BBVA

Situación

Research Department

May 2004

Growth still at 2.5% with changes
Inflation heading for 3%
Fiscal consolidation, the composition matters
Oil returns to centre stage
Challenges of an enlarged EU

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Editorial Board:

1. International environment

The prospects for global activity in 2004 have improved in the past few months. Only the European economy has been left behind as a consequence of the negative impact of the accumulated appreciation of the euro on competitiveness and the increase in the geopolitical risks after the 11-M attacks that have added downward risks to growth in domestic demand, which was already weak.

In the rest of the regions, prospects have improved significantly. In the United States, after growth in activity of 6% in the second half of 2003, it is expected that in the first half of 2004, the figures will come in at around 4%. It is foreseeable that in the second half of the year growth will slow given the temporary nature of some of the factors that have been driving it such as tax cuts and low interest rates, and as a result of the negative impact on activity that new factors such as the increase in the price of oil could have. In any case, in order to maintain a high growth trajectory, the evolution of investment will be key. In this sense, one should highlight the significant pick-up in corporate earnings and the fact that US companies are taking advantage of the improvement in financing conditions to reduce their debt levels; factors that facilitate an increase in capital expenditure, which currently has reached double-digit growth levels. In the US economy one can also detect an improvement in employment, the variable that had lagged most in this recovery. The start of the upward cycle in interest rates is around the corner.

In Asia, everything points to growth coming in above expectations in the early part of 2004. China, with growth close to double digits in the first quarter of the year, is consolidating itself as the regional motor, while expectations have grown that Japan is emerging from the spiral of recession-deflation given the greater strength of growth based on exports and capital expenditure. The improvement in the US economy has strengthened the dollar, thereby reducing the need to intervene in the foreign exchange market to stem the appreciation of the yen. This constitutes a more comfortable position for the Japanese authorities. As a whole, the Asian region is showing notable dynamism, translating into an increase in demand for commodities, whose prices have risen considerably in a structural manner as a result of the incorporation of new players on the demand side in the global market. This, along with greater demand from the United States and favourable liquidity conditions are driving upward revisions of growth forecasts for 2004 in another region, namely Latin America. The size of the upward cycle of interest rates in the United States constitutes in the short term the main risk factor for the emerging markets as has been seen in the adjustment in the debt differentials of these countries in response to the change in expectations for monetary policy.

Within this context of improving activity, and with confirmation of restrictions in supply in the oil market imposed by OPEC, expectations have been generated of an increase in inflation as reflected in the pick-up in the inflation rates that are factored in for indexed bonds. This is an indicator which, despite being influenced by technical factors, appears to approximate with considerable reliability the balance of risks for inflation[1]. Since the start of this year, forecasts for inflation for the industrialised countries as a group have been revised upwards.

Within this environment, the recent increase in bond yields in anticipation of the start of the upward cycle of interest rates in the United States is justified as a response to the increase in inflationary pressures and high growth as well as to a slowdown in the purchase of bonds by the Asian central banks. It is true that the impact of this last factor on yields

[1] See in this respect IMF (2004): "Financial Stability Report" and especially ECB (2004): "Recent developments in long-term inflation expectations", Monthly Bulletin, April.

Table 1.1. Growth forecasts

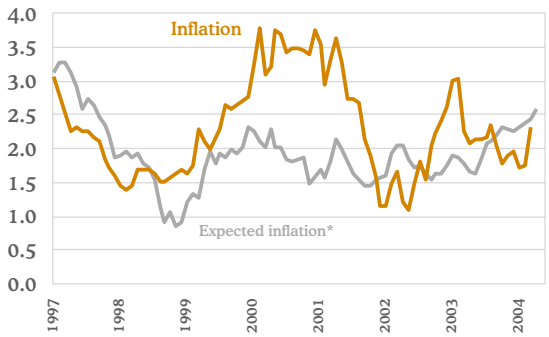
oya

	2002	2003	2004	2005
OECD	**1.7**	**2.1**	**3.2**	**2.9**
USA	2.2	3.1	4.1	3.3
EMU	0.9	0.4	1.7	2.3
Japan	-0.3	2.6	3.7	2.6
Developing countries	**4.4**	**5.8**	**5.9**	**5.6**
Transition countries	**4.9**	**6.4**	**5.4**	**4.9**
WORLD	**3.0**	**3.9**	**4.4**	**4.1**

Source: IMF and BBVA

Graph 1.1.

USA: Expected and observed inflation

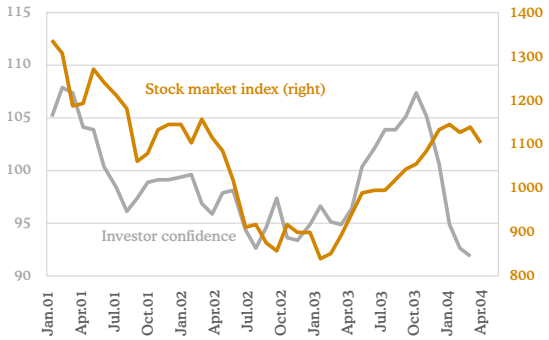


* Factored in for inflation-indexed bonds

Source: Labour Department and US Treasury

Graph 1.2.

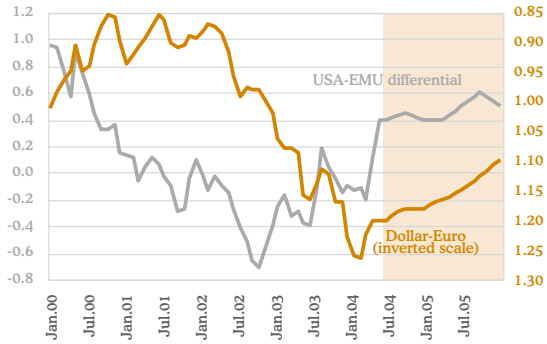
Investor confidence and Standard & Poor's index



Source: S&P and State Street

Graph 1.3.

Dollar-euro exchange rate and USA-EMU interest rate differential



Source: Federal Reserve and BBVA

Table 1.2. Inflation forecasts

oya

	2002	2003	2004	2005
OECD	**1.6**	**1.9**	**1.9**	**1.7**
US	1.6	2.3	2.4	2.0
EMU	2.3	2.1	2.0	1.9
Japan	-0.9	-0.3	-0.4	-0.1
Developing countries	**4.5**	**5.5**	**5.1**	**4.7**
Transition countries	**14.2**	**11.0**	**8.2**	**7.0**
WORLD	**3.3**	**3.7**	**3.3**	**3.1**

Source: FMI and BBVA

is a controversial issue. While the BIS (2004)[2] sees no significant impact, other authors have identified it as a determining factor in developments in the yield curve, one to which they attribute a fall of one percentage point in interest rates[3].

It appears clear that in any case the upward movement in long-term interest rates in the United States is correcting the over-valuation shown by the bond market in the past few years. The key issue over the next few months, therefore, is the extent and speed of the additional pick-up in yields that could take place. This is linked to the prospects for the evolution of the Fed funds rate in the United States, which in turn depends on developments in labour market data, inflation, and the perception of the potential risks in financial variables of maintaining a situation of high liquidity. Within an environment of uncertainty about the sustainability of growth and with the caution that reigns as regards the recovery in the US labour market and the impact of the pending productivity gains in that economy, it is to be hoped that the Federal Reserve take a gradual approach to interest-rate hikes. This would translate into interest rates at the end of 2004 standing at 1.5%, half a point above the current level. Under this scenario, for the 10-year maturity, the scope for further rises in yields is limited, with a target of around 5.1% for the end of this year. There is no doubt that risks are building in favour of more intense increases, above all taking into account the fiscal situation and possible surprises on the upside for prices.

The main risk for activity currently derives from a combination of higher interest rates – increasing at a rate above that described above - (as is being discounted by the futures markets), an increase in the price of oil and a growth slowdown in some of the more dynamic economies such as the Chinese that could bring about a larger-than-forecast adjustment to US growth in 2005.

In any case, the speculation about interest-rate hikes, along with a drop in investor confidence from the start of the year, as seen in the State Street index, has brought a halt to the rise in stock prices that began in March 2003.

The dollar marks the difference

The situation described for US yields differs from that seen in Europe and makes evident the decoupling of the two economies. The slow recovery of activity in Europe is putting a ceiling on the increase in rates at the long-end of the yield curve. The ECB is not expected to adjust rates upwards until 2005. As a result, the widening of the differential between interest rates in the United States and the EMU could continue over the next few months.

This evolution of the differential in yields should lead to the dollar appreciating against the euro. In fact, it is surprising that it has not risen more than it has against the euro after the movement in interest rates in the months of April and May. In the short term, this factor is going to be key in the behaviour of the exchange rate. As a result, the uncertainties surrounding developments in the dollar have been displaced to the second half of the year. These will be linked to the sustainability of growth in the United States, that is, to the doubts thrown up concerning growth based in part on considerable fiscal and monetary impulse. Within this context of uncertainty, an increase in long-term interest rates could take place, an increase that would be global in nature and which the IMF[4] estimates at least at half a percentage point. Although this would involve a scenario of higher interest rates, it would be accompanied by a depreciation of the dollar given the lower confidence in the US economy.

[2] See BIS (2004): "Quarterly Review: International Banking and Financial Market Developments", March.
[3] See Dooley, M., D Folkerts-Landau and P. Garber (2004): "The Revived Bretton Woods System. The Effects of Periphery Intervention and Reserve Management on Interest Rates & Exchange Rates in Center Countries", NBER Working Paper No. 10332.
[4] See IMF (2004): "The global implications of the US fiscal deficit and of China's growth", World Economic Outlook, Chapter 2, April.

2. The real economy

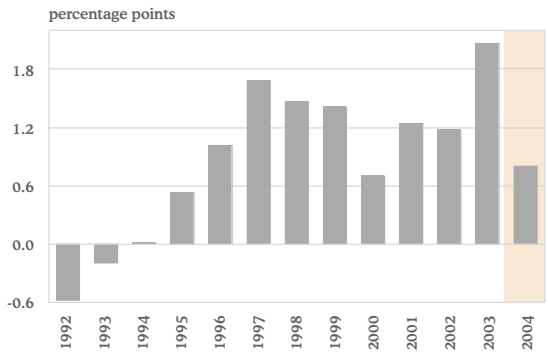
2004: activity expanding but with drags

The differential between Spain's economic growth in 2003 and that of EMU as a whole stood at 2 percentage points (GDP growth was 2.4% and 0.4%, respectively), the highest since 1987[1], and three times the average differential over the previous 11 years. The faster rate of growth in the Spanish economy was due to the combination of a set of favourable factors mainly linked to domestic consumption, which has allowed Spain's economic cycle to decouple from the rest of the EMU. Some of these domestic factors (negative real interest rates, IRPF reform) have also given rise to the accumulation of a series of imbalances (borrowing needs in the economy, rising household indebtedness, constant increases in relative prices in Spain versus EMU as a whole) which in the new context of monetary union do not spark "warning signals" in interest rates and/or the exchange rate. However, these imbalances bring about a deterioration in the economy's price competitiveness and therefore put a brake on growth in investment and exports. That is to say, they limit the capacity of the economy to grow and create jobs, which has been supported by wage moderation, the reforms undertaken in the labour market and increasing flows of immigrants.

In 2004, growth will nonetheless again be driven by stronger domestic demand. External demand, with growth in trade expected to be close to its historical average both for the world economy overall as well as for the group of countries with which Spain trades, will continue to make a negative contribution to growth due to faster import growth. The Spanish economy should continue to converge in real terms with the rest of the EMU in 2004, though the differential in GDP growth will be under

1 According to data compiled by the European Commission.

Graph 2.1.
Growth differential versus EMU



Source: INE, Eurostat and BBVA

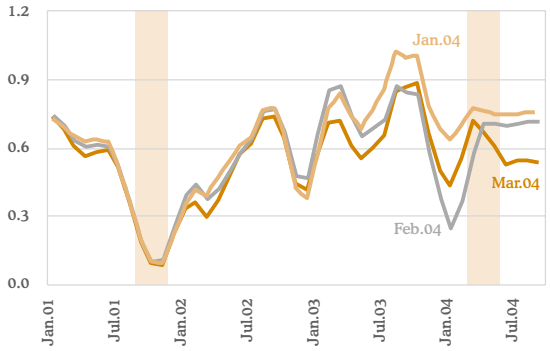
Table 2.1. Macroeconomic data

seasonally-adjusted data year-on-year rates	2002 Q1	2002 Q2	2002 Q3	2002 Q4	2003 Q1	2003 Q2	2003 Q3	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2001	2002	2003	2004
Household consumption (1)	2.0	2.8	2.5	3.3	3.0	2.8	3.1	3.0	3.3	2.9	2.7	2.8	2.8	2.6	3.0	2.9
Public consumption	4.6	4.5	4.2	4.2	4.3	4.5	4.8	4.8	4.7	4.5	4.4	4.5	3.6	4.4	4.6	4.5
Gross fixed capital formation	0.7	-0.9	1.5	2.9	3.2	3.4	3.0	2.5	3.0	4.0	3.5	4.2	3.3	1.0	3.0	3.7
Capital goods and other pr.	-3.7	-6.5	-2.4	1.9	2.8	2.9	1.9	1.2	2.4	5.5	5.5	7.0	0.4	-2.7	2.2	5.1
Construction	4.6	3.9	4.8	3.7	3.5	3.8	3.8	3.6	3.6	2.8	2.0	2.0	5.8	4.2	3.7	2.6
Inventories (*)	-0.3	-0.8	0.0	1.1	0.3	-0.1	0.2	-0.2	0.2	0.0	0.0	0.0	-0.1	0.0	0.0	0.0
Domestic demand (*)	**1.9**	**1.4**	**2.6**	**4.5**	**3.6**	**3.2**	**3.7**	**3.1**	**3.8**	**3.6**	**3.3**	**3.5**	**3.0**	**2.6**	**3.4**	**3.5**
Exports	-3.6	-1.9	1.2	4.4	4.4	7.8	2.2	1.8	4.1	6.8	8.7	8.6	3.6	0.0	4.0	7.1
Imports	-4.2	-3.5	3.4	11.8	8.5	10.1	5.9	2.7	6.7	9.0	10.0	11.3	4.0	1.8	6.7	9.3
Net exports (*)	**0.3**	**0.6**	**-0.8**	**-2.4**	**-1.4**	**-0.9**	**-1.3**	**-0.4**	**-1.0**	**-1.0**	**-0.8**	**-1.3**	**-0.2**	**-0.6**	**-1.0**	**-1.0**
GDP at market prices	**2.2**	**2.0**	**1.8**	**2.1**	**2.2**	**2.3**	**2.4**	**2.7**	**2.8**	**2.6**	**2.5**	**2.2**	**2.8**	**2.0**	**2.4**	**2.5**
Agriculture	7.5	2.0	1.8	-6.6	-1.6	-0.6	0.9	4.2	4.7	3.6	2.5	1.9	-3.3	1.0	0.7	3.2
Industry (2)	-0.2	-0.6	0.9	2.3	2.1	1.7	0.6	0.8	1.1	1.1	0.9	0.5	2.4	0.6	1.3	0.9
Construction	5.1	4.5	5.5	4.1	3.4	3.7	3.8	3.5	3.5	3.3	2.4	0.7	5.5	4.8	3.6	2.4
Services	2.1	2.5	1.9	2.2	1.7	1.6	2.5	2.7	3.4	3.1	2.8	3.0	3.3	2.2	2.1	3.1
market	1.8	2.4	1.9	2.3	1.5	1.2	2.2	2.4	3.3	3.1	2.8	3.0	3.3	2.1	1.8	3.1
non-market	3.1	2.6	2.0	1.8	2.5	3.0	3.7	3.9	3.5	3.1	2.8	2.8	3.0	2.3	3.3	3.1
Net tax on products	4.2	3.4	0.3	3.1	6.6	9.3	5.5	5.7	1.7	1.4	4.1	2.4	1.8	2.7	6.8	2.4

(*) Contribution to GDP growth
(1) Includes NPISH
(2) Energy and industrial branches

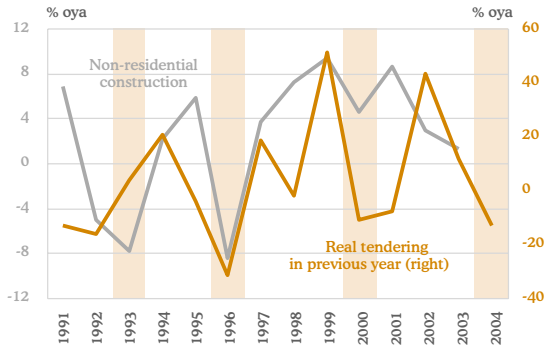
Source: INE and BBVA

Graph 2.2.
BBVA-IA



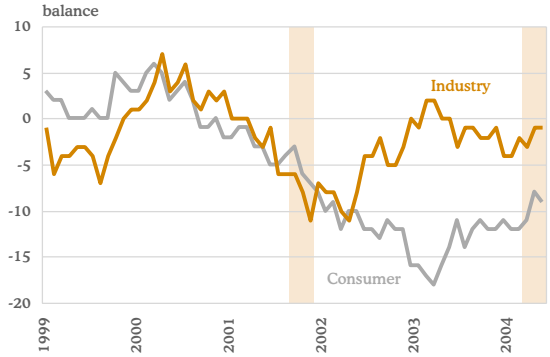
Shaded areas are September 2001 and March 2004
Source: BBVA

Graph 2.3.
Non-residential construction and tendering



Shaded areas are general election periods
Source: Eurostat, Ministry of Development and BBVA

Graph 2.4.
Confidence indicators



Shaded areas are September 2001 and March 2004
Source: European Commission

1%. GDP is expected to grow by 2.5% in 2004, a rate almost 1 point faster than in EMU as a whole.

National Accounts data for the first quarter of 2004 show that GDP grew at an annual rate of 2.8%, which could increase the "risk" of growth in 2004 coming in above the average rate of 2.5% initially forecast. However, two events in March shifted the balance of risks to this projection for growth of 2.5% in 2004 back to the centre. These were the terrorist attacks in Madrid on March 11 and the change of governing party.

With regard to the terrorist attacks, and assuming that atrocities of this magnitude do not happen again, the recent behaviour of the short-term economic indicators does not show any significant changes compared with the months before March. This would mean that the macroeconomic consequences of the terrorist attacks on March 11 have been very limited. However, the BBVA-IA activity indicator[2] shows a noticeable deterioration in its short-term forecasts from its January level. This is a signal of downward risks to the current economic climate of the Spanish economy, although it has to be borne in mind that the fall in the BBVA-IA may not necessarily be a direct consequence of 11-M; it might, for instance, be a loss of momentum linked to a weaker situation in Europe.

Secondly, the change in Spain's ruling party will bring changes in a number of fiscal policy priorities, which, at least in the short term, will mean lower spending on public works than the levels anticipated. Activity in this sector in 2004 will therefore slow more quickly than initially estimated because of the electoral cycle. This will be a transitory effect, however, which should be more than offset by higher spending in the future.

In principle, both these events constitute demand shocks with effects limited to the short term, in the case of the terrorist attacks because of the impact on the confidence of economic agents and in the case of the new government because of the inevitable delays arising from changes in public investment priorities. However, there could also be a supply-side component with a much longer-lasting impact. If the increased uncertainty and insecurity in the wake of the attacks manifests itself in the form of a structural increase in security expenditure or measures that impede trade, then there would be a negative impact. Likewise, the size of the impact on the economy resulting from the change in government will depend on whether it elects to strengthen the process of market liberalization and enhance competition or whether it opts to apply additional restrictions.

Finally, the increase in the dollar price of oil in recent weeks, to levels not seen since 1991, represents a downward risk to activity and an upward risk to prices if this trend continues in the second half of the year. Under a central scenario with gradually falling oil prices, from an average $35 per barrel of Brent in May to $29 in December, we stand by our forecast for GDP growth of 2.5% in 2004 and for inflation to drop from 3% in 2003 to 2.9%. However, if the price of oil remains between 34 and 35 dollars a barrel in the second half of the year, GDP growth could be between 0.2 and 0.3 points lower than initially forecast and inflation between 0.1 and 0.2 points higher. For a fuller discussion of this, see Box "The price of oil and the Spanish economy" at the end of this section.

[2] A synthesis of different variables for expectations, activity, consumption and employment. For more details, see Balmaseda, M. and J. Cubero, "BBVA-IA: an activity indicator for the Spanish economy", Situación Spain, March 2003, BBVA.

11-M: macroeconomic effects not discernible, but not necessarily zero

The latest information provided by the economic climate indicators shows that the March 11 attacks had a very limited impact[3]. It is particularly striking that in April both household and industrial confidence strengthened in Spain after having trended sideways for almost one year[4]. These results contrast with events in 2001. Then, the New York and Washington attacks on September 11 sparked a fall in the confidence of the economic agents. However, the impact on the Spanish confidence indicators was limited and transitory, and it did not bring about a change in the previous trends of the expectations variables.

The latest consumption indicators such as car registrations, hotel booking trends for the next few months and the number of hotel room nights showed no statistically surprising changes between March and May either nationwide or for the Madrid Community. As regards the labour market indicators, both INEM unemployment and Social Security registrations recorded readings in March and April within their forecast ranges.

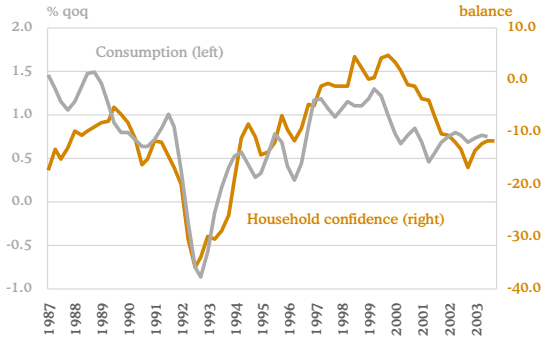
However, the fall in the level of the BBVA-IA state of the economy indicator is noteworthy because it is the most pronounced over the past few months. Until all the indicators are available and because of the possible revisions to data already released (for example, in the industrial production index), the connection between the deterioration in the outlook of the BBVA-IA between January and March and the effects of 11-M is admittedly a tentative one. It does however constitute a warning signal to be taken into consideration. In this sense, the contemporary correlation between the quarterly level of the BBVA-IA and GDP growth corrected for irregular and seasonal factors is 0.84.

Does confidence matter? Yes, but employment more

The most important channel through which the terrorist attacks could affect growth is that of consumer confidence. A dip in this would hurt household consumption. As is well known, the fundamental determinants of consumption trends in the long term are households' disposable income and their level of wealth, which includes financial as well as property wealth[5]. Variables such as real interest rates, unemployment and household confidence do not affect the structural behaviour of the level of consumption. The variables just cited, and changes in the long-term determinants, do however play an important part in changes in consumption in the short term, although consumer expectations are only of marginal importance[6].

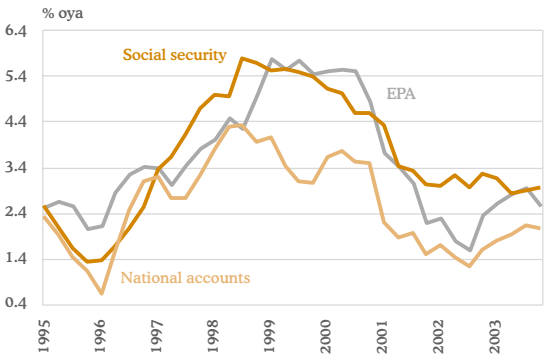
All of this is not to say that the deterioration in confidence will have a negligible effect on consumption since it seems difficult to imagine a significant deterioration in household expectations without the rest of the explanatory variables of consumption showing a similar behaviour: households' disposable income and wealth largely via employment.

Graph 2.5.
Consumption and confidence



Source: European Commission, INE and BBVA

Graph 2.6.
Employment



Source: INE, Ministry of Labour and BBVA

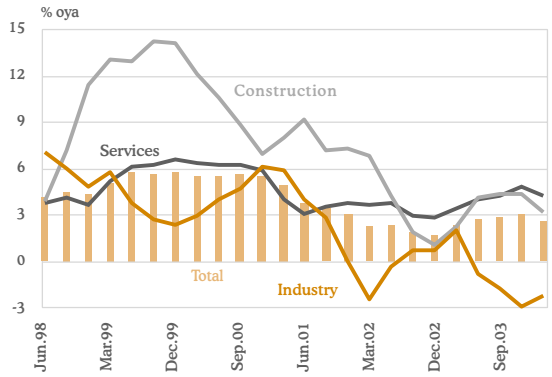
[3] In comparative terms, the damage caused by the March 11 attacks has been of much smaller economic magnitude than the devastation of September 11, 2001. According to a study by M. Buesa at the Universidad Complutense, the Madrid attacks have inflicted losses amounting to only 0.02% of Spain's GDP, between 25 and 50 times smaller than the losses in GDP in the United States after the attacks on New York and Washington.

