflows are perceived in these countries as having a temporary component – especially after their intensification at the end of 2010 – with the attendant risks of excessive exchange-rate appreciation or sudden reversal.

The capital inflows, combined with upward inflationary pressures, posed a dilemma for monetary policy

The sizeable capital inflows and appreciation pressures coincided with growing pressures on inflation, giving rise to a monetary policy dilemma in the Latin American and Asian economies. On the one hand, interest rate rises were desirable to contain the increase in inflation – against a background of closing output gaps and rising commodity prices – and to avoid the unanchoring of inflation expectations. On the other hand, interest rate rises might contribute to fuelling the capital inflows and increasing the pressure on the exchange rate. The emerging economies responded to this challenge

EXCHANGE RATES AND CAPITAL FLOWS IN EMERGING ECONOMIES

CHART 3.9



SOURCES: Datastream and IMF.

a Africa, Latin America and Caribbean, Central and Eastern Europe, Confederation of Independent States, Middle East and emerging Asia.
b IMF forecasts.
c CPI-based. An increase (decrease) denotes an appreciation (depreciation) of the currency.
d Areas analysed: Emerging Asia (India, Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines), Central Europe (Czech Republic, Hungary and Poland) and Latin America (Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru).
e Areas analysed: Emerging Asia (India, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines), Central Europe (Czech Republic, Hungary and Poland) and Latin America (Brazil, Mexico, Chile and Colombia).
f 2010: latest data available.

with a combination of measures: interest rate rises, controlled appreciation and accumulation of reserves, as well as administrative or macro-prudential measures, and even capital controls.

Interest rate rises were made in Asia and in most Latin American countries, although they were interrupted or toned down when capital inflows were at their strongest, following the summer. Many countries also used quantitative measures – primarily increases in reserve requirements – to tighten monetary conditions. With regard to exchange rates, larger appreciations were generally tolerated in Latin America than in Asia. In China the authorities announced a return to the pre-crisis exchange-rate regime and permitted some appreciation of the renminbi against its reference basket, but its extent was limited. There was also a generalised intensification of accumulation of reserves to mitigate exchange-rate appreciation, with the result that the holdings of these assets reached new historic highs (see Chart 3.9).

MAIN FINANCIAL FLOWS MANAGEMENT AND MACRO-PRUDENTIAL MEASURES **TABLE 3.2**

MEASURE		COUNTRY (implementation date in brackets)
Financial flow restrictions (capital controls)	Tax on financial inflows	Brazil (Oct-10 and Mar-11), Thailand (Oct-10) South Korea (Nov-10)
	Establishment of minimum investment period	Indonesia (Sep-10)
Financial flow liberalisation	Liberalisation of capital outflows	Thailand (Feb-10 and Sep-10), Chile (Nov-10), Peru (various)
Macro-prudential measures	Restrictions on LTV (loan-to-value) and DTI (debt to income) in real-estate loans	China, Hong Kong, South Korea (Mar-11)
	increasing capital requirements	Brazil (Dec-10)
	Increasing reserve requirement (a)	China (various), India (Oct-10), Brazil (Dec-10), Indonesia (Dec-10), Malaysia (Mar-11), Turkey (various), Peru (various)
	Increasing reserve requirements for foreign-currency deposits	Peru (Jul, Sep and Oct-10)
	Limit on banks' short foreign-currency positions	South Korea (Jun-10), Brazil (Jan-11), Peru (Feb-11), China (Mar-11)

SOURCE: Banco de España.

a Cash ratios can also be considered to be an alternative monetary policy measure, although they are increasingly being used with macro-prudential objectives.

Notable among the measures adopted were those to moderate capital inflows

Many countries considered it necessary to resort to other kinds of measures (summarised in Table 3.2) to deal with the heavy capital inflows and their impact on exchange rates. In some countries measures were taken to liberalise financial outflows. In other cases, macro-prudential-type measures were adopted to moderate the effects of capital inflows, such as limits on the growth of real-estate lending or loan-to-value (LTV) ratios. Also, measures to hinder the financial movements of non-residents (capital controls) were adopted, with specific features depending on the country concerned, notable among them being taxes on portfolio transactions in Brazil and South Korea. Unlike in previous episodes, capital controls had greater international acceptance, albeit only as a last resort.

Fiscal policy stances did not help alleviate the economic policy dilemma

A contractionary fiscal policy stance in the emerging economies might have facilitated the management of exchange rate and monetary policies against a background of highly dynamic activity and, in some cases, of overheating. However, although the fiscal results were favourable, in marked contrast to the developed economies, the fiscal policy stance was not clearly restrictive in practically any country.

4 Towards a global environment of greater economic and financial stability

The achievement of greater global economic and financial stability requires strengthened multilateral coordination and the adoption of reforms

The seriousness of the crisis and the subsequent response have highlighted the need to articulate macroeconomic and financial policies to avoid the appearance of imbalances and to make progress in establishing a more stable economic and financial environment. This section reviews the progress towards this objective in three fundamental areas: i) financial system rationalisation and restructuring; ii) private sector balance sheet adjustment and fiscal consolidation in the main developed economies, and iii) the coordination of international economic policies, to mitigate the risks of re-emergence of global imbalances and of reappearance of financial excesses.

4.1 FINANCIAL SYSTEM REFORM: SITUATION, PROSPECTS AND PROCESSES

The processes to adjust and reorganise the banking sector moved forward last year …

In 2010 banking activity improved. Most banks reinforced their financial position during the year, with the support of strengthening balance sheets and progressive divestment, on one hand, and the gradual normalisation of certain wholesale funding and bond issuance markets, on the other (see Chart 3.5). Also, the profits of international banks recovered to around their pre-crisis levels. This behaviour was not homogeneous however: US and British banks achieved high profitability, while that of Japanese and euro area banks was more moderate. Capital ratios rose significantly, in line with this improvement and in response to the financial crisis. This bolstering of capital took place against a background of stricter regulatory requirements and, in some specific cases, with the injection of public capital. Cross-border activity remained relatively moderate, but international banks increased their exposure to emerging areas, in particular to Latin America and Asia, where the banking systems were only temporarily affected by the crisis. Notwithstanding these positive developments, the process of reorganising and reshaping the banking and financial system has yet to be completed, and bank lending and financing conditions continue to be constrained by supply-side factors. In addition, numerous segments of the securitisation markets have still to be reactivated. At the same time, the weakness of the demand for credit and the financial fragility of borrowers are also limiting growth in lending to the private sector, which is notably slack.

… driven by the continued existence of sizeable public support …

The improvement in the financial sector continued to be underpinned by sizeable support, both from governments and central banks. At the end of 2010, the total amount of public support actually used by the financial sector stood at around 20% of GDP in the main economies, which was almost the same as in the previous year (see Chart 3.10). In general, there was a reduction in the support in the form of Treasury guarantees and central bank liquidity and financing facilities, which was offset by the increase in central bank asset purchases. In the United States, public support stood at 22% of GDP as at end-2010 (5 pp less than at end-2009), with a notable reduction in the support in the form of capital injections. The level of financial support in the United Kingdom remains the highest among the main advanced economies, at more than 50% of GDP, although it has fallen slightly. In Japan and in the euro area there was a fresh increase in support in 2010, although from much lower levels (6% and 15% of GDP, respectively). Given the nature of this support, in which outright purchases and capital injections are gaining in weight, it is likely to be maintained for a prolonged period.

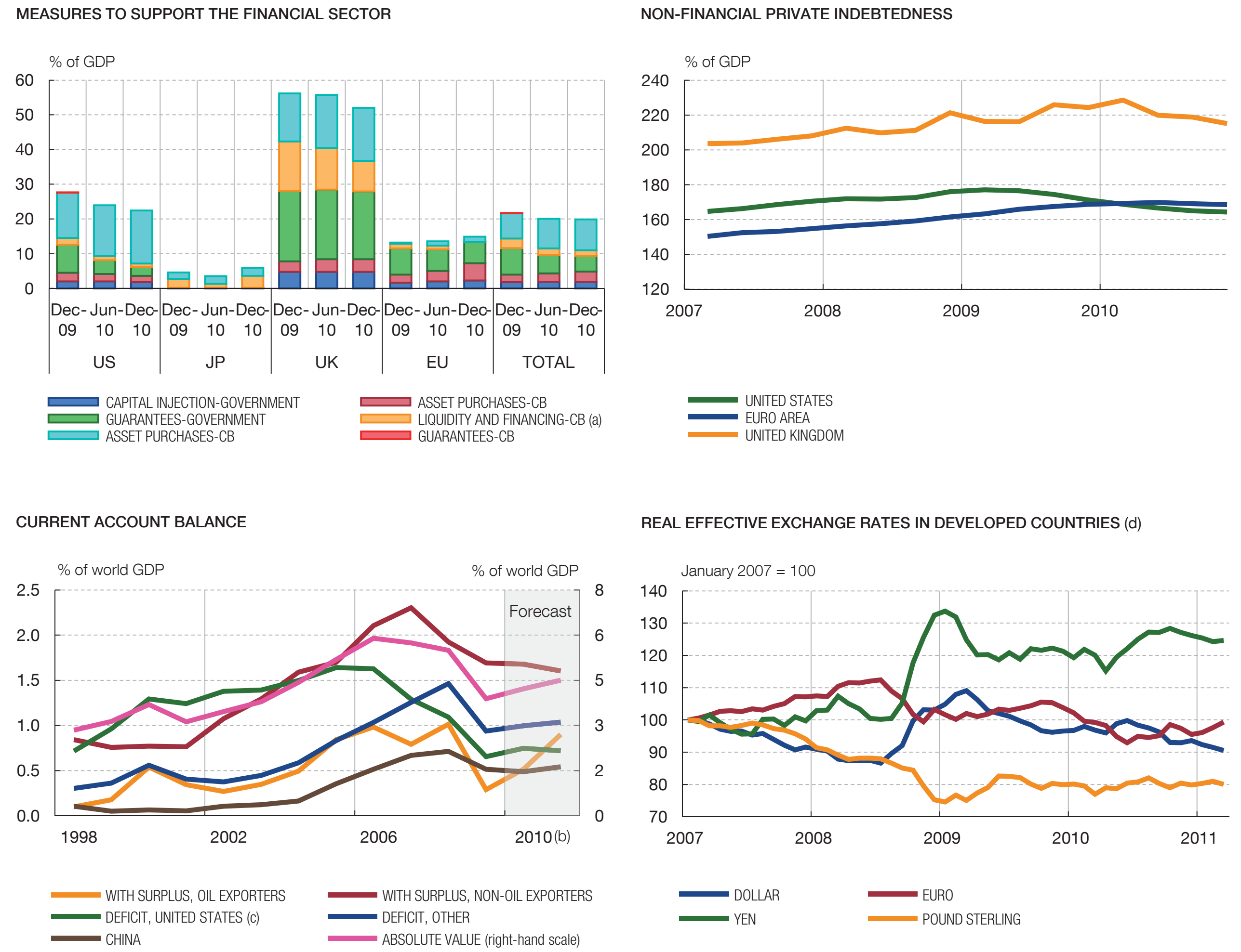
… and regulatory and financial reform

In 2010, the financial and regulatory reform initiatives coordinated at the global level lost some of their prominence to domestic ones. However, among the former, the approval by the G20 in November of the set of measures known as Basel III should be highlighted. These measures involve a strengthening of the capital and liquidity requirements to be met by financial institutions, at the global level, although some aspects have still to be developed (liquidity ratios, systemic institutions, etc.) and the period for full compliance is generous (until 2018, in some cases).

Among the reforms proposed at the national level, the Dodd-Frank law was passed in the United States and in the United Kingdom the government presented a consultative document outlining a new reform, which must be approved in 2011. The main characteristics of both these financial reform programmes are set out in Table 3.3. They have common elements, such as the far-reaching review of regulatory and supervisory structures and the creation of institutions in the macroprudential area and for the protection of financial service consumers. Unlike the gradual strategy adopted by European countries, the US reform proposes a global transformation, extending to most of the financial sector, to reduce the probability of new crises and to mitigate their potential effects on the economy

GLOBAL ECONOMIC AND FINANCIAL STABILITY

CHART 3.10



SOURCES: Datastream, Goldman Sachs, national statistics, Banco de España, Federal Reserve, ECB, Bank of England and Bank of Japan.

a Liquidity and financing-CB includes the increase in net lending since June 2008.
b IMF forecasts.
c Sign changed.
d CPI-based. An increase (decrease) denotes an appreciation (depreciation) of the currency.

and, in particular, on public finances. The reform proposed by the new British government focuses more on the regulatory architecture and assigns a larger role to the Bank of England.

4.2 DELEVERAGING PROCESSES

Private-sector indebtedness in the main advanced economies continues to hamper economic recovery and endanger financial stability

One adjustment that needs to be made following the crisis is linked to the excessive indebtedness of the private sector in the main developed economies and to the necessary deleveraging process (see Chart 3.10). In the United States, Japan and the United Kingdom (in contrast to the euro area) the ratio of non-financial private-sector debt tended to decline in 2010. In the case of households the decline reflects the increase in disposable income, high savings rates and weak lending. In the corporate sector, the fall was mainly the result of rises in financial asset prices. However, private sector deleveraging is proceeding slowly and, on historical evidence, can be expected to continue for several years. Persistently very high debt ratios not only hamper economic recovery (by limiting the leeway for private demand expansion), but also represent a risk to financial stability, since further adverse developments may lead to default, with negative repercussions for creditors.

COMPARATIVE SUMMARY OF FINANCIAL REFORMS

TABLE 3.3

	UNITED STATES	UNITED KINGDOM
Nature and state of the reform	General: Dodd-Frank Wall Street Reform and Consumer Protection Act.	Partial, gradual and segmented reforms. Current institutional framework focus.
	Approved, but still to be implemented.	Approval of legislation foreseeable for mid-2011.
Financial stability coordination	Financial Stability Oversight Committee (FSOC).	Financial Policy Committee.
	Presided and coordinated by the Treasury.	Led by the Bank of England.
Supervision	Multiple supervisors.	Solvency supervisor separate from market performance (Twin Peaks).
Treatment of systemic institutions	Higher capital and liquidity requirements, strengthened supervision, new resolution regimes, living wills and stress tests.	
Separation of activities	Volcker rule and other limits.	Under study by the Independent Commission on Banking.
Consumer protection	Independent agency attached to Federal Reserve.	Independent agency.
Remuneration systems	Principles based: deferred salaries and conditionality based on medium-term performance.	

SOURCE: Banco de España.

In addition, there are problems arising from the increase in public-sector indebtedness

On top of these problems of excessive private-sector indebtedness has come the sharp increase in public debt (by 15 pp of GDP on average in the main advanced economies since 2008), which has offset the reduction in private debt. The upward trend in public debt is still far from being contained in most of the advanced countries, and highlights problems of fiscal sustainability and the general need for consolidation in the advanced economies, in addition to the adjustment imposed by the sovereign crisis in Europe. As discussed in Section 3.1, in countries like Japan and the United States, which also display unsustainable long-term fiscal trends (see Chart 3.7), fiscal consolidation has been postponed, since it has been subordinated to short-term priorities. In short, the need for fiscal adjustment and ongoing private-sector deleveraging will weigh on growth prospects in the advanced economies in the coming years.

4.3 GLOBAL IMBALANCES AND INTERNATIONAL POLICY COORDINATION

Global imbalances grew in 2010, following the significant correction in 2009

Following the sharp correction recorded in 2009, global imbalances grew moderately last year, in line with the recovery and the increase in commodity prices (see Chart 3.10). This growth was reflected in the slight increase in the absolute value of current-account balances, to 4.5% of world GDP, although this was well below its pre-crisis levels (around 6% in 2006). Among countries with current-account deficits, that of the United States increased slightly, to 3.2% of GDP, less than half its level in 2006. Among countries with surpluses, the increase in those of oil exporting countries was notable. By contrast, the surplus in China fell slightly, to 5.2% of GDP. As a result of this growth in imbalances, they have become one of the G20's main concerns once again.

The G20 has consolidated its position as the forum for economic policy coordination at the international level …

The financial crisis highlighted the complexity of the links between economies and financial systems, and the overriding need for international coordination of national actions in order to achieve balanced growth that is sustainable in the medium term. The G20 has consolidated its position as the main forum for this coordination, underpinned by the prominence within it of the emerging economies, in line with their greater importance at the world level (see Box 3.1). Against this background, reduction of global imbalances is one of its main objectives. In addition to repeating the need for orderly and gradual fiscal adjustment, the G20 has recommended countries with current-account deficits to take measures to stimulate saving and promote competitiveness, while urging surplus countries to adopt measures to stimulate internal sources of growth. With the aim of fostering greater commitment among its members, the G20 has based this debate on a "Mutual Assessment Process" and has just defined a set of indicators of macroeconomic imbalances for countries of major global importance, in relation to which assessments and policy recommendations can be made.

... although, the impetus for coordination has weakened

Notwithstanding the intense activity centred on the G20, the impetus for coordination weakened last year. The different rates of economic recovery and the different domestic priorities have given rise to diverging policy responses, as analysed in Section 3, which have not always been well received by the rest of the economies. In particular, the new expansionary phase of monetary policy in the United States acted as a trigger for significant intervention in the foreign exchange markets by emerging countries and some developed countries, such as Japan and Switzerland, and led to greater resort to administrative measures and capital controls, that ultimately run the risk of segmenting international capital markets, and thus acting against the climate of international coordination.

In short, the results of international policy coordination were ambiguous last year. On one hand, a certain fatigue can be perceived, following the peaks of tension in the economic crisis, and a trend towards the prevalence of national interests. At the same time, the G20 has consolidated its position as the forum for governance of the world economy and has an intense agenda.

5 Outlook and risks

The economic outlook is for continued growth at a somewhat more moderate rate, with significant downside risks, owing to the weakness of the fundamentals in the developed economies...

The baseline scenario of the economic outlook for 2011 is for continuity of the global recovery, although at a more moderate rate than in 2010. According to the IMF's latest forecasts, world growth in 2011 will be 4.4%, half a percentage point down from 2010, and the notable difference between the advanced and emerging economies will be maintained. This scenario is subject to notable downside risks, particularly in the developed economies, where the economic momentum continues to be based largely on policies of monetary and fiscal stimulus. Self-sustaining growth in domestic demand and, in particular, private consumption requires a significant improvement in labour markets (which is still insufficient, despite the positive signs in the United States, in the first quarter of 2011) and progress in deleveraging. At the same time, a stronger pick-up in private productive investment in the United States cannot be ruled out, owing to the strength of company balance sheets and the firming of confidence.

… intensified by the fragility of public finances…

The deterioration in public finances and its link to the fragility of the financial systems are another important source of risks. The new fiscal stimulus programmes in the United States have sustained growth in the short run, but have postponed fiscal consolidation, while concerns have been growing regarding the situation of state and local authority finances, which could erode the long-term fiscal position. In general, there is a risk of a sudden and substantial rise in the cost of financing public debt in the developed economies, given the imbalance between the supply and demand for public debt securities that may be generated during the recovery. The increase in long-term rates may have a further negative impact on domestic demand and financial stability.

... against a background in which the normalisation and reshaping of the financial system remains slow

At the same time, despite the improvement in the financial situation, the restructuring of some banking systems has still not been completed, and the necessary reshaping of the financial architecture will depend on the implementation of regulatory reform at the national and global levels. The impact of these developments on financing conditions, the flow of credit and, more generally, activity, is still uncertain.

The rise in commodity prices is a serious threat to global growth

The most palpable risks in the current situation arise from the upward trend in commodity prices (in particular, that of oil), which has intensified since early 2011 owing to the conflicts in the Arab countries. The direct impact on activity may be limited, but the possible monetary policy reactions to a sharp rise in inflation, and their impact on uncertainty, when confidence has still not been firmly established, would have more significant consequences. In addition, the policy dilemmas in the emerging economies may be exacerbated. In these economies risks of overheating and of increases in financial vulnerabilities are discernible, although the uncertainty associated with greater inflationary pressures may reduce the attractiveness of these economies and stem inflows. In any case, from a long-term perspective, the higher commodity prices, inevitably associated with growing demand from the emerging economies, may constrain global growth capacity and affect its distribution by region.

These risk factors require the implementation of policies to strengthen the outlook for growth and financial stability

In short, although the recovery in the world economy seems to be firming, the obstacles and challenges are notable, and the risks are on various fronts, including the inflation one. Against this background, economic policies designed to strengthen the foundations of growth and financial stability should prevail over more short-term stimuli, although these have been vital at the most acute moments of the crisis.

1 Sovereign debt crisis in the euro area

The sovereign debt crisis prompted a reform of the institutional framework and an overhaul of the priorities of economic policy

The economic recovery proceeded throughout last year and 2011 to date, driven by the strength of the world economy, the expansionary economic policy stance and the fiscal policy stimulus in the first half of the year (see Chart 4.1). Nevertheless, in 2010 the euro area faced a severe sovereign debt crisis which affected various member countries and posed a serious threat to the stability of the area. The gravity of the situation called for substantial reform of the institutional framework underpinning the euro area, directed particularly at the mechanisms of economic policy coordination and supervision. The role of structural policies was also strengthened so as to achieve greater efficiency in the use of factors of production and return to a path of sustained economic growth, which is vital in those economies that have to reabsorb imbalances accumulated in the past.

The crisis stemmed from major imbalances in some Member States

The doubts about the sustainability of public finances in various euro area member countries, which are at the origin of the sovereign debt crisis, stemmed from a combination of diverse factors. General government finances deteriorated notably as a result of the activation of automatic stabilisers during the crisis, the roll-out of discretionary stimulus measures and, in some countries, the loss of the extraordinary revenue associated with the real estate boom and the use of public funds to stabilise the banking sector. Moreover, in some cases the starting level of public debt was already high at the outset of the crisis, a situation which was aggravated by the high contingent liabilities arising from the foreseeable impact of progressive population aging on the public pension system and by the uncertainty surrounding the return of the funds invested in bank restructuring processes. However, leaving aside these purely fiscal developments, the growth outlook for some euro area economies was inauspicious due to the accumulation of macroeconomic imbalances over the past decade, which has given rise to high levels of private indebtedness, substantial loss of competitiveness and elements of fragility in banking systems.

... but also evidenced deficiencies in the design and functioning of policy coordination and crisis prevention and resolution mechanisms in the EU and the euro area

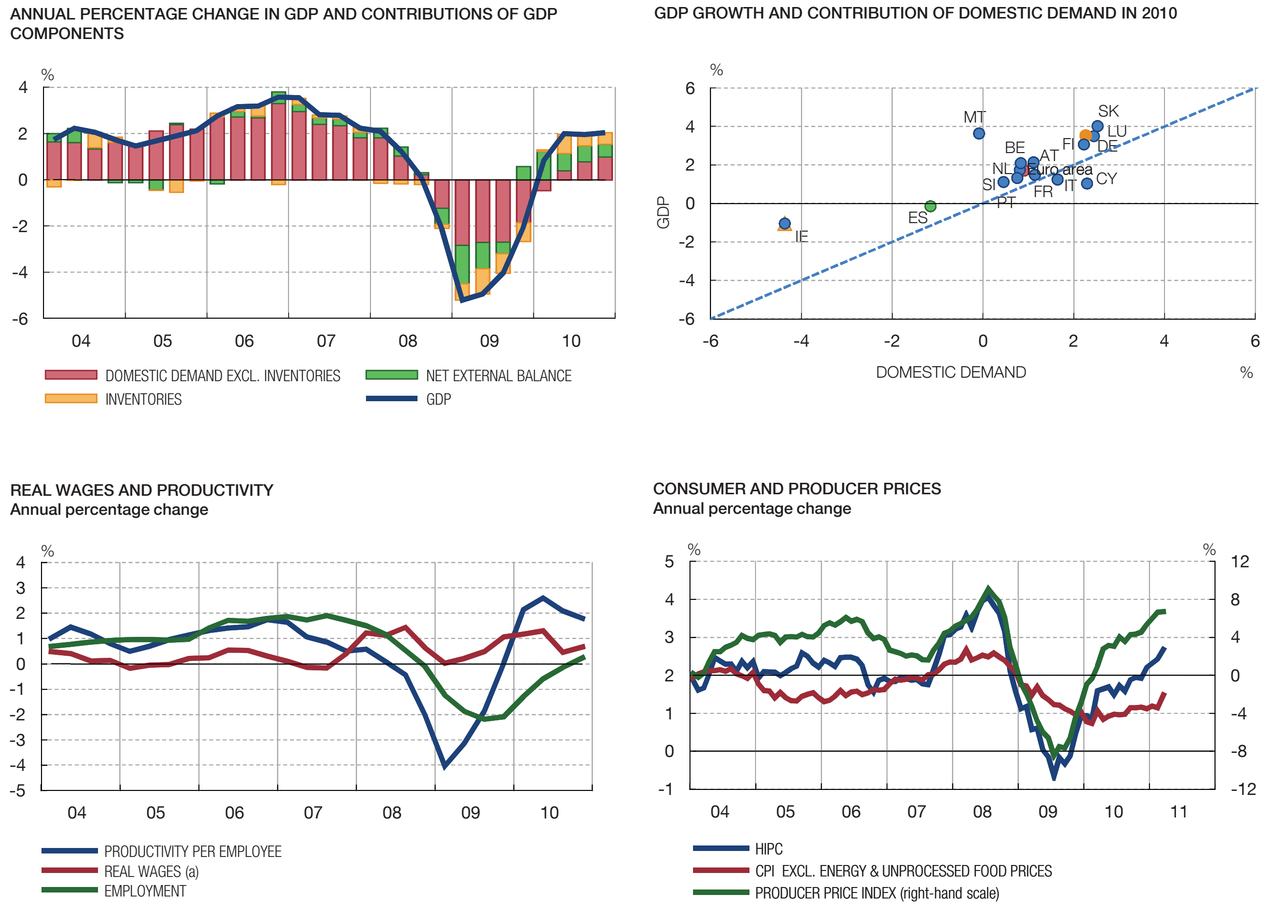
The crisis also highlighted fundamental fragilities in the instruments of coordination and macroeconomic supervision of the euro area, which proved to be insufficient to instil the necessary degree of discipline and give due attention to the macro-financial imbalances developing in some economies and requiring corrective economic policy action. It also became apparent that the euro area authorities did not have formal mechanisms for coordinated crisis management and resolution, which meant that the required financial assistance had to be hastily designed and implemented. Both of these shortcomings take on greater importance in a situation in which, as the current crisis has shown, shocks are propagated between euro area countries substantially more rapidly and intensely: the drastic repricing of one country's sovereign risk was rapidly transformed into a heightened perception of bank vulnerability, a change in the assessment of the economic situation in other countries and a widespread crisis of confidence in the euro area.

Sovereign spreads widened to differing extents

The credit rating of public debt was downgraded in all of the most strongly affected countries and sovereign spreads rose suddenly, albeit to differing extents depending on the fiscal and economic situation and outlook of the countries involved (see Chart 4.2). Greek public debt was downgraded to speculative status and its spread over the German bund exceeded 1,200 basis points (bp) despite the financial assistance received in May. The rates in Ireland and Portugal climbed to 700 bp and 600 bp, respectively, above the German bund. The deterioration in sovereign risk premia in Spain, Italy and Belgium was more limited, but significant at times, particularly in Spain.

EURO AREA: GROWTH, LABOUR MARKET AND PRICES

CHART 4.1



SOURCE: Eurostat.

a Difference between the change in compensation per employee and the GDP deflator.

... and tension was appreciable in other financial markets

The tension also affected other financial variables, in some cases very unevenly across sectors and countries. The euro exchange rate depreciated by more than 10% in nominal effective terms from October 2009 to end-2010, against a background of high volatility. The EUROSTOXX 50 index fell by 6% in the year and, save the German DAX which rose by more than 16%, the main European stock exchanges fell sharply, particularly in the financial sector and in the countries hit hardest by the crisis (see Chart 4.3). Moreover, the fall in government bond prices exposed the euro area banking sector to losses in their available-for-sale asset portfolios, while the perceived greater fragility of the public sector weakened the explicit or implicit guarantee that it can provide to the financial system. The institutions of the most affected countries faced more limited access to the wholesale funding markets and encountered serious liquidity problems, having to resort to Eurosystem funds and, in extreme cases, to emergency liquidity assistance from their respective national central banks. By contrast, non-financial corporations and, above all, households were comparatively less affected by these tensions, since they scarcely passed through to the availability and cost of bank loans, although countries did vary somewhat in this respect. Against a background of notable weakness in demand, lending followed a similar cyclical pattern to that observed historically.

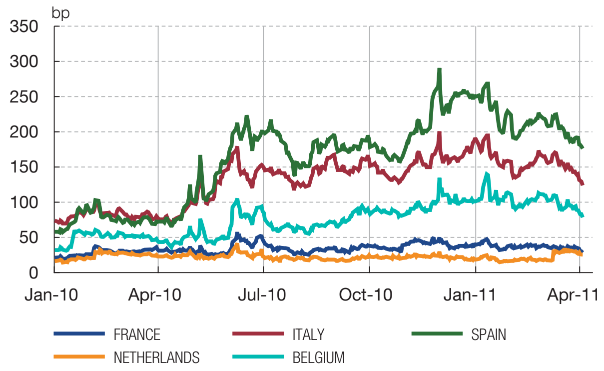
The institutional response of the euro area initially calmed the tensions...

After serious deficiencies were found in the statistical information on its public accounts and various months of hesitation and reluctance, Greece finally requested financial assistance in May. This support amounted to €100 billion, provided under a programme of

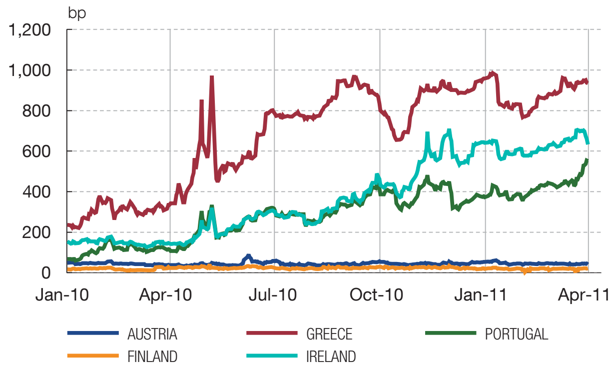
EURO AREA: SOVEREIGN SPREADS OVER GERMANY

CHART 4.2

TEN-YEAR BONDS



TEN-YEAR BONDS

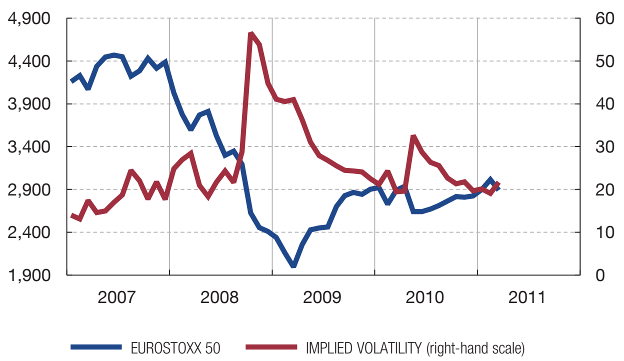


SOURCE: Eurostat.

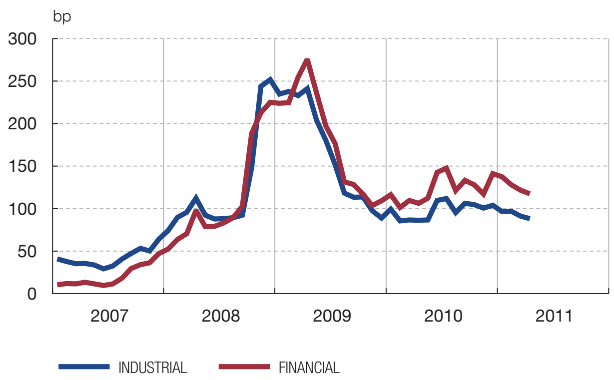
FINANCIAL CONDITIONS IN THE EURO AREA

CHART 4.3

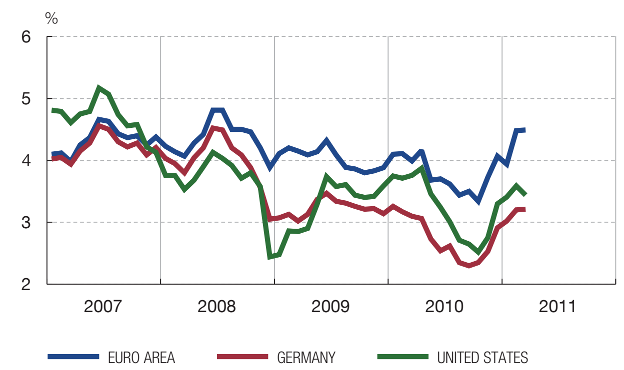
STOCK MARKET INDICES
End period



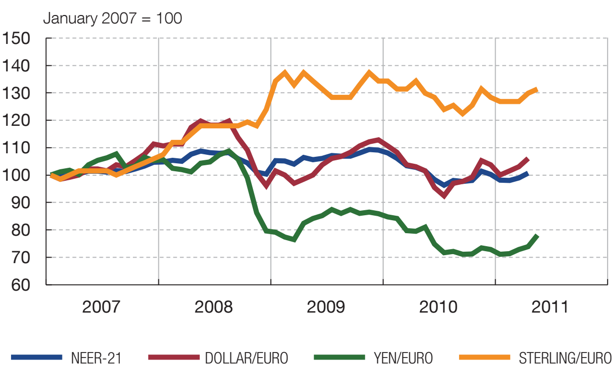
CORPORATE BOND SPREADS



TEN-YEAR GOVERNMENT BOND YIELD
Monthly average



EXCHANGE RATES FOR THE EURO



SOURCES: ECB and JP Morgan.

bilateral loans from euro area countries (€80 billion) and from the IMF, subject to strict conditionality. Further, to reduce the risk of contagion, a new financial assistance scheme was designed which, under similar conditions to those of the Greek programme, would be available until mid-2013 to any euro area member needing it. This scheme comprises: the new European Financial Stabilisation Mechanism (EFSM), a euro area instrument able to mobilise up to €60 billion; the European Financial Stability Facility (EFSF), able to grant loans with a maximum guarantee of €440 billion from euro area Member States; and IMF financing equal to up to 50% of the amount drawn from the EFSM and the EFSF. The tensions during the summer were eased by establishment of these instruments, along with the commencement of work to improve European governance, the publication of bank stress tests and the expediting and strengthening of fiscal consolidation plans with a firm commitment to introduce structural reforms in some euro area Member States.

... but the worsening of the situation of the banking sector and of the Irish public finances, and the difficulties in agreeing on an internal economic adjustment programme in Portugal (in 2011) required activation of the new support mechanisms

However, the situation changed when in Ireland the deterioration in the financial position of its banks sparked a fresh outbreak of tensions. The excessive size of the Irish banking sector relative to the economy as a whole, the concentration of real estate risk and its dependence on wholesale financing made this sector extremely vulnerable to the international financial crisis (from 2008), to the intense domestic recession and to the adjustment in the Irish real estate sector. These circumstances forced activation of the financial support mechanisms at the end of November, with an assistance programme valued at €85 billion, which included funds to be contributed by the Irish government itself and bilateral loans from the United Kingdom, Sweden and Denmark.

Later, in April 2011, Portugal also requested financial support from the European institutions and the IMF. The institutional paralysis in this economy following the resignation of the government, when a fresh fiscal adjustment plan was rejected in parliament, made it the focus of the tensions. Its problems achieving fiscal consolidation objectives had previously been highlighted, against a background in which the competitive imbalances accumulated in recent years and the high indebtedness of firms and households hampered the attainment of a sustained rate of growth. The support programme approved in May amounted to €78 billion, to be distributed equally between the EFSF, the EFSM and the IMF, and, like the previous programmes, it is subject to strict conditionality, with relatively ambitious structural reform measures required.

In March 2011 substantial changes to the institutional framework of the euro area were adopted, but the area continued to confront the biggest challenge of its history

The recurrent bouts of instability during the first few months of 2011 were also fuelled by the lack of determination on the part of the governments to clarify certain details of present and future support mechanisms. In this context, in March the European Council sanctioned the legislative reforms in progress to strengthen the domestic economic policy coordination and mutual supervision mechanisms and adopted significant measures to further the design of the future European Stability Mechanism (ESM), which will begin to function in July 2013. Also, to strengthen the governments' resolve to establish policies more favourable to growth and more consistent with the financial integration environment achieved in the euro area, the heads of state and government of the euro area decided to establish the Euro Plus Pact. The new strengthened governance framework was thus practically given its final shape. In the medium term, this new framework will reduce the probability of a repetition of situations like the present one and, in the event they do occur, give the area the necessary tools to manage them effectively.

However, in the shorter term, sovereign risk spreads continue to fluctuate sharply, reflecting the complexities of the situation in Ireland, in Portugal and, fundamentally, in Greece. The difficulties that have become apparent in complying with the timetable envisaged in the programme for Greece are presenting the euro area with a challenge unprecedented in its short history; a significant effort will be required to rule out the possibility of unpredictable traumatic scenarios for the common European project.

EURO AREA: MAIN MACROECONOMIC INDICATORS

TABLE 4.1

	2008	2009	2010	2010 Q1	Q2	Q3	Q4
DEMAND AND OUTPUT (quarter-on-quarter rates):							
Gross domestic product	0.3	-4.1	1.7	0.4	1.0	0.4	0.3
Private consumption	0.4	-1.1	0.8	0.3	0.2	0.2	0.4
Government consumption	2.3	2.5	0.7	-0.1	0.2	0.4	0.1
Gross fixed capital formation	-1.0	-11.2	-1.0	-0.2	2.1	-0.2	-0.5
Non-residential private investment	0.3	-14.9	0.7	0.7	2.5	0.4	0.8
Residential investment	-5.3	-10.7	-3.6	-0.6	0.7	-0.3	-0.2
Public investment	1.6	5.1	-3.4	-3.8	-0.1	-0.4	-1.5
Exports	0.7	-13.1	10.9	3.0	4.5	2.1	1.5
Imports	0.6	-11.7	9.0	3.6	4.2	1.5	1.0
Contributions to GDP growth in percentage points:							
Domestic demand	0.5	-2.5	0.4	0.1	0.5	0.1	0.1
Change in stocks	-0.2	-0.9	0.5	0.4	0.3	0.0	-0.1
External demand	0.0	-0.7	0.8	-0.1	0.2	0.3	0.4
PRICES AND COSTS (year-on-year rates):							
Consumer prices (annual average)	3.3	0.3	1.6	1.1	1.6	1.7	2.0
GDP deflator	2.1	1.0	0.8	0.5	0.8	1.1	1.0
Unit labour costs	3.7	3.8	-0.4	-0.5	-0.5	-0.6	-0.2
Compensation per employee	3.2	1.4	1.7	1.6	2.1	1.5	1.6
Labour productivity	-0.4	-2.3	2.2	2.2	2.6	2.1	1.8
GENERAL GOVERNMENT (% of GDP):							
Total expenditure	46.9	50.8	50.8				
Current expenditure	43.1	46.6	46.6				
Public investment	2.6	2.8	2.7				
Total revenue	44.9	44.5	44.4				
Primary deficit (–) / surplus (+)	1.0	-3.5	-3.5				
Deficit (–) / surplus (+)	-2.0	-6.3	-6.3				
Public debt	69.8	79.2	84.2				
LABOUR MARKET:							
Total employment (quarter-on-quarter rates)	0.8	-1.8	-0.4	0.0	0.1	0.0	0.2
Unemployment (% of labour force)	7.7	9.5	10.1	10.0	10.1	10.1	10.0
BALANCE OF PAYMENTS (% of GDP)							
Current account	-1.4	-0.3	-0.4	-0.8	-0.8	-0.3	0.2
DEBT RATIOS:							
Households (% of GDI)	95.6	97.4	98.7	97.3	98.4	98.4	98.7
Non-financial corporations (% of GOS)	494.4	555.5	538.1	554.3	549.4	545.8	538.1

SOURCES: ECB, European Commission and OECD.

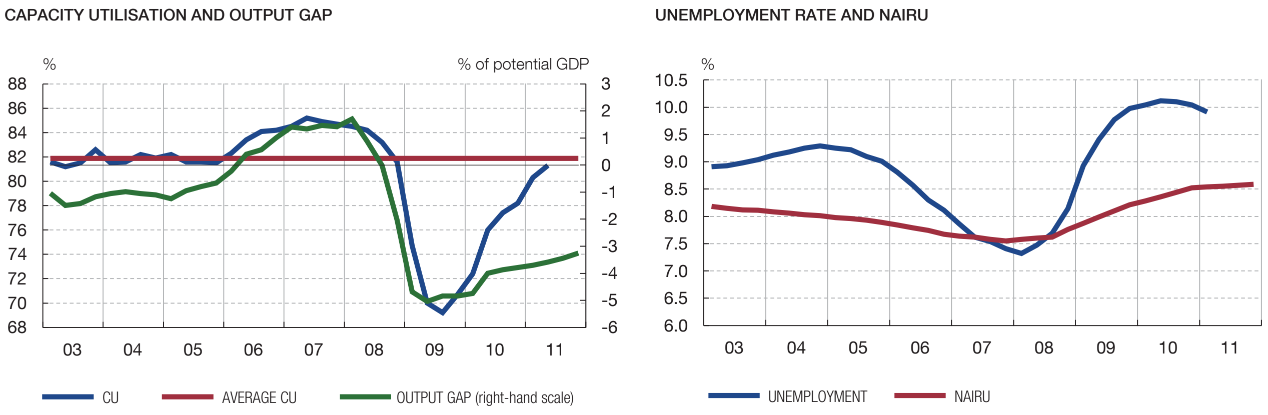
2 Macroeconomic developments: consolidation of the recovery

In 2010 the recovery in the euro area firmed, underpinned by foreign trade and the change in the inventory cycle

During 2010 the recovery in economic activity that commenced in mid-2009 continued, so that GDP grew by 1.7%, following a decline of 4.1% in 2009. As seen in Table 4.1, goods and services exports grew notably, following the collapse recorded in 2009, thanks to the boost from world trade, while the increase was somewhat more contained in the case of imports, in line with their smaller decline in the recession. Accordingly, the contribution of net external demand was very positive, and the largest to have been recorded since the start of Stage Three of EMU. The contribution of the change in inventories was also large in historical terms.

SLACKNESS OF ECONOMIC CONDITIONS

CHART 4.4



SOURCES: European Commission and OECD.

While growth in domestic demand was weaker

Domestic demand also recovered, although less strongly. Among its components, private consumption – notable on account of its relative importance – increased, despite the reduction in disposable income, driven by the growth in financial and non-financial wealth and by the improvement in expectations regarding the economic situation. Fiscal consolidation in the euro area countries resulted in a notable slowdown in government consumption and a sharp fall in public investment. Finally, there was a pick-up in business investment, spurred by the expansion in final demand, while residential investment fell for the third year running, since the adjustment in the real-estate sector in some euro area countries has still not been completed.

Employment stabilised

Euro area employment declined slightly in 2010 as a whole, but tended to stabilise over the year as hours worked recovered to their pre-crisis levels (see Charts 4.1 and 4.4, and Box 4.1). However, the rate of unemployment increased again, with joblessness concentrated among young people and the long-term unemployed, which involves a loss of human capital.

The divergence in the performance of activity across the euro area countries has been very marked

By country, significant differences in the performance of activity were recorded, with a vigorous increase in GDP in Germany and significant falls in Greece and Ireland, as a consequence of the general collapse in the components of their domestic demand, largely associated with the low levels of confidence and the application of the highly restrictive fiscal policies needed to restore fiscal sustainability and market confidence. Increased buoyancy in the German economy was based partly on the export growth, assisted by the robust growth in the world economy, but also by the business restructuring and structural reforms undertaken over the last decade, which have resulted in competitiveness improvements. In addition, German domestic demand displayed a comparatively strong recovery, owing to the buoyancy of equipment investment, which was driven by exports, and of government consumption, given the limited need for fiscal adjustment.

Inflation rose, impacted by the surge in commodity prices

Since the beginning of 2010, the developments in the harmonised index of consumer prices (HICP) have been determined by the strong rise in its energy and food components, linked to the progressive increase in commodity prices. This tendency intensified from the end of the year, as a consequence of the rise in the price of oil stemming from the bouts of political instability in certain oil producing countries, so that inflation reached 2.8% in April 2011, up from 1% in January 2010 (see Chart 4.1). The year-on-year rate of change in the prices of the most stable components of the HICP (services and non-energy industrial

During the recent economic and financial crisis, there has been less job destruction in the euro area as a whole, in relation to the fall in activity (see table below). However, this aggregate performance masks very diversified behaviour. In Austria, Belgium and Germany, despite the contraction in activity, the decline in employment has been very limited or even zero, in contrast – especially in Germany – with the crisis experienced at the beginning of the 1990s. At the opposite end of the spectrum, Spain and Ireland stand out not only because employment over-reacted to the fall in activity, with the numbers employed declining by more than 8%, but also because job destruction has lasted longer (see Panel 3).

The diversity of employment's reaction to the fall in activity seems to be in response to the combination of three factors:[1] the idiosyncratic nature of the recession in certain countries, aside from the global financial shock; the structure of national labour markets; and the different economic policy responses implemented by governments.

In Spain and Ireland the contraction in activity has been accompanied by a specific shock in the real estate sector. Thus, in Ireland, the decline in the construction sector seems to have directly explained half of the job destruction (see Panel 1), with a reduction of this sector's weight in the labour force of more than 4 pp during the crisis. In Spain 40% of the jobs destroyed were in construction,[2] a sector that represented 12% of total employment in the economy at the beginning of the crisis.

The labour market legislative framework in each country has also played an important role in limiting or amplifying the scale of the contraction in employment.[3] In line with economic literature, job destruction has been more contained in countries with greater stability in contracts (linked to higher firing costs) and with more flexible collective bargaining systems. This positive effect of the institutional framework on incentives to maintain employment has been particularly important in those countries with higher demand for skilled labour in which, therefore, the potential costs to firms of laying off employees are higher. This has been the case of Germany and Austria, where, although the proportion of skilled workers among new generations joining the labour market is constantly increasing as a result of the inversion of the population pyramid, these workers are not sufficient to replace those leaving the labour force (see Panel 2, where skill is approximated by educational attainment level).

Finally, all the governments in the euro area have implemented new economic policy measures or have strengthened existing ones with a two-fold objective. On one hand, this was to stimulate employment demand, either through specific employment policies (short-time work programmes, cuts in social security contributions) or through fiscal stimulus programmes (reduction of direct taxes, creation of public-sector employment, aid for specific sectors, such as the automobile sector). On the other, it was to mitigate the adverse effects of unemployment (training programmes, the strengthening of job seeking agencies, the increase in unemployment assistance benefit). However, the economic situation and structural framework of each country prompted certain governments to use certain measures more intensively. For instance, countries like Germany, Belgium and Italy have strengthened their short-time work programmes, which was reflected in the contraction in the number of hours worked per employee – by up to 4% in Germany and 2% in Italy and Belgium. In countries with more specific shocks, government efforts were focused on supplementing the income of the unemployed, updating their training and fostering new activities.

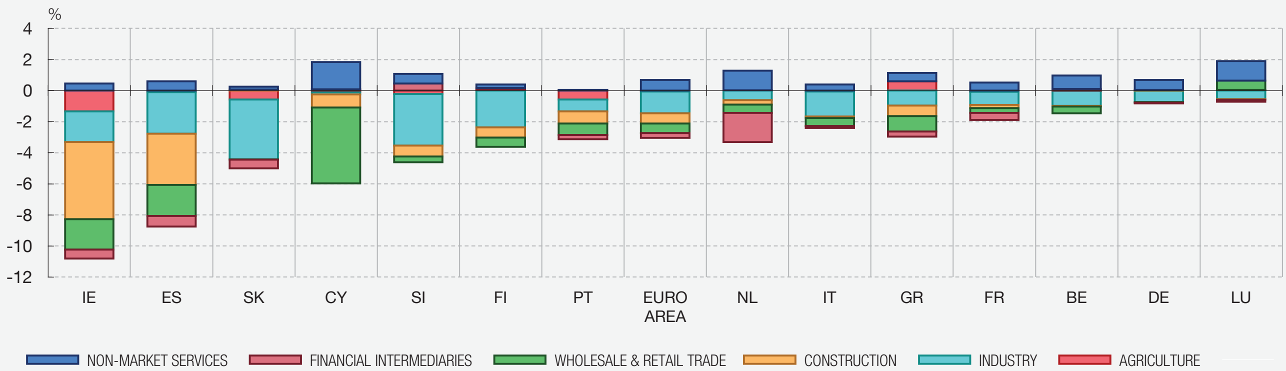
Ultimately, the varied response, in terms of employment, of the various euro area countries to the recent contraction in activity has underlined the importance of an institutionally flexible labour market within a monetary union. Moving towards wage bargaining models which permit flexible adjustments to changes in the economic situation of firms; hiring models which encourage the investment in human capital; and education systems which enhance future workers' adaptability and mobility have become a key element, not only for cushioning the negative effects of a recession but also for boosting the recovery of activity. Accordingly, those countries which weathered the recession best in terms of employment (Germany, Belgium and France) are those which began to record the first signs of job creation in 2010 (see Panel 3).

1 See *OECD Employment Outlook* 2010.
2 In the *Boletín Económico* December 2010 the contraction of housing investment is estimated to account for 60% of the jobs destroyed during the crisis in Spain, if the spill-over effects on other sectors of the economy are considered.
3 See Chapter 3 of *IMF World Economic Outlook* April 2010 and the ECB *Final Report of the Wage Dynamics Network* (December 2009).

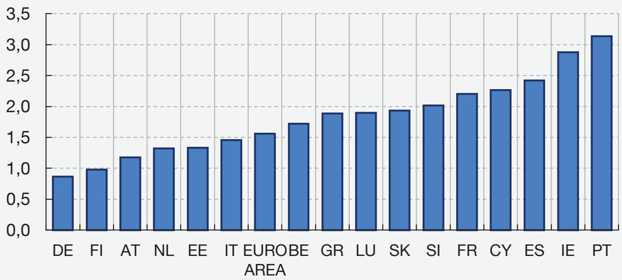
RATE OF CHANGE AND ELASTICITY OF EMPLOYMENT

	Rate of change in employment (%) (d)	Elasticity of employment to GDP (b)	
	Crisis 2008 Q3 - 2010 Q1	Crisis 1992 Q1 - 1993 Q2	Crisis 2008 Q1 - 2009 Q2
Ireland	-10.3	0.5	1.0
Spain	-8.1	1.8	1.7
Finland	-3.2	2.8	0.3
Portugal	-3.1	0.8	0.6
Euro area	-2.4	1.0	0.3
Netherlands	-2.0	1.1	0.1
Italy	-2.0	1.0	0.2
Greece (a)	-1.8	n.a.	0.2
France	-1.4	0.5	0.1
Austria (a)	-1.0	n.a.	0.3
Belgium	-0.5	0.5	-0.1
Germany	-0.1	1.0	0.0

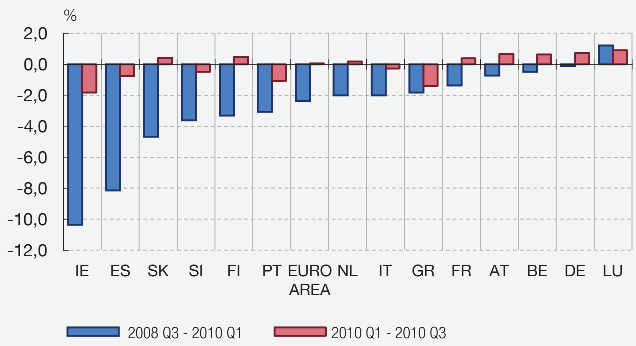
1 SECTORAL CONTRIBUTION TO JOB DESTRUCTION. 2008 Q3 - 2010 Q1 (c)



2 LABOUR FORCE WITH UNIVERSITY STUDIES IN 2010. RATIO BETWEEN THE SIZE OF AGED 25-34 COHORT AND THAT OF THE AGED 50-59 COHORT (c)



3 JOB DESTRUCTION AND CREATION IN THE EURO AREA BY COUNTRY (d)

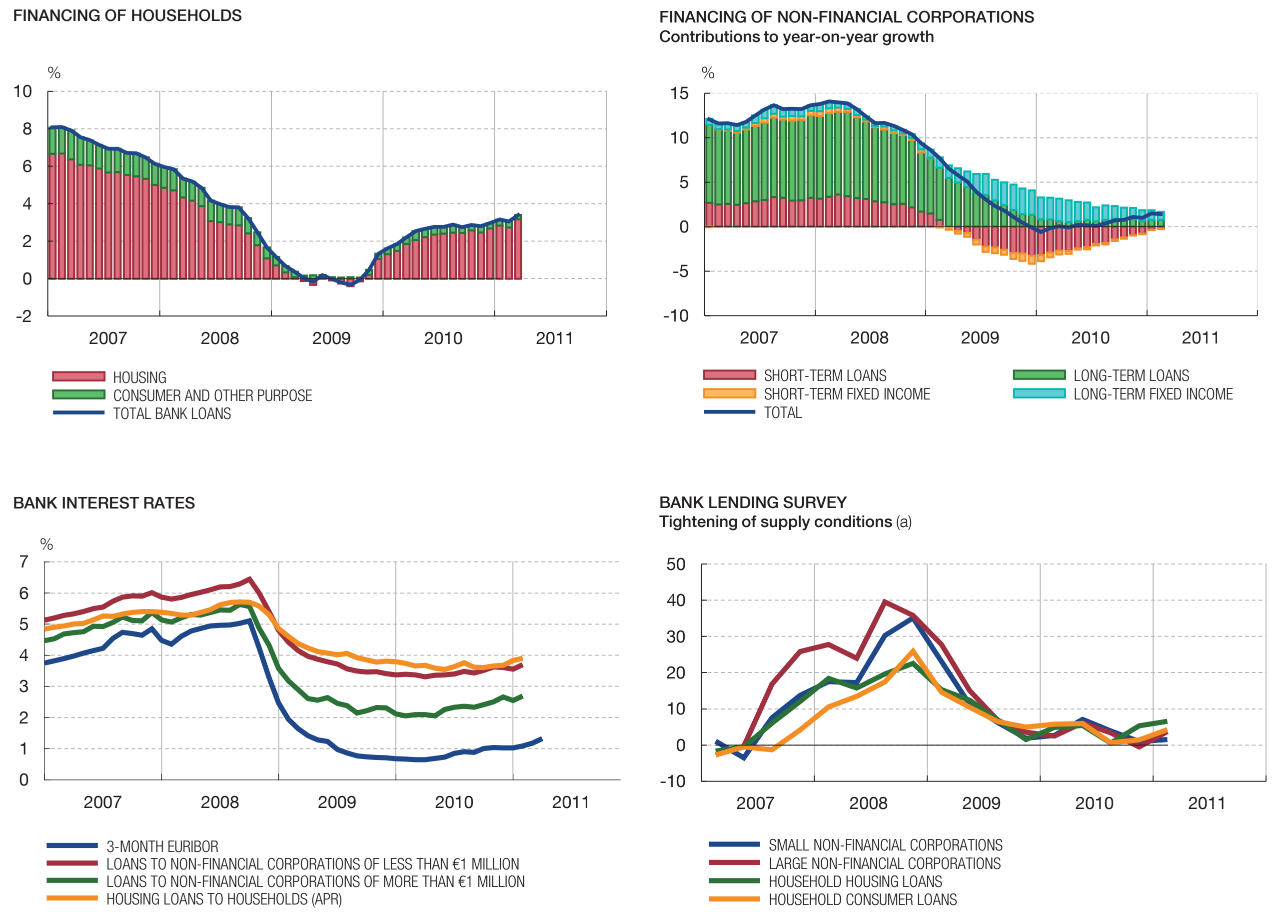


SOURCES: Eurostat and OECD.

a The data for Austria and Greece are from Eurostat and are only available to 2009 Q4.
b The contractionary stages are defined as the period between the last quarter of positive quarter-on-quarter growth of activity in the euro area as a whole and the last quarter of quarter-on-quarter decline.
c A ratio value of less than 1 means that the labour force with university studies aged between 50 and 59 is more numerous than the corresponding group aged between 25 and 34. This is the case of Germany and Finland. At the other extreme would be Portugal where the labour force with university studies aged between 25 and 34 is three times higher than the corresponding group aged between 50 and 59.
d The change in employment was calculated from the last quarter of positive quarter-on-quarter growth in employment in the euro area as a whole and the last quarter of quarter-on-quarter decline.

