Situación Spain

December 2001

- GDP growth in 2002: 1,7%
- Inflation: energetic fall towards 2%
- Collective bargaining: let it not joint the unemployed
- Is there an "euro effect" in the Spanish economy?

Research Department

BBVA

Closing date: 29 November, 2001

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1. International environment

Global deceleration

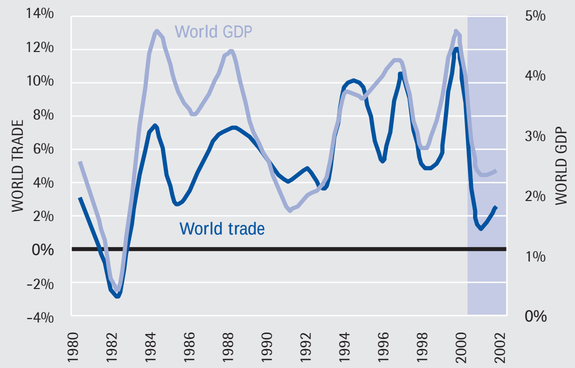
The worsening outlook for world growth in recent months is a reflection of the growing uncertainty. Though already present in the economy, this uncertainty increased in the wake of the terrorist attacks in the United States on September 11. In this context, world economic growth in 2001 will probably be down by a half from last year. While 2000 was clearly an exceptional year for growth and world trade, a growth rate of 2.4% in 2001 will be the lowest since the start of the 1990s, and also the first time for 20 years that the three major industrial economies – the United States, the Economic and Monetary Union (EMU) and Japan – have slowed together. In contrast to events at the time of the oil crises, no single common factor can be identified as the cause of this slowdown. Rather, it seems to be linked to a combination of a variety of factors, in many instances associated with problems domestically.

Inflated expectations about the benefits of the New Economy, the bursting of the stock market bubble and a high degree of monetary restriction probably lie behind the slump in consumer and business confidence in the United States and hence that economy's slowdown. In Europe, the decline in consumers' disposable income due to higher oil and food prices, limited progress with structural reforms, sparse evidence of a technology shock similar to that in the United States and a sharp stock market setback (after the auctions for third-generation mobile telephone licences) join forces with the effects of slower growth in world trade and a slide in confidence (slightly lagging that in the United States). The European economies with the strongest export ties to the United States or most specialised in technology or capital goods are being affected particularly strongly by the slowdown in world trade. This is the case in Germany, Ireland, the Netherlands and Finland. In Japan, the vicious circle of recession and deflation is intensifying as external demand weakens, and the economy is experiencing its third recession since 1991. The critical state of the banking system, with a volume of problem loans that is probably close to 50% of GDP, casts a shadow over prospects for the months ahead.

Graph 1.1

GDP and world trade

% oya



Sources: IMF and BBVA

Elsewhere, domestic problems in a number of emerging market economies are getting worse because of increased risk aversion among international investors - this reduces the volume of capital flows to these economies so badly in need of external financing – and the slowdown in world trade. Following an exceptional 12% growth rate in 2000, the volume of world trade is expected at best to expand by 2% in 2001, its slowest growth since 1982. The fall-off in international demand for information and communication technology goods is particularly noteworthy, given the vulnerability of the economies of South-east Asia in this respect. Only China, on the back of its entry into the World Trade Organisation (WTO), Russia, which, despite the decline in oil prices, is benefiting from the measures adopted in recent years and

Table 1.1. Growth forecasts

	1999	2000	2001	2002
OECD	3.3	3.8	1.0	0.9
USA	4.1	4.1	1.1	0.8
EMU	2.6	3.4	1.5	1.3
UK	2.1	2.9	2.2	2.0
Japan	0.8	1.5	-0.7	-0.8
Developing countries	3.6	5.5	4.1	4.4
Latin America	0.0	4.3	0.8	1.5
Transition countries	2.6	5.8	3.8	4.2
WORLD	3.6	4.7	2.4	2.4

Sources: FMI and BBVA

Table 1.2. Inflation forecasts

	1999	2000	2001	2002
OECD	1.9	2.5	2.4	1.5
USA	2.2	3.4	2.8	1.4
EMU	1.1	2.3	2.6	1.8
UK	2.3	2.1	2.2	2.3
Japan	-0.3	-0.7	-0.8	-0.7
Developing countries	6.0	6.1	5.5	4.6
Latin America	8.8	8.0	6.3	5.8
Transition countries	45.4	20.3	16.5	10.7
WORLD	5.2	4.2	3.7	2.5

Sources: FMI and BBVA

the Eastern European countries are enjoying above-world-average growth rates.