[4] A large proportion of the questionnaires in the March surveys were collected before the attacks.

[5] A review of the factors that affect private consumption in Spain can be found in Balmaseda, M. and P. Tello: "Have the determinants of private consumption changed in Spain?", Situación Spain, July 2002, BBVA.

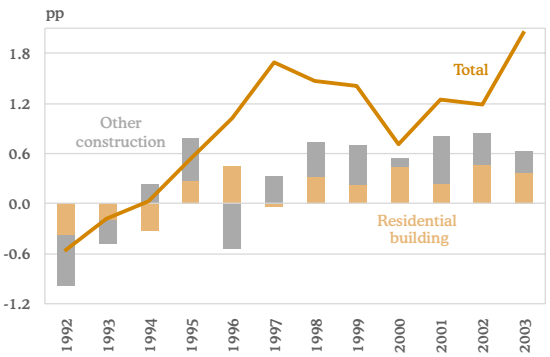
[6] Balmaseda and Tello (2002) estimate a consumption function in which the elasticity of private consumption to household confidence (measured using the indicator of the European Commission) is statistically significant, albeit very small (0.0003), whereas the elasticity of growth in disposable income is estimated at 0.1548. It should also be borne in mind that the identification and estimation of the short-term relationship depends on the variables considered and even the sample period. For instance, the inclusion or not of unemployment as an explanatory variable for consumption in the short term affects the value of the coefficient of consumer confidence and is even in itself statistically significant.

Graph 2.7.
EPA employed



Source: INE and BBVA

Graph 2.8.
Contributions to growth differential versus EMU



2003 data for construction are up to the third quarter

Source: Eurostat, INE and BBVA

The capitalization of the Spanish stock market has continued to mirror developments in international markets[7]. With regard to house prices, the main asset of households, in the first quarter of 2004 they rose by over 15%, in line with rates of increase in 2003.

Turning to the labour market, the data for the first few months of 2004 confirm the weaker employment outlook. The sharp deceleration in the number of foreigners registering for social security over the course of last year and the levelling off in both total registrations (at annual rates of growth close to 3%) and INEM unemployment were already pointing to a slowdown in employment growth. This was also reflected in the EPA labour force survey: the annual rate of employment growth in the first quarter of 2004 was 2.6%, 0.4 points down from the fourth quarter of 2003 and the first fall since the end of 2002. Industry was the only sector to register a pick-up in employment, although rates of change have been negative since the middle of 2002. As regards the labour force, the annual rate of increase of 2.2% was the lowest since the definitional change in 2001, which limited the increase in the rate of unemployment to only 0.2 points, to 11.4%.

Against this backdrop, we continue to foresee employment growth slowing in 2004, to a rate of around 2.1% (down from 2.7% in 2003). It should be noted that in 2003 labour costs continued to accelerate, both in terms of salaried-employee compensation as well as unit labour costs. Even in real terms (adjusted for the growth in the GDP deflator) both variables are trending upwards, especially in services and construction. These developments are consistent with a scenario of slower employment growth.

Finally, as regards labour market trends, it should be highlighted that the EPA survey still has to be adapted to the population structure based on the 2001 census and the rapid increase in immigration flows. All of this will entail a revision of the series compiled since 1997, thereby affecting expectations as to their development. Moreover, this will be a first step in a process that will culminate in a change of base year in the National Accounts, from Base Year 1995 to Base Year 2000, resulting in a revision of both the level and the growth profile of GDP. In this sense, adjustments that bring employment trends as measured by the National Accounts closer to those of the EPA survey would have the effect of increasing average GDP growth over the period 1991-2002 from 2.6% to 3.2%.

2004, an electoral year

Household consumption and construction investment have been the demand components underpinning the differential in growth between the Spanish economy and EMU between 1995 and 2003. Over this period the growth differential was 1.3 percentage points, with household consumption contributing 0.8 points and construction investment 0.6 points. Almost half of Spain's growth differential in the past 9 years therefore stems from investment in construction. And not only because of stronger growth in residential building, non-residential activity too has registered higher growth rates in the industrial and services sectors (mainly retail distribution) and civil engineering projects (transport infrastructure and water engineering projects). According to the Eurostat breakdown of construction investment into residential and non-residential construction, it can be seen that the contribution of construction to the differential in Spanish growth is divided equally between both subcomponents, each of them with 0.3 percentage points.

The effect of the electoral cycle (the strengthening of activity before electoral periods and the subsequent weakening later) meant that at the end of 2003 it was already foreseeable that the slowdown in civil

[7] The IBEX 35 regained its March 10 level at the beginning of April. Other international indices of reference had a similar pattern in this period, although they did not register such steep falls in the week of March 15 to 19.

engineering activity would gather pace in 2004. In this sense, a 13% fall in public tendering in 2003 in real terms points to slower growth in civil engineering activity in 2004[8].

In this environment, the change of government also means that the infrastructure investment priorities and plans in place up to now, such as the National Hydrological Plan, will be changed. A change of direction in public spending requires certain administrative procedures which, in the short term, will act as a brake, in addition to that of the electoral cycle, on civil engineering activity in 2004.

Residential construction, a fall-off in demand

The situation in the residential building sector is one of demand-side tensions as shown by the fact that despite an increase in volumes of production, houses prices have continued to rise quickly. Thus, although investment in residential building grew by 7% in 2003, the fastest increase since 2000, new house prices rose by 14.5%, only 2 points less than in 2002. The nominal rate of increase in house prices has therefore been above 10% since the beginning of 2000.

The affordability ratios of households have continued to deteriorate as a consequence of the rapid pace of house price increases, which has outweighed the positive effect of lower interest rates and higher wage income. In a sector whose activity is led by demand, and within this residential household demand is the most important, this means that the medium-term outlook is for slower rates of increase in house prices. Moreover, in the first few months of 2004, house sales have continued to slow in a number of markets, which could lead to a slower pace of house building in those areas where oversupply is greatest.

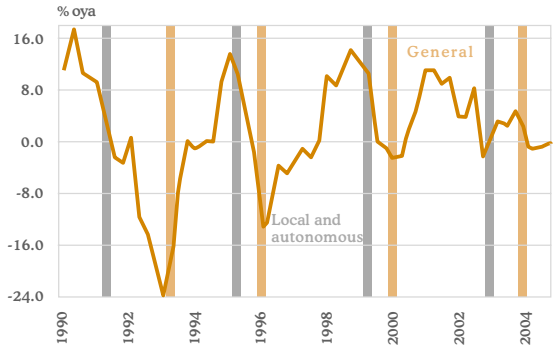
External stimulus, limited by domestic factors

With a negative contribution to GDP of 1 percentage point, the external environment will have a contractionary effect on the Spanish economy in 2004. Offsetting this will be the acceleration forecast in domestic demand. This year will see GDP growth in the EMU pick up for the first time since 2000. Added to this will be the stimulus provided by the increase in world trade in goods observed already in 2003 and stronger growth in the markets where Spain sends the bulk of its goods exports[9]. However, in the past few years, Spanish goods exports have failed to improve their market share to any significant extent. As Graph 2.10 shows, the boost in the mid-1980s that came with Spain's entry into the European Economic Community (EEC) and at the beginning of the 1990s due to the devaluations enabled Spanish goods exports to grow at faster rates than external demand. Since 1998, however, exports have been unable to sustain this relatively faster growth and have instead closely mirrored growth in external demand. This phase coincides with sharp increases in relative prices in the Spanish economy compared with its main competitors. This situation limits Spain's capacity to grow overseas and must be compensated for by either controlling margins or improving factors other than prices.

Corporate investment, which is increasingly linked to external factors, will also pick up on the back of the improving international environment and against the backdrop of easy financing conditions. The real cost of capital is expected to fall again in 2004, remaining below 3% for the second consecutive year. In addition, corporate leverage and financial expenditure ratios, as estimated by the Central Balance Sheet Office of the Bank of Spain, continued to improve in 2003. However, given the increasing levels of indebtedness, the evolution of corporate balance sheets could curtail to some extent future developments in investment. In this sense, the fall in the share of finan-

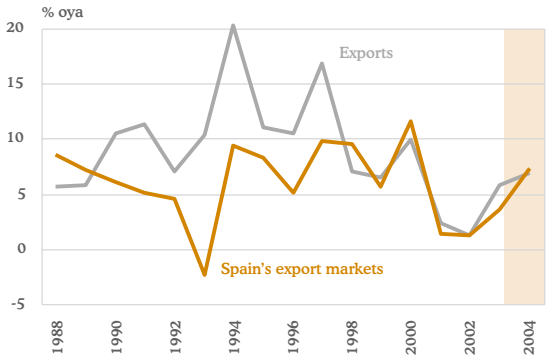
[8] From the time of tendering, the average execution period is assumed to be between 12 and 18 months. Tendering grew by 12% in real terms in 2002.
[9] The OECD estimates growth in the potential markets of its member countries weighting the data and forecasts with each country's share in the foreign trade of the target zone.

Graph 2.9.
Electoral cycle
Civil engineering and elections



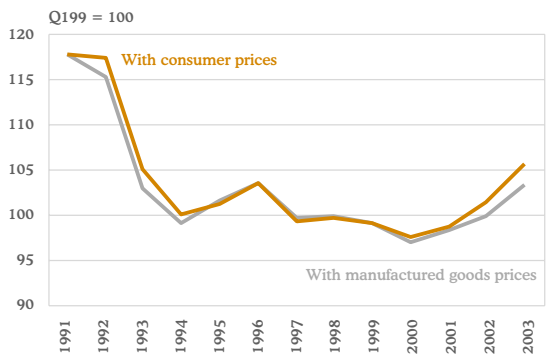
Source: Ministry of Development and BBVA

Graph 2.10.
Goods exports and external demand



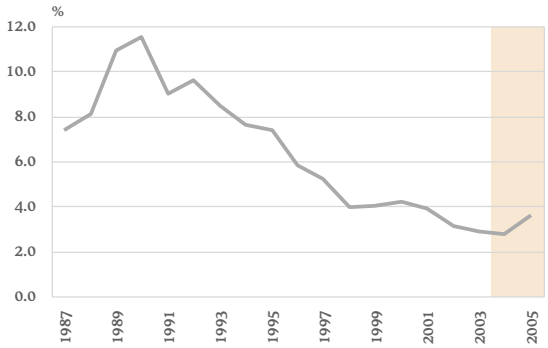
Source: INE, OCDE and BBVA

Graph 2.11.
Real effective exchange rate versus OECD



Source: Bank of Spain

Graph 2.12.
Real cost of capital



Source: BBVA

cial expenditure in companies' profit and loss accounts was entirely due to the decline in interest rates since the increase in debt volumes led to an increase in debt-service costs. This effect will gradually wear off over the next few quarters as long-term interest rates rise. In addition, the momentum of recovery in Europe may be less intense than forecast, which could ultimately affect the expectations companies have for expansion.

New government, supply shock

In addition to the transitory boosts that may be delivered via fiscal policy, the actions of the government also affect the economy through the changes made in the regulation of specific markets and competition legislation, as well as through public investment in education. Decisions on these issues have permanent effects on the economy since they affect the productive process and are therefore supply shocks. These will be positive if they facilitate growth in economic activity and employment without causing imbalances in prices or in corporate and household balance sheets.

The Spanish Socialist Workers Party's (PSOE) victory in the March general elections will not mean a radical change in the direction of economic policy. In this sense, there exists a broad political consensus about the positive effects on the nominal stability of the economy of fiscal balance, although the new government aims to attain this over the course of the economic cycle, rather than on a year-by-year basis. The zero deficit target will thus give way to a zero structural deficit target[10] (the deficit corrected for the economic cycle). This means that the discretional application of an expansionary fiscal policy in recessions has to be compensated in expansions (see fiscal policy section for greater detail). The government also aims to simplify the tax system through a reform designed to change the number of tax brackets, rates and allowances in corporate and personal income tax.

With regard to microeconomic policies, an effort will be made to encourage innovation and R+D in order to enhance productivity in the Spanish economy. Supervisory bodies and competition authorities will also be strengthened to limit government intervention in the economy.

However, a number of the proposals in the new government's programme are in fact unlikely to further the aim of less economic intervention. In particular, the process of liberalisation of goods and services markets, necessary for greater efficiency in production, could stall or even slip back in the retailing sector. This would be the case if in the end tighter restrictions are imposed on trading hours than those that apply at present, in contrast to the unrestricted trading hours the current legislation envisages in 2005 [11] .

As regards the labour market, the PSOE's election manifesto includes a commitment not to carry out any type of reform without the prior agreement of the social agents. This will make it practically impossible to embark on far-reaching reforms such as that of the collective bargaining process, firing costs and unemployment benefits.

The labour market and the productivity challenge

The Spanish economy has clocked up an impressive job creation record over the past few years. Between 1995 and 2003, full-time equivalent employment rose by 22%, triple the rate in the rest of the countries in

[10] In a year of strong growth, revenues rise more quickly (indirect receipts because of higher consumption, social security contributions due to employment growth) and spending rises more slowly (as a result of falls in certain "social spending" items such as unemployment benefits). The zero deficit target in a year of strong growth therefore means that when these effects are corrected, a structural deficit is obtained.

[11] In this regard, in its latest report on the Spanish economy, the International Monetary Fund quantifies the cost in terms of inflation and employment of imposing regional barriers to retail distribution.

the euro area over the same period. The increased used of this factor of production in the economy is the result of a combination of 3 factors: wage moderation, legal reforms in the labour market - which need to be taken further - and immigration.

The wage moderation in Spain reflects a change in attitude in the behaviour of the trade unions, as evidenced by a decline in "wage aggressiveness"[12] compared with the situation in other expansion phases. In the first expansion phase over the period 1987-1991, therefore, real wage increases are explained exclusively by "wage aggressiveness", whereas in the period 1995-1998 real compensation would have fallen further had it not been for the positive inflation surprises (actual inflation below forecast inflation). By contrast, the period 1999-2003 saw a rise in the "wage aggressiveness" component, although not to the extent of reaching the levels that existed at the end of the 1980s. Wage demands therefore were once again higher than the increases that were finally registered due entirely to the upward surprises observed in inflation. If this situation were to last, wage moderation, one of the key factors behind the expansion phase that started in the second half of the 1990s, would be derailed, which constitutes a risk factor given the low growth in the productivity of employment. In this context, the reform of collective bargaining becomes all the more necessary. Increasing the negotiating capacity of parties at a company level in relation to the sectoral and autonomous levels, to the extent even of eliminating the latter, would allow wage developments to reflect movements in corporate productivity more closely. This condition in the long term is conducive to higher employment.

For their part, the legal reforms of the labour market have mainly affected entry and exit mechanisms: hiring types and dismissal costs and regulations[13] . Decisions taken in this area can be of great importance, especially in aspects such as temporary employment, which fell sharply in the private sector of the economy following the approval in 1997 of the employment-promoting permanent contract with lower dismissal costs. Between 1998 and 2000, the ratio of temporary work for private-sector employees fell by 4 percentage points, its fastest ever rate of decline. At the same time, the ratio of temporary employment in the public sector has continued to trend upwards (16.1% in 1995 and 22.7% in 2003), thereby reducing the overall economy-wide decline in this ratio.

According to the EPA labour force survey, one-quarter of the employment created since 2000 has been taken up by immigrants, which represents a *de facto* deregulation of the labour market. The availability of a flow of workers with unrestricted geographical mobility and with relatively low wage demands in comparison with those of the native population has helped to meet the increasing demand for labour, which has been particularly intense in certain sectors such as construction.

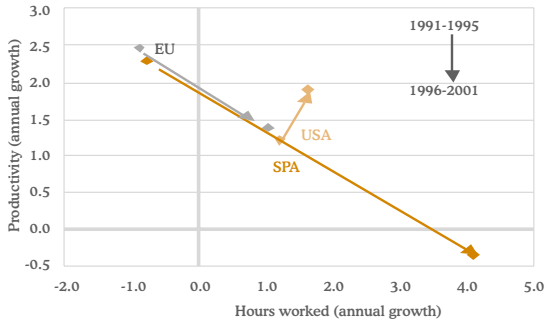
However, the increased use of labour has not been combined with greater efficiency in how it is used to bring about a shift in the production frontier of the economy, a concept that can be roughly estimated using potential GDP. The European experience in general, and the Spanish experience in particular, shows that there has been a substitution between productivity and hours worked, in contrast to what has happened in the United States, where the economy has managed to combine a more intensive and more efficient use of resources.

[12] The difference between real growth in salaried-employee compensation and the inflation surprise in excess of expectations.
[13] Finally, in 2002, in line with the EU recommendations for achieving the Lisbon objectives, a number of measures were approved to make unemployment benefits a greater incentive for the unemployed to find work.

Graph 2.13.
Real wages and wage aggressiveness

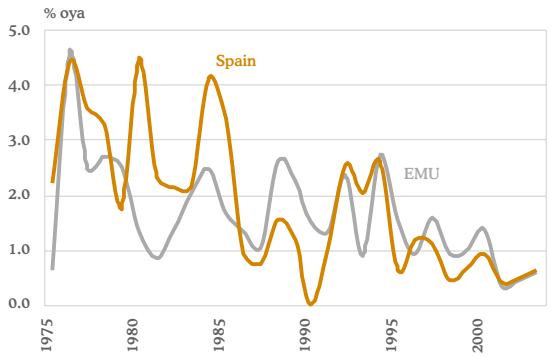
Source: BBVA

Graph 2.14.
Contribution of productivity and hours worked to GDP growth



Source: Timmer et al. (2003) and European Commission

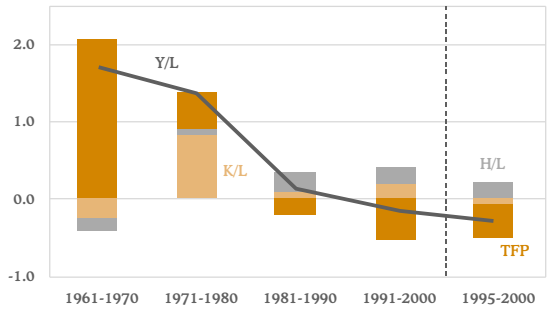
Graph 2.15.
Apparent productivity of labour



Source: European Commission and BBVA

Graph 2.16.

Productivity differential between Spain and EMU

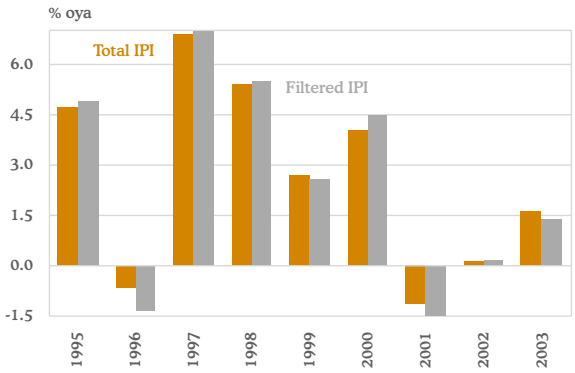


Source: European Commission and BBVA

The apparent productivity of labour (Y/L) can be broken down into the contributions of physical capital per employee (K/L), the quality of human capital (H/L) and total factor productivity (TFP), that part of productivity growth that cannot be explained by the rest of the factors and which can be attributed to technological progress or efficiency. As can be seen in Graph 2.16, the gradual deterioration in the productivity differential between Spain and the rest of the EMU has taken place as a result of the less efficient use of labour since human capital has made a positive contribution, while the contribution of the stock of capital per employee is practically zero.

Is detected the "leap-year" effect on growth?

The effect of the labour calendar on IPI



Source: INE and BBVA

Leap-year effect?
Estimation of an ARIMA model for GDP

Variable	Dependent variable: ΔLnPIB Coefficient	Standard deviation	t statistic	Prob.
ΔLeap year	**0.002**	**0.002**	**1.23**	**0.22**
ΔIQ286	0.027	0.004	7.02	0.00
ΔIQ490	0.037	0.004	9.47	0.00
AR(2)	0.680	0.079	8.57	0.00
MA(3)	0.473	0.099	4.79	0.00
Adjusted R^2:	0.55	Durbin-Watson stat.:		1.96

Source: BBVA

It would seem reasonable that since 2004 is a leap year with 366 days, one more than in 2003, economic activity would be, other things being equal, approximately 0.3% higher than in a non-leap year. This figure is the greater percentage of time represented by the extra day in a leap year. However, there are other factors to take into consideration within the context of what could be described generically as the calendar effects on an economy. That is, one must also consider the fact that bank holidays and vacational periods have a different effect than working days, and even within themselves bring about specific effects on activity. This occurs, for example, in the Industrial Production Index (IPI), in the retail sales index and hotel room nights. In addition, the sign of the impact of the calendar differs according to the variable in question. Weekends and holiday periods mean a drop in industrial activity, construction, the public sector and commerce (above all if there are restrictions on opening hours). However, they cause an increase in activities connected with leisure: hotels, restaurants, culture and transport. A priori, given the greater weight in GDP of "non-holiday" activities, a greater number of bank holidays would mean a drop in activity. In this sense, in 2004 in Spain there are between Monday and Friday six bank holidays on a national level, one more than in 2003. In this way, the leap-year effect and the number of bank holidays during working days would have a negative impact on the level of activity in 2004, and therefore, on forecast growth in comparison with 2003.

Within the area of the National Accounts, the impact of a leap year on levels of activity is not detectable since by agreement[1] it has been established that quarterly and annual figures need to be consistent over time. That is to say, annual GDP has to be the sum of the four quarters of the year, a figure that besides is the same regardless of the corrections carried out in the quarterly variable. The level of not adjusted annual GDP is the same as that for GDP adjusted for seasonal changes and calendar effects, something that is not the case for example with the IPI. The IPI in one given year need not coincide with the filtered variable, corrected for the effect of the leap-year (where appropriate), the number of working days, bank holidays and vacations (Graph 1).

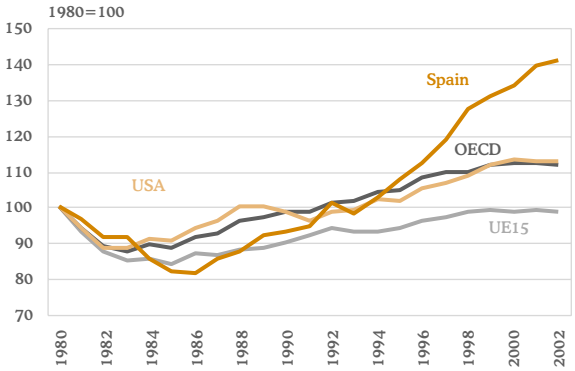
In order to estimate the effect of the leap year on GDP, one can begin with the seasonal and calendar factor estimated by the INE[2]. In this time series a variable that includes the leap-year effect turns out not to be statistically significant[3]. This result is to be expected given the time coherence restriction followed in drawing up the National Accounts. Alternatively, one can estimate an ARIMA model for non-adjusted GDP, including a specific intervention variable for the leap year. Neither in this case does this variable prove to be statistically significant[4].

To sum up, the effect of the leap year on growth is theoretically positive, but is also statistically not significant both because of the time coherence in measuring GDP as well as the impact of other calendar effects.

[1] Handbook of National Accounts. European System of Accounts, ESA 95.
[2] This factor is the quotient of non-adjusted GDP and that on a seasonally-adjusted basis and corrected for calendar changes.
[3] An ARIMA model is estimated and a variable that represents the leap year is added to it.
[4] The probability of the effect of the leap year on growth being statistically null is over 20% in all of the models estimated.