PRIVATE SECTOR FINANCING

CHART 4.5



SOURCE: ECB.

a Indicator = % of institutions that have considerably tightened standards x 1 + % of insitutitons that have tightened standards to some extent x 1/2 - % of institutions that have eased standards to some extent x 1/2 - % of institutions that have considerably eased conditions x 1.

goods) held at low levels, owing to the persistence of a high degree of economic slack in the area and wage moderation, which have offset the increases in indirect taxes and the recovery in profit margins that followed their sharp fall during the recession.

The growth in loans to the private sector was contained

Against this background, and with some differences across countries, loans to households and non-financial corporations displayed a mild tendency to recover, which has continued in 2011, while the credit standards for the approval of loans maintained the restrictiveness built up in the past (see Chart 4.5). This increase in financing, along with the weakness of income in these sectors, caused the household debt ratio to rise slightly, while that of firms was corrected downward somewhat (see Table 4.1).

3 The role of demand-side policies: reaction and limitations

The expansionary capacity of demand-side policies was becoming exhausted. Monetary policy maintained its expansionary stance and a broad range of non-standard measures

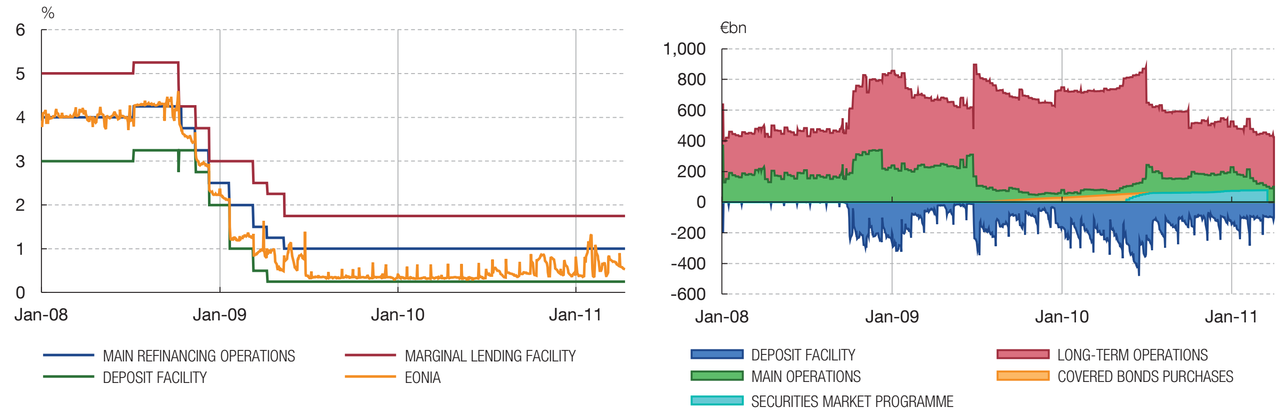
During 2010, it became clear that the policies to expand demand deployed with full force to combat the financial crisis in the previous period had reached their limits. Monetary policy remained expansionary, against a background of an absence of medium-term inflationary pressures and slow growth. The ECB's Governing Council kept its key policy rate at 1% until its meeting of 7 April, when it decided to raise it by 25 bp (see Chart 4.6). At the same time, the situation in the markets led the Eurosystem to extend the duration of its full allotment liquidity tenders. The extraordinary six and twelve-month loans that were introduced when tensions on the financial markets were at their highest matured, without the generation of frictions, reducing gross liquidity. Also, the covered bond purchase programme

EURO AREA MONETARY POLICY

CHART 4.6

OFFICIAL INTEREST RATES AND EONIA

LIQUIDITY SUPPLIED BY THE EUROSYSTEM AND THE SECURITIES MARKETS PROGRAMMES



SOURCE: ECB.

came to an end in June following the staggered purchase of €60 billion. This measure had been established in 2009 to mitigate the distortions generated by the crisis in this market segment and so avoid repercussions for the flow of bank credit and the interest rates charged for such credit. Similarly, the heightened tensions in certain public debt markets and their negative impact on the transmission mechanism led to the establishment of the Securities Markets Programme in May 2010, which concentrated on the sterilised purchase of government bonds in the secondary markets of the countries most affected. During the first few months of this programme the purchases amounted to €60 billion. Subsequently, more purchases were made for smaller amounts, and the total portfolio acquired had risen to somewhat more than €76 billion by the end of April.

Fiscal policy contributed to the recovery, but began to change direction towards fiscal consolidation...

In 2010 in the euro area as a whole, fiscal policy continued to make a decisive contribution to the recovery in economic activity, through the operation of automatic stabilisers and support to the banking system. However, after the first few months of the year the discretionary measures to stimulate demand and support the labour market that had been deployed during 2009 were progressively phased out and the excessive deficit situation in most of the euro area countries forced them to draw up medium-term fiscal consolidation plans, against a background in which the economic recovery began to firm. This change of direction in fiscal policy meant that the euro area deficit remained practically unchanged from the previous year, at 6% of GDP, although this represents a deterioration of almost 6 percentage points (pp) from 2007. The cyclically adjusted deficit barely rose, as compared with an increase of 1.8 pp in 2009 (see Chart 4.7). The debt ratio for the euro area as a whole reached 85.4% of GDP, historically a very high level.

... a change that was speeded up by the sovereign debt crisis, which forced some economies to bring forward their fiscal consolidation plans

The tensions in the sovereign debt markets in April and May focused attention on the risks inherent in a situation of widespread excessive deficits and forced decisive and relatively rapid corrective measures to be taken to allay investors' doubts regarding the sustainability of public finances. The sovereign debt crisis thus led not only to the need to abandon the expansionary stance with which fiscal policy had responded in Europe to the first effects of the international financial crisis, but also to some urgency to turn it around so as to reduce long-term interest rates (by reducing the risk premium), giving space to private spending to recover momentum and contribute to a revival in activity. The first economy to step up its efforts was Greece, in return for the concession of financial assistance. Following the extraordinary meeting of the Ecofin Council at the beginning of May, Spain introduced

EURO AREA: FISCAL POLICY

CHART 4.7

SOURCE: European Commission, Stability and Convergence Programmes.

a EC forecast for 2011.
b Stability programmes prepared in 2010.

consolidation measures to supplement those envisaged in its stability programmes and brought forward some of those planned for 2011. In the final quarter of the year it was Ireland that, after recognising a deficit of close to 30% of GDP in 2010, largely linked to the cost of the bank rescue operations, had to draw up a fiscal consolidation plan. Portugal also adopted packages of additional measures on various occasions. The other economies designed austerity programs which have generally begun to be applied this year. Under the consolidation plans established, the euro area general government deficit is expected to decline to almost 4% of GDP in 2011, and to below 3% in 2030.

4 European governance review and other economic policy initiatives

The crisis has highlighted structural weaknesses in the institutional architecture of the euro area

The turmoil in the sovereign debt market has highlighted structural weaknesses in the institutional architecture of the monetary union, which were not given sufficient attention during the years of expansion but which now pose an unprecedented challenge to the area's stability. Since the start of Stage Three of EMU, the agreed arrangements for economic governance have been based on the principle of subsidiarity, whereby each state has maintained sovereignty over all economic policy decisions other than those of monetary policy, although they have been subject to coordination mechanisms of varying degrees of strictness, designed to reduce the negative externalities that measures introduced in one economy may have on the other countries in the area. In the case of fiscal policy, the Stability and Growth Pact was established to maintain budget discipline, while macroeconomic and structural policies were subject to laxer peer review-based coordination mechanisms. This framework has proved insufficient to achieve the degree of economic policy consistency necessary in a monetary union. On one hand, the SGP was not capable of promoting sustained fiscal consolidation during the expansionary phase, to give countries sufficient leeway to confront the downturn. The degree of discretion existing in the application of this procedure allowed many EU countries to fail to comply with the established deficit and debt thresholds repeatedly, without any effective mechanism being put in place to resolve the situation (sanctions or some other type of incentive). In many economies high levels of private indebtedness, substantial competitiveness losses and weaknesses in banking systems built up, which were not given due attention. Nor were there instruments available to channel financial support rapidly and transparently to those countries that might need it as part of an orderly crisis management process. As a backdrop to all this, an unprecedented degree of trade and financial integration significantly increased the speed and force with which difficulties are transmitted from one economy to another.

A three-pronged governance reform process is under way

The European institutions and governments decided to undertake a far-reaching review of this governance regime to correct the problems detected and to avoid similar situations occurring in future. The "Special Van Rompuy Group" was set up for this purpose in spring 2010, with the mandate of studying how to make the architecture of the euro area more solid. The EU, ECB and all the EU Member States participated in this working group. The review of the institutional framework undertaken as a result of the group's conclusions focuses on three fundamental areas: strengthening the SGP to increase fiscal discipline, improved supervision of macroeconomic imbalances and the creation of a permanent crisis-management mechanism. Although there are still aspects that may be changed during the process of approval by the European Parliament, which should be concluded in June 2011, the fundamental elements are already well defined.

The strengthening of fiscal discipline through reform of the SGP

In the fiscal sphere, the reform assigns greater importance to the public debt criterion, as originally envisaged by the SGP. First, a more rapid adjustment path towards medium-term objectives is proposed for countries with a level of debt of over 60% of GDP and, second, when this threshold is exceeded an excessive deficit procedure (EDP) will be opened or, if one has already been opened, will not be closed, even if the deficit is below 3% of GDP, as long as the debt-to-GDP ratio is not being reduced satisfactorily. Moreover, the incentives for governments to achieve a greater degree of compliance are strengthened, with the introduction of a broader, more transparent system of sanctions, to be activated at an earlier stage. It is also intended to make the application of these sanctions more automatic through the reverse voting procedure, which involves automatic approval of the Commission's proposals, unless they are rejected in time by a qualified majority of the governments. In addition, reform of the national fiscal frameworks is proposed, including the need for the accounts, statistics and forecasting practices to be adapted to EU rules, the adoption of multi-year fiscal planning to guarantee the medium-term objectives agreed, the establishment of rules limiting the expansion of public spending and indebtedness, and the creation of independent fiscal councils to supervise the design and execution of budgetary policy.

A new procedure for the surveillance and correction of macroeconomic imbalances is introduced

The reform introduces a new framework for the prevention and correction of excessive macroeconomic imbalances, including an early warning mechanism to prevent such imbalances from jeopardising financial stability in the euro area. On its preventive side, this new mechanism will seek to identify the countries with a potential risk of "excessive imbalance", using a set of economic indicators complemented by expert analysis. The excessive imbalance procedure will be initiated once it is considered that said imbalance reaches an excessive scale. It will recommend the adoption of a series of corrective measures over a specific period for the country in question, and it might conclude with sanctions if the recommendations are repeatedly not fulfilled.

And a permanent crisis-management and resolution mechanism is created, the European Stability Mechanism

The strengthening of the fiscal and macroeconomic surveillance instruments will minimise the possibility of vulnerabilities arising in the future that may jeopardise euro area stability. However, it is not reasonable to believe that this or any other framework might be capable of obviating that probability. The third pillar of the reform, therefore, resides on the setting up of a permanent crisis-management mechanism, the European Stability Mechanism (ESM), which will come into force in mid-2013, replacing the EFSF. To do this, article 136 of the EU Treaty has had to be amended, leaving the no bail-out clause in article 125 intact. This mechanism has an effective lending capacity of €500 billion, and it is intended to provide funds to solvent economies facing liquidity problems, under strict conditionality and at non-concessional interest rates. The financial assistance will normally take the form of loans and, in exceptional cases, of debt purchases on the primary market, without therefore attaining the operational flexibility that the Eurosystem had proposed. In exceptional cases of insolvency, the mechanism will provide for an orderly restructuring of debt, which will be tackled on a case-by-case basis through negotiation with private creditors.

January 2011 saw the start of the European Semester, for the coordination of different economic policies

To provide for better coordination of the various economic policy decisions under this new framework, it was agreed to set up the European Semester. This will take place during the first six months of each year and will conclude with the formulation of specific fiscal, macroeconomic and structural recommendations for each country. In January this year, the EC presented its *Annual Report on Growth*, which contains a roadmap for the euro area-wide economic policy that the different governments should take into consideration when setting out their respective Stability Programmes and their National Reform Plans. Also integrated into this new instrument is the revision of the preliminary structural reforms under the Europe 2020 strategy, approved in spring 2010 and whose main objectives are the increase in employment rates and social cohesion, the promotion of innovation (where hardly any improvements have been observed since the Lisbon strategy was set in place), the use of renewable energies and energy efficiency, the reduction in the early school leavers rate and an increase in the proportion of the population completing higher studies. The aim is to re-launch growth-boosting policies that lessen the impact the crisis may have exerted on potential GDP and that prevent the re-emergence of imbalances.

Priority is given to the reform of pensions systems and improvements to fiscal institutions...

Significant among the recommendations in the aforementioned report is, in the fiscal area, the advisability of pursuing the ongoing reform of pensions systems which many euro area economies have tackled in recent years, adapting benefits to the changes in life expectancy and in the population pyramid, while encouraging people to work to a later age. Emphasis is also placed on the need for national fiscal frameworks and institutions to include rules restricting public spending and debt levels, in line with SGP commitments.

... and to the revision of collective bargaining arrangements in some countries, the full transposition of the Services Directive and improvements in active employment policies

For progress in correcting macroeconomic imbalances, the economies that have built up losses on competitiveness should revise their collective bargaining arrangements so as to attain greater consistency between wage increases and changes in productivity. The countries with persistent current-account surpluses should analyse the causes that check the buoyancy of their demand. It is also considered important to boost the potential of the single market by means of the full transposition of the Services Directive in all the Member

States, the liberalisation of professional services and the development of instruments to attract private capital to finance growth, such as private equity funds. And, finally, it is recommended that social security contributions be reduced, setting this off by bolstering other taxes, that employment contracts be made more flexible and that disincentives to a second member of a family unit joining the labour market, which are present in some income tax systems, be eliminated.

The heads of state and government signed the Euro Plus Pact

While all the foregoing measures involve a substantial improvement to the European governance framework, the final results will obviously continue to depend largely on governments' readiness to meet the commitments undertaken. To reinforce this commitment, the euro area heads of state and government signed the Euro Plus Pact in March 2011 with the aim of fostering competitiveness and employment, contributing to the sustainability of public finances and reinforcing financial stability. The priorities and measures considered in the Pact largely coincide with those in the EC's *Annual Growth Report* under the aforementioned procedures and instruments for the oversight of compliance therewith. But the Pact raises governments' commitment to the maximum political level.

The European Systemic Risk Board will be responsible for macroprudential supervision in the EU

Finally, in the financial field, the crisis has also highlighted the shortcomings of a regulatory framework based exclusively on the prudential supervision of individual institutions, one that is insufficient to appreciate in full the complex interrelatedness of financial assets and intermediaries that ultimately give rise to systemic risks. These considerations have led to the definition of a new, specific economic policy area, namely macroprudential policy. This area has an eminently pre-emptive gearing and has the dual aim of making the financial system as a whole more resilient to shocks and minimising the impact on the real economy in instances of crisis. The pursuit of macroprudential policy is being addressed through numerous national and international initiatives. In the European Union, this task has been assumed by the European Systemic Risk Board (ESRB), which has been fully operational since January 2011. This body is part of the European Financial Supervision System, which incorporates three new European supervisory authorities entrusted with microprudential duties. The ESRB, in which the ECB and the ESCB central banks participate, will oversee the European financial system as a whole. It will be tasked with identifying systemic vulnerabilities and with issuing non-binding warnings and recommendations, so that corrective measures may be adopted.

5 Outlook and challenges

The speed of exit from the crisis will depend on the measures adopted

The projections available generally suggest that the pick-up in activity will continue to firm this year and next, albeit at a slower pace and in an environment still shrouded in uncertainty, which poses highly complex risks on both the domestic and European fronts.

The economies that built up the biggest imbalances will have to correct them in an environment of weak growth

In the domestic policy sphere, several economies have to readjust spending in a way that will enable their public and private debt levels to become more sustainable. And, at the same time, they must restore lost competitiveness through productivity gains and wage containment. Strict compliance with fiscal consolidation commitments, which is a prerequisite for the area as a whole, poses a challenge which is all the greater the lesser the growth prospects for each country. In this connection, it is also essential to see through far-reaching structural reforms which, in addition to bringing adjustments about, increase growth potential, prevent the crisis from exerting a durable impact on labour markets and enhance the capacity to export to markets where the competitive pressures from the emerging economies are increasingly more demanding.

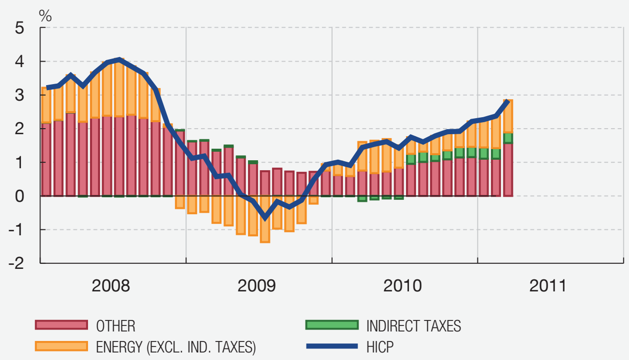
In recent months euro area inflation has risen notably due largely to dearer commodity prices in international markets and to the increase in certain indirect taxes as a result of fiscal consolidation efforts. In particular, according to an accounting breakdown of the year-on-year growth of the HICP, it is estimated that the direct impact of these components' behaviour would explain around 60% of the increase in the inflation rate between February 2010 and February 2011 (see Panel 1). On the basis of historical evidence, these factors could generate indirectly upward pressures on prices. For instance, certain estimates indicate that a permanent increase of 10% in oil prices would represent, after three years, an average increase in the euro area HICP of 0.5 pp. 0.1 pp would be due to price rises in goods which use any of the dearer inputs and another 0.1 pp would be as a result of the second-round effects arising when the revision of inflation expectations prompts agents to demand increases in wages and margins.[1] However, according to economic theory, inflation depends positively on future inflation expectations but also negatively on the level of economic slack and, consequently, these indirect effects could have a more limited impact in a situation such as the present one.

The most recent empirical studies which approximate the level of slack using the output gap or the distance between recorded and potential growth have shown that, in practice, it is difficult to find a stable relationship between these three variables. This can be attributed basically to three factors. Firstly, potential growth is measured with a high level of imprecision. Accordingly, Panel 2 shows that, at a time of great uncertainty such as at present, the discrepancies between international organisations' forecasts about the level of economic slack in the euro area for the period 2010-2012 may be high. In any event, all the estimates agree that the level of euro area activity is clearly below its potential and will remain so for the next two years. This is confirmed by the behaviour of the indicator of production capacity utilisation and of several measures of slack in the labour market.

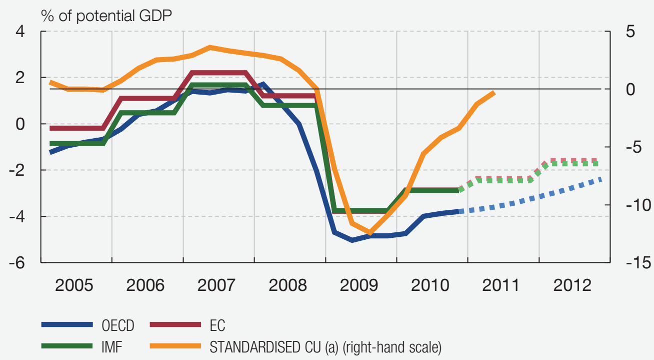
Secondly, it is difficult to estimate which part of the temporary price variations ultimately feed through to households' and firms' inflation expectations. Accordingly, Panel 3 shows that, although

1 See Strauch et al. (2010), *Energy Markets and the Euro Area Macroeconomy,* Occasional Paper no. 113, European Central Bank.

1 CONTRIBUTION OF ENERGY AND INDIRECT TAXES TO THE YEAR-ON-YEAR RATE OF CHANGE IN HICP



2 ESTIMATES OF THE OUTPUT GAP



3 HICP: SHORT AND LONG-TERM FORECASTS (b)

	2011	2012	Long term
Consensus (July 2010)	1.5	1.5	1.9
Consensus (October 2010)	1.6	1.5	2.1
Consensus (March 2011)	2.3	1.8	2.1
Eurobarometer (July 2010)	1.5	1.6	1.9
Eurobarometer (October 2010)	1.4	1.7	1.9
Eurobarometer (March 2011)	2.2	1.8	2.0

4 RATE OF CHANGE IN THE PRIVATE CONSUMPTION DEFLATOR

			2010			
	2009	2010	Q1	Q2	Q3	Q4
Rest of the world (c)	-0.5	-0.1	-0.6	0.1	0.1	0.0
Oil prices	-0.2	0.4	1.0	0.3	0.2	0.3
Financial factors	0.3	0.2	0.3	0.3	0.0	0.1
Wages and prices	0.1	0.1	0.2	0.1	0.1	0.0
Private demand	0.0	-0.1	-0.1	-0.1	-0.1	0.0
Government demand	0.2	-0.1	0.0	-0.1	-0.1	-0.1
Productivity	-0.1	0.1	0.1	0.0	0.1	0.0
Private consumption deflator	-0.4	0.5	0.9	0.7	0.3	0.2

SOURCES: EUROSTAT and Banco de España.

a Production capacity utilisation.
b The *Consensus* of July 2010 did not include forecasts for the long term or for 2012 and, consequently, the forecasts published in April 2010 were used. The *Consensus* of March 2011 did not include long-term forecasts and, consequently, those published in October 2010 were used. The Eurobarometer of March 2011 did not include long-term forecasts and, consequently, those published in January 2011 were used.
c The rest of the world includes global demand, world prices and the world interest rate.

inflation forecasts for 2011 have been revised upwards due to the recent rises in oil prices, both the forecasts for 2012 and the long-term inflation expectations remain stable at approximately 2%.

Finally, it should be noted that the degree of correlation between inflation and the output gap depends on the nature of the shocks affecting the economy. In particular, shocks which raise production costs, as is the case of oil prices, tend to reduce current and potential output to a similar extent and, consequently, the increase in prices is not accompanied by significant variations in the output gap.

In this connection, according to the Banco de España's BEMOD model,[2] which distinguishes between different types of shocks, the rise in oil prices explains a very significant part of the increase in European inflation (approximated in this case by the private consumption deflator) during the second half of 2010 (see Panel 4). Similarly, in the first three quarters of the year wages have grown slightly higher than would be suggested by their determinants, compared with the moderation seen in the first decade of this century. By contrast, the fiscal consolidation plans and timid recovery of private demand are helping to contain price rises, which suggests that the output gap remains negative. Finally, accommodative monetary policy contributed to the recovery during 2010 and to containing deflationary pressures. Thus, supply shocks seem to explain a relevant portion of the increase in inflation in a situation of relative production slack.

Consequently, the final effects on inflation of the current rise in prices, which is closely linked to the increase in oil prices, will depend crucially on the capacity of economic policy to keep inflation expectations anchored.

2 See J. Andrés, P. Burriel and Á. Estrada (2006), *Bemod: a DSGE model for the Spanish economy and the rest of the euro area,* Working Paper no. 0631, Banco de España, and J. Andrés, S. Hurtado, E. Ortega and C. Thomas (2010), "Spain in the euro: a General Equilibrium Analysis", *SERIEs Journal of the Spanish Economic Association,* Vol. 1, pp. 1 and 2.

Diligently addressing the restructuring of the banking sector will allow financial stability to be preserved

The possibilities of growth spreading throughout the euro area also depend on the ongoing European banking system restructuring, downsizing and recapitalisation processes being satisfactorily concluded. Preserving financial stability will help break the vicious circles in which risks to economic growth, fiscal imbalances and bank funding difficulties all combine, impairing agents' confidence and translating into unwished-for tightening of financing conditions.

Monetary policy faces a complex scenario of slow economic recovery and latent tensions in debt markets

In the European arena, monetary policy also faces a complex horizon in which it will have to progressively adapt its current accommodative stance to the present cyclical upturn in the area as a whole, ensuring inflation expectations are anchored so as to prevent the recent tensions stemming from dearer commodities and food from causing second-round effects on wages (see Box 4.2). Further, the ongoing withdrawal of the unconventional measures that were introduced at the most critical junctures of the financial crisis must be finalised, as retaining them longer than necessary might impair their effectiveness and detract from the central bank's credibility, give rise to distortions in relative asset prices and delay reforms in the banking sector. Such a task, however, will call for careful timing of decisions, so as to prevent tensions arising on markets where the situation is still one of relative fragility.

Reform of the institutional framework should be ambitious and should not disregard the challenges arising from the singular situation besetting Greece

The level of financial integration and economic interdependence attained in the euro area means a high degree of ambition must be maintained in the process of revision of European governance. Along these lines, the Eurosystem has called for the inclusion of more demanding criteria for the correction of imbalances and - especially in the fiscal area – greater automaticity for supervision and sanctioning procedures so as to make them less vulnerable to the willingness of national governments to comply with the commitments they have undertaken. It is also essential that the various mechanisms established by euro area governments to preserve financial stability across the area should have sufficient resources and the appropriate instruments to effectively perform their functions. Finally, it would also be advisable to reflect on how to deploy the other instruments available to the EU (including the budget) to support the adjustment and reform processes in countries facing difficulties.

More immediately, Greece's apparent difficulties in returning to the market in 2012, as initially envisaged in their financial support programme, have raised uncertainty among investors and given rise to untimely debates about how realistic traumatic scenarios of slippage in the degree of economic integration attained in Europe and, therefore, of backtracking in the common European project may be. So that the considerable efforts to shape a new and more effective governance framework may come to fruition, this challenge - perhaps the most difficult one faced by the euro area since its creation - must first be conclusively overcome.

In 2010, activity declined slightly, by -0.1%, reflecting a negative carry-over effect deriving from the intense contraction in 2009. That said, the Spanish economy commenced its recovery in 2010, with a slight increase in activity in each quarter except for the third. As seen in Chart 5.1, the upturn in 2010 was modest in comparison with the loss of output during the recession: as against a cumulative decline in activity of almost 5 percentage points (pp) in 2008 and 2009, in 2010 activity recovered by barely 0.6 pp. In 2011 Q1 this process of slow growth continued with output growth of 0.3%. The outlook for 2011 and 2012, according to the *Spanish economic projections report* published by the Banco de España in March, is one of continuation of this gradual recovery, although the pre-crisis level of output will still not have been reached by the end of 2012.

This pace of recovery is also slower than the one observed following the recession of the early 1990s. Among other factors, this is due to the negative performance projected for government consumption and housing investment in 2011 and 2012, in comparison with 1995 and 1996, as a result of the greater intensity of the fiscal and real-estate-market adjustment in the present crisis. By contrast, the recovery in government consumption is not projected to be very different in the next two years from that seen in the mid-1990s and the contribution of net external demand to output is projected to be even higher in 2011 and 2012, despite the absence of the exchange rate instrument. The recovery in activity is therefore expected to be gradual as a result of the adjustment of the imbalances accumulated during the upturn and of the fiscal deterioration that emerged during the crisis, which are currently manifest in the need to reduce public demand to make it more consistent with the resources available, while the possibilities of an expansion in private demand are limited by the high indebtedness. In this process, the improvement in net exports will support growth and permit a reduction in the recourse to external saving. The slowness of the pick-up in activity also contrasts with the stronger recovery discernible in the euro area. Although the depth of the recession in the euro area was similar to that in Spain, in terms of the decline in output, there was a significant increase in activity in the euro area in 2010, which is expected to continue in 2011 and 2012.

The severity of the recession and slowness of the recovery have resulted in substantial excess capacity in the Spanish economy, which is manifest in a very large negative output gap and high rate of unemployment, and have had a significant negative impact on potential output.

1 Monetary and financial conditions

The financial strains raised the cost of financing for general government and credit institutions...

The strains in the euro area financial markets stemming from the sovereign debt crisis were reflected in a significant rise in the cost of financing for general government and credit institutions, and in greater difficulty for the latter to obtain access to wholesale markets. The strains reached a peak in November. Subsequently, the risk premiums of resident issuers have tended to fall, within a context of marked volatility, although they remain relatively high (over 200 basis points (bp) in May 2011).

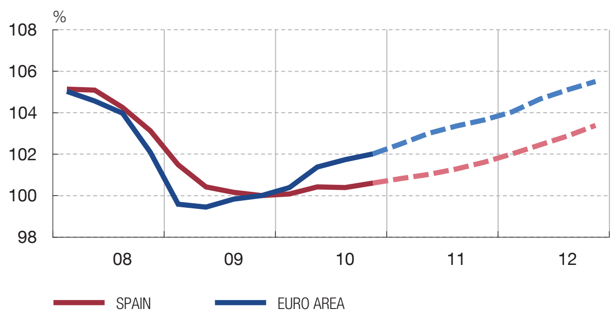
... and contributed to a certain tightening of the financing conditions for firms and households, which were also affected by the increase in market interest rates

The cost of bank financing for households and non-financial firms also increased from mid-2010 (see Chart 5.2). This was the result of the increase in interbank yields and, from early 2011, of a progressive passing through of the rise in the cost of financial institutions' liabilities to the margins they apply to their transactions with customers. Credit standards remained restrictive and, according to the Bank Lending Survey (BLS), tightened further, albeit moderately, in 2010 Q2, basically as a consequence of the financial strains. Subsequently they have remained unchanged, except in 2011 Q1, when they tightened again

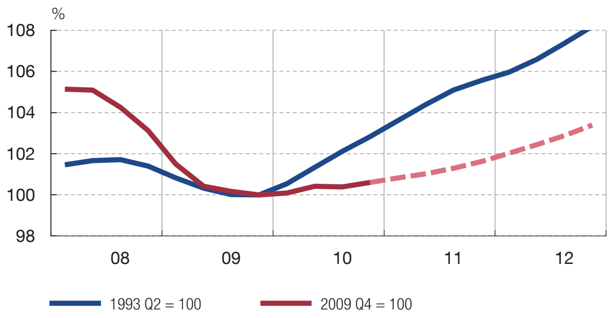
CHARACTERISATION OF THE CURRENT CYCLE (a)

CHART 5.1

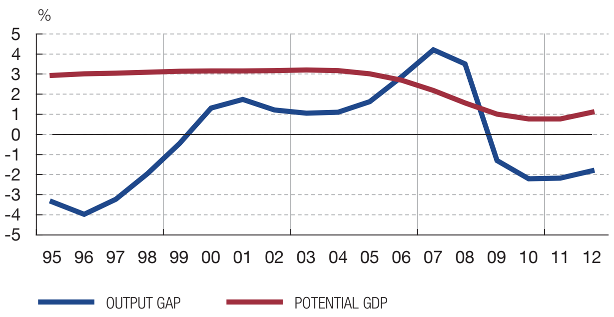
GDP
2009 Q4 = 100



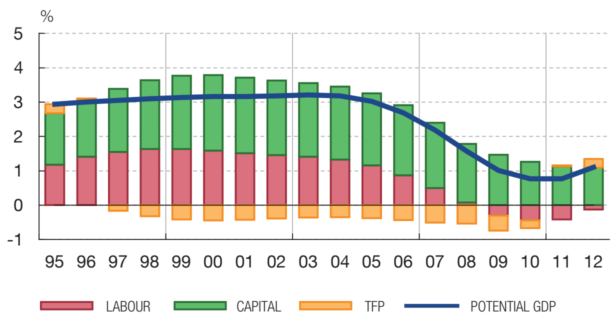
SPAIN'S GDP



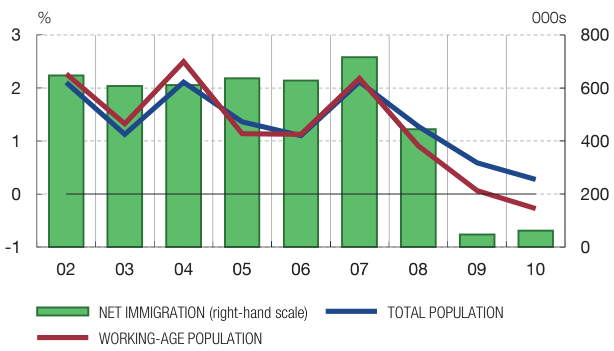
OUTPUT GAP AND POTENTIAL GROWTH OF THE ECONOMY



CONTRIBUTIONS TO THE POTENTIAL GROWTH OF THE ECONOMY

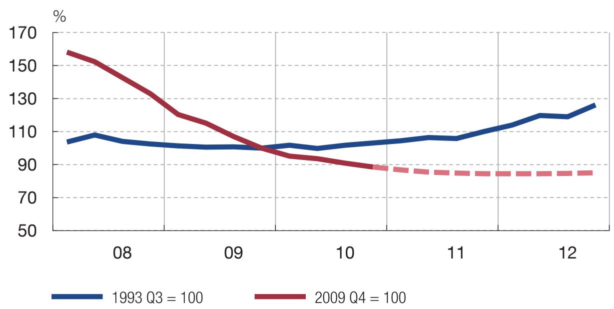


POPULATION FIGURES

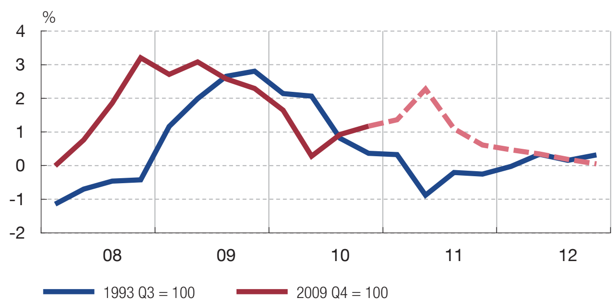


PRIVATE CONSUMPTION

HOUSING INVESTMENT



EXTERNAL DEMAND CONTRIBUTIONS (b)

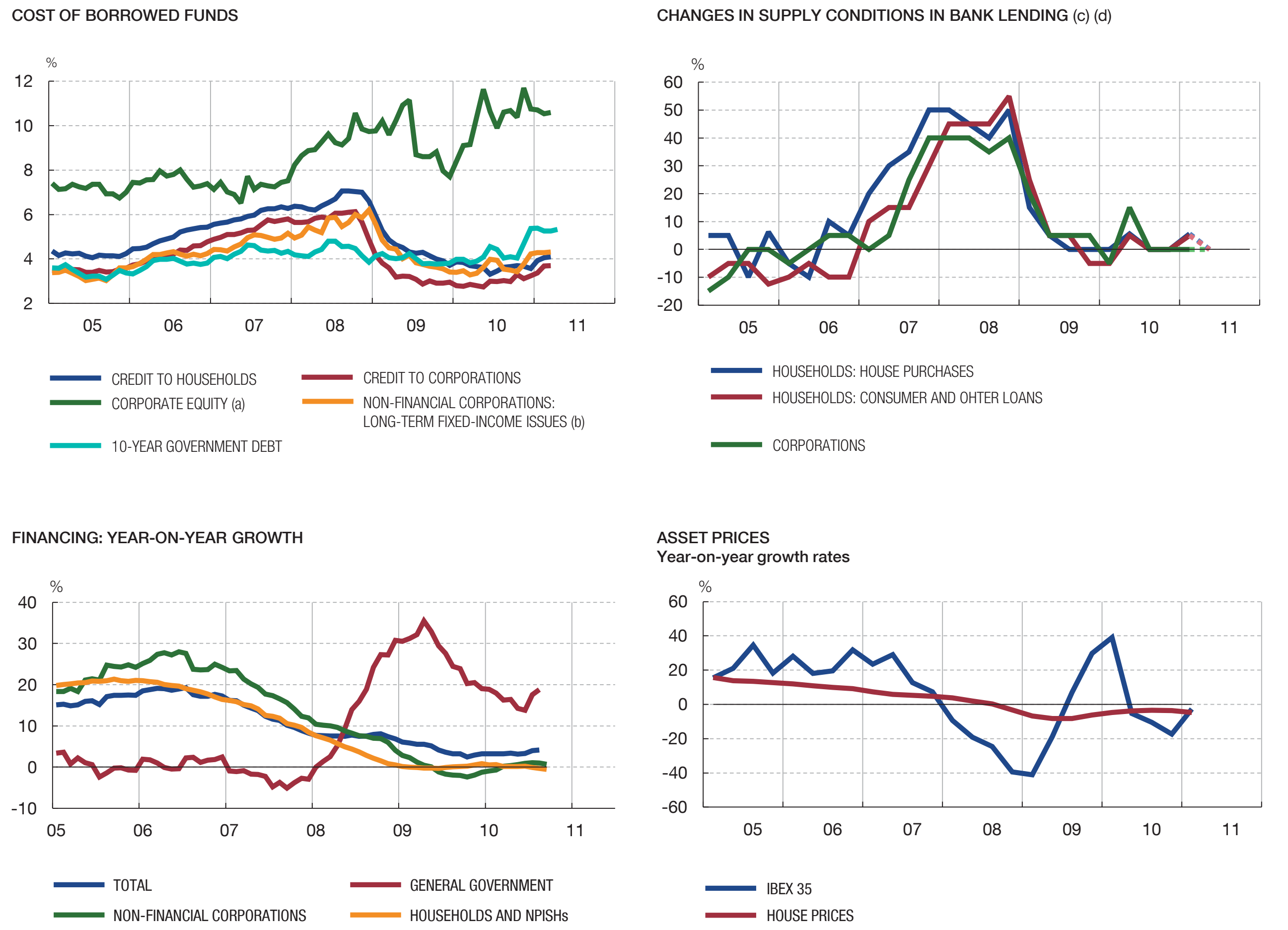


SOURCE: INE and Banco de España.

a Forecasts in broken line.
b Year-on-year growth rates.

FINANCING OF RESIDENT NON-FINANCIAL SECTORS AND ASSET PRICES

CHART 5.2



SOURCES: Ministerio de Vivienda, 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 interest rate on long-term fixed income 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.
c Indicator = % of institutions reporting a considerable tightening × 1 + % of institutions reporting some tightening × 1/2 – % of institutions reporting some easing × 1/2 – % of institutions reporting considerable easing × 1.
d The broken line indicates forecasts made the previous quarter by respondents.

somewhat in the household financing segment. The turmoil also led to a rise in the cost for non-financial firms of issuing fixed and variable-income securities.

The decline in the price of financial and real assets also contributed to the tightening of financial conditions, but the exchange rate depreciation had the opposite effect

The price of financial and real assets declined in 2010 (the IBEX 35 index fell by 17.4% and the value of housing by 3.5%, which in the latter case made a total fall from the peak values recorded in early 2008 of 13% in nominal terms and 18% in real terms). This also contributed to the tightening of financial conditions, although the depreciation of the nominal effective exchange rate had the opposite effect. In the first few months of 2011, stock markets recovered, growing by 7.5% in the period to 6 May 2011, but the price of housing fell by a further 2.6% in Q1, making a total fall of 20% in real terms, and the euro appreciated significantly.

Despite the stagnation of the debt of households and non-financial corporations...

Against this background, non-financial private sector debt continued to reflect a pattern of slow deleveraging in the case of households and selective deleveraging in that of firms. Household liabilities remained practically unchanged in 2010, although they have contracted slightly since the beginning of 2011, while in the case of non-financial corporations bank lending was reduced in activities linked to the real-estate sector, while its growth was close to zero or slightly positive in other activities. The developments in bank lending and in indebtedness in general are analysed in detail by sector in Chapter 6 of this Report.

... the household debt ratio barely changed, owing to the unfavourable performance of household income, while that of firms fell slightly

Despite the stagnation of household liabilities in the last few years, the household debt ratio has barely fallen from the high levels it reached in 2007, owing to the slackness of the sector's income. However, the associated debt burden continued to fall in 2010 as a whole, thanks to the decline in the average annual cost of outstanding debt, although interest rates began to increase in the final months of the year. In the case of non-financial corporations, the recovery in corporate earnings contributed to a larger – albeit moderate – cut in the debt ratio, and also in the associated debt burden, which was driven by the decline in the average cost of outstanding debt. That said, the corporate sector remains highly leveraged, although the situation varies from sector to sector (see Box 6.2).

2 Economic policies

2.1 FISCAL POLICY

2010 marked the commencement of a vigorous fiscal adjustment, which has gone beyond the initial plans

A fiscal consolidation process was initiated in 2010. This process began with the approval in December 2009 of the State budget for 2010 and was reaffirmed by the February 2010 Stability Programme Update (SPU), which set a path to cut the deficit to 3% of GDP in 2013. In May 2010, as a consequence of the European sovereign debt crisis, the Spanish government decided to speed up the consolidation process, with more of the adjustment to be made in 2010 and 2011, while maintaining the target of a budget deficit of 3% of GDP in 2013. The deficit cutting path was thus adjusted to 9.3% of GDP in 2010 (as against the 9.8% initially planned), 6% in 2011 (as against the target of 7.5% of GDP established in the January 2010 SPU) and 4.4% in 2012 (as against the previous level of 5.3%).

The provisional results for 2010 show that the budget deficit targets were achieved – an important milestone for the credibility of the rest of the consolidation path

The provisional budget outturn data for general government as a whole for 2010 show an improvement of 0.1 pp on the target of 9.3% of GDP, which would mean that the deficit was cut by almost 2 pp with respect to 2009 (see Table 5.1). This result was based on an increase of 1 pp in the revenue-to-GDP ratio and a fall in the spending ratio of 0.8 pp. The adjustment was focused on capital expenditure, which was reduced by 1 pp of GDP, and final consumption expenditure (compensation of employees and inputs), which contributed 0.5 pp. Other spending items, such as subsidies and current and capital transfers moderated significantly, but were higher than initially planned. By contrast, social benefits rose by 0.7 pp of GDP, given the inertia of spending on pensions and the high degree of persistence of spending on unemployment benefits. On the revenue side, the strong growth in indirect taxes (in particular, in VAT receipts) offset the less dynamic performance of direct taxes and social contributions. Notable by sector were the improved performance of central government in relation to the target set, the disappearance of the traditional social security surplus and the failure by regional and local governments to comply with their targets.

Public debt increased significantly in 2010, to 60% of GDP, which is still well below the EU average

Partly on account of this large deficit, public debt increased significantly, from 53.3% of GDP in 2009 to 60.1% in 2010, although, given the favourable starting situation it remained well below the EU average. The increase in debt was due to the high budget deficit, which was partly offset by the effect on the debt ratio of positive nominal GDP growth (0.5 pp of GDP) and by the deficit-debt adjustments (2 pp of GDP). The interest burden associated with this level of debt reached 1.9% of GDP in 2010, increasing by somewhat more than 0.1 pp of GDP with respect to 2009, owing to the larger volume of outstanding debt, despite a slight fall in the implicit financing rate. In the coming years, given the expected trend in public debt and interest rates, the interest burden will continue to rise relative to GDP, which will increase the magnitude of the fiscal drive needed to reduce the budget deficit.

MAIN GENERAL GOVERNMENT NON-FINANCIAL TRANSACTIONS

TABLE 5.1

% of GDP

	2005	2006	2007	2008	2009	2010
1 NON-FINANCIAL RESOURCES	39.4	40.4	41.1	37.1	34.7	35.7
Current resources	38.6	39.7	40.6	36.9	34.7	35.7
Taxes on products and imports	12.2	12.3	11.7	9.9	8.7	10.1
Taxes on income and wealth	10.9	11.7	12.9	10.8	9.6	9.4
Social contributions	12.9	12.9	13.0	13.2	13.3	13.2
Other current resources (a)	2.6	2.8	3.0	3.0	3.1	3.1
Capital resources (b)	0.8	0.7	0.5	0.2	-0.1	0.0
2 NON-FINANCIAL USES (c)	38.4	38.4	39.2	41.3	45.8	45.0
Compensation of employees	10.0	10.0	10.2	10.9	11.9	11.7
Other final consumption expenditure	7.6	7.6	7.7	8.2	8.8	8.5
Social benefits other than social transfers in kind	11.6	11.5	11.6	12.4	14.5	15.2
Subsidies	1.0	1.0	1.1	1.1	1.1	1.1
Interest (c)	1.8	1.6	1.6	1.6	1.8	1.9
Other transfers	1.5	1.6	1.5	1.6	1.9	1.7
Capital uses	4.9	5.1	5.4	5.4	5.9	4.9
Gross capital formation	3.6	3.7	4.0	3.9	4.4	3.7
Other capital uses (d)	1.4	1.3	1.4	1.5	1.5	1.2
3 NET LENDING (+) OR NET BORROWING (-) (c) (3=1-2)	1.0	2.0	1.9	-4.2	-11.1	-9.2
MEMORANDUM ITEMS:						
Final consumption	18.0	18.0	18.4	19.5	21.1	20.8
Primary surplus	2.8	3.7	3.5	-2.6	-9.4	-7.3
Gross debt (c)	43.0	39.6	36.1	39.8	53.3	60.1

SOURCE: Structural indicators of the Spanish economy and the EU, Banco de España.

a Includes gross operating surplus.
b The negative sign in 2009 is due to the adjustment for uncertain revenue included with that sign in these resources.
c According to the Excessive Deficit Procedure methodology.
d Includes net acquisitions of non-financial non-produced assets.

The adjustment of the budget deficit in 2010 was essentially structural

The structural improvement in government finances more than offset the negative contribution of the business cycle and the interest burden (see Chart 2.2). Primary structural spending was reduced by somewhat more than 1 pp of GDP, basically due to the withdrawal of the stimulus measures that affected 2009 (see Table 5.2), while tax rises and the withdrawal of temporary revenue-side measures contributed 2 pp of GDP. Despite this improvement, the structural government deficit remained high in 2010, at around 8% of GDP.

The budget results for 2010 show that the main risks of deviation are associated, first, with the behaviour of regional and local government...

The budget results for 2010 show that the main risks in future will be associated, first, with the behaviour of regional and local governments. In this respect, fiscal discipline among regional and local governments, in particular the former, depends crucially on strict compliance with a measure adopted in 2010: approval by the Fiscal and Financial Policy Council of the criteria to be followed by the Ministry of Economic Affairs and Finance when authorising regional government debt operations during the period 2010-13. These criteria lay down two general rules: the indebtedness of regional governments must be in line with the deficit-reduction path; and no operation will be authorised that increases the level of indebtedness of a regional government until the Fiscal and Financial Policy Council has issued a favourable report on its rebalancing plan. These criteria were applied for the first time in November 2010 and affected two

FACTORS EXPLAINING CHANGES IN THE CYCLICALLY ADJUSTED GENERAL GOVERNMENT BALANCE IN SPAIN (a)

TABLE 5.2

Percentage of trend GDP

Increase (+)/Reduction (-)	2010	2011
Cyclically adjusted general government balance	2.8	2.9
Interest payments	0.1	0.3
Cyclically adjusted general government primary balance	2.9	3.2
BREAKDOWN OF THE CYCLICALLY ADUSTED PRIMARY BALANCE		
Total revenues	1.6	0.9
Total taxes and social contributions	1.6	0.6
Legislative changes	1.3	0.7
Progressiveness	0.0	0.1
Decoupling of the tax base from GDP	-0.1	-0.1
Residual (unexplained effects)	0.3	-0.1
Other revenues	-0.1	0.2
Primary expenditure	-1.4	-2.3
Social benefits	0.5	-0.1
Of which: retirement pensions	*0.3*	*0.2*
Of which: unemployment benefits	*0.1*	*-0.1*
Subsidies	0.0	-0.3
Compensation of employees	-0.3	-0.6
Inputs	-0.3	-0.3
Public investment	-0.7	-0.8
Other expenditure	-0.5	-0.3
Memorandum items:		
General government balance (as a percentage of nominal GDP)	1.9	2.9
Cyclical component (as a percentage of nominal GDP)	-0.9	-0.1

SOURCE: Banco de España.

a The fiscal balance is presented in accordance with the Excessive Deficit Protocol definition.

regional governments, Murcia and Castile-La Mancha, which had to specify their mandatory adjustment plans. Likewise, a measure was approved in 2010 that only allows local governments to seek long-term public or private credit in 2011 if their debt does not exceed 75% of their revenues and the credit is to be used for investment already in progress, or else for co-funded projects. Also, homogeneous regional government data on the budget outturn for the previous quarter were published for the first time in December 2010. This practice, which has continued at the beginning of 2011 and will be repeated on a quarterly basis, amounts to a significant advance in terms of transparency.

... and, second, with the inertia observed in certain spending items

The magnitude, nature and composition of the spending cuts needed to achieve the targets set mean that their fulfilment is uncertain. First, a significant proportion of public spending in Spain is associated with items that have traditionally displayed significant upward inertia, such as spending on education, health and pensions. Second, spending on unemployment benefits, against a background of very high rates of unemployment, amounted to 3 percentage points of GDP in 2010, the highest level in the euro area. The saving measures proposed should be specific and must be accompanied by considerations of efficiency in the provision of services and by further structural reforms, like the recent pensions reform (see Box 2.3).

The recent updated Stability Programme sets an appropriate consolidation path, which must be strictly complied with

On 28 April 2011 the government presented a new Stability Programme Update (SPU) for the period 2011-14. This SPU confirms the budget consolidation path to 2013 approved in May 2010, which, if complied with, will enable the Stability Pact limits to be complied with, in accordance with the recommendations of the European Council. The general government deficit would stand at 3% of GDP in 2013 and the public debt-to-GDP ratio would stabilise at slightly below 70% of GDP in 2012-13, up from 60.1% in 2010. The SPU also presents the deficit target for 2014 (2.1%), when it is planned to reduce public debt to 68.9% of GDP. If these targets are achieved, the strategy proposed in May 2010 of bringing forward to 2010 and 2011 70% of the structural adjustment for the whole of the period 2009-13 would be validated. In addition, from the viewpoint of the quality of public finances, of the total adjustment to be made in the period 2009-13, 65% comes from spending reductions, and 35% from the adjustment of government consumption (21% of the total from the reduction of compensation of employees). However, the April 2011 SPU is based on a macroeconomic scenario that entails relatively high GDP growth rates and if these are not confirmed the achievement of the fiscal projections would be complicated. In this respect, the SPU includes a commitment to comply with the government deficit reduction targets even if the actual macroeconomic scenario is less favourable than the one envisaged.

2.2 OTHER ECONOMIC POLICIES

Certain demand policies introduced during the crisis were withdrawn in 2010...

The year 2010 was characterised by the gradual withdrawal of certain policies designed to sustain short-term demand that had been introduced during the crisis. However, the resources used to finance productive investment and the working capital of SMEs and the self-employed, through different ICO facilities, were maintained. In addition, a new programme of ICO financing at market prices was approved for the period 15 June 2010 to 31 December 2011, under which direct loans were granted to the self-employed and SMEs, with the credit risk involved assumed by the ICO. From its launch until March 2011, around 3,000 applications were approved under this programme, with an average amount of €40,000.

... and certain structural reforms were introduced, among which that of the labour market, with the aim of reducing duality and wage rigidity, was notable

In addition, certain structural reforms were introduced, including notably the labour market reform. The aims of this reform, approved through an emergency procedure in June and ratified by Parliament in September, include the reduction of duality and wage rigidity, two of the main structural problems in the Spanish labour market. The main changes made by this Law are, first, improvement in the actual possibilities of wage opt-out, so that, following the reform, this is permitted if the firm and workers agree to it, irrespective of the provisions of the higher-level agreement. Second, the encouragement of permanent hiring, by increasing the possibilities for objective dismissal, through redefining the economic grounds (which now include the current or anticipated adverse situation of the firm), and by significantly widening the eligibility criteria for employment-promoting contracts (with lower firing costs). New limits are established for temporary hiring, the maximum duration of a contract for a specific task being limited to two years, which can be extended to three by agreement, and the costs of termination of temporary contracts are increased, to 12 days per year worked in 2015. Private employment agencies are permitted to act in the labour intermediation process, in cooperation with the public employment service, which should facilitate the process of matching job offers with job seekers. Finally, the possibilities for making applications for suspension of contracts or short-time working are widened, with the aim of smoothing employment adjustments.

The evidence on the impact of the reform is still limited

It is still too early to assess the extent to which the aims of the Law are being achieved, given the short period since its approval and the difficulty in untangling its influence from other developments in recent months relating to the cycle. The greater possibili-

LABOUR MARKET: SOME IMPORTANT INDICATORS

TABLE 5.3

		PERMANENT AND PART-TIME HIRING (a)				APPLICATION FOR SHORT-TIME WORKING (c)		OBJECTIVE DISMISSAL (d)
		Total permanent (a)	Permanent employment promoting (a)	Temporary employment ratio (b)	Part-time ratio (b)	Number of employees	Weights	
2000		8.7	—	32.2	8.0	1,282	2.1	—
2001		9.3	—	32.2	8.1	771	0.6	18.2
2002		9.0	4.7	31.8	8.3	1,268	1.8	18.1
2003		8.7	4.4	31.8	8.4	2,008	2.4	14.0
2004		8.7	3.9	32.5	9.1	525	0.9	11.6
2005		9.0	1.7	33.3	12.3	850	1.2	10.6
2006		11.8	3.9	34.0	12.1	157	0.3	8.9
2007		11.9	4.6	31.7	12.1	226	0.4	7.7
2008		11.5	3.5	29.3	12.3	2,675	1.8	10.6
2009		9.4	1.6	25.4	13.3	20,591	3.7	15.2
2010		8.5	1.9	24.9	14.0	38,136	12.7	18.3
2009								
	Q1	11.1	1.8	25.4	13.2	4,843	2.6	15.3
	Q2	9.6	1.7	25.2	13.5	6,948	4.8	15.4
	Q3	8.3	1.5	25.9	12.8	5,640	5.2	14.8
	Q4	8.6	1.5	25.1	13.9	3,160	2.8	15.1
2010								
	Q1	9.6	1.6	24.4	14.0	3,304	4.2	16.3
	Q2	8.7	1.5	24.9	14.2	2,517	3.7	17.1
	Q3	7.5	1.7	25.6	13.4	10,096	18.0	18.7
	Q4	8.4	2.7	24.8	14.2	22,219	22.8	21.6
2011								
	Q1 (e)	9.4	2.0	24.8	14.8	9,930	22.4	24.1

SOURCE: Ministerio de Trabajo e Inmigración and INE.

a The weight of this type of hiring in total hiring.
b Ratio to EPA employees.
c Number of workers affected by an application for short-time working and their weight in the total number of workers subject to all types of labour force adjustment applications.
d Initial beneficiaries of contributory benefits as a result of an objective dismissal as a percentaje of all beneficiairies as a result of dismissals or applications for labour force reduction.
e 2011 Q1 only covers January and February in the case of objective dismissals.

ties for wage opt-outs should result in more moderate wage settlements, but this, as mentioned below, was not apparent in the first few months of 2011. At the end of 2010 an increase in hiring based on employment-promoting contracts was detected, in line with expectations, although the total number of permanent contracts has barely increased (see Table 5.3). Finally, there was a rise in applications for short-time working in the second half of 2010, in line with the new incentives provided by the reform, and there is also some evidence of an increase in the percentage of dismissals on objective grounds.