This scenario of weakening world demand and the associated fall in commodity prices has contributed to take world inflation down to its lowest level since the end of the 1960s. As a result, central banks are spared the dilemma of having to choose between stimulating growth or reining-in inflation, as occurs in growth slowdowns caused mainly by supply factors, such as oil crises. In this context, monetary conditions around the globe have eased significantly in 2001, though to varying degrees across countries depending on their initial level. Interest rates are likely to remain low in the months ahead. Only when the uncertainty clears away and signs of a recovery in activity, spearheaded by the U.S. economy, begin to show up will rates start to turn upwards. That is unlikely to happen before the second half of next year, however.

Weaker short-term outlook, but recovery in 2002

Against a backdrop of slowing activity and world trade, the events on September 11 in the United States have had a number of significant implications. Thus, although the direct cost has been small, the indirect effects showing up in the form of a decline in the expectations of consumers, businessmen and international investors have weakened the outlook for the short term. In particular, they have helped to tip the U.S. economy into recession. Moreover, they have strengthened the downward movement of interest rates around the world and have led to the adoption of expansionary fiscal policy measures, especially in the United States. Thus, although the situation in the short run has deteriorated, the economic policy measures adopted should underpin a recovery in activity in the months ahead, though clearly the timing and strength of this will not be the same everywhere. The correction of the stock market bubble and positive oil price developments support this recovery scenario. In view of the above, world output growth in 2002 is projected at 2.4%; that is, the same growth rate as in 2001, but instead of trending downwards as in 2001, growth in 2002 is expected to pick up gradually.

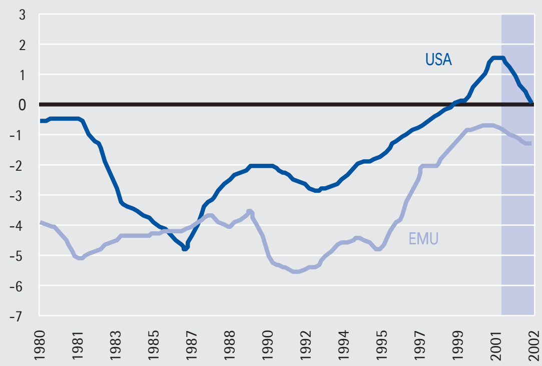
Different policy leeway and effectiveness, different outlook for the USA and EMU

After a significant downturn, but aided by the considerable scope for demand policy action at its disposal, the United States seems likely to return to near potential growth rates in the second half of 2002. Nominal interest rates - currently at 2% - have come down by some 4.5 percentage points. Scope for further downward adjustment is limited: only one further one-quarter of a percentage point of easing is likely, possibly before the end of 2001. Given that underlying inflation has remained relatively stable over the past year, this represents a sharp decline in real interest rates, similar to or even greater than those observed in past economic downturns. On the fiscal policy front, the tax rebates implemented at the end of last year - at a time when the structural fiscal surplus was over 1.5% of GDP - have served to support household disposable income. This was joined by the approval of a US$55 billion hike (0.5% of GDP) in public spending after September 11 to aid reconstruction and help those sectors worst hit by the terrorist attacks. These measures, along with others that are likely to be added in the coming months, will probably reduce the structural surplus to a figure near equilibrium in 2002, but still a far cry from the structural deficits expected in European public accounts. In addition to these measures, the U.S. economy seems to be continuing to benefit from the positive effects of the productivity shock. Productivity growth has remained robust, as reflected in a 1.8% advance in the third quarter of 2001. Moreover, the deceleration in investment has not been confined to information and communication technology goods, but is markedly intense in the other sectors. All of this suggests that demand factors, rather than supply factors, are holding sway in the economic slowdown. In this case, demand policy measures are likely to prove effective to stimulate activity. While projected growth in 2002, at 0.8%, will be lower than the 1.1% rate forecast for 2001,

Graph 1.2

Public structural balances

(% of GDP)



Source: BBVA

activity is expected to trend upwards throughout next year. In this context, long-term interest rates will probably be above 5% in the second half of the year, while official interest rates seem likely to rise to 2.5%.