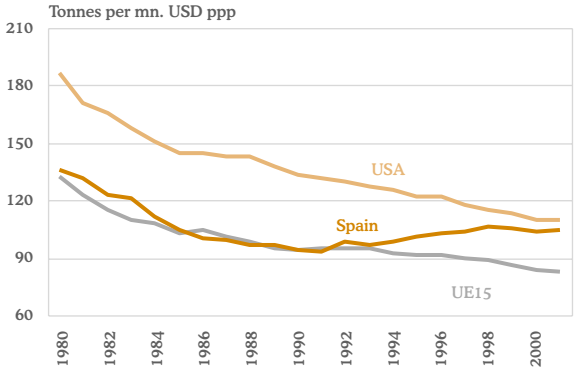
The price of oil and the Spanish economy

Consumption of oil



Source: British Petroleum

Consumption of oil per unit of GDP



Source: BBVA using data from British Petroleum, Groningen Growth & Development Centre and OECD

The fluctuations in the price of oil affect the level of activity and prices both via output (supply) and the expenditure of economic agents (demand). On the one hand, the use of oil as a source of energy in the system as a whole and, in addition, as a basic raw material in the chemical industry means that the variation in its price affects the cost structure of the entire productive process, and hence the level of activity and prices. Also, the transfer of resources from importing countries to oil producers affects the disposable income of economic agents, which has an impact on the level of their spending on consumption and investment. Finally, there is also an indirect effect on spending as a result of the changes in the expectations of agents.

Oil consumption: economic growth and price

In 2002, global consumption of oil was on average 18% higher than in 1980, as a result of uneven developments in the different economic areas. In the OECD as a whole, the increase was 12%, while in the European Union annual consumption in 2002 was 1% lower than in 1980. However, in some Asian countries (India, China, South Korea), increases of between 200% and 300% have taken place in the annual consumption of crude oil in the period mentioned. There are three factors that explain evolution. Firstly, economic growth: a higher level of production requires more inputs, and therefore, more petroleum. In this sense, the development of the emerging economies, with the growing dynamism of large countries such as China and India, is based on the production of energy-intensive goods as opposed to services activities, which have a greater weight in the industrial countries. Secondly, the consumption of oil is influenced by the efficiency of its use, and lastly because of the greater or lesser use of alternative energy sources and raw materials.

These factors are related to the evolution of the price of oil, a variable that determines the extent of demand, as is the case with any other product or service. In addition, the difficulty involved in substituting other inputs for oil in a short period of time means that the elasticity of demand for crude to its price is relatively low. This in turn heightens the impact on agents' income as a result of fluctuations in its price.

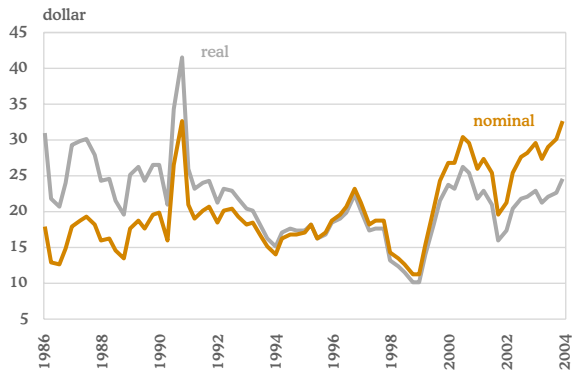
In the case of the Spanish economy, annual consumption of oil in 2002 was 40% higher than in 1980, much higher, for example, than the 13% increase registered in the United States, and the fall mentioned above for the European Union as a whole. In addition, although Spain has registered relatively higher growth compared with the European Union as a whole, this factor on its own does not explain the relatively higher consumption of oil in Spain.

Since 1980, the consumption of oil per unit of GDP has been falling in the European Union as a whole as well as in the United States. In the European Union in 2001, 83 tonnes of oil were consumed to obtain a million dollars of GDP, 37% less than in 1980. In the United States, consumption was 110 tonnes, 40% less than in 1980. In Spain, the respective figures are 104 tonnes and a fall of 23%. However, from the start of the 1990s, and unlike what has happened in industrial countries as a whole, Spain has gradually increased its consumption of oil per unit of GDP. As a result, the relative consumption of oil in Spain has been distancing itself from the average figures for the European Union and approaching those for the United States. If the trend of more intense use of crude oil in Spain and less intense in the United States continues, within a few years, the consumption of oil per unit of GDP will be greater in Spain.

The extent of the shock. The price of oil

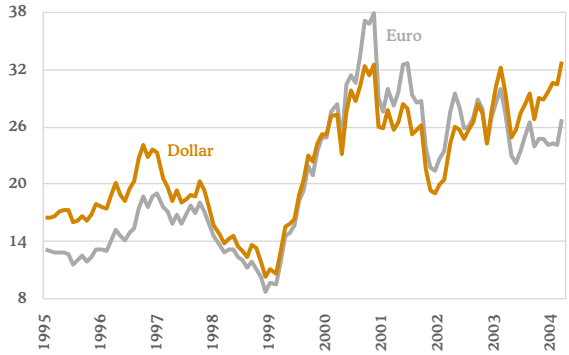
In the month of May the price of a barrel of Brent crude stood at $35.5, a level not seen since the end of 1990. However, in real terms current prices are significantly below those at that moment. In this sense, if you adjust for the GDP deflator, the current price of a barrel of Brent would be $26, 15 less than in the fourth quarter of 1990.

Brent oil prices ($/barrel)



Source: Datastream, INE and BBVA

Brent oil prices ($/barrel)



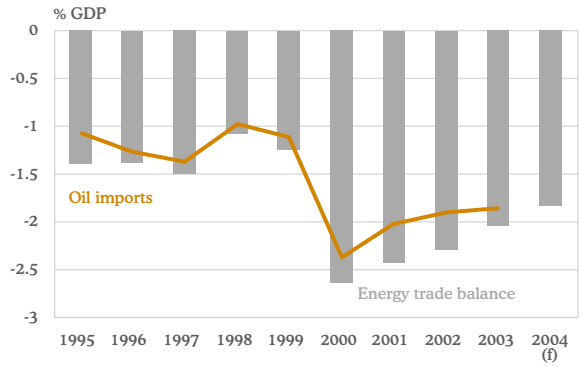
Source: Datastream and BBVA

In addition, the magnitude of the current rise in the price of oil is also being moderated by the strength of the euro against the dollar. The same barrel of oil that costs $35.5, the highest figure in 13 years, is worth 29.6 euros, eight less than in November 2000. Then, you needed 1.16 euros to buy a dollar, whereas now only 0.83 euros are required.

The magnitude of the current shock on the Spanish economy

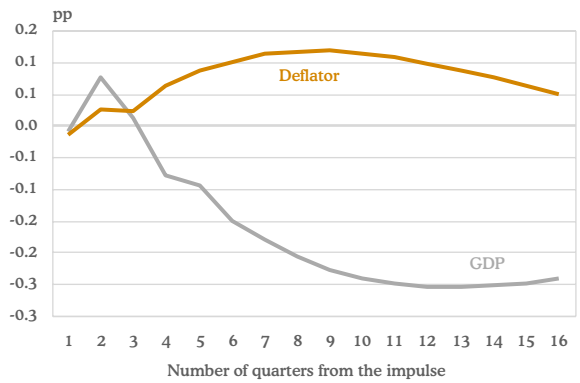
A rise in the price of oil above the initial scenario for 2004 means an increased transfer of income from the Spanish economy to oil-exporting economies. In addition, this process is intensified by the low elasticity of demand for energy in the short term. In this sense, the value of oil purchases has varied in the past five years around 2% of GDP, with a forecast energy trade gap of 1.8% in 2004, less than the 2.1% registered in 2003. If the price of crude remains at the average for April-May ($34 a barrel), the energy trade deficit would increase, other things being equal, by 0.3 percentage points above the initial estimate of 1.8 points. This would reduce disposable income in the economy by the same magnitude, and would put a brake on household consumption and corporate investment. In a dynamic context in which the impact deriving from oil on activity and price levels in the economy, as well as the interaction of these, is considered, this would result in a rise of three dollars in the price of a barrel of oil over the level of Q104 ($32.6) shaving two tenths off GDP under the central scenario, and adding 0.1 percentage points to prices. In this way, the impact on activity would be more intense than on inflation, and in any case more marked in the second and third years after the shock than in the short term.

Energy deficit of the Spanish economy



Source: INE and BBVA

Response of activity and prices to a 10% increase in oil prices



Source: BBVA

13

Restrictions in the retail trade activity

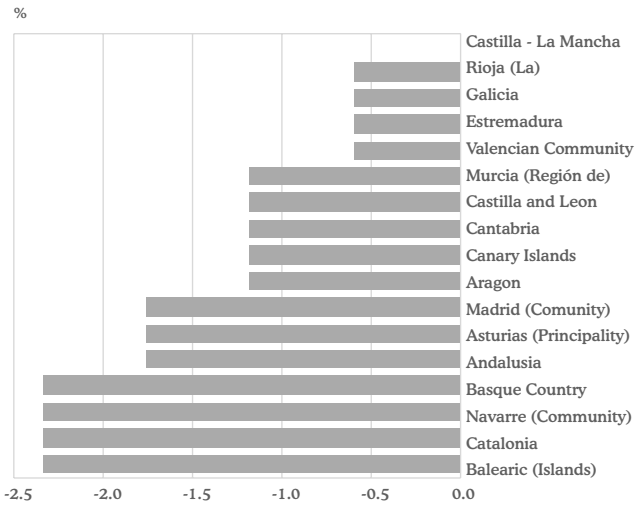
Requirements for the granting of the second licence by autonomous regions to large retail establishments

	1	2	3	4	5	6	7	Total
Balearic Islands	x	x	x				x	4
Catalonia	x				x	x	x	4
Navarre	x			x	x		x	4
Basque Country	x	x	x				x	4
Andalusia	x			x			x	3
Asturias				x	x		x	3
Madrid	x			x	x			3
Aragon	x						x	2
Canarias	x						x	2
Cantabria				x			x	2
Castilla and Leon	x						x	2
Murcia	x			x				2
Valencian Comunity	x							1
Estremadura	x							1
Galicia	x							1
Rioja	x							1
Castilla - La Mancha								0

1. Large establishment in terms of municipality. 2. Large establishment according to different criteria. 3. Large establishment depending on ownership. 4. Special restrictions on hard discount establishments. 5. Special limitations on "medium" establishments. 6. Viability plan required. 7. Moratoria on new establishments.

Source: Competition Tribunal

Effect of territorial regulations on the level of employment in the services sector



The magnitude of the effect estimated is sensitive to the specification of the variables that incorporate the regulation of the CCAA.

Source: BBVA

In Spain, shops had free rein to decide their opening hours between May 1985 and December 1993. Then, as a result of the clash of responsibilities thrown up by the legislation of the different Autonomous Regions (CCAA), the government, with the excuse that a situation of crisis existed, introduced regulations for trading hours, allowing the CCAA to restrict opening during bank holidays. A minimum of eight days for opening during the year and 72 hours of activity during the working week were established, although with detailed exceptions for certain establishments (petrol stations, florists, cake shops etc) and geographic areas (tourist centres) defined by each CCAA. In January 1996, the Retail Trade Law delayed until 2001 the possibility of returning to an unrestricted regime for trading hours, conditional also on the agreement of the Autonomous Government in question. Finally, in 2000, the Government again pushed back until 2005 unrestricted trading hours, although allowing it for small independent establishments[1] . In addition, the minimum number of trading hours and bank holidays in which establishments could open were extended, although in the case of the latter gradually at the rate of one per year until a total of 12.

The current legislative decentralisation implies a multiplication of the territorial regulations over the retail distribution sector. According to the typology drawn up by the Tribunal de Defensa de la Competencia (Spanish competition watchdog), there are seven different classes of requirements (see table above) imposed by the Autonomous Governments for the granting of the second licence, which in addition to the municipal, is required for "large establishments" to be authorised to open. This interventionist approach, which through administrative "incentives", aims to design the supply of commerce to best fit the needs of consumers[2] has imposed limitations on competition, which favours the market clout of companies already established and the consolidation of local monopolies.

It is difficult to calculate the costs in terms of employment implied by the lower level of efficiency of the retail distribution market as a result of territorial regulations. The IMF[3] , after estimating a panel data model for the 17 autonomous regions for the period 1995-2001, finds evidence of a lower increase in employment as a result of the existing regulations. According to its estimates, "on average, imposing one of the seven types of barriers identified in the Competition Tribunal's report increases inflation and lowers employment in the long run by 0.1 percentage points and 10%; the costs are much higher for the most restrictive regions (the Balearic Islands, Catalonia, Navarre and the Basque Country)".

Replicating this exercise for the most recent period using employment figures for the services sector of the EPA (Labour Force survey), the results obtained statistically confirm the negative impact of the restrictions applied to the retail distribution sector. The impact is more intense in those CCAA with a greater degree of intervention.

[1] Defined as those not belonging to distribution groups and with less than 300 square metres of sales space.

[2] The only survey of consumers on regulations governing the retail sector was carried out by the Organization of Consumers and Users (OCU) in 2003 among its members. Three out of every four people surveyed wanted the re-establishment of unrestricted trading hours that was in place until 1993, and also wanted this extended to other activities (Administration, financial system).

[3] "A Tentative Assessment of the Costs of Regional Restrictions". IMF, February 2004. Spain Report for the 2003 Article IV Consultation.

3. Prices and wages

Inflation is back

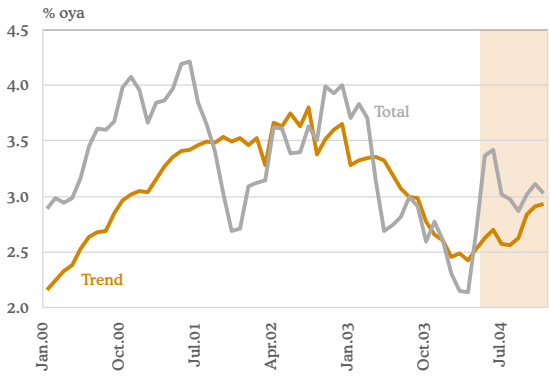
Inflation in March stood at 2.1%, the lowest rate in the past 5 years. Moreover, this fall was observed to a greater or lesser extent in the various indicators of consumer price inflation. CPI inflation went from a 3.7% rate in the first quarter of 2003 to 2.2% in the same period of 2004; the IPSEBENE measure of inflation slowed from 3.2% to 2.3% and BBVA Trend CPI fell from 3.3% to 2.5%. This fall of close to one percentage point in the indicators of underlying inflation and of 1.5 percentage points in overall CPI was due to the combination of several positive factors. The first of these is the strong appreciation of the euro, especially against the dollar, which moderates import costs, and the cost of energy goods in particular. In this regard, the euro appreciated from 1.00 dollars to the euro in the fourth quarter of 2002 to 1.25 on average in the first quarter of 2004. Crude oil prices in dollars fell throughout 2003, from $32 a barrel in February to close to $28 in November. This intensified the positive effect of the exchange rate, resulting in a 17% drop in the price of Brent in euros over this period. Since then, however, oil prices have been rising and in May stood at an average of $35.5 a barrel.

The exchange rate has also made possible the fall registered in manufactured goods inflation. For instance, the prices of products such as clothing and footwear only rose by 1.1% in the first quarter of the year, one third of the average increase registered over the previous 5 years. The decline in the rate of inflation of non-durable consumer goods (ex-food) as a whole in 2003 was also a reflection of the rounding up of prices in 2002 in the switch from pesetas to euros. This phenomenon resulted in a one-off rise in inflation in 2002 and in the subjective perception that households have of price developments[1].

With regard to the other goods in the CPI basket, in the case of food products the absence of any significant supply constraints affecting prices led to slower rates of inflation in the course of 2003, with a fall from 4.8% to 4% between the first quarter of 2003 and the first quarter of 2004. Finally, the rate of increase of services prices, the component with the greatest weight in the CPI basket and the least volatile,

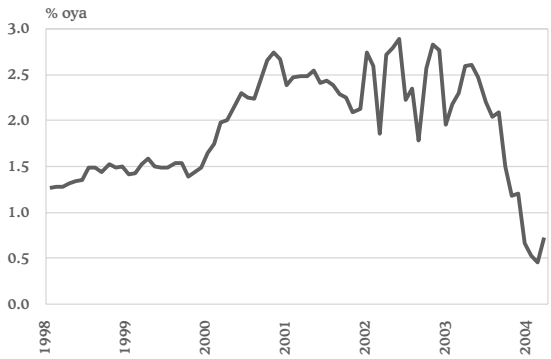
[1] For a more detailed analysis, see "El efecto del canje del euro en el IPC", Box 5.5, p. 125, Informe Económico 2002, BBVA.

Graph 3.1.
Inflation



Source: INE and BBVA

Graph 3.2.
Non-energy industrial goods inflation



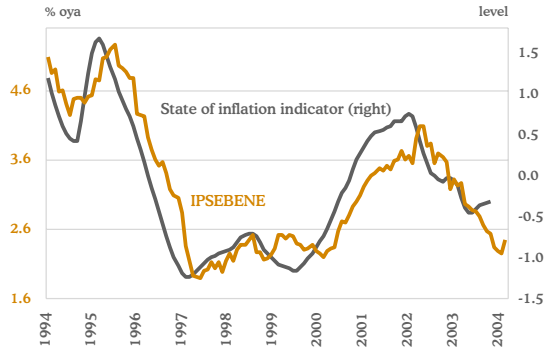
Source: INE and BBVA

Table 3.1. Inflation

	Overall inflation			IPSEBENE			Residual CPI			Trend CPI		
	2003	2004	2005	2003	2004	2005	2003	2004	2005	2003	2004	2005
Jan.	3.7	2.3	3.2	3.2	2.3	3.0	4.9	1.9	3.5	3.3	2.5	3.0
Feb.	3.8	2.1	3.3	3.3	2.3	3.1	5.3	1.2	4.0	3.3	2.5	3.0
Mar.	3.7	2.1	3.1	3.2	2.2	3.2	4.7	1.3	3.5	3.3	2.4	3.0
Apr.	3.1	2.7	2.8	3.3	2.4	2.9	2.6	3.2	2.3	3.4	2.5	3.0
May	2.7	3.5	2.7	3.0	2.9	2.9	0.8	5.6	2.0	3.3	2.6	3.0
Jun.	2.7	3.4	2.7	2.9	2.9	2.9	1.4	5.6	2.0	3.2	2.7	3.0
Jul.	2.8	3.0	2.9	2.9	2.9	2.9	2.1	4.3	2.5	3.1	2.6	3.0
Aug.	3.0	3.0	2.8	2.9	3.0	2.9	3.0	4.2	2.5	3.0	2.6	3.0
Sep.	2.9	2.9	2.9	2.8	2.9	2.9	2.7	3.5	2.7	3.0	2.6	3.0
Oct.	2.6	3.0	2.8	2.6	3.0	2.8	2.1	3.5	2.7	2.8	2.8	2.9
Nov.	2.8	3.1	2.8	2.6	3.1	2.8	3.1	3.7	2.8	2.7	2.9	2.9
Dec.	2.6	3.0	2.9	2.5	3.2	2.8	2.6	3.3	2.8	2.6	2.9	2.9
Average	**3.0**	**2.9**	**2.9**	**2.9**	**2.8**	**2.9**	**2.9**	**3.4**	**2.8**	**3.1**	**2.6**	**3.0**

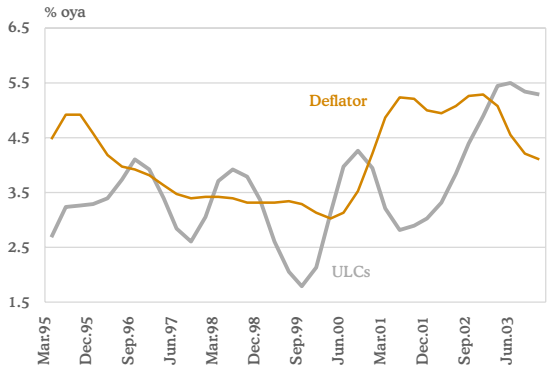
Source: INE and BBVA forecasts

Graph 3.3.
IPSEBENE and BBVA State of Inflation indicator



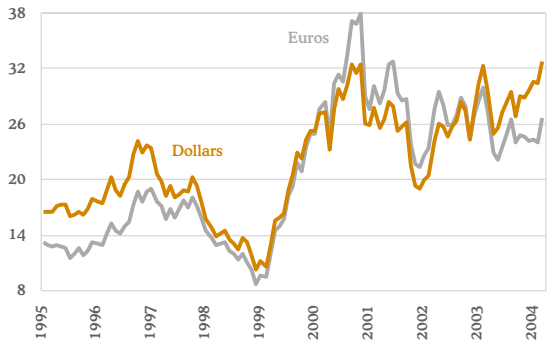
Source: INE and BBVA

Graph 3.4.
Market services



Source: INE and BBVA

Graph 3.5.
Brent oil prices (per barrel)



Source: Datastream and BBVA

fell back by only 0.2 points, from 3.8% to 3.6%, over the period mentioned.

At the beginning of the second quarter of 2004, however, inflation started to turn upwards as a consequence of the change in sign or magnitude of some of the factors just described and the impact of others not hitherto mentioned such as labour costs. In the very short term, the positive basis of comparison effect of high oil prices in the first quarter of 2003 associated with the uncertainty surrounding the Iraq war will disappear. Moreover, high oil prices (Brent has been above $32 a barrel since early March), together with the appreciation of the dollar (which may have moved off its lows against the euro), will accentuate the inflationary "spike" in the second quarter of 2004. In this period, therefore, the rate of CPI inflation could rise to above 3.0%.

Last year's fall in inflation, not only in consumer price inflation but also in that registered by the GDP and household consumption deflators, came about despite the fact that labour costs again picked up in 2003. Unit labour costs rose by 3.6%, 0.3 points more than in 2002 and growth in employee compensation accelerated for the fourth consecutive year, with a rate of increase of 4.2% in 2003. These developments, along with the fact that the apparent productivity of labour remained steady at around 0.5%, mean that the deceleration in prices was due to a compression of margins[2]. This occurred not just in industry, which is exposed to competition both abroad and at home, but in market services as well, a development not seen since 2000.

Margin compression cannot be sustained indefinitely. This loss of corporate competitiveness has costs in terms of activity, with a direct impact on the ability of companies to make investments and generate employment. The extension in 2004 of the Inter-confederation Collective Bargaining Agreement, a wage settlement agreed by the social agents that establishes a wage increase of 2% plus a margin linked to gains in productivity, suggests that wage increases will not be significantly above those agreed in 2003 (3.5% in collective wage agreements). In any case, it is foreseen that the inflation catch-up clauses will have an upward impact similar to the one registered in 2003. December inflation overshot the 2% reference value by 0.6 points in 2003, a figure close to the overshoot expected in 2004 (2002 saw an overshoot of 1.4 points).

In this context, the pronounced deterioration in "external" inflationary factors (the prospect of depreciation in the euro exchange rate, upward risks to oil prices and price rises in the rest of the commodities) and the more moderate, but persistent, increase in domestic costs translate into a higher inflation outlook in Spain. In this sense, BBVA Research Department's Indicator of the State of Inflation was already recording an increase in the end-2003 data that signals the rise in inflationary tensions expected to show up in the general inflation indices over the coming months. Graph 3.3 shows how the BBVA State of Inflation Indicator has anticipated the turning points in IPSEBENE inflation in recent years.

Our projection for 2004 is for CPI inflation to rise by 2.9%. Although this is one tenth of a point less than in 2003, the lowest annual rates of inflation this year are already behind us. For BBVA Trend CPI, we project a faster pace of acceleration between 2004 and 2005. For its part, the inflation differential with EMU as a whole should be just under the 1% level registered in 2003.

Currently, the risk that looms largest in the inflation environment is the behaviour of crude oil prices. In recent weeks, oil has been affected by the growing geopolitical tensions, a situation further complicated by the reduction in OPEC production quotas and the low level of reserves of refined oil products. In the EMU, however, the upward impact of oil

[2] The development of margins is estimated by the gap between the growth in unit labour costs and the corresponding deflator.

prices on inflation (and to a greater or lesser extent that of other commodities) is being restrained by the strength of the euro. In March and April the price of oil in dollars hit levels in excess of $32 a barrel, a figure not seen since the third quarters of 1990 and 2000. Yet the same barrel of Brent cost 27.5 euros in April, 10 less than in the third quarter of 2000.