This reform was supplemented by subsequent developments which combine incentives for short-term hiring with changes to active policies

Following the approval of this Law certain additional measures were introduced in relation to the labour market. Inter alia, the use of part-time contracts for certain groups is promoted and there are plans to design individualised programmes to improve the employability of the groups most affected by the crisis.

As regards other policies, noteworthy were the elimination of the housing deduction for incomes above a certain level, the approval of the retail trade law...

As regards other reforms, notable, first, are the measures approved to make the purchase and rental of housing fiscally comparable, through the elimination of the deduction for house purchase for incomes above a certain threshold and the equalising of the deductions for purchase and rental for other incomes from 1 January 2011. This reform amounts to significant progress in tax neutrality with respect to the two ways of possessing housing, which is especially necessary in the case of Spain owing, among other aspects, to the low weight of rented housing and the perverse effects of this on worker mobility.

In addition, the Law on default[1] was amended in order to limit the power of general government and large firms when establishing payment conditions, which during the crisis appear to have had a particularly adverse impact on the liquidity of SMEs and the self-employed. Also, the process of transposition of the Services Directive continued in 2010, with the approval of the Law to Reform the Retail Trade Law, which reduces the administrative burden of setting up retail establishments, although the regional governments have retained most of the regional licences required for the opening of large retail outlets.

... as well as the approval of the sustainable economy Law, which includes, among other measures, simplification of the administrative steps involved in starting up a business activity and an improvement in the regulatory environment

In February 2011 the sustainable economy Law was approved, which includes, inter alia, a set of measures designed to reduce the time needed to start up a business that has already been incorporated. Given that the most onerous part, in terms of time and money, of the process of creating a firm is precisely that of starting up the business, implementation of the measures envisaged in this Law could simplify this process considerably.

With regard to the regulatory environment, the sustainable economy Law establishes certain principles of good regulation. To apply these principles, the Law requires that an ex-ante analysis be carried out of the regulatory impact of every initiative, as well as an ex-post analysis to verify the achievement of its aims. In addition, modification of the organisational structure of the National Energy Commission, the Telecommunications Market Commission and the National Postal Sector Commission is proposed, with a reduction in the number of board members in each case, the establishment of a non-renewable 6-year term, a prohibition on the attendance of members of the government or senior management at board meetings and the acts of these regulatory bodies concluding administrative proceedings. Together these changes may give these regulatory bodies greater independence. Also, among measures to reform the financial market, in line with international agreements to increase transparency and enhance corporate governance, the sustainable economy Law amends the Securities Market Law so that listed companies make available to their shareholders a remuneration report to be approved by the shareholders in general meeting.

Finally, the approval of measures to moderate the increase in the tariff deficit and the promotion of a privatisation programme is also noteworthy

As regards the energy sector, measures were adopted at the end of the year to contain the creation of future tariff deficits and the Electricity Debt Amortisation Fund (FADE, by its Spanish initials) was set up during the year, with the object of providing liquidity to electricity utilities through securitisation of the accumulated debt deriving from the tariff deficit. In addition, a reduction in subsidies for renewable energy was approved.[2] Finally, in the context of the fiscal consolidation process a programme of partial privatisations was announced, which would affect both the management of airports and lotteries.

1 Law 15/2010 of 5 July 2010 on measures to combat default in commercial transactions.
2 For photovoltaic installations the premiums and the hours eligible for premiums have been reduced.

3 Demand

3.1 NATIONAL DEMAND

National demand continued to adjust in 2010, but at a more moderate pace compared with 2009

The adjustment of national demand, which had been very intense in 2009, continued in 2010, albeit at a more moderate pace, of -1.1% (see Table 5.4). This slowdown in the decline in domestic agents' spending was the result of opposite movements in its public and private components.

The path of private consumption over the year was bumpy, owing to the bringing forward of spending caused by the VAT increase in July

Private consumption, which grew by 1.2%, behaved irregularly in 2010, since certain temporary factors (including notably the rise in VAT rates on 1 July) led to a shift in the timing of spending decisions, which tended to be concentrated in the first half of the year (see Chart 5.3). This phenomenon particularly affected the acquisition of durables, whose timing was also influenced by the extension to the first half of the subsidies for new car purchases. In the year as a whole, car purchases fell, although the consumption of durable goods grew moderately.

Household income fell...

Household disposable income declined by 4.4% in real terms, the largest fall in recent decades (see Chart 5.4). This decline, which contrasts with the increase of 1.6% in 2009, is explained by the confluence of various factors. First, the change in fiscal policy stance moderated the contribution of general government to household income, while the boost provided in 2009 by net interest income was reversed in 2010, with income deducted from households, since interest receipts declined to a greater extent than interest payments. In addition, wage income fell again, since the lower intensity of job destruction was offset by the greater wage moderation in the private sector and the cut in the wages of public-sector employees. Finally, the decline in nominal income, by -1.1%, was exacerbated by the loss of purchasing power deriving from the rise in inflation.

... which led households to smooth their consumption using their savings

Despite the fall in real income, consumption rose modestly. In the context described of deteriorating income, this led to a sharp fall in the household saving rate, which stood at 13.1% at end-2010, down almost 5 pp from 2009, although still somewhat above its historical average level. This seems to reflect the desire of households to smooth their consumption, by lowering their saving rate from the high levels of 2008 and 2009. This cushioning role for savings has been underpinned by a certain stabilisation in consumer confidence, partly influenced by the moderation in the rate of deterioration of the labour market, although uncertainty remained high and confidence was sensitive to various events, such as the strains in the sovereign debt market and, in 2011, the rise in oil prices and interest rates. In this respect, against a background of continued declines in real income, the rise in consumption in 2011 will be marginal. This, at least in the short term, will not prevent a further fall in the saving rate, until there is some sign of a recovery in income.

Residential investment continued to decline owing to the low level of commencement of new projects and the stock of unsold housing is still very high

Last year residential investment remained very weak, as a consequence of the gradual stabilisation of housing starts at very low levels, while a larger number of houses continued to be completed (see Chart 5.5). This led to a further decline in the volume of construction in progress, the growth rate of which stood at around -17%. The execution of new residential projects continued to be curbed in 2010 by the slackness of demand and by the presence of a significant volume of unsold housing, which led housing starts to stand at around 125,000, approximately one-sixth of their level just three years earlier. However, the convergence in recent quarters between starts and completions points towards stabilisation of the rate of housing construction and, therefore, of residential investment towards the end of this year.

CONSUMPTION AND GROSS FIXED CAPITAL FORMATION BY INSTITUTIONAL SECTOR

TABLE 5.4

	% of GDP (a)		RATE OF CHANGE (b)					
	2000	2010	2005	2006	2007	2008	2009	2010
NATIONAL DEMAND	103.1	102.2	5.1	5.2	4.1	-0.6	-6.0	-1.1
HOUSEHOLDS AND NPISHs								
Final consumption expenditure	59.7	58.4	4.2	3.8	3.7	-0.6	-4.2	1.2
Durable consumption	6.3	3.7	5.5	3.8	3.3	-14.6	-10.9	3.8
Non-durable consumption	53.4	54.7	4.1	3.8	3.7	0.7	-3.7	1.1
Housing	6.1	4.7	6.1	6.2	2.5	-10.7	-24.5	-16.8
CORPORATIONS								
Private productive investment (c)	16.6	14.1	7.4	7.7	3.8	-2.4	-18.2	-0.6
Construction	4.8	5.4	5.7	4.8	-0.6	1.2	-7.7	1.6
Capital goods	7.3	4.8	9.1	10.5	10.2	-4.0	-29.2	3.7
Other (d)	4.4	3.9	7.1	7.5	0.8	-4.1	-16.2	-8.2
GENERAL GOVERNMENT								
Final consumption expenditure	17.2	20.9	5.5	4.6	5.5	5.8	3.2	-0.7
Gross fixed capital formation	3.2	3.7	7.8	7.5	13.1	-1.5	11.2	-17.3
Construction	2.3	2.7	7.3	8.1	13.7	-4.4	14.6	-21.0
Capital goods	0.8	1.0	9.3	6.0	11.3	7.5	1.8	-6.2
MEMORANDUM ITEMS:								
Gross fixed capital formation	25.8	22.6	7.0	7.2	4.5	-4.8	-16.0	-7.6
Capital goods	8.1	5.9	9.2	9.9	10.4	-2.5	-24.8	1.8
Machinery	5.7	4.3	6.9	10.3	11.7	0.4	-23.1	2.1
Transport	2.4	1.6	14.0	9.1	7.6	-8.9	-28.9	0.9
Construction	13.3	12.8	6.1	6.0	3.2	-5.9	-11.9	-11.1
Housing	6.1	4.7	6.1	6.2	2.5	-10.7	-24.5	-16.8
Other construction	7.2	8.1	6.2	5.8	4.0	-0.8	-0.1	-7.2
Other (d)	4.4	3.9	7.1	7.5	0.8	-4.1	-16.2	-8.2

SOURCE: INE and Banco de España.

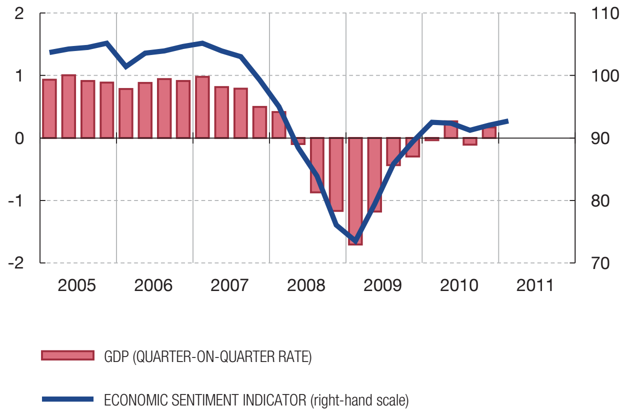
a National Accounts, base 2000, current prices.
b National Accounts, base 2000, rates of change of volume indices.
c Includes investment by sole propietors.
d This investment includes real estate, legal, accounting, consultancy and software services, among others.

In 2010 certain temporary factors helped to sustain the demand for housing

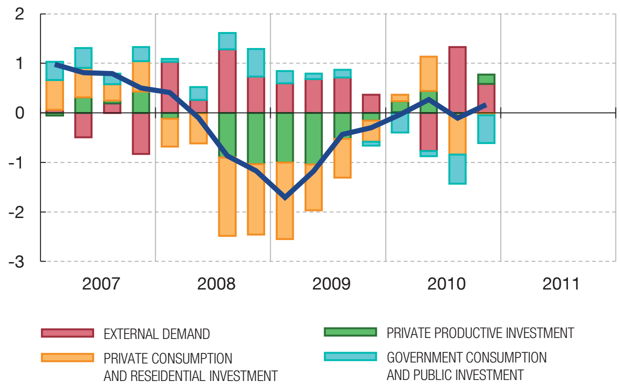
In 2010 the cycle of successive contractions in house purchases that started in 2007 came to an end, with positive year-on-year growth of around 6% and 490,000 houses sold. However, this amount represents little more than 50% of the peak level, recorded in 2006. In addition, the timid growth last year in transactions partly reflects the bringing forward of purchase decisions caused by temporary fiscal factors, such as the increase in indirect taxes in July 2010 and the partial elimination in January 2011 of tax deductions for the purchase of principal residences. Simultaneously, other more permanent factors appear to have had mixed effects. On one hand, purchase decisions were driven by an improvement in accessibility indicators associated with the falls in the prices of residential assets and with the low interest rates that predominated during the year on average. On the other hand, the weakness of household income and the tightening of mortgage credit standards appear to have had a negative effect on the volume of transactions. Housing starts are currently estimated to be below the demand for new housing, so that the stock of unsold housing will gradually be absorbed, although residential investment can be expected to remain markedly slack for some years, which should also affect prices. In this respect, Box 5.1 makes an international comparison of the adjustment of housing prices during the crisis.

MAIN MACROECONOMIC AGGREGATES (a) CHART 5.3

GDP AND CONFIDENCE INDICATOR



CONTRIBUTIONS TO QUARTER-ON-QUARTER GDP GROWTH

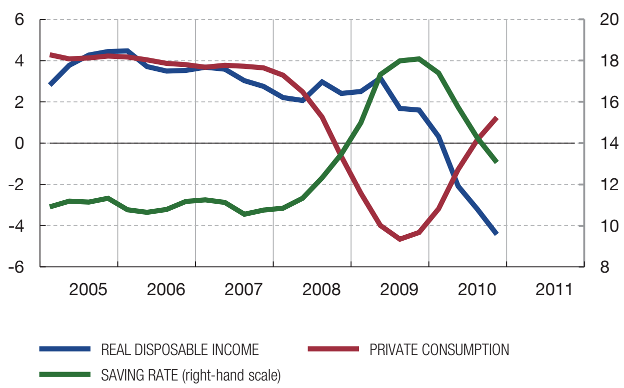


SOURCE: INE.

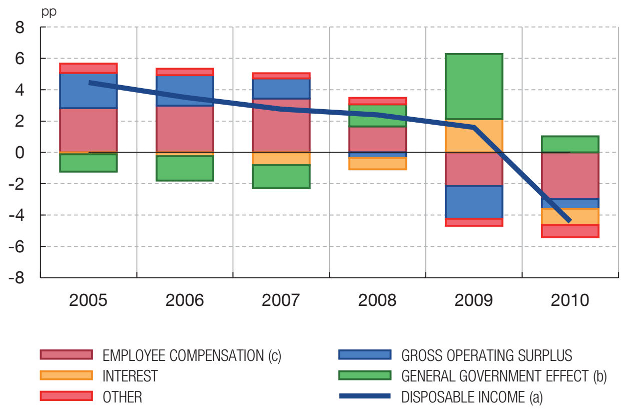
a National Accounts, base 2000. Year-on-year rates of change based on seasonally adjusted series of volume indices.

FINAL CONSUMPTION OF HOUSEHOLDS CHART 5.4

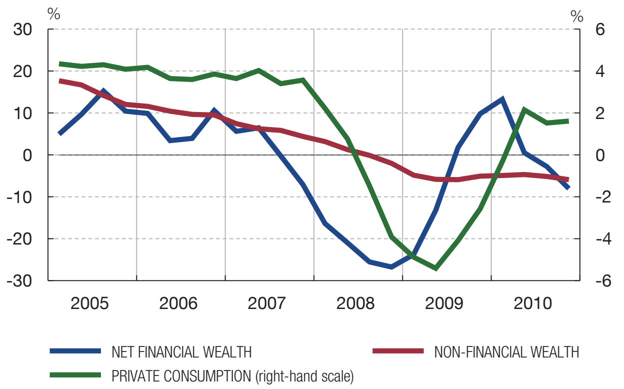
INCOME, CONSUMPTION AND SAVING RATE (a)
(in cumulative four-quarter terms)



CONTRIBUTION TO REAL GROWTH OF DISPOSABLE INCOME



HOUSEHOLD WEALTH AND CONSUMPTION (a)

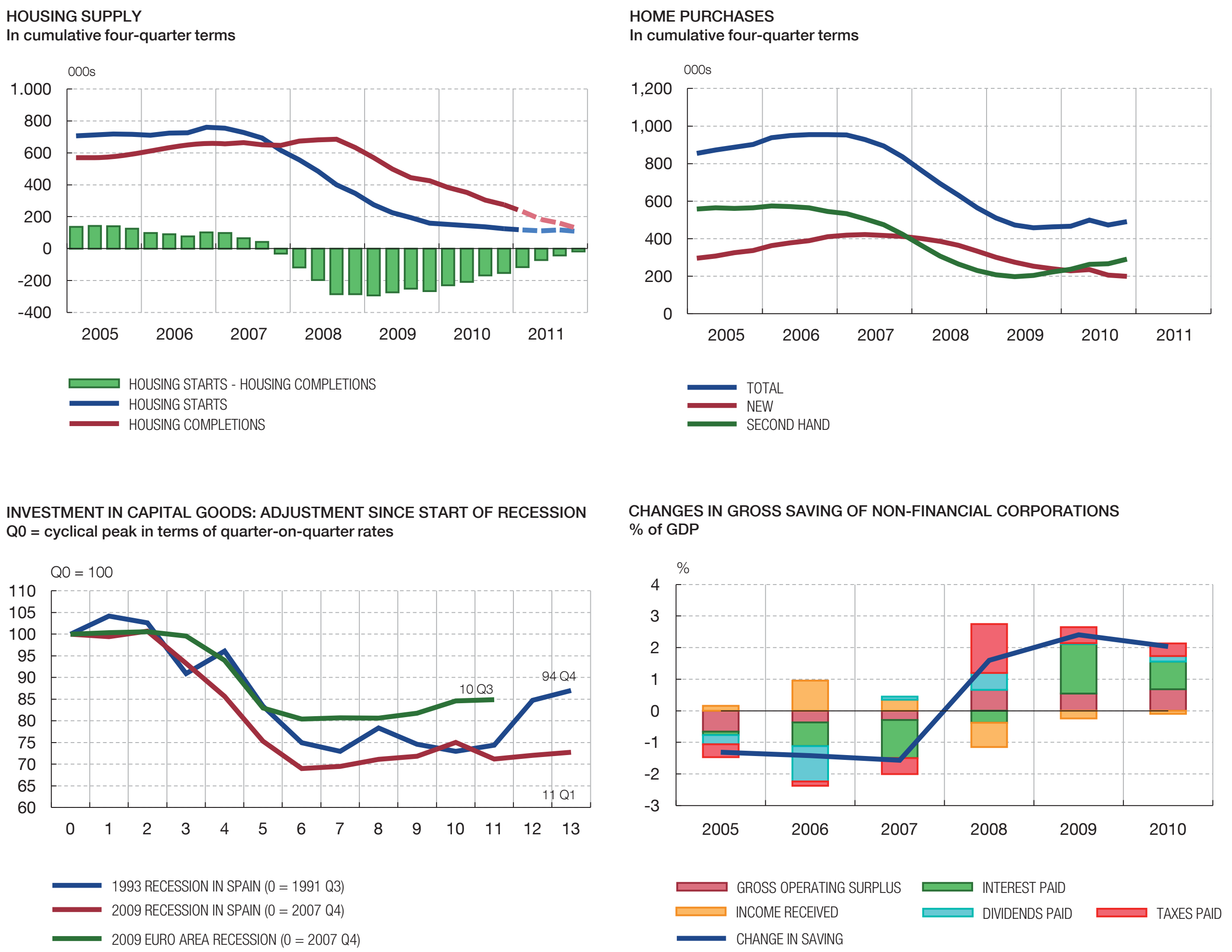


CONFIDENCE INDICATORS (d)

SOURCES: INE, Banco de España, European Commission and Eurostat.

a Year-on-year rate.
b Includes social benefits, social contributions and income and wealth taxes.
c Gross compensation per employee.
d Difference between the percentage of individuals who think that the situation is improving and that of those who think it is worsening.

HOUSING INVESTMENT AND PRIVATE PRODUCTIVE INVESTMENT CHART 5.5



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

Business investment continued the mild recovery that began in late 2009, driven by exports

Private non-residential investment continued on the path of mild recovery that began in late 2009, reaching positive year-on-year growth rates in the second half of 2010, although in the year as a whole it posted a modest decline, of 0.6%. This gradual improvement occurred thanks to the favourable behaviour of external demand and the improvement in industrial confidence. Also, the annual average cost of bank financing fell, while other credit conditions, although they remained tight, did not deteriorate with respect to 2009. Finally, the financial position of firms improved in 2010, with a slight correction of the debt ratio and an increase in profitability, which eased the financial pressure on investment (see Chart 6.6). In 2011, the gradual improvement in domestic demand and a continuation of the favourable behaviour of exports are expected to boost business investment, despite the foreseeable increase in the cost of financing.

Spending on capital goods posted a positive growth rate in 2010, although, in comparison with similar past episodes and with the euro area, its recovery has been moderate

Behaviour varied considerably across products. In particular, capital goods expanded moderately, partly because, following the sharp decline in 2009, their replacement demand increased. The overall adjustment of investment in capital goods during the crisis has been more drastic than in the euro area, and the initial phase of the cyclical upswing is proving more muted than in similar episodes in the past (see Chart 5.5).

Since 2007 a group of advanced countries, Spain among them, have seen their real estate markets undergo a severe adjustment. Previously, during the upturn, many of these economies had witnessed high growth in house prices and notably buoyant residential investment, attaining levels that proved hardly sustainable either from the standpoint of productive and financial resources geared to real estate activity or from that of asset valuation. From 1997 to 2007, real average house prices rose by 115% in Spain, while they increased by almost 160% in Ireland, 140% in the United Kingdom and around 80% in the United States. In France the increase was 50%, above the euro area average, which stood at 40% (see panel 1). In the current phase of the adjustment the excesses built up previously are being corrected, with cross-country differences in the scale and pattern of adjustment (of prices and amounts).

In Spain's case the upturn in the housing cycle was linked to strong demand-side pressures which, though underpinned in part by the course of certain fundamentals and met by a highly dynamic response in terms of the production of housing units, gave rise to strong pressure on the value of residential assets. Demographic factors (population and household size) determined high growth in the demand for housing, which was also boosted by the cut in real interest rates associated with the change in regime that Monetary Union membership entailed. As housing is a long-lasting asset, the demand for it and its price are highly sensitive to permanent declines in interest rates, especially when, moreover, conditions conducive to an increase in credit and in indebtedness prevail, as occurred in Spain. While the nature of some of these factors was common to other countries, their impact was heterogeneous and of differing intensity. Thus, for instance, whereas household debt in Spain rose to around 130% of GDI in 2007, this ratio was even higher in Ireland, at 200%. In other economies, such as France and, above all, the United States and the United Kingdom, the changes in these demand variables were less significant.

The rising course of house prices prompted a strong boost to activity in a large number of economies. In early 2007, at the height of the cycle, the production of new houses peaked in many markets. The strong growth in the volume of housing starts and, consequently, in construction was reflected in National Accounts figures, whereby the weight of investment in housing in GDP moved on a rising trajectory in these areas, reaching particularly high levels in Ireland and Spain (14% and 9%, respectively; see panel 2). Occasionally, the pressure of demand on real assets was not confined to housing but also fed through to non-residential real estate assets (shopping centres, offices, etc.). That drove the exuberance of investment in this market segment, involving the disproportionate development of new projects, and prompted price trajectories in these assets which, ultimately, proved unsustainable. In these circumstances, the situation of the Irish real estate market was particularly paradigmatic.

Admittedly, the macroeconomic fundamentals in place during the expansionary phase could warrant a rising path in house prices and residential investment; but there is also consensus that the increases observed might contain a somewhat significant component of overreaction. Thus, in relation to prices, and according to the analysis conducted by the International Monetary Fund, the residential market in Spain at end-2007 evidenced a level of prices in real terms that exceeded that warranted by its determinants by 17%. That said, the figure estimated for other economies was higher (in Ireland, the United Kingdom and France, the overvaluation amounted to 32%, 28% and 22%, respectively) (see panel 3).

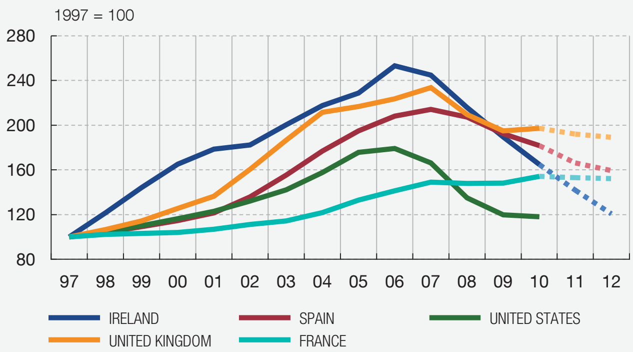
Although the excessive size of housing markets in these countries was patent in early 2007, the outbreak of the international financial crisis heightened the factors of fragility, giving rise to very sharp adjustment trajectories. In Ireland's case, the fact that the rises in both house prices and residential investment during the boom was sharper suggested that the correction in this country might be greater than that in other economies. Indeed, on National Accounts data, the cumulative decline in residential investment from its peak to date would be close to 70% in Ireland, while the fall in other markets was less intense (57% in the United States and 43% in Spain, while in the United Kingdom the decline was approximately 20%).

The adjustment of house prices has also been sharper in Ireland, with a cumulative decline of 35% in real terms, similar to that observed for the United States. However, it should be stressed that, in the case of the US market, the adjustment had run its course in 2009 and that prices have held relatively stable since then. Conversely, the declining course of prices in Ireland has run to the present. In the United Kingdom, the real adjustment of house prices has been less pronounced, leading to a total fall of close to 17%. For 2011 and 2012, further declines in prices are forecast in Ireland and, more modestly so, in the United Kingdom.

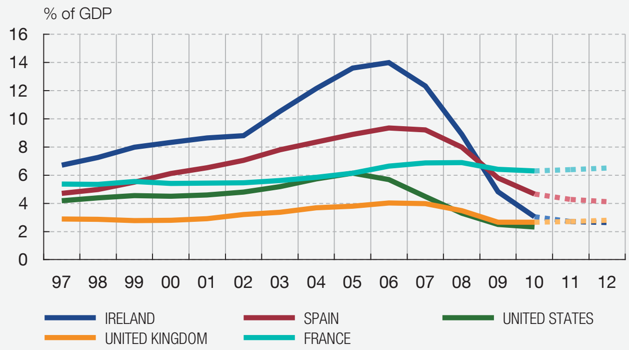
In Spain's case house prices, according to information from the Ministry of Development, have fallen in real terms by 20% from 2007 to 2011 Q1 (and by 15% in nominal terms), slightly more sharply than in the United Kingdom. As earlier mentioned, the different trend in fundamentals would warrant a different correction in each case. But certain features of the Spanish mortgage market, where debtors respond with all their assets to debts incurred, compared with other countries, such as the United States, where liability is limited in some cases to the house that has been mortgaged, introduce an element which tends to limit the adjustment of prices in Spain. This characteristic can be seen, moreover, in Spain's relatively small non-performing mortgage loan ratio compared with other countries.

It should also be underscored that the average adjustment of house prices in Spain masks significant differences in terms of the particular characteristics of each dwelling (geographical or inner-city loca-

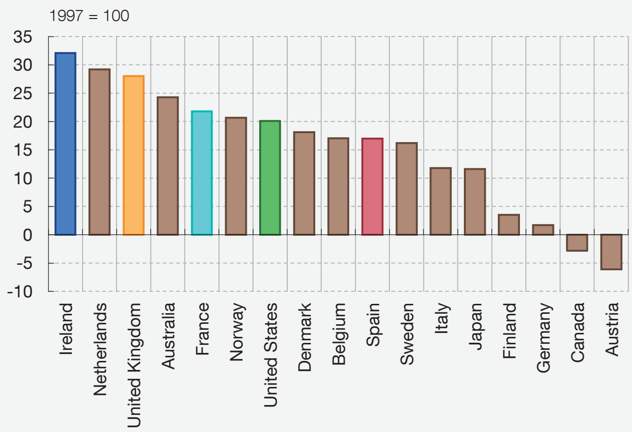
1 PRICE OF HOUSING (REAL TERMS) (a)



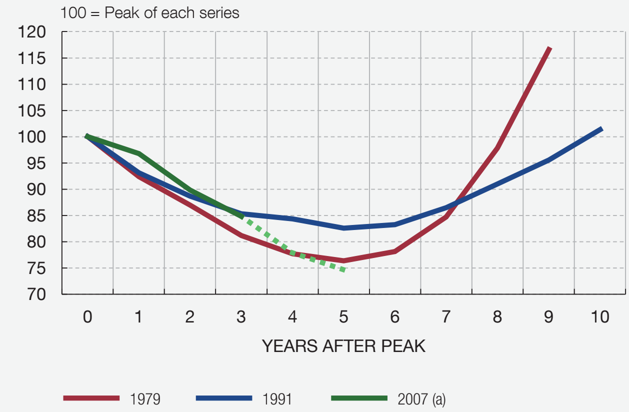
2 HOUSING INVESTMENT



3 IMF ESTIMATION OF THE OVERVALUATION OF REAL HOUSE PRICES IN 2007 (b)

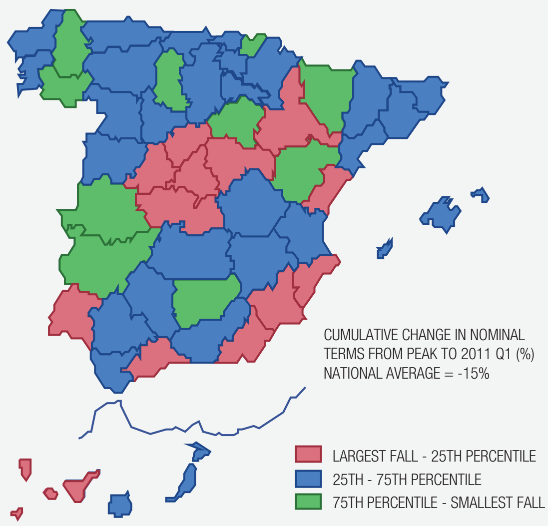


4 COMPARISON OF HOUSE PRICES IN SPAIN IN THE CURRENT AND PREVIOUS BUSINESS CYCLES



5 INDICATOR OF HOUSING AFFORDABILITY IN SPAIN (c)

6 PROVINCIAL BREAKDOWN OF HOUSE PRICE ADJUSTMENT



SOURCES: INE, Ministerio de Fomento, AMECO, Datastream, IMF and Banco de España.

a The 2011 and 2012 forecasts are from the EBA central scenario (March 2011).
b World Economic Outlook (October 2007 and April 2008). For the United States the calculation is for 2006.
c Annual theoretical effort excluding deductions.

tion, age, first or second home, etc.). Thus, the area encompassing the Mediterranean provinces and those close to the Madrid region have posted an average fall in prices that is 5 pp more marked than the national aggregate, whereas in other areas, by contrast, the decline has been very small and even non-existent (see panel 6). It should likewise be highlighted that the real cumulative adjustment in house prices in Spain in the current cycle is similar, to date, to that which took place during the correction phase in the early 1990s. That said, moderate cuts might be expected to continue over the near horizon as a result of the sizeable overhang of houses for sale and of the foreseeable increase in the cost of mortgage financing, which will exert downward pressure on the value of the assets to ease its impact on the affordability indicators (see panel 5). As a result, the cumulative correction in house prices could amount to 25% in real terms in 2012, drawing close to the path observed in the real estate crisis in the 1970s (see panel 4).

The increase in saving and the fall in business investment allowed the corporate sector to record net lending

In a framework in which access to external financing (through borrowing or securities issuance) remained highly restricted, the generation of internal funds enabled private productive investment to be sustained, in addition to some deleveraging. In 2010 business saving continued to grow, underpinned by the recovery in the gross operating surplus and the reduction in the interest burden. This increase in saving, along with the moderate fall in investment, enabled the financial position of firms to improve, with overall net lending of 0.4% of GDP in 2010.

General government's contribution to demand was strongly contractionary

Finally, as mentioned, general government demand was contractionary. The stepping up in the spring of the budget consolidation process meant that government consumption and public investment, which had previously helped to sustain domestic demand, ceased to do so in 2010. Moreover, given the pending fiscal adjustment, these spending components can be expected to continue to make a negative contribution over the next few years.

3.2 EXTERNAL DEMAND

In 2010 net external demand again made a positive contribution to GDP growth, thanks to more buoyant exports

Net external demand again made a notable positive contribution to GDP growth in 2010 (1 pp), although it was smaller than in 2009. The notable momentum of exports of goods and services (which grew by more than 10% in real terms) should be highlighted, while imports of goods and services also recovered, although to a lesser extent, recording modest growth (5.4% in real terms) given the weak rise in final demand. In the months that have already elapsed in 2011, trade flows have exhibited marked strength, especially in the case of exports, so that net external demand is expected to contribute positively to output again.

Goods exports, favoured by the expansion of world trade and accumulated competitiveness improvements, drove the recovery of the Spanish economy

Following the collapse of world trade in 2009, goods exports were the Spanish economy's main engine of growth in 2010, with an annual increase of 13.6%, which exceeded the growth in Spain's export markets. The stimulus from the upswing in world trade and competitiveness gains (largely due to wage containment) more than offset the negative effect of the progressive disappearance of the exceptional measures implemented in some countries last year, like the vehicle replacement support programmes that had stimulated sales abroad in 2009. Also, the weakness of national demand encouraged Spanish firms to sell their products abroad.

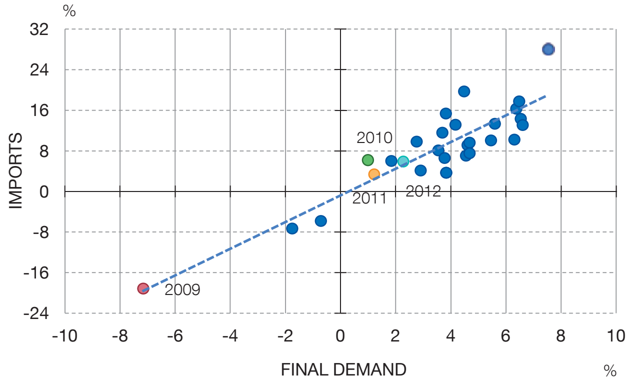
... with similar buoyancy across most geographical areas and products

According to the information available at firm level, the drastic decline in goods exports in 2009 was attributable, above all, to a reduction in the average amount exported by each firm and, to a much lesser extent, to the withdrawal of firms from export markets. This

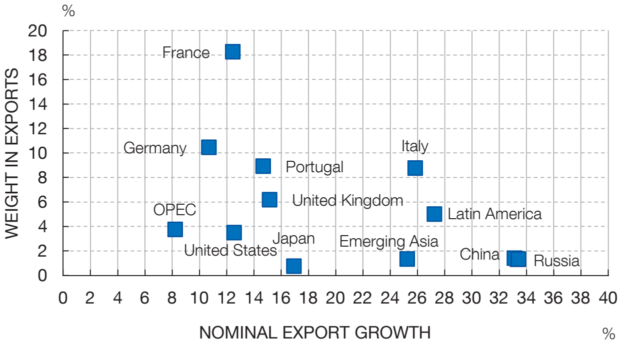
CHART 5.6

GOODS EXPORTS AND GROWTH OF SPANISH EXPORT MARKETS
1985-2012 (rates of change)

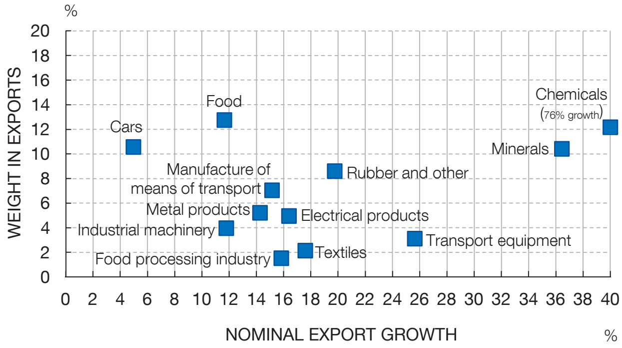
GOODS IMPORTS AND FINAL DEMAND
1985-2012 (rates of change)



GOODS EXPORTS BY REGION
2010



GOODS EXPORTS BY PRODUCT GROUP
2010



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

suggests that firms withstood the world trade crisis well, facilitating the subsequent recovery in their sales. Although the presence of Spanish firms in the fastest-growing markets (in particular, in emerging economies) is still low, sales to these economies recorded very high growth rates in 2010 as a whole, which is contributing to the necessary geographical diversification of Spanish exports (see Chart 5.6). Finally, by type of product, the acceleration in exports was across-the-board, although it was most notable in the chemicals and basic metals industries and transport equipment, while sales of cars, although growing by somewhat less, made a significant contribution to the recovery of exports in 2010, given their large weight in total exports.

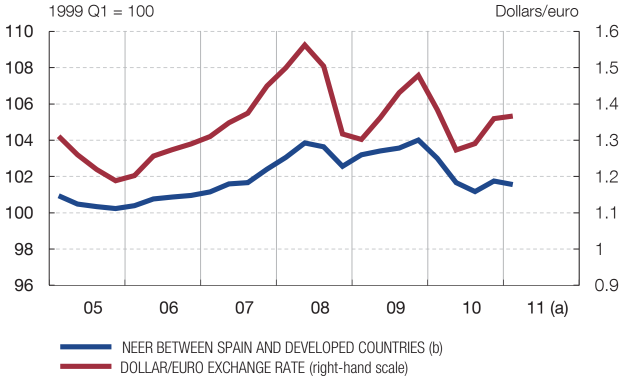
The share of goods exports in world markets increased slightly

In 2010 as a whole, Spain's share of world exports, in real terms, improved slightly, having remained relatively stable in the previous two years, when the gain in share in the developed countries, in particular in the euro area, was offset by the loss in the emerging areas (see Chart 5.7). In the euro area, Germany also increased its market share, while those of France and, in particular, Italy declined. In the first few months of 2011 exports have continued to drive growth, displaying greater buoyancy than world markets, which suggests that Spain's market share continues to expand.

COMPETITIVENESS INDICES AND EXPORT SHARES

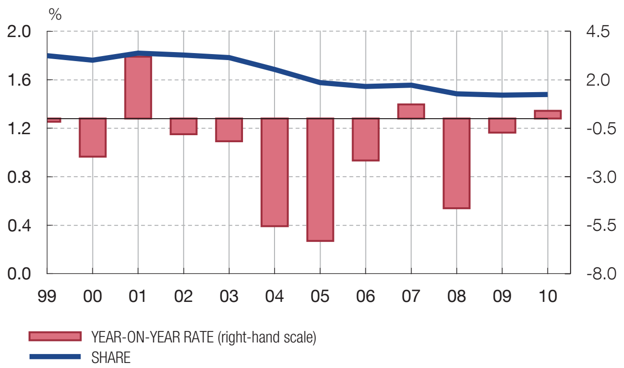
CHART 5.7

EXCHANGE RATES

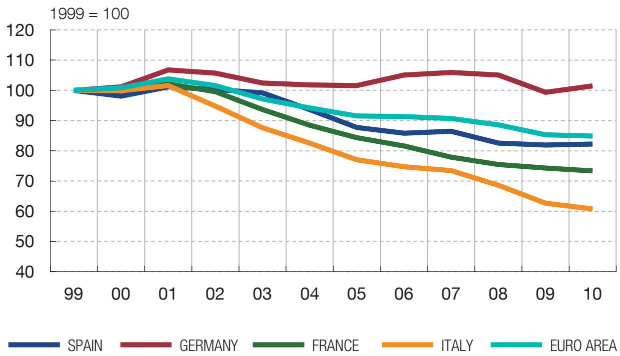


REER VIS-À-VIS DEVELOPED COUNTRIES (b)

SPAIN'S SHARE OF WORLD GOODS EXPORTS
Constant 2000 prices



SHARE OF GOODS EXPORTS IN REAL TERMS
100 = 1999 Indices



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

a Average of available data.
b An increase (decrease) in the index denotes a loss (gain) in competitiveness.

Services exports also recorded positive growth, although it was more moderate than in the case of goods

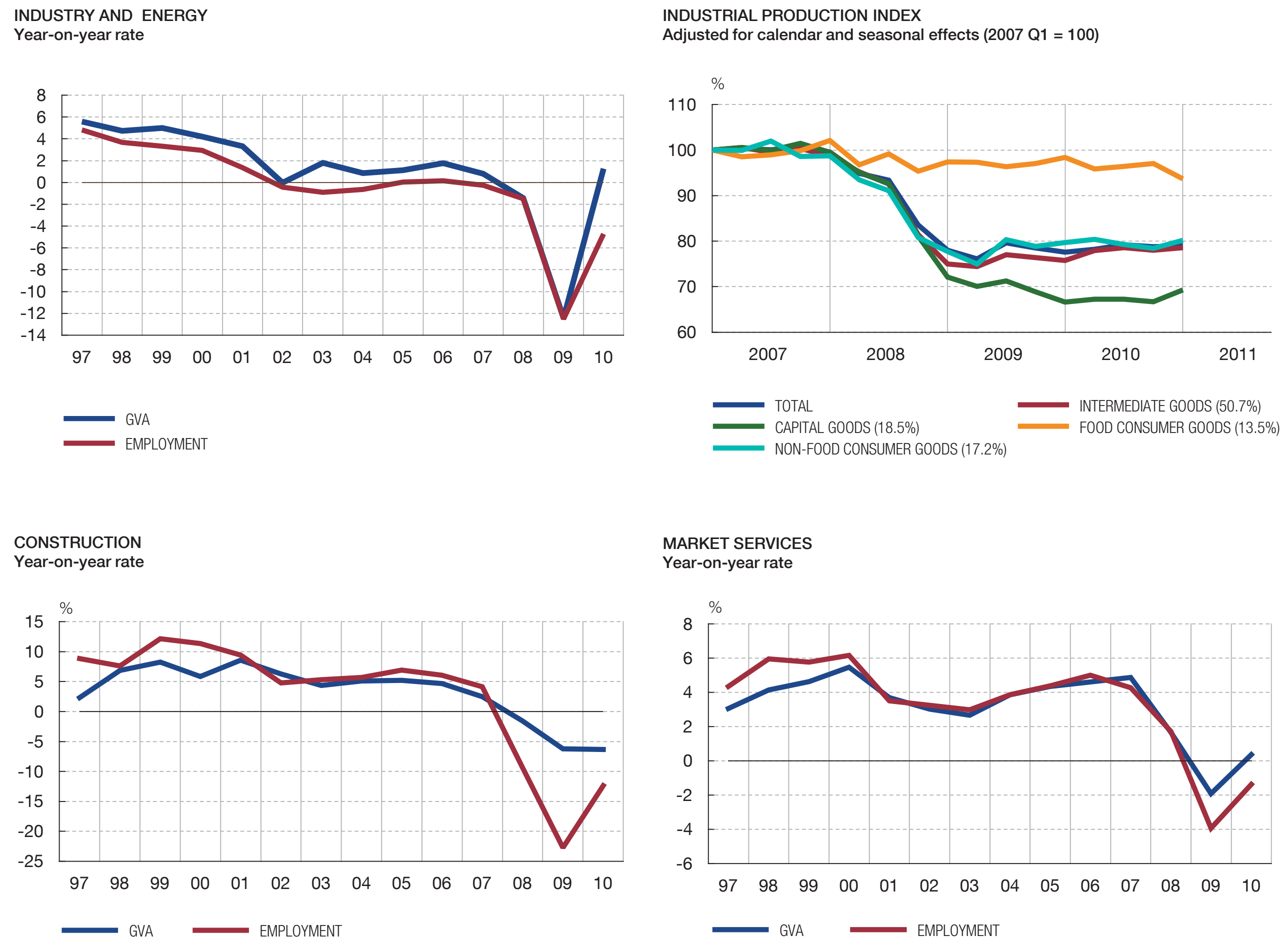
Services exports also returned to a positive growth path in 2010 (4.2%), especially non-tourism services (5.5%), in step with the growth in activity and, in particular, in goods trade and tourist flows, which boosted transport services. Tourism receipts benefited from the emergence from the economic crisis of some of the main countries that provide tourists for Spain and the weakness of the euro against the dollar and sterling. Along with an aggressive price cutting policy, this helped to mitigate growing competition from the eastern Mediterranean countries. However, the negative impact of certain exceptional events, such as the temporary closure of European airspace due to a volcanic eruption in Iceland, adverse meteorological conditions and the air traffic controllers strike in Spain, meant that tourism receipts continued to post moderate growth rates in 2010 (2.5%). In 2011, the growth rate of services exports is expected to accelerate, as the economic position of Spain's main customers continues to strengthen and tourists have been diverted towards Spain as a result of the geopolitical instability in certain Arab countries.

The rate of recovery of imports was influenced by two opposing factors: the weakness of domestic demand and the buoyancy of exports

The recovery of goods imports was much more moderate than that of goods exports (with an annual increase of 6.2%), given the weakness of national demand and the rise in the prices of imported products, especially commodities. That said, import penetration in final demand increased again in 2010. The pattern of imports over the year was largely determined by the bringing forward of consumption decisions to the second quarter from

GVA AND EMPLOYMENT BY BRANCH OF ACTIVITY

CHART 5.8



SOURCE: INE and Banco de España.

the third quarter (which indicates the dependence of the Spanish economy on goods for which there is no domestically produced equivalent). As at year-end, import growth was strongly linked to the buoyancy of exports, especially in those sectors that are highly dependent on imported inputs. In 2011 the growth of imports will again be constrained by the relatively moderate recovery in domestic demand, in particular private consumption, and by the increase in their prices, although the strength of exports may have some positive effect on imports.

4 Activity

The fall in activity in the market economy, which was still suffering from the contraction in construction, moderated in 2010

The decline in activity in the market economy as a whole moderated by more than 4 pp in terms of gross value added (GVA), to -0.4%, which exceeded the decline in GDP as a whole by more than 3 pp. Both the industrial and the services sectors posted positive, albeit modest, rates of change, following the notable falls in 2009, while GVA in construction contracted at a high rate. For its part, the GVA of non-market services decelerated notably during the year, growing at an annual average rate of 0.8%, as against 2.1% in 2009.

After contracting for two years running, the industrial and energy sectors grew again, underpinned by exports

Following the marked cumulative adjustment during the preceding two years, GVA in the industrial and energy sectors returned to positive growth rates in 2010 (1.3%), driven by external demand (see Chart 5.8). All the large industrial sectors grew, except those producing capital goods, which continued to contract, but at a notably lower rate. The highest growth was in the intermediate goods (in particular, the chemicals industry, in line with the buoyancy of this sector's exports) and, to a lesser extent, non-food consumer goods sectors.

Despite the modest recovery last year and at the beginning of 2011, the current level of industrial output is still approximately 20% lower than in 2007, which is a sharper contraction than in the main euro area countries. These developments are partly attributable to the spill-over effects of the decline in construction on certain industrial sectors. More positively, those sectors with a higher technological content suffered a smaller adjustment during the crisis and have performed more favourably during the early stages of the recovery, which is probably related to their higher export orientation. However, their low weight in the industrial sector as a whole (around 7.5%) limits their contribution to the expansion of the sector, which will depend in future upon the behaviour of the medium and low-technology, labour-intensive sectors, which are the largest.

Market services also showed some improvement, based mainly on domestic demand

GVA in market services increased by 0.4% in 2010, following the significant decrease of around 2% recorded the previous year. In comparison with industry, the sector's contraction during the recession was much less intense. Moreover, production in market services industries has already generally recovered to around its pre-crisis levels. Activity in the wholesale and retail trade, which is the largest one, fluctuated during 2010 as a result of the introduction of VAT in July, although it generally remained weak, in line with consumption. Other sectors, such as hotels and restaurants and transport and storage services, benefited from the buoyancy of goods exports and tourism, which partly offset the greater slackness of domestic activity.

The rate of decline in construction accelerated slightly, with adjustment in the residential component coming on top of the strong contraction in public works

GVA in construction continued the intense adjustment process that had commenced three years earlier, with a fall of more than 6% in 2010. As already seen when demand was analysed, this was attributable to continuation of the intense adjustment of residential investment and the sharp reduction in public investment, within the framework of fiscal consolidation.

5 The labour market

The destruction of employment continued in 2010, but at a slower pace

Employment fell in 2010 at an average rate of 2.3% (4% in the market economy). As a result the total destruction of jobs since 2007 Q3 exceeds two million, which shows the severity of the impact of the economic crisis on employment. However, the decline in employment was more than 4 pp less than in 2009 (see Chart 5.9). Going forward, as in the case of activity, the recovery in employment is expected to be slow.

Productivity, as usual, behaved countercyclically

Productivity in 2010 grew by 2.3%, a more moderate rate than in 2009, confirming once again the countercyclical nature of this variable in the Spanish economy. This behaviour is the result of the combination of a high degree of wage rigidity and strong segmentation of the labour market, which means that the adjustment to shocks takes place mainly through the level of employment, in particular, temporary employment. Since temporary workers on average have lower levels of training and experience than other workers, a reduction in their numbers leads to an increase in average productivity. In fact, temporary employment fell by 4% in 2010, while permanent employment declined by 1.5%. The same pattern of behaviour was seen right across the market economy, with the rise in productivity in industry standing out.

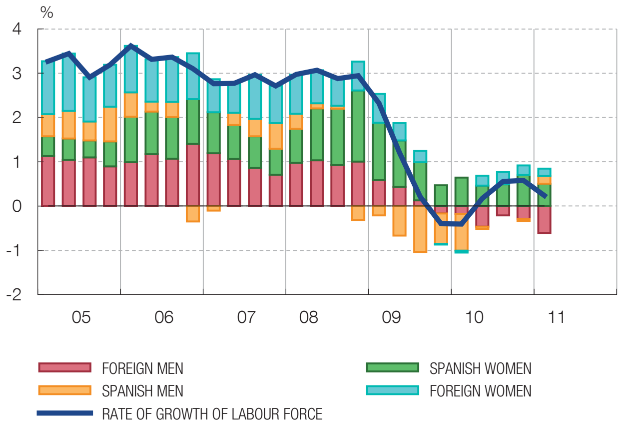
In construction, employment continued to be destroyed at a marked rate...

Construction continued to be the sector in which most employment was destroyed in 2010, with an average change of -12.5%, although the decline in employment in industry was also considerable (-5.8%). For its part, employment in non-market services grew by 2.2%, a similar rate to 2009, although it decelerated as the year elapsed. According to

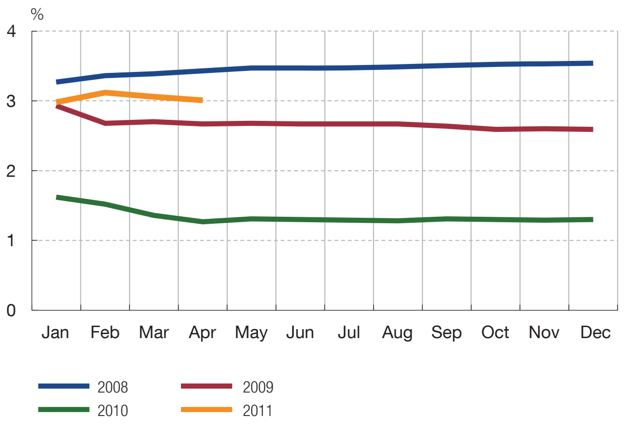
EMPLOYMENT AND WAGES CHART 5.9

OUTPUT AND EMPLOYMENT (a)
Year-on-year rate

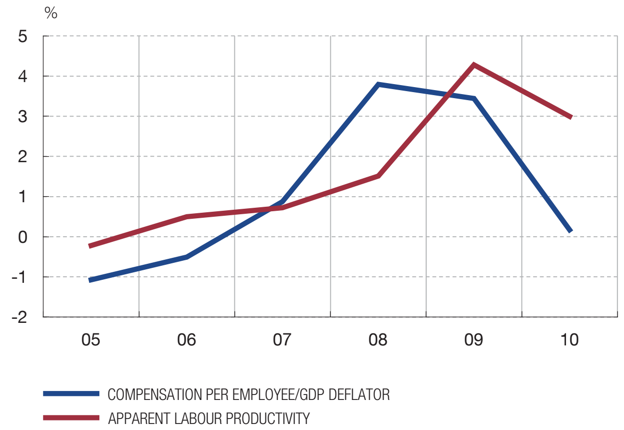
YEAR-ON-YEAR LABOUR FORCE GROWTH
Contributions by sex and nationality (b)



WAGE RATES (c)



REAL WAGES AND PRODUCTIVITY IN THE MARKET ECONOMY (d)



SOURCES: INE and Banco de España.

a Seasonally-adjusted QNA series. Full-time equivalent employment. The 2011 data correspond to those in the March 2011 *Spanish economic projections report*.
b The EPA (Spanish Labour Force Survey) series are linked on the basis of the 2005 Q1 control survey.
c Cumulative data from January until the latest month of the year available. Last figure: April 2011.
d Seasonally-adjusted QNA series. Full-time equivalent employment.

data from the Register of Personnel in General Government Service, growth was more moderate, at around 0.8% (on data to July 2010), as against 2.2% in 2009, as a result of the progressive application of the public sector employment reduction plan.

... while in other sectors the fall in employment was halted

Although destruction of employment occurred in almost all sectors of the market economy, the rate of deterioration moderated with respect to 2009. It can be seen from the quarterly profile for 2010 that the destruction of employment practically stopped in market services, while in agriculture there was timid job creation.

Participation decisions barely responded to the adverse labour market conditions

In contrast with previous crises the participation rate continued to display some strength, despite the severe deterioration in the labour market, with a moderate increase (of 0.1 pp, to 60%). This enabled the labour force growth rate to remain in positive territory (0.2%), despite being lower than in 2009 (0.8%), on account of the slowdown in the increase in the immigrant population that has been recorded since soon after the start of the crisis. Male participation and that of younger persons (aged 16-24) did respond negatively to the cyclical situation. In the case of the latter there was an increase in their participation in training activities. The reduction in the participation of these groups was not sufficient, however, to offset the tendency towards greater female participation in the labour market.

Unemployment grew rapidly, but at a slower rate than in 2009

The growth of unemployment moderated, but remained strong, standing at 11.6% in 2010, and the rate of unemployment rose to 20.1%, up more than 2 pp from 2009. This increase was broad-based, but more marked among the youngest, those with low skill levels and foreigners. Long-term unemployment rose sharply and its relative incidence (42.5%) stood at high levels (52.6% among 45-64 year olds), a worrying situation given the greater difficulty that the long-term unemployed have returning to the labour market.

Wages moderated in 2010...

The signing in February 2010 of the 2010-2012 Employment and Collective Bargaining Agreement by the social partners, along with the significant cut in the wages of public-sector employees and the moderate inflation rates deriving from the unemployment gap, created a more favourable setting for wage moderation in 2010. Compensation per employee in the market economy grew by 1.4%, down 2.3 pp from 2009, in line with the growth in wage rates agreed in collective bargaining (1.3%, as against 2.3% in 2009). The slowdown in non-market services was even sharper, with an average fall of 1.8% in 2010, owing to the general government wage cut.