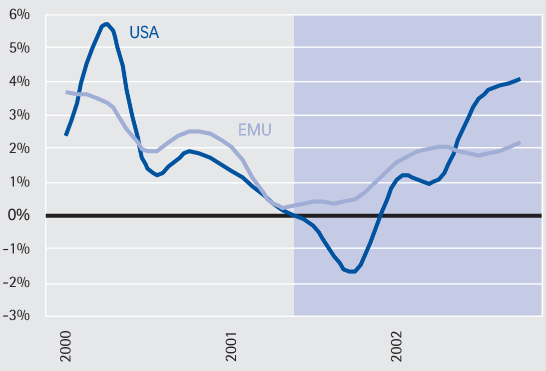
In Europe, the slowdown is linked to both demand factors and supply problems. There is also limited scope for adjusting demand policies. Monetary conditions are the easiest for several years as a result of a combination of the lowest level of real interest rates for two decades and real exchange rate depreciation. After lowering interest rates by 1.5 percentage points, to 3.25%, the European Central Bank has very little leeway left for further cuts. With underlying inflation running at over 2%, European interest rates are unlikely to go below 3%. The structural deficit in public finances shows that there is virtually no room for the adoption of discretionary measures in budgetary policy. A number of countries such as Germany are also in the troublesome position of having a public deficit in excess of 2.5% of GDP.

The EMU economy is therefore expected to grow by 1.3% in 2002, following growth of 1.5% this year. Even though activity is likely to be supported by a recovery in world trade in the second half of the year, growth will be slower than in the United States. Growth in Europe will thus have succeeded in overtaking that of the United States only briefly and by a relatively small amount. EMU also faces a number of uncertainties in the short run. Recent months have seen a fall-off in demand for cash, probably linked to an influx of hoarded cash on concerns relating to the changeover to the euro at the start of 2002. Part of this cash is probably being used to bring forward consumption decisions for durable goods and investment in housing, which, though helping to support growth in 2001, could have a negative effect on activity in the second half of 2002.

Graph 1.3

GDP

Annualised quarterly rate



Sources: Commerce Department, Eurostat and BBVA

In this context, ECB interest rates are likely to remain at 3% in 2002, while long-term rates should be lower than in the United States. The euro has some limited scope for appreciation in the short run associated with the uncertainty surrounding the U.S. economy. In the medium term, however, the greater potential for recovery in the U.S. economy could generate downward pressure on the euro. This situation will be little changed by the physical changeover to the new currency at the start of 2002.

Downside risks to the international scenario

Against a backdrop of weakening demand, exacerbated by the September 11 attacks, the main risk in the coming months is that associated with a more intense and protracted decline in business and consumer confidence, as occurred in the United States at the start of the 1990s (see Article "Uncertainty and Consumption in the United States"). It is for this reason that the objective of the economic policy measures adopted is primarily to shore up confidence, after its marked slide in recent few months.

In the medium term, there is little risk of this situation giving rise to a supply shock and the associated negative and long-lasting consequences for world growth. On the one hand, the price of oil in 2002 is expected on average to remain below that of 2001. This will be a reflection of an environment characterised by moderate demand and difficulties in reducing the supply of oil, both because of cracks within OPEC and a lack of cooperation from non-OPEC countries in cutting back production. On the other hand, the start of a new round of WTO trade negotiations, following the Doha meeting in early November, reflects a commitment to strengthen further international efforts to guarantee the progressive liberalisation of international trade. This seeks to safeguard against the protectionist temptations that can arise in periods of uncertainty such as at present.

To sum up, the risks to growth forecasts for 2002 are on the downside and are associated mainly with a deeper and protracted loss of confidence among economic agents. However, the policy measures adopted suggest that activity should recovery, as anticipated by the slope of bond yield curves in recent months and the recovery in equity prices. The latter, having hit a low point for the year in the wake of the terrorist attacks in the United States, have since climbed back to their early September levels.