The relatively high value of the euro against the dollar is moderating the effect of the oil shock on the economy by reducing the transfer of income to the oil producers resulting from the price increases and given the relative rigidity that exists in demand. In the long run, however, the impact from oil depends not only on what it costs to import but also how intensely it is used in economic activity. Between 1996 and 2001, final consumption of energy in Spain rose by 30%, compared with 7% in the EU as a whole, that is to say, 4.3 times as much. Over the same period, Spain's GDP expanded by 21%, 1.5 times more than the 14% increase for the EU.

4. Fiscal policy

Historical AAPP surplus in 2003, in contrast to Europe

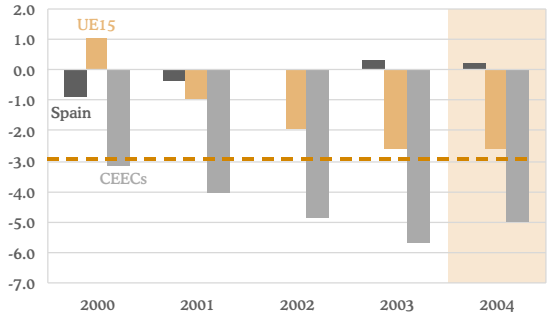
In 2003, the general government (AAPP) accounts registered a surplus for the first time since 1975, at 2.574 billion euros, the equivalent of 0.35% of GDP (see Graph 4.1). This represented a stronger performance than the balanced budget target established in the Fiscal Stability Law (LGEP) and completed the process of fiscal consolidation that started in the 1990s and which had already taken the public accounts to a position near balance in 2002 (a deficit of 314 million euros, or 0.05% of GDP)[1].

As Table 4.1 reports, this outturn was fuelled by extraordinarily strong growth in indirect tax revenues, with VAT collections up by 10.3% over the previous year. Receipts from Social Security contributions also played a major role. As was expected, the ongoing process of job creation and the impact on this of the immigration boom, along with an increase in the maximum contribution bases in excess of the targeted rate of inflation, sent social contributions above the budgeted figures (to over 100 billion euros and a growth rate of 7.2%, which was higher than that of the associated pensions).

In addition, on the spending side, the downward trend in interest payments continued due to the fall in debt volumes, the swap operations conducted by the State and the effect of lower interest rates. For the AAPP as a whole, the level of debt declined not only as a percentage of

[1] The previous budget projection already envisaged a small surplus in 2002 (357 million euros, or 0.05% of GDP). However, the inclusion of the accounts of RTVE, the State broadcaster, as mandated by the EU, increased the deficit of the AAPP by one tenth of a point both in 2002 as well as in 2000 and 2001.

Graph 4.1.
Net lending (+) or borrowing (-) in Spain and Europe, 2000-2004 (*)
% GDP



(*) 2004 figures are BBVA forecasts for Spain and European Commission forecasts for Europe.
Source: IGAE, Eurostat, European Commission and BBVA

Table 4.1. The non-financial accounts of the AAPP in 2003 (National Accounts)

	AA.PP.		STATE	
	Millions of euros	% annual growth	Millions of euros	% annual growth
NON-FINANCIAL EXPENDITURE	**293,543**	**5.6**	**112,566**	**0.7**
Total current expenditure	257,958	5.8	99,425	0.3
Compensation of employees	76,839	6.7	17,676	4.1
Intermediate inputs	32,454	6.1	4,949	1.9
Social benefits (*)	91,054	6.1	7,269	5.4
Interest	18,653	-5.2	15,807	-4.5
Others	38,958	-7.9	53,724	-6.7
Capital expenditure	35,585	4.3	13,141	3.9
Gross fixed capital formation	25,748	9.3	5,951	12.7
Others	9,837	-5.0	7,190	-8.7
NON-FINANCIAL REVENUE	**296,117**	**6.7**	**110,449**	**1.9**
Total current revenue	290,243	6.4	111,046	2.0
VAT	44,116	10.3	25,764	7.3
Income tax	76,066	3.6	57,371	1.4
Social security contributions (**)	101,259	7.2	6,540	5.9
Others	68,802	-14.6	21,371	-12.7
Capital revenue	5,874	23.4	-597	18.0
NET LENDING (+) OR BORROWING (-)	**2,574**	-919.7	**-2,117**	-38.1
(% GDP)	**0.35**		**-0.29**	
DEBT	**377,527**	-0.6	**302,010**	-2.1
(% GDP)	**50.8**		**40.6**	

(*) Other than social transfers in kind.
(**) Includes both effective and imputed contributions.
Source: IGAE, Ministry of Economics and Finance, Eurostat and BBVA

GDP, to 50.8%, but also in nominal terms despite the inclusion of RTVE debt.

The most controversial component of the advance in fiscal consolidation during 2003, which will be analysed below, is the relaxation of expenditure containment in current primary spending. These items, mainly represented by salaried-employee compensation, intermediate inputs and social benefits, increased in line with the growth in nominal GDP (6.7%). This development can only be partly explained by the autonomous and municipal elections that were held.

This effort to attain and maintain sound public accounts, as legally required by the LGEP, goes beyond the requirements of the Stability and Growth Pact (SGP) and finds few followers in the rest of the economies in the European Union (EU). Graph 4.1 shows how the EU-15 as a whole registered at the end of 2003 a deficit of 2.6% of GDP (2.1% when cyclically adjusted). Only Belgium, Denmark, Ireland, Luxembourg, Finland and Sweden ran a budget in balance or surplus. The fiscal situation of the 10 central and eastern European countries that have just entered the EU is much worse except in the case of Estonia (see Article, "An enlarged EU from the Spanish perspective", in this issue of Situación Spain), with an average deficit at the end of the year of 5.7%. The European Commission's forecasts for the next few years contained in its Spring Report barely alter this situation. However, far from imitating the rest of the member countries, Spain should seek to preserve this advantage and even enhance the composition of the surplus in order to ensure that the change is a permanent one and support potential growth in the economy.

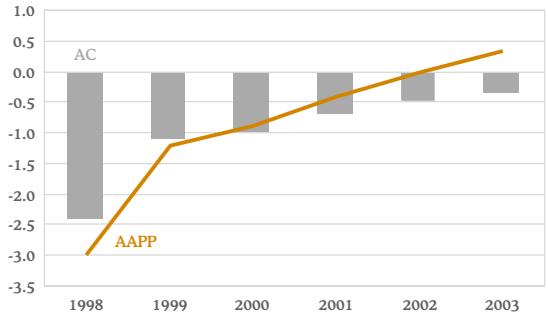
The State complied with the spending ceiling...

The ceiling on non-financial spending by the State was assessed for the first time in fiscal year 2003. Spending finally came in at 113.787 billion euros in cash-balance terms (112.566 billion in National Accounts terms), so that the ceiling of 114.517 billion euros was therefore observed. This positive outcome was due to a notable adjustment at the end of the year since the data on changes in credit up to November (2.850 billion euros) were already above the allocation of funds to the Reserve Fund expected to ensure compliance with the spending ceiling (the result of unforeseen developments such as the deployment of Spanish troops in Iraq and the compensation paid to town halls and provincial councils for the partial suppression of the Economic Activity Tax)[2].

This fact, and the strong performance of indirect tax revenues (VAT collections rose by 7.3%), made it possible for the Central Administration (AC) as a whole - State and Autonomous Institutions - to post a deficit of 0.4% of GDP at the end of 2003. This was a slight improvement on the budgeted deficit target of 0.5% of GDP, despite the inclusion of RTVE debt (see Graph 4.2).

This shows the effectiveness of simple fiscal rules given that, as shown in Table 4.1, current spending control was much greater at the State level than in the rest of the AAPP (its growth rate was significantly below nominal GDP: salaried-employee compensation 4.1%; intermediate inputs 1.9%, and social benefits 5.4%). This paved the way for a strong recovery in gross fixed capital formation. This outturn needs to be viewed in context, however, as fiscal year 2003 was the first in which full responsibility for education and health care - items that traditionally show the largest overspends - was transferred from the Central Administration to the Territorial Administrations (AATT).

Graph 4.2.
Net lending (+) or borrowing (-) of the AC, 1998-2003
% GDP



Source: IGAE and BBVA

[2] More precisely, changes in credit totalling 1.649 billion euros were financed out of the Reserve Fund, increasing credit for State spending by some 1.201 billion euros. If this had all been executed, spending would have reached 115.718 billion euros, 1% above the ceiling, an overshoot in any case much lower than those observed traditionally. However, spending execution was 98.3% of credit assigned, which was below the 98.9% necessary for compliance with the ceiling.

...the Territorial Administrations repeated the deficit

In fact, as expected, the AATT failed to attain the position of budget balance projected by the government, with a deficit of 1.322 billion euros, or 0.2% of GDP, in the autonomous communities (CCAA) and 547 million, or 0.1% of GDP, in the local corporations (CCLL). While this is the same outturn in terms of GDP as in 2002, consolidating the progress made with respect to 2001 despite the transfer of responsibilities (see Graph 4.3), it represents a breach of the LGEP. This obliges the AATT to draw up financial and economic plans for the correction of the imbalance within 3 months of the completion of the budget in those CCLL that run a deficit (article 22 of the LGEP) and within 20 days for the CCAA (article 8.7 of the Organic Law complementary to the LGEP). Unfortunately, to date there is no breakdown of data available for regions that fail to comply[3].

In addition, the CCAA failed in their commitment to keep the volume of outstanding debt below the level that existed at the end of 2002. According to Bank of Spain data, the level of debt increased to 43.565 billion euros, 4.6% above the level in the previous fiscal year[4]. Only the growth in GDP accounts for the fact that CCAA debt remained at 5.9% of GDP, the same percentage as in 2002.

...and the Social Security system generated the surplus

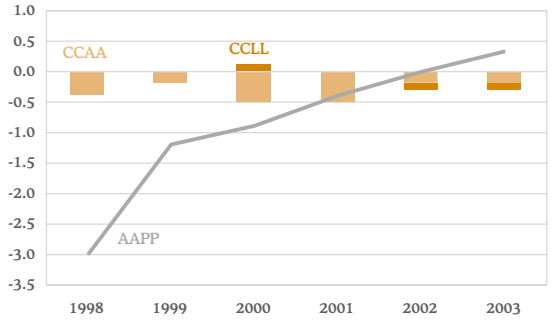
Graph 4.4 shows that, for yet another fiscal year, the Social Security system (SS) recorded a better-than-budgeted performance, registering a surplus of 1% of GDP (see Box, "The process of fiscal consolidation in Spain in Stability Plans for the period 1992-2007"). This paved the way for the Central Administrations to comply with the balanced budget requirement of the LGEP[5] by quite a wide margin with a surplus of 0.5% of GDP (4.443 billion euros). The exceptional behaviour of social contributions, mainly due to the momentum provided by approximately 400,000 new contributors, is even more remarkable when ones takes account of the fact that there was a Social Security surplus in spite of the overspend that was registered (in pensions spending alone this amounted to 943 million euros, to be paid over 2003 and 2004).

This resulted in an increase in the Reserve Fund, the resources of which now stand at 15.182 billion euros, the equivalent of 2% of GDP. It is useful to again stress the importance of maintaining the level of the Reserve Fund, given that Social Security contributions are in economic terms future spending obligations and that these will be pushed up even more by the demographic prospects in Spain (only partly mitigated by the increase in immigration). The Fund's endowment cannot be considered to be a substitute for the reforms needed, but rather as an instrument with which to buffer the negative effects of the economic cycle without having to resort to reducing benefits or increasing contributions. The revision of the Pact of Toledo at the end of 2003, which brought a very correct diagnosis of the system of social protection, needs to be fleshed out with specific practical measures, as noted by the European Commission in its assessment of Spain's Stability Plan for 2003-2007.

2004 budget in (actual and structural) balance

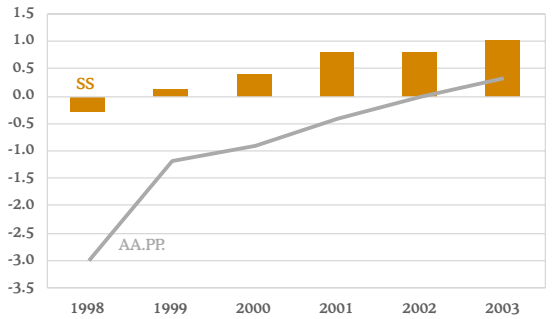
Fiscal year 2004 is expected to close with a slight surplus of around 0.2 or 0.3 points[6], a moderate version of developments in 2003. Thus, as

Graph 4.3.
Net lending (+) or borrowing (-) of the AATT, 1998-2003
% GDP



Source: IGAE and BBVA

Graph 4.4.
Net lending (+) or borrowing (-) of the SS, 1998-2003
% GDP



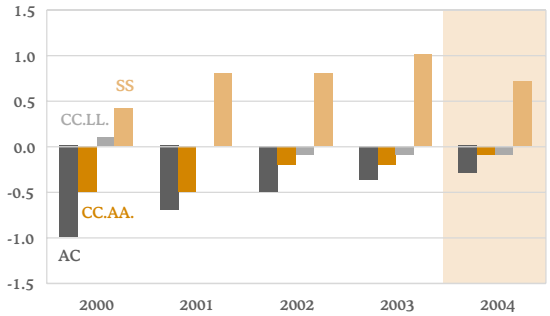
Source: IGAE and BBVA

[3] The only information available is from newspaper reports after the full assembly of the Financial and Fiscal Policy Council in May that at least the Canary Islands, Galicia, the Balearic Islands and Catalonia posted a deficit. Also, during the approval of the 2004 Budget for Catalonia, the Generalitat estimated the deficit in 2003 at 1.177 billion euros.
[4] CCLL debt increased by 5.6%, to stand at 23.243 billion euros (3.1% of GDP), according to the Bank of Spain.
[5] Under the LGEP, the combined accounts of the Central Administration and the Social Security system are required to be in balance until the process of separating the sources of financing has been completed.
[6] This outcome is contingent upon the payment of the debt owed to Andalusia as compensation for the previous regional financing system (approximately 2.50 billion euros). Government estimates of this item, as well as for the inclusion of the RTVE deficit, would add around 0.5 points of deficit in 2004. As a result, the year would end with a deficit of 0.2 or 0.3 points.

Graph 4.5.

Net lending (+) or borrowing (-) of the AAPP, 2000-2004 (*)

% GDP



(*) 2004 figures are BBVA Research Department forecasts. They do not include settlement of the Andalusian debt, which according to official estimates would increase the AC deficit by 0.4 points.

Source: IGAE and BBVA

Graph 4.5 illustrates, the Social Security system will once again make a budget surplus possible, with a surplus a few tenths of a point above the targeted figure of 0.4% of GDP. Meanwhile, the imbalance of the AATT could be reduced a little (both the CCAA and the CCLL will likely post a deficit of one or two tenths of a point instead of a balanced budget as forecast). For its part, the State will stay on its adjustment path, with an end-year deficit close to the budgeted figure of 0.4% (including the Autonomous Institutions)[7].

In any case, with budget forecasts normally subject to a high degree of uncertainty, at this time special caution needs to be employed. In the first place, the budget execution data for 2004 are as yet very limited (up to March for the social security system[8] and the first four months of the year for the State). In addition, the data available suffer from a lack of homogeneity (the most significant are reported in Table 4.2) given that the CCLL have only had a share of IRPF (personal income tax), VAT and Excise tax revenues since this year (when the financial part of their new system of financing became operative) and because first-quarter revenues in 2003 were boosted by a quarterly settlement in January of 2003 and by the fact that the partial IRPF reform was not yet being applied and therefore withholding taxes in January and February were not reduced.

With all of these caveats, and despite the expected slowdown in consumption and weaker rate of job creation, a strong revenue performance is expected in 2004 both for direct and indirect taxes as well as for social security contributions. Further support will be provided as the effects of the IRPF reform weaken (this was concentrated in 2003) and by the statistical effect of the change in the EU budgetary system approved in Berlin in 1999, which entails an increase in the GNP resource and a decline in VAT collected in Spain.

But without a doubt, the main notes of caution derive from the change of government. Firstly, due to the electoral calendar, the legal mandate for setting the limit on non-financial spending of the State (during the first four months of the year according to Articles 8 and 13 of the LGEP) has not been met. In addition, members of the new executive have made a number of announcements, both during campaigning and after

[7] The payment of the Andalusian debt mentioned above would increase this imbalance by a further 0.4 points.

[8] By way of illustration, the data point to an acceleration in spending on financial assistance (above that of January 2002 and January 2003) and a slight slowdown in social security contributions given the 2.7% rate of growth in the number of registrations between March 2003 and March 2004 (several tenths of a point slower than in previous fiscal years).

Table 4.2. Non-financial revenue and spending in cash-balance terms, January-April 2004 (main items)

	State		CCAA and CCLL		Total	
	Millions of euros	Annual growth (%)	Millions of euros	Annual growth (%)	Millions of euros	Annual growth (%)
DIRECT TAXES AND SOCIAL SECURITY CONTRIBUTIONS	19,600	-1.2	5,086	14.3	24,686	1.6
Personal income tax	14,594	-7.1	5,086	14.3	19,680	-2.4
INDIRECT TAXES	19,857	5.0	7,595	11.1	27,452	6.6
Value added tax	15,987	4.5	5,054	12.8	21,041	6.4
Excise taxes	3,090	5.0	2,541	7.9	5,631	6.3
TOTAL NON-FINANCIAL REVENUE	44,565	3.3	12,681	12.4	57,246	5.2
TOTAL NON-FINANCIAL SPENDING	36,986	-1.7	n.a.	n.a.	n.a.	n.a.
NET LENDING (+) OR BORROWING (-)	7,579	37.1	n.a.	n.a.	n.a.	n.a.

Note: The comparison between 2003 and 2004 for the State and AATT accounts is not homogeneous since it is affected by the participation of the CCLL in the revenue of the main taxes since January of 2004.

Source: IGAE and BBVA

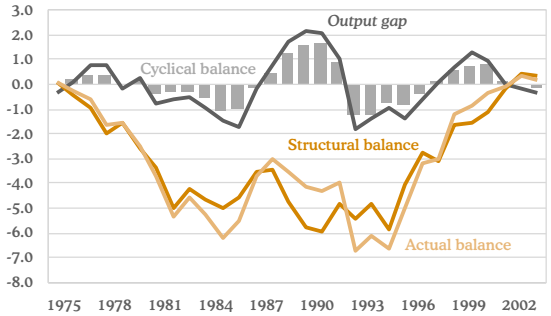
the naming of the members of the administration, the details and timeframe of which are still lacking, but whose direction seems to point to a higher level of public spending (minimum pensions, minimum wage, Housing Plan, spending on education and R&D), and whose compatibility with the pledge to cut current spending remains to be seen. In the area of public revenues, the proposals seem support the maintenance of collection levels, although plans to lower social security contributions and the Net Wealth Tax have been announced. In any case, the impact of the electoral cycle, whose clearest manifestation will be a slowdown in civil engineering work and with it public investment in 2004[9], will provide the government with a certain margin to avoid a deficit in the current year (as well as the likely inflation overshoot, which, as was the case in the past few years, will add a few tenths of a percentage point to collections). In fact, the paradigmatic fiscal rule announced is the maintenance of a balanced budget over the course of the economic cycle (see Box "Balancing the budget over the economic cycle"). Currently, given the slight negative cyclical position of the Spanish economy as measured by the output gap, the cycle will raise the deficit in 2004 by between 0.1 or 0.2 points, with the structural surplus coming in at 0.35% of GDP (see Graph 4.6)

The *ups and downs* of fiscal consolidation in Spain from 1995

The traditional way of analysing the process of consolidation in Spain is by evaluating the period 1996-2003 as a whole. During this period, most of the fiscal adjustment was concentrated on the reduction in the ratio of public spending to GDP largely through the decline in interest payments and, to a lesser extent, the containment of primary current spending, without impacting on public investment. Only a fifth of the consolidation was accounted for by higher taxes, particularly indirect taxes. The size of the adjustment, and above all its composition (which generally speaking has followed the recommendations of academic studies in order to guarantee its continuity and not place limits on productivity and potential growth) are remarkable.

[9] See *Situación Real Estate,* June 2004, BBVA Research Department.

Graph 4.6.
Cyclically-adjusted budget balance 1975-2004 (*)
% GDP



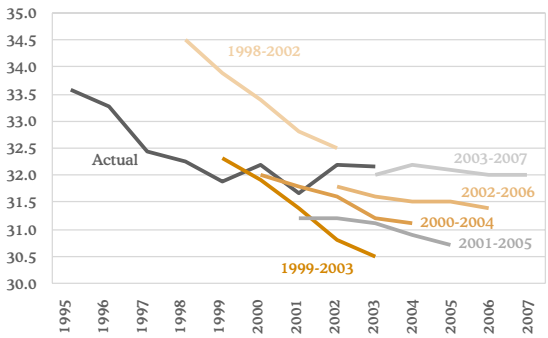
(*) 2004 figure, as well as the estimated output gap and the breakdown of the public deficit into its cyclical and structural components, are BBVA Research Department estimates.
Source: IGAE, INE and BBVA

Table 4.3. Fiscal consolidation in Spain, 1995-2003 (*)
(Cumulative change, % GDP)

	1995-1999	1999-2003	2003 level
CHANGE IN PUBLIC SPENDING	**-4.8**	**-0.7**	**39.5**
Change in:			
Primary current spending	-1.7	0.3	32.2
Interest payments	-1.7	-1.0	2.5
Capital spending	-1.4	0.0	4.8
CHANGE IN PUBLIC REVENUE	**0.6**	**0.9**	**39.9**
Change in:			
Indirect taxes	1.5	0.2	11.9
Direct taxes	0.1	0.4	10.6
Social security contributions	0.1	0.5	13.6
Other revenue	-1.1	-0.2	3.8
CHANGE IN FISCAL BALANCE	**5.4**	**1.5**	**0.3**
CHANGE IN STRUCTURAL FISCAL BALANCE	**4.2**	**2.1**	**0.4**
CHANGE IN PRIMARY STRUCTURAL BALANCE	**2.5**	**1.0**	**2.9**

(*) In each period the cumulative change in each of the headings as a percentage of GDP is calculated. The periods were selected in order to highlight the different composition of the fiscal consolidation process.
Source: IGAE and BBVA

Graph 4.7.
Primary current spending
% GDP



Source: IGAE, Ministry of Finance and BBVA

However, this time period, which covers the two mandates of the Popular Party Government, presents an incomplete picture of the process. In the first place, the decision to undertake fiscal consolidation could be regarded as dating back to 1995, the first year in which the accounts of the AAPP according to ESA-95 were available (see Table 4.3). Between 1995 and 1996, the reduction in the public deficit was very significant, 1.7 percentage points (1.8 percentage points in structural terms), likewise concentrated on a reduction in public spending as a percentage of GDP. However, this consolidation was based almost exclusively on a fall in capital spending, an effect that is consistent with the electoral cycle (which boosted this component in 1995 and reduced it in 1996). Therefore, the maintenance of the public investment effort between 1996 and 2003 at around 4.5-4.8% in terms of capital spending should not hide the fact that it was preceded by a reduction in investment that has not been compensated for since.

Secondly, even in the period 1996-2003, one can see a certain change in the make-up of the process. Between 1996 and 1999, consolidation was based almost in its entirety (3.5 percentage points out of 3.7 percentage points) on a reduction in non-productive spending (financial spending 1.8 percentage points, current primary spending 1.4 percentage points). Public investment was hardly touched, and neither were revenues substantially increased (only indirect taxes, the least harmful for efficiency, and associated with the strength of consumption). In structural terms, the accumulated adjustment was 2.4 percentage points (4.2 percentage points since 1995). On the other hand, since 1999, a certain relaxation in the process is apparent on account of the "Maastricht fatigue" common to the majority of European economies, with the structural adjustment standing at 2.1 percentage points, half of what it was in the preceding period. In addition, of the 1.5 percentage point improvement in fiscal consolidation, 1.1 percentage points came from higher taxes and Social Security contributions. In the area of spending, the reduction (0.7 percentage points) was due entirely to the fall in interest payments (1.0 percentage point), while primary current spending increased as a percentage of GDP. It is significant that since the 1999-2003 Stability Plan (drawn up at the end of 1999), the target has been to reduce primary current spending. This, however, has barely moved between 31.7% and 32.2% of GDP. In fact, as Graph 4.7 shows, the 2003-2007 Plan sets this figure at 32% of GDP, significantly above the 31.5% included in the Plan drawn up the previous year.

All of this, should not blind us to recent achievements, but instead allow us to pinpoint more appropriate practices in the area of budgeting - some of which have already been set in motion - and to underscore that it would be useful to adopt new measures, taking advantage of the change in government.