... although there are signs of a rise in 2011

However, the sharp rise in inflation in the final stages of 2010 and the first few months of 2011 caused the wage increases in the agreements registered at the beginning of this year to be higher than those in 2010 (around 3%). There is therefore a risk that the high inflation in late 2010 and early 2011 will feed through into excessive wages, thereby hampering the recovery in competitiveness and employment.

6 Prices and costs

Inflation is tending to rise, owing to factors that are, in principle, temporary...

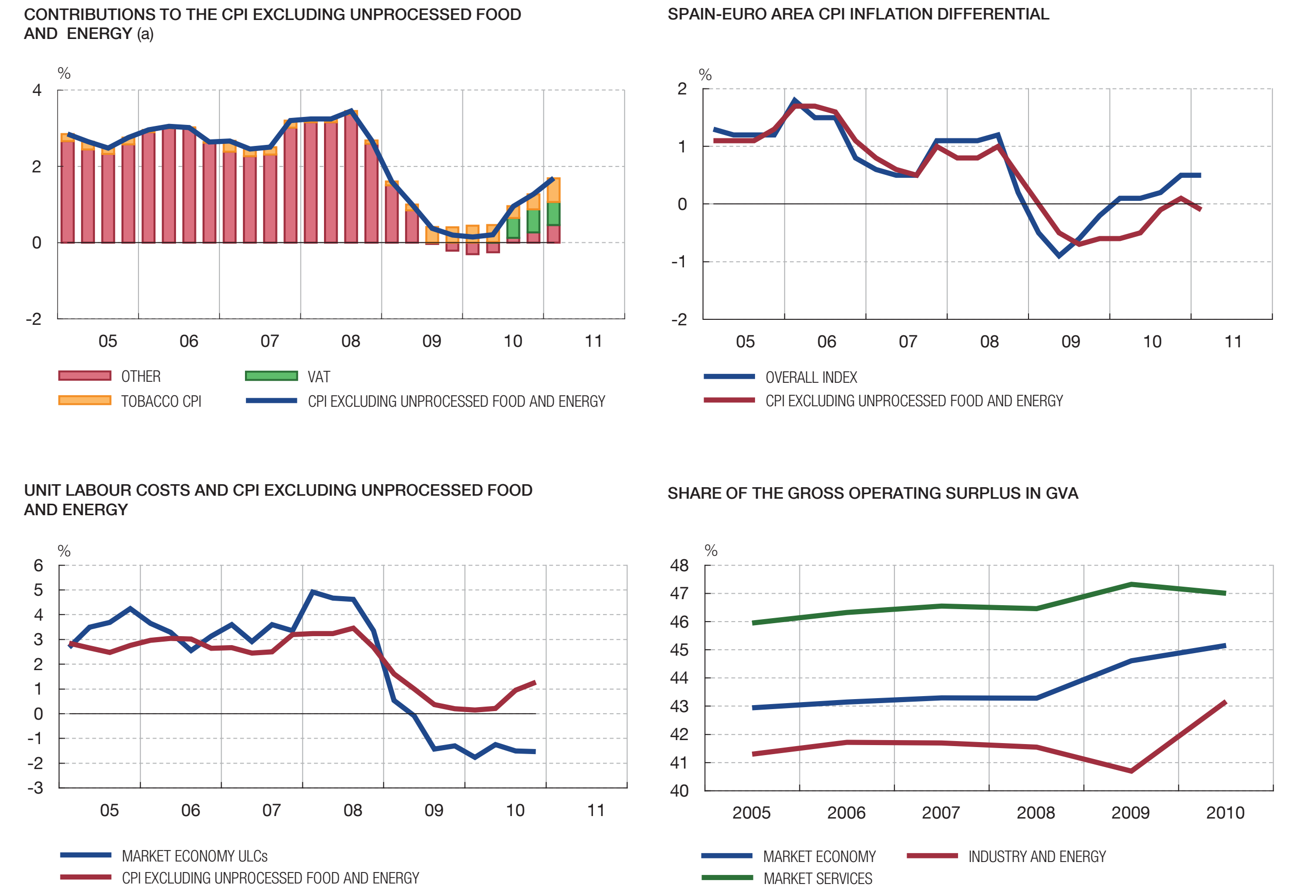
The gradual increase in the rate of growth of the CPI, which had commenced in summer 2009, continued last year (see Chart 5.10). Specifically, the average annual inflation rate in 2010 was 1.8%, while in December the annual rate was 3%, 2.2 pp higher than in the same month a year earlier. This tendency for inflation to rise continued at the beginning of 2011, until April, when it peaked at 3.8% and began to fall. The developments described reflect, above all, the concurrence of various predominantly temporary factors whose impact on the rate of change of the CPI should, in principle, disappear during 2011. These factors include the rise in commodities prices (especially the oil price) on international markets, certain tax rises (within the fiscal consolidation framework) and the increase in certain regulated prices.

For this reason, to explain inflation developments in 2010 and early 2011 it is useful to break down the annual growth rate of the CPI, in order to quantify the approximate contributions of each of these factors. The difference between the overall indicator and the total contribution of these factors gives a more accurate indication of underlying inflationary pressures. Specifically, of the 2.2 pp by which inflation increased between December 2009 and December 2010, the temporary factors would together explain 1.4 pp, the residual part, unrelated to these factors, being 0.8 pp.

... such as the trend in energy prices...

The behaviour of the prices of energy goods explains 0.7 pp of the increase in inflation last year. The notable acceleration in these prices in 2010 and early 2011 reflected, above all, an external shock, namely a significant rise in the US-dollar oil price, against a background of strong demand expansion in the emerging countries, geopolitical tensions in certain producing countries and a lack of exploration. However, other factors also contributed to the increase in energy prices. First, not only did the pre-tax prices of heating and vehicle

INFLATION DETERMINANTS CHART 5.10



SOURCES: INE and Banco de España.

a The tobacco CPI does not include the estimated effect of the rise in VAT rates.

fuels swiftly reflect, as usual, the rise in the cost of oil, but the price increases were larger in Spain than in the euro area as a whole, which may be a consequence of insufficient competition in the sector, as well as the rigidity of energy demand in Spain. Second, the regulated prices of natural gas, butane gas and electricity were increased in order to bring them into line with cost.

... and indirect taxes

Standing out among the fiscal consolidation measures with direct effects on prices is the July 2010 increase in VAT rates. Final prices would have increased by 1.1 pp if the tax change had been fully passed through. However, the various estimates available indicate that the actual pass-through was around 50%, so that the tax increase would explain 0.6 pp of the change in the overall CPI. This pass-through is smaller than that estimated for the increases in VAT rates in 1992 and 1995, which may be because the weakness of household consumption at the current stage in the cycle caused part of the tax rise to be absorbed in producers' and retailers' margins. The increase in taxes on tobacco also had a discernible effect on the CPI.

The CPI excluding unprocessed food and energy reached a record low...

On average last year, the CPI excluding unprocessed food and energy increased by 0.6%, a record low rate. This was consistent with the slackness of demand, which led, in particular, to a marked slowdown in services prices. This containment of underlying inflation meant that, despite the larger increase in indirect taxes in Spain, the inflation differential with respect to the euro area, in terms of the CPI excluding unprocessed food and energy, was negative (-0.3%) for the second consecutive year.

... reflecting the sharp fall in unit labour costs

The reduction of unit labour costs intensified relative to 2009, as a consequence of the greater containment of compensation per employee (which was more pronounced in the economy as a whole than in the market economy), since apparent labour productivity growth was lower than in 2009, reflecting the moderation of the job destruction process. At the same time, profit margins (approximated by the share of the operating surplus in value added) increased with respect to previous years, especially in the case of industry.

Other price indicators did not moderate in 2010, basically owing to the imported component

The rate of growth of private demand deflators increased in 2010, reflecting the strong acceleration (by almost 17 pp) in import prices. For its part, the government consumption deflator fell in 2010 as a consequence of the public sector pay cuts. The acceleration of the domestic component of inflation, approximated by the GDP deflator, was more modest. It increased by 1% in 2010, as against 0.6% in 2009.

Price and cost competitiveness gains were recorded

For the second consecutive year there were improvements in the price and cost competitiveness indicators vis-à-vis the developed countries, so that part of the loss accumulated in previous years was recovered. The gains, which in the case of competition with non-euro area countries were favoured by exchange rate developments, were particularly intense in terms of unit labour costs. This improvement in competitiveness contributed, as already indicated, to the slight rise in the market share of Spanish exports, in real terms, on the world market.

Inflation can be expected to moderate significantly in the second half of 2011 and in 2012

In principle, the impact on the annual inflation rate of the factors that have been temporarily driving it will tend to disappear gradually in the second half of 2011, which should enable consumer price inflation to stand at around 2% at the end of 2011 and at 1.5% in 2012 as a whole. However, these projections are subject to a high degree of uncertainty, since the oil price is too. In addition, the indirect effects of past oil price rises on the prices of other goods and the emergence of so-called second-round effects (i.e. the inflationary effects that arise when, in response to an external shock, agents attempt to maintain their margins and wages in real terms) represent channels that may put further pressure on domestic prices. An inappropriate reaction by the various agents to the inflation shocks recorded during 2010 would lead to persistently higher inflation rates, competitiveness losses and reductions in employment and activity.

7 The nation's net borrowing and the capital account of the institutional sectors

The nation's net borrowing continued to decline in 2010 owing to the improvement in the non-energy trade balance and the income balance

The Spanish economy's net borrowing continued to decline in 2010, although less sharply than in 2009. On national accounts data, Spain's net borrowing reached 3.9% of GDP, 1.2 pp less than in 2009 (see Chart 5.11). This improvement mainly reflected the decline in the income deficit (by 0.9 pp of GDP) and in the non-energy trade balance (by 0.6 pp), with a slight increase in the services surplus. Also, the capital transactions surplus widened, by 0.3 pp of GDP. These developments offset the increase in the energy deficit.

The lower net income payments to the rest of the world are primarily explained by the appreciable increase in the dividends received by Spanish multinationals

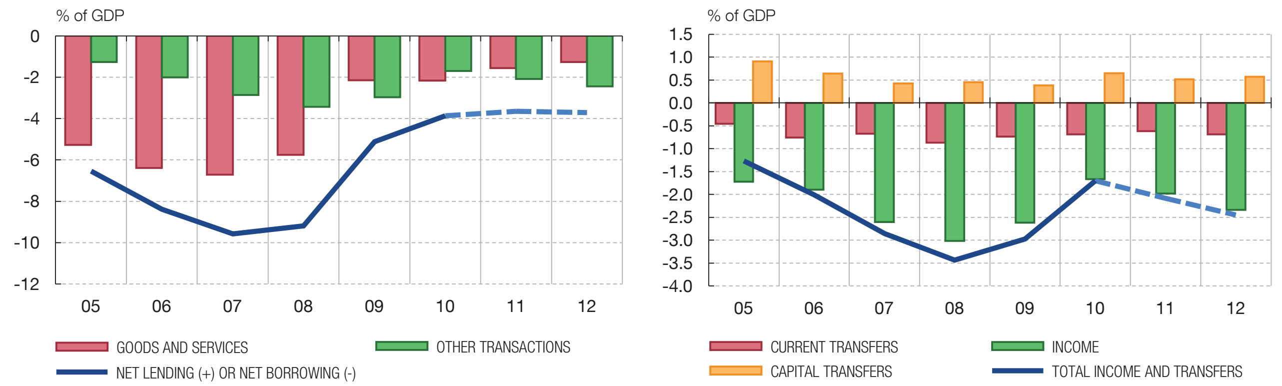
The decline in the income deficit basically reflects the notable increase, to an all-time high, in the direct investment dividends received by Spanish multinationals and the low average level of interest rates in 2010. In the latter case, the correction of the income deficit moderated during the second half, in line with the rise in the cost of financing.

REST OF THE WORLD ACCOUNT

CHART 5.11

NET LENDING (+) OR NET BORROWING (-) OF THE NATION

EXTERNAL BALANCE OF OTHER TRANSACTIONS



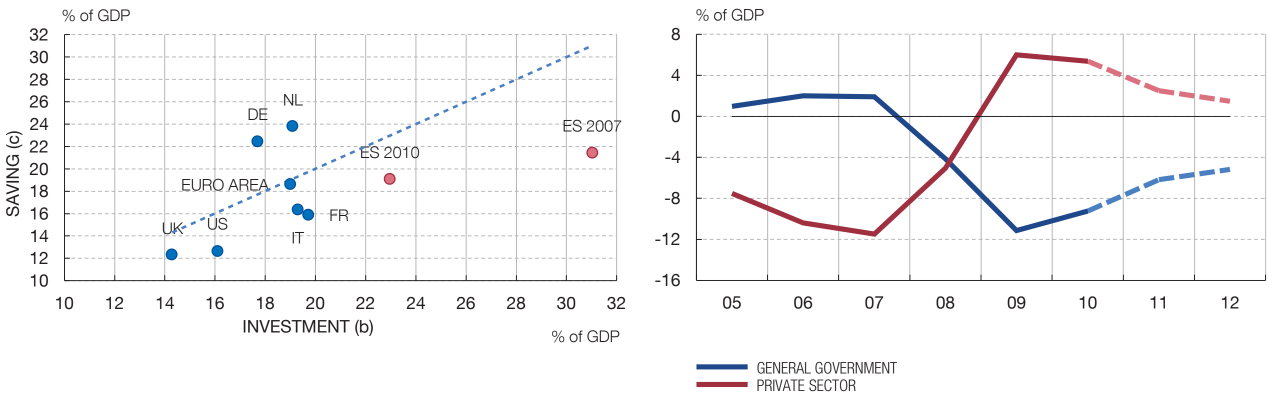
SOURCES: INE, Departamento de Aduanas and Banco de España.

SAVING, INVESTMENT AND NET LENDING OR NET BORROWING (a)

CHART 5.12

INTERNATIONAL COMPARISON (2010)

NET LENDING (+) OR NET BORROWING (-) BY SECTOR



SOURCES: ERUOSTAT, INE and Banco de España.

a Except for Spain, the 2010 data are forecasts of the European Commission.
b Gross capital formation.
c Gross saving.

The rise in the oil price and the increase in income payments abroad are not conducive to more significant declines in the external deficit in future

The notable rise in oil prices in 2011, the magnitude and duration of which is subject to great uncertainty, and the upward trend in interest rates limit the margin for correction of the external deficit. Given the considerable dependence of the Spanish economy on imported goods, especially energy, and the interest burden entailed by the debt assumed in the past vis-à-vis the rest of the world, it is important to review through which channels additional and permanent corrections in the external deficit might be achieved (see Box 5.2).

The lower public-sector net borrowing more than offset the reduction in the net lending of the non-financial private sector

The decline in the net borrowing of the Spanish economy in 2010 is explained by the fall in national investment (by 1.5 pp of GDP to 22.5%), which widely exceeded that in the gross national savings ratio (of 0.4 pp of GDP to 18.5%) (see Chart 5.12). It should be noted that the ratio of investment to GDP in Spain remains above that of the main European countries, despite the 8 pp decline in this ratio since 2007. In 2010 private-sector net lending

In 2010 the Spanish economy continued reducing its external deficit. On National Accounts data, net borrowing stood at 3.9% of GDP that year, 1.2 pp less than in 2009 and almost 6 pp down on the 2007 peak (see panel 1). This adjustment needs to continue, especially since Spain has built up a significant negative output gap, with a substantial decline in investment, which should lessen the resort to foreign saving. Further, in 2010 the primary external balance was still in deficit (2.2% of GDP), suggesting that, in the absence of vigorous growth in activity, the Spanish economy's international investment position (IIP) will remain strongly negative.

Some of the factors that have hindered the correction of the external deficit in 2010 Q2 point to the presence of certain weaknesses in the Spanish economy, which need to be addressed to achieve further and persistent reductions in the deficit. In 2010, net borrowing was affected by the higher payments to the rest of the world connected with the increase in the energy bill. The rise in oil prices[1] and the Spanish economy's high dependence on imported energy inputs account for the significant deterioration in the energy balance that year, to 3.3% of GDP (0.8 pp more than in 2009). Also, the rapid response of other imports to the modest pick-up in final demand in 2010 suggests that the traditional high income elasticity of Spanish imports has not changed significantly during the downturn, although this aspect should be analysed with caution.[2] The buoyancy of exports and the slight increase in private consumption in 2010 – demand components with a greater import content than investment in construction – largely explain the recovery in purchases abroad that year (31% and 38% of the

1 The price of Brent crude rose by 35% on average in 2010, after declining by 33% in 2009.

2 Estimates of the income elasticity of Spanish goods imports for the period 1995-2010, based on parameters that change over time, point in this direction.

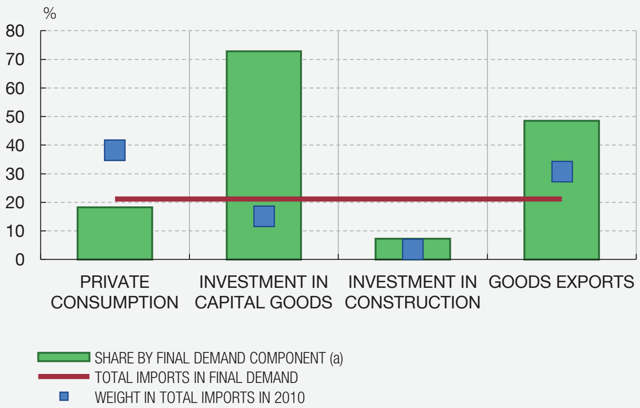
1 THE NATION'S NET BORROWING

% of GDP

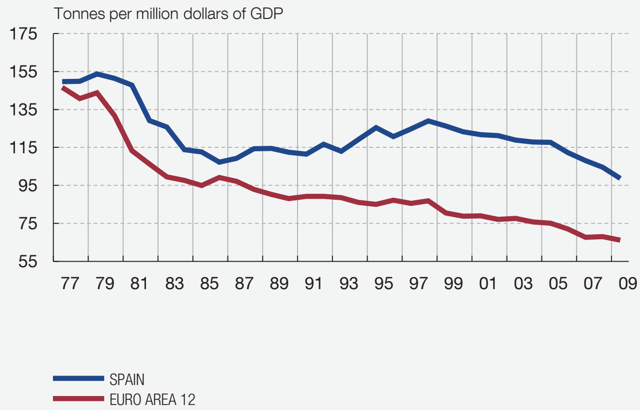
	2007	2008	2009	2010	2011	2012
Goods and services balance	-6.7	-5.8	-2.2	-2.2	-1.6	-1.3
Energy balance	-3.2	-4.1	-2.5	-3.3	-4.2	-4.2
Non-energy goods and services balance	-3.5	-1.7	0.4	1.1	2.6	2.9
Income	-2.6	-3.0	-2.6	-1.7	-2.0	-2.3
Other	-0.3	-0.4	-0.4	0.0	-0.1	-0.1
Net borrowing	**-9.6**	**-9.2**	**-5.1**	**-3.9**	**-3.7**	**-3.7**
MEMORANDUM ITEM:						
Primary external balance	-7.0	-6.2	-2.5	-2.2	-1.7	-1.4

SOURCES: Departamento de Aduanas, INE and Banco de España.

1 SHARE OF IMPORTS IN THE MAIN COMPONENTS OF FINAL DEMAND
2005



2 NET OIL IMPORTS
Constant 2000 prices



SOURCES: International Energy Agency, Eurostat, INE and Banco de España.

a Banco de España calculations based on the Input-Output framework of the Spanish National Accounts.

total, respectively)[3] (see panel 1). All told, thanks to the strength of exports, boosted by the recovery in global trade and the gains in competitiveness made over the past two years, the trade surplus in non-energy goods and services increased in 2010 to 1.1% of GDP.

The forecasts for 2011 and 2012 indicate that the external deficit will narrow marginally, despite the fact that goods and services exports are expected to continue to perform well. The main obstacles to more rapid adjustment are, firstly, dearer oil (strongly affected by the growing geopolitical instability in the Arab world) and, secondly, the increase in the income deficit, owing to the rise in interest rates in the presence of a large negative IIP. Here it is worth reviewing the different channels through which the Spanish economy might correct its external deficit more quickly. Three possible channels for this improvement are gains in price-competitiveness, greater openness to foreign markets and a reduction in import dependence, in particular energy dependence.

Spanish monetary union membership makes it impossible to resort to competitive devaluations to make Spanish products cheaper on foreign markets, and make imports dearer. Accordingly, gains in price-competitiveness must be generated through productivity gains and price and wage moderation, which would be more readily attainable if measures were introduced to improve the workings of the markets for goods, services and productive factors. That would further allow an increase in those Spanish companies able to penetrate new markets, boosting the beneficial effects of gains in competitiveness on exports. Against this background, the Quarterly Macroeconometric Model of the Banco de España (MTBE)[4] has been enlisted to simulate the effect on the external deficit of a 1 pp reduction in relative export prices in both 2011 and 2012.[5] As can be seen in panel 2, this measure would allow the external deficit to be reduced by 0.5 pp of GDP in 2012.

Export performance depends not only on how competitive exports are, but also on the intensity of the demand for them. The diversification of Spanish exports towards products with higher value-added and towards more dynamic markets would have a positive impact on their performance. In fact, were Spanish firms to progressively increase their sales to emerging countries so that Spanish export markets grew at a similar rate to world markets in 2011 and 2012 (i.e. by 7.5%, instead of the 6% projected), then according to the MTBE there would be an improvement in the nominal trade balance from the first year, which would reach 0.6 pp of GDP in 2012. To encourage the diversification of exports towards countries with dynamic demand, firms' access to culturally and geographically distant markets needs to be facilitated, and their establishment in such markets needs to be strengthened.

Finally, limiting the high degree of oil dependence, which ties the performance of the external balance to fluctuations in the price of crude, is crucial. Spain's oil imports per unit of GDP are much higher than for the euro area as a whole (see panel 2). Were this difference halved over the coming years, the energy deficit would be reduced by around half a percentage point of GDP. Hence, the measures necessary to permanently reduce such external energy dependence must not be delayed.[6]

To avoid the growing demand for goods and services imports hampering the correction of the external deficit during upswings it would also be desirable to reduce the high level of dependence on imports of goods with higher value-added and technology. Were the long-term income elasticity of Spanish imports to be reduced to similar levels to those observed in the large euro area countries, the favourable impact on the external balance of the above simulations would be much greater.

3 These weights are based on the import content of each of the final demand components estimated using 2005 input-output tables.
4 To perform this simulation, the price elasticity of exports was increased, in line with the estimates at a more disaggregated level, and the response of imports to changes in final demand was moderated.
5 Given the weight of unit labour costs, mark-ups and inputs in the export price formation process, this reduction in prices could be achieved through a further decrease of 1.5 pp in ULCs and mark-ups in each one of these two years.
6 The plan to step up energy saving and efficiency approved by the Council of Ministers on 4 March includes a number of proposals to achieve an estimated total saving on energy imports of €2.3 billion per annum.

2 CUMULATIVE IMPACT ON SPAIN'S EXTERNAL DEFICIT OF DIFFERENT MEASURES

% of GDP

	2011	2012
1 Gains in price-competitiveness of 1% in 2011 and in 2012	0.3	0.5
2 Growth in Spain's export markets of 1.4% in 2011 and 1.6% in 2012	0.3	0.6
3 Progressive reduction of net oil imports	0.2	0.5
TOTAL IMPACT	**0.7**	**1.6**

SOURCE: Banco de España.

The simulations performed show that progress towards the achievement of external balance, which includes laying the foundations for curbing and reversing the upward trend in the negative IIP, requires ambitious measures on a number of fronts, to achieve more efficient price and wage setting, to increase the productivity of firms and to reduce the dependence of the Spanish economy on imports, especially of energy. The simulations performed show that even if there were a rapid improvement in all these areas, which would reduce the external deficit in 2011 and 2012, the primary component would only be balanced in the latter year, so that the IIP would barely fall. That said, apart from reducing the external deficit, the abovementioned measures would boost activity, which would have favourable effects on financial market confidence in the growth capacity of the Spanish economy and on the sustainability of foreign debt.

was reduced (by 0.6 pp of GDP, to 5.4%), owing to the behaviour of households and financial institutions, which cancelled out the improvement in the financial position of non-financial corporations (which recorded net lending for the first time since 1996). Accordingly, the decline in the nation's net borrowing reflected the fall in that of general government (by 1.9 pp of GDP, to 9.2%). The correction of the budget deficit in the next few years is expected to be offset by a decline in private-sector net lending, so that the nation's net borrowing will hardly be reduced. In this respect, more sustained progress in reducing the external deficit would require higher savings ratios or lower investment by households and firms.

Despite its net borrowing, the Spanish economy's net external indebtedness declined in 2010, owing to the positive impact of valuation effects

The increase in the nation's net borrowing was not reflected in the international investment position, owing to the impact of valuation effects. These effects resulted from the depreciation of the euro vis-à-vis the pound sterling and the US dollar and the fall in the prices of Spanish financial assets relative to foreign ones (in particular equities), and they made the net debit position fall by 4 pp of GDP in 2010, to stand at around 87%. In a year characterised by recurring strains on financial markets, net borrowing was mainly covered through portfolio investment in long-term fixed income, as a result of both the decline in the holdings abroad of this type of security by residents in Spain and of investment by non-residents in government debt. Spain's foreign debt (a variable that includes liabilities vis-à-vis non-residents that give rise to debt or interest payments, i.e. claims on Spain) fell by 2.8% of GDP in 2010, to 164%.

1 Introduction

Euro area financial market tensions shaped financial developments in Spain

Financial developments in Spain in 2010 were strongly influenced by the tension in the euro area financial markets. The most difficult moments stemmed from the debt crises of Greece (between May and June) and Ireland (between November and December), which prompted requests for financial assistance by these two economies. For the reasons explained in detail in Chapter 1 of this Annual Report, Spain was among the countries most affected by the ensuing crisis of confidence: the imbalances accumulated during the phase of expansion and some areas of vulnerability aggravated by the crisis (such as labour market rigidities or certain structural aspects of the functioning of savings banks) fuelled investors' misgivings. These tensions led to significant tightening of financing conditions in wholesale markets, where risk premia rose and funds became less readily available. The most strongly affected sectors were general government and credit institutions, which are the ones that raise most funds in these markets (see Box 6.1).

Given this situation, numerous measures were taken in the financial area

To address the crisis, European and national authorities took measures in various areas.[1] In the national financial area, which is the subject of this chapter, it should be remembered, first, that in 2009 the FROB had already been set up for the dual purpose of providing a solution for the institutions that had ceased to be viable and of promoting the integration of viable institutions by expediting their restructuring.

Action was taken in 2010 to increase financial transparency and so restore the confidence of investors in the Spanish financial system. Noteworthy here was the performance and publication, in coordination with the other EU authorities, of banking system stress tests in July 2010, which in Spain were conducted on a large number of institutions (well above the 50% required), including all savings banks. Moreover, the results were published in greater detail. Subsequently, first savings banks, and subsequently all other banks, had to make public their level of exposure to the real estate sector (at end-2009) and disclose expressly and in detail each type of transaction and the collateral taken, as well as the amount, broken down by category, of potentially troubled loans to the sector (non-performing, doubtful, standard under special surveillance and foreclosed).

In the regulatory field, summer 2010 saw a tightening of provisioning rules, which were already comparatively more stringent in Spain than in other countries. The new legislation hastened the requirement to provision all past-due loans, albeit recognising explicitly the value of collateral (after severe haircuts). Also, the requirements regarding foreclosed assets and assets given in satisfaction of debt were tightened to encourage their prompt sale. At that time savings bank law was reformed to remedy the main structural weaknesses of this sub-sector. More specifically, the professional standards required of savings bank managers and directors were tightened and new channels established for raising high quality funds, through, among other options, the indirect exercise of financial activity via a public limited company having the nature of a commercial bank and able to issue ordinary shares.

The resurgence of tensions at the end of the year was conducive to the approval of Royal Decree-Law 2/2011, which raised the minimum required core capital to 8% or 10% of risk-weighted assets, depending on certain characteristics of the institution (percentage of

1 For more details, see also Box 1.2 of this Annual Report.

THE IMPACT OF FINANCIAL MARKET TENSIONS ON RESIDENT SECTOR FINANCING

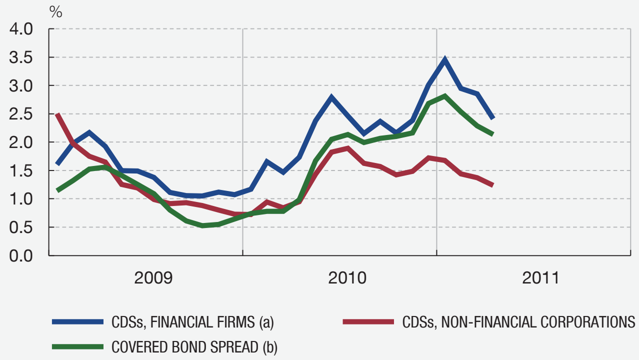
BOX 6.1

The public debt crisis caused problems of market confidence in various euro area are economies, with Spain among the countries most strongly affected. This meant that, in the two main waves of the crisis (in spring, centred on Greece, and in autumn 2010, in Ireland), risk premia rose on the securities issued by resident sectors and fundraising became more difficult, especially for credit institutions. In the two bouts of the crisis, the measures taken by Spanish and European authorities finally contributed to the easing of tensions.

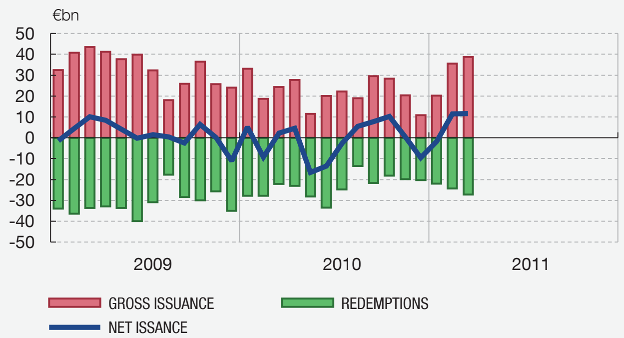
In the case of general government, the misgivings of the markets were accompanied by the downgrading of Spanish sovereign debt

1 TEN-YEAR SPANISH GOVERNMENT BONDS

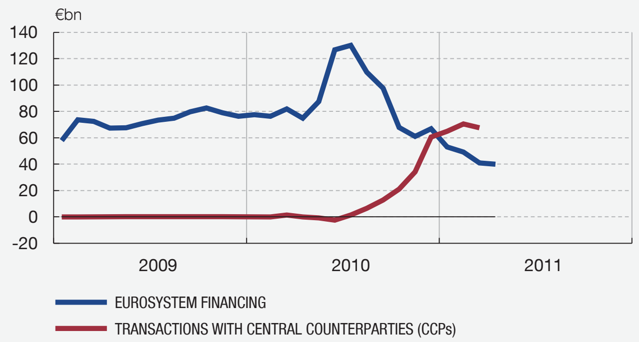
2 FIVE-YEAR CDSs AND SPANISH PRIVATE FIXED INCOME SPREADS



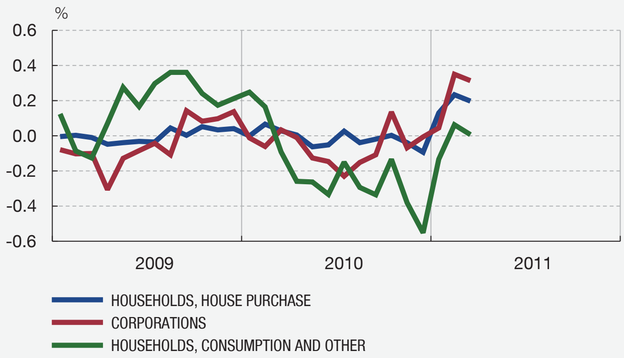
3 FIXED INCOME SECURITIES OF CREDIT INSTITUTIONS (c)



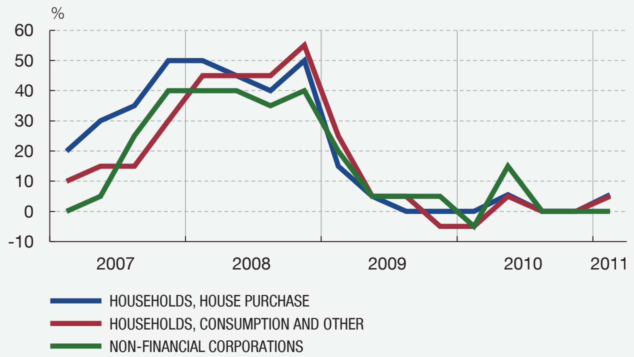
4 EUROSYSTEM AND CENTRAL COUNTERPARTIES (CCPs) FINANCING



5 SURPRISES IN LOAN INTEREST RATES (d)



6 CHANGES IN CONDITIONS OFFERED IN BANK LOANS (e)



SOURCES: BCE, JP Morgan and Banco de España.

a Arithmetic mean of eight institutions.
b Three-five year asset swap spread.
c Including financing through resident, but not non-resident, subsidiaries.
d Differences between the interest rates applied in new loans with the projections derived from a an interbank rate transmission model and the cyclical position of the economy (projections made with origin in January 2009).
e Indicator = % of institutions perceiving considerable tightening x 1 + % of institutions perceiving a certain tightening x 1/2 – % of institutions perceiving a certain relaxation x 1/2 – % of institutions perceiving considerable relaxation x 1.

(S&P downgraded it from AA+ to AA in April 2010, Fitch downgraded from AAA to AA+ in May, Moody's from Aaa to Aa1 in September 2010 and then to Aa2 in March 2011). As a result of the deterioration of investor confidence, the cost of issuance rose from below 3.9% for 10-year bonds in December 2009 to more than 5.4% a year later, while the spread with respect to the German bund, which was barely 60 bp in December 2009, rose to 200 bp in June and 290 bp in late November 2010 (see Chart 1). Subsequently, this risk premium tended downward amidst high volatility, although it continues to be high and subject to significant fluctuations.

Financial institutions, some of whose credit ratings were downgraded, were also affected by problems of investor confidence. Thus, the cost of issuing mortgage covered bonds (these assets, since they are secured by the best collateral, are those that have been most readily accepted by investors since the beginning of the economic and financial crisis) has increased considerably and, as result, the spread over the swap interest rate has risen from around 60 bp in 2009 to more than 290 bp on average in the closing months of 2010 (see Chart 2). Credit default swap (CDS) premia also increased. As with general government securities, in the opening months of 2011 the risk premia on securities issued by financial institutions decreased, although they remain well above their levels of 2009.

The crisis not only increased market financing costs, but also, when tensions were at a peak, affected the amount of funds raised by credit institutions. Thus, at the most critical time of the first wave of tension (in May and June), gross issuance by these institutions was insufficient to cover the maturities of outstanding debt (see Chart 3). Hence, like the banks of other European countries, they had to resort to the liquidity provided by the Eurosystem, a peak of €130 bn being reached in July (see Chart 4). At end-2010 net issuance again turned negative amidst the tensions accompanying the Irish crisis, but on this occasion banks were able to cover their funding needs through repos traded in international central counterparty clearing houses (such as LCH, Clearnet or Eurex Clearing), once some of them had become members of these systems which diversify the risks assumed by providers of funds. In this way, recourse to the Eurosystem was reduced.

The tighter fundraising conditions in the wholesale markets also lead to an increase in competition for deposits, which caused the interest rates on these transactions to rise during the year from 1.3% in February 2010 to 1.6% in March 2011. The increase in costs was not passed through immediately to household and corporate loans, since these had some leeway to absorb the shock. However, the increase in the margins applied to these transactions from the beginning of 2011 cannot be explained by their ordinary behaviour, indicating that a gradual pass-through seems to have commenced (see Chart 5. Hence, if the interest rates on new loans are compared with the projections derived from an interbank rate transmission model and the cyclical position of the Spanish economy, it can be seen that, both for house purchase loans to households and for loans to non-financial corporations, the rates remained in line with expectations for most of the year, but from early 2011 there was an increase in financial costs not explained by the model.[1] Also, according to the bank lending survey, credit institutions slightly tightened credit standards in 2010 Q2, mainly as a result of the effect of market tensions, although subsequently they seem to have held them unchanged until the opening months of 2011, when they again tightened them in the household financing segment (see Chart 6).

Turning to non-financial corporations, there was also an increase in the cost of raising funds in the markets, the channel used by the largest firms, although less so than by financial firms and general government (see Chart 2). Unquestionably, the high international diversification of non-financial corporations contributed to them being less affected by the financial tensions.

Although tensions eased in the opening months of 2011, spreads and risk premia continue to be high. The persistence or worsening of this situation would entail some risks for the Spanish economy. Thus, in the case of general government, the higher interest rates demanded by the market, although they slowly pass through to the debt burden (at the pace that maturing debt is rolled over), exert continuous pressure on public finances. This weakens the net interest income of banks because the higher cost of liabilities cannot be passed through to loans that have already been granted. Lastly, both non-financial corporations and households may have to face additional tightening of the credit standards for new loans, since financial institutions will have to pass through to their customers the higher cost of funding. Furthermore, if in extreme situations the difficulties of some institutions in refinancing their debt on the markets become more serious, the need to make a more thorough adjustment to their balance sheets may lead to stricter credit standards.

1 For more detailed information on the equations used in this projection exercise, see Nieto and Nieto (2011), *La transmisión de los tipos de interés de mercado a los tipos de interés bancarios en España*.

capital stock or voting rights held by third parties and relative weight of wholesale funding) and empowered the FROB to recapitalise those institutions failing to comply with these new requirements on their own.

In addition, the process of restructuring of the Spanish financial system initiated in the previous year was speeded up, so that by the cut-off date of this Annual Report the number of savings banks had been reduced from 45 to 18 institutions or groups. This process of integration has been accompanied by the restructuring of the institutions involved. The consolidation of the financial system, once it is operationally complete, will entail a significant decrease in capacity, which will help to reduce the excess size accumulated during the long expansionary stage. The implications of these changes are discussed in Section 4 of this chapter, although other regular publications of the Banco de España, such as the *Financial Stability Report* and the *Report on Banking Supervision in Spain*, discuss in greater detail the situation of the financial system and the restructuring and recapitalisation strategy.

… which contributed, along with others adopted at national and European level, to easing the tension, although risk premia remain at high levels and subject to high volatility

Since end-2010, Spain has tended to decouple from the countries most seriously affected by the market tension. The request for financial assistance by the Portuguese authorities in April 2011, and the deterioration in Portugal's sovereign spread which preceded it, did not, in fact, have an impact on Spanish financial variables comparable to that caused by the Greek and Irish crises. In any event, risk premia remain at high levels and subject to fluctuations linked to the varying market perception of the various events relating to the development and management of the sovereign debt crisis in the various countries.

Credit institutions have come under significant pressure…

Against this background, the activity of credit institutions has been subject to significant pressure. First, the sovereign debt crisis led to a significant rise in their funding costs, both on the wholesale markets and, indirectly, in funds obtained through deposits, because of the heightened competition for alternative sources of funds. Second, they have continued absorbing the losses derived from the impairment of assets relating to construction and real estate development, a segment in which doubtless asset ratios have continued to grow rapidly (see Chart 6.1).

… and, since early 2011, they have begun to pass through the higher cost of liabilities to loans

The cost of bank financing to households and firms has remained low. Since mid-2010, however, it has tended to increase as a result of progressive pass-through of the higher cost of financial institutions' liabilities to loan interest rates. This pass-through is not yet complete, so further increases will probably be seen.

Meanwhile, credit standards remained stringent and, according to the bank lending survey (BLS), tightened further during the past year, albeit moderately, and also during the first three months of this year in the household lending segment.

The debt of households and non-financial corporations continued to show little dynamism…

Against this background, household debt remained practically stagnant in 2010 and has contracted slightly since the beginning of 2011. In firms, bank credit decreased in real estate-related activities, and in other areas showed practically zero or slightly positive growth.

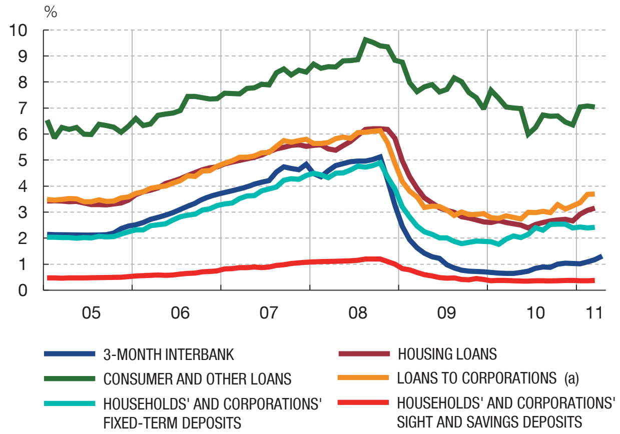
… although debt ratios scarcely changed due to the behaviour of income

Despite the stagnation of household liabilities in recent years, the debt ratio scarcely decreased from the high levels of mid-2008 due to income sluggishness (see Box 6.2). The notable weight of debt for house purchase and its long repayment period also help to explain the slowness with which household leverage is being corrected. Meanwhile, wealth again decreased in 2010, basically due to the loss in value of the real estate com-

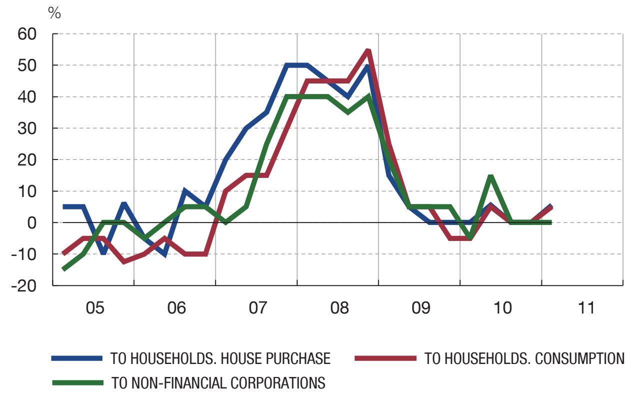
INTEREST RATES, LOAN CONDITIONS, CREDIT, HOUSE PRICES AND DOUBTFUL ASSETS RATIOS

CHART 6.1

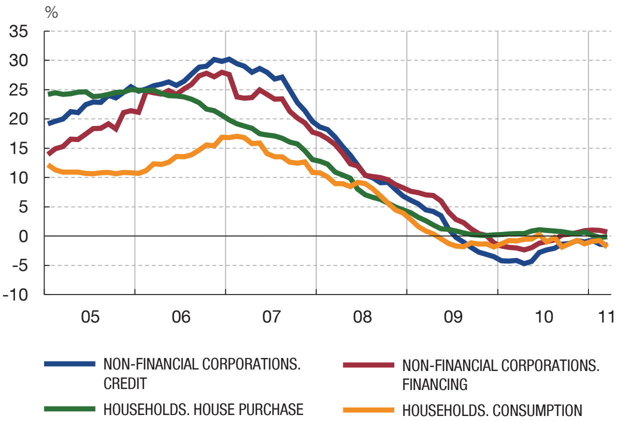
INTEREST RATES



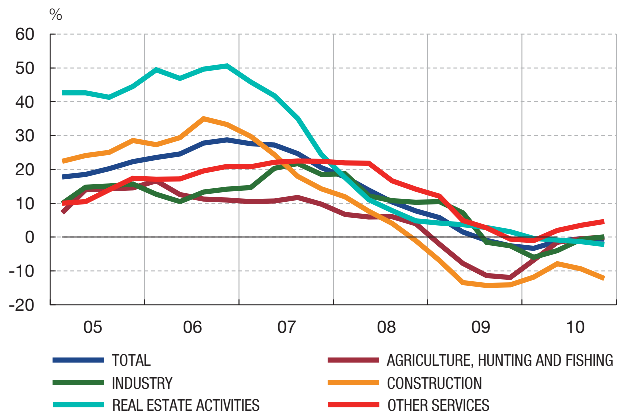
LOAN CONDITIONS OFFERED BY BANKS (b)



CREDIT EVOLUTION (c)

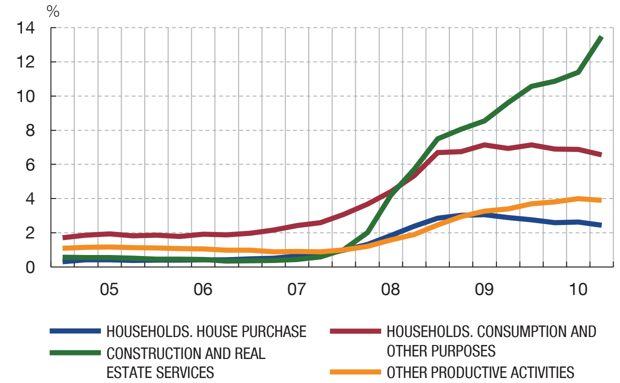


LENDING TO PRODUCTIVE ACTIVITIES
(Annual growth)



PRICE PER SQUARE METRE OF APPRAISED HOUSING

DOUBTFUL ASSETS RATIOS (d)



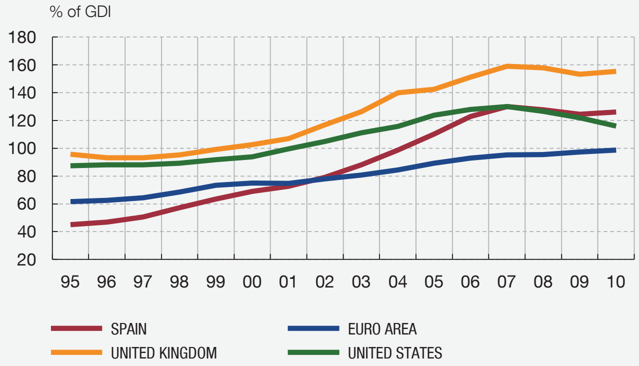
SOURCES: ECB and Banco de España.

a Calculated as a weighted average of the interest rates of various operations grouped according to their volume. For loans over €1 million, the interest rate is obtained by addding to the NDER (narrowly defined effective rate), which does not include commission and other expenses, a moving average of these expenses.
b Cumulative changes in the diffusion index so a positive sign denotes tightening.
c Year-on-year rates.
d Calculated as doubtful credit/total credit.

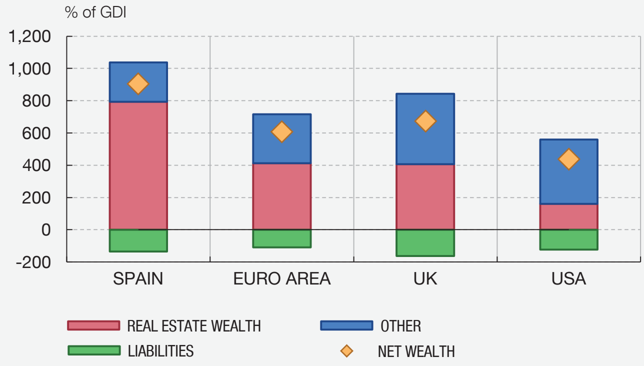
The notable increase in household and non-financial corporation liabilities between the mid-1990s and the outbreak of the crisis took the debt of both these sectors to historically high levels, above those in the rest of the euro area. Household debt currently stands at nearly 125% of gross disposable income, above the euro area average (98%) and similar to the ratio in the United States (one of the 19%), although below that in the United Kingdom (151%) (see Chart 1). Since the highs of mid-2008, which practically tripled those of the mid-1990s, the decrease in this indicator has been very slight (scarcely 5 pp). Two factors explain the slowness of this process: first, the weakness of household income in this period (denominator of the ratio), and, second, the long debt repayment periods of house purchase loans.[1] These loans constitute the bulk of the financing of this sector in Spain, and this, even in the current situation of little new lending, makes

1 On average, in Spain the residual maturity of collateralised loans is 14 years.

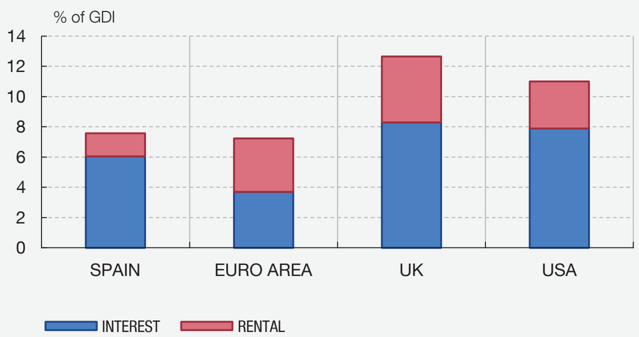
1 HOUSEHOLD DEBT RATIO



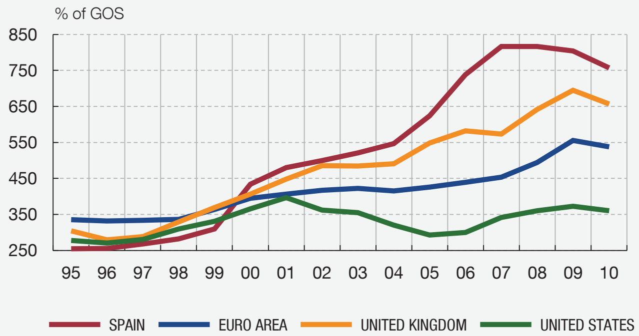
2 HOUSEHOLD GROSS WEALTH. 2010 (a)



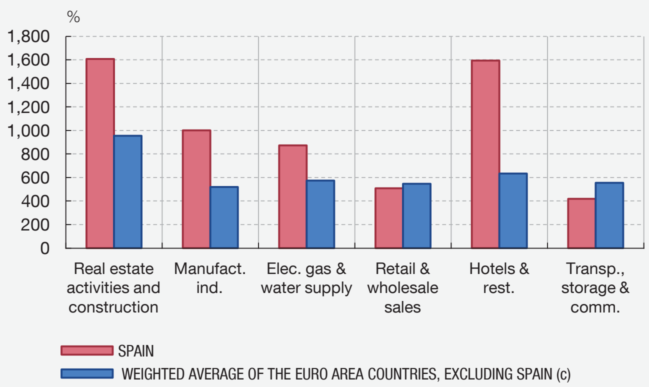
3 INTEREST AND HOUSE RENTAL PAYMENTS OF HOUSEHOLDS. 2009



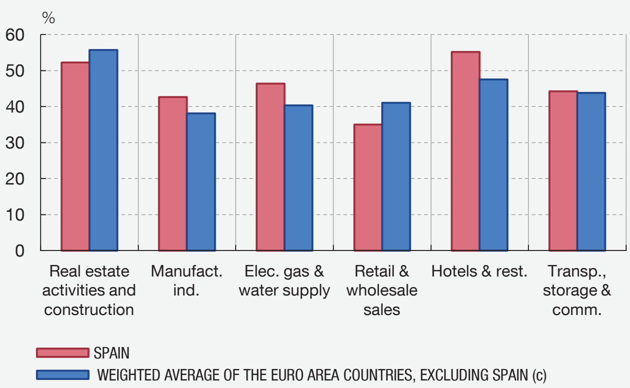
4 DEBT RATIO OF NON-FINANCIAL CORPORATIONS



5 DEBT (b) / GROSS OPERATING PROFIT OF NON-FINANCIAL CORPORATIONS. SECTORAL BREAKDOWN. 2009



6 DEBT (b) / TOTAL ASSETS OF NON-FINANCIAL CORPORATIONS. SECTORAL BREAKDOWN. 2009



SOURCES: Banco de España, INE, ECB, BACH, Eurostat, Federal Reserve, Bureau of Economic Analysis, UK Office for National Statistics and Bank of England.

a UK figures relate to 2009.
b Debt does not include short-term trade credit.
c GDP-weighted average of the ratios in Germany, France, Italy, Portugal and Belgium.

it difficult to reduce liabilities quickly. Deleveraging must thus be a process sustained over time, the duration of which will depend, among other things, on the economy's capacity to recover.

To assess the implications of the level of leverage, it is important to analyse the final purpose of the liabilities. In this respect, in Spain the higher household debt compared with other euro area countries can be traced to the residential mortgage component, since the ratio consumer credit is much the same fraction of gross disposable income as in other euro area economies. This, in turn, is related to the greater propensity to invest in housing in Spain (which reflects the greater preference for ownership and the popularity of second homes), with the consequent higher levels of wealth, even after deducting debt (see Chart 2). Unquestionably, the fact that a large part of these liabilities is secured by assets tends to mitigate some sources of vulnerability associated with such debt. The greater wealth of households would, in principle, allow them to save a smaller proportion of their income and to spend less on rental than the households of other economies with a lower percentage of owner occupancy (see Chart 3). However, this situation is not exempt from significant risks, for the following reasons. First, although there are no homogeneous statistics to allow a comparison of the total debt burden of households, all the evidence indicates that, as a proportion of disposable income, the debt burden in Spain is higher than the euro area average, even if rental expense is added in, which reduces the funds available for consumption. Second, since wealth is more concentrated in property ownership than in other countries, it tends to be less liquid, and thus less available for use in coping with unforeseen situations, and, in addition, it is more sensitive to changes in house prices, thus showing sharper negative wealth effects in situations like the present one of declining values. Lastly, a high level of debt increases vulnerability to interest rate rises (given the marked predominance of floating rate loans in Spain) or to adverse shocks in income (such as, for example, job loss). In this respect, the recent crisis has increased the percentage of households with debts which, as a result of the rise in unemployment, are in a more fragile position, which has naturally obliged them to cut spending more than if they did not have those financial obligations.

In the case of firms, corporate indebtedness in Spain, measured in terms of gross operating surplus, is higher than in the euro area as a whole and than in the United States and in the United Kingdom (see Chart 4). As with households, the scant dynamism of business profits has constrained the correction of the debt to income ratio in the last few years (since 2008 it has decreased by 12 pp, scarcely 1% of its value).

The aggregate corporate debt indicator conceals, however, a high sectoral dispersion. Thus, Chart 5 shows that in most areas of activity the debt to income ratio is higher than in the rest of the euro area, the difference being extremely marked in some of them. In the case of real estate activities and construction, which account for a significant part of corporate debt in Spain (practically half of bank loans, the main financing instrument used by firms). The high volume of debt in these cases basically reflects the ample stock of unsold real estate assets. As this stock is progressively absorbed, these liabilities will tend to be transferred to the agents which acquired the real estate (mainly households), although maybe some of these outstanding loans will end up being written off. All this will tend to reduce the debt ratio. Indeed, it is in firms of this type where debt adjustments have been sharpest in the last two years.

Also in manufacturing and in hotels and restaurants, the levels of debt are very high in comparison with those in other euro area countries, although, in these cases, the divergences have increased particularly sharply since the outbreak of the crisis due to the unfavourable trend in income. It can therefore be expected that a portion of the deleveraging will take place through the recovery of business surpluses. In fact, in terms of balance sheet size, the differences from other euro area economies are not so marked (see Chart 6). By contrast, in other sectors (wholesale and retail trade and transport, storage and communication), the leverage ratio is similar to or lower than in the rest of the euro area. In any event, the high corporate indebtedness detracts from the dynamism of investment because it makes it harder for firms to expand activity with debt financing, while the financial obligation to pay interest and repay principal reduce the funds available for expenses.