2. The real economy

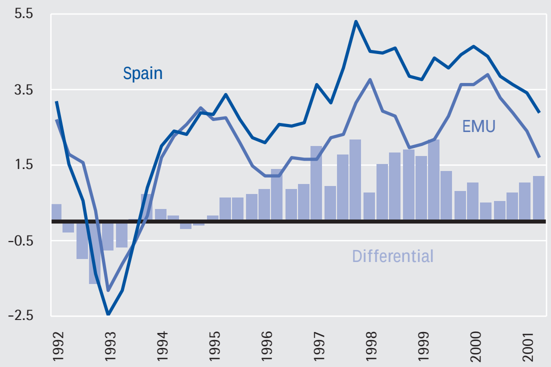
Economic slowdown; but a growth differential with EMU

The Spanish economy is adjusting to the deterioration in the international environment - which turned even more negative as a result of the terrorist attacks on September 11 – with domestic cyclical conditions marked by the gradual slowing in domestic demand that started in mid-1999. Thus, after averaging 4.1% between 1997-2000, GDP growth in 2001 will probably slow to 2.8%. And the outlook for 2002 is for further deceleration, to 1.7%.

The Spanish economy will nonetheless grow at a faster rate than EMU as a whole, both in 2001 and 2002, allowing the process of real convergence to continue. The average growth differential in 2001-2002 is expected to be 0.9 percentage points, two tenths of a point more than over the last 10 years.

Graph 2.1

Economic growth



Sources: INE and BBVA, deseasonalized data

In addition, the fiscal targets set by the Maastricht criteria have been strictly adhered to. Public debt has for the first time fallen to below 60% of GDP, and is trending downwards, while a balanced budget should be attained.

Unwinding of transitory impulses

The Spanish economy grew at rates above 3% between the first quarters of 1997 and 2001. A total of 17 quarters, this was the second longest expansion above this growth rate since 1980[1]. Since the year 2000, however, the rate of growth has been slowing quarter by quarter. This deceleration is due to the unwinding of the transitory factors, both on the demand and supply side, that had driven the economy to growth rates above potential[2]. A breakdown of growth into the permanent and transitory factors that have supported it shows that both elements have been losing momentum since the first half of 2000.

Real interest rates, which accumulated a fall of 410 basis points between 1995 and 1999, have turned upwards from the historic low registered in 1999. The decline in infla-

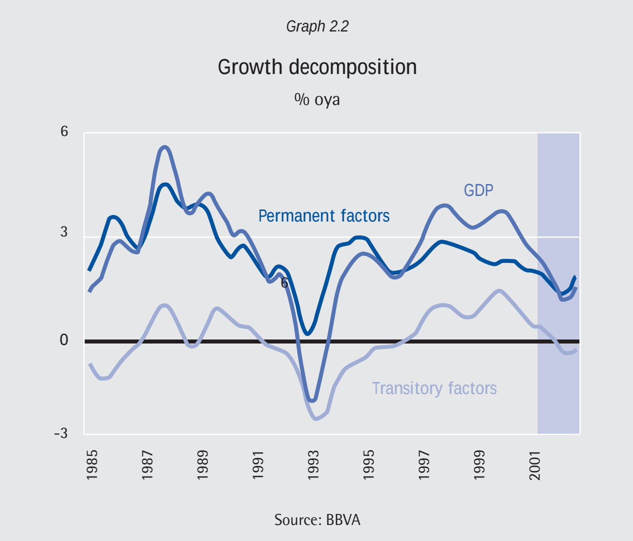
[1] GDP growth was above 3% for 22 consecutive quarters between Q485 and Q191.

[2] See "The Spanish economic miracle: a macro perspective", Manuel Balmaseda, Miguel Sebastián and Patry Tello. Situación Spain, June 2000, BBVA.

Table 2.1.