Improvements needed in Spanish budgetary policy

Among analysts of the national accounts in Spain, there is a notable consensus that there is a need to improve the information available on the budget. The inclusion of the accounts of RTVE, and the acceptance of a recommendation by the IMF (ROSC - Report on the Observance of Standards and Codes) for a report to be drawn up on fiscal transparency, represent without doubt an important step forward in facilitating the economic analysis of the budget and its transparency. However, there are matters still pending in this area, as highlighted by the IMF (2004)[10] in relation to the transformation of the public sector in Spain. In the first place, more details need to be provided on the investment projects and how they are financed in the state-owned corporate sector (Railway Infrastructure Manager (GIF), Spanish Airports and Air Navigation (AENA) and State Ports), entities that carry out practically 45 percent of public investment. In concrete, more detailed and easily ac-

[10] *Staff Report for the 2003 Article IV Consultation*, February 2004.

cessible data on their operations would be desirable, particularly for those that use deferred means of financing and which will have an impact on the amount of public spending in the medium term.

Secondly, it is essential that there be greater availability, both in terms of disaggregation and up-to-date figures, of the accounts of the AATT, which, according to an advance report published in May 2004 by the IGAE, in 2003 managed 30.6% of the non-financial assets of the country (and an even higher proportion of spending after the transfer of responsibility for education and health). Lastly, budgeting in terms of budget accounting and the definition of targets on a National Accounts basis require more information on the necessary adjustments carried out in the budget according to both methodologies.

The second main issue for the experts is the need to maintain a balanced budget. In this sense, the regulation limiting State spending (and the associated contingency fund, in order to limit the traditional changes in credit) has worked and the possibility of incorporating this into the new rule of a balanced budget over the economic cycle should be studied. As regards this, the methodology used in the calculations should be explained with maximum clarity, and responsibility for the setting of its parameters should possibly fall upon some independent organisation to minimise the credibility risks highlighted in the Box mentioned above (“Balancing the budget over the economic cycle”).

In terms of the items that make up the budget, fiscal consolidation in the period 1996-1999 was exemplary. However, the contribution made to fiscal consolidation by the drop in interest payments is difficult to repeat, and the margin available for further cuts in primary current spending is a lot more limited than was the case in the middle of the past decade, even though the new executive has committed itself to reducing it by a further 2%. In the area of spending, the aim of strengthening those budget items that theoretically enhance productivity is laudable, although one should not forget that this is not the only option available. What is more, exogenous growth models suggest an increase in efficiency by means of innovation in management, a reduction in red tape, and an increase in market competition as the long-term sources of productivity growth. On the institutional front, efforts should be focused on the AATT, which are responsible for the management of health and education, and the State, which continues to post a deficit in its accounts that is only offset by the Social Security system. In this case, one has to take into account the temporary nature of Social Security surplus, and the need to undertake reforms in the system of social protection despite the (mandatory) maintenance of the Reserve Fund.

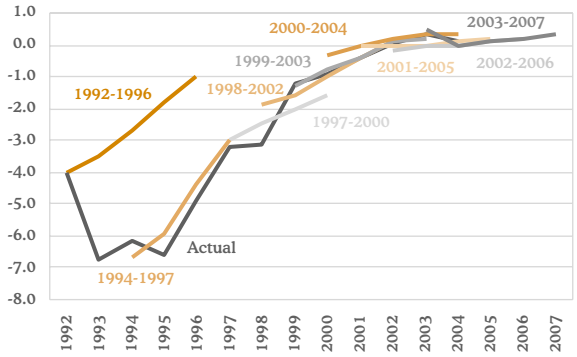
These after all are principles that have already been incorporated into the LGEP, which establishes budgetary equilibrium, transparency, multiannual budgeting and efficiency in the allocation and use of resources as the requirements of a modern Treasury, but which would benefit from being strengthened and reformulated where appropriate.

The process of fiscal consolidation in Spain in Stability Plans for the period 1992-2007

Graph 1.

Net lending(+) or net borrowing (-) of general government

% GDP

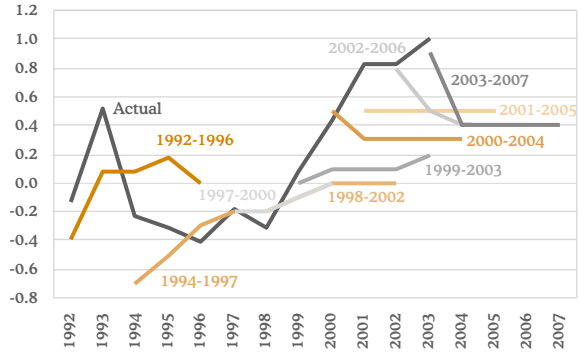


Source: IGAE, Ministry of Finance and BBVA

Graph 2.

Net lending(+) or net borrowing (-) of Social Security

% GDP



Source: IGAE, Ministry of Finance and BBVA

In the past few years, there has been a remarkable transformation in Spain in the process of drawing up, approving, carrying out and monitoring the public sector budgets, in line with the economic and social transformation that has taken place in the country. Among these changes, which have given rise to what may be considered to be a *new budgetary model*, what stands out is the transfer of responsibilities to the Territorial Administrations (AATT) and the new legislative framework for the budget.

Focusing on the latter, the drawing up of the 2004 State Budget involved the introduction of the third basic element of the Fiscal Stability Law (LGEP)[1], namely the presentation of a multi-annual budgetary scenario for the period 2004-2006. However, this process has been in place since 1992, without legal requirement but with a very similar content, as an instrument of fiscal surveillance established in the process of convergence as promoted by the Maastricht Treaty. Since 1999, the Stability and Growth Pact requires the presentation of an annual Stability Programme under the conviction that sound public finances constitute a basic requirement for the stability of the European Monetary Union[2]. To this end, we have analysed the central scenarios for growth in Spain's *Convergence Programmes* for 1992, 1994 and 1997 and of the six *Stability Programmes* of the Kingdom of Spain between 1998 and 2003 with a view to evaluating the progress made in the budgetary model.

The noteworthy achievements of Spain in the area of fiscal consolidation, including turning around a deficit for the general government (AAPP) of 6.6% of GDP in 1995 into a surplus of 0.3% in 2003 - the first ever for the Treasury since the restoration of democracy - are well known. This adjustment has been carried out mainly through a reduction in public spending, particularly due to a cut in financial expenses and current primary spending (excluding capital spending[3] and interest payments) as is recommended in the economic literature for a permanent change that is not harmful to productivity and potential growth[4] (see "Fiscal Policy" section). In addition, this consolidation appears to have engendered a virtuous circle with enormous credibility due to the excellent compliance with the fiscal deficit targets since the Convergence Plan of 1994 (see Graph 1)[5].

However, a deeper analysis of the official budget forecasts recommends caution when it comes to the outcome. The favourable outcome in the targets and forecasts of the balance of the public accounts masks significant surprises in the balances of the different administrations, as well as the internal offsetting of real growth against inflation. These deviations have been particularly evident since 2000[6].

[1] The application of the LGEP already involved in 2003 the establishment of an objective for triennial budgetary balance in the AAPP and in the sub-sectors of which it is composed (Central Administration and the Social Security system, Autonomous Regions and Local Corporations), as well as the establishment of a ceiling for total non-financial spending of the State. In addition, the financing system of the AATT was fully applied in 2003. Additionally, during the passage of the budgets in Congress, approval took place of the General Law 38/2003 on Subsidies, the General Law 47/2003 on the Budget and the General Law 58/2003 on Taxation, documents that completed the process of change in the legal regime of the Public Treasury in Spain carried out by the Popular Party Government.

[2] The minimum requirements on content were also established. On an operative basis, since 1999, at the end of year *t*, the Plan that covers the period *t-t+3* is presented. Therefore, at the moment of elaboration and presentation, a lot of final data on *t-1* are available, and therefore we do not take this year into account. The evaluation, therefore, has been carried out beginning with the forecast for year *t*, although one has to take into account that at the moment the Plan is drawn up, there is already a lot of information on that year as well, in such a way that the initial deviations are minor.

[3] In addition, capital spending fell by a similar amount as in the case of primary current spending. This occurred mainly between 1995 and 1996 and is linked to the *political cycle*.

[4] In general terms, an increase in fiscal pressure can be accompanied by a loss of efficiency in the productive process, undermining productivity growth. As regards whether or not this process is of a temporary or permanent nature, the empirical literature tends to show that fiscal consolidations based on increases in taxes only have temporary effects, since spending increases later.

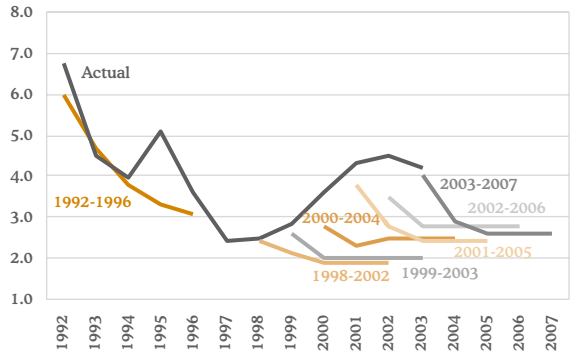
[5] In clear contrast with the results of the Plans of the majority of the European economies, in particular Germany and France. See Strauch, R., M. Hallerberg and J. von Hagen (2004): "Budgetary forecasts in Europe. The track record of Stability and Convergence Programs". European Central Bank *Working Paper* No. 307, February.

[6] Given the lack of availability of the accounts series for the AAPP in terms of ESA-95 before 1995, the figures according to ESA-79 have been used for years 1992-1994. The biases that this could cause are minimised by the high level of aggregation of the items used, and in any case would not affect the main results.

Graph 3.

Inflation

GDP deflator, annual growth, %

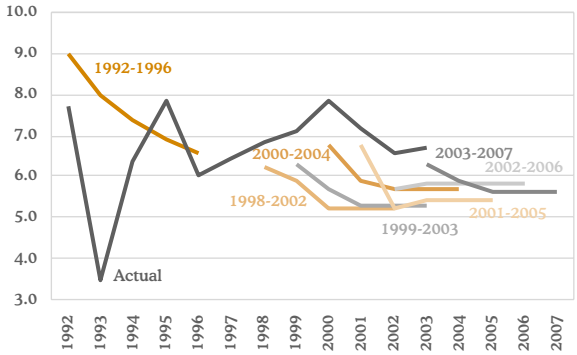


Source: IGAE, Ministry of Finance and BBVA

Graph 4.

Nominal GDP growth

Annual growth, %



Source: IGAE, Ministry of Finance and BBVA

In the first place, what stands out in the institutional area is the excellent contribution of the Social Security system due to the strong job creation driven by the immigration boom. This phenomenon, which has surpassed all expectations, explains to a large extent why the surplus of the social security system has been between 0.5 and 1 percentage point above forecast for all of the Plans since 2000 (see Graph 2). In concrete, in 2003, the surplus reached 1% of GDP, five tenths of a point above the figure forecast in the 2002-2006 Plan (drawn up at the start of 2003). The positive surprises in the revenues of the Social Security system can be put down to Social Security contributions, which have compensated for the systematic deviation of spending on pensions due to higher-than-expected inflation[7].

In terms of the macroeconomic forecasts, the positive behaviour of the budget balance since 2000 has been possible largely due to overshoots in the rate of increase of prices, which have more than offset lower real output growth[8]. Real GDP has grown in general terms between 0.5 and 1 percentage point less than forecast. However, inflation, as measured by the change in the GDP deflator, has done so at a rate of about 1.5 percentage points above the forecast trend (see Graph 3), which has allowed nominal growth in the economy to systematically exceed the forecasts (between 0.5 and 1 percentage point), hardly decelerating since the maximum point in the cycle in 2000 (Graph 4). By way of illustration, nominal growth in 2003 was 6.6% (against the forecast of 5.8% in the 2002-2006 Plan) as a result of real growth of 2.4% (forecast 3%) and inflation of 4.2% (forecast 2.8%). This nominal growth in the economy explains a large part of the increases in tax collections in Spain over the past few years[9].

According to BBVA forecasts, the 2003-2007 Stability Plan approved by the European Union in the first quarter of 2004[10] suffers from the same biases. It is foreseeable that the social security sub-sector will show a surplus slightly above forecast, while the AATT sector could register, as was the case in 2003, a slight deficit (about 0.2 or 0.3 points, compared with the forecast of equilibrium). In addition, real growth in the economy could once again be over-estimated (by about 0.5 points given a forecast of growth of 3% according to the Plan, compared with 2.5% according to BBVA), while growth in prices could be under-estimated (by 1.2 percentage points in the GDP deflator, given the forecast of 2.9% according to the Plan and 4.1% according to BBVA). As a result, nominal growth would once again be significantly higher than forecast (6.7% according to BBVA and 5.9% according to the Plan). This would drive tax collections even higher and enable the achievement of a balanced budget, even if there are upward deviations in spending.

The credibility of the model is not only the product of the achievements in the area of budget balances. Stabilising expectations requires forecasting its components with certain guarantees to the extent that they affect the decisions of economic agents in different ways. To this should be added the fact that none of the Plans forecast a scenario of slowing economic growth. This fact, which is common to the Plans of the rest of the economies of the European Union, demands a high level of caution when it comes to rating the Spanish budgetary model. Without doubt, significant improvements have been introduced in the past decade. But the medium-term challenges require that these be strengthened.

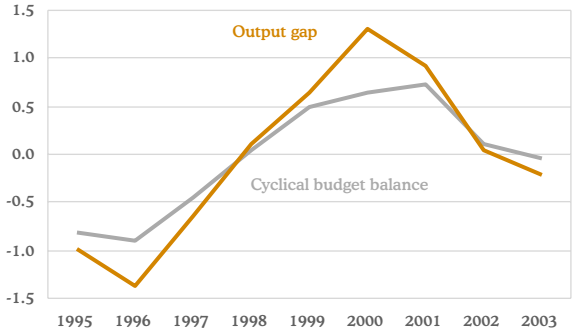
[7] Unfortunately, the Stability Plans do not disaggregate the balance of the Social Security system or the other sub-sectors of the AAPP into their main items.
[8] The Stability Plans for the periods 1994-1997 and 1997-2000 only included inflation forecasts for the private consumption deflator, and therefore, the comments and graphs on inflation and nominal growth refer exclusively to the rest of the Plans.
[9] Forecasts for tax receipts were introduced for the first time in the 2001-2005 Stability Plan, which makes it difficult to calculate the impact of the deviations in the GDP deflator. In any case, this is a natural line for extending this research by going further into the different impacts by types of tax.
[10] In concrete, the Commission and the Council rated the macroeconomic scenario as realistic, although both noted that the balanced budget target was modest given real growth and, above all, the forecast evolution of the GDP deflator. As regards the long-term perspectives, the Commission found the public accounts in a good position to face the challenge of an ageing population, although they advised the undertaking of deep structural reforms in the Welfare State under the recommendations of the Pact of Toledo, as well as putting emphasis on coordination with the AATT.

Balancing the budget over the economic cycle

Graph 1.

Budget balance and economic cycle in Spain, 1995-2003

% GDP

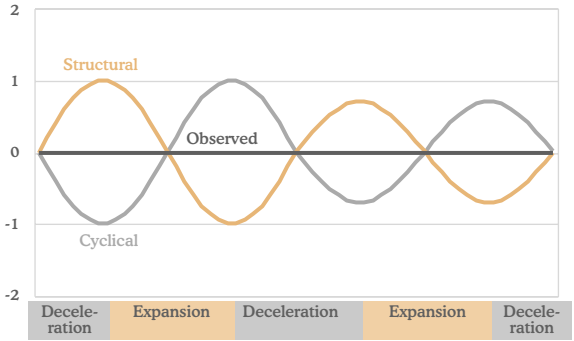


Source: IGAE, INE and BBVA

Graph 2.

Alternative I. Observed budget balance in equilibrium year by year

% GDP



Source: BBVA

Budgetary policy has three classic functions: to assign resources under the principle of efficiency when there are market failures, the redistribution of income under the principle of equity according to the preferences of society, and stabilisation, with the aim of reducing the volatility of economic cycles. The most direct indicator to gauge the functioning of the Public Sector in these areas is the budget balance. However, this balance is an imperfect indicator of the direction of budget policy since it is influenced by transitory factors that are not fully controlled by the economic authorities.

The economic cycle significantly affects public accounts both in terms of their components as well as on an aggregated basis. In phases of expansion, public revenues come in above their trend evolution, given their progressive nature. On the spending side, certain items, amongst which should be highlighted unemployment benefits, are also affected by the cyclical position of the economy. Thus, in the expansion phase, the share of unemployment benefits in the economy as a whole is reduced. In the deceleration phase, the direction of the impact is the reverse. In short, the effect of the cycle on the public accounts is pro-cyclical, increasing the public surplus (or reducing the deficit) in upward phases of the cycle and reducing it (increasing the deficit) in phases of deceleration. Graph 1 shows the evolution of the cyclical budget balance and the output gap in Spain from 1995 to 2003[1], in which the pro-cyclical impact of economic activity is clearly visible.

As a consequence of this fact, it is not enough only to analyse the observed budget balance to carry out an evaluation of fiscal policy. A rigorous analysis requires recourse to measures of the balance of the public accounts independent of the impact of the economic cycle; that is, the "structural budget balance", which is also known as the "cyclically-adjusted balance"[2]. Discretionary fiscal policy, therefore, is measured as the variation in the structural budget balance.

The Public Sector, like the rest of the economic agents, faces an intertemporal budget restriction, which, in a simplified fashion, is equivalent to a situation in which in the long term revenues have to be equal to spending. Therefore, financial orthodoxy requires the Public Sector budget to be balanced over the medium term. The consensus that exists with regard to this point contrasts, however, with the fact that there are at least three alternative ways of guaranteeing the same outcome.

The first alternative consists in setting a balanced budget year by year (see Graph 2). In this case, the structural budget balance, defined as the observed budget balance less the cyclical budget balance, needs to fully compensate for the action of the "automatic stabilisers", that is to say, of the revenue and spending items that vary with the economic cycle, smoothing it out. This in practice involves applying a discretional pro-cyclical policy, and therefore a destabilising one.

The advantages of this type of fiscal rule, therefore, do not derive from economic fundamentals, but rather practical issues. A balanced budget on an annual basis brings with it maximum transparency, easy application, and is hard to manipulate, aspects that should lend credibility to fiscal policy[3].

The second set of alternatives, which in theory guarantees an observed budget balance of zero on average over the medium term, consists of establishing that the budget be in balance over the course of the economic cycle. The first option that exists in this sense consists of setting the structural balance in equilibrium on a year-by-year basis. Given that by definition the cyclical balance is zero on average, the balance observed comprising of the aggregate of both will be in equilibrium. Graph 3 represents this second alternative. As is logical, the surpluses accumulated in the upward phase of the cycle will be offset by the deficits in the deceleration phase.

[1] The budget balance is defined as the net lending (+) or net borrowing (-) of general government (AAPP) according to the National Accounts. In order to obtain the cyclical balance, the cyclical position of the economy is measured as the output gap, applying the Hodrick-Prescott filter with a lambda of 10 to real GDP from 1970 up to 2007 (from 2004 according to BBVA Research Department forecasts). The cyclical component of direct and indirect taxes, social security contributions and other taxes is estimated by applying historical elasticities, according to BBVA calculations, for each budget item to the output gap. As regards unemployment benefits, the cyclical component is estimated on the basis of the difference between the observed rate of unemployment and the rate of unemployment consistent with an average rate of capacity utilization (MURU) obtained using Okun's Law.

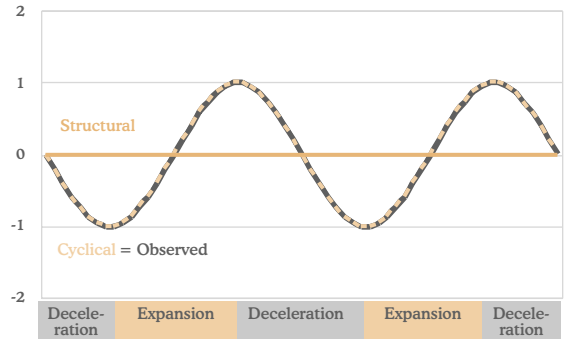
[2] However, besides the economic cycle, items related to the financing of public debt are also not entirely the responsibility of the economic authorities, neither in terms of volume (because they have been accumulated by the budget imbalances of previous governments), nor in terms of interest rates (fixed by the financial markets). To the extent that the control exercised by the economic authorities over items of financial spending is limited, the empirical literature recommends that one use measures for the budget balance excluding interest charges; that is the "primary balance". Fiscal policy in this case would be measured by the variation in the structural primary balance.

[3] Added to this is the fact that this type of budgetary institution offers protection against the bias towards deficits that derives from the incentives that both politicians and citizens have towards increases in spending above revenues (González-Páramo, J.M. (2001): Costes y beneficios de la disciplina fiscal: la Ley de Estabilidad Presupuestaria en perspectiva. *Estudios de Hacienda Pública*. Instituto de Estudios Fiscales. Madrid).

Graph 3.

Alternative II. Structural budget balance in equilibrium year by year

% GDP

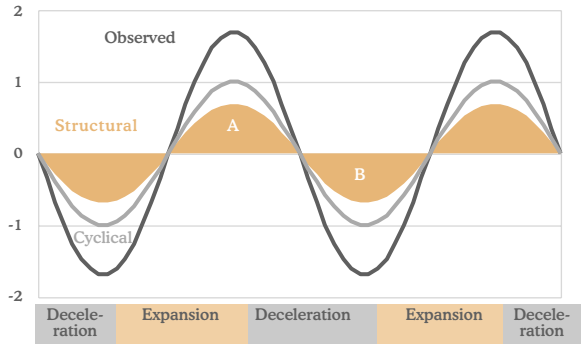


Source: BBVA

Graph 4.

Alternative III. Structural budget balance in equilibrium over the cycle

% GDP



Source: BBVA

This second option is fully in accordance with orthodoxy in fiscal policy and allows the budget to fulfil its stabilising function by allowing the automatic stabilisers to work freely (although it makes discretionary fiscal policies that translate into variations in the structural balance impossible).

However, in the first place its application presents a degree of additional difficulty by requiring a robust estimation of the economic cycle, both in terms of its duration and intensity, as well as the current cyclical position of the economy[4]. It also requires quantifying the impact of the economic cycle on all of the items in the budget[5]. All of this weakens the transparency, application and non-manipulation of this rule, possibly giving rise to credibility problems in the case of these parameters being set by government-dependent agencies. In any case, in practice, this approach only requires an accurate estimate of the potential growth of the economy (whose estimation is regularly carried out by many different public and private institutions) and to compensate expansionary regulatory changes with legislative modifications in the opposite direction.

Another line of criticism lodged against this option comes from the fact that it rejects the possibility of using discretionary fiscal policy to stabilise the economic cycle. As a response to this limitation, a third option within the maintenance of a balanced budget over the economic cycle is based on a more benign perception of the stabilising function undertaken by discretionary fiscal policy. This in fact could be considered more important in the case of the European Monetary Union given the absence of national monetary policy and the loss of the exchange rate as instruments of stabilisation. Under this preference, fiscal policy should act in a discretionary manner in the face of asymmetric shocks that affect an economy which are not considered by definition to be among the targets of the monetary authority. This option also allows the guarantee of budgetary stability if the accumulation of structural surpluses in expansion phases finances structural deficits in slowdown phases.

Graphically, this option entails designing a path for the structural budget balance around equilibrium, whose maximum and minimum levels coincide with the peaks and troughs of the economic cycle. The funds accumulated from the surpluses in the expansion phase (defined by area A in Graph 4) should be sufficient to finance the depletions accumulated in the period of deceleration (area B).

The main criticism of this type of rule derives from questions regarding its application, given that the empirical evidence regarding discretionary fiscal activity, particularly in Europe, shows that it has failed to be counter-cyclical. Actually, it has tended to be essentially pro-cyclical. The political cycles and the workings of fiscal policy itself, changes to which require on occasions complicated legislative processes, explain to a large extent the difficulty of stabilising the economic cycle with this instrument. In addition, the risks associated with the greater degree of freedom of the economic authorities, as previously described, can become accentuated in the case of a monetary union with countries that behave as “free riders” to the extent that less sound fiscal situations scarcely carry a penalty when it comes to funding them in the financial markets. Lastly, advances in the economic integration of countries should reduce the frequency of asymmetrical shocks, whose identification in fact is not trivial.