The deleveraging of the private sector initiated in the last few years is far from having concluded. The most important contribution to this process will come from the recovery of income. Therefore, actions taken to boost economic growth are the best way to quickly complete the process which will prevent the high debt from weakening spending, especially in a setting in which interest rates will tend to increase.

ponent as house prices fell by 3.5% in the year as a whole. With the 2011 Q1 figure, which showed an increased rate of contraction, the cumulative fall is 15% (20% in real terms) from the high at the beginning of 2008. It should also be kept in mind that there is a notable dispersion in wealth across the sector, so the aggregate indicators fail to capture the deterioration that may have taken place in the groups in a more fragile position, such as, for example, unemployed debtors. Also, the prolongation of the crisis and the pattern of slow recovery are eroding the resources that households can deploy to deal with the deterioration of their situation.

In the case of non-financial corporations, the recovery of business profits, the scant dynamism of borrowing and the lower average cost of outstanding debt gave rise to a slight decrease in the debt ratio and the associated debt burden. In any event, the leverage of the business sector as a whole remains high, although the dispersion within the sector is high.

The debt and debt burden of general government continued to rise

The fiscal consolidation programme implemented by general government was instrumental in slowing the sector's liabilities following the marked deterioration in public finances in 2009, although they continued to grow rapidly. This, together with the scant economic dynamism, led to an increase in the public debt ratio and in the debt burden to GDP ratio.

If the recent economic policy actions continue in the same vein as in the past, the recovery of investor confidence will firm, although risks persist…

Although financial market tensions have eased in the early months of 2011, the continuing high risk premia mean that the possibility of a worsening cannot be ruled out. This would be particularly injurious for an economy which continues to depend on the savings of the rest of the world. The higher cost of funding for institutions, the economic situation of some borrowers and financial institutions' exposure to the real estate sector continue to pose significant challenges. Therefore, the actions aimed at strengthening the economy's ability to grow and those designed to underpin the soundness of the financial system continue to be essential not only to restore the GDP growth rates needed to complete the convergence of the Spanish economy with the standards of the more developed European countries, but also to complete the process of recovery of investor confidence initiated at the beginning of the year.

… and the high private sector indebtedness continues to hinder the recovery of spending

The recovery of growth, moreover, is essential also for correcting the high leverage of the non-financial private sector, which has barely been corrected since the peaks recorded at the beginning of the crisis, and which continues to hinder the expansion of demand, since it reduces the scope for financing consumption and investment through borrowing and consumes a large part of the disposable income of the sector.

2 The Spanish financial markets

2.1 MARKET PRICES

The sovereign debt crisis has raised the financing costs of resident issuers in the fixed income markets…

Spanish financial market prices were strongly affected by the tensions arising from the sovereign debt crisis. The yields on general government securities rose and the spreads over the German bund widened (see Box 6.1). The rise affected all terms, although it was somewhat sharper in the short- and medium-term tranches of the yield curve (up to three years), where yields increased by nearly two percentage points (pp) in 2010 (see Chart 6.2). Also, funding costs of financial institutions increased as a reflection of investors' doubts regarding the situation of some savings banks. By contrast, the interest rates on securities issued by non-financial corporations increased more moderately, benefiting from the broad international diversification of the firms which use this type of instruments for financing.

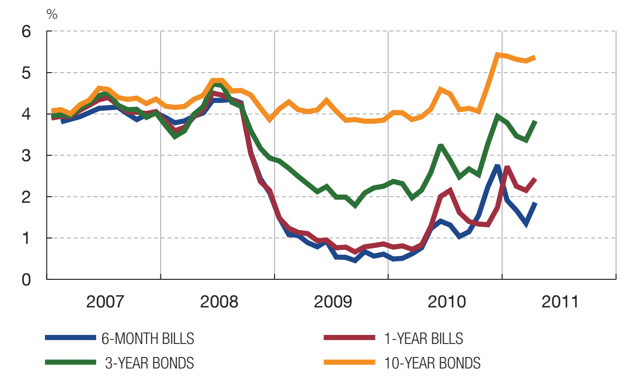
The period of highest tension came at the end of November. Subsequently, the risk premia of resident issuers tended to decrease. The behaviour of volatility was not unrelated to the measures taken by Spanish and European authorities. In any event, these premia remain high and subject to major fluctuations.

… and has caused stock market prices to fall and volatility to rise

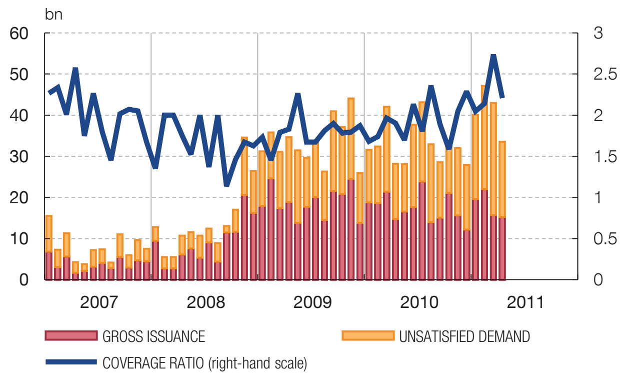
The turmoil also spread to the stock markets, where prices fell and volatility rose, ending the favourable trend seen since March 2009. At the time of greatest debt market tension (at the end of November), the IBEX 35 was down by 22.4% on its end-2009 level. This performance was worse than those of the EUROSTOXX 50, the EU stock exchange index, which at that date was down by 10.6%, and the US S&P 500, which was up by 5.9%. Among the sectors showing the sharpest falls were real estate (55%) and finance (33.6%). Subsequently, this trend reversed, and stock markets rose in most sectors, although volatility continued to be high.

FINANCIAL MARKETS CHART 6.2

SPANISH DEBT YIELDS (a)



PUBLIC DEBT AUCTIONS



STOCK EXCHANGE INDICES

IMPLIED VOLATILITY (b)

SOURCES: ECB and Banco de España.

a Monthly averages.
b Five-day moving average.

2.2 THE PRIMARY MARKETS

Net issuance of marketable debt securities decreased appreciably…

Net issuance of bonds by resident sectors fell sharply to €74 bn, compared with €190 bn in the previous year (see Table 6.1). This was explained basically by the decrease in net borrowing by general government and credit institutions, although it was also true that the tighter financing conditions in these markets did not favour the use of this means of financing.

The bulk of net bond issuance was by general government (€76 bn). This amount, which represented a decrease of €51 bn with respect to 2009, resulted from an increase in the volume issued by regional governments and a decrease in issuance by State government, these variations being in line with the changes in the borrowing needs of these two sub-sectors. Despite the tensions prevailing on financial markets and the downgrades in Spanish debt ratings by rating agencies, the Spanish bond auctions achieved ample coverage (demand to allotted funds) ratios, albeit at a progressively higher cost. Of the €63 bn issued by the State, more than 93% was medium and long term, meaning that the average life of outstanding debt was lengthened from 6.4 to 6.6 years, thus contributing to reduce the refinancing risk.

As a result of credit institutions' lower funding needs and of the wholesale market tensions, monetary financial institutions and their resident and non-resident subsidiaries made net redemptions of bonds amounting to €15 bn. There was a shift towards instruments involving lower risk. Thus, issues of paper guaranteed by the State and of covered

ISSUANCE AND PUBLIC OFFERINGS OF MARKETABLE SECURITIES — TABLE 6.1

€bn

	2007	2008	2009	2010
NET ISSUANCE BY RESIDENTS	268.3	145.9	199.7	89.5
FIXED INCOME	222.4	131.1	189.5	74.7
Monetary financial institutions	78.2	-26.9	39.6	7.8
Other financial intermediaries	146.5	104.6	21.5	-10.9
Of which:				
Financial vehicle corporations	*106.9*	*95.0*	*14.9*	*-5.9*
Subsidiaries of monetary financial institutions	*34.5*	*7.4*	*-8.8*	*-12.2*
Subsidiaries of non-financial corporations	*4.5*	*3.0*	*14.5*	*7.4*
Non-financial corporations	2.0	1.9	0.7	1.3
Central government	-4.7	50.2	119.4	63.2
Regional and local government	0.4	1.4	8.4	13.2
EQUITIES	46.0	14.8	10.2	14.8
Monetary financial institutions	12.0	10.0	3.0	6.6
Other financial intermediaries	3.5	1.4	0.4	0.1
Non-financial corporations	30.5	3.4	6.8	8.1
PUBLIC OFFERINGS	2.1	0.0	0.0	0.5
MEMORANDUM ITEM:				
Net issuance by foreign subsidiaries	9.5	12.9	-2.0	-8.9
Financial institutions	8.2	14.3	-3.4	-10.6
Non-financial corporations	1.3	-1.4	1.4	1.7

SOURCE: Banco de España.

bonds amounted, in net terms, to €12 bn and €13 bn, respectively, while gross placements of other instruments were less than maturities. Against a background in which the securitisation market continues to be inactive and in which institutions hold an ample volume of collateral, the balance of the securities issued by financial vehicle corporations (asset-backed bonds) fell for the first time in many years. By contrast, net issuance by non-financial corporations turned positive again (€10 bn, including that by resident and non-resident subsidiaries). The higher net borrowing by firms of this type (basically large multinationals), whose business is highly diversified internationally, and the fact that these have been less affected by the financial turmoil explain the greater dynamism of this primary market segment compared with that of financial firms.

… but, by contrast, issuance of equity securities increased

Equity issuance by both credit institutions and non-financial corporations increased, amounting in total to €15 bn, up 45% on 2009. However, it should be noted that this growth was heavily influenced by two specific transactions (one in each sector).

2.3 SECONDARY MARKET ACTIVITY

Secondary market trading varied depending on the segment

Secondary market activity varied across segments (see Table 6.2). In public debt, the volume traded remained somewhat below €19,000 bn, combining an increase in spot transactions, which grew by nearly 90% despite momentary liquidity problems following the outbreaks of tension in May and November, and a decrease in repo and sell/buy-back transactions. The fall in the latter is partly associated with problems of investor confidence since, when tensions peaked, investors perceived a high risk in bilateral repo transactions with Spanish institutions, believing there was a high negative correlation between the risk of default by financial institutions and the value of the asset used as collateral in these transactions (Spanish Treasury debt). In the second half of the year some institutions begin to oper-

TURNOVER ON SECONDARY AND DERIVATIVES MARKETS — TABLE 6.2

€bn

	2007	2008	2009	2010
PUBLIC-DEBT BOOK-ENTRY MARKET (a)	22,664	19,944	18,522	18,552
Spot	3,177	2,202	2,470	4,635
Repos and sell/buy-back agreements	19,193	17,477	15,903	13,761
Forward	294	265	150	156
AIAF FIXED-INCOME MARKET	900	2,401	3,692	3,658
Commercial paper	482	577	529	383
Covered bonds and asset-backed securities	329	1,740	2,849	2,413
Other	90	83	314	862
STOCK EXCHANGE: FIXED INCOME	90	80	75	67
STOCK EXCHANGE: EQUITIES	1,670	1,245	898	1,038
MEFF DERIVATIVES MARKETS	1,451	1,073	710	1,263
IBEX 35	1,384	989	622	1,158
Equity derivatives	68	84	88	105

SOURCES: Bolsas y Mercados Españoles, Federation of European Stock Exchanges and Banco de España.

a Only includes transactions in State securities.

ate in repo markets with central counterparties clearing houses, in which the supposed link is substantially diluted. In this way, trading was channelled partly through foreign trading platforms (such as BrokerTec or Eurex Repo), instead of through the Spanish debt market.

The volumes traded on the AIAF bond market remained around the levels of 2009. The decrease in spot transactions was offset by the increase in repo and sell/buy-back transactions. A major feature was the fall in covered bond and asset-backed bond transactions, which had grown notably in the previous two years. By contrast, the downward trend in equity market trading volumes since the outbreak of the financial crisis in 2007 was interrupted. The volumes of spot and derivatives transactions moved up above €1,000 bn and €1,200 bn, respectively. However, this increase also reflected, at least in part, the climb in average prices, which raised the unit value of transactions.

3 External investment in and financing of the Spanish economy

The financial tensions made it more difficult to raise funds abroad

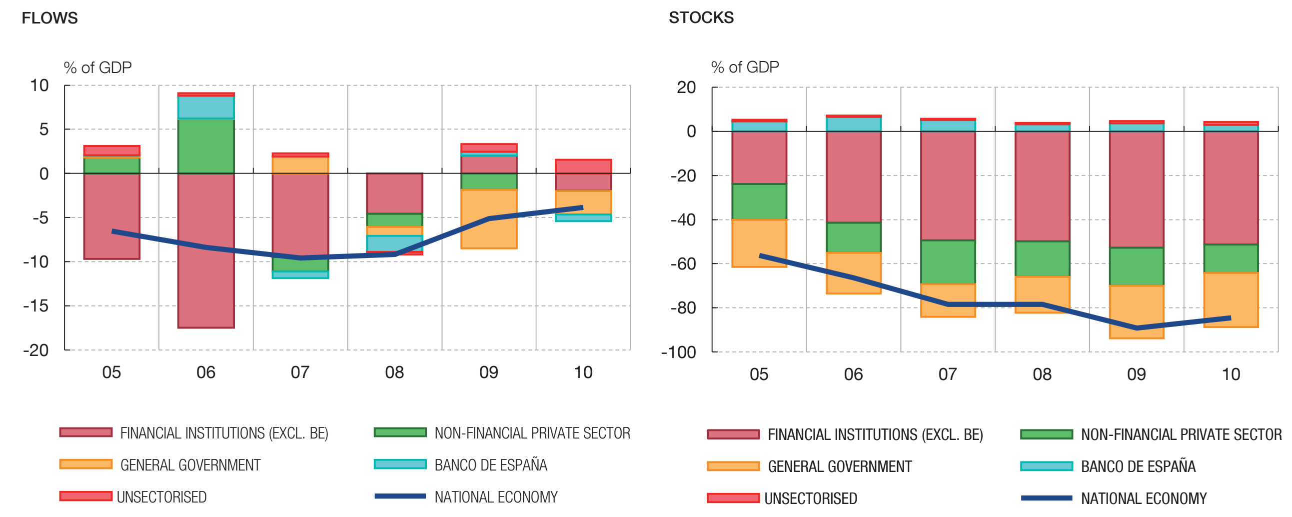
The nation's net borrowing decreased again last year, falling, in 12-month cumulated terms, to a figure equivalent to 3.9% of GDP (compared with 5.1% at end-2009, as shown by Chart 6.3). The behaviour of financial flows vis-à-vis the rest of the world evidences the considerable difficulties that the Spanish economy has had in raising funds abroad as a result of the euro area sovereign debt crisis.

Borrowing requirements were met through capital inflows channelled mainly in the form of instruments issued by general government and non-financial corporations…

In line with the lower borrowing requirements and the greater difficulty in raising funds as a result of the sovereign debt crisis, the funds received from abroad decreased again in 2010, being limited to a figure equivalent to 0.6% of GDP, down from the 4.9% recorded in the previous year and well below the 23.7% reached in 2007 (see Table 6.3). Capital inflows were channelled mainly through instruments issued by non-financial corporations and general government, specifically loans from the rest of the world and shares, in the first case, and fixed income securities, in the second case. The funds raised by the latter instrument by general government amounted to 2% of GDP. By contrast, the volume of securities issued by financial institutions held by the rest of the world decreased (by 1.1% of GDP in the case of credit institutions, and by 2.4% of GDP for other financial institutions including fi-

NET FINANCIAL ASSETS VIS-À-VIS THE REST OF THE WORLD
(Changes in and contributions of components)

CHART 6.3



SOURCE: Banco de España.

nancial vehicle corporations). There was also a slight decrease in the net debit position in the interbank market, along with an accompanying change in its composition. In particular, flows in the form of collateralised transactions increased considerably, being favoured by the trading in central counterparty clearing houses, and uncollateralised net transactions fell.

… and also through the reduction of external assets held by residents

The nation’s net borrowing was covered, lastly, by the reduction of external assets held by residents (3.3% of GDP). Noteworthy was the contraction in holdings of securities other than shares by an amount equivalent to 7% of GDP, in net terms, effected mainly by institutional investors and credit institutions. By contrast, there was an increase in acquisitions of shares and other equity securities (2.3% of GDP). In this line, the downward path followed over the past two years by Spanish foreign direct investment was interrupted and this item increased by 0.9 pp to 1.6% of GDP, an amount similar to that represented by the direct investment of non-residents in Spain, which also increased by nearly 1 pp.

The balance of the nation’s net liabilities decreased slightly

Despite the net negative sign of the nation’s financial transactions, the movements in prices (upwards in assets and downwards in liabilities) meant that the balance of the nation’s net liabilities to the rest of the world decreased by nearly 4 pp to around 85% of GDP, according to the Financial Accounts of the Spanish Economy (see Chart 6.3). External assets amounted to 130% of GDP, while gross liabilities were 215% (165% relating to gross debt and 50% to equity). Sectoral analysis shows that financial institutions had the largest net debit position vis-à-vis the rest of the world, followed by general government (amounting in the first case to 52% of GDP and in the second to 25.4%). The net debit position of the non-financial private sector is close to 13% of GDP, down 4 pp on the previous year.

4 Spanish financial intermediaries

4.1 CREDIT INSTITUTIONS[2]

The effects of the crisis in Spain and the tensions in financial markets set in motion a merger and restructuring process in financial institutions which particularly affected savings banks. The objectives of this process, furthered by the creation of the FROB in

2 For more details of the situation of Spanish credit institutions, see the *Report on Banking Supervision in Spain* and the *Financial Stability Report* of the Banco de España, the specialised publications of the Banco de España which discuss these subjects in greatest depth.

FINANCIAL TRANSACTIONS OF THE NATION
Cumulative four-quarter data

TABLE 6.3

% of GDP

	2007	2008	2009	2010
NET FINANCIAL TRANSACTIONS	-9.6	-9.2	-5.1	-3.9
FINANCIAL TRANSACTIONS (ASSETS)	14.1	0.7	-0.2	-3.3
Gold and SDRs	0.0	0.0	0.0	0.0
Cash and deposits	1.4	-1.3	-3.2	-1.4
Of which:				
Interbank, credit institutions (a)	*4.2*	*-0.5*	*-1.7*	*-1.3*
Securities other than shares	1.6	1.3	0.0	-6.9
Of which:				
Credit institutions	*1.8*	*1.5*	*1.2*	*-3.0*
Institutional investors	*0.0*	*-1.3*	*-0.5*	*-3.3*
Shares and other equity	8.8	1.7	1.6	2.4
Of which:				
Non-financial corporations	*6.6*	*3.0*	*0.1*	*2.4*
Institutional investors	*-1.1*	*-1.6*	*0.3*	*0.8*
Loans	1.2	0.8	0.2	0.4
FINANCIAL TRANSACTIONS (LIABILITIES)	23.7	9.9	4.9	0.6
Deposits	6.7	8.0	-0.5	-0.5
Of which:				
Interbank, credit institutions (a)	*6.7*	*6.2*	*0.7*	*-7.3*
Repos, credit institutions (b)	*0.1*	*0.2*	*0.1*	*5.7*
Interbank, BE (intra-system position)	*-0.3*	*1.9*	*-0.8*	*0.2*
Securities other than shares	8.1	-2.7	3.8	-1.5
Of which:				
General government	*-1.3*	*1.1*	*5.4*	*2.0*
Credit institutions	*3.6*	*-1.9*	*1.1*	*-1.1*
Other non-monetary financial institutions	*5.8*	*-1.9*	*-2.6*	*-2.4*
Shares and other equity	4.6	3.2	1.1	0.8
Of which:				
Non-financial corporations	*4.7*	*2.4*	*0.3*	*1.1*
Loans	3.1	2.9	0.3	1.2
Other, net (c)	0.2	0.2	-1.1	-1.7
MEMORANDUM ITEMS:				
Spanish direct investment abroad	9.5	4.7	0.7	1.6
Foreign direct investment in Spain	4.5	4.8	0.6	1.5

SOURCE: Banco de España.

a Excluding repos.
b Including transactions with central counterparty clearing houses.
c Includes, along with other items, the asset-side caption showing insurance technical reserves and the net flow of trade credit.

2010 saw a significant concentration in Spanish savings banks

2009, are various. First, after a period of vigorous growth in banking activity, the system as a whole had reached a size which, although commensurate with the relative weight reached in other developed economies, was excessive in a scenario characterised by a moderating trend in the growth rate of financial activity and by the need for deleveraging of a significant portion of Spanish households and firms. The concentration of financial institutions also aims to achieve synergies and economies of scale to make for more efficient financial intermediation. A larger size of the resulting groups should make it easier to achieve additional increases in efficiency and to access the capital markets. Along these same lines, the exercise of savings bank financial activity by limited liability companies licensed as banks broadens the range of instruments accessible to the latter, enabling them to issue ordinary shares. Finally, the process under way contributes to strengthening the solvency of the sub-sector and to improving its management capacity, since some of the more vulnerable institutions are now being absorbed by others in a stronger position.

Although the process of concentration is not limited only to savings banks, most of the concentration transactions are taking place in this sub-sector. This is basically because of the more pronounced imbalances accumulated in the phase preceding the crisis: faster balance sheet growth and excess capacity, greater need to raise funds through the issuance of securities on wholesale markets instead of traditional instruments and a higher exposure to the real estate development sector. Nor should it be overlooked that these institutions were characterised by a singular corporate structure which hindered the issuance of high-quality capital instruments (voting shares) in a crisis situation, when the volume of internally generated funds decreases considerably. Recent events have also demonstrated the need for substantial improvements in the governance of these institutions.

The process has been supported only partially by government aid and accompanied by the recapitalisation of institutions

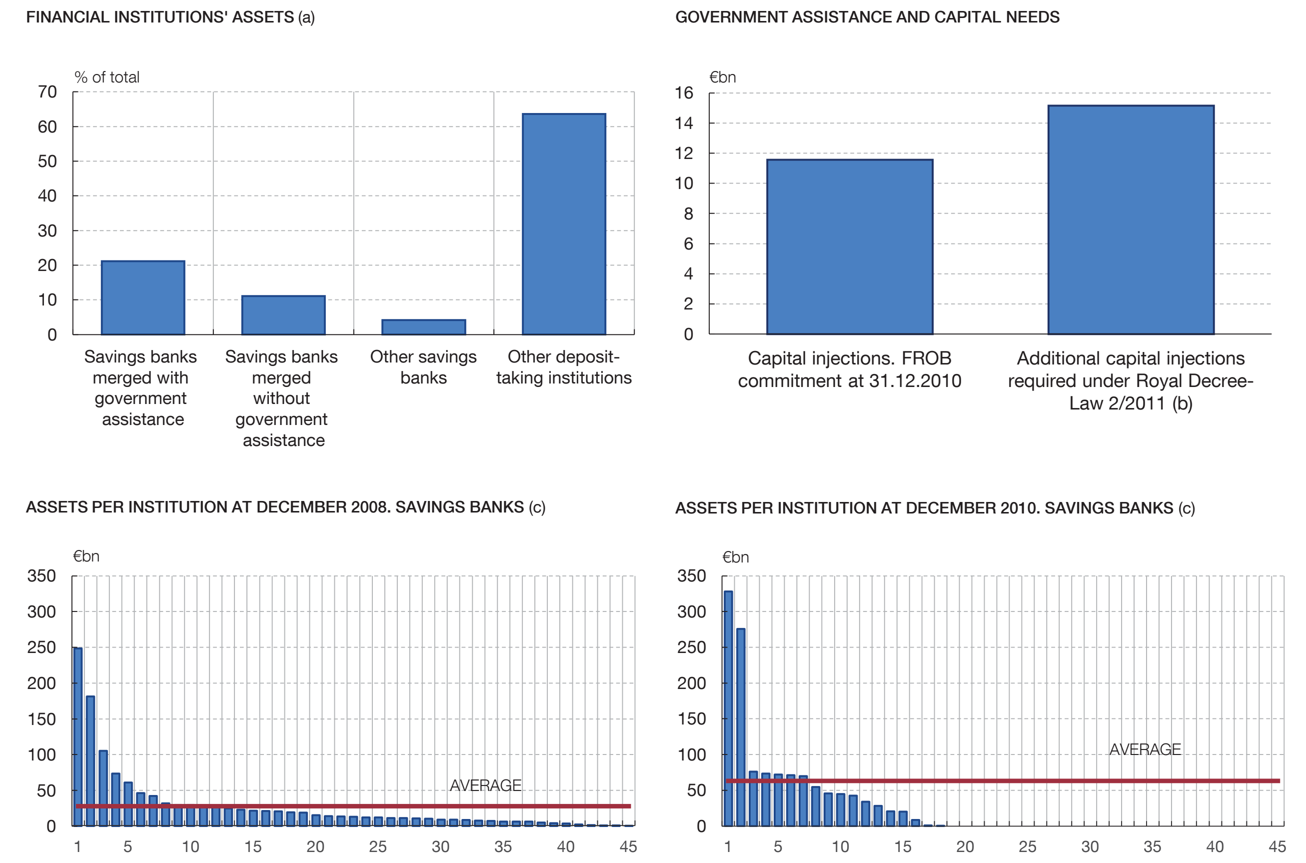
As shown in the top left panel of Chart 6.4, the processes of concentration under way have involved most of the savings bank sector, although not all savings banks have made use of government funds. In terms of the credit system as a whole, the savings banks involved in mergers with assistance from the FROB represent somewhat more than 20% of total assets, while those that have undertaken processes of this type without the use of government funds represent 11% of the total.

In this process up to December 2010, the FROB had committed a total of €11,559 million (see top right panel of Chart 6.4). On 10 March 2011, the Banco de España made public the additional amounts to be raised by the various Spanish credit institutions to comply with the new capital requirements approved at the beginning of 2011 on the basis of their situation at 31 December 2010. In all, they amount to a €15,152 million, of which €14,077 million related to savings banks. Subsequently, the initial project of the Banco Base institutional protection scheme (IPS), for which assistance of €1,493 million had been earmarked (this amount was included in the aforementioned €11,559 million), was aborted and the two institutions or groups resulting from that rupture designed their recapitalisation strategies to meet the new needs derived from the provisions of Royal Decree-Law 2/2011. This entailed some changes with respect to the situation in March. In any event, the amount of the sector's recapitalisation needs finally covered by the FROB will depend on the private funds raised by institutions and on their possible strategic decisions on asset sales or concentration transactions. However, in any event, the final outcome will be that Spanish intermediaries will find themselves, in September of this year (or March 2012 at the latest) with a minimum core capital[3] ratio of 8% or 10%, depending on the characteristics of the institution.

3 Defined in Royal Decree-Law 2/2011 of 4 March 2011. For more details, see Box 1.2 of this Annual Report.

FINANCIAL SYSTEM RESTRUCTURING

CHART 6.4



SOURCE: Banco de España.

a Data drawn from consolidated balance sheets as at 31.12.2010. Situation at the beginning of May 2011.
b Estimated amounts, based on data at 31.12.2010, required to comply with Royal Decree-Law, according to the BE publication of 10 March 2011.
c Consolidated data. Those relating to December 2010 take into account the group structure at the beginning of May 2011.

All this has brought a substantial change in the structure of the savings bank sector

Although the process is still under way, the changes in 2010 entailed a significant transformation of the Spanish savings bank sector. In terms of the size of institutions and of their degree of concentration (see the bottom panels of Chart 6.4), it brought an increase in average size from €28 bn at end-2008 to €70 bn two years later. The number of savings banks decreased from 45 to 18 savings bank institutions or groups.

Institutionally, the process took the form of both mergers (seven operations) and the formation of IPSs (five operations). The latter necessarily involve the formation of a commercial bank which acts as the central institution of the IPS, carrying out its financial activity and to which the bulk of the group's assets have been or will shortly be transferred. In this way, practically all financial activity is transferred to institutions which are limited liability companies, thereby altering the previous corporate structure. This movement was strengthened by the reform of the savings bank law and by the capital reinforcement requirements laid down by Royal Decree-Law 2/2011.

The savings bank law reform included in Royal Decree-Law 11/2010 of 9 July 2010 made it possible for all savings banks to indirectly exercise their financial activity through a commercial bank. Subsequently, Royal Decree-Law 2/2011 accentuated this trend by encouraging the entry of private investors in the capital of institutions. The intention here is to foster more professional management, increase the role of market discipline and, at the same time, make it easier to raise additional top-quality capital where necessary. The Royal Decree-Law also increases the minimum level of core capital (10%, as against 8%) for those institutions that have not distributed to third parties equity securities representing 20% or more of their capital and raise a significant portion of their funds in the wholesale financial markets. Compliance with the first part of these requirements requires the existence of an institution legally organised as a limited liability company which can issue these securities, leaving to one side the possibility of issuing non-voting equity units ("cuotas participativas") of savings banks. In addition, it is made compulsory to choose the option of indirect exercise of financial activity in order to be eligible for the new assistance from the FROB, which in all cases will take the form of acquisition of ordinary shares of the group. These acquisitions will necessarily be temporary and the related securities will be resold to private investors and within a maximum of five years, whereupon the final result will be the same.

On 14 April of this year the Banco de España approved the various strategies which the institutions involved had drawn up to meet the new capital requirements. Two weeks later, on 28 April and within the legally stipulated time period, those savings banks or groups of savings banks which have chosen the FROB as the primary source of capital funding to meet these new requirements submitted their plans.

Total assets in Spain remained stagnant and the number of branches and staff decreased

Against this background, the consolidated total assets of Spanish institutions as a whole increased slightly as a result of the growth of business abroad, since that in Spain remained practically stagnant, for the second year running (see Table 6.4).[4] Moreover, in December the number of branches and staff in Spain had decreased by 6% and 5%, respectively, from their peaks in 2008, and the institutions involved in merger processes with FROB support recorded the provisions needed to cover the cost of the agreed headcount and branch network reductions over the next few years.

There was a decrease in the volume of credit granted

The credit granted to the resident private sector also shrank slightly. According to the bank lending survey, this seems to be due to sluggish demand and shrinking supply. Demand remained basically stagnant in the case of non-financial corporations, fluctuated throughout the year with no clear trend in respect of household residential mortgages and performed somewhat more negatively in consumer credit and other lending to households. The credit standards for the approval of new loans continued to be strict and generally tightened slightly in 2010 Q2, mainly as a result of wholesale financial market tensions, although subsequently they remained steady. In the early months of 2011 they tightened further in the household credit segment.

… and the cost rose moderately

The interest rates applied in new loans to households and non-financial corporations remained low. However, from the beginning of this year institutions have begun to pass through more actively the higher cost of their liabilities to their lending rates. This has resulted in a rise of between 55 basis points (bp) and 115 bp in the cost of bank financing to households and firms between June 2010 and March 2011.

...partly influenced by the financial market tensions

The difficulty in raising funds on the wholesale markets and their higher cost meant that the institutions temporarily had to resort more to the Eurosystem in spring and summer. Subsequently, such recourse to the Eurosystem decreased to account for only 1.4% of the consolidated total balance sheet at December 2010 (against 2% a year earlier) and have continued to decrease during this year. Their place has basically been taken by funds from

4 Owing to the restructuring carried out in the last few days of the year, the figures for 2010 had to be adjusted to make them comparable with those for 2009. This comparison must therefore be interpreted with caution.

CREDIT INSTITUTIONS
BALANCE SHEET AND INCOME STATEMENT (a)

TABLE 6.4

	CONSOLIDATED			INDIVIDUAL		
	Dec-09	Dec-10	Y-o-y rate (%)	Dec-09	Dec-10	Y-o-y rate (%)
MAIN BALANCE SHEET ITEMS (% of TA)						
TOTAL ASSETS (€bn)	3,739.9	3,816.5	2.0	3,142.4	3,122.0	-0.6
Credit	64.1	63.4	0.8	61.5	61.2	-1.2
Of which: resident private sector in Spain				56.1	55.4	-1.8
Debt securities	13.5	12.8	-3.4	13.2	12.7	-4.6
Other assets	22.4	23.8	8.8	25.3	26.1	2.6
LIABILITIES						
Banco de España and other central banks	3.3	2.5	-23.2	3.6	2.4	-33.7
Interbank deposits (b)	14.2	15.6	12.0	17.6	19.6	10.5
Customer deposits (c)	49.6	50.6	4.1	50.5	49.9	-1.7
Of which: households and non-fin.corps. res. in Spain				29.3	30.4	3.1
Marketable securities	17.0	14.6	-12.2	12.5	11.4	-9.6
Other liabilities	9.8	10.9	13.2	9.8	11.0	12.1
Equity	6.1	5.8	-2.4	6.0	5.6	-6.9
INCOME STATEMENT (% of ATA)						
(+) Interest income	4.10	3.35	-15.7	3.42	2.54	-25.0
(–) Interest expense	2.12	1.57	-23.7	1.97	1.39	-28.8
Net interest income	1.98	1.78	-7.1	1.45	1.15	-19.9
Gross margin	3.01	2.78	-5.1	2.26	2.10	-6.3
(–) Operating expenses	1.30	1.32	4.1	0.98	0.97	0.0
(–) Write-downs of and provisions for financial assets	1.05	0.85	-14.9	0.77	0.72	-4.3
Operating profit	0.67	0.61	-7.6	0.53	0.42	-21.1
After-tax profit	0.54	0.47	-10.0	0.42	0.32	-23.7
RATIOS (%)						
Solvency	12.2	11.9				
Doubtful assets/TA	3.1	3.5		3.1	3.5	
Foreign operations/TA	23.3	26.3				
Efficiency (OE/GI)	43.1	47.2		43.2	45.1	
ROE (d)	9.3	7.5		7.1	5.7	

SOURCE: Banco de España.

a Owing to the restructuring processes carried out in the closing days of the year, the 2010 figures have had to be adjusted to make them comparable with those of 2009. This comparison therefore had to be regarded with some caution.
b Including money market transactions with central counterparties.
c Including liabilities to securitisation financial vehicle corporations.
d Although stated at both consolidated and individual level, it should be noted that this item is more representative in the former case, since the individual figure does not include all group operations.

repo transactions carried out through foreign central counterparties. The net funds raised in this way amounted to around €60 bn at end-2010, against a value of practically zero at the beginning of that year. Nevertheless, the market tensions also prompted fiercer competition for deposits from the public, the cost of which increased significantly (54 bp between December 2009 and March 2011, in time deposits).

Cumulative provisions and write-downs are high

Credit institutions also recorded significant write-downs. Thus, while the growth rate of doubtful assets moderated (from year-on-year growth of 48% in 2009 to 15% in 2010), provisions continued to increase at a rate of more than 25%. In 2010 additional provisions were charged to cover losses on foreclosed real estate and other commitments relating to planned staff reductions. In all, from January 2008 the sector has recognised and borne €96 bn of losses on its assets, representing approximately 5% of total credit to the private sector at December 2007 and 9% of GDP.

Write-downs and the contraction of net interest income resulted in a fresh decline in profits in 2010

Provisioning charges, along with the contraction in net interest income, resulted in a further decrease in net profits, which, however, remained positive (see Table 6.4).

The new capital requirements and the increased transparency should help to normalise access to market funding, although significant challenges persist

Despite the lower profits earned, Spanish credit institutions continued to increase their top-quality capital (core capital) until it accounted for 9.5% of total risk-weighted assets at end-2010 (including contributions from the FROB). At the same time, the overall solvency ratio decreased slightly from 12.2% in December 2009 to 11.9% twelve months later. During 2011, as a result of the new requirements approved by the government in February, the less well capitalised institutions are making additional advances in this respect.

In any event, institutions still face significant challenges relating to the still-fragile economic situation of some of their borrowers, the higher cost of their funding sources and their exposure to the real estate sector, so they will have to continue making efforts to strengthen their financial position and reduce their cost structure.

4.2 INSTITUTIONAL INVESTORS

The competition from bank deposits and the high perception of risk by savers continued to affect the sector negatively

The activity of institutional investors continued to be affected by the competition for funds in the form of bank deposits and by the still high perception of risk by savers. This led, yet another year, to a decline in the net assets of collective investment companies and funds and to a modest increase in the case of insurance companies and pension funds (see Chart 6.5).

Holders of investment funds made net redemptions during the year, these withdrawals being most notable in those institutions with a more conservative investment policy (money market funds and short-term bond funds), which are the ones that compete most directly with credit institutions. Meanwhile, the renewed financial market tensions led to lower yields than in the previous year, practically across the board. Against this background, management entities continued to market mainly instruments of the conservative nature. The high debt issuance by Spanish general government and the greater preference for instruments issued by residents favoured a further increase in the holdings of securities of this type, while external assets decreased.

Investment by private equity institutions showed a notable recovery in comparison with the previous year, albeit based mainly on the activity of foreign operators. By contrast, the funds raised by Spanish private equity institutions decreased slightly with respect to 2009, as did those raised by real estate funds and hedge funds.

The process of savings bank concentration may affect the structure of the sector in the coming quarters, given the significant weight of savings bank subsidiaries in collective investment.

5 The financial flows and balance sheet position of the non-financial sector

5.1 HOUSEHOLDS

Following its significant deceleration between mid-2006 and end-2009, household debt remained practically flat in 2010 as a result of a slight increase in that incurred for real estate purchases and a moderate decrease in consumer credit and other lending. Since the beginning of the current year, it has contracted slightly as a result of a decrease in both these components.

INSTITUTIONAL INVESTORS

CHART 6.5

SOURCES: Comisión Nacional del Mercado de Valores, Banco de España and Dirección General de Seguros y Fondos de Pensiones.

a Shares and other equity in CIIs and reserves of insuranece 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.

Household debt remained practically stagnant but the scan dynamism of income prevented the debt ratio from decreasing, while wealth and the debt burden continued to fall

Despite the scat momentum of household debt, the debt ratio of the sector remained steady due to the stagnation of income and to the high relative weight of debt for house purchases and the long mortgage loan maturities, which also influence the dynamics of household deleveraging (see Box 6.2). This indicator thus continues at high levels (at end-2010 it was around 125% of GDI, some 5 pp below the peak at mid-2008; see Chart 1 of Box 6.2). Meanwhile, net wealth continued to fall, basically as a result of the declining value of the real estate component, and, to a lesser extent, of the financial component. The debt burden also decreased again because of the fall in the average cost of financing (see Chart 6.6). However, this indicator captures movements in interbank interest rates with a certain lag, so foreseeably the rise in these rates since mid-2010 will gradually pass through to debt service in the next few quarters.

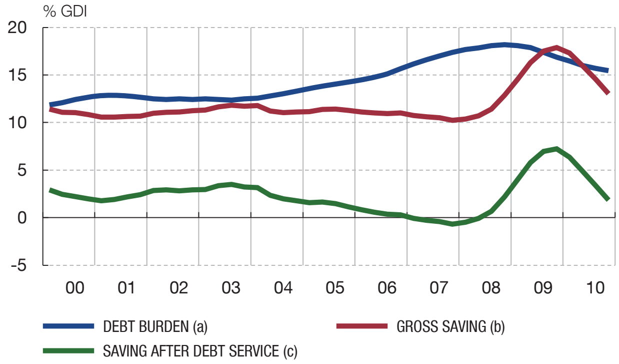
The doubtful loans ratio decreased

The lower debt burden contributed to a slight fall in the doubtful asset ratios of the sector in 2010 (in the previous three years they had trended upwards), both for house purchase loans and for consumer credit and other lending (down by 0.4 pp in both cases to stand at 2.4% and 6.6%, respectively).

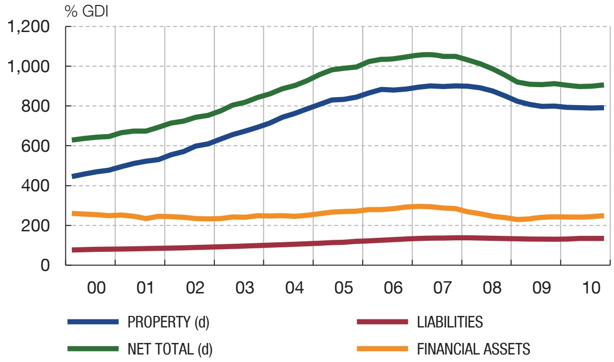
INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs

CHART 6.6

DEBT BURDEN AND SAVING



WEALTH



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

a Estimated interest payments plus debt repayments.
b Balance of use of disposable income account.
c Gross saving less estimated debt repayments.
d 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.

This aggregate situation is compatible with a more vulnerable financial position of some segments of the population

The latest available information from the survey of household finances shows that between 2005 and early 2009 the level of financial pressure increased more markedly in some segments which are comparatively more vulnerable. In households in which no member works, the proportion of those with some type of loan increased by more than 6 pp (the equivalent of somewhat less than 2% of total households) during this period to 21%, while for the sector as a whole the rise was practically zero. This change, however, basically reflects the fact that a significant number of the members of indebted households moved from employed to unemployed status. In the households in which no member works, the percentage of those with a debt burden exceeding 40% of their income stood at nearly 25% at the beginning of 2009 (as against 16.6% for indebted households as a whole). By age group, younger households showed the largest increases in the proportion exceeding this threshold. Thus, for example, in households headed by a person below age 35 (10% of household units), it rose to 24% (9.2 pp more than in 2005).

5.2 FIRMS

Corporate financing showed greater dynamism from mid-2010 onwards, although it varied significantly across sectors

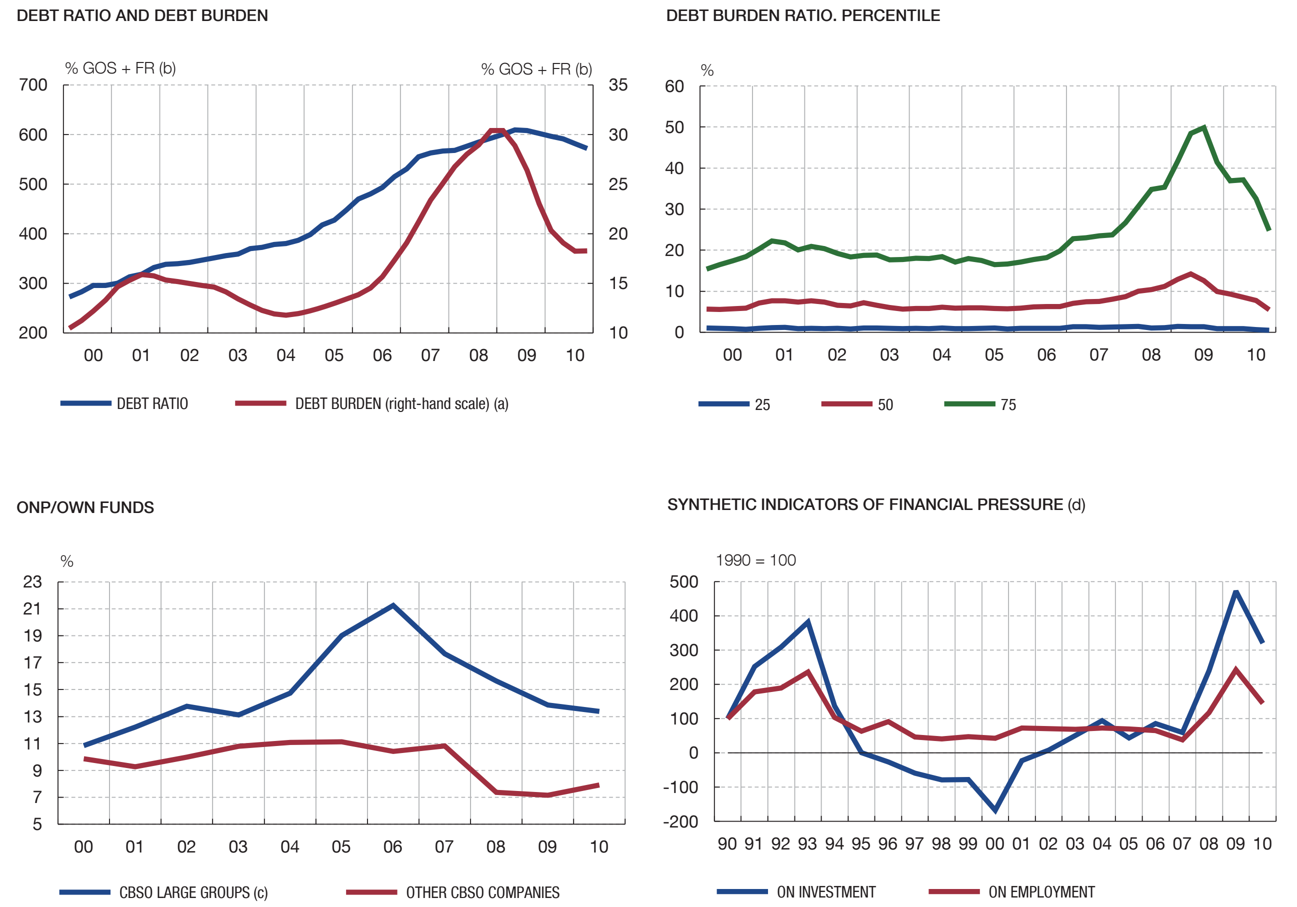
From mid-2010, the debt of non-financial corporations has followed a path of recovery and from 2010 Q3 its growth rate has been slightly positive. By instrument, this came about because lending by resident credit institutions contracted more slowly and lending by non-residents picked up, while financing obtained via fixed income securities continued to grow quickly. Behind this recovery are a number of differing sectoral patterns, consistent with a process of selective deleveraging across the various areas of activity. Thus those linked to the housing market continued to show negative growth rates of bank credit, while the others posted year-end growth rates that were positive or around zero (see Chart 6.1). The available information indicates that the differences between larger firms and SMEs (in areas unrelated to the real estate sector) seem to be less marked than those observed in the more acute phases of the crisis.

The sector became a net lender for the first time since 1998

Net borrowing by firms showed a credit balance for the first time since 1998, for an amount equivalent to 1.3% of GDP, according to the Financial Accounts. However, the financing gap, which approximates the funds required to bridge the difference between gross corporate saving and gross capital formation plus permanent foreign investment, was positive and stood at 0.8% of GDP, 0.5 pp less than a year earlier.

INDICATORS OF THE FINANCIAL POSITION OF NON-FINANCIAL CORPORATIONS

CHART 6.7



SOURCE: Banco de España.

a Estimated interest payments.
b Gross operating surplus plus financial revenue.
c 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.
d Indicators based on debt, debt burden and profit ratios of the firms reporting to the CBSO annual and quarterly surveys, appying coefficients to take into account the impact of these variables on investment and employment and to reflect the importance of each firm in the total in terms of the stock of capital and of employment. A value of more (less) than 100 indicates higher (lower) financial pressure than in the base year. For more datails, see Hernando and Martínez-Carrascal (2003), *El impacto de la posición financiera de las empresas sobre la inversión y el empleo, Boletín Económico,* November, Banco de España.

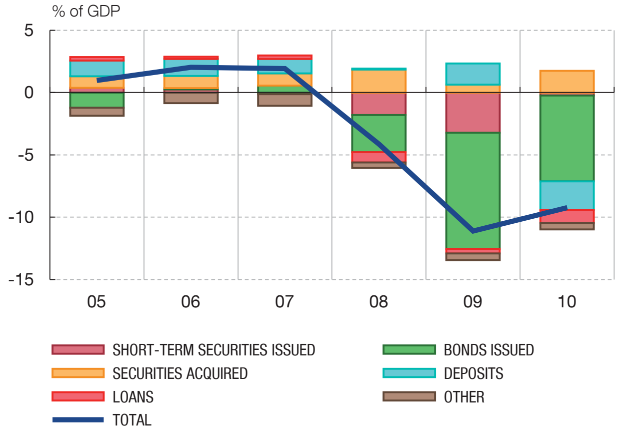
The financial position indicators of firms showed a certain improvement

The aggregate financial position of the sector showed a certain improvement. The recovery of economic results and the scan dynamism of liabilities meant that the debt ratio decreased slightly and profitability increased. This performance, along with the decline in the average cost of outstanding debt, allowed the debt burden to drop (see Chart 6.7). Moreover, in the sample of firms reporting to the Central Balance Sheet Data Office Quarterly Survey (CBQ), the dispersion of the distribution of these ratios decreased, since the improvement was more marked in those firms in a more unfavourable financial position. The overall effect of this was a reduction in the synthetic indicators of financial pressure on investment and employment, from the peaks reached between the end of 2009 and the beginning of 2010 (see Chart 6.7). These developments at aggregate level were compatible with uneven behaviour across sectors. Thus, according to the CBQ, the improvement in these indicators was most apparent in industry, a sector which had recorded a particularly marked deterioration in 2009. Further, analysts revised upward the profit expectations of listed companies in 2010, both for the long-term and for the short-term, and the growth rate for the latter turned positive.

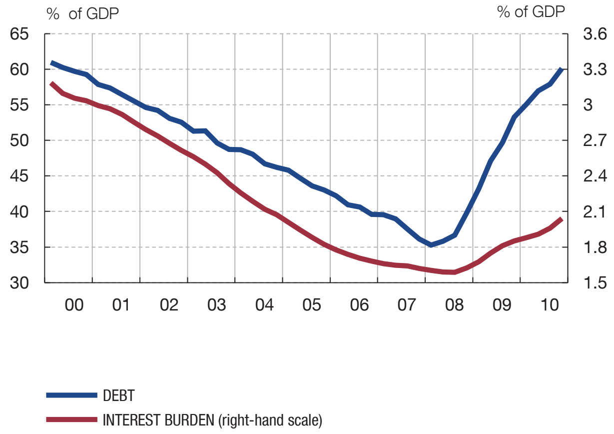
GENERAL GOVERNMENT

CHART 6.8

NET FINANCIAL TRANSACTIONS
BREAKDOWN BY INSTRUMENT (a)



DEBT RATIO AND INTEREST BURDEN



SOURCE: Banco de España.

a A positive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilities.ation x 1.

Despite decreasing slightly, corporate debt continues to be high (around 800% of gross operating surplus), with no significant reduction since 2008. This ratio is particularly high in some sectors, such as construction and real estate services (see Box 6.2), where the doubtful assets ratio increased most sharply and reached 13.5% at end-2010 (against 3.9% in other sectors).

5.3 GENERAL GOVERNMENT

Public sector net borrowing decreased, although it continues to be high…

The fiscal consolidation efforts made enabled the budget deficit to be reduced to 9.2% of GDP, 1.9 pp less than in 2009. The breakdown by instrument shows that the budget deficit was basically covered by long-term securities issuance for a net amount equivalent to 6.9% of GDP (see Chart 6.8). Moreover, general government acquired securities amounting to 1.7% of GDP, these investments being partly linked to the measures to support the financial system.

… which gave rise to a significant rise in the sector's liabilities and, as a result, in the debt and debt burden ratios

Despite slowing, the sector's liabilities rose notably (their growth rate was 13.8%). This, along with the scant dynamism of GDP, resulted in an increase in indebtedness, which reached 60% of GDP at end-2010, nearly 7 pp more than in the previous year, and in the associated debt burden, albeit moderate taking it to 2% of GDP. Despite the rise in market interest rates, the average cost of liabilities scarcely changed, due to the slowness with which these movements pass through to interest payments.

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 2010. Some of these aspects will be addressed in greater detail in the monographic reports published annually by various departments of the Bank (Banking Supervision, Balance of Payments, Claims 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

As in previous years, in 2010 the Banco de España's activity as a Eurosystem member was intense. The Governor took part in the regular meetings of the Governing Council and the General Council of the ECB at which decisions on monetary policy, inter alia, were taken, as is explained in detail in Chapters 1 and 4 of this *Annual Report*.

The Banco de España's activity with respect to committees and working groups was intense

A large number of professionals from the Banco de España participated in the committees, working groups and other Eurosystem bodies which prepare meetings and assist the ECB's governing bodies in their decision-taking.

In the context of the activities related to the Monetary Policy Committee (MPC), the Bank participated actively in the regular forecasting exercises of the Eurosystem and the ECB and in the drafting of the report on public finances as well as that prepared annually by the Committee on structural features which this year covered retail trade and its impact on price setting.

Also, as a member of the MPC and in coordination with the Market Operations Committee (MOC), the Banco de España contributed to adapting the operational framework to the circumstances arising from sovereign debt market instability which meant the reintroduction of certain exceptional measures to provide liquidity (that had begun to be withdrawn at the beginning of 2010) and the introduction mid-2010 of the Securities Markets Programme to acquire securities on the secondary market. The Banco de España took part concurrently in the discussions about the design of the strategy to withdraw the exceptional measures taken during the financial crisis as and when they ceased to be necessary.

In the field of payment systems, the Banco de España continued to participate in the management of TARGET2, which plays an essential role in monetary policy conduct and in the functioning of the euro money market. This system operated satisfactorily in 2010 and achieved an availability level of 99.99%. A new profile for internet-based access was introduced in 2010 which was offered to participants with a low payment volume for which it will considerably simplify the system participation requirements.

The Banco de España contributed to the important progress made in 2010 in two of the main projects currently being implemented by the Eurosystem: TARGET2-Securities (T2S), in the area of securities settlement, and CCBM2, for collateral management in its credit operations.

T2S creates a centralised platform for the settlement of securities transactions in euro and other currencies. The Banco de España, together with the central banks of Germany, France and Italy, is responsible for developing and maintaining T2S. It also participates with one member on the T2S Programme Board, created by the Governing Council of the

ECB with the aim of ensuring the timely and successful completion of the T2S Programme in 2014. The user requirements document was completed at the beginning of 2010 and IT and business development work continued. As for the preparation of the legal framework, the T2S guideline was published and progress was made in drawing up the agreements that will be entered into between the Eurosystem and the central securities depositories and central banks which do not belong to the euro area. Another important step was taken in November with the approval of the pricing for T2S.

In the area of CCBM2, in 2010 the user requirements document was finalised, the appropriateness of the project was confirmed on the basis of a qualitative and quantitative analysis, and the financial arrangements, the payment schedule of central banks and the project plan were approved. All the NCBs in the Eurosystem expressed their commitment to participate in CCBM2, although the modular structure of the future platform allows certain NCBs to opt for acquiring only specific functions. The Banco de España forms part of the various working groups created to manage the project and in 2010 assisted the central banks directly responsible for developing CCBM2 (Belgium and the Netherlands) with the design of certain functional aspects.

More than two years after the Single Euro Payments Area (SEPA) was launched, the Banco de España continued coordinating the work to achieve the successful transition to SEPA in Spain, leading the fora created for this purpose and encouraging and facilitating the migration of general government.

The Bank contributed to the drafting of the seventh SEPA Progress Report which includes the major milestones achieved since the publication of the previous report and the future challenges and key aspects for the success of this initiative. The report underlines the Eurosystem's firm support for European legislators to set a SEPA migration end date, which will make a decisive contribution to achieving an integrated euro payments market.