Trend-cycle data % oya	2001				2002						
	1Q01	2Q01	3Q01	4Q01	1Q02	2Q02	3Q02	4Q02	2000	2001	2002
Household consumption (1)	2.9	2.7	2.5	2.4	2.2	1.8	1.7	1.5	4.0	2.6	1.8
Public consumption	2.4	1.9	3.5	3.6	3.0	3.0	3.0	3.0	4.0	2.9	3.0
Gross fixed capital formation	2.9	3.7	2.5	1.9	0.7	-0.9	-0.7	0.0	5.7	2.7	-0.2
Capital goods and other products	0.1	1.3	-0.5	-1.0	-2.5	-4.5	-3.5	-1.5	5.1	0.0	-3.0
Construction	5.4	5.8	5.1	4.4	3.3	2.0	1.6	1.2	6.2	5.2	2.0
Inventories (*)	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.0
Domestic Demand (*)	2.9	2.9	2.7	2.5	2.0	1.4	1.4	1.5	4.2	2.7	1.6
Exports	7.7	5.9	5.1	4.4	3.7	2.7	2.4	3.0	9.6	5.7	3.0
Imports	6.1	5.3	4.9	4.7	4.0	2.5	2.0	1.5	9.8	5.2	2.5
Net exports (*)	0.4	0.1	0.0	-0.2	-0.2	0.0	0.1	0.4	-0.2	0.1	0.1
GDP at market prices	3.3	3.0	2.7	2.4	1.9	1.4	1.5	1.9	4.1	2.8	1.7
Agriculture	1.7	1.3	0.4	-1.1	-2.7	-4.2	-2.6	-1.5	1.5	0.6	-2.8
Industry (2)	3.0	2.7	1.1	1.7	0.9	0.2	1.1	1.5	4.0	2.1	0.9
Construction	6.1	6.0	5.5	4.4	3.0	2.0	1.8	2.2	6.3	5.5	2.3
Services	3.3	3.0	3.1	2.3	2.5	2.3	2.1	2.4	3.9	2.9	2.3
Market services	3.7	3.5	3.2	2.8	2.6	2.4	2.4	2.4	4.2	3.3	2.4
Non-market services	1.6	1.2	2.8	0.4	2.2	2.0	1.0	2.1	2.7	1.5	1.8
Net tax on products	2.1	1.5	2.2	4.3	1.3	0.6	0.7	1.2	5.1	2.5	1.0

(*) Contribution to GDP growth; (1) Includes NPISH
(2) Includes energy
Sources: INE and BBVA forecasts



tion since the final four months of 2001 and the recovery expected in the global economy for the latter part of 2002 suggest that real interest rates in 2002 will be higher than in 2001, though still at historically low levels for the Spanish economy. Real 3-month interbank rates are likely to be 0.7% on average in 2002, 0.1 of a point higher than in 2001, but 200 basis points below the average for the period 1995-2000.

Despite the inflation differential with EMU, the other component of monetary conditions, the exchange rate, provided a boost to competitiveness and hence fuelled growth in 1999 and 2000. However, the relatively stable nominal exchange rate expected for the euro in the quarters ahead and the continuing inflation differential with EMU will hit Spanish competitiveness in 2001 and 2002. A final component of demand, in this case an external one, is world trade, which, after growing at rates of over 10% in 2000, will slow considerably in 2001 and 2002.

On the supply side, wage moderation has been another element making a positive contribution to growth in recent years (wage "aggressiveness" fell markedly). However, the overshooting of inflation expectations in 1999 and 2000, in an environment of above-potential growth, pushed up wage settlements and increased the importance of inflation-adjustment clauses. As a result of this ex-post wage indexing, the transitory shocks affecting the cost structure (mainly energy costs) become more persistent, reducing the flexibility of the economy and hence its capacity for growth and employment generation.

The behaviour of costs in the remainder of 2001 and in 2002 will be moderated by the decline in commodity prices, and particularly in the price of oil. The average price of a barrel of oil is expected to fall to US$17.5 in 2002, from US$25 in 2001. This will be its lowest level since 1998. An increase in oil prices of almost 16 dollars, from US$12.8 a barrel on average in 1998, to US$28.4 in 2000[3], is one of the causes of the current economic slowdown because of the loss of income entailed for economic agents and the rise in production costs.