The heightened debate in Europe on fiscal rules after the establishment of the Stability and Growth Pact (SGP) and in Spain with the Fiscal Stability Law (LGEP) should be focused on weighing up with the maximum rigour the advantages and disadvantages of each of the options. In concrete, the LGEP opts for the first option, although with some differences. As regards the SGP, given its objective of balance or surplus over the medium term, it appears to support the side of a balanced budget over the course of the cycle – without deciding between the second and third options – as a requirement for fiscal policy not to cause problems in the implementation of monetary policy.

Also, the debate should not sidestep an additional matter of great importance. Not only is the size of the budget balance in itself key in determining the achievement of the objectives of public policies (essentially the welfare of citizens) in which budgetary stability stands out as a requirement, but also the size of the Public Sector as well as the composition of revenue and spending items.

[4] Although the alternatives are well known – one can highlight amongst the statistical methods the application of the Hodrick-Prescott filter to obtain trends, as well as the estimation of the production function of the economy as a structural option – the results are sensitive to their technical specifications and require assumptions that are subject to controversy.

[5] These effects, which are normally measured by the elasticity of the budget item to the output gap, need to be corrected for changes in legislation and the impact of prices. In addition, the use of the output gap based on real GDP is an approximation, given that the relevant elasticities should take into account not economic activity in general, but rather the evolution of the tax bases for each type of tax.

5. The financial system

Increase in financial savings of households

After three years falling, the financial assets of households increased by 12% in 2003, breaking a downward trend in the financial savings of households that began in 2000. As can be seen in Graph 5.1, all classes of financial assets made a positive contribution to this growth, a situation that had not occurred since 1995. Under a scenario of low interest rates and a recovery in the financial markets (the rise in the IBEX-35 in 2003 was 28%), households have diversified their savings in search of higher returns.

In fact, the biggest increases were in investment funds, stocks and other types of securities, compared with a less buoyant performance by deposits and insurance products.

Households opt for sight deposits, companies time deposits

In effect, during 2003 households channelled only 23% of new savings towards deposits, compared with 36% in 2002, which caused a fall of 1 percentage point in their growth rate to 4.3%. This rate of growth has been maintained at similar levels in 2004. Deposits by households grew 4.9% year-on-year in March. However, a breakdown by type of deposit shows significant differences. The good performance of transactional deposits (sight and savings), which experienced growth of 11% year-on-year, contrasts with the negative development of savings directed at term deposits, which as a consequence of low interest rates (negative in real terms), posted a year-on-year fall of 0.3% in the same period.

The deposits of non-financial companies for their part showed a notable deceleration in the first few months of 2004. In terms of the type of deposit, the trend observed is the opposite to that of households. Transactional deposits suffered a deceleration that took year-on-year growth to 5%. By contrast, time deposits enjoyed strong growth of around 34%.

Despite the relatively modest increase in deposits, the differential in growth of these compared with the EMU remained at levels similar to those of the past three years (5 percentage points). This is the result of stronger growth in the Spanish economy during this period and the greater weight of deposits in the assets of Spanish households compared with those in the rest of Europe.

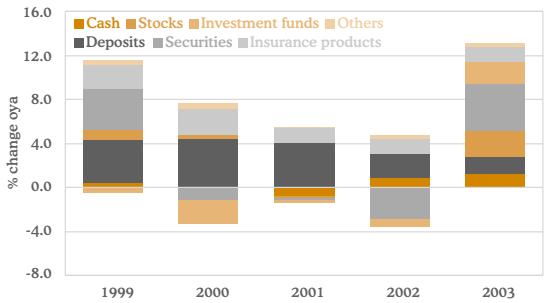
However, the same trends can be seen in the different types of deposits. As in Spain, the time deposits of households are those that have felt most the low level of interest rates, falling by 3% in February. By contrast, transactional deposits and deposits by companies showed stronger growth.

Investment in funds

The net assets of investment funds experienced year-on-year growth of 19% in March 2004, compared with a fall of 2.4% in the same period a year earlier. This increase in the total volume of assets under management was due 30% to revaluation, and the remaining 70% as a result of net inflows (8.1 billion euros in the first quarter of 2004, 37% above that in the same period a year earlier).

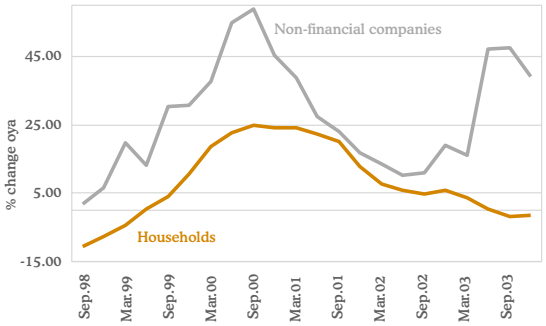
The buoyancy of the investment fund market has been accompanied by a shift in the composition of the type of funds involved. In fact, over the past four years, three stages are clearly visible. In the first of these, which began after the technology bubble burst and aversion to risk grew, money-market funds (FIAMMs) experienced stronger growth, acting as a safe haven for savings. In this way, net inflows to these

Graph 5.1.
Contribution to growth in household assets



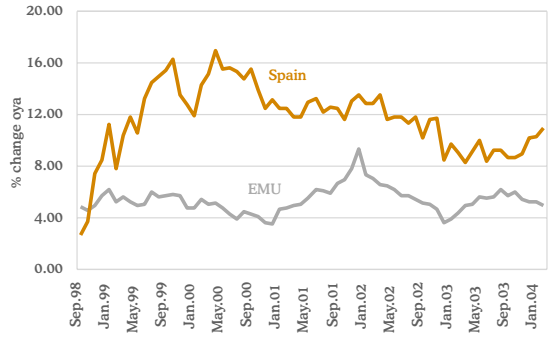
Source: Bank of Spain

Graph 5.2.
Time deposits of households and non-financial companies



Source: Bank of Spain and BCE

Graph 5.3.
Time deposits



Source: Bank of Spain and BCE

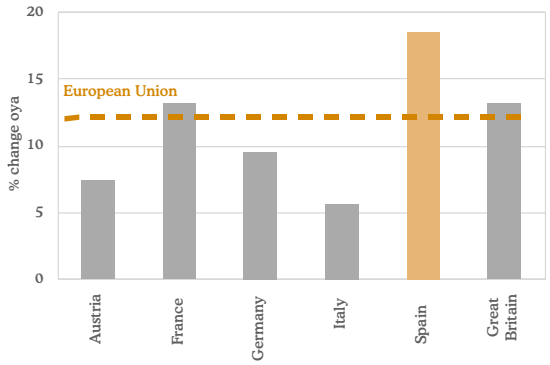
types of funds in the years 2001 and 2002 were above 8 billion euros, while there was a net outflow for other types of funds.

The second stage occurred in 2003, when a change in savers' preferences took place as they directed their new investments towards guaranteed stock market funds. These were the recipients of 11 billion euros of net contributions during last year. Finally, during the third stage, developments in the stock markets and the low level of interest rates spurred growth in contributions towards stock market products (mainly global ones), which are currently the main destination of savings in investment funds. In fact, during the first quarter of 2004, these types of fund already had received net inflows of over 8.5 billion euros.

Investment funds in the EMU also underwent a strong recovery in 2003 (the value of net assets increased 12% with respect to the previous year), although not as intense as the Spanish funds, which showed growth of 8 percentage points above the European average. This was due to both lower rises in value and lower net inflows. In addition, the elimination of the fiscal toll provided its own impetus to the Spanish market in 2003.

Graph 5.4.

Growth in net assets of investment funds in the European Union (2003)



Source: Fefsi

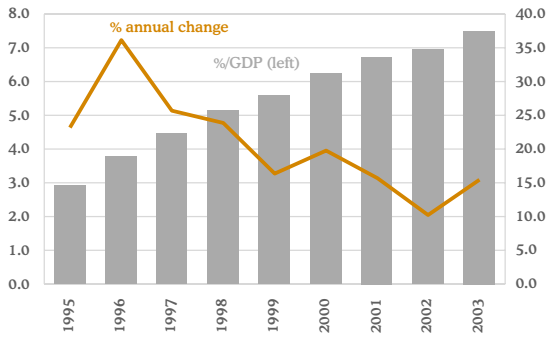
After outsourcing, revaluation

The net assets of pension funds totalled 55.765 billion euros at the end of 2003, with the annual growth rate increasing by 5 percentage points to 15%. The was due mainly to the recovery in the financial markets, which brought about a turnaround in the average annual returns of pensions funds from a fall of 4.4% at the end of 2002 to an increase of 5.4% at the end of 2003.

In fact, an analysis of net inflows shows that they fell 23% during 2003 due to the basis of comparison effect of the strong contributions to company pension plans as a result of the completion of the period of outsourcing at the end of 2002. Thus, for the first time in two years, growth in pension funds was once again led by individual plans, whose net assets increased by 19% in 2003.

Graph 5.5.

Growth in net assets of pension funds (2003)



Source: Inverco and INE

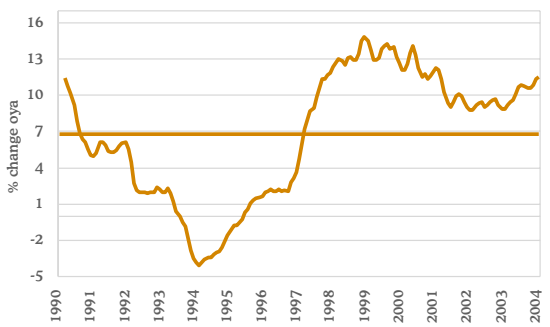
Credit expansion revived

In 2003, the expansion in credit to the private sector not only continued for the seventh year in a row, but also picked up in pace. This trend continued apace in the first two months of this year. Growth in managed credit (including securitisations) stood at 16.8% in March 2004, 2.5 percentage points above that in the same period a year earlier.

The acceleration in lending took place equally for households as for companies, although with greater strength in the case of the former. The level of lending to households reached 55% of GDP in 2003, 4 percentage points above 2002. Home acquisition continued to be the main end of the demand for credit. In fact, its weight in the level of household debt increased to 81% of loans. This type of credit, which includes securitisations, broke the trend of deceleration in 2003 that had begun in the middle of 2001, showing a marked increase during the last quarter of last year. This trend was confirmed during the first quarter of 2004. Lending for the acquisition of a home increased at a rate above 22%, a level not seen since the start of the expansion in credit, and one that makes manifest the strength of the property sector.

Graph 5.6.

Real change in credit to other resident sectors



Source: Bank of Spain and INE

Growth in other forms of lending to households remained stable during 2003 and the first few months of 2004. However, the evolution of the different segments of this lending was different. On the one hand, consumer credit, which underwent a slowdown during 2003, reversed this trend at the start of the year, growing at a rate of 9% during the first quarter. On the other hand, other forms of lending to households continued to post strong growth (20%) during 2003, but started to slow down in the first few months of 2004.

The evolution of lending to companies during 2003 showed levels of growth similar to the previous year (12%). As is the case with households, the advance of the property sector continued to be the main driving force behind this type of financing. In fact, lending for real-estate activity (which grew at rates close to 40% throughout the whole of 2003) and lending for construction (which despite a slowdown, ended 2003 with a rate of growth of 15%) accounted for almost 80% of the growth in credit to companies.

If these two sectors are excluded from total lending to companies, one can see that the falling trend that started in 1999 continued, with growth in 2003 of around 5%.

In fact, all segments, with the exception of lending for real-estate activity and credit for other services, underwent a slowdown during last year.

In keeping with the strength of the property market, the type of lending that continued to increase most was mortgage lending[1], which maintained growth levels of close to 24%. Within this segment, the strongest growth during the past two years was registered by mortgage credit to companies. In addition to the dynamism of lending to real-estate developers, this could also point to some companies opting to raise funds through loans with mortgage guarantees because of the low level of interest rates.

Securitisation and mortgage bonds on the increase

The expansion in lending and the moderate growth in deposits have led credit institutions to look increasingly to issuing securities as a means of obtaining resources to finance fresh demand for credit. During last year, asset-backed bonds worth a total 36.7 billion euros (which doubled the outstanding balance of this type of security) and mortgage-backed bonds worth 20 billion euros were issued. This pace was maintained during the first four months of the year to the extent that the balance of securitised assets in total credit granted to the private sector is now over 8%.

The fact that the assets that back these types of issues are not accounted for in the balance sheet creates significant divergences between the evolution of lending in the balance sheets of credit institutions and the actual amount that has been lent. This effect is particularly marked in lending for the acquisition of a home, given that mortgage securitisation makes up a significant proportion of the total. In fact, in 2003, the inclusion or otherwise of securitisation changes the trend in this type of financing given that it is slowing down when securitisation is excluded but accelerating when it is brought into the calculation.

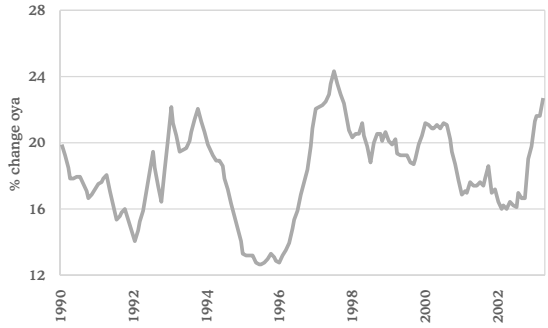
More lending than in the EMU

The growth in lending to the private sector in Spain stands at almost 10 percentage points above that for the EMU. Although the growth differential with the EMU partly explains the greater dynamism of lending in Spain, there are at the same time other factors that contribute to the maintenance of this difference in favour of Spain: the structural change in interest rates, the fact that Spaniards are bridging the gap in levels of indebtedness with the most developed countries in the EMU and the greater robustness of the Spanish property market.

As can be seen in Graph 5.10, when household credit is analysed in terms of its use with respect to GDP, it emerges that the principal difference between Spanish households and the rest of the EMU rests in lending for property acquisitions, while as regards the rest of lending, the structure is very similar.

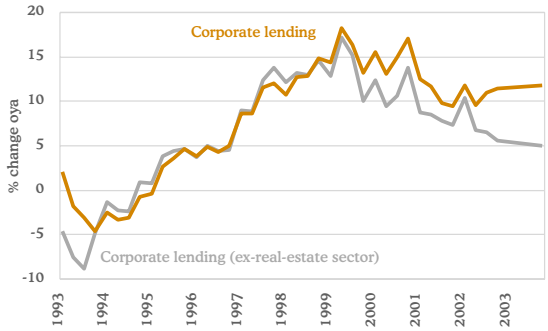
[1] For more information on the explanatory factors behind mortgage financing, see Hernansanz, C., J. F. Izquierdo, "The expansion in mortgage credit: activity, interest rates and house prices", Situación Real Estate, BBVA, July 2004.

Graph 5.7.
Credit to households for house purchases



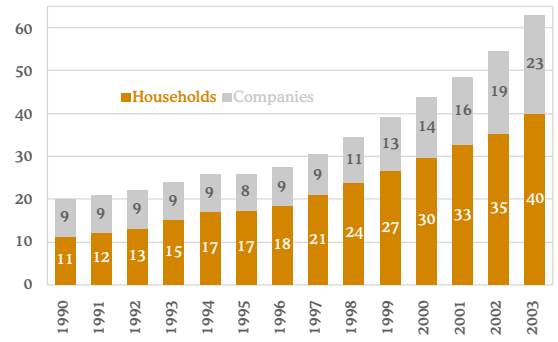
Source: Bank of Spain

Graph 5.8.
Growth in corporate lending



Source: Bank of Spain

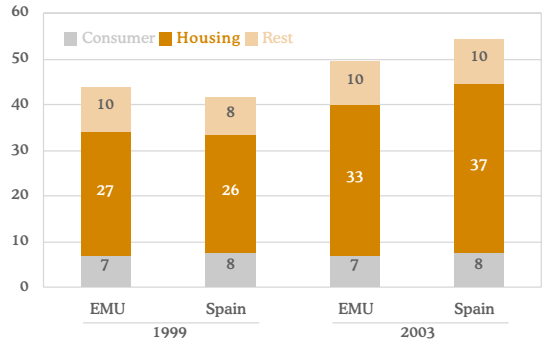
Graph 5.9.
Mortgage lending as % of GDP



Source: Bank of Spain and INE

Graph 5.10.

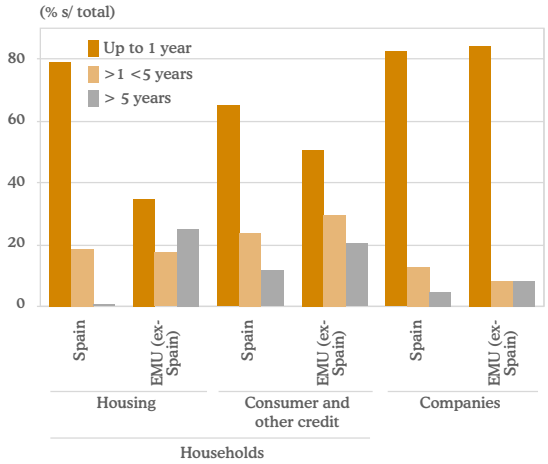
Credit to households as % of GDP



Source: Bank of Spain and ECB

Graph 5.11.

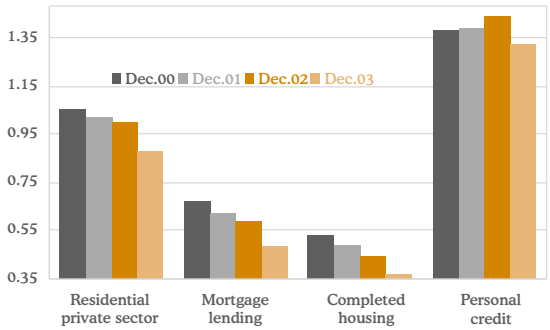
Interest rate structure of new operations



Source: Bank of Spain and ECB

Graph 5.12.

Non-performing loan ratio by type of lending



Source: AHE

…and shorter terms

The ECB has started to publish new statistics on interest rates that standardise how information is treated by the countries in the euro area. However, comparing the interest rates that apply for new credit operations in the EMU with those in Spain continues to be complicated. There are cultural differences that are difficult to surmount, such as, for example, in the case of housing loans, where fixed or variable interest rates may apply, and where the normal timeframe for changes to the loan may vary from one banking system to another.

While in Spain the majority of loans are granted on a variable interest basis subject to revision after a year (around 80% of new operations, compared with 35% in the EMU), in other countries, such as in Germany, it is more common for loans to be awarded that are revisable after five years. This means that when we compare the time period for revising the interest rates of new operations, considerable similarities are observable for corporate loans, whereas, in the case of Spanish households, the exposure to changes in interest rates is far greater.

The different structure of loans in different countries means that competitive pressures affect some products more than others. From this point of view, one can observe that for one-year loans, Spain is more competitive than the average of countries in the EMU (34 basis points less in January), whereas for products of between 5 and 10 years it loses this advantage (150 basis points more).

In terms of consumer credit, it can be seen that Spanish credit entities are less competitive in the area of short-term loans, despite the fact there has been a slight convergence during 2003. On the other hand, in the case of company loans, the interest rates offered by Spanish entities are more competitive for all types of loans except for uncovered ones due to the fact that this type of financing is more common in Europe than in Spain.

The non-performing loan ratio hits new lows

Growth in lending has been accompanied by stability in the volume of non-performing loans, which has resulted in the non-performing loan ratio of savings and commercial banks as a whole hitting an historic low of 0.76% in the first quarter of 2004.

Credit institutions continue to enjoy improvements in the quality of their portfolios as a result of enhanced risk management, low interest rates, the increase in the weight of mortgage credit where the non-performing loan ratio is very much lower (0.36% in December 2003), and positive developments in unemployment.

As can be seen in the attached graphs, all types of lending to households have shown falls in their non-performing loan ratios throughout the year. Although data series are not available for corporate non-performing loans, the indicators related to solvency (suspensions of payments, bankruptcies) have also shown an improvement in 2003.

These trends will continue in 2004

In what is left of the year, the search for higher returns in a stable environment of low interest rates and improved growth expectations could continue to encourage the channelling of new savings towards more sophisticated products with greater exposure to the equities markets.

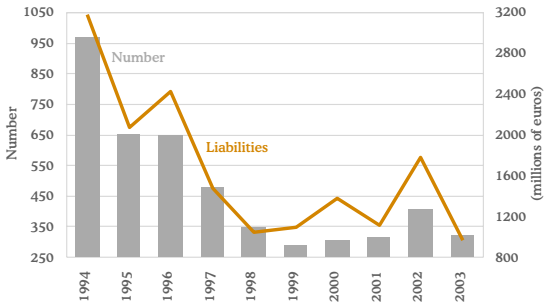
The factors mentioned above will underpin the dynamism of the credit market. In fact, the latest survey on bank lending by the Bank of Spain points to an easing of restrictions on the supply of all types of credit and stronger growth in the demand for financing on the part of companies.

However, a certain slowdown in the case of demand for loans to acquire property is expected.

Even then, it is foreseeable that mortgage lending will continue to lead the expansion within the context of a slight moderation in the property market. The loss of dynamism in this sector will bring about a shift in the composition of corporate lending, with a recovery in the industrial sector and non-real estate services.

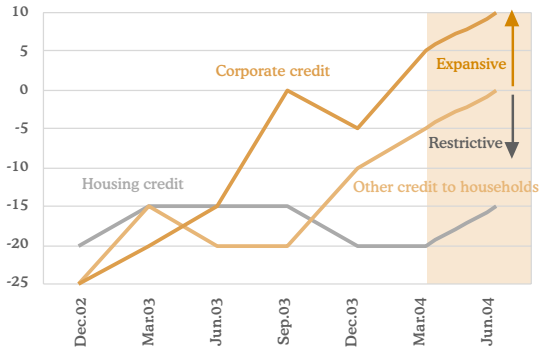
On the other hand, the marked importance of mortgage lending in total financing, combined with the expected stability in the labour market, does not lead one to foresee significant changes in the quality of the credit portfolio of lending entities, with non-performing loans expected to remain very close to their current low levels.

Graph 5.13.
Suspensions of payment



Source: INE

Graph 5.14.
Credit supply according to bank lending survey



Source: Bank of Spain

Table 5.1. Financial variables

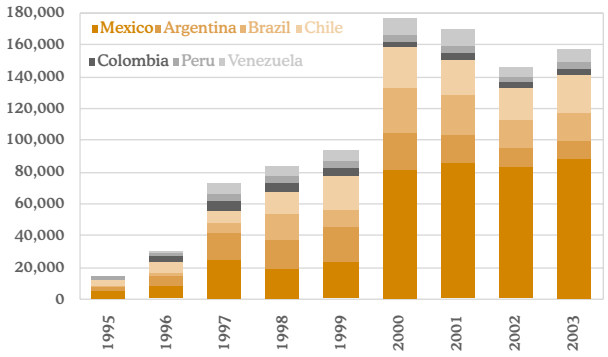
(% annual change, unless otherwise indicated)

	2001*	2002*	Dec-03	Jan-04	Feb-04	Mar-04	Balance (euros bn)
Private sector deposits	13.6	8.5	10.2	10.2	10.8	10.7	558
- Sight and savings	14.4	7.6	11.2	11.8	12.1	11.3	317
- Time	12.6	9.8	8.8	8.0	9.1	10.0	241
Net assets of investment funds	-2.7	-4.0	15.9	17.4	17.7	19.1	209
- FIAMM	32.5	20.9	9.2	5.5	2.7	2.6	57
- FIM	-10.5	-12.1	18.9	22.9	24.6	26.6	153
Net assets of pension funds	15.8	10.3	15.4	—	—	17.5	57
- Individual	12.7	8.5	19.2	—	—	22.3	32
- Employee	21.1	13.0	10.9	—	—	11.7	24
Credit to private sector (banks and savings banks)	11.0	12.8	14.9	14.4	15.5	15.9	749
Mortgage	18.4	19.3	21.6	21.1	21.2	21.7	422
Other credit	4.5	6.4	7.6	7.0	9.0	9.2	327
Bad debt ratio (banks and savings banks)**	0.90	0.92	0.79	0.79	0.78	0.76	n.a.