The Banco de España undertook to comply with its production quota of 50 and 5 euro banknotes

In 2010 the Banco de España continued to perform the functions entrusted to it as a member of the Eurosystem, for the production, safe-keeping, distribution and quality control of euro banknotes and for the fight against counterfeiting. In the area of banknote production, the Banco de España undertook to comply with its production quota in the Eurosystem which resulted in commissioning the production of 50 and 5 euro banknotes. As for the safe-keeping, storage and transport of banknotes, in addition to the banknotes the Bank owns, it holds custody of a portion of the banknotes owned by the ECB which are part of the Eurosystem's strategic stock. The Bank participates actively in banknote distribution throughout the euro area and was chosen for another year to assess the quality of banknotes in circulation in the Eurosystem.

The Bank played an important role in the preparation of the second series of euro banknotes which will be put into circulation in coming years. It participated in working meetings and performed technical tests at its premises.

The Banco de España participated actively in the work performed by the Banking Supervision Committee (BSC). This committee was disbanded after twelve years as a result of the creation of the European Systemic Risk Board (ESRB). The ESRB's Advisory Technical Committee's functions were going to overlap with those of the BSC. Similarly, the Governing Council decided to create the Financial Stability Committee, which commenced operations at the beginning of 2011 and will support the Governing Council of the ECB in fulfilling its financial stability functions.

As for the compilation of statistics, the Banco de España has been active on the Statistics Committee and in the corresponding working groups. In addition to this, in 2010 it chaired the task force which decided that it was appropriate to enlarge the current lists of monetary financial institutions (MFIs), investment funds and financial vehicle corporations and create a Eurosystem Register of Institutions which can be useful in areas other than statistics and, specifically, for the ESRB.

As a member of the ESCB, the Banco de España participated in the preparation of two half-yearly reports of the ECB on financial stability and contributed to the analysis of the same frequency undertaken for the Financial Stability Table of the Economic and Financial Committee. Also noteworthy in this connection are two other publications: the report on banking structures and the report on recent developments in supervisory structures of Member States of the European Union. Lastly, mention must be made of the work, undertaken in close cooperation with the Committee of European Banking Supervisors (CEBS), on the analysis of the impact of new prudential requirements which specifically include the pro-cyclicality of minimum capital requirements.

The new institutional framework for financial supervision in the EU was approved in November 2010

The new institutional framework for financial supervision in the EU was finally approved at the end of November 2010 and came into force on 1 January 2011. Thus, the European System of Financial Supervision was given legal form through an EU Regulation. It is based on two pillars:

- The ESRB, responsible for macro-prudential oversight of the EU in order to contribute to the prevention or mitigation of systemic risk. The president and vice-president of the ECB and the governors or presidents of the national central banks of EU countries are members of the ESRB's General Board, which also has a scientific and a technical advisory committee.

- Three European supervisory authorities created on the basis of the European Committees of Supervisors: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). These authorities are entrusted with contributing to setting common supervisory standards and practices.

In December 2010 the first meeting of the Risk Management Committee (RMC) was held. It was created by the Governing Council of the ECB, around the structure of the Risk Management Working Group (RMWG) which until then reported to the MOC. The main function of the new Committee consists of the surveillance, measurement and management of financial risk generated by Eurosystem operations.

3 International activities

The Banco de España continued to work on consolidating its international profile. For this purpose, it maintained a smooth dialogue with central banks, financial supervisors and regulators, as well as with multilateral organisations, both bilaterally and within international fora, many of which have been created in the wake of the crisis.

3.1 INTERNATIONAL RELATIONS

In the EU, the Banco de España was involved, as part of the Spanish delegation, in various Community working groups and committees.

As in previous years, the Governor participated together with European central bank governors and finance ministers in the informal ECOFIN meetings, the first held in April 2010 in Madrid, coinciding with the Spanish presidency of the EU Council, and the second in September 2010 in Brussels, under the Belgian presidency.

The work of the Economic and Financial Committee (EFC) in its full composition, with the participation of central banks, focused primarily on the regular review of the EU's economic and financial situation and the annual analysis of the stability and convergence programmes, and the excessive deficit procedures which had been initiated. Secondly, the Committee continued to coordinate a joint European position at international meetings of the G20, the Financial Stability Board (FSB) and the International Monetary Fund (IMF), which in 2010 included the reform of quotas and of IMF governance.

The work schedule of the Economic Policy Committee (EPC) placed particular emphasis on the work undertaken in the first half of 2010 prior to the renewal of the Lisbon Strategy (the 2020 Strategy) and on discussions on the reform of economic governance in Europe.

Noteworthy in the supervisory realm was the Banco de España's contribution to the activity of the CEBS, the most notable points of which were as follows:

— Provision of technical advice to the European Commission on successive amendments to the capital directives, including the incorporation into European regulations of the FSB's recommendations and standards on compensation, which were finally approved in December 2010, and the introduction of the prudential requirements of Basel III, which are still pending implementing regulations.

— Cooperation and convergence of supervisory practices through the preparation of new guidelines and the updating of previous ones. For instance, in 2010 guidelines were published on joint assessment and joint decision regarding capital adequacy, remuneration policy, liquidity cost, recognition of external credit assessment institutions, operational risk, concentration risk, stress tests, risk transparency during periods of crisis and risk management.

— Work connected with supervisory transparency and restoring market confidence. The stress tests were performed in summer 2010 to analyse the solvency of a large group of European banks in situations of stress. The Banco de España participated actively in these tests which in the case of Spain covered practically all credit institutions.

In the global financial arena, the FSB (of which the Banco de España is a member) continued the work which it had begun the previous year on the treatment of the moral hazard of systemic institutions. Furthermore, it began to analyse other issues such as the regulation and supervision of activities outside the banking sector and the intensity and effectiveness of a supervision model. Also worthy of note are the peer reviews which are of two types. On one hand, there are thematic reviews, one was published on compensation in 2010 and another two were begun on risk disclosure and mortgage origination practices. On the other, there are country-specific peer reviews: the first report on Mexico was published in September and the FSB worked in 2010 on the reports on Spain and Italy, which were published at the beginning of 2011. Finally, the work by the Board to assess vulnerabilities in the financial system should be underlined.

The activities of the Bank for International Settlements (BIS), restricted to central banks, were especially intense this year. Particularly noteworthy were the bi-monthly meetings of governors and the work conducted in the different committees on which the Banco de España is present. These include, in particular, the Committee on the Global Financial System and the Markets Committee. The Bank made a significant contribution at the various events organised by the BIS and, in particular, to the extensive network of working groups resulting from the above-mentioned committees, which included, most notably, the joint organisation of a roundtable discussion on the future of international banking in Mexico city.

The Basel Committee reformed the capital rules

The change made by the Basel Committee on Banking Supervision (BCBS) with respect to capital and liquidity was particularly important at international level. This reform is part of its response to the lessons learnt during the crisis and was backed by the FSB and the leaders of the G-20.

In relation to these measures, and especially within the framework of systemic institutions, the approval of the proposal on contingent capital prepared by the Basel Committee should be underlined.

Within the framework of cross-sectoral supervision, the Bank was involved in the work of the Joint Forum (an international group of bank, securities and insurance supervisors) which in 2010 focused on commencing the update of the principles on conglomerates dating from 1999 and the preparation of a report on modelling for the banking and insurance sector. Similarly, intra-group support, the framework of securitisations and the use of credit ratings in various financial products were analysed.

The Banco de España continues to preside, along with the Federal Reserve Bank of Philadelphia, the International Operational Risk Working Group (IORWG), whose main aim is to act as a centre of competence for advanced operational risk management among central banks. The Working Group, which meets annually, brings together operational risk management officers of more than 40 central banks and monetary authorities.

As is customary, the Bank works closely with the IMF, both at institutional level and providing support to the Spanish representatives in this organisation. To this end, the Bank contributed actively to preparing and defining stances on the matters discussed at the IMF which were of particular importance for Spain.

The Fund's activity in 2010 was dictated, on one hand, by developing measures and providing financing to assist countries to exit the crisis and, on the other, to studying and applying preventive measures with a view to the future. The IMF handled the increase in the institution's quotas, approved the expansion of the New Arrangements to Borrow (in which Spain participates) and made them more flexible and modernised its own catalogue of financing instruments.

Furthermore, in 2010 the IMF actively assisted the EU to support European countries with financing problems (in particular, Greece and Ireland). In order for the representation of countries at the IMF to better reflect the current status quo in the global economy, the structure of the Fund's Executive Board was discussed. As a result of concern about strengthening financial and multilateral supervision, new reports were prepared and mandatory assessments of the financial system for systemically-important countries were imposed.

The Banco de España also collaborated with the IMF, as in previous years, in discussions on the customary Article IV reports relating to the countries of most interest to Spain. In particular, in 2010, discussions were held on the Article IV reports on Spain and on euro area policies. In the field of multilateral surveillance, the Banco de España also contributed comments on the IMF's half-yearly *World Economic Outlook* and *Global Financial Stability Report* discussed at its bilateral meetings in which the Banco de España participates.

The Banco de España has become more actively involved in G-20 projects

During 2010, the Banco de España has become increasingly more actively involved in G-20 projects. Accordingly, it prepared reports on important issues for this forum such as financial regulatory reform, coordination of macroeconomic policies to strengthen the global framework for growth, reform of the international monetary system and the strengthening of global financial insurance networks.

In 2010 the Bank maintained its close collaboration with the main multilateral development banks (the World Bank, the Asian Development Bank and the Inter-American Development Bank) and, at a bilateral level, with other central banks and banking supervisors, through high-level and technical meetings. Also, as in previous years, the Bank was included in the Spanish delegations participating in the periodic meetings of the Paris Club and in OECD and EU working groups on export credit.

Collaboration with Latin American organisations was stepped up. Thus, in the case of the Center for Latin American Monetary Studies (CEMLA), which is the main forum for coordination of Latin American central banks, the Bank participated in the meetings of governors, of the Alternates Committee, of the Audit Committee and of the Treasury Committee. It also participated in CEMLA's working groups, and can be considered one of the chief contributors to its training activities, a good number of which are organised jointly.

Lastly, the Bank continued to strengthen its ties with the Latin American supervisors through the Association of Supervisors of Banks of the Americas (ASBA). Accordingly, in 2010 various seminars were held in Brazil, Uruguay and Spain. The main themes of work during the year were stress tests, liquidity and microfinance.

Sustained growth continued in cooperation and technical assistance

One element that makes a decisive contribution to the external projection of the Bank is the provision of technical cooperation and assistance to other central banks and supervisory and regulatory agencies. In recent years this activity has grown steadily, with the Banco de España viewed as a benchmark in the field of central banking and financial regulation and supervision. The Bank has extended the technical cooperation subject to prior planning, which is provided bilaterally or through collaboration with various multilateral organisations such as CEMLA, the ASBA, the Central American Monetary Council, the IMF, the World Bank and the BIS Financial Stability Institute.

The forms of technical cooperation include courses and seminars, study and working visits to the Bank, experts from the Bank sent to missions in situ, technical assistance activities and attending to an almost constant stream of consultations on a wide variety of subjects. The Bank offers training individually and in collaboration with other institutions either through face-to-face sessions or in combination with e-learning. 17 courses were organised in total in 2010.

As for geographical distribution, as in previous years, in 2010 technical cooperation was concentrated mainly in the area of Latin America, on language and cultural grounds and also for financial and economic reasons. In other geographical areas, such as the Mediterranean basin and eastern Europe, the Bank applied the same model as in previous years, essentially providing cooperation in conjunction with other central banks and supervisory agencies, by participating in several programmes coordinated within the Eurosystem and financed with EU funds. The Bank's Internal Audit Department is contributing to the TACIS III project for Technical Assistance for the Commonwealth of Independent States, in collaboration, together with another eight Eurosystem central banks and the ECB, with the Central Bank of Russia. In turn, experts from the Financial Regulation Department are contributing to the progress made in a programme for the Eurosystem, in collaboration with another 14 central banks and the ECB, for the EU accession and potential accession countries. Similarly, the Information Systems Department is participating in a joint Eurosystem programme to provide technical assistance to the Central Bank of Bosnia and Herzegovina.

3.2 CONFERENCES, MEETINGS AND SEMINARS ORGANISED BY THE BANCO DE ESPAÑA

During 2010 the Banco de España worked intensely on the organisation of high-level events and meetings aimed at sharing knowledge and exchanging views on topical issues.

The key event was the Fifth High-Level Seminar of the Eurosystem and Latin American Central Banks, organised jointly with the European Central Bank (ECB), which took place on 10 December 2010 in Madrid. The seminar addressed the economic repercussions of and economic policy responses to global imbalances and financial flows. It was presided by the Governor of the Banco de España and the President of the European Central Bank, Jean-Claude Trichet. It was attended by governors, deputy-governors and high-level officials of central banks in Latin America and the Eurosystem, in addition to the representatives of organisations such as the European Commission and CEMLA.

During the Spanish presidency of the European Union, a high-level seminar was held in April at the Bank's headquarters which was organised jointly with EUROFI and attended by leaders of the financial sector and national and international public authorities, including Finance Ministers, central banks, regulators and supervisors. Its purpose was defining priorities to reform the financial regulatory and supervisory framework.

Also within the framework of the Spanish presidency an informal seminar of the Working Group of the Council of the European Union on export credit was organised in May together with the State Secretary for Trade. The seminar analysed various aspects of financing trade and the presence of Spanish banks in Latin America. Lastly, as is customary, there were various presentations of reports at the Banco de España by international institutions such as the Inter-American Development Bank “El Mundo Post-Crisis Financiera Global: Lecciones, Desafíos y Perspectivas para América Latina” (The World in the wake of the Global Financial Crisis: Lessons, Challenges and Outlook for Latin America), the World Bank (Annual Report on Economic Outlook) and the IMF (World Economic Outlook).

In 2010 the Banco de España organised numerous conferences of a more academic nature (see Section 4.2.).

4 Economic analysis and research

Economic analysis and research are essential for performing the functions entrusted to the Banco de España. In 2010 analysis and research on the Spanish economy and its international environment were carried out fundamentally to give advice to the Bank's governing bodies for the performance of said functions. As a result of these activities, 39 working papers and 2 occasional papers were published as well as 47 articles in academic journals and specialised books (22 of which in anonymously refereed journals).

4.1 PRIORITY AREAS OF ANALYSIS

The research agenda of the Banco de España revolved around four major areas:

— Macroeconomic modelling and forecasting.

— Monetary policy and its transmission mechanisms.

— Financial stability.

— Spanish economy.

The research agenda centred on the crisis and its economic policy implications

The Banco de España's research agenda in 2010 centred on the analysis of the crisis and its economic policy implications. In particular, special attention was paid to: studying the adjustment and recovery process of the world economy and, to a greater extent, the euro area and the Spanish economy; improving the integration of financial and real aspects into usual macroeconomic analysis; the analysis of credit and the optimal indebtedness of corporations and households; the identification of the optimum size of the financial sectors and the most suitable policies for preventing them from becoming oversized; the inclusion of elements of financial stability in the formulation of monetary policy; the role of fiscal policy in the current situation; the sovereign debt crisis in certain European countries; the effect of the crisis on the level and rate of potential growth; and suitable structural policies for promoting potential growth.

As regards macroeconomic modelling and forecasting, the main findings obtained refer to the incorporation of expectations into the quarterly macroeconomic model used for the analysis and forecasting of the Spanish economy, the development of general equilibrium models with rational agents to simulate fiscal measures in Spain and the extension of dynamic factor models to identify turning points in the principal economic variables and the further development of tools to predict activity in the very short term. As for tools for analysis, at the end of 2010 the preliminary findings of the Survey of Household Finances (EFF-2008) were published which provide a detailed approximation of the financial situation of Spanish households and, therefore, greater information for the analysis of consumption and saving decisions.

The two main results in relation to the analysis of monetary policy and its transmission mechanisms relate to i) the analysis of optimal monetary policy when there are restrictions on indebtedness and monopolistic competition in the banking system, and ii) monetary policy implementation through possible changes to central banks' deposit and lending facilities.

In 2010 research on financial stability and analysis of the international financial system continued to focus on various aspects of the crisis and on regulatory measures designed to reduce the likelihood and impact of such crises. Research began on counterparty risk analysis, work advanced on the different mechanisms for mitigating procyclicality in a risk-sensitive regulatory framework, various aspects of stress-testing methodology were addressed and progress continued in the analysis of the role of competition in risk taking. Other topics addressed were the analysis of the international capital flows, global imbalances and the risk diversification associated with financial integration, and of the determinants of sovereign risk and financial crises.

Lastly, research on the Spanish economy covered two major subject areas. Firstly, the adjustment of the Spanish economy and its determinants have been researched in greater depth, paying particular attention to the impact of institutional and structural characteristics (the labour market, demography and business structure, openness to foreign trade and the real estate sector). Secondly, research examined the rationale for economic policy recommendations in different areas (fiscal policy, structural policy) and evaluated their macroeconomic impact.

4.2 RELATIONS WITH ACADEMIA

The Banco de España's connections with academia and with the economic research units at other central banks and international institutions were maintained through the four traditional channels.

First, the analysis and research produced by the Banco de España was presented and discussed at national and international seminars, and conferences, and published through the profession's usual channels.

Second, the Banco de España organises several series of seminars, in which members of the academic community participate, including a weekly economic research seminar. As regards scientific meetings, the Banco de España organised, with other institutions, five international conferences: the conference on *Interactions between Monetary and Fiscal Policies*, in February; the seminar *Towards more Efficient Labour Markets*, organised with the IMF in May; the seventeenth European Summer Symposium in International Macroeconomics (ESSIM), organised jointly by the Centre for Economic Policy Research (CEPR) at the Bank's facilities in Roda de Bará (Tarragona), in May; the second International Journal of Central Banking (IJCB) Financial Stability Conference titled, *The Theory and Practice of Macro-Prudential Regulation*, held in June by CEMFI at the Banco de España, and the conference *Financial Globalization: Shifting Balances*, organised jointly with the World Bank and the Barcelona Centre de Recerca en Economía Internacional de Barcelona (CREI) in July.

The Bank also sponsored sessions at academic conferences, such as those of the European Economic Association and the Latin American and Caribbean Economic Association.

Third, the Banco de España continued to contribute to research networks, both within the Eurosystem for analysis of the euro area economy, such as that set up to work on marco-prudential regulation, and in Latin America, such as that set up in CEMLA. The Bank also maintains its regular visitor and external adviser programmes, which promote projects that may be considered strategic in different areas of analysis and research.

Lastly, 2010 saw the second edition of the *Programa de excelencia en educación e investigación en economía monetaria, financiera y bancaria* (Programme for excellence in monetary, financial and banking economics education and research) aimed at promoting excellence in teaching and research in the areas of macroeconomics, monetary policy, finance, financial system supervision and international economics, through the establishment of cooperation agreements with universities and research centres to secure grants for recruiting teaching and research staff and for undertaking research projects.

4.3 DISSEMINATION AND COMMUNICATION

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 completed or ongoing research and the *Revista de Estabilidad Financiera*. All these activities are included in the Economic Research Portal, a section on the Bank's website.

INSTITUTIONS SUPERVISED BY THE BANCO DE ESPAÑA

TABLE 7.1

	31.12.10
INSTITUTIONS SUPERVISED BY THE BANCO DE ESPAÑA	**339**
Banks	72
Savings banks (a)	36
Credit cooperatives	82
Branches of foreign credit institutions	89
Specialised credit institutions	59
Electronic money institutions	1
OTHER	143
Mutual guarantee and reguarantee companies	25
Currency-exchange and money-transfer bureaux	61
Appraisal companies	55
	2
TOTAL	**482**

a The figures relate to the number of institutions included in the Register of Institutions at 31.12.10. However, in the case of the savings banks, as a result of the merger and integration processes this figure was reduced to 18 institutions or groups plus CECA.

5 Banking supervision and regulation

At 31 December 2010, a total of 481 institutions of various kinds were supervised by the Banco de España, of which 339 were credit institutions (CIs). The Banco de España exercises a process of ongoing supervision of these institutions[1].

5.1 SUPERVISORY ACTIVITY

The Banco de España supervises 339 credit institutions

The essential aim of the supervisory process is to keep updated each institution's supervisory risk profile, taking the appropriate measures to correct it when necessary. To this end, the Banco de España has 22 operational inspection divisions and seven support or cross-departmental divisions, comprising bank examiners, senior analysts, IT auditors, junior analysts and administrative staff.

The number of inspections in 2010 amounted to 179, 39 of which were still under way at 31 December, and essentially include traditional on-site inspections and continuous monitoring on-site.

The number of groups of CIs in which supervisory teams have a permanent presence was increased to 15

In 2010 the above-mentioned continuous monitoring on-site, which involves a permanent presence at the institution, was extended to 15 groups of CIs compared with ten in 2009. This system is particularly intensive in the case of the two main banking groups. More than 50 individuals are assigned to these banking groups only to perform this function.

A further 329 special reviews were also performed in relation to CIs, including:

- Specific monitoring actions, apart from those mentioned above, such as, for example, studies of claims arising from troubled assets.
- Examination of internal capital adequacy assessment reports prepared by institutions and the supervisory process arising from such examination.

1 Available in the "Banking Supervision" section of the Banco de España's website: www.bde.es/webbde/en/.

— The impact analysis of regulatory changes on each institution.

— The most important actions arising from relations with national and international supervisors and bodies in the case of groups of CIs with a presence in Spain and other countries.

— The stress tests.

In addition, the Banco de España conducted the various administrative procedures subject to prior authorisation: loans to senior officers, the taking of qualifying holdings in Spanish institutions, acquisitions of qualifying holdings or of control abroad, etc.

56% of all requirements referred to credit risk

Against this background, letters were sent to supervised institutions containing 192 requirements relating to matters such as: credit risk (loan approval criteria and credit risk classification and provisioning), management and internal control, own funds and solvency, and other matters (transparency vis-à-vis customers, deficiencies in reporting to the Banco de España's Central Credit Register, etc.). As usual, credit risk was the main area of recommendations, with 108 requirements, or 56% of the total.

On 22 May 2010 the Banco de España resolved to replace the directors of CajaSur and to appoint the Fund for the Orderly Restructuring of the Banking Sector (FROB) as the institution's provisional administrator, as a consequence of its viability problems. This action was conducted within the new framework established by Royal Decree-Law 9/2009 and was resolved in just 55 days with its adjudication through a competitive process to Bilbao Bizkaia Kutxa (BBK). This was the only precautionary "intervention" measure that needed to be adopted during 2010. The process of resolution of the crisis of Caja Castilla-La Mancha (CCM), that commenced in 2009, was also concluded in 2010, with its assets and liabilities being integrated into Cajastur. Unlike the action in relation to CajaSur, the approach to the handling of the crisis of this institution was traditional and involved the participation of the Savings Bank Deposit Guarantee Fund.

In relation to the internal models of the eight Spanish groups of CIs authorised to use internal ratings based (IRB) methods to calculate regulatory capital for credit risk, the processes for authorising new portfolios continued in accordance with the successive roll-out plans presented to the Banco de España, which include the approval of exposures at subsidiaries abroad in close coordination with local supervisors. In addition, the monitoring of the models already approved has been strengthened, especially with regard to the modifications that the institutions are introducing. A key element in the monitoring of the models is the review of the internal control framework that institutions have to ensure that the approved models are maintained and used appropriately. With regard to the validation of internal models to calculate the regulatory capital for operational risk, in 2010 the conditions for approval and the results of the operational risk model approved for a Spanish group were monitored.

The Banco de España continued to work actively in the area of international supervisory cooperation, through "colleges of supervisors". The Banco de España hosted the meetings of the colleges of the two Spanish international banking groups and participated, in its capacity as host country supervisor, in six meetings of colleges of banking groups with foreign parents.

In 2010 five cooperation agreements of the kind provided for in Article 131 of Directive 2006/48/EC, relating to the supervision of European groups of credit institutions with subsidiaries in Spain, and a bilateral cooperation agreement with an EU country (Rumania) were signed. In addition, the cooperation agreement between EU financial supervisors, central banks and ministries of economic affairs and finance for cross-border financial stability signed in 2008 was extended to all the countries in the European Economic Area (Iceland, Norway, Liechtenstein).

5.2 IMPOSING OF SANCTIONS

In 2010 seven sanctioning proceedings were opened against supervised institutions and 50 of their directors

In 2010 a total of seven sanctioning proceedings were opened against institutions of various kinds including: a credit institution (a savings bank); a currency-exchange and cross-border money transfer bureau and other companies, that were engaging without the correct authorisation in activities restricted to credit institutions (in one case), or in the purchase and sale of foreign currency and the arrangement of cross-border money transfers (in another three cases). Finally, a disciplinary proceeding was initiated against a foreign foundation for breach of the rules on qualifying holdings, and a proceeding initiated in 2009 was extended to the director of a currency-exchange bureau.

In addition, in order to clarify any potential liability of directors and managers of sanctioned institutions, 50 sanctioning proceedings were opened against them in 2010, in conjunction with the proceedings brought against the corresponding institutions.

Seven sanctioning proceedings against institutions and 22 against directors or managers were resolved, resulting in 82 sanctions

In 2010 a total of 7 cases against various types of institutions and 22 cases against directors and managers were resolved.

In relation to the proceedings opened against a savings bank, an appraisal company and a currency-exchange and cross-border money transfer bureau, the following were imposed:

— Four sanctions on institutions and 38 sanctions on their directors or managers for the commission of very serious infringements.

— Six sanctions on institutions and 28 sanctions on their directors or managers for the commission of serious infringements.

— Two sanctions on institutions for the commission of minor infringements (legally directors or managers cannot be sanctioned for these infringements).

Similarly, proceedings were resolved against another type of legal entity for the pursuit of certain activities without the mandatory authorisation. Thus, a sanction was imposed on a legal entity for engaging in the activity of arranging cross-border money transfers without having obtained the necessary authorisation from the Banco de España or being duly registered. In another three proceedings three legal entities were sanctioned for engaging without authorisation in activities legally restricted to credit institutions.

A savings bank was sanctioned for committing one serious and two very serious infringements

Notable among the proceedings resolved is one against a savings bank and 20 members of its board of directors and management, in which this credit institution was found to have committed three infringements, two of which were classified as very serious and the third as serious. As regards the very serious infringements, deficiencies were found in its organisational structure, in its internal control mechanisms and in its administrative and accounting procedures, and such deficiencies were found to have jeopardised the viability and solvency of the institution, for which reason sanctions were imposed on the savings bank and on 17 of the members of its board of directors and management subject to the proceedings, since they were considered responsible for this situation. Also the institution was found to have failed for at least six months to meet 80% of the capital requirements made, so that the relevant sanction was imposed on the institution, and 16 of the 20 directors and managers subject to the proceedings were considered responsible for this infringement. Finally, the savings bank was considered to have committed a serious infringement by failing to comply with the rules in force regarding the limits on exposures, as a result of which a sanction was imposed on the institution. Of its directors and managers, 16 were considered responsible for this conduct and the relevant sanction was imposed on them.

Aside from the proceeding described above, disciplinary proceedings against an appraisal company and a currency-exchange and cross-border money transfer bureau and their corresponding directors or mangers were resolved. This type of institutions supervised by the Banco de España must comply with the applicable sectoral regulations because it is considered that it is necessary to ensure that they function correctly due to the activity they perform and its impact on the financial sector.

An appraisal company committed one very serious, one serious and one minor infringement

Appraisal companies issue reports and certificates which can be used in the mortgage market and determine the value of assets used as collateral by credit institutions. Consequently, on one hand, their valuation must be reliable and documented, respecting regulatorily established criteria, and on the other, their organisation must have the administrative, technical and human resources attributes which guarantee their internal control.

Thus, in view of the importance of such an activity, in the proceeding resolved in respect of an appraisal company and its directors four sanctions were imposed for very serious infringements (one on the company and the other three on each of its directors), since the contents of the appraisals were found to lack veracity and consistency and, in particular, the data and evidence arising from the valuation activity performed failed to match. Also, four sanctions were imposed for serious infringements (one on the company and the other three on each of its directors) arising from organisational deficiencies of an administrative and technical kind and relating to personnel in the internal control procedures that guarantee the correct performance of appraisals. And finally, one sanction was imposed for the commission of one minor infringement, owing to non-compliance with the applicable rules on civil liability insurance.

A currency-exchange and cross-border money transfer bureau committed one very serious, one minor and three serious infringements

It is essential that the accounting records of currency-exchange and cross-border money transfer bureaux provide a true and fair view of the institution concerned and that, in turn, its capitalisation levels are above the minimum required.

In the proceeding resolved against a currency-exchange bureau, the latter was found to have committed a very serious infringement, consisting of fundamental irregularities in its accounting records that prevented the entity's net worth and financial position from being known, for which sanctions were imposed on the bureau and on the two directors. Also, the bureau was found to have committed three serious infringements arising from its failure to perform various obligations, these being the obligations to have a minimum level of capital, to duly provide information to the supervisory authority and, finally, to perform only those operations it is authorised to perform, for which three sanctions were imposed. The directors of the bureau were considered likewise responsible for these infringements and a total of three sanctions were imposed on each. Finally, a sanction was imposed on the bureau for a minor infringement consisting of a breach of the rules regulating the recording of its transactions.

Four legal entities were sanctioned for pursuing activities without the corresponding authorisation

A legal entity was sanctioned for performing the activity of cross-border money transfers professionally with the public without having obtained the necessary authorisation from the Banco de España or having been duly registered.

Similarly, three legal entities were sanctioned for pursuing the activities of taking repayable funds from the public, which are restricted to credit institutions, without having obtained the corresponding authorisation to do so. Furthermore, they were required to immediately cease such activities.

Most of the sanctions imposed were fines, a total of 13 of varying amount were imposed on institutions and 66 on directors or managers. Similarly, in one case it was considered appropriate to impose three sanctions of public reprimand (published in the *Official State Gazette*) on an institution. In the same case, considering the particular responsibility of two directors or managers for the offence, it was also agreed to impose on each one two sanctions disqualifying them from serving as a director or manager at any credit institution or in the financial sector.

In addition to the foregoing, in 2010 a proceeding against a credit institution for non-compliance with minimum reserve requirements was resolved. This type of proceeding is brought and resolved by the European Central Bank and the Banco de España is responsible for processing it.

5.3 REGULATORY ACTIVITY AND CHANGES

Of the nine circulars published, noteworthy are the circular addressing the solvency of credit institutions and that amending the provisioning of credit risk

The Banco de España worked intensely in 2010 to develop and implement the organisational and disciplinary regulations applicable to institutions subject to supervision. Noteworthy among the nine circulars published is the circular on the solvency of credit institutions, which includes various EU rules aimed at promoting improvements in risk management (especially of liquidity-related risks) through guidelines included in an annex to the circular. The accounting changes were equally important and included most notably: changes to the treatment of consolidated financial statements and of business combinations; the delimitation of the special accounting register of credits and loans which serve as coverage for issues of mortgage securities and, especially, the improvements introduced in the analysis and provisioning of credit risk and impairment losses on foreclosed assets.

Also worth mentioning is the establishment of compulsory general principles for advertising by credit institutions, since the prior authorisation regime was replaced by one which is more in line with that of other financial institutions. Noteworthy among the other circulars is that completing the Law and Royal Decree regulating the qualifying holdings in credit institutions by harmonising their treatment at European and sectoral level with that of insurance and investment companies.

In addition to issuing the aforementioned implementing regulations, the Bank participated actively in drafting rules at different levels on banking and financial matters, which ultimately resulted in the corresponding external and internal reports being released. And, in the same vein, it participated in several international committees and working groups on banking regulation, which covered especially matters of solvency, accounting, financial institution management (corporate and self-governance) and transparency of operations.

As an extension of its regulatory function, the Bank also interpreted and applied the regulations governing the activity of institutions, especially the solvency and accounting regulations, settling many enquiries received from institutions, other departments of the Bank or other regulatory agencies. It also provided technical assistance on regulatory matters both in and outside Spain (participating in various working groups, organising seminars, etc.). At this point, mention should also be made of the monitoring and checks performed on issues of financial instruments eligible as own funds made by credit institutions involving, in 2010, the resolution of 81 proceedings.

As regards exercise of the Bank's power in the area of transparency and bank customer protection, almost 3,700 cases were processed until the removal in June of the authorisation regime, prior to publication, of advertising projects referring to the cost or rates of return of the products offered. There were 833 cases in relation to the verification and registration of brochures that refer to fee and commission charges (prices of bank services). Furthermore, the Bank Customer's Portal, a section on the Banco de España's website that aims to provide guidance, in 2010 recorded a total of 2,329,523 pages viewings and handled almost 5,100 enquiries, 2,500 of which received a written reply.

Lastly, the Bank also plays a part in proceedings for the creation of supervised institutions, and of amendment of their articles of association, advising the Minister for Economy and Finance and drawing up the mandatory reports. And it is responsible for various public registers, such as the register of supervised institutions and their agents, and confidential registers, including, in particular, the register of senior officers.

5.3.1 Regulatory changes

In 2010 there were various regulatory changes which included most notably:

The reform of the legal regime of savings banks makes it easier for them to have access to capital and provides new forms of engaging in their financial activity

1 Changes that aim to improve the legal regime applicable to credit institutions. For instance:

— *Royal Decree-Law 11/2010 of 9 July 2010 on the governing bodies and other aspects of the legal regime for savings banks*. This Royal Decree-Law essentially aims to make it easier for the savings banks to have access to core capital, to promote the professionalisation of their governing bodies and to provide new forms of engaging in their financial activity.

2 Changes that aim to strengthen the solvency of credit institutions and to promote restructuring processes. These include:

— *Royal Decree-Law 6/2010 of 9 April 2010 on measures to promote economic recovery and employment*. This Royal Decree-Law clarifies the regime applicable to the credit institutions in institutional protection schemes (IPSs), expedites the orderly restructuring process of the sector through the FROB and facilitates the operations of financial vehicle corporations.

— *Royal Decree 628/2010 of 14 May 2010 amending Royal Decree 2606/1996 of 20 December 1996 on credit institution deposit guarantee funds and Royal Decree 948/2001 of 3 August 2001 on investor compensation schemes*. This Royal Decree completed the transposition of European regulations on deposit guarantee schemes which were amended in 2009.

The regulation applicable to payment services and banking advertising was amended

3 Changes that affect the operational framework within which credit institutions and other financial intermediaries work. These include:

— *Ministerial Order EHA/1608/2010 of 14 June 2010 on transparency of conditions and information requirements for payment services*. This Ministerial Order completes the transposition of European regulations on payment services which, in matters of transparency, are subject exclusively to its provisions. Furthermore, it repeals existing provisions on the valuation rules of banking operations.

— *Ministerial Order EHA/1718/2010 of 11 June 2010 on regulation and control of the advertising of banking services and products*. This replaces the regime in force until then of prior authorisation of the advertising of credit institutions by a two-pronged monitoring system based on the establishment of general principles and criteria and requirements in relation to appropriate internal control mechanisms. The advertising activity of payment institutions is subject to a similar regime.

— *Ministerial Order EHA/1665/2010 of 11 June 2010 implementing Articles 71 and 76 of Royal Decree 217/2008 of 15 February 2008 on the legal regime of investment firms and of other investment services entities*. This Ministerial Order transferred to the CNMV the competence on standard contracts and the verification and registering of fee and commission charges relating to transactions and services performed on the public debt book-entry market, which until then corresponded to the Banco de España. At the same time it modifies the procedures for the verification and registering of the fees/commissions relating to investment services, provided by investment firms and credit institutions.

4 The fourth and final group comprises rules addressed to financial institutions other than credit institutions that are supervised by the Banco de España. For instance:

— *Royal Decree 712/2010 of 28 May 2010 on the legal regime governing payment services and payment institutions*. This implements the legal regime of payment institutions in a similar way to that of other financial institutions, by taking into consideration the specific features and operating limitations of payment institutions.

These changes are completed by the above-mentioned implementation of the organisational and disciplinary regulations applicable to credit institutions, in the form of the following circulars of the Banco de España:

— *Circular 1/2010 of 27 January 2010 concerning statistics on interest rates applied to deposits and loans vis-à-vis households and non-financial corporations*.

— *Circulars 2/2010 of 27 January 2010, 3/2010 of 29 June 2010 and 8/2010 of 30 November 2010 amending Circular 4/2004 of 22 December 2004 on public and confidential financial reporting rules and formats*.

— *Circular 4/2010 of 30 July 2010 on agents of credit institutions and the agreements entered into for the regular provision of financial services*.

— *Circular 5/2010 of 28 September 2010 on the information that the potential acquirer of a qualifying holding in a credit institution must submit*.

— *Circular 6/2010 of 28 September 2010 on the advertising of banking services and products*.

— *Circular 7/2010 of 30 November 2010 developing certain aspects of the mortgage market.*

— *Circular 9/2010 of 22 December 2010 amending Circular 3/2008 of 22 May 2008 on the determination and control of minimum own funds*.

Finally, the changes made to the EU regulatory framework include, for our purposes here, only the following:

— *Directive 2010/76/EU, of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for resecuritisations, and the supervisory review of remuneration policies*. In addition to introducing certain improvements in the management of risks arising from operations with certain financial instruments, this directive attempts to make credit institutions' remuneration structures compatible with more appropriate management of their risks.

5.4 FINANCIAL AND PRUDENTIAL REPORTING

5.4.1 Prudential reporting requirements

The entry into force of *Circular 3/2010 of 29 June 2010* amending the criteria to be applied by credit institutions in the provisioning of credit exposures and of foreclosed assets entailed the updating of the formats of the confidential returns for reporting such information and of the instructions and correlations for preparing it.

The Circular meant, furthermore, that the information of mutual guarantee companies would be out of date, since the regulations governing credit institutions in this connection are applicable to these financial auxiliaries. Until the Ministry of Economic Affairs and Finance updates the ministerial order on the presentation of accounting information by mutual guarantee companies, these companies have been requested to voluntarily submit the updated information in accordance with the new criteria.

Likewise, in 2010 the Banco de España continued to participate very actively within the CEBS, which was replaced by the European Banking Authority, in revising the accounting returns with prudential information (FINREP) and the solvency returns (COREP) in order to prepare shared formats for use in the European Union from 2013.

5.4.2 Reception of financial data in XBRL

As a result of the publication of Banco de España Circulars 1/2010 and 2/2010, it was necessary to modify, from the data as at 30 June 2010, the returns submitted by credit institutions in order to comply with the European Central Bank's statistical reporting requirements in relation to interest rates and information on the balance sheets of MFIs. The Bank capitalised on this in order to make the use of XBRL compulsory for the submission of this information, thus continuing its policy of introducing this standard as a system for receiving and validating all financial information from institutions supervised by it.

As a prior step for the preparation of the XBRL taxonomy of statistical information, a multidimensional data model was constructed, which is compatible with the ECB's taxonomy, and will serve as a benchmark for preparing taxonomies in the future.

5.4.3 Electronic documentation

All the financial statements were incorporated in 2010 into the telematic system established for financial reporting purposes and the receipt of this type of information on paper was almost completely eliminated.

5.5 CENTRAL CREDIT REGISTER

The Banco de España manages the Central Credit Register (CCR), which contains individualised information on the credit exposure of reporting institutions (basically credit institutions) to their customers. This information is used by the institutions for granting and monitoring exposure. It is also utilised by the Banco de España, in conjunction with the data from the accounting and own funds statements of the reporting institutions, for prudential supervision and other tasks which are legally entrusted to it, maintaining the confidentiality of the individual data.

The number of exposures declared to the CCR decreased by 2.8%

In 2010 the number of exposures declared to the CCR decreased from 32.9 million at end-2009 to 32 million at end-2010 (down 2.8%), although the total amount of these exposures held at the €3.8 billion of December 2009. The number of different borrowers declared to the CCR declined from 17.4 million at end-2009 to 17.1 million at end-2010 (down 1.7%).

As part of its function to provide reports to reporting institutions, in 2010 the CCR sent a total of 290.3 million automatic reports compared with 297.2 million in 2009, representing the second consecutive annual decline, which in this case amounts to 2.3%. Also, for the second year running, requests for reports for new lending transactions declined from 5.2 million in 2009 to 4.6 million in 2010 (down 11.54%), which reflects less lending in the system.

Borrowers can now request their exposure reports or submit claims to the CCR over the Internet

Borrowers' requests for reports rose from 110,741 in 2009 to 117,154 in 2010. This growth was particularly significant on account of the new service offered by the CCR from April for obtaining the reports over the Internet using a digital signature (issued by the Spanish public printing works for individuals and legal entities and the electronic national identity card). This channel was used intensively to request 25,452 reports from 15 April to 31 December 2010.

568 claims were made to the CRR by borrowers, who exercised their right to rectify data, compared with 508 in 2009 (up 11.8%). From 1 December 2010 it is also possible to submit claims online and 19 claims were made in this way in December.

As regards the exchange of information with the central credit registers managed by six other central banks of EU Member States (Germany, Austria, Belgium, France, Italy and Portugal), as at September 2010 (date of the latest available data), the CCR received information on exposures of 4,045 Spanish legal persons (an increase of 3.3% on the same period a year earlier) recorded in the other central credit registers, amounting to €230,770 million (down 1%). In turn, the CCR sent to these registers information on 1,662 legal persons resident in the other six countries (down 9.2%), relating to exposures amounting to €40,097 million (down 12%).

6 Operational functions

6.1 MONETARY POLICY AND MANAGEMENT OF THE BANCO DE ESPAÑA'S ASSETS

The implementation of monetary policy in the euro area is carried out in a coordinated fashion by the European Central Bank and the national central banks. The Governing Council of the ECB takes the monetary policy decisions, while the national central banks perform the liquidity providing/absorbing operations and manage the collateral provided by the credit institutions within their purview.

As a result of the sovereign debt crisis, the gradual withdrawal of the exceptional measures was delayed

The gradual withdrawal of exceptional measures adopted to address the financial crisis in 2010 was delayed significantly by the sovereign debt crisis which was at its worst in May and November. As a result of the problems observed in May, the Eurosystem implemented the Securities Markets Programme which was a temporary addition to the Covered Bonds Purchase Programme that began in July 2009 and which ended on 1 July 2010. At the end of 2010, the Eurosystem held in total under the two programmes a portfolio of €135 billion, €13 billion of which were managed by the Banco de España.

As in 2009, during 2010 the funding granted by the Eurosystem through its monetary policy operations was higher than credit institutions' liquidity requirements and, consequently, they placed their surplus liquidity in the deposit facility. However, during 2010 the structure of Eurosystem operations showed a notable return to normal: volumes in the main refinancing operations increased and those in longer-term refinancing operations decreased (particularly due to the maturity in June of the one-year refinancing operation) and, finally, use of the deposit facility has declined substantially.

The average liquidity requirements of the euro area as a whole and of Spain performed very similarly, falling by 6.5% and 6.8%, respectively. Spanish institutions continued along the same vein as in the previous two years, increasing their use of Eurosystem funds and acting as net lenders to the rest of the European banking system. Thus, Spanish institutions obtained net funding from the Eurosystem that totalled €96 billion, an increase of 30% with respect to 2009. However, this change was amply offset by the increase in funds delivered through TARGET to the rest of the European system which amounted to €61 billion.

Average gross financing obtained by Spanish institutions from the Eurosystem represented 15% of the total

Once again in 2010 the gross financing obtained by Spanish institutions in Eurosystem liquidity injection operations stood on average at 15% of the total which represents a significant increase from 11.4% in 2009. However, this change in their share of financing was reversed partially in 2010 Q4 and, as a result, stood at 13.2% in December 2010.

In addition to the above-mentioned Eurosystem portfolios, the Banco de España owns a portfolio of euro-denominated fixed-income bonds with an average outstanding balance of €80 billion in 2010. Holdings of foreign currency denominated assets stood on average at $13 billion. As at 31 December 2010, assets in euro, foreign currency and gold totalled €96 billion.

Throughout 2010 the Banco de España continued to manage part of the ECB's foreign reserves which had an average volume of $7 billion.

6.2 MANAGEMENT OF PAYMENT SYSTEMS

TARGET2-Banco de España availability reached 100%

The Spanish system of large-value payments, TARGET2-Banco de España (the Spanish component of TARGET2) operated soundly and stably in 2010, reaching availability of 100%. During the year the system processed more than 7.5 million transactions, remaining flat with respect to 2009, in line with the transactions processed by TARGET2 overall. Transactions amounting to more than €88 billion were settled which is 5% down on the previous year's figures.

With regard to retail payments, around 1,590 million transactions, totalling approximately €1.7 billion were processed through the National Electronic Clearing System (SNCE), which is managed by Iberpay, a company owned by the system's participants. The total transactions processed by SNCE recorded a year-on-year growth rate of 2.8%, similar to that in 2009. The amounts processed hardly changed in 2010 and the strong year-on-year decline in 2009 came to a halt.

SEPA credit transfers from Spain increased significantly

As for the adaptation of the Spanish retail payments system to SEPA (the Single Euro Payments Area), noteworthy is the entry into force of *Payment Services Law 16/2009* which together with the incorporation of a set of improvements in the design and processing of SEPA payment instruments contributed to the highly significant growth in the volume of SEPA-compliant credit transfers from Spain. The number of SEPA transactions processed increased four-fold during 2010 (65.7 million transfers compared with 16.8 million in 2009), meaning that the migration rate reached its highest level in November 2010 of around 22%. This figure continued to be considerably higher than the average for Europe as whole.

However, the situation is different for SEPA direct debits. Although practically all Spanish institutions have been able to offer this new Pan-European instrument since November 2010, its use is still very limited.

70% of bank cards already include the new chip

As for the adaptation of bank payment cards to SEPA, it should be noted that during 2010 the introduction of the international EMV standard in ATMs and POSs was practically completed (100% and 94%, respectively). Approximately 70% of the total number of cards in circulation had migrated to this new technology which is based on the inclusion of a chip.

The Banco de España continued to represent the institutions owning Iberpay, at their request, at STEP2 which is managed by EBA Clearing. Thus, these institutions can exchange SEPA credit transfers with any institution in the single payments area. The transfer operations processed through this "payment gateway" (Iberpay-Banco de España-STEP2) are settled in the accounts that the institutions represented hold in TARGET2-Banco de España. In July 2010 a new "payment gateway" service came into operation for SEPA direct debit transactions.

6.2.1 Oversight of payment systems

During 2010 the Banco de España continued to perform its task of oversight of payment systems, with the aim of contributing to their security and efficient operation. The fifth edition of the *Annual Report on Oversight of Payment Systems*[2] was published to provide information on the most notable developments in national payment systems and the oversight activities carried out.

TARGET2 and the SNCE are the main payment systems subject to oversight. The oversight tasks of TARGET2 are undertaken jointly with other Eurosystem central banks and are coordinated by the ECB, while the oversight of SNCE is performed by the Banco de España in accordance with the shared criteria and policies set for the whole Eurosystem. In 2010, the Bank began an exercise to evaluate the degree of compliance with the basic oversight principles applicable to the SNCE which will end in 2011 and whose general findings are planned to be published in the *Annual Report on Oversight of Payment Systems*.

6.3 BANKNOTE MANAGEMENT

In 2010, within the framework of Eurosystem agreements for euro banknote production, the Banco de España was responsible for producing 844 million 50 and 5 euro banknotes (it was responsible for 50 and 20 euro banknotes in 2009). These banknotes were produced following the quality and security standards set by the Governing Council of the ECB. Part of the total amount produced was used to cover domestic requirements, while the remainder was sent to other Eurosystem central banks, according to the agreements and distribution timetables established. Also, the Banco de España received consignments of banknotes of other denominations produced by other Eurosystem members.

2 Available in the "Publications" section of the Banco de España's website at www.bde.es/webbde/en/

In 2010 the Bank received 3,200 million banknotes from credit institutions, 11% more than the previous year's figure. In turn, the Banco de España delivered 3,007 million banknotes to credit institutions, 10.4% more than in 2009. As in previous years, the volume of banknotes received exceeded those withdrawn, resulting in net negative issuance of 5, 10 and 20 euro banknotes. In any event, these figures do not signify a reduction in the number of banknotes in circulation given the sizeable inflows of notes into Spain which are introduced by visitors from other European countries.

In the area of banknote custody and distribution, the Banco de España continued working on the improvement of a system to distribute banknotes and coins flexibly and swiftly, guaranteeing they are available anywhere in Spain in the amounts and with the characteristics required at the lowest possible cost. As a result of close collaboration with the banking industry very particular logistic activities have been managed effectively and safely.

One of the Banco de España's functions is to monitor the quality of cash in circulation by withdrawing counterfeits and maintaining high quality banknotes. In this area, on a daily basis the Bank checks and monitors counterfeits which appear in the market in collaboration with the police and the legal authorities in Spain, the ECB and other central banks that issue euro banknotes and coins. As a result of this coordination, considerable success has been achieved in the fight against counterfeiting by identifying and withholding several consignments of counterfeit banknotes before they were put into circulation. As for the quality and fitness of banknotes in circulation, the Bank continued to analyse and check the banknotes which are withdrawn daily from circulation, destroying those which are damaged and replacing them with new or high-quality used banknotes. More than 3,900 million banknotes were checked and sorted at the Banco de España throughout the year.

At end-2010, 100% of the banknotes dispensed by ATMs had been subject to authenticity and quality checks

The adaptation period for Spain to comply with the rules established by the Eurosystem in the *European framework for euro banknote recirculation* (ECB Decision of 16 September 2010) ended on 31 December 2010. This framework affects all cash handlers and establishes very strict rules for the rigorous monitoring of the authenticity of euro banknotes in circulation and levels of quality and fitness. Consequently, at end-2010, all the banknotes dispensed by Spanish ATMs had been subject to a prior test for genuineness and classified by fitness, according to the rules established, by machines certified by the Bank or that came directly from it. Furthermore, all the banknotes recirculated over the counter had been manually processed by trained professionals or by machines which passed the tests agreed by the Eurosystem. The procedure represents an important guarantee for European citizens as regards the authenticity of euro banknotes in circulation and is a first-rate instrument for preserving and maintaining the public's confidence in euro banknotes.

The Banco de España also has the function, entrusted to it by the Treasury, of putting coins into circulation. In 2010 1,022 million coins were put into circulation and 245 million were withdrawn from circulation, with the result that net issuance grew by 777 million coins to 15,645 million coins at year-end. Also in this area, as with banknotes, important legal provisions were adopted that will strengthen monitoring and checking systems to guarantee the authenticity and the quality of the coins in circulation.

6.4 TRANSACTIONS OF THE FUND FOR THE ACQUISITION OF FINANCIAL ASSETS

In accordance with the corresponding regulations, the Banco de España continued to implement the Fund for the Acquisition of Financial Assets (FAFA), acting as its agent and custodian through the Treasury Special Schemes Support Service. This task includes the management of the cash flows generated by the securities in its portfolio and undertaking the valuation adjustments of assets due to changes in prices, as well as keeping the accounts of transactions and preparing its annual accounts and periodic reports.

In 2010 the repo transactions arranged as a result of the first auction for the acquisition of assets matured and the resulting amount was paid into the Treasury.

7 The statistical function of the Banco de España

The statistical function of the Banco de España is established in its Law of Autonomy and in the National Statistics Plan. The Law of Autonomy provides that the Banco de España shall compile and publish statistics relating to its functions and that it shall assist the ECB in the compilation of the statistical information needed for the fulfilment of the functions of the European System of Central Banks (ESCB). The main statistics compiled by the Banco de España under the Law of Autonomy relate to financial institutions and markets and to interest rates. The statistics compiled under the current Plan 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).

In addition, the Banco de España, through its Central Balance Sheet Data Office, compiles information on the balance sheet position and the results of non-financial corporations, using questionnaires completed voluntarily by the reporting firms, and on the annual accounts filed by non-financial corporations at the Mercantile Registries. All these statistics are published in the Boletín Estadístico, in monographic publications and on the Banco de España's website.

Apart from compiling and disseminating the above-mentioned statistics, the Bank also uses statistics produced by other Spanish agencies and supervisors (INE, IGAE, ministries, CNMV, DGSFP, etc.) and by international organisations as a source for another area of statistical work that it makes available to its own analysts and to the general public. Moreover, Banco de España representatives take an active part in international statistical fora (within the ESCB, the European Commission through Eurostat, the European Committee of Central Balance Sheet Data Offices, the IMF, BIS, OECD, etc.). The Bank also maintains databases that permit analysis of the evolution of the variables for which data are collected.

7.1 MAIN CHANGES INTRODUCED IN 2010

During 2010 the statistics were updated and disseminated along with the corresponding methodological notes and notes on changes, in accordance with the calendar which is kept up to date on the Banco de España's website. The most notable elements of the other work undertaken by the Banco de España are mentioned below.

7.1.1 Monetary and financial statistics

The Bank began to compile and send statistics to the ECB under the latter's new requirements on credit institutions' financial returns, securitisation operations and interest rates applied to customers, which is detailed in Circulars 1/2010 and 2/2010, both of 27 January 2010. Also in accordance with the ECB's guidelines, the Bank began to compile new statistics on financial vehicle corporations. Furthermore, work began within the framework of the ESCB to provide information security by security on the financial assets in the form of marketable securities held by resident sectors and the time series for the Bank Lending Survey began to be disseminated on the Banco de España's website.

7.2 BALANCE OF PAYMENTS AND INTERNATIONAL INVESTMENT POSITION STATISTICS

During 2010 work continued on adapting the information system on cross-border economic transactions to Regulation 924/2009 on cross-border transactions and to the sixth edition of the Balance of Payments and International Investment Position Manual, which was completed and published by the IMF in 2009. Accordingly, the information requirements were determined by the ECB and Eurostat. Similarly, a European procedure for the exchange of information on intra-European investment came into operation which represents the first practical experience in the area of the systematic regular exchange of information on specific cross-border operations.

7.3 BALANCE SHEET POSITION AND RESULTS OF NON-FINANCIAL CORPORATIONS ACCORDING TO THE CENTRAL BALANCE SHEET DATA OFFICE

2010 saw the completion of the work to adapt the various products of the Central Balance Sheet Data Office to the Spanish National Classification of Economic Activities (CNAE-2009). This new classification was included in the data contributed to the European database BACH (Bank for the Account of Companies Harmonised), which was also provided for the first time with the information of small companies which filed their data at the Mercantile Registries, notably increasing the coverage of Spain. Lastly, following the line adopted in previous years to increase the dissemination of its products and to facilitate electronic access to corporations and users in 2010 all its publications were disseminated via the Internet.

7.4 WORK RELATING TO THE COLLECTION, MANAGEMENT AND DISSEMINATION OF STATISTICAL INFORMATION

In addition to the improvements in the infrastructure for collecting, exchanging and accessing statistical information (which are partly related to the projects mentioned in previous sections), work continued in this area to provide data collection procedures by electronic means, with the introduction of a new Internet application for receiving information from corporations and individuals and with the inclusion of these procedures in the Banco de España's Virtual Office.

8 Claims Service

The most important challenge in 2010 for the Claims Service was the need to handle the drastic rise in the volume of claims in the two previous years.

Consequently, the Claims Service was compelled to introduce new working and organisational methods in order to maximise its resources and boost efficiency.

Growth of the Claims Service's activity continued but more smoothly

The data on the Claims Service's activity during 2010 show that it has continued to grow, albeit more smoothly than in previous years (more detailed information is provided in the Claims Service's annual report). For instance, during 2010 the number of written claims received rose by approximately 7% with respect to the previous year. Similarly, the number of claims resolved increased by around 11% over 2009.