Collective bargaining; an essential reform

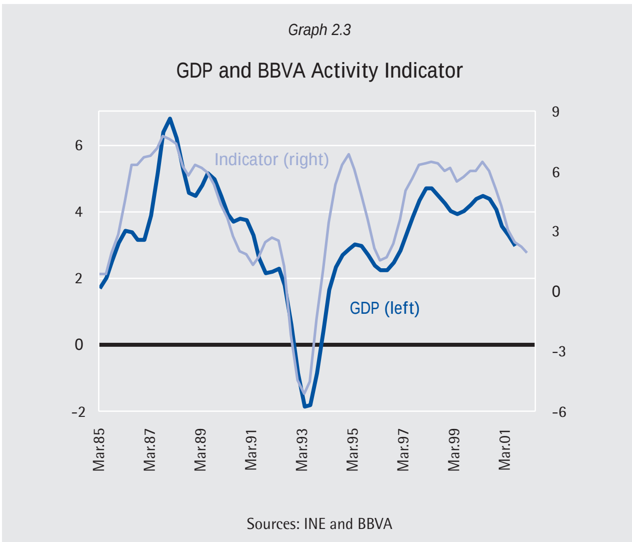
Irrespective of the transitory effect of the factors noted above, reforms in product, services and factor markets must continue if there is to be a permanent increase in productivity. A crucial step in this regard would be the approval of a reform in the structure of collective bargaining, revamping the wage-bargaining process from industry or regional settlements to firm-level agreements geared to adapting wage demands more closely to increases in productivity (see "A small step in labour market reform", Situación Spain, June 2001).

Deceleration because of internal factors

The latest short-term economic information, aggregated in the BBVA Activity Index, is consistent with a third-quarter GDP growth rate of 2.7%, down three tenths of a point from the annual growth rate of the previous quarter.

In this sense, the economic slowdown in Spain in 2001 is less intense than elsewhere in EMU (particularly in Germany) and, of course, than in the United States, where,

[3] The effect of the increase in the world market price of crude oil was strengthened in Spain by the depreciation of the euro. The energy bill rose by 21%, as a result.



according to the NBER, the economy has already entered recession. The factors restraining the deceleration in 2001 are twofold: the "euro effect" and the relative lag with which external shocks are transmitted to the Spanish economy. However, these very factors will cause Spanish economic activity to continue to slow in 2002, and delay recovery compared with the other Western economies.

The "euro effect": more consumption and investment in 2001, less in 2002

The "euro effect"[4] involves the bringing forward of spending decisions to 2001 in response to the uncertainty surrounding the changeover from peseta to euro notes and coins in the first two months of 2002. This is leading to an influx of part of the cash that people have stored up. While some of this is being used to finance normal spending, a portion is also being devoted to consumption over and above that which would take place under normal circumstances and to over-investment in the residential construction sector. As a result, household consumption and investment in residential construction in 2001 are performing more strongly than their underlying determinants would warrant. This early spending in 2001 will translate into a reduction in spending in the years ahead.

With regard to the cyclical alignment of the Spanish economy with the international environment, the correlation existing between different business expectations indicators for Spain and Germany reach their highest level (close to 0.80) contemporaneously, whereas between Spain (or Germany) and the United States the strongest linear relationship is found with a lag of 2 or 3 quarters. When quarterly GDP growth rates or those of the economic cycle are compared, the highest degree of linear correlation is found with a lag of 2 to 3 quarters.

In view of the above, the activity slowdown in the United States may be expected to be reflected in Europe with a lag of 2 or 3 quarters. Similarly, the recovery expected in the United States from the second quarter of 2002 onwards will have expansionary effects in Europe between 2 and 3 quarters later.

Saving and the "euro effect" will weaken consumption growth in 2002

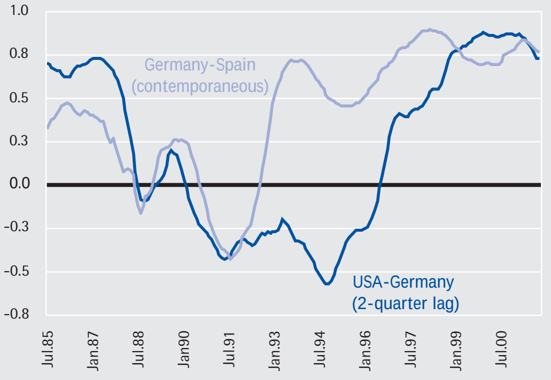
Despite the fact that a number of current household spending indicators (retail sales, car registrations) picked up in the first three quarters of 2001, the deterioration in household expectations initiated in mid-2000 has continued. This divergent behaviour may be at least partially the result of the above-mentioned "euro effect", as spending decisions that would otherwise be effected in 2002 or later are being brought forward. This would reduce the growth rate of consumption next year. Household consumption growth is thus expected to be 2.6% in 2001, but, given the outlook for developments in household disposable income, growth seems likely to slow to 1.8% in 2002 in real terms. The above forecasts for consumption in 2001 and 2002 are consistent with a stable saving rate at 2000 levels, at just over 11% of income.