* Year-end
** non-perfoming loans/total credit
Source: Bank of Spain and Inverco

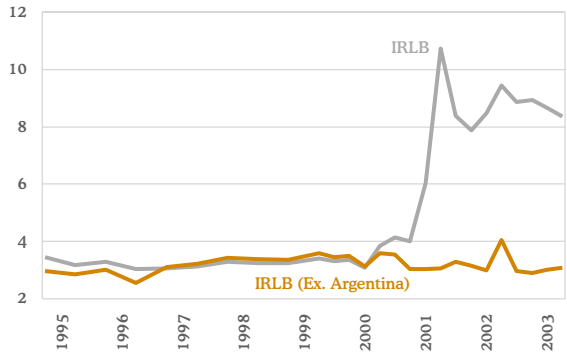
A Latin American risk index for the Spanish banks

Investment by Spanish banks in Latin America



Source: BIS

Latam risk index for Spanish banks



Source: BBVA

In the second half of the 1990s, the Spanish banking system began a process of expansion in Latin America led by the two major financial groups. In order to develop this international presence, Spanish banks opted to set up locally in these countries through the acquisition of big stakes in some of the main financial groups in the region[1] . In this way, the exposure of Spanish banks in Latin America has increased in the past few years. In December 2003, the consolidated assets of the Spanish banking system in Latin America reached $159 billion, which represented 39% of their total assets overseas.

The high growth potential of the Latin American economies, their low level of banking penetration and the ample scope for improving the efficiency of their financial systems provide banking investments in this region with the potential to generate profits above those even of the developed countries. However, as an emerging region, Latin America has a profile of higher economic and financial volatility than the richer economies, which increases the vulnerability of the Spanish financial system to the shocks that these economies suffer.

In order to evaluate how the recent uncertainties that have surrounded some of the main economies in the region have affected the Spanish banking system, we have developed an index of Latin American risk for Spanish banks (IRLB)[2] . The IRLB is calculated by multiplying the ratio of Spanish banks' assets in each Latin American country to the total assets they possess in Latin America (ω_i) by the associated probability of default (PD). In this way, with a_i being the assets of Spanish banks in the Latin American country i and A_{LATAM} the volume of total consolidated assets of Spanish banks in the region, the indicator is defined as following:

$$\omega_i = a_i / A_{LATAM}$$

$$IRLB = \Sigma \omega_i * PD_i$$

As a measure of the exposure of the banks in each of the countries, we have used statistics on overseas consolidated assets published by the Bank for International Settlements in Basel (BIS). Thus, the LRIB measures the risk deriving from the exposure of the Spanish banking system to Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. These seven countries account for 98% of the consolidated assets of Spanish banks in Latin America.

In order to calculate the probability of default, we have used the foreign-currency sovereign rating of the ratings agency Standard and Poor's. The use of the sovereign rating, although it constitutes a ceiling for the rest of local-currency debt issuers, implies a certain simplification. On the one hand, investments by banks in the private sector in Latin America (60% of the total) are well above those for the public sector (20.8%). In addition, amongst overseas assets are included both loans and bonds, which means that the quality of the total lending portfolio is assumed to be equal to the risk of sovereign bonds. However, the aspect of the index that is worth highlighting more than its absolute level is its development over time, which means that the use of the sovereign rating as a measure of risk of the portfolio of banks assets does not invalidate the conclusions of the analysis.

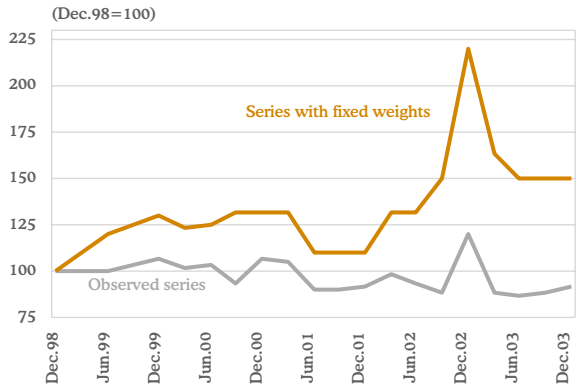
Another aspect that affects the index is the exchange rate since the BIS expresses these assets in dollars regardless of the currency in which they are denominated. Because of this, the depreciation of a currency could result in a country losing its weighting in the LRIB. This factor is significant mainly in those countries in which exposure is principally denominated in the local currency.

With respect to tenure, according to BIS figures, 45.3%[3] of the assets of international banks in Latin America are short term (below 1 year), while almost 47% are long term. However, given that bonds and loans in these countries normally

[1] For an analysis of the expansion of Spanish banks in Latin America, see Hernansanz, C., and M. Sebastián, "The Spanish Banks' Strategy in Latin America, Working Paper No. 3/00, BBVA Research Department, October, 2000.
[2] The methodology used for this indicator is based on that used in "Average sovereign rating: calculation and discussion", BIS Quarterly Review, September 2003 (pages 22-23).
[3] The total percentage does not add up to 100 due to the fact that there is a part of the figures that has not been classified.

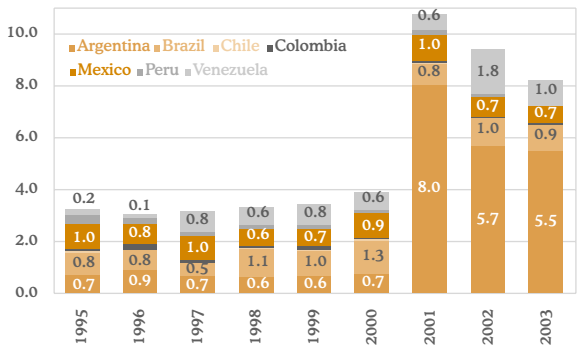
LRIB for Spanish banks

Fixed weights ex. Argentina



Source: BBVA

Contributions to the index of each country



Source: BBVA

have a relatively short-term maturity profile, the average tenure for the exposure of Spanish banks in the region has been estimated at 2 years.

The attached graph presents the development of the LRIB since 1995. The index remained relatively stable throughout the sample until the situation in Argentina started to deteriorate. In fact, if we exclude this country, the index would continue to show today a level of risk similar to that in 1995. This fact contrasts with the increasing exposure of the Spanish banks in the region and with the different episodes of financial volatility experienced during this period, particularly the Tequila crisis (1994), the Asian crisis (1997) and the Brazilian crisis (1999). As explained below, the main reason behind this performance rests in the fact that the selection of the destination countries for investments over the past few years has allowed an increase in exposure without a significant increase in risk.

Thus, if one analyses in a chronological manner the evolution of the index, one can see that during the first stage, despite the deterioration in Mexico's sovereign rating in September 1995 and Venezuela's in March 1996, there was no increase in risk due in part to the improvement in the risk ratings for Chile and Brazil at the end of 1995. From the middle of 1996 up until the end of 1998, the ratings of the countries in the region were stable with the exception of an upgrade in the ratings for Argentina, Brazil and Venezuela during the first half of 1997. Therefore, during these years, the evolution of the LRIB was marked by the different investments in countries with better or worse credit ratings.

On the other hand, in the period between 1999 and December 2000, a generalised deterioration in the solvency ratings of the economies in the region took place. With the exception of Chile and Mexico, all the countries suffered downgrades in their ratings during these two years. However, Spanish banks increased their investments in a significant manner in the Mexican banking system, which allowed the risk level to remain stable.

However, the crisis in Argentina brought about a significant deterioration in the LRIB, which doubled its value to the extent of reaching a record high at the end of 2001. Although Argentina currently finds itself in a situation of selective default, we have used as the associated default probability for the calculation of the index, the amount of the haircut announced by the government for sovereign bonds. However, this could imply an overstatement of the risk involved in the current exposure to Argentina in the IRLB since part of the debt has already been restructured (particularly that held by local banks) and bonds are being issued with a CCC rating. In fact, an upgrade in the minimum rating (CCC) with the current figures would bring about a drop in the current level of the LRIB of 43%.

Since December 2001, the fall in the importance of investment in Argentina brought about by the forced exit from Convertibility, the deterioration in the solvency of Venezuela, which has practically been corrected in the past few months, and particularly the increase in the importance of investment in Mexico along with the upgrade to "investment grade" of Mexican debt in the third quarter of 2002 by Standard and Poor's have been the factors that explain the recent fall in the LRIB.

Therefore, an analysis of the index shows that the active management of Spanish banking entities has meant that the risk that Latin America implies for the banking system has not undergone an appreciable deterioration, with the exception of Argentina, despite the gradual increase in exposure to the region. As a result of this investment policy, currently 70% of the assets of banks in the region are located in countries with "investment grade."

The alternative outcome that would have occurred from a passive investment policy on the part of the Spanish banks is reflected in the attached graph. If banking investments had remained stable in the region at the levels of the end of 1998, the LRIB, excluding again Argentina, would be 58 percentage points higher than it is at present.

6. Article: An enlarged EU from the Spanish perspective (*)

BBVA Research Department

1. Introduction

After five years in which the record of monetary policy in the European Monetary Union (EMU) has been one of notable success, the process of European integration has been given a new boost with the enlargement incorporating countries from Eastern Europe. On May 1, 2004, 10 of the economies of Central and Eastern Europe (henceforth referred to as CEECs) became members of the European Union (EU) in what is the fifth enlargement of the community[1]. The accession of Poland, Hungary, the Czech Republic, Slovenia, Estonia, Cyprus, Slovakia, Latvia, Lithuania and Malta is the most important enlargement from a quantitative point of view both in terms of the number of countries involved as well as population and territorial extension.

But this enlargement is not just another enlargement. On the contrary, it signifies a qualitative leap in the process of integration in Europe in that it fulfils one of the main social and political goals in the construction of the EU: namely the accession of countries from Eastern Europe. In short, it involves an enlargement without precedent in recent history that will in any case take another step forward with the entry of Bulgaria and Romania, which is foreseen in 2007 (once they have complied with the legislative and economic criteria), and the start of formal negotiations in the short term with Turkey[2].

However, the historic nature of this event does not hide the fact that, particularly in economic terms, the message of May 1 is basically symbolic. In the first place, three of the main channels of the economic impact of the enlargement, namely trade (the free circulation of goods and a single market), financial (capital flows and foreign direct investment, FDI) and labour (immigration flows) have been in place over the past few years[3]. Secondly, there are a number of transitional agreements in place covering the content of the *community acquis* that will delay subsequent effects (such as, for example, in the area of competition and state subsidies for companies, and, paradigmatically labour mobility). Third and finally, the entry of the bulk of these economies in the EMU is not expected to take place until the end of the current decade.

As a result of all of the above, this study will address in the first place the social and economic challenges facing the new partners in the EU in their path towards monetary union and real convergence. This route has been travelled with considerable success in the past few decades by the Spanish economy in its process of integration in Europe. The EU has constituted the main axis of economic policy in Spain throughout the past quarter of a century as the impulse behind and justification for the structural reforms that have been undertaken. In this regard, the

(*)This article is based on two previously published papers in which the figures have been updated and the conclusions re-evaluated: M. Balmaseda, M. Sebastián and P. Tello (2003): "La ampliación, el comercio y la inversión extranjera directa", in J. Hay (editor): *Desafíos. La Unión Europea ante su ampliación*, Siddharth Mehta Ed., Madrid, pp.131-149 and A. Melguizo and D. Taguas (2004): "La ampliación europea al Este: mucho más que economía", *Boletín de Estudios Económicos*, Vol. LXI, No. 181, April, pp. 19-43. Universidad Comercial de Deusto. We are grateful for assistance of Aleksandra Czerlunczakiewicz of the BBVA Research Department.

[1] The first enlargement dates from 1973 with the entry of Denmark, Ireland and the United Kingdom, which joined the founding countries Germany, France, Belgium, Italy, Luxembourg and The Netherlands. The year 1981 brought the accession of Greece and 1986 that of Spain and Portugal. The last enlargement took place in 1995 with the incorporation of Austria, Finland and Sweden.

[2] This process will not be complete until the incorporation of the rest of the Balkan countries (Croatia, Bosnia-Herzegovina, Serbia-Montenegro, Macedonia and Albania) and the tightening of ties with the countries of the former Soviet Union.

[3] The fourth is budgetary, which is anticipated to take full effect from 2007. In any case, it is evident that the effects will not be felt uniformly among countries involved. For a review and quantification of these effects for Spain, see Balmaseda *et al.* (2003) as cited above as well as CES (2004) and Martín *et al.* (2002) among others.

Table 1. Main socio-economic indicators

	Population (millions, Jan-04)	Geographical area (km^2)	GDP (bn €, 2002)	GDP pc (ppp, UE15=100)
Czech Rep.	10.2	78,865	78.2	62
Estonia	1.3	45,227	6.9	40
Cyprus	0.7	9,251	10.8	77
Latvia	2.3	64,589	8.9	35
Lithuania	3.4	65,300	14.7	39
Hungary	10.1	93,034	68.9	53
Malta	0.4	316	4.4	69
Poland	38.2	312,685	202.3	41
Slovenia	2.0	20,273	23.3	69
Slovakia	5.4	49,033	25.7	47
CEECs	**74.1**	**738,573**	**444.1**	**47**
EU15	**380.8**	**3,234,295**	**9,168.5**	**100**
EU25	**454.9**	**3,972,868**	**9,612.6**	**91**
USA	291.4	5,692,799	11,084.0	137

Source: Eurostat and BBVA

Table 2. Productive structure, employment in 2002

	Agriculture	Industry	Services
Czech Rep.	4.3	36.0	59.7
Estonia	6.8	31.2	62.0
Cyprus	n.a.	n.a.	n.a.
Latvia	15.1	24.4	60.5
Lithuania	17.4	27.4	55.2
Hungary	6.2	34.1	59.7
Malta	n.a.	n.a.	n.a.
Poland	26.9	25.2	47.9
Slovenia	11.0	37.0	52.0
Slovakia	5.0	34.5	60.5
CEECs	**17.0**	**30.3**	**52.7**
EU15	**4.0**	**24.9**	**71.1**
EU25	**6.0**	**25.8**	**68.2**
USA	1.7	16.6	81.7

Source: Eurostat, Bureau of Labor Statistics and BBVA

experience of Spain, which in this quarter of a century has transformed itself from being a peripheral and marginal economy in Europe into a fully-fledged member of the EMU, can serve as an example for the CEECs. Finally, we look at the challenges facing an enlarged EU in the coming years. Among these, what stands out is bridging the productivity gap with the United States, based on job creation and innovation; the strengthening of the institutions of the community as the guarantor of the proper functioning of monetary and fiscal policies; and the full integration of its societies.

2. The challenges facing the new member countries in the European Union

As has already been outlined, this expansion towards the East is the biggest both in terms of the cultural and political diversity involved as well as the scale of its reach. The 10 new entrant economies, as shown in Table 1, will increase the population of the EU by 74 million, or 19 percent, and extend its territory by over 700,000 km^2, or 23 percent. On the other hand, their contribution in terms of production is more modest, adding barely an extra 5 percent to the community's GDP. This means a reduction in the per capita income of the EU (nine percentage points) in the short term.

An analysis of the productive structure of these economies from the perspective of economic growth allows one to identify the reduction in the size of the agricultural and labour-intensive industrial sectors as one of the main challenges in achieving real convergence with the rest of the EU (See Tables 2 & 3). Despite the profound changes in their productive structures carried out in the past few years, currently, while in the EU15 only 4 percent of jobs are accounted for in the primary branches of the economy and 2 percent in the United States, the ratio in the case of the CEECs still stands at 17 percent. The low level of productivity of the agricultural sector is especially striking in Poland, where 27 percent of the workforce are employed on the land, yet scarcely contribute 3 percent to the value added of the economy.

3. The political and social challenges: migratory flows

The European Council held in June 1993 in Copenhagen set the criteria that candidate countries have to meet for entry to the EU. These reflected the specific nature of the process and encompassed three main areas. The political criterion stipulates that candidate countries must have stable democracies that respect human rights. The economic criterion requires that they have a free market economy in place, and the third criterion is the adoption of community legislation. In hindsight, it would appear that these main areas of action have been met with notable success under the belief that compliance with the EU democratic credo is the ideal way to guarantee peace and economic prosperity amongst its communities. However, without doubt, the democratic structures of these countries need to be consolidated so as to enhance their populations' perception of them.

Within this political and social environment, migration flows have emerged as the most important challenge, both for the recipient countries of the EU as well as the emerging economies. The benefits of the phenomenon of immigration for the former are well known, and are particularly evident in the labour market where it helps ease supply limitations (both in low-qualified sectors as well as the high-technology ones). However, the effects on the emerging economies such as those in Eastern Europe are less clear. In this case, the impact depends on the extent of the benefits of the receipt of remittances and of the possible return of immigrants after a period working abroad, against the *brain drain* involved in the emigration of qualified workers.

The social integration of these groups as well as the minimisation of the costs that could be incurred by a massive influx of foreign workers in the systems of social protection of the recipient countries, as well as in the situation of their less well qualified workers, constitute the rationale behind the establishment of the restrictions on mobility operative for a maximum of seven years that are included in the Accession Treaties[4]. However, in the first place, this response is not totally justified in view of the results of the principal studies in relation to the limited prospect of migratory movements (despite traditional considerations such as the marked differences in per capita income and wages, the relatively greater generosity of social protection systems and access to free education, geographical proximity and historical and cultural ties). Secondly, it could turn out to be counterproductive by introducing incentives that intensify the process of displacement of high value-added activities (such as services associated with the new technologies), given the limitations in qualified labour of the major industrial economies, as Marin (2004) argues. These arguments[5], and the known fact that a large part of the migration flows have anticipated formal entry to the EU (as seen in Germany, where more than 10 percent of immigrants arriving in 2002 were from Poland), reinforce the idea that efforts in this area should be concentrated on lifting the restrictions in place – although these could be maintained in certain regions (in Austria and Germany) and focus on the type of immigration (short term or long term) – and on strengthening coordination between the recipient and emerging countries.

4. The economic challenges

The recent economic development of the CEECs has been characterised by the maintenance of a positive growth differential with the EU of 1.5 percentage points since 1996 (See Graph 1), as is typical of a traditional process of convergence based in general terms on investment and exports. In addition, there has been extraordinary success in controlling inflation (Graph 2), which has fallen in these countries as a whole from 16 percent after the introduction of a market economy in 1996 to 1.9 percent in 2003 (inflation is forecast to pick up a little, to around 3.5 percent, as is consistent in any case with the "Balassa-Samuelson effect" within the convergence dynamics)[6].

4.1. Macroeconomic stability

For a more rigorous evaluation of the situation and prospects of these countries, the normal strategy is to analyse the degree of fulfilment of the Maastricht nominal convergence criteria (requirements for entry to the EMU), as well as the progress made with structural reforms in their product and factor markets[7]. Unlike the first phase of setting up the EMU, the new EU member countries have accepted as part of the acquisition of the *community acquis* to give up, whenever macroeconomic stability allows, the exercise of monetary policy and their currencies[8]. In this way, national economic policies have to consider compliance with the Maastricht criteria as the target: an inflation rate no more than 1.5 percentage points above the average of the three countries with the lowest inflation rates within the EU; long-term interest rates no more than 2 percentage points above the average of the three countries with

[4] These measures have differed among countries, and include the setting of limits on the entitlement to social benefits as in the case of the United Kingdom, Portugal and Italy, as well as making the granting of a work permit in Holland conditional on there being no Dutch national available to cover the job.

[5] Without forgetting the risk of losing popular support for the process of European construction in the countries of the East on the realisation that open frontiers do not exist. Professor Boeri refers to this when he says, "high walls create bad neighbours", which is the counterpoint of Robert Frost's poem *Mending Wall* in which he writes, "good fences make good neighbors".

[6] In addition, although in the case of economic growth, dispersion has hardly varied in the past decade, in the case of inflation, the process of reining in prices has been accompanied by an extraordinary convergence in the trends of all countries.

[7] A more detailed analysis of these issues can be found, for example, in García and Del Río (2003).

[8] That is to say, the opt-out clause exercised by the United Kingdom and Denmark will not be available.

Table 3. Productive structure, value added in 2002

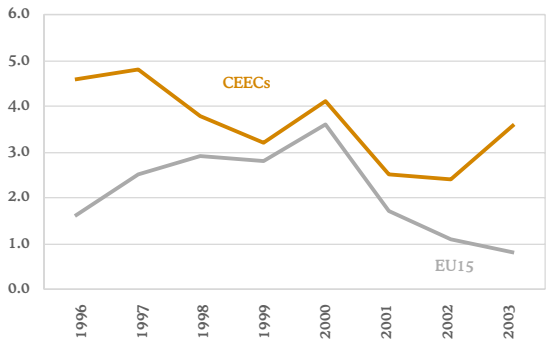
	Agriculture	Industry	Services
Czech Rep.	3.2	37.3	59.5
Estonia	5.4	29.4	65.2
Cyprus	4.1	20.3	75.6
Latvia	4.7	24.7	70.6
Lithuania	7.1	30.5	62.4
Hungary	3.7	30.7	65.6
Malta	2.8	28.2	69.0
Poland	3.1	30.0	66.9
Slovenia	3.0	35.2	61.8
Slovakia	4.4	31.1	64.5
CEECs	**3.5**	**31.4**	**65.1**
EU15	**2.0**	**27.0**	**71.0**
EU25	**2.1**	**27.2**	**70.7**
USA	1.4	19.7	78.9

Source: Eurostat, Bureau of Economic Analysis and BBVA

Graph 1.

GDP growth in Europe, 1996-2003

(% annual growth)

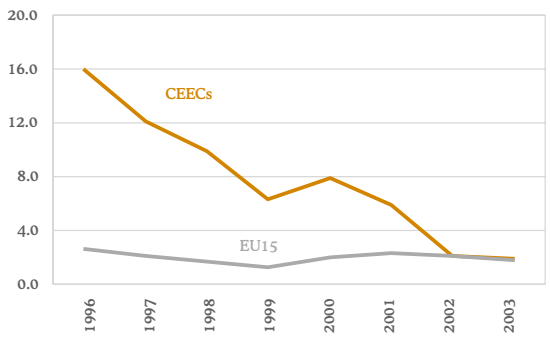


Source: European Commission and BBVA

Graph 2.

Inflation in Europe, 1996-2003

(% annual growth, consumption deflator)



Source: European Commission and BBVA

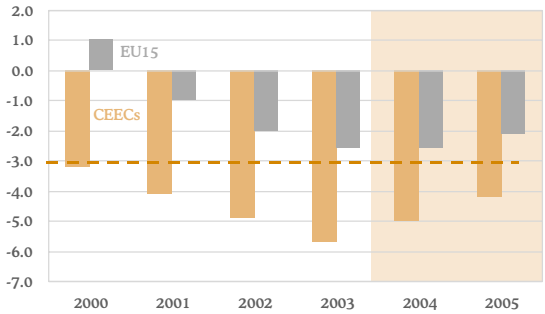
the lowest inflation rates; a public deficit no more than 3 percent of GDP; public debt no more than 60 percent of GDP, and for the currency to have been in the European Monetary System (EMS II) for at least two years and to have remained within the +/- 15 percent fluctuation band around a fixed parity against the euro that has not been modified at the request of the country. Table 4 includes a recent evaluation of these criteria for the 10 new partners in the EU.

There is a very strong consensus that fiscal consolidation, that is, keeping the public deficit below the 3-percent limit, will be the most difficult task. As Graph 3 shows, the CEECs as a whole have breached this limit every year in the period 1996-2003, and it is foreseen that they will continue to do so over the next few years according to the forecasts of the Spring Report of the European Commission.

The relatively high level of fiscal pressure[9], which generally stands at between 30 and 40 percent of GDP, a level similar to the EU average, and the very recommendations of academic literature on the superiority of fiscal consolidation based on containing current spending and on reducing taxes, make it advisable that these countries opt at this stage for reining-in non-productive public spending. Elections in the main countries involved (Poland, Hungary, the Czech Republic and Slovakia) over the next few years will introduce an additional degree of uncertainty about the probability of this benign scenario[10].