In 2010 signed reports totalled 4,865, up 4% on 2009.

The Service's activity in the area of enquiries decreased in comparison with 2009 since 3,394 queries were submitted electronically, 1,443 fewer than in the previous year.

Notable in raising the Service's external profile at European level was its participation in the two annual meetings of FIN-NET, the European network for settling cross-border financial disputes out of court in the European Union, of which Spain is a founder member.

Similarly, the Claims Service participated actively in the conferences and seminars given to employees of Municipal Offices for Consumer Affairs under the Financial Education Plan 2008-2012 (see Section 9.2.2), implemented jointly by the Banco de España and the National Securities Market Commission (other institutions such as the Directorate General of Insurance and Pension Funds, the Ministry of Education and the National Consumer Affairs Institute, among others, have become involved).

9 External communication

As a public agency, the Banco de España has the obligation of accountability vis-à-vis the general public, although in the case of the Bank a balance must be struck between this obligation and the need for confidentiality, a key element in performing its duties as financial system supervisor. The communication policy of the Banco de España has a twofold objective: to improve knowledge about the Bank's functions and actions and to contribute to the confidence of citizens in the financial system. The need to strengthen confidence in the financial system has become particularly important in the context of the current financial crisis and, consequently, transparency about the situation of the banking system has been constant in all the communication activities performed by the Bank in 2010.

9.1 MEDIA RELATIONS

Media relations focused on the crisis and the restructuring of the financial system

During 2010, the Bank's relations with the media focused on the international financial crisis and the restructuring of Spain's financial system. For instance, most of the public speeches by the Bank's management during this period addressed the economic outlook and the reform of the banking system. The challenges facing the financial system also gave rise to the vast majority of requests for information received and were present in many of the Bank's publications.

In addition to the usual informative meetings to disseminate the work of the Bank's various departments, worth noting was the media coverage of the results of the stress testing of credit institutions and of the information on the savings banks restructuring process. The presentation of the financial education website www.finanzasparatodos.es ("finance for everyone") (see Section 9.2.2) in May, the award ceremony of the Bernácer prize in June and that of the King Juan Carlos economics prize in November were also widely reported in the media.

Requests for interviews from foreign media grew by 70% with respect to 2009

Following the previous year's trend, in 2010 a high number of requests for interviews were made by foreign media, which as described above, centred on the consequences of the crisis for the Spanish financial system. Overall, various representatives of the Bank gave around 30 interviews (a third more than in the previous year), most of them to foreign media. The reform of the banking system stimulated the interest of the international specialist press, which resulted in a rise of 70% in requests for interviews from foreign media with respect to 2009. As has become customary, approximately a quarter of the interviews given in this period came within the Bank's branch network-based communication plan, the purpose of which is to acquaint local and regional media with the Banco de España's activities.

Nonetheless, as in previous years, the main channel for communicating the Bank's viewpoint regarding the economic situation and the financial system was its regular publications, such as the *Annual Report*, the *Economic Bulletin* and the *Financial Stability Report*, and the public speeches made by its management. In addition to the Governor's regular appearances before Parliament (in June, to present the *Annual Report*, and in October, before the Parliamentary Budget Committee and in November, before the Senate Budget Committee), the Deputy Governor, as Chairman of the Governing Committee of the FROB, appeared before Parliament in June, September and December to report in camera on the FROB's action to date. In addition to these appearances, members of the Bank's governing bodies participated in more than 40 domestic and international fora.

9.2 INSTITUTIONAL COMMUNICATION PROGRAMME

As a result of the Banco de España's commitment to offer direct information to the public, its most important communication channel in terms of speed, efficiency and cost, is its website.

9.2.1 Information to the public

The website received 2.7 million visitors, 12.5% up on 2009

The access statistics corroborate the importance of the website. In 2010 there were 2.7 million visitors in total compared with 2.4 million in the previous year, up 12.5% on the previous year. The number of pages visited by users exceeded 25 million, as against 23 million in 2009, representing an increase of 8%.

In 2010 the process of translating the website into English was completed in order to satisfy the growing demand for information from international users. In addition, more than 200 projects relating to architecture, the enlargement or improvement of content were undertaken for a website comprising more than 2,000 pages and 20,000 files.

Together with the website, the Banco de España has made available to users several portals which are aimed at covering the specific information needs of certain segments. Noteworthy among these Portals is the Bank Customer's Portal, which was visited by more than 500,000 users, and the content included in the Educational Portal created in 2010, which recorded more than 84,000 visitors.

Also noteworthy is the role played by the Virtual Office, opened in January 2010, which has enabled members of the public, corporations, financial institutions and general government to perform administrative procedures and submit queries electronically to the Banco de España. In its first year of existence it was visited by 89,000 users and the most frequently requested administrative procedure was the "Request for reports on exposures from the Central Credit Register by borrowers".

The Bank handled more than 53,000 queries from members of the public and corporations

In 2010 the Banco de España handled 53,658 requests from corporations and members of the public from various specialised information points. Noteworthy, in terms of volume, were the 31,627 enquiries received from the public by the Claims Service about several aspects of their relationship with banks. In turn, the Bank Customer's Portal processed 5,100 requests and the Statistical Information Service responded to around 11,000. The most commonly requested information related to financial statistics (institutions and markets) followed by interest and exchange rates.

In line with the Banco de España's wish to make itself better known to different social groups, last year it distributed 31,000 copies of informative materials and 15,000 units of informative and educational products of the Eurosystem and of the European Commission. These items were distributed by post and during guided visits of the Bank. Furthermore, there were more than 36,000 downloads from the Educational Portal of various educational materials (brochures, presentations and videos).

The Bank has a policy of multilingual presentation of the materials which, since they are addressed to the residents of regions with co-official languages, require translation and it actively participates in the translation into these languages of materials which are produced by the Eurosystem for the general public.

9.2.2 Educational initiatives

The Financial Education Plan implemented the portal www.finanzasparatodos.es and a pilot programme of classes in Compulsory Secondary Education

The Financial Education Plan is a joint project of the Spanish National Securities Market Commission and the Banco de España, which aims to improve the financial education of current and future users of financial services. For this purpose, in 2010 two of the Plan's more far-reaching initiatives were implemented: the portal www.finanzasparatodos.es ("finance for everyone") and the pilot programme to provide financial education in Compulsory Secondary Education.

The portal, which was presented in May, includes basic practical advice, tools and other means for managing personal finances. Since its launch until year-end, more than 1,046,051 pages were visited. The website also contains resources and games for young people, and educational guides can be downloaded.

In this academic year, in collaboration with the Ministry of Education, the Bank introduced a pilot programme to familiarise secondary school students with financial culture. More than 2,600 students in the third year of Compulsory Secondary Education from 32 schools throughout Spain took part in this programme. Once the results have been analysed, the initiative will cover all 15 year old students.

Additionally, in 2010 the Banco de España participated regularly in educational fora organised by universities and other academic bodies.

During its fifth year of existence, the Virtual Classroom, an educational portal for young people to foster knowledge of the Banco de España and spread awareness of its mission to guarantee the stability of prices, payments and the financial system, became established as a learning tool for the educational community. This is clear from the fact that 270,000 portal pages were consulted by over 61,000 visitors during 2010.

A total of 2,430 students participated in the 4th Competition for Schools organised by the Banco de España

The Competition for Schools organised by the Banco de España for upper-level secondary and middle-level vocational training students is an educational instrument which fosters excellence and the entrepreneurial spirit of students and has aroused growing interest among schools since it was created. The 4th Competition for Schools, held in the 2009-2010 academic year, merited the participation of 2,430 students from 486 schools, which is considerably higher than the figures for last year when 1,716 students from 214 teams competed.

The 4th Competition for Schools (dedicated to financial stability), in which 486 teams from public and private schools throughout Spain took part, was divided into a first general qualifying round and a second round consisting of a written contribution based on the theme “Financial stability: a task for all”. The winner was the Camilo José Cela Secondary School located in Pozuelo de Alarcón (Madrid). The diploma and prize (eight laptop computers) were awarded at a ceremony presided by the Deputy Governor of the Banco de España.

The Educational Corner, the section of the Educational Portal on the Banco de España’s website for primary school teachers and students, permits the downloading of educational support materials and provides supplementary activities for the students to do in class or at home. These materials include, most notably, “The Safe”, a game for use in the classrooms of upper primary school students, which aims to promote basic knowledge about the euro, the Banco de España and the ECB through a game in which students and their teacher represent different agents in the real financial economy. The teams of students face situations, questions and problems which they must resolve with the help of background information cards which can be acquired from other teams in a sort of information market. Each question is resolved with a transaction involving euro banknotes and, consequently, the game includes specimen euro banknotes enabling students to handle them and identify their characteristics and security features. In 2010, 440 schools requested the Bank to send this game to them.

The Banco de España provides for institutional and educational visits to its headquarters in Madrid and to its branches. In 2010 it welcomed more than 4,900 visitors compared with 2,500 visitors in 2009. Furthermore, at the end of 2010 volunteers from the Sports and Cultural Club of Banco de España Employees began to help with the guided visits.

9.2.3 Institutional relations with the European Central Bank

In 2010, the Banco de España carried out communication activities as a member of the ESCB. In addition to helping to define and implement the Eurosystem’s communication strategy through its participation in the Eurosystem and ESCB Communications Committee and to publishing ECB press releases and communications on its website, the Communication Department carried out various initiatives under the Eurosystem communication plan, notably including the visit of Spanish media to the ECB, the updating of information materials, in particular, those on euro banknotes and the preparation of interactive educational materials and of a competition on price stability for upper secondary school students.

10 Internal organisation and administration

As at 31 December 2010, the Banco de España's headcount amounted to 2,709 employees, the lowest figure in the last five years.

10.1 HUMAN RESOURCES AND ORGANISATION

This decrease was due especially to the retirement of an exceptionally high number of employees (145 in total) which represent 6% of the headcount. This was partly on account of changes in the legislation governing retirement in Spain and partly on account of a large group of employees reaching retirement age in 2010.

Headcount decreased to 2,709 employees

As for the breakdown of headcount, the number of more highly qualified employees continued to increase and reached approximately 60% of the total, while the number of less qualified employees continued to contract (currently 7.3% of the total).

Under the internal mobility project introduced in 2007 to facilitate the professional development of employees, 222 employees changed job in 2010, 9% of headcount compared with 8% in 2009. Similarly, 30 positions of responsibility were filled internally as opposed to only two which were filled externally through a competitive examination.

Females accounted for more than 40% of the workforce

Also as a result of active policies for equal opportunities, the proportion of females in the workforce grew again with respect to the previous year and currently stands at slightly more than 40%.

In the area of in-house training, the Executive Commission approved the 2010-2013 four-year Training Plan, which includes different types of programmes. These will focus particularly on technical training, which will be organised into seven schools of technical knowledge.

68% of the workforce attended a training course in 2010

In 2010, the number of hours of training given amounted to 143,099 in total, which represents an average of 51 hours per employee and a total of 5,074 places were taken up on training courses, following the same trend as in the previous year. 68% of the workforce attended a training course in 2010 and 197 employees attended international courses. 99 employees from other central banks and international bodies participated in Banco de España training courses.

During 2010 27 selection processes for permanent posts were organised, 15 internal processes and 12 external ones, involving 417 and 9,382 applicants, respectively. These posts were filled successfully.

Furthermore, 202 individuals were selected to fill temporary posts in order to cover staffing needs arising from Eurosystem projects and short-term absences, up to the legally permitted coverage levels.

As in past years, in order to contribute to the practical training of university students, the Bank continued the previous trend of welcoming in each academic year a representative number of suitable university students who wish to gain practical working experience in the financial sector (in total, there were 61 grant-holders in different areas of the Bank).

Last year was particularly significant because of the wage cut introduced by *Royal Decree-Law 8/2010 of 20 May 2010, adopting extraordinary budget-deficit-reduction measures*.

The Banco de España applied the corresponding reduction to employee remuneration in line with the provisions of the above-mentioned Royal Decree-Law through an agreement with the staff trade union representatives.

10.2 PROCUREMENT AND GENERAL SERVICES

As part of the reorganisation of the Directorate General Services, the Procurement and General Services Department assumed the functions of the Maintenance, Construction, and Security Services, in order to optimise resources.

In the area of procurement the Annual Plan approved for 2010 was fully complied with and a total of 191 procurement processes were transacted. Furthermore, 204 contracts were extended and prices were renegotiated leading to a considerable reduction in costs.

From the standpoint of joint Eurosystem procurement, the Banco de España participated actively in the work of the Eurosystem Procurement Coordination Office, it was involved in two working groups and five joint tenders, and eleven new documents on good procurement practices were drawn up.

The activity of the Maintenance and Works Service during 2010 addressed the improvement in the reliability of facilities, greater energy efficiency and the removal of architectural barriers as well as recovering space at the Cibeles premises.

Noteworthy in the branch network were the following:

- Overhaul of cash handling rooms at the Zaragoza branch.
- Renovation of electromechanical installations in Zaragoza and Bilbao.
- Updating and extension of the fire-prevention system in Seville and of the air-conditioning system in Valencia.
- Also, the Plan to Improve Security and Video Surveillance Systems began and will continue in 2011.

10.3 INFORMATION SYSTEMS

In 2010 the Information Systems Department was reorganised and the number of divisions and units was reduced to increase efficiency and improve system availability, in line with the shared target of the whole Directorate General Services.

Developments regarding Eurosystem projects, apart from those described in section 2 in relation to TARGET2-Securities, were as follows:

- MOP (Market Operations Platform): an agreement was reached between the central banks of France, Spain, Italy and Germany and the ECB to develop the project and subsequently supply the service to the Eurosystem. The Banco de España and the Bank of France will lead the project and will host the development and production systems.
- Eurosystem Public Key Infrastructure (ESCB-PKI): as a result of the reorganisation of the IAM (Identity and Access Management) project, the Banco de

España will undertake this project on its own (making it the first service that it will provide to the Eurosystem as a supplier) and it should be in operation in September 2011.

— ESCB Mail Program: this project which is led by the Banco de España, is geared at providing a new mail infrastructure which will permit the secure exchange of messages between ESCB members. Part of the work was undertaken in 2010, in collaboration with the Bundesbank and the Bank of Italy, including the replacement of the CebaMail mail system by another system with new technology called ESCBMail.

As for operational applications, noteworthy was the introduction of the CDI system to manage banknote cash transactions. Once it had been implemented and brought on stream, work commenced on a new system to handle cash deposits and withdrawals both of banknotes and coins in accordance with international standards.

The most salient actions in respect of IT infrastructures are as follows:

— Creation of two new devices for the telematic exchange of information with external institutions: the automated exchange of operations (ITO) and the exchange of files via the Internet (ITW), which open up new possibilities and are more flexible.

— Signing of two major strategic agreements:

  — Four-year agreement to cover the capacity requirements of the central computers and their maintenance as well as the software licenses required.

  — Software license and maintenance agreement for 2011-2013.

— Updating of security rules. Three new internal regulations were published.

— Completion of the work to increase the connection speed between branches and Madrid and the installation of alarm systems linking branches to police stations.

— Commencement of a project to modernise the telephone system which will introduce IP-based voice technology (or IP telephony), unifying the voice and data networks and improving the availability of the service in case of a disaster.

In the area of business continuity, a new room was equipped exclusively for restarting the most critical business processes in crisis situations. Due to this new room, it was possible to perform the restarting exercises for the first time under real working conditions, as recommended by best practices. Likewise, a tool to automate communications for crisis situations was used for the first time.

10.4 CORPORATE DOCUMENT POLICY

During 2010 initiatives continued to be implemented in the form of projects relating to electronic administration and the modernisation of documentation processing.

On 1 January the Virtual Office came into operation

On 1 January the Banco de España's Virtual Office came into operation. The Virtual Office is the website available to members of the public who wish to deal with the Bank electronically. During 2010 information on 34 processes and services was published on this website with descriptions tailored to target audiences, along with the related technical specifications and regulations. More than 97,000 members of the public used this service to perform administrative procedures and the Bank answered their questions through the queries mailbox.

Following the Virtual Office, the next step in implementing the electronic administration model is bringing the Electronic Register into operation. For this purpose, in 2010 the necessary efforts were made to standardise the prior physical registration processes required: a Single General Register system was created at the Banco de España, the corresponding regulations were enacted (Internal General Register Circular 2/2010 of 22 December 2010) and a computer application was installed which ensures full integration of the recording of entries in the register in Madrid and at the branches. The foregoing will make it possible to address the electronic register project in 2011, which represents a direct improvement to the services provided to the public and which, internally, also simplifies and streamlines management and strengthens the monitoring of the registration processes and their legal certainty.

Also, in order to modernise the filing of documentation, an ambitious project was undertaken to re-organise and optimise storage space in the Archives which freed up 12,400m of shelves (part of the space recovered will be used for offices), the Bank's collections were reorganised and a computer program was installed to locate and monitor them.

As for the Bank's historical, art and document collections, particular attention was paid to its magnificent collection of architectural plans. The cataloguing of nearly 1700 plans was completed, 430 were restored, and they were digitalised in accordance with the standardised equipment maintenance procedures.

10.5 CONTROL, BUDGET AND ACCOUNTING

In 2010 the new budget control computer software was implemented. It improves management and control procedures in respect of the Bank's expenses and investments.

In 2010 the new accounting software continued to be improved and greater automaticity was achieved in submitting financial statements to the ECB.

Also in 2010, following the preparation of the Bank's first risk maps, the information obtained continued to be used and the risk mitigation measures proposed by each of the Bank's departments were implemented. Similarly, after the methodology, which was used previously to determine the risks and processes, was adjusted, the first two-year review of the Bank's processes as a whole began, which will lead to the preparation of a new risk map at the end of 2011.

Lastly, as regards the Bank's international presence, it continued to work closely in respect of training with members of Latin American central banks.

10.6 INTERNAL AUDIT

According to the Statute approved by Internal Circular 4/2007 of 20 July 2007, the aim of internal auditing is to evaluate the efficacy, sufficiency and suitability of all the systems and procedures established for the management and control of risks. The internal audit function is performed by the Internal Audit Department, 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's audit activity is specified in an Annual Plan approved by the Governor and reported to the Executive Commission. In accordance with the 2010 plan, the Internal Audit Department carried out the following main audits: annual accounts of the Banco de España; the report envisaged in Law 44/2002 on Financial System Reform Measures; administration of the IT security of the Directorate General Banking Regulation; authorisations and administrative procedures of the Directorate General Banking Supervision; procurement processes of the Procurement and General Services Department; general government statistics; the processing of proceedings; advice for participation in international meetings; monitoring the access of individuals and merchandise to the buildings at the Cibeles complex; the ECB's strategic stock of banknotes; banknote production; recording of financial instruments related to monetary policy operations; monetary policy operations; maintenance and operation of IT infrastructures and systems, and payment systems oversight. Finally, it monitored the recommendations of the specific audits of the Banco de España and of those common to the ESCB.

ANNUAL ACCOUNTS OF THE BANCO DE ESPAÑA
2010

1 INTRODUCTION

The annual accounts of the Banco de España ("the Bank") 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 2000), comprise the balance sheet, the profit and loss account and the notes on the accounts. The accounts have been prepared in accordance with the internal accounting rules and principles of the Banco de España. These rules and principles are based on the accounting framework established for national central banks (NCBs) of the European System of Central Banks (ESCB)[1] pursuant to Article 26.4 of the Statute of the ESCB on standardisation of accounting and reporting procedures relating to operations undertaken by NCBs. In the cases not regulated by Eurosystem accounting legislation, the Banco de España applies its internal policies based on 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 for Economic Affairs 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.g) of the aforementioned Law, is responsible for preparing the Bank's annual accounts.

Unless otherwise indicated, the figures are expressed in millions of euro. Those relating to 2009 are presented solely for comparison with 2010. 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. The structure of the Banco de España balance sheet differs from that of previous years with regard to the numbering of various items, due to the full and total adoption of the central bank annual balance sheet format set out in Annex VIII of the European Central Bank Guideline of 11 November 2010 on the legal framework for accounting and financial reporting in the ESCB (ECB/2010/20).

This document presents the accounts for the year 2010. Section 2 includes the balance sheet and profit and loss account at 31 December 2010; Section 3 contains the notes on the accounts, with the accounting policies that have served as a framework for their preparation, the explanatory notes on the most important aspects of the balance sheet and profit and loss account, and the changes in capital, reserves, provisions and revaluation accounts; and Section 4, in compliance with Article 4.2 of the Law of Autonomy, details the contributions made to the Deposit Guarantee Funds and

1 Guideline of the European Central Bank of 11 November 2010 on the legal framework for accounting and financial reporting in the ESCB (ECB/2010/20).

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, along with the estimated amount.

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.

BALANCE SHEET OF THE BANCO DE ESPAÑA AS AT 31 DECEMBER 2010

EUR m

	NOTE NUMBER	2010	2009
ASSETS			
1 Gold and gold receivables	**1**	**9,555.49**	**6,938.31**
2 Claims on non-euro area residents denominated in foreign currency		**14,040.29**	**12,306.81**
2.1 Receivables from the IFM	2	4,782.17	4,119.17
2.2 Balances with banks and security investments, external loans and other external assets	3	9,258.12	8,187.65
3 Claims on euro area residents denominated in foreign currency	**4**	**0.06**	**0.01**
4 Claims on non-euro area residents denominated in euro		**907.25**	**1,014.96**
4.1 Balances with banks, securities investments and loans	5	907.25	1,014.96
4.2 Claims arising from the credit facility under ERM II		—	—
5 Lending to euro area credit institutions related to monetary policy operations denominated in euro	**6**	**61,550.47**	**90,087.62**
5.1 Main refinancing operations		20,285.31	657.70
5.2 Longer-term refinancing operations		39,662.77	89,421.45
5.3 Fine-tuning reverse operations		1,585.00	—
5.4 Structural reverse operations		—	—
5.5 Marginal lending facility		—	—
5.6 Credits related to margin calls		17.39	8.47
6 Other claims on euro area credit institutions denominated in euro	**7**	**2.04**	**1,151.64**
7 Securities of euro area residents denominated in euro	**8**	**87,827.96**	**84,340.68**
7.1 Securities held for monetary policy purposes		13,906.71	3,400.37
7.2 Other securities		73,921.24	80,940.31
8 General government debt denominated in euro	**9**	**4,081.98**	**4,665.45**
9 Intra-Eurosystem claims	**10**	**20,945.82**	**13,121.19**
9.1 Participating interest in ECB		801.70	663.30
9.2 Claims equivalent to the transfer of foreign reserves		4,783.65	4,783.65
9.4 Net claims related to the allocation of euro banknotes within the Eurosystem		15,360.48	7,674.24
9.5 Other claims within the Eurosystem (net)		—	—
10 Items in course of settlement		**1.06**	**0.34**
11 Other assets		**3,708.73**	**4,324.48**
11.2 Tangible and intangible fixed assets	11	254.61	240.45
11.3 Other financial assets	12	47.18	50.45
11.4 Off-balance sheet instruments revaluation differences	13	—	—
11.5 Accruals and prepaid expenses	14	1,891.39	2,126.12
11.6 Sundry	15	1,515.55	1,907.47
TOTAL ASSETS		**202,621.16**	**217,951.50**

BALANCE SHEET OF THE BANCO DE ESPAÑA AS AT 31 DECEMBER 2010 (cont'd)

EUR m

	NOTE NUMBER	2010	2009
LIABILITIES			
1 Banknotes in circulation	**16**	**91,917.98**	**88,273.78**
2 Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	**17**	**26,964.03**	**35,089.02**
2.1 Current accounts (covering the minimum reserve system)		19,950.00	24,736.02
2.2 Deposit facility		6,997.50	10,352.00
2.3 Fixed-term deposits		—	—
2.4 Fine-tuning reverse operations		—	—
2.5 Deposits related to margin calls		16.53	1.00
3 Other liabilities to euro area credit institutions denominated in euro		**0.14**	**0.09**
5 Liabilites to other euro area residents denominated in euro		**9,488.74**	**32,725.57**
5.1 General government	18	9,336.63	31,233.05
5.2 Other liabilities	19	152.11	1,492.52
6 Liabilities to non-euro area residents denominated in euro	**20**	**400.15**	**264.49**
7 Liabilities to euro area residents denominated in foreign currency		**0.93**	**0.86**
8 Liabilities to non-euro area residents denominated in foreign currency		**0.76**	**0.69**
8.1 Deposits, balances and other liabilities	21	0.76	0.69
8.2 Liabilities arising from the credit facility under ERM II		—	—
9 Counterpart of special drawing rights allocated by the IMF	**22**	**3,272.05**	**3,078.08**
10 Intra-Eurosystem liabilities	**23**	**50,864.34**	**41,033.92**
10.2 Liabilities related to promissory notes backing the issuance of ECB debt certificates		—	—
10.3 Net liabilities related to the allocation of euro banknotes within the Eurosystem		—	—
10.4 Other liabilities within the Eurosystem (net)		50,864.34	41,033.92
11 Items in course of settlement	**24**	**138.39**	**103.69**
12 Other liabilities		**300.24**	**375.92**
12.1 Off-balance-sheet instruments revaluation differences	25	30.43	79.67
12.2 Accruals and income collected in advance	26	80.96	69.06
12.3 Sundry	27	188.84	227.19
13 Provisions	**28**	**5,478.81**	**5,312.04**
14 Revaluation accounts	**29**	**9,274.59**	**7,020.16**
15 Capital and reserves		**1,950.00**	**2,000.00**
15.1 Capital	30	1,000.00	1,000.00
15.2 Reserves	31	950.00	1,000.00
16 Profit for the year	**32**	**2,570.00**	**2,673.18**
TOTAL LIABILITIES		**202,621.16**	**217,951.50**

PROFIT AND LOSS ACCOUNT OF THE BANCO DE ESPAÑA FOR THE YEAR ENDING 31 DECEMBER 2010

EUR m

		NOTE NUMBER	2010	2009
1	Interest income	1	4,450.57	4,669.85
2	Interest expense	2	1,040.39	1,005.29
3	**Net interest income (1 – 2)**		**3,410.18**	**3,664.57**
4	Realised gains/losses arising from financial operations	3	366.04	108.54
5	Write-downs on financial assets and positions	4	793.89	193.12
6	Transfer to/from provisions for foreign exchange rate, price and credit risks	5	407.96	688.14
7	**Net result of financial operations, write-downs and risk provisions (4 – 5 – 6)**		**-835.81**	**-772.72**
8	Fees and commissions income		20.07	23.77
9	Fees and commissions expense		11.12	13.20
10	**Net income from fees and commissions (8 – 9)**	**6**	**8.95**	**10.57**
11	Income from equity shares and participating interests	7	191.04	117.94
12	Net result of pooling of monetary income	8	253.47	193.99
13	Other income and losses	9	-11.56	-12.93
14	**TOTAL NET INCOME (3 + 7 + 10 + 11 + 12 + 13)**		**3,016.27**	**3,201.42**
15	Staff costs	10	228.40	230.96
16	Administrative expenses	11	117.83	121.51
17	Depreciation of tangible and intangible fixed assets	12	27.34	25.58
18	Banknote production services	13	61.71	71.45
19	Other expenses		3.27	2.85
20	**TOTAL OPERATING EXPENSES (15 + 16 + 17 + 18 + 19)**		**438.54**	**452.35**
21	Transfers and additions to other funds and provisions	14	7.73	75.89
22	**PROFIT FOR THE YEAR (14 – 20 – 21)**	**15**	**2,570.00**	**2,673.18**

Countersigned by
The Governor,

MIGUEL FERNÁNDEZ ORDÓÑEZ

The Comptroller,

JOSÉ MIGUEL GARCÍA HERNANDO

3.1 Accounting policies

1 BASIC PRINCIPLES

The annual accounts of the Banco de España present fairly its net worth, financial and economic position. They have been drawn up in accordance with the following accounting principles: prudence, recognition of post-balance-sheet events, going concern, the accruals principle, consistency and comparability, no offset, matching of revenues and expenses, and materiality. These principles conform to those set out in the accounting guides and instructions of the ECB.

2 BASIS OF ACCOUNTING

The annual accounts have been prepared on a historical cost basis, modified as necessary to include market valuation of trading-book 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, except that forward transactions in foreign currencies are booked at the spot settlement date. If a period end falls between the trade date and the spot settlement date, both spot and forward transactions are 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,[2] 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, gold 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.

Unrealised losses existing at the end of the year are taken to the profit and loss account and the average book value 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.

Foreign currencies

Spot purchases or sales of foreign currencies are recorded at the settlement date, affecting the foreign currency position from that date. Gains and losses on the spot sale of for-

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2 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 taken to profit and loss when the asset is sold or, alternatively, they are used to offset unrealised losses.

eign 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. If a period-end falls between the trade date and the spot settlement date, the transactions have to be recognised at the trade 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.

Accrued interest denominated in foreign currency is recorded on a daily basis, generally 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 and expense accounts.

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

The Banco de España holds three separate securities portfolios: a trading portfolio, a held to maturity portfolio and a monetary policy portfolio (set up in accordance with the ECB Governing Council decisions of 7 May 2009, 4 June 2009 and 9 May 2010).

In all three cases, the securities are recorded initially at acquisition cost, which is determined by the cash amount paid, less any accrued gross coupon.

The cost of securities sold or redeemed is determined by the average book value 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 Operations Committee.

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 (except for unrealised losses at year-end) are reflected in adjustment accounts and credited or debited, respectively, to revaluation and expense accounts. 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. These unrealised losses are considered irreversible. The year-end adjustment was made using the market prices as at 28, 29 and 30 December 2010, depending on the class of security involved.

Securities within the held-to-maturity portfolio and the monetary policy portfolio are not subject to any periodic valuation, except for recognition, where applicable, of loss of value due to asset impairment.

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 within each portfolio. These accruals are recorded daily.

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.

The ECB establishes the conditions applicable to the monetary policy operations conducted by Eurosystem central banks and the need to obtain adequate collateral for them. Also, Article 32.4 of the Statute of the ESCB and of the ECB stipulates that the Governing Council may decide that national central banks shall be indemnified, in exceptional circumstances, for specific losses arising from monetary policy operations undertaken for the ESCB. Indemnification shall be in a form deemed appropriate in the judgment of the Governing Council; these amounts may be offset against the national central banks' monetary income (see Note 28 on the balance sheet and Note 8 on the profit and loss account).

Loans to the State

In accordance with the Guideline of the European Central Bank of 11 November 2010 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2010/20), they are valued at nominal amount (see Notes 9 and 28 to the balance sheet and Note 5 to the profit and loss account).

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

Fixed assets are defined as those 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.

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.

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.

Fixed assets are deemed not to include those assets which, although meeting the conditions to be classed as such, 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, normally for control reasons.

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 or that they are fully depreciated.

Computer applications developed specifically for the Banco de España the cost of which does not exceed €300,000 are recorded directly as expenses and are not eligible for subsequent capitalisation.

After initial recognition, fixed assets are valued at acquisition cost less accumulated depreciation or amortisation and any impairment losses.

The acquisition cost of a fixed asset, net of its residual value, is depreciated or amortised systematically during its useful life on a straight-line 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.

The depreciation/amortisation rates and estimated useful lives applied to the various fixed assets in 2010 were as follows:

	Depreciation /Amortisation Rate (%)	Useful life (years)
Buildings and structures	2	50
Renovation work	4	25
Plant in buildings	10	10
Security-related plant in buildings	20	5
Furniture and fittings	10	10
Office machines for the handling of banknotes and coins	10	10
Other office machines	20	5
Computer equipment	25	4
Transport equipment. Cars and motor bikes	25	4
Transport equipment. Trucks and buses	10	10
Library collection	10	10
Other tangible fixed assets	20	5
Computer applications	20	5
Industrial property	—	Number of years of exclusive use

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 NCBs, which together comprise the Eurosystem, have issued euro banknotes since 1 January 2002.[3] 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.[4]

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 item "Banknotes in circulation" on the liability side of their respective balance sheets.

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,[5] are disclosed under the 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).

3 Decision of the European Central Bank of 13 December 2010 on the issue of euro banknotes (ECB/2010/29).
4 The banknote allocation key is that which results from applying 92 % to the Eurosystem subscribed capital key.
5 Decision of the ECB of 25 November 2010 on the allocation of monetary income of the national central banks of Member States whose currency is the euro (ECB/2010/23).

From 2002 until 2007, the intra-Eurosystem balances arising from the allocation of euro banknotes were 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 were effected by taking into account the differences between the average value of banknotes in circulation of each NCB in the specified reference period[6] and the average value of banknotes that would have been allocated to them during that period under the ECB's capital key. The adjustments were reduced in annual stages until the end of 2007. However, this mechanism has also been applied in the case of new Member States adopting the euro so as to calculate the amount of compensation corresponding to each of them under the aforementioned calculation method. This adjustment is gradually reduced over a six-year period, being held unchanged during each financial year.

The interest income and expense on intra-Eurosystem balances relating to banknote allocation is cleared through the accounts of the ECB and is disclosed under "Net interest income" in the profit and loss account.

Under the ECB Decision of 25 November 2010 (ECB/2010/24) on the interim distribution to euro area NCBs of the ECB's income on euro banknotes in circulation arising from the 8% of euro banknotes assigned to it and from securities purchased under the Securities Markets Programme, this income belongs to the NCBs and will be allocated in full to them in the financial year in which it accrues. Settlement takes place in January of the following year, in the form of an interim distribution of the income. The Governing Council may decide to reduce ECB income on euro banknotes in circulation by the costs incurred by the ECB in connection with the issue and handling of banknotes. This Decision establishes that the ECB Governing Council shall decide before the end of the financial year whether all or part of the ECB's income arising from the aforementioned SMP securities and, if necessary, all or part of the ECB's income on euro banknotes in circulation should be retained to the extent necessary to ensure that the amount of the distributed income does not exceed the ECB's net profit for that year. The ECB Governing Council may also decide to transfer all or part of this income to an ECB provision for foreign exchange rate, interest rate, credit and gold price risks. The amount distributed to NCBs is shown in the profit and loss account item "Income from equity shares and participating interests".

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 TARGET2[7] 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 TARGET2 operations, the resulting balance is included as an asset or liability, as appropriate, under the balance sheet 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).

6 The reference period taken has a duration of 24 months and it begins 30 months prior to the euro cash changeover date.

7 Trans-European Automated Real-time Gross settlement Express Transfer system.

Recognition of income and expenses

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

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

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

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

Premiums or discounts on purchased securities are calculated and shown as reductions of or additions to 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 for Bank employees is of the defined-contribution type. The Pension Fund of which this Scheme forms part is external and closed-end. Contributions made by the Banco de España on behalf of the employees who, having joined the Bank after 1 February 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.

Provisions

In application of the principle of prudence, the liabilities side of the balance sheet includes provisions approved by the Executive Commission of the Banco de España which are considered necessary to cover adequately, on objective criteria, the risks derived from the financial positions held and other losses of a diverse nature (see Note 28 on the balance sheet).

Off-balance-sheet positions[8]

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. Since these futures are denominated in foreign currency, such settlements shall affect the foreign currency position on the day on which they take place.

3 CONSIDERATIONS REGARDING THE ESTIMATES MADE

These annual accounts were prepared using Bank estimates to quantify some of the assets, liabilities, expenses, commitments and, in particular, provisions recorded in them

8 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 items 11.4 on the assets side and 12.1 on the liabilities side, depending on their sign.

(see Note 28 on the balance sheet). As regards monetary policy operations, since they are conducted jointly in the Eurosystem, the estimates made by the ESCB are also taken into account [see Notes 6 and 8.a) on the balance sheet].

These estimates assume an ongoing slow economic recovery and instability in some debt markets. Although these estimates are based on the best information available at end-2010, future events may require them to be changed in the coming financial years. Any such changes would be made prospectively in accordance with current accounting rules.

4 POST-BALANCE-SHEET EVENTS

Assets, liabilities and the profit and loss account are adjusted on the basis of events taking place between the end of the accounting period and date of preparation of the annual accounts, should those events materially affect the Banco de España's year-end financial position. The events occurring after year-end which do not affect the assets and liabilities at that date do not give rise to adjustments thereto, although if they are material they are disclosed in the notes on the accounts.

3.2 Notes on the balance sheet

1 GOLD AND GOLD RECEIVABLES

The Banco de España's gold holdings amount to €9,555.49 million, consisting of 9.054 million troy ounces[9] of fine gold valued at a market price of €1,055.42 per ounce. These holdings did not change during the financial year. The value of these holdings is €2,617.18 million more than in 2009, as a result of the rise in the market price (at end-2009 the price per ounce was €766.35). This increase is included in the liability revaluation accounts. The cost of the gold holdings is €850.43 million.

2 CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY.— RECEIVABLES FROM THE IMF

This 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 granted to the IMF.

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 essentially 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 and the bilateral loan agreement between the IMF and Spain. The facility is used to finance low-interest loans to the poorest countries. The Banco de España has given a commitment to contribute up to SDR 830 million to it, the amount drawn down at end-2010 being €393.51 million (SDR 340 million). The bilateral loan agreement concluded to support the IMF's ability to provide balance of payments assistance to its members has a limit in SDRs equivalent to €4,140 million and the transactions carried out in 2010 totalled €301.68 million (SDR 261 million).

The breakdown in 2009 and 2010 is as follows:

9 One troy ounce is equal to 31.1035 grams.

EUR m

Type of asset	2010	2009	Change
Reserve tranche position	692.76	541.30	151.46
Special drawing rights (allocation)	3,394.22	3,221.20	173.01
Other claims on the IMF	695.19	356.66	338.53
TOTAL	**4,782.17**	**4,119.17**	**663.00**

The overall amount of claims on the IMF increased by €663.00 million with respect to the balance at end-2009.

The increase in the reserve tranche position account (€151.46 million) is basically due to the Banco de España's net contributions to the IMF for loans to third countries (Greece, Latvia, Serbia and Ukrania, among others). Of this increase, €110.40 million related to the net increase in amounts denominated in foreign currencies and €41.07 million to the effect of the change in market foreign exchange rates between the two years. Spain's IMF quota was not changed in 2010, remaining at SDR 3,048.90 million.

The increase of 173.01 million in the special drawing rights (allocation) account was due to the effect of the year-end market foreign exchange rates, which accounted for an increase of €201.21 million, less the decrease in foreign currency due to the net effect of loan disposals and repayments (€28.20 million).

The increase in the "Other claims on the IMF" account (€338.53million) is due to the Banco de España's contributions to the IMF's PRGF III programme and the transactions under the bilateral loan agreement, which resulted in an increase of €297.31 million, and to an addition of €41.21 million resulting from the change in 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 0.864155. The SDR is defined in terms of a basket of currencies. Its value is determined as the weighted sum of the exchange rates of four major currencies: the US dollar, the euro, the yen and the pound sterling. The interest rate, which is updated weekly, remained between 0.40% and 0.22% 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 item includes current accounts, deposits, debt security investments in the trading and held-to-maturity portfolios and other claims on non-euro area residents denominated in foreign currency. The held-to-maturity portfolio consists of securities with fixed or determinable payments which the Banco de España intends to hold until maturity.

The total amount as at 31 December 2010 was €9,258.12 million, with the following breakdown:

EUR m

Type of asset	2010	2009	Change
Deposits	142.11	144.65	-2.55
Security investments	9,115.69	8,042.39	1,073.30
Trading portfolio	3,712.65	4,149.24	-436.59
Held-to-maturity portfolio	5,403.04	3,893.15	1,509.88
Other	0.32	0.60	-0.28
TOTAL	**9,258.12**	**8,187.65**	**1,070.47**

As at 31 December 2010, 99.88% 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 1.3362).

The increase in the balance of this item (€1,070.47 million) was due to the net effect of the factors listed in the following table:

EUR m

Reason for change	Amount
Net investment	397.66
Changes of market exchange rates as at 31 December	671.05
Changes of securities market prices as at 31 December	3.16
Accrued interest receivable	-1.59
Other	0.18
TOTAL	**1,070.47**

4 CLAIMS ON EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY

This balance sheet item may include current accounts, balances with banks and security investments. Its balance of €0.06 million at 31 December 2010 is €0.05 million more than that of the previous year, due to the increase in the balance of US dollar denominated demand accounts at monetary financial institutions.

5 CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN EURO.—BALANCES WITH BANKS, SECURITY INVESTMENTS AND LOANS

Included here is the balance of current accounts at correspondents and trading and held-to maturity portfolio securities denominated in euro. The held-to-maturity portfolio consists of securities with fixed or determinable payments which the Banco de España intends to hold until maturity.

The breakdown is as follows:

EUR m

Type of asset	2010	2009	Change
Balances with banks	0.20	0.21	-0.01
Security investments	907.05	1,014.75	-107.70
Trading portfolio	—	108.94	-108.94
Held-to-maturity portfolio	907.05	905.81	1.24
TOTAL	**907.25**	**1,014.96**	**-107.71**

Of the total of this heading (€907.25 million), most (€907.05 million) relates to fixed-income securities included in the held-to-maturity portfolio, which increased by €1.24 million with respect to the balance as at 31 December 2009. This portfolio consists of euro-denominated securities issued by international organisations (the European Investment Bank and the Bank for International Settlements) and by non-euro area States. The trading portfolio, which had a balance of €108.94 million at 31 December 2009, had a zero balance at the end of the reporting year as a result of sales in 2010.

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 total amount of these loans in the Eurosystem as a whole is €546,747 million, of which €61,550.47 are included in the balance sheet of the Banco de España. Pursuant to Article 32.4 of the ESCB/ECB Statute, any counterparty risks that materialise in monetary policy operations must be shared by all Eurosystem banks in proportion to their share of the subscribed capital of the ECB according to the capital keys in force when these risks materialise (see the provision for counterparty risks in Eurosystem monetary policy operations, in Note 28.- Provisions).

The breakdown by type of transaction is as follows:

EUR m

Type of operation	2010	2009	Change
Main financing operations	20,285.31	657.70	19,627.61
Longer-term refinancing operations	39,662.77	89,421.45	-49,758.68
Fine-tuning reverse operations	1,585.00	—	1,585.00
Structural reverse operations	—	—	—
Marginal lending facility	—	—	—
Credits related to margin calls	17.39	8.47	8.92
TOTAL	61,550.47	90,087.62	-28,537.15

Throughout the whole of 2010, against a background of money market tensions in the euro area, the ECB continued to conduct liquidity-providing operations of various maturities to meet the additional liquidity demands of counterparties.

The balance of this item as at 31 December 2010 is 31.68% less than that of 2009. However, the average daily balance of the financing granted during the year increased by 22.68% (€99,291.50 million in 2010, against €80,937.90 million in 2009).

a Main refinancing operations

They are executed through liquidity providing reverse transactions with a weekly frequency and a maturity of one week, normally by means of standard tenders. These operations play a pivotal role in achieving the aims of steering interest rate, managing market liquidity and signalling the monetary policy stance. However, in 2010, continuing the trend initiated in previous years, they were used less than longer-term refinancing operations. In this connection, it should be noted that only 12.36% of annual average financing was extended through them. In 2010 these operations were conducted at fixed rate with allotment of the total amount bid.

The balance of this item at 31 December 2010 was €20,285.31 million (€657.70 at 31 December 2009) and its daily average balance during the year was €12,270.58 (€15,544.88 in 2009).

b Longer-term refinancing operations

These operations aim to provide counterparties with additional longer-term refinancing. In 2010 operations were conducted with maturities equal to the reserve maintenance period and with maturities of three and six months. From October 2008, these operations are also conducted at fixed rate with allotment of the total amount bid, although in 2010 a floating-rate three-month refinancing operation was also carried out.

The balance of these operations at end-2010 amounted to €39,662.77 million (64.44% of the total), having decreased by €49,758.68 with respect to the previous year. However, the average balance increased (from €65,354.89 in 2009 to €86,561.06 in 2010), representing 87.20% of overall financing in the year.

c Fine-tuning reverse operations

The purpose of these operations is to regulate the market liquidity situation and control interest rates, particularly 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-2010 was €1,585.00 million. In 2010 four fine-tuning reverse operations took place in the Eurosystem. Financing was obtained by Spanish credit institutions in all of them.

d Structural reverse operations

These are reverse open-market transactions through standard tenders to enable the Eurosystem to adjust its structural liquidity position vis-á-vis the financial sector.

The end-2010 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 balance at the end of 2010 was zero. As in 2009, there were few of these operations 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 on the balance sheet). 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 December 2010 this item had a balance of €17.39 million, up €8.92 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 €2.04 million as at 31 December 2010 includes the amount of the correspondent accounts with credit institutions The decrease with respect to the previous year (€1,149.60 million) resulted from the repayment in 2010 of all the liquidity-support loans granted to credit institutions in the previous year (€1,150 million as at 31 December 2009).

8 SECURITIES OF EURO AREA RESIDENTS DENOMINATED IN EURO

a Securities held for monetary policy purposes

This item includes the amount of euro-denominated fixed-income securities issued by euro area residents which were acquired by the Banco de España for monetary policy purposes under the covered bond purchase programme[10] and under the securities markets programme.[11] These securities were classified as held-to-maturity (see “Securities” in Section 3.1 “Accounting policies”. The securities purchases under the covered bond purchase programme were completed in June 2010.

10 Decision of the ECB of 2 July 2009 on the implementation of the covered bond purchase programme (ECB/2009/16).

11 Decision of the ECB of 14 May 2010 establishing a securities markets programme (ECB/2010/5).

The balance of this item at 31 December 2010 was €13,906.71 million and there was no objective evidence that these assets were impaired at year-end.

The total amount of the securities acquired by all Eurosystem NCBs under the aforementioned securities markets programme amounted to €60,873.44 million, of which €7,382.70 million were included in the balance sheet of the Banco de España. Pursuant to Article 32.4 of the ESCB/ECB Statute, any risks that materialise in the securities included in this portfolio must be shared by all Eurosystem central banks in proportion to their share of the subscribed capital of the ECB according to the capital keys in force.

b Other securities

This item includes that part of the Bank's trading and held-to-maturity portfolios which consists of euro-denominated fixed-income securities issued by euro area residents that are not held for monetary policy purposes. The held-to-maturity portfolio consists of securities with fixed or determinable payments which the Banco de España intends to hold until maturity. The breakdown of this item is as follows:

EUR m

Security investments	2010	2009	Change
Trading portfolio	33,027.21	40,279.80	-7,252.60
Held-to-maturity portfolio	40,894.03	40,660.51	233.53
TOTAL	**73,921.24**	**80,940.31**	**-7,019.07**

The balance of this item as at 31 December 2010 was €73,921.24 million, of which 44.7% related to trading portfolio securities and the remainder (55.3%) to held-to-maturity securities.

Overall, these securities decreased by €7,019.07 million in 2010. It was, however, trading securities which underwent a decrease, of €7,252.60 million, whereas held-to-maturity securities increased by €233.53 million.

Specifically, the changes were for the reasons reflected in the following table:

EUR m

Reason for change	Trading portfolio	Held-to maturity portfolio	Total
Net purchase of securities	-5,744.07	343.28	-5,400.78
Unrealised gains at year-end (a)	-830.85	—	-830.85
Unrealised losses at year-end (a)	-790.92	—	-790.92
Accrued implicit interest	113.25	-109.76	3.49
TOTAL	**-7,252.60**	**233.53**	**-7,019.07**

a As stated in Section 3.1 "Accounting policies", no periodic valuation is performed on the held-to-maturity portfolio.

This portfolio includes securities issued by general government and by financial institutions in the euro area. 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

This item includes loans which, by virtue of their respective laws of creation, were granted to the State prior to the entry into force of Law 21/1993 of 29 December 1993 on the State budget for 1994. Initially they were to be repaid at their nominal amount on a straight-line basis over twenty-five years by means of yearly payments as from 1999, inclusive, in accordance with transitional provision seven of the aforementioned law. However, on 26 March 2007 an agreement was entered into with the central government to bring forward the repayment schedule of these loans, such that they mature in full by 2015 at the latest and the Treasury can request early repayment of all or part of them. Loans repaid early are paid by the Treasury at the cash amount of their market value at the time. A provision has been set up for losses arising from early repayment of these loans (see Note 28 on the balance sheet).

Under that agreement, in 2010 two instalments of the Law 3/1983 loan (that of the reporting year and the last outstanding instalment of the original repayment schedule) and the instalments of the other two loans corresponding to the reporting year were paid.

The outstanding nominal balance as at 31 December 2010 of the loans granted to the State amounted to €4,081.98 million, broken down as follows:

EUR m

	2010	2009	Change
Treasury. Law 3/1983 special account	976.26	1,171.51	-195.25
Treasury. Law 4/1990 special account	2,779.19	3,126.59	-347.40
Treasury. Credits arising from subscription for participating interests, contributions and quotas in international agencies	326.53	367.35	-40.82
TOTAL	**4,081.98**	**4,665.45**	**-583.47**

The change was solely due to yearly repayments on the above-mentioned loans, as set out above. The amounts are shown in the above table.

10 INTRA-EUROSYSTEM LIABILITIES

This heading includes the amounts of the following items:

EUR m

Type of asset	2010	2009	Change
Participating interest in the ECB	801.70	663.30	138.40
Claims equivalent to the transfer of foreign reserve assets to the ECB	4,783.65	4,783.65	—
Net claims related to the allocation of euro banknotes within the Eurosystem	15,360.48	7,674.24	7,686.23
Other claims within the Eurosystem (net)	—	—	—
TOTAL	**20,945.82**	**13,121.19**	**7,824.63**

a Participating interest in the ECB

Pursuant to Article 28 of the ESCB Statute, the ESCB national central banks are the sole subscribers to the capital of the ECB. Subscriptions depend on the participating interests fixed in accordance with Article 29 of the ESCB Statute based on each country's share in the total population and gross domestic product of the ESCB countries per data furnished by the European Commission. These subscriptions must be adjusted every five years or whenever new Member States join the European Union, i.e. when their NCBs join the ESCB. Since 1 January 2009 the Banco de España's key for subscription of ECB capital has been 8.3040%.

In 2010 the ECB decided to increase its subscribed capital by €5 billion, from €5,760,652,402.58 to €10,760,652,402.58, with effect from 29 December 2010 and the euro area national central banks agreed to pay their additional capital contributions in three equal annual instalments. The first of these payments took place on 29 December 2010 and the other two instalments will be paid at the end of 2011 and 2012, respectively.

As a result of this increase, the subscribed capital and paid-up capital of the national central banks is as follows:

EUR

	Subscribed capital as at 28 December 2010	Paid-up capital as at 28 December 2010	Subscribed capital as at 29 December 2010	Paid-up capital as at 29 December 2010
Nationale Bank van België/Banque Nationale de Belgique	139,730,384.68	139,730,384.68	261,010,384.68	180,157,051.35
Deutsche Bundesbank	1,090,912,027.43	1,090,912,027.43	2,037,777,027.43	1,406,533,694.10
Central Bank and Financial Services Authority of Ireland	63,983,566.24	63,983,566.24	119,518,566.24	82,495,232.91
Bank of Greece	113,191,059.06	113,191,059.06	211,436,059.06	145,939,392.39
Banco de España	478,364,575.51	478,364,575.51	893,564,575.51	616,764,575.51
Banque de France	819,233,899.48	819,233,899.48	1,530,293,899.48	1,056,253,899.48
Banca d'Italia	719,885,688.14	719,885,688.14	1,344,715,688.14	928,162,354.81
Central Bank of Cyprus	7,886,333.14	7,886,333.14	14,731,333.14	10,167,999.81
Banque centrale du Luxembourg	10,063,859.75	10,063,859.75	18,798,859.75	12,975,526.42
Central Bank of Malta	3,640,732.32	3,640,732.32	6,800,732.32	4,694,065.65
De Nederlandsche Bank	229,746,339.12	229,746,339.12	429,156,339.12	296,216,339.12
Oesterreichische Nationalbank	111,854,587.70	111,854,587.70	208,939,587.70	144,216,254.37
Banco de Portugal	100,834,459.65	100,834,459.65	188,354,459.65	130,007,792.98
Banka Slovenije	18,941,025.10	18,941,025.10	35,381,025.10	24,421,025.10
Národná banka Slovenska	39,944,363.76	39,944,363.76	74,614,363.76	51,501,030.43
Suomen Pankki – Finlands Bank	72,232,820.48	72,232,820.48	134,927,820.48	93,131,153.81
Subtotal for euro area NCBs	**4,020,445,721.55**	**4,020,445,721.55**	**7,510,020,721.55**	**5,183,637,388.22**
Българска народна банка (Bulgarian National Bank)	50,037,026.77	3,502,591.87	93,467,026.77	3,505,013.50
Česká Národní banka	83,368,161.57	5,835,771.31	155,728,161.57	5,839,806.06
Danmarks Nationalbank	85,459,278.39	5,982,149.49	159,634,278.39	5,986,285.44
Eesti Pank	10,311,567.80	721,809.75	19,261,567.80	722,308.79
Latvijas Banka	16,342,970.87	1,144,007.96	30,527,970.87	1,144,798.91
Lietuvos bankas	24,517,336.63	1,716,213.56	45,797,336.63	1,717,400.12
Magyar Nemzeti Bank	79,819,599.69	5,587,371.98	149,099,599.69	5,591,234.99
Narodowy Bank Polski	282,006,977.72	19,740,488.44	526,776,977.72	19,754,136.66
Banca Naţională a României	141,971,278.46	9,937,989.49	265,196,278.46	9,944,860.44
Sveriges Riksbank	130,087,052.56	9,106,093.68	242,997,052.56	9,112,389.47
Bank of England	836,285,430.59	58,539,980.14	1,562,145,430.59	58,580,453.65
Subtotal for non-euro area NCBs	**1,740,206,681.03**	**121,814,467.67**	**3,250,631,681.03**	**121,898,688.04**
TOTAL (a)	**5,760,652,402.58**	**4,142,260,189.22**	**10,760,652,402.58**	**5,305,536,076.26**

a Due to rounding, the subtotals and totals may not equal the sum of the individual figures in the table.

As regards the Banco de España, the above table shows that its subscribed capital increased from €478.36 million to €893.56 million, equivalent to 8.3040% of the ECB's capital stock. As stated above, the first instalment of €138.40 million of this increase was paid on 29 December 2010. As a result, the capital disbursed by the Banco de España reached €616.76 million.

This item also includes the participating interest in ECB equity. Its balance of €184.94 million at 31 December 2010 is the amount paid in previous years for the Banco de España's participating interest in ECB reserves due to the increase in the Banco de España's share of the ECB capital key b Claims equivalent to the transfer of foreign reserve assets to the ECB

These represent the ECB's debt to the Banco de España arising from the transfer of foreign reserve assets to the ECB. The claims equivalent to the transferred reserves are denominated in euro at a value fixed from the time of their transfer. They are remunerated at the marginal rate for the Eurosystem's main refinancing operations, reduced by 15% to reflect a zero return on the gold component. Their year-end balance of €4,783.65 million is unchanged from the previous year.

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

This item, the balance of which amounted to €15,360.48 million at end-2010, 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 when there is an overall debit balance (see "Banknotes in circulation" and "Intra-Eurosystem balances" in the section on accounting policies).