If one had to highlight a second area of potential debate, this would be the stability of the central exchange rate within EMS II, which has been open to entry to candidate countries since May 1. From the middle of the 1990s, the majority of these countries have opted to make their exchange-rate regimes more flexible after an initial period of fixed or semi-fixed exchange rates whose objective was to anchor inflation expectations (for a review of the current regimes, see Table 5)[11]. However, there are measures that lessen this risk, in

Graph 3.
Public surplus (+)/deficit (-) in Europe, 1996-2005
(% GDP)



Source: European Commission and BBVA

[9] In addition, the tax systems of these countries are based on the collection of indirect taxes on consumption as recommended by Public Finance theory. As a result of this, there is a limited margin a priori for gains in efficiency, and in the end run economic growth, based on changes to the tax structure.
[10] Another point at issue is the adequacy of the 3-percent limit itself. This is particularly the case given the current discrediting of the SGP, which the European Commission itself forecast will be breached in 2004 by six of the 12 members of the EMU (Germany, France, Greece, Italy, The Netherlands and Portugal), and the greater historic volatility of the emerging economies in Europe.
[11] In recent times, the debate has also intensified about the *euroization* of these countries, an option that is not officially supported by the ECB.

Table 4. Evaluation of convergence criteria in 2003 (*)

	Inflation (year-on-year, Dec.)	Interest rates (10-year bonds, Dec.)	Fiscal balance (-deficit, % GDP)	Public debt (% GDP)	Exchange rate (versus average, max., 2 years)
Czech Rep.	0.1	4.8	-12.9	37.6	-7.6
Estonia	1.3	4.8	2.6	5.8	0.1
Cyprus	4.0	4.8	-6.3	72.2	1.6
Latvia	3.5	5.1	-1.8	15.6	10.1
Lithuania	-1.1	4.8	-1.7	21.9	4.6
Hungary	4.7	8.2	-5.9	59.0	10.4
Malta	1.3	4.7	-9.7	72.0	-5.0
Poland	0.7	6.8	-4.1	45.4	-15.5
Slovenia	5.4	5.3	-1.8	27.1	-5.9
Slovakia	7.7	5.4	-3.6	42.8	6.6
Reference value (**)	2.8	6.5	-3.0	60.0	+/- 15%

(*) Shaded areas indicate non-compliance with criterion for EMU entry.
(**) The reference value for inflation is established as the average of the 3 countries with the lowest inflation rates as at December 2003 (Germany, France and the United Kingdom) plus 1.5 pp, while that for interest rates is the average of long-term rates in these 3 countries plus 2 pp. The volatility of the exchange rate is measured as the difference in percent between the strongest rate or the weakest rate of their currencies versus the average against the euro in the last 2 years.
Source: European Commission and BBVA

particular, the possibility of getting across the idea of a strong political commitment, not only from the candidate countries, but also from the community's institutions. In fact, as shown in Table 4, the majority of countries have complied with this criterion in the past two years[12].

Concerning structural reforms, the goal embodied in the *community acquis* is the establishment of functioning free markets (characterised by price liberalisation, the absence of barriers to entry, systems to protect property, legal and contractual rights, macroeconomic stability and developed financial systems), with the ability to handle competitive pressures and market forces within the EU. In this area, according to the latest reports by the European Commission, the advances made have been significant, although the process could only be regarded as complete in the cases of Cyprus and Malta. In the rest of the economies, additional measures are required to strengthen investment in both physical and human capital, reduce the presence of the State in the economy and increase the still limited alignment of their cycles with that of the EU as a whole.

4.2 Monetary Union and real convergence

The first entries to the EMU are expected in 2007 when the majority of the countries that make up the Helsinki group (Slovakia, Latvia, Lithuania and Malta) are expected to join (Table 5 contains the target entry dates of the national governments). It probably will not be until the end of the decade or the beginning of the following when the biggest economies – Poland, the Czech Republic and Hungary – take up the single currency. In order for this to come about, it is essential once again that these economies develop efficient and sufficient fiscal systems that allow them to address asymmetrical shocks (which by definition are not policy concerns of a common monetary policy) as well as minimise their impact according to the recommendations of the literature on optimal monetary areas (encouraging factor mobility, trade integration and cyclical synchronisation, among others). The literature available on the correlation of the economic cycles of these countries with those of the EMU has failed to throw up any consensus, except in the case of Poland, whose economy is highly aligned with the German economic cycle[13].

[12] In any case, this assertion is very simplified in that it assumes as the reference exchange rate the average of the past two years, and is therefore, of limited representativeness given the trend developments in the period in question. Therefore, it cannot be ruled out that once within the EMS II their volatility increases, particularly if a parity is set that is not in line with the fundamentals.
[13] An additional note of caution needs to be added here, in that a disturbance of the same sign and magnitude causes different effects on the economy depending on the channels along which these effects are spread.

Table 5. Exchange rate regimes and EMU entry

	Exchange rate regime	EMS II participation target date (national government's target)	Euro introduction target date (national government's target)
Poland	Float	n.a.	2008-2009
Czech Rep.	Managed float	n.a.	n.a.
Slovenia	Managed float	First half of 2005	n.a.
Slovakia	Managed float linked to euro	n.a.	2008-2009
Estonia	Currency board based on euro	Immediately (May 2004)	2006
Lithuania	Currency board based on euro	n.a.	n.a.
Hungary	Pegged to euro with wide bands (+/- 15%)	Immediately	January 2008
Cyprus	Pegged to euro with wide bands (+/- 15%)	n.a.	2007
Latvia	Pegged to SDR	January 2005	January 2008
Malta	Pegged to a trade weighted basket	Immediately	Immediately (after convergence)

Source: European Commission (2003) and BBVA

In the area of real convergence, the economies of the East have also generally made notable progress. Per capita income can be broken down into a product of economic factors (productivity, *GDP/Employed* and the employment rate, *Employed/Labour Force*), socio-economic factors (the participation rate, *Labour Force/Population 15-65*) and demographic factors (the ratio of the working-age population, *Population 15-65/Population*), according to the equation:

$$\frac{GDP}{Population} \equiv \frac{GDP}{Employed} \times \frac{Employed}{Labour\ Force} \times \frac{Labour\ Force}{Pop\ 15\text{-}65} \times \frac{Pop\ 15\text{-}65}{Population}$$

Table 6 shows the progress made in real convergence by these economies. Per capita income (adjusted for purchasing power parity) was scarcely 47 percent of the average in the EU in 2002[14]. This is due to the low starting point that resulted from the dismantling at the start of the decade of the productive structures of these centrally-planned economies, given that since 1995 the differential has been reduced by 4 percentage points. Productivity has been the main source of real convergence in the past few years. This has shown growth rates significantly above those for the EU, although as has already been mentioned, significant restructuring of the productive sector is still pending. Of particular importance is the reduction in the amount of labour employed in the primary branches of the economy, which would speed up the process of enhancing the efficiency of the productive system. In addition, Van Ark and Piatkowski (2004) argue that part of the advance in productivity has been due to massive investment in Information Technologies in the industrial sector as part of the process of restructuring, which logically will slacken off in the next few years.

The second source of real convergence, although of far less importance, has been demographic. The ratio of the working-age population to the population as a whole has increased by between 0.5 percent and 1 percent in the main economies in the East, compared with a sideways trend in the EU. This is particularly significant in that it came about despite significant levels of migratory flows. On the

[14] The per capita incomes of Spain, Greece and Portugal at the moment of their accession were between 60 and 70 percent.

Table 6. Real convergence: growth in GDP per capita, 1995-2003
(average annual growth, %)

	Total	Productivity	Participation rate	Employment rate	Demographic factor
Czech Rep. (*)	1.9	2.3	-1.7	0.9	0.5
Estonia	5.8	6.0	0.0	-0.4	0.3
Cyprus	2.1	4.5	-0.1	-2.9	0.6
Latvia	6.8	4.1	-0.8	-0.3	0.7
Lithuania	5.8	5.5	-0.1	0.2	0.3
Hungary	4.0	2.8	0.5	0.4	0.2
Malta	2.0	2.4	-0.4	0.1	0.0
Poland	3.9	4.9	-1.0	-0.6	0.6
Slovenia	3.6	2.8	0.1	0.6	0.2
Slovakia	3.7	4.1	-0.8	-0.3	0.7
CEECs (**)	**4.0**	**3.9**	**-0.4**	**-0.2**	**0.4**
EU15	**1.8**	**1.0**	**0.3**	**0.6**	**-0.1**

(*) In the case of the Czech Republic, the employment figures are for the civil sector.
(**) Figures for the CEECs are the simple mean of the 10 countries, and are therefore included for the purpose of illustration.
Source: European Commission and BBVA

other hand, the labour force participation rate has levelled off and the employment rate has fallen in the region as a whole, compared with the modest increase seen in the EU. This is a reflection of the restructuring process in these economies that has raised the unemployment rate to above 14 percent, compared with 8 percent in the EU. The main challenge of the CEE economies is to consolidate the process of real convergence. In order to achieve this, it is necessary to combine advances in productivity with greater dynamism in the labour market, both in terms of job creation and an increase in the labour force. This task is not exclusive to the economies of the East, rather it is a challenge shared by other economies in the EU such as Spain's.

5. Spanish lessons for Central and Eastern Europe

The process of integration of the Spanish economy in Europe bears notable similarities to that of the CEECs, but also a few differences. In both cases, the departure point was that of centrally-planned economies and non-democratic systems. The success of the Spanish economy within the EU in the past decades should offer a few useful lessons for the new partners in the Union. The Spanish experience, although not fully replicable, highlights the difficulties in the process of convergence in the short term, with considerable costs in terms of real convergence, as well as the importance of taking advantage of the opportunities presented by integration in Europe.

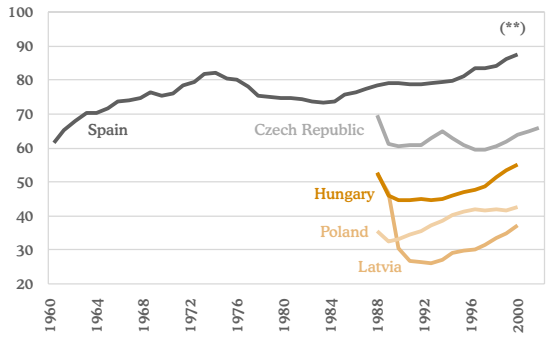
The process of real convergence of the Spanish economy with the rest of Europe, which had been very rapid up until 1974, slowed down in the period 1975-1986 due to the uncertainties associated with the process of political transition, the wage shock and the two oil crises that took place. However, the process of opening up and the modernisation carried out during this decade, which had its reflection in industrial reconversion and the start of privatisation, allowed the Spanish economy to register important gains in terms of efficiency. During this period, Spain transformed itself from being a country characterised by a high level of economic centralisation and interventionism and an authoritarian political regime into a full market economy with a democratic system. The goal of European integration made the transformation of the Spanish economic structure possible. Europe became the axis of the objectives of economic policy, shared by economic agents as a whole, and which manifested itself in an opening up to trade, nominal stability and fiscal consolidation. At the same time, Europe was also the "excuse" for the introduction of reforms, such as the restructuring of agriculture, the privatisation of public companies (mining sector), deregulation in a number of sectors, industrial reconversion and the reform of the labour market, which were not necessarily backed domestically, but which were considered necessary to guarantee future growth.

For this reason, the experience of Spain and the rest of the Cohesion countries (Portugal, Ireland, Greece) should serve as a point of reference for the CEECs, which currently find themselves immersed both in the process of modernising their economic structures and of integrating fully in the EU. This suggests that it is entirely normal that these economies go through a period in which per capita income is eroded in relative terms (see Graph 4) before beginning the process of convergence with the rest of Europe. The duration of this transitional phase will depend on the size and depth of the reforms that are undertaken. In Spain, after the lost decade (1975-1986) in terms of real convergence with the EU, the economy has neared the average in Europe in real terms with the exception of the recession of 1992-1993. Spain's membership of the European Economic Community (EEC) and later the EMU has without doubt contributed to this.

Graph 4.

Real convergence in Europe, (1960-2003)*

(GDP per capita, current prices, ppp EU15=100)



(*) 2003 data are European Commission forecasts.
(**) The 3 major CEE economies are illustrated, along with Latvia, which underwent the most important adjustment.

Source: European Commission and BBVA

As has already been mentioned, in some respects the experience of the CEECs is similar to that of the Spanish economy. Both have undergone a political transition, which in turn paved the way for economic change: from a centrally-planned economy to a free market one. In addition, they share the same economic problems that Spain had: high inflation rates, high interest rates, high unemployment rates, and a current account deficit. On the other hand, the weight of the CEECs in the EU-15 is very reduced, 19.5% in terms of population and 4.8% in terms of GDP, the same as the Southern countries in Europe at the start of the 1980s in the EU-9 at 21.4% of the population and 10.4% of GDP. Therefore, the impact on the EU of the enlargement towards the East will be limited, comparable, at most, to the integration of the countries from the South of Europe. However, as happened in the case of the latter, the gains derived from the more efficient allocation of resources, the increase in investment, and the subsequent impulse given to productivity will allow the economies of the CEECs to enjoy a level of economic and political stability that in turn will drive growth.

The process of integration for the CEECs, although involving similar problems to those encountered by the countries in the South of Europe and Spain in particular at the end of the 1970s, also contains notable differences. In the first place, joining the EU today is much more complex since it involves not only entry to a common market, but also taking on common policies in the areas of justice, foreign policy and a common currency (among other aspects included in the *community acquis*). In addition, the departure point for the CEECs reflects very significant disparities. The per capita income of the candidate countries, 47% of that of the EU-15, is significantly below that of the Cohesion countries (66%), which will make the process of convergence very long and complicated. This will condition the allocation of the community's budget, in particular in the area of regional and cohesion policy, which is directed at fomenting the convergence of the less developed countries. In this sense, the CEECs will have less negotiating power than that enjoyed in the past by the Cohesion countries, which allowed them to have a decisive influence on the Community budgets. The lower level of development and per capita income, along with the geographical proximity of Central Europe, could make immigration a significant point of difference compared with the experience of the previous enlargement (Portugal and Greece did not have a border with the countries of the EU-15 and Spain only with France).

On the other hand, it is true that the degree of market liberalisation in Spain in 1986 when the country joined the EEC was well below that of its European partners. The process of deregulating industry and the financial markets that began in 1959 with the Stabilisation Plan was still in the early stages, with important sectors of the economy strongly protected or in the hands of the State. But at the moment Spain joined, the foundations of a market economy had already been laid, and constituted the bases of the Spanish economic system. The starting point for the candidate countries is very different as they are currently distant from the situation of the Spanish economy in 1986 and even in 1975. The transformation of these economies is being carried out in a laudable fashion, but they still find themselves at a very early stage of their development. The processes of opening-up of the economy, privatisation, deregulation of industry, the financial markets, and to a lesser extent agriculture, along with the free flow of capital have made giant steps forward, but it will take a long time before this bears fruit. As was the case in Spain, the adjustments necessary in order to modernise the economic structure will put a brake on the process of convergence with the EU and even involve a step backwards. This is already taking place in the majority of the CEECs. The experience of Spain shows that there is "light at the end of the tunnel", and that this process is necessary in order to improve the efficiency of the economy and potential growth, which will later make room for advances in real convergence.

6. The great Europe in the face of the 21st century, employment, innovation and culture

The enlarged European Union of 25 member countries, with further incorporations still to come, constitutes one of the most important regions on a global level, as much due to its geographical reach and size of population as in economic terms (see Graphs 5 & 6). The joint challenges, therefore, must lie in taking advantage of its larger size, translating this into a reduction in the *productive gap* with the United States. That is to say, from the widening phase, one has to move on to the stage of deepening the process of European construction.

At the start of the 21st century, the determinants of economic prosperity seem to be well known, and are in fact the same as those that have historically characterised the most dynamic economies: the employment creation and innovation (understood in the broadest sense, from human capital to investment in R&D and in Information Technologies). The Lisbon Agenda approved in March 2000 was spot on in its objectives, even though in practice it has not been implemented. Some of the new partners in the EU, in particular Estonia, Slovenia, and Latvia, are on a similar level to the EU average in all these aspects, from the Information Society, innovation and network industries to the development of the business environment (WEF 2004). In fact, their experience could serve as an example to EU economies that are lagging in this respect, amongst which are those of southern Europe. In fact, compared with these, they even find themselves in a position of advantage. The task that is at hand consists of taking advantage of the positive shock associated with the enlargement of the EU in order to give a renewed push to the process, and match, as far as is possible, and in keeping with Europe's own identity, the extraordinary process of economic expansion of the United States in the mid-1990s of strong job creation and an acceleration in productivity (See Graph 7).

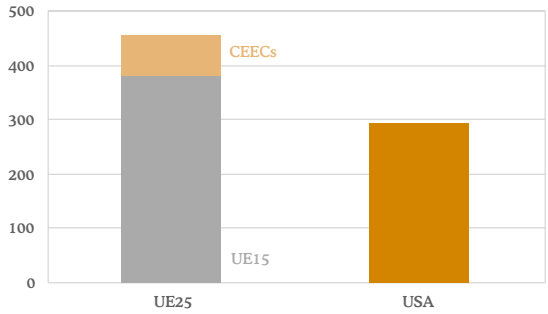
The recovery of the differential in the creation of employment in favour of Europe, helped by the higher proportion of young people in the countries of Eastern Europe, the narrowing of the productivity differential based on the stock of human capital, the adoption of innovative business management techniques and the spread throughout the whole productive system of new technologies, represent the main economic challenge.

On the level of macroeconomic policies, the initial challenge consists in increasing the credibility and prestige of the community's institutions not only among the new member countries, but also, and perhaps especially, in those that make up the old EU-15. Scarcely two decades ago, it would have been hard to imagine that governments would give up the level of sovereignty that "Frankfurt", the ECB headquarters, currently holds[15] . The outcome of the first five years of a common monetary policy is positive. This needs to be continued, given that the next qualitative leap is the incorporation of the economies of the East into the euro area. Secondly, the reform initiatives in the financial sector and the products market (such as in the road transport and automotive sectors) led by the Commission in the past 15 years have been very significant. There is a need to continue with these as well as with the improvement in budgetary management, and in the monitoring of the fiscal polices of the national governments.

Finally, the ultimate goal has to be the social integration of the countries involved. Never before in the course of history have such rich and diverse communities decided to voluntarily commit themselves to undertaking common objectives. This will involve the need to overcome cultural differences and purely material motives. It also entails avoiding, or

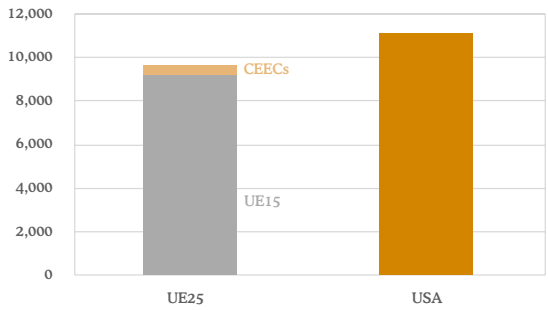
[15] On the other hand, the ceding of sovereignty to "Brussels", the headquarters of the European Commission, is much more questionable due to the limited size of the community budget, which scarcely makes up 1 percent of total output of the region (against 20 percent for the US federal government).

Graph 5.
The weight of the enlarged European Union: population
(millions in 2004)



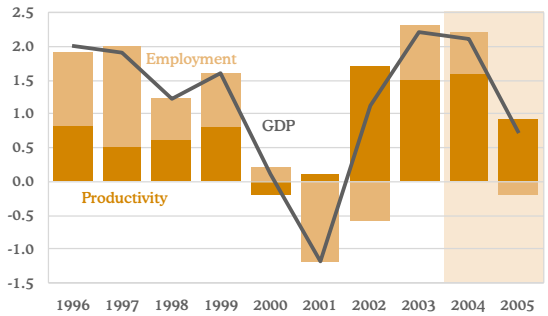
Source: Eurostat and BBVA

Graph 6.
The weight of the enlarged European Union: GDP
(millions of euros in 2002)



Source: Eurostat and BBVA

Graph 7.
Growth differential between USA and EU25, 1996-2005
(% annual growth)



Source: European Commission and BBVA

at least in the short term limiting, the importance of national interests, respecting the identity of the countries involved, in particular the smaller ones. These are big long-term challenges that will involve costs in the short term, but which will allow the conflicts that characterised Europe in the 20th century to be left behind. They should also be understood as the continuation of a success story of growth and expansion, not only economically but also politically. In fact, this is an opportunity for Europe to increase its political weight to match its economic weight. In this, Europe has a great way forward to the East.

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Summary of forecasts

(% change y/y, except for express indication)

	1999	2000	2001	2002	2003	2004
GDP at constant prices 1995	**4.2**	**4.2**	**2.8**	**2.0**	**2.4**	**2.5**
Expenditure						
Private consumption	4.7	4.0	2.8	2.6	3.0	2.9
Public consumption	4.2	5.1	3.6	4.4	4.6	4.5
Gross Fixed Capital Formation	8.8	5.7	3.3	1.0	3.0	3.7
Capital Goods	8.6	5.1	0.4	-2.7	2.2	5.1
Construction	9.0	6.1	5.8	4.2	3.7	2.6
Inventories (*)	0.1	-0.1	-0.1	0.0	0.0	0.0
Internal Demand (*)	**5.6**	**4.6**	**3.0**	**2.6**	**3.4**	**3.5**
Exports (goods and services)	7.7	10.0	3.6	0.0	4.0	7.1
Imports (goods and services)	12.6	10.6	4.0	1.8	6.7	9.3
External Demand (*)	**-1.4**	**-0.4**	**-0.2**	**-0.6**	**-1.0**	**-1.0**
Activity						
Industry	3.9	3.9	2.4	0.6	1.3	0.9
Construction	8.5	6.0	5.5	4.8	3.6	2.4
Services	4.1	4.1	3.3	2.2	2.1	3.1
GDP at current prices	**7.1**	**7.8**	**7.1**	**6.6**	**6.7**	**6.7**
Euro, billions	**565**	**610**	**653**	**696**	**743**	**793**
Prices and costs						
GDP Deflator	2.8	3.5	4.2	4.4	4.2	4.1
Private Consumption Deflator	2.4	3.1	3.3	3.5	3.1	2.5
CPI	2.3	3.4	3.6	3.5	3.0	2.9
Inflation gap with EMU (p.p.)	1.1	1.2	1.0	1.3	1.0	0.9
Compensation of employees	2.7	3.7	3.8	3.9	4.2	3.8
Unitary Labour Costs (ULC)	2.1	3.1	3.4	3.4	3.6	3.0
Competitiveness (real effective exchange rate)	-1.5	-3.2	2.0	3.2	6.0	1.4
Labour Market						
Labour force	1.8	3.3	-0.2	3.0	2.6	2.1
Employment, LFS	5.5	5.5	3.8	2.0	2.7	2.1
Increase, thousands of people	760	802	576	312	437	345
Employment, National Account	3.7	3.6	2.4	1.5	1.8	1.7
Unemployment rate (% of labour force)	15.7	13.9	10.5	11.4	11.3	11.4
Productivity	0.5	0.6	0.4	0.5	0.6	0.8
Public Sector						
Debt (% GDP)	63.1	61.2	57.5	54.6	50.8	49.0
Deficit (% GDP)	-1.2	-0.9	-0.4	0.0	0.3	0.2
External Sector						
Trade Balance (% GDP)	-5.8	-7.1	-6.6	-6.0	-6.1	-6.5
Current Account Balance (% GDP)	-2.3	-3.4	-2.8	-2.4	-3.0	-2.5
International Outlook						
GDP: World	3.6	4.6	2.4	3.0	3.9	4.4
US	4.4	3.7	0.5	2.2	3.1	4.1
EMU	2.6	3.5	1.6	0.9	0.4	1.7
World Trade	6.2	13.1	-0.1	4.6	7.2	7.0
CPI: US	2.2	3.4	2.8	1.6	2.3	2.4
EMU	1.1	2.3	2.6	2.3	2.1	2.0
Exchange rate: $ / €	1.07	0.92	0.90	0.94	1.13	1.20
Brent Barrel, price ($)	18.0	28.4	24.9	25.0	28.5	31.7

Exchange rate and interest rate (**)	**Apr-04**	**Sep-04**	**Dec-04**	**Mar-05**	**Jun-05**
Official interest rate					
US	1.00	1.25	1.50	2.00	2.50
EMU	2.00	2.00	2.00	2.00	2.25
10 year interest rate (**)					
US	4.32	4.90	5.10	5.20	5.40
Germany	4.11	4.35	4.60	4.70	4.80
Exchange rate (**)					
$/€	1.20	1.18	1.18	1.17	1.15
¥/$	108	110	108	106	104

Source: official institutions and BBVA

(*) Contribution to GDP growth

(**) Forecasts, end of period

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