The increase with respect to 2009 (€7,686.23 million) was due to the decrease in banknotes put into circulation by the Banco de España in 2010 (-5.0%) and the contrasting rise in the Eurosystem as a whole (growth of 4.1%), which resulted in the aforementioned increase in the balance of these accounts.

d Other claims within the Eurosystem (net)

In accordance with Eurosystem rules, since the accounts making up this item have a net credit balance, this information is presented on the liabilities side of the balance sheet (see Note 23 on the balance sheet).

11 TANGIBLE AND INTANGIBLE FIXED ASSETS

The balance of this item amounted to €254.61 million at end-2010, of which €593.17 million related to cost and €338.56 a million to accumulated depreciation.

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

EUR m

	2010	2009	Change
TANGIBLE FIXED ASSETS	485.85	470.11	15.74
Land and unbuilt plots	5.35	5.35	—
Buildings, structures and renovation work	107.45	106.41	1.04
Plant in buildings	171.72	162.67	9.05
Furniture and fittings	37.19	36.42	0.77
Office machines other than computer equipment	48.20	47.59	0.61
Computer equipment	58.59	55.56	3.03
Transport equipment	8.52	8.67	-0.15
Library collection	5.59	5.01	0.57
Other tangible fixed assets	4.31	3.90	0.41
Art collection	38.93	38.54	0.39
INTANGIBLE FIXED ASSETS	60.42	53.03	7.39
Computer applications	60.36	52.97	7.39
Industrial property	0.06	0.06	—
FIXED ASSETS IN PROGRESS	46.90	30.35	16.55
Buildings, plant in buildings and other structures under construction	24.45	20.28	4.17
Computer applications under development	19.24	9.20	10.05
Other fixed assets in progress	3.21	0.87	2.34
TOTAL	**593.17**	**553.49**	**39.68**

EUR m

Accumulated depreciation or amortisation	2010	2009	Change
TANGIBLE FIXED ASSETS	-294.35	-274.75	-19.61
Buildings, structures and renovation work	-35.25	-32.92	-2.34
Plant in buildings	-130.42	-121.86	-8.56
Furniture and fittings	-25.41	-23.36	-2.05
Office machines other than computer equipment	-40.28	-39.44	-0.83
Computer equipment	-49.59	-45.14	-4.44
Transport equipment	-6.84	-6.27	-0.56
Library collection	-2.89	-2.39	-0.50
Other tangible fixed assets	-3.67	-3.36	-0.31
INTANGIBLE FIXED ASSETS	-44.21	-38.30	-5.91
Computer applications	-44.15	-38.24	-5.91
Industrial property	-0.06	-0.06	—
TOTAL	**-338.56**	**-313.04**	**-25.52**

The increase in fixed assets in 2010 basically arose from increased investment in development of certain computer applications, from the refurbishment of the mezzanine floor of the historic Cibeles building, from the completion of upgrades of electrical and air conditioning fixtures in the Madrid buildings and in several branches, and from diverse improvements to these buildings.[12]

12 OTHER FINANCIAL ASSETS

This item includes €47.18 million of financial investments relating basically to the Banco de España's participating interests in the Bank for International Settlements and Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A. The decrease of €3.26 million in these financial assets was due to the lower underlying book value of this firm.

13 OFF-BALANCE-SHEET INSTRUMENTS REVALUATION DIFFERENCES

This 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, as in 2010, it is recorded under the same heading in liability item 12.1 (see Note 25 on the balance sheet).

14 ACCRUALS AND PREPAID EXPENSES

The main components of this item, the balance of which amounts to €1,891.39 million, are as follows:

12 The refurbishment of buildings is accounted for as an addition to fixed assets if it meets the criteria set out in Section 3.1 "Accounting policies" in regard to tangible and intangible fixed assets.

EUR m

	2010	2009	Change
ACCRUED INTEREST ARISING FROM SECURITIES ACQUISITIONS AND ACCRUED COUPON INTEREST RECEIVABLE	1,775.91	1,720.19	55.72
Trading portfolio	584.13	813.46	-229.33
Denominated in foreign currency	9.89	8.89	1.00
Denominated in euro	574.23	804.56	-230.33
Held-to-maturity portfolio	859.56	848.17	11.39
Denominated in foreign currency	44.68	34.30	10.38
Denominated in euro	814.88	813.87	1.01
Held for monetary policy purposes	332.22	58.56	273.66
OTHER ACCRUED INTEREST RECEIVABLE	112.01	402.72	-290.72
Claims on the IMF	3.75	2.72	1.04
Swap transacctions	0.95	—	0.95
On claims equivalent to the transfer of foreign reserves to the ECB	41.23	52.72	-11.49
On intra-Eurosystem claims arising from banknote adjustments	38.86	19.66	19.20
On monetary policy operations	27.14	324.73	-297.59
On liquidity-providing loans	—	2.02	-2.02
Other	0.08	0.88	-0.80
ACCRUED COMMISSIONS RECEIVABLE AND PREPAID EXPENSES	3.47	3.21	0.26
TOTAL	**1,891.39**	**2,126.12**	**-234.73**

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 the trading portfolio (€574.23 million), from the held-to maturity portfolio (€814.88 million) and from monetary policy operations (€332.22 million). In total, this interest increased by €55.72 million with respect to 2009. Furthermore, accrued interest receivable on monetary policy operations decreased significantly (by €297.59 million) due to the lower volume of outstanding transactions at year-end. There was also a decrease in interest receivable on claims equivalent to the transfer of foreign reserve assets to the ECB due to the lower average rate of return, while the interest accrued on intra-Eurosystem banknote adjustment and offsetting accounts increased as a result of the larger balance to be remunerated.

15 OTHER ASSETS. SUNDRY

The most significant components of this item, which totals €1,515.55 million, are the transfer to the Treasury on 1 December 2010 of €1,316.49 million, equivalent to 70% of the Bank's distributable profits earned to 30 September 2010, adjusted in line with the projected performance of profits up to year-end (see Note 15 on the profit and loss account), which was €390.18 million lower than in the previous year, and the home loans and repayable advances granted to Bank employees, the balance of which, at €187.26 million, was down by €2.14 million from 2009.

16 BANKNOTES IN CIRCULATION

The balance of banknotes in circulation (€91,917.98 million) represents the Banco de España's share in the total euro banknotes in circulation (see "Banknotes in circulation" in Section 3.1 Accounting policies) according to the Eurosystem euro banknote allocation key (10.9465% of the total issue by all the central banks) after deducting those corresponding to the Eurosystem (8% of the ECB total). This balance was €3,644.20 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 €26,964.03 million at end-2010, €8,124.99 million less than in the previous year. This decline was due to the fall in the balance of credit institution current accounts (including minimum reserves) and to the decrease in the deposit facility.

The breakdown and the amounts in both reporting years are as follows:

EUR m

Type of liability	2010	2009	Change
Current accounts (covering the minimum reserve system)	19,950.00	24,736.02	-4,786.02
Deposit facility	6,997.50	10,352.00	-3,354.50
Fixed-term deposits	—	—	—
Fine-tuning reverse operations	—	—	—
Deposits related to margin calls	16.53	1.00	15.53
TOTAL	**26,964.03**	**35,089.02**	**-8,124.99**

The first component, which includes the total current accounts held by credit institutions at the Banco de España, in which they maintain the minimum reserves required for monetary policy implementation purposes, underwent a decrease of €4,786.02 million. Its average balance also decreased during the year, falling from €26,052.70 million in 2009 to €25,383.94 million in 2010.

The item "Deposit facility", which includes overnight deposits remunerated at a fixed interest rate (appreciably lower than the interest rate on main refinancing operations), also decreased, from €10,352.00 million in 2009 to €6,997.50 million in 2010. However, the average balance increased (€9,393.71 million in 2010 compared with €7,535.94 million in 2009).

With regard to fixed-term deposits, as in 2009, there was no balance as at 31 December 2010. They are fine-tuning operations (liquidity withdrawals) that take the form of deposits. During 2010 the Eurosystem carried out 45 operations of this type.

The other captions in this item relate to fine tuning reverse operations and deposits related to margin calls. As at 31 December 2010, fine tuning reverse operations had a zero balance, while institutions' deposits related to margin calls amounted to €16.53 million (€1.00 million in 2009).

18 LIABILITIES TO OTHER EURO AREA RESIDENTS DENOMINATED IN EURO.— GENERAL GOVERNMENT

This item includes the deposits held by general government with the Banco de España. The outstanding balance at year-end was €9,336.63 million, which breaks down as follows:

EUR m

	2010	2009	Change
Central government (State)	3,633.00	14,429.06	-10,796.06
Treasury current account	300.01	305.25	
Other central government agencies and similar bodies	3,332.98	14,123.81	
Territorial government	355.48	960.17	-604.69
Regional (autonomous) governments, administrative agencies and similar bodies	351.16	954.85	
Local government	4.32	5.32	
Social security funds	5,348.15	15,843.81	-10,495.66
Social Security System	5,347.19	14,773.28	
Other	0.96	1,070.54	
TOTAL	**9,336.63**	**31,233.05**	**-21,896.42**

The substantial decrease in this item (€21,896.42 million) was basically due to the smaller balances held by Social Security Funds (€10,495.66 million) and by the Fund for the Orderly Restructuring of the Banking Sector (FROB) under "Other central government agencies and similar bodies" (€8,718.93 million) and, to a lesser extent, to the decrease in the balances held by the Treasury and territorial (regional and local) government.

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-2010 was €152.11 million, and its decrease of €1,340.41 million with respect to end-2009 was basically due to the decrease in the balances of the current accounts of State agencies (€1,231.26 million).

20 LIABILITIES TO NON-EURO AREA RESIDENTS DENOMINATED IN EURO

This item includes basically the euro-denominated accounts held by international organisations, non-Eurosystem monetary authorities and central banks to which reserve management services are provided. The balance of €400.15 million was €135.67 million higher than a year earlier, mainly due to an increase in deposits of the central banks to which reserve management services are provided.

21 LIABILITIES TO NON-EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY.—DEPOSITS, BALANCES AND OTHER LIABILITIES

This item basically includes the foreign-currency balances of non-euro area central banks and collateralised inward deposits recorded in respect of reverse transactions conducted under repurchase agreements. The end-2010 balance of €0.76 million was €0.06 million more than at the end of 2009 as a result of the significant increase in US$-denominated deposits placed by these institutions.

22 COUNTERPART OF SPECIAL DRAWING RIGHTS ALLOCATED BY THE IMF

This item of €3,272.05 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 increased by €193.97 million with respect to the previous year, due to the variation in the exchange rate.

23 INTRA-EUROSYSTEM LIABILITIES

This item, which as at 31 December 2010 had a balance of €50,864.34 million, comprises the following two sub-items:

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

In accordance with Eurosystem rules, since the accounts making up this item have a net debit balance, this information is presented on the assets side of the balance sheet.

b Other liabilities within the Eurosystem (net)

The balance of €50,864.34 million as at 31 December 2010 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 TARGET2 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; 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 seigniorage income relating to euro banknotes issued by the ECB and of the securities acquired by the ECB under the securities markets programme.

Regarding the first component, the year-end net transfers via TARGET2 had a credit balance of €50,922.53 million, while the correspondent accounts showed a debit balance of

€0.15 million. The remuneration of this position is calculated daily at the marginal interest rate of Eurosystem main refinancing operations.

The second component, i.e. the position vis-à-vis the ECB in respect of the annual pooling and allocation of monetary income within the Eurosystem national central banks, had a debit balance of €58.05 million at year-end (see "Net result of pooling of monetary income" in Note 8 on the profit and loss account).

Finally, in regard to the position vis-à-vis the ECB relating to the distribution of income arising from the seigniorage of euro banknotes issued on its behalf by the NCBs and to the securities purchased under the securities markets programme, pursuant to the Decision of the European Central Bank of 25 November 2010 (ECB/2010/24), 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 Accounting Policies). In 2010 the Governing Council decided not to distribute this income.

24 ITEMS IN COURSE OF SETTLEMENT

Included here are various accounts which as at 31 December 2010 were in the course of settlement, such as transfer instructions pending execution and transfers sent to deposit institutions yet to be reimbursed.

The balance of this item amounted to €138.39 million at end-2010, of which €125.69 related to transfers to accounts with other institutions, with payment of those transfers yet to be made.

25 OFF-BALANCE-SHEET INSTRUMENTS REVALUATION DIFFERENCES

This 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, it is recorded under the same heading in asset item 11.4. Its credit balance of €30.43 million as at end-2010 is the net value of the forward and swap transactions outstanding at that date that are listed below:

		2010				2009
Operation	Position	Currency	Currency amount (million)	Market exchange rate	Equivalent (million €)	Equivalent (million €)
SWAP	DEBTOR	EUR	2,888.29	1.0000	2,888.29	170.00
		CHF	—	1.2504	—	157.34
	CREDITOR	EUR	—	1.0000	—	170.00
		CHF	—	1.2504	—	157.34
		USD	3,900.00	1.3362	2,918.72	—
FORWARD	DEBTOR	EUR	—	1.0000	—	2,627.54
	CREDITOR	USD	—	1.3362	—	2,707.21
NET POSITION					**30.43**	**79.67**

The only unmatured transactions at year-end were swaps of euro against US dollars.

Regarding exceptional liquidity-providing transactions in the form of swaps, which reached a considerable volume in previous years, it should be noted that in January 2010 the ECB Governing Council decided, in agreement with the central banks involved, to cease these transactions in view of the lower demand and of the improvements in the functioning of the financial markets. However, in mid-2010 the ECB decided to continue the liquidity providing arrangements (swap line) with the Federal Reserve until 1 August 2011 in response to the resurgence of tensions in US dollar denominated short-term funding on the European markets. However, Spanish institutions did not participate in transactions of this kind.

26 LIABILITY ACCRUAL ACCOUNTS AND INCOME COLLECTED IN ADVANCE

This item includes interest accrued but not yet paid, expenses accrued but not yet paid and income collected in advance.

As at 31 December 2010, its balance amounted to €80.96 million, the main component being interest accrued but not yet paid (€74.24 million). The increase in this item in 2010 (€12.30 million) basically resulted from the larger amount of interest incurred on intra-Eurosystem accounts relating to TARGET2 transactions (€13.84 million) and from the interest incurred on the minimum reserves held by credit institutions (€2.02 million) which were payable at year-end. These increases were partly offset by the decrease in the interest payable to remunerate the Fund for the Orderly Restructuring of the Banking Sector (FROB) accounts (€2.28 million) and the Social Security accounts (€1.22 milion).

27 OTHER LIABILITIES.— SUNDRY

This includes other liabilities not classifiable above.

As at 31 December 2010 the balance of this item amounted to €188.84 million (€38.35 million less than in 2009) and its main component was the “Banco de España employee social welfare scheme (Mutualidad de empleados).- Contributions payable” (€72.51 million). The most significant change relates to the decrease of €46.96 million in this debt to the employee social welfare scheme.

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

	2010	2009	Change
For exchange rate and interest rate risks	3,957.27	3,808.71	148.57
For early repayment of special loans	786.25	734.01	52.23
For counterparty risks in Eurosystem monetary policy operations	239.07	434.49	-195.42
For credit risk	336.20	168.91	167.29
For operational risk	22.86	22.86	—
For exchange of withdrawn peseta banknotes	50.46	17.70	32.76
For early and regular retirement	25.85	33.05	-7.20
For death and retirement assistance	59.70	72.47	-12.77
For sundry liabilities and charges	1.15	19.84	-18.69
TOTAL	**5,478.81**	**5,312.04**	**166.77**

Provision for exchange rate and interest rate risks

This is the most important provision. 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 December 2010 amounted to €3,957.27 million, which was €148.57 more than in 2009 (see Note 5 on the profit and loss account).

The balance of this provision is revised annually based on the Banco de España’s valuation of its exposure to the aforementioned risks by value-at-risk methodology. This review takes into account, in addition to that valuation, a number of factors, including the estimated profit for the coming year and the envisaged behaviour of risk assets and others deemed to be worthy of consideration under the circumstances. In this respect, on 30 December 2009 and 2 February 2011 the Executive Commission adjusted to market conditions the methodology used to calculate the provision for exchange rate and interest rate risks. To do so, it set, inter alia, the calculation basis and the percentages of coverage to be applied for exchange rate and interest rate risks in each portfolio.

Provision for losses arising from early repayment of special loans

The agreement in 2007 with the Spanish State government whereby the Treasury can ask to repay a portion or all of these loans early, paying a cash amount equal to their market value instead of their nominal amount, led the Banco de España to set up in that year a provision for losses due to early repayment of special loans, so as to cover the possible losses that may arise from early repayment of these loans (recorded in asset item 8; see Note 9 on the balance sheet). The balance of this provision was set at the difference between the nominal amount and the current market value of the loans. Its balance of €786.25 million as at 31 December 2010 was €52.23 million more than in the previous year.

Provision for counterparty risk in Eurosystem monetary policy operations

In accordance with the general accounting principle of prudence, the ECB Governing Council considered it appropriate in 2008 to establish a buffer totalling €5,736.00 million against counterparty risks in monetary policy operations (see these operations in Note 6 on the balance sheet). In accordance to Article 32.4 of the ESCB/ECB Statute, this buffer will be funded among all Eurosystem national central banks in proportion to their subscribed capital key shares in the ECB prevailing at the time. As a result, the Banco de España recorded a provision of €621.35 million, equivalent to 10.8324% of the total provision, which decreased to €434.49 at the end of 2009. On 4 February 2011 the ECB Governing Council reviewed the adequacy of the amount of this provision with effect as at 31 December 2010 and decided to reduce it from €4,011 million to €2,207 million. As a result, the Banco de España provision was set at €239.07 million and, accordingly, a portion of it amounting to €195.42 million was released (see Note 8 on the profit and loss account).

Provision for credit and operational risks

In 2009 the Executive Commission approved a methodology for calculating the credit risk on Banco de España investment portfolios, as a basis for setting up a provision for credit risk, as well as the percentage of coverage to be applied to the value of the risk exposure. This provision is reviewed yearly in accordance with the valuation made by the Banco de España of its risk exposure. This methodology was used in 2010 to record a provision of €167.29 million, the balance of which reached €336.20 at the end of the year.

Also, the Executive Commission approved in 2009 a methodology for calculating operational risk, to be reviewed yearly. It will be used to set aside a provision for any losses arising from operational risk. Once this exercise had been completed, an analysis of the appropriate amount for this provision concluded that it should have a balance of €22.86 million, the same as in the previous year.

Provision for exchange of peseta banknotes withdrawn from circulation due to the introduction of the euro

This provision was recorded initially in 2005 to cater for the exchange of any peseta banknotes withdrawn from circulation due to the introduction of the euro that may be tendered at the Banco de España. At the same time, the Council of Ministers decided that if the amount of banknotes tendered for exchange exceeded the amount of the provision at that time, the Banco de España would meet the excess with a charge to its reserves.

In November 2010 the balance of the provision fell to zero. Accordingly, pursuant to a resolution of the Executive Commission, an additional €50 million were provisioned (provision for a period of approximately five years), using the Banco de España reserves arising from the retention of 2005 earnings. At the end of the reporting year this provision had a balance of €48.31 million.

Other provisions

In the reporting year there were decreases in the provision for payments to early and regular retirees as a result of the use thereof for its intended purpose (€7.20 million) and in the provision for sundry risks and expenses (€18.69 million).

29 REVALUATION ACCOUNTS

This item includes the revaluations arising from unrealised gains on financial assets and liabilities valued at market prices and exchange rates at year-end. It may be broken down as follows:

EUR m

Type of account	2010	2009	Change
Gold	8,705.06	6,087.88	2,617.18
Foreign currency	468.33	0.25	468.09
Securities (trading portfolio)	83.73	911.31	-827.58
Issued in foreign currency by non-euro area residents	40.79	34.67	6.12
Issued in euro by non-euro area residents	—	2.85	-2.85
Issued in euro by euro area residents	42.94	873.79	-830.85
Other	17.47	20.72	-3.25
TOTAL	**9,274.59**	**7,020.16**	**2,254.43**

The balance of revaluation accounts at end-2010 was €9,274.59, up €2,254.43 on 2009. The main change was in gold, the unrealised gains on which were €2,617.18 million higher as a result of the increase in its market price (up from €766.35 per ounce at 31 December 2009 to €1,055.42 per ounce at 31 December 2010). Its balance at 31 December 2010 was €8,705.06 million.

With regard to fixed-income securities in the trading portfolio, there was a decrease in unrealised gains arising basically on securities issued in euro by euro area residents (€830.85 million), as a result of security price movements driven by interest rates. This decrease was minimally offset by the increase in foreign currency denominated securities issued by non-euro area residents (€6.12 million)

As regards the foreign exchange revaluation accounts, the unrealised gains on foreign currencies increased by €468.09 million, basically due to the appreciation of the US dollar and the SDR against the euro (€405.78 million and €62.19 million, respectively).

30 CAPITAL

As at 31 December 2010 the capital of the Banco de España amounted to €1,000 million, with no change in the year. Of this amount, €1.37 million were constituted pursuant to Decree-Law 18/1962 of 7 June 1962 and €998.63 million as a capital increase carried out in 2006 through the retention of 2005 earnings.

31 RESERVES

As at 31 December 2010 the reserves of the Banco de España amounted to €950 million. This balance is €50 million lower than in the previous year as a result of the recording, with a charge to reserves, of a provision of this amount for exchange of peseta banknotes withdrawn from circulation due to the introduction of the euro (see Note 28 on the balance sheet).

Included in this 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 and 2006 profit taken to reserves, authorised by the Council of Ministers, respectively, on 28 July 2006 and 29 June 2007 in application of the legal provisions cited in the previous note.

32 PROFIT FOR THE YEAR

The net profit for 2010, after deducting the transfer to the Beneficent Social Fund (€25.96 million), amounted to €2,570.00 million, down 3.9% on 2009. Of this amount, €1,316.49 million was paid to the Treasury on 1 December 2010, in accordance with Royal Decree 2059/2008 of 12 December 2008 (see Note 15 on the profit and loss account "Profit for the year").

During the year, the following amounts were also paid to the Treasury out of 2009 profits:

a) On 1 March 2010, €699.19 million, which, together with the payment in December 2009, amounted to 90% of the €2,673.18 million of distributable profit for that year.

b) On 13 August 2010, once the balance sheet and profit and loss account for the year 2009 had been approved by the Council of Ministers, €267.32 million, representing the rest of the distributable profit for that year.

The details of the various components of the profit for 2010 and the reasons for the changes in them with respect to 2009 are given in Section 3.3 below on the profit and loss account.

3.3 Notes on the profit and loss account

This item includes income from interest accrued on the main assets of the Banco de España. The breakdown in 2010 and 2009 is as follows:

1 INTEREST INCOME

EUR m and %

	Interest income			Average investment in 2010	Average yield in 2010
	2010	2009	Change		
FOREIGN CURRENCY	285.15	305.63	-20.48	12,702.47	2.2
Securities	266.38	255.82	10.56	8,096.64	3.2
Deposits and other assets	18.74	18.33	0.42	4,605.83	0.4
Exceptional liquidity providing operations	0.02	31.48	-31.45		
EURO	4,165.42	4,364.23	-198.80	202,799.46	2.0
Securities	2,978.79	2,945.21	33.58	86,990.00	3.4
Monetary policy operations	1,006.76	1,280.53	-273.77	99,291.50	1.0
Intra-Eurosystem accounts	160.19	104.18	56.00	16,517.95	1.0
Claims equivalent to the transfer of foreign reserves to the ECB	41.23	52.72	-11.49	4,783.65	0.9
Claims related to allocation of eurobanknotes within the Eurosystem	118.96	51.46	67.50	11,732.79	1.0
Other claims within the Eurosystem (net)	—	—	—	1.51	
Other assets	19.68	34.30	-14.62	—	
TOTAL	**4,450.57**	**4,669.85**	**-219.28**	**215,501.93**	**2.0**

Interest income decreased by €219.28 million in 2010 with respect to 2009. This decrease was a result of a fall of €198.80 million in the return on euro-denominated investments and, to a lesser extent, of a decline in income from foreign-currency investments (€20.48 million).

Of the €285.15 million of interest on foreign-currency investments, €266.38 million arose from investments in fixed-income securities denominated in US dollars, €18.74 million from deposits and other assets, and €0.02 million from exceptional liquidity providing operations which generated expenses for the same amount. Interest on this dollar-denominated portfolio increased by €10.56 million and that on deposits and other assets was up by €0.42 million; by contrast, interest on exceptional liquidity providing operations dropped significantly (€31.45 million) due to the small amount of these operations in 2010. Overall, the average return on foreign-currency investments was 2.2%, compared with 3.0% in 2009.

Euro-denominated interest income (€4,165.42 million) arose basically from the securities portfolios (€2,978.79 million, an increase of €33.58 million), monetary policy operations (€1,006.76 million, down €273.77 million) and intra-Eurosystem balances (€160.19 million, up €56.00 million).

The main reason for the decrease of €198.80 million in euro-denominated income with respect to the previous year was the lower average return in the reporting year (down from 2.5% in 2009 to 2.0% in 2010), partly offset by an increase in the average balance of the aforementioned assets (up from €171,070.37 in 2009 to €202,799.46 in 2010).

Specifically, analysis of the average investment made discloses the significant increase in monetary policy operations (€99,291.50 million in 2010 against €80,937.90 million in 2009), derived from the higher funding requested by Spanish financial institutions from the ECB. There was also an increase in claims related to the allocation of euro banknotes, which rose from €4,533.66 million in 2009 to €11,732.79 million in 2010 as a result of changes in banknotes put into circulation (-5.0% in Spain, compared with 4.1% in the Eurosystem as a whole). Investment in securities increased by €6,174.84 million (7.6%), basically in the monetary policy portfolio. It should be noted with regard to this portfolio that in May 2010 purchases began under the securities markets programme, while the covered bond purchase programme was declared to have concluded in June 2010.

2 INTEREST EXPENSE

This item includes interest expenditure on the liabilities listed below, as follows:

EUR m and %

	Interest expense			Average financing in 2010	Average cost in 2010
	2010	2009	Change		
FOREIGN CURRENCY	10.02	35.19	-25.17	3,115.88	0.3
Swap and forward	0.51	—	0.51		
Exceptional liquidity providing operations	0.02	31.48	-31.45		
Other liabilities	9.48	3.72	5.77	3,115.88	0.3
EURO	1,030.37	970.10	60.27	119,475.45	0.9
Remuneration of minimum reserves	256.30	333.08	-76.79	25,383.94	1.0
Deposit facility	23.81	59.06	-35.25	9,393.71	0.2
Fixed-term deposits	8.64	5.32	3.32	1,659.37	0.5
General government deposits	122.86	147.96	-25.10	22,135.39	0.6
Other liabilities within the Eurosystem (net)	617.49	422.02	195.47	60,903.05	1.0
Other liabilities denominated in euro	1.28	2.65	-1.37		
TOTAL	**1,040.39**	**1,005.29**	**35.10**	**122,591.33**	**0.8**

Interest expenses increased by €35.10 million in 2010 as a result of a rise in expenses on euro-denominated liabilities (€60.27 million) and a fall in interest expenses on liabilities denominated in foreign currencies (€25.17 million).

Of the euro-denominated interest expenses (€1,030.37 million), €617.49 million relate to the remuneration of other intra-Eurosystem balances (TARGET2), €256.30 million to remuneration of minimum reserves, €122.86 million to remuneration of general government deposits and the remainder to remuneration of the deposit facility, fixed-term deposits (fine-tuning operations) and other euro-denominated liabilities.

The increase in euro-denominated expenses (€60.27 million) basically resulted from the higher average balance of the aforementioned liabilities, which rose from €87,617.81 million in 2009 to €119,475.45 million in 2010, partly offset by the lower average cost at which they were remunerated, which dropped from 1.1% in 2009 to 0.9% in 2010.

Regarding the net credit balance of intra-Eurosystem balances arising from TARGET2 transactions, interest expenses rose by €195.47 million because of the considerable increase in its average balance with respect to 2009 from €33,514.58 million to €60,903.05 million in 2010, partly offset by the decrease in the average cost (1.0% in 2010 versus 1.2% in 2009).

Interest expenses denominated in foreign currencies (€10.02 million) related almost solely to allocated SDRs (€9.48 million), since in 2010 the volume of exceptional liquidity providing operations was very small and generated expenses of only €0.02 million (€31.48 million in 2009).

3 REALISED GAINS/LOSSES ARISING FROM FINANCIAL OPERATIONS

This item includes the profits and losses arising from dealing in financial assets. In 2010 the net gains in this connection amounted to €366.04 million, arising from the following sources:

EUR m

	2010	2009	Change
FOREIGN CURRENCY	47.45	-120.27	167.71
Sale of gold	—	—	—
Sale of foreign currency (exchange gains/losses	31.39	-169.57	200.96
Sale of securities (price gains/losses)	14.85	49.53	-34.68
Other gains/losses	1.20	-0.23	1.43
EURO	318.59	228.81	89.78
Sale of securities (price gains/losses)	318.59	228.81	89.78
TOTAL	**366.04**	**108.54**	**257.50**

Compared with the prior year, the total amount recorded in 2010 increased by €257.50 million due to the gains on the sale of foreign currencies in contrast to the losses in 2009, basically in US dollars (€185.74 million) and SDRs (€14.51 million) and to the higher gains on the sale of euro-denominated fixed-income securities (€89.78 million). These two increases were partly offset by the smaller gains on the sale of US dollar-denominated securities (€34.68 million).

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 2010 and 2009 is as follows:

EUR m

	2010	2009	Change
FOREIGN CURRENCY	2.97	179.01	-176.04
Foreign currency (exchange rate losses)	0.05	175.57	-175.52
Securities (price losses)	2.92	3.44	-0.52
EURO	790.92	14.11	776.81
Securities (price losses)	790.92	14.11	776.81
TOTAL	**793.89**	**193.12**	**600.77**

Unrealised losses in 2010 amounted to €793.89 million, most of which related to euro-denominated fixed-income securities from the trading portfolio (€790.92 million) as a result of the adverse performance of the price of some securities in this portfolio. Comparison with 2009 shows that these high unrealised losses were responsible for the increase, since in 2009 they amounted to €14.11 million. Also notable was the decrease in unrealised exchange losses denominated in foreign currency (€175.52 million), since there were no losses at end-2010 on either US dollars or SDRs.

5 TRANSFERS FROM/TO PROVISIONS FOR FOREIGN EXCHANGE RATE, PRICE AND CREDIT RISKS

EUR m

	2010	2009	Change
Transfers to provisions	-1,109.75	-1,066.82	-42.93
Foreign exchange rate and interest rate risk	-942.46	-897.91	-44.55
Credit risk	-167.29	-168.91	1.62
Transfer from exchange rate and interest rate provision	793.89	193.12	600.77
Transfer/reversal from provision for losses arising from early repayment of special loans	-92.10	185.56	-277.66
TOTAL	**-407.96**	**-688.14**	**280.19**

This includes, first, the transfer of €793.89 million from the provision for foreign exchange rate and interest rate risks to cover the losses recorded at end-2010 and, second, the transfer of €942.46 million to this provision to cover the estimated foreign exchange rate and price risks associated with the financial positions subject to such risks, in accordance with the Executive Commission resolution of 10 February 2011.

This item also includes the transfer to the provision for credit risk in accordance with an Executive Commission resolution, amounting to €167.29 million in 2010.

Lastly, regarding the provision for losses arising from early repayment of special loans derived from the adjustment of changes in the market value of these assets, in 2010 the provisioning expense underwent a negative change of €277.66 with respect to 2009, due to the charge of €92.10 million in 2010 as against the recovery of €185.56 million in 2009.

6 NET INCOME FROM FEES AND COMMISSIONS

This basically includes income and expenses arising from fees and commissions for banking services and the like (TARGET2, transfers, handling of cheques, custody and administration of securities, etc.). It may be broken down as follows:

EUR m

	2010	2009	Change
1 Income from fees and commissions	20.07	23.77	-3.70
Foreign operations	0.03	0.02	0.01
Domestic operations	20.05	23.76	-3.71
2 Expenses from fees and commissions	11.12	13.20	-2.08
Foreign operations	3.06	2.96	0.09
Domestic operations	8.06	10.24	-2.17
NET INCOME FROM FEES AND COMMISSIONS (1-2)	**8.95**	**10.57**	**-1.62**

Net fee and commission income in 2010 (€8.95 million) was €1.62 million less than in 2009. This variation relates basically to the lower fee income from securities transactions and the smaller amount of fees and commissions received by the Banco de España from the holders of direct accounts. This lower income was partially offset by the lower expense of fees and commissions paid on security transactions carried out through the Sistema Nacional de Compensación Electrónica (National Electronic Clearing System).

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 from ordinary operations, seignorage income, income generated by the ECB portfolio derived from the security market programme and the dividends on other shares and participating interests.

Of the total amount of €191.04 million recorded, €174.43 million relate to the ECB ordinary dividend, €8.80 million to dividends on the participating interest in Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, SA (BME) and €7.81 million to participating interests in international agencies (Bank for International Settlements).

In 2010 the ECB Governing Council decided not to distribute among the Eurosystem central banks the banknote seigniorage income or that generated by its securities portfolio purchased under the security market programme, but rather to retain that income to record a provision for foreign exchange rate, interest rate, credit and gold price risks.

Compared with 2009, the amount recorded in 2010 was €73.10 million higher, basically due to the larger ordinary dividend distributed by the ECB in the reporting year (paid out of 2009 profit), partly offset by the aforementioned absence of an ECB dividend from seigniorage income (€93.66 million were allocated to the Banco de España in 2009).

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 TARGET2 transactions whenever they have a credit balance; and net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem whenever they have a credit balance. 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; monetary policy portfolio securities; intra-Eurosystem claims equivalent to the transfer of foreign reserve assets to the ECB; net intra-Eurosystem claims resulting from TARGET2 transactions, whenever they have a debit balance; net intra-Eurosystem claims related to the allocation of euro banknotes in the Eurosystem, whenever they have a debit balance; and a limited amount of each NCB's gold holdings, in proportion to its capital key. Gold is considered to generate no income and the securities acquired under the covered bond purchase programme are deemed to generate income at the interest rate on main refinancing operations. 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 most recent marginal interest rate on main refinancing operations.

The breakdown of this item in 2009 and 2010 is as follows:

EUR m

	2010	2009	Change
Monetary income pooled	-1,177.53	-1,349.81	172.28
Monetary income allocated	1,235.58	1,356.94	-121.36
Provision for counterparty risk in monetary policy operations and for ECB losses	195.42	186.86	8.56
TOTAL	**253.47**	**193.99**	**59.48**

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 2010, amounting to €1,177.53 million, and that reallocated to it, amounting to €1,236.86 million, is equivalent to a net allocation of €59.34 million. From this net allocation should be deducted €1.29 million for the Banco de España's share of the losses on Eurosystem monetary policy operations (the expense of the professional consulting and audit services of independent experts and the settlement of the final loss from the insolvency of Indover Bank). Compared with 2009, there was a positive net change of €50.92 million in these results.

Also, with regard to the provision for counterparty risk in Eurosystem monetary policy operations, on 4 February 2011 the ECB Governing Council approved the amounts relating to each NCB. Accordingly, the Banco de España reversed a portion of the provision recorded (€195.42 million out of a total of €434.49 million), resulting in a change of €8.56 million in profit (in 2009 €186.86 million were released).

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

	2010	2009	Change
Extraordinary profit	0.35	2.36	-2.01
Employee social welfare scheme	-13.14	-17.80	4.65
Sundry	1.23	2.51	-1.28
TOTAL	**-11.56**	**-12.93**	**1.36**

As can be seen, this item shows a net loss of €11.56 million, which is €1.36 million less than in 2009, basically due to the decrease in the principal of the debt to the employee social welfare scheme (Mutualidad de Empleados), which generated lower expenses of €4.65 million.

10 STAFF COSTS

This item includes the headings "Wages and salaries", "Contributions to pension scheme" and "Social security contributions and employee benefits".

The breakdown of changes by component is as follows:

EUR m and %

	2010	2009	Change	(%)
Gross staff costs	230.86	233.04	-2.17	-0.9
Wages and salaries	174.12	177.84	-3.71	-2.1
Social Security	32.27	32.09	0.18	0.5
Staff welfare expenses	18.01	17.05	0.96	5.6
Contributions to Pension Scheme	6.46	6.05	0.41	6.7
Reversal of staff costs due to capitalisation of computer applications	-2.47	-2.07	-0.39	18.9
TOTAL	**228.40**	**230.96**	**-2.56**	**-1.1**

It balance decreased from €230.96 million in 2009 to €228.40 million in 2010, a fall of €2.56 million (1.1%). The main reason for this decrease was the wage reduction derived from the application from June of Royal Decree-Law 8/2010 on extraordinary measures to reduce the budget deficit, partly offset by the higher expense of temporary hires (€2.55 million), due basically to Eurosystem projects, and a number of factors of varying nature (wage drift due to promotions, increased social security contributions, medical and pharmaceutical assistance, pension scheme, etc.).

The following table sets out the changes in permanent and temporary staff, in terms of average number of employees:

	2010	2009	Change	%
AVERAGE NUMBER OF EMPLOYEES	2,733.2	2,745.8	-12.6	-0.5
1 Permanent staff	2,488.7	2,570.9	-82.2	-3.2
Managerial staff	1,485.9	1,476.2	9.7	0.7
Administrative staff	816.5	886.3	-69.8	-7.9
Other	186.3	208.4	-22.2	-10.6
2 Temporary staff	244.5	174.9	69.6	39.8
Managerial staff	131.2	107.8	23.4	21.7
Administrative staff	101.1	59.8	41.3	69.0
Other	12.3	7.4	4.9	65.5

As at 31 December 2010, the Bank's total staff numbered 2,709 employees, 18 fewer than at the same date of the previous year, as a result of the smaller number of permanent employees (down from 2,545 at 31 December 2009 to 2,432 at 31 December 2010, partly offset by a significant rise in temporary hires (95 workers) for the aforementioned reasons. Most noteworthy as regards staff composition by gender was the increase of 47 in the number of women, which, together with the decrease of 65 in the number of men, meant that women now account for 40% of the Bank's total staff.

11 ADMINISTRATIVE EXPENSES

This item includes expenses arising from the purchase of current assets and of diverse services received during the year, as follows:

EUR m and %

	2010	2009	Change	%
Gross administrative expenses	123.44	123.81	-0.37	-0.3
Renting and maintenance	33.03	32.32	0.71	2.2
Material and supply	11.10	10.97	0.13	1.2
External services	62.76	64.08	-1.32	-2.1
Training. promotion and selection	4.02	3.20	0.81	25.4
Sundry operating expenses	12.53	13.23	-0.70	-5.3
Reversal of administrative expenses due to capitalisation of computer applications	-5.61	-2.30	-3.31	143.9
TOTAL	**117.83**	**121.51**	**-3.68**	**-3.0**

The above table shows that in 2010 the most significant administrative expenses were external services (€62.76 million), mainly IT services (€38.11 million) and rental and maintenance (€33.03 million), composed mainly of hardware and software rental and maintenance (€15.12 million) and property rental and maintenance (€12.05 million).

Goods and services expenses decreased in 2010 (€3.68 million). The reasons for this decrease were basically the higher recovery of expenses due to capitalisation of computer applications (€3.31 million) and the fall in external services expenses (€1.32 million) due mainly to the lower expense of computer services procurement (€1.07 million).

"External services" include €139,164.25 (including VAT) relating to the fees of the external auditors Deloitte, S.L. for the audits in 2010 of the Bank's annual accounts and of certain aspects of the Bank's management of European Central Bank reserves, the latter being the only service provided by the auditor to the Bank. In 2010 no services were received from or amounts paid to other firms related to the auditor.

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 and %

	2010	2009	Change	%
Depreciation of buildings. structures and renovation work	2.33	2.27	0.06	2.4
Depreciation of plant in buildings	8.32	7.25	1.07	14.8
Depreciation of furniture and fittings	2.07	1.94	0.12	6.2
Depreciation of office machines other than computer equipment	1.98	1.79	0.19	10.7
Depreciation of computer equipment	5.18	5.31	-0.13	-2.4
Depreciation of transport equipment	0.71	0.83	-0.12	-13.9
Depreciation of other tangible fixed assets	0.30	0.26	0.05	18.3
Depreciation of library collection	0.54	0.51	0.03	5.0
Amortisation of computer applications	5.90	5.42	0.49	9.0
TOTAL	**27.34**	**25.58**	**1.76**	**6.9**

13 BANKNOTE PRODUCTION SERVICES

This amount (€61.71 million) corresponds to payments made by the Banco de España to purchase banknotes from the National Mint. The decrease with respect to the previous year (€9.74 million) was because in 2010, despite the higher costs due to the rise in VAT, the volume of purchases of €50 and €20 banknotes, with a higher unit cost, decreased, and, at the same time, a significant volume of €5 banknotes, with a lower unit cost, was purchased (in 2009 no banknotes of this denomination were purchased).

14 TRANSFERS AND ADDITIONS TO OTHER FUNDS AND PROVISIONS

The net balance of transfers and applications to other funds and provisions in 2010 amounted to €7.73 million, compared with €75.89 million in 2009. This decrease (€68.16 million) derived basically from the decline of €17.74 million in the provision for sundry risks and expenses relating mainly to litigation finalised in 2010 in favour of the Bank (in 2009 €17.61 million were transferred to this provision) and from the updating of the provision for death and retirement assistance referred to in Article 190 of the Banco de España Conditions of Employment, which entailed a credit of €5.33 million to the profit and loss account. This item also includes transfers to and releases from the provision for operational risks, which in 2010 was used to cover losses arising from operational risk (€0.03 million) and was replenished so as to raise its balance to the agreed level of €22.86 million. The transfer to the Beneficent Social Fund amounted to €25.96 million (€27.00 million in 2009).

The Banco de España, because of the nature of its activity, is not an institution with a high environmental risk. Accordingly, in 2010 it was not considered necessary to record any provision for environmental liabilities and charges.

15 PROFIT FOR THE YEAR

Pursuant to Article 1.1.b) of Royal Decree 2059/2008 of 12 December 2008, the Banco de España must pay into the Treasury, on the first working day of March 2011, 90% of the profits earned and recorded up to 31 December of the previous year, less the amount paid on 1 December of the previous year.

On 1 December 2010 the Banco de España paid into the Treasury €1,316.49 million, equal to 70% of the profit recorded as at 30 September 2010.[13]

Once the year had ended, and taking into account that the provisional profits amounted to €2,570.00 million and that 90% of the profits was €2,313.00 million, a payment of €996.51 million was made to the Treasury on 1 March 2011.

The payments to the Treasury of 2010 profit are as follows:

EUR m

1	Total profit for 2010	2,570.00
2	Payments to the Treasury	2,313.00
	On 1.12.2010	1,316.49
	On 1.3.2011. Difference between the above amount and 90% of profit as at 31.12.2010	996.51
3	Profit payable to the Treasury	257.00
	At date of approval of the 2010 accounts	257.00

3.4 Changes in capital, reserves, provisions and revaluation accounts

The following table shows the changes in the reporting year, which, in addition to the accounting profit, include the net gains not recognised as income in the profit and loss account, the change in provisions and the effect on the balance sheet of the appropriation of profit for the year.

13 Pursuant to the aforementioned Royal Decree, the payment resolution must take into consideration the foreseeable performance of profits up to the end of the year. For this reason, account was taken of a number of factors which entailed a risk of lower profit estimated at €802.77 million. Accordingly, this amount was subtracted from the Banco de España profit of €2,683.47 million as at 30 September, resulting in a profit of €1,880.70 million, 70 % of which was paid into the Treasury.

EUR m

	Capital	Reserves	Revaluation accounts	Undistibuted profit	Provisions	Total
A) 2010 OPENING BALANCE	**1,000.00**	**1,000.00**	**7,020.16**	**966.51**	**5,312.04**	**15,298.72**
1 UNRECOGNISED NET GAINS IN PROFIT AND LOSS			2,254.43			2,254.43
In gold			2,617.18			2,617.18
In foreign currency			468.09			468.09
In securities			-827.58			-827.58
Other			-3.25			-3.25
2 2010 PROFIT				2,570.00		2,570.00
3 CHANGE IN PROVISIONS		-50.00			166.77	116.77
4 APPROPRIATION OF PROFIT				-2,283.00		-2,283.00
Payment to the Treasury of 2009 profit				-966.51		-966.51
Payment to the Treasury of 2010 profit				-1,316.49		-1,316.49
B) CHANGES IN THE YEAR. B = 1+2+3+4	—	**-50.00**	**2,254.43**	**287.00**	**166.77**	**2,658.19**
C) 2010 CLOSING BALANCE. C = A + B	**1,000.00**	**950.00**	**9,274.59**	**1,253.51**	**5,478.81**	**17,956.91**

The changes reflected in this table have been explained above in the explanatory notes on the balance sheet and profit and loss account that refer to provisions (Note 28 on the balance sheet), revaluation accounts (Note 29 on the balance sheet), capital (Note 30 on the balance sheet), reserves (Note 31 on the balance sheet) and profit for the year (Note 32 on the balance sheet and Note 15 on the profit and loss account).

4 SPECIFIC INFORMATION REQUIRED BY ARTICLE 4.2 OF THE LAW OF AUTONOMY OF THE BANCO DE ESPAÑA OF 1 JUNE 1994

4.1 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 aforementioned Royal Decree-Law 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 2010 the Banco de España made no contributions whatsoever to these Funds.

4.2 Loss of profit

The table below shows the loans outstanding in 2010 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	Average balance in 2010	Interest rate received (%)	Reference interest rate (%)	Estimated loss of profit
Net State debt	3,937.24	—	1.00	39.37
Housing loans and repayable advances to employees	41.70	0.13	1.00	0.36
Housing loans	7.46	0.75	1.00	0.02
Repayable advances	34.24	—	1.00	0.34
TOTAL	**3,978.95**	**0.00**	**1.00**	**39.73**

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.

The reference rate used to estimate the loss of profit in all the loans is the daily average of the marginal interest rate on main refinancing operations conducted during the year.

4.3 Other transactions

On 26 March 2007 an agreement was entered into with the State government to bring forward the repayment schedule of the loans granted to the State prior to the entry into force of Law 21/1993 of 29 December 1993 on the State Budget for 1994 (Law 3/1983 loan, Law 4/1990 loan and credits arising from subscription for participating interests, contributions and quotas in international agencies), such that they all reach final maturity by 2015 at the latest and the Treasury can request early repayment of part or all of these facilities, paying on the due date the effective market price instead of the nominal amount. Under this agreement, in 2010 payment was received of two instalments of the first of the aforementioned facilities (that for the reporting year and the last outstanding instalment of the original repayment schedule), along with the reporting year instalments of the other two facilities, the repayment date of all of them being brought forward from 31 December to 30 April. In accordance with the foregoing, on 30 April 2010 the Treasury paid to the Banco de España the amount of €543.60 million, the effective market price of the debt repaid on that date.

1 REPORT OF THE EXTERNAL AUDITORS

Deloitte.

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Translation of a report originally issued in Spanish based on our work performed in accordance with International Standards on Auditing. In the event of a discrepancy, the Spanish- language version prevails.

To the Governor of the Banco de España:

We have audited the financial statements of the Banco de España which, in accordance with Article 29.1 of its Internal Rules, comprise the balance sheet al 31 December 2010 and the related income statements and notes to the financial statements for the year then ended.

Responsibility for the financial statements

The Executive Commission of the Banco de España is responsible for organising the Bank and appointing its directors general. Under the Internal Rules of the Banco de España, the Directorate General Services is responsible for preparing the financial statements in accordance with the internal accounting rules and principles of the Banco de España, which are indicated in Note 3.1 to the accompanying notes to the financial statements 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 financial statements that are free from material misstatements due either to fraud or error; the selection and application of appropiate accounting rules; and the performance of the estimates considered to be reasonable in the circumstances (see Note 3.1.3. of the accompanying financial statements). Pursuant to Article 21. g) of Law 13/1994, of 1 June, on the Autonomy of the Banco de España, these financial statements are prepared by the Governing Council of the Banco de España.

Responsibility of the auditor

Our responsibility is to express an opinion on the financial statements 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 financial statements are free material misstatements or irregularities.

An audit entails the performance of procedures designed to obtain evidence supponting the amounts and disclosures contained in the financial statements. The procedures selected depend on the auditor's judgment, which includes the assessment of the risks of the occurrence of material misstatements or irregularities in the financial statements 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 financial statements by the entity, in order to design audit prodecures that are appropiate 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 financial statements. We consider that the evidence we have obtained is sufficient and adequate to provide a basis on which to express our audit opinion.

Opinion

In our opinion, the accompanying financial statements for 2010 present fairly, in all material respects, the net worth and financial position of the Banco de España at 31 December 2010 and the results of its operations in the year then ended, in conformity with the internal accounting rules and principles of the Banco de España, which are indicated in Note 3.1 to the accompanying financial statements and are based on the accounting regulations established for the member central banks of the European System of Central Banks.

DELOITTE, S.L.

Miguel Ángel Bailón

26 May 2011

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Domicilio social: Plaza Pablo Ruiz Picasso, 1, Torre Picasso, 28020, Madrid.

2 REPORT OF THE AUDIT COMMITTEE

We the undersigned, Ángel Luis López Roa, Ana María Sánchez Trujillo and Carmen Alonso Ledesma, 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 2010.

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 2010, 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 2010, 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, Budget 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 2010 give a true and fair view of the net worth and financial position of the Banco de España.

Madrid, 5 May 2011.

Ángel Luis López Roa	Ana María Sánchez Trujillo	Carmen Alonso Ledesma

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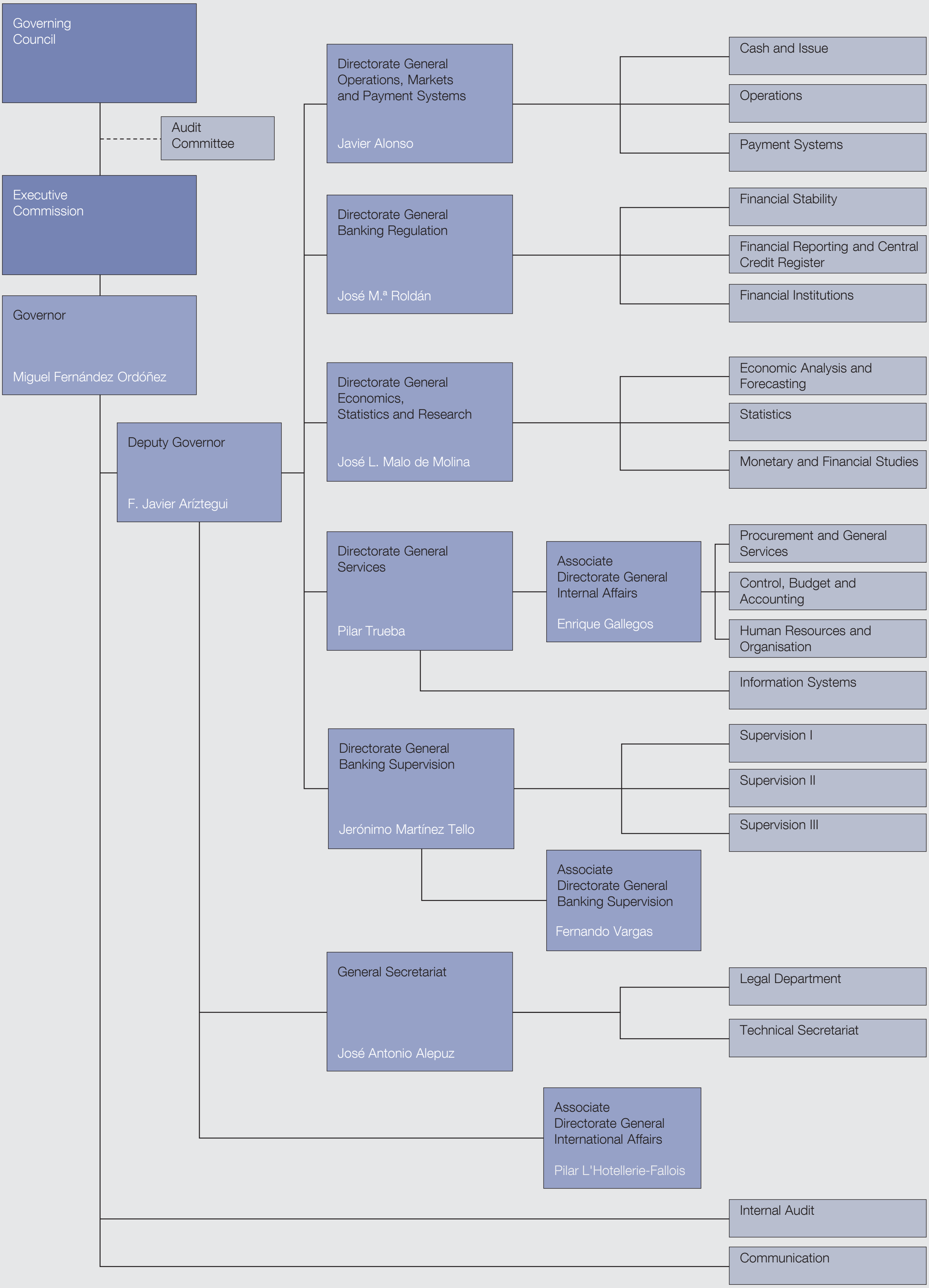
COMPOSITION OF THE GOVERNING BODIES
OF THE BANCO DE ESPAÑA

ORGANISATION CHART



GOVERNING COUNCIL

GOVERNOR	Miguel Fernández Ordóñez
DEPUTY GOVERNOR	F. Javier Aríztegui
COUNCIL MEMBERS	Carmen Alonso Ledesma Ángel Luis López Roa Guillem López José María Marín Vicente Salas Ana M.ª Sánchez Trujillo
DIRECTOR GENERAL OF THE TREASURY AND FINANCIAL POLICY	Soledad Núñez
VICE-PRESIDENT OF THE NATIONAL SECURITIES MARKET COMMISSION	Fernando Restoy
DIRECTORS GENERAL OF THE BANK (Without a right to vote)	José Luis Malo de Molina José María Roldán Pilar Trueba Javier Alonso Jerónimo Martínez Tello
SECRETARY (Without a right to vote)	José Antonio Alepuz
REPRESENTATIVE OF THE BANK'S PERSONNEL (Without a right to vote)	M.ª Luisa Teijeiro

EXECUTIVE COMMISSION

GOVERNOR	Miguel Fernández Ordóñez
DEPUTY GOVERNOR	F. Javier Arízteguí
COUNCIL MEMBERS	Ángel Luis López Roa Vicente Salas
DIRECTORS GENERAL (Without a right to vote)	José Luis Malo de Molina José María Roldán Pilar Trueba Javier Alonso Jerónimo Martínez Tello
SECRETARY (Without a right to vote)	José Antonio Alepuz

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MISCELLANEOUS PUBLICATIONS[1]

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3 A quarterly update of the tables of this publication is also disseminated on the Internet.
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