Household financial saving represented 11.2% of gross disposable income in 2002, continuing the deteriora-

[4] See the Article "Is there a *euro effect* in the Spanish economy?", in this issue of Situación Spain.

Graph 2.4

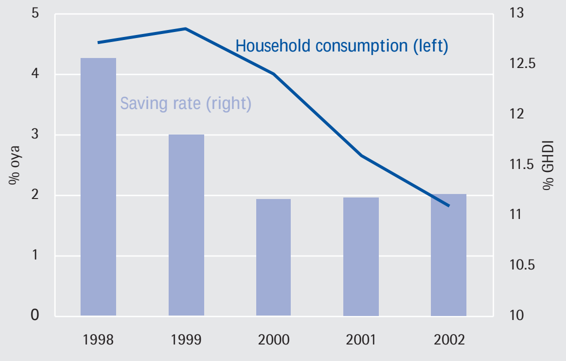
Industrial confidence correlation



Sources: Ministry of Science and Technology, Datastream and BBVA

Graph 2.5

Consumption and saving



Source: BBVA

tion observed in the second half of the 1990s. Given the uncertainty surrounding the path of economic activity next year, no further reduction in household saving is likely (it is running at an all-time low). A sharp fall in the rate of job creation during the course of this year will weaken expectations as to household income, which in turn will encourage precautionary saving. A further worsening in the economic environment and hence in households' expected income growth would bring about a greater-than-expected deceleration in private consumption.

Construction: civil engineering supports the sector

Activity indicators in the construction sector have recorded a positive and stable performance in the first two quarters of 2001. There was a significant increase in production of construction materials and an expansion in employment. The buoyancy of civil engineering works, at a time when demand for residential building is gradually slowing, has kept investment in construction high in the first part of the year.

The strength of order books has sustained optimism among agents in the sector, most notably with regard to the civil engineering segment. This contrasts with the somewhat slacker picture apparent in the building segment, linked to a decline in the number of residential projects. In the second half of the year, activity is expected to ease back and the annual growth rate of construction investment is projected at 5.2% on average in 2001, one percentage point slower than in the previous year.

In 2002, civil engineering work should continue to grow briskly, with average annual rates of growth projected at around 5%. A slowing Spanish economy and the end of the "euro effect" will weaken activity in the building segment, however. Average growth in the construction sector overall in 2002 is projected at 2%, but growth will trend downwards as the year advances.

Expectations and the cost of capital are weakening capital goods investment

Short-term indicators for capital goods investment have deteriorated sharply during the course of 2001, as reflected by the Industrial Climate Index published by the European Commission for industry as a whole. In October this survey registered its worst reading since March 1997. The deterioration first seen in the second half of 2000 has therefore strengthened, reflecting a weakening order book performance (especially in domestic orders), unwanted stock-building and a lower level of activity. This situation is shared by the capital goods industry.

Annual growth rates of industrial production in the capital goods branches as a whole have been falling since the first quarter of 2001, in line with the decline observed in exports of these goods and the deceleration in domestic activity. Thus, the degree of capacity utilisation in the capital goods industry was 79.2% in the third quarter of 2001, 2.2 points down from the previous quarter.

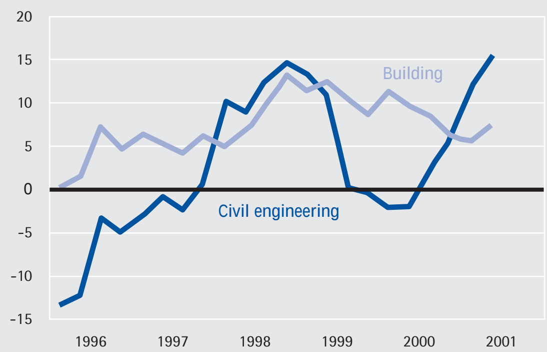
In addition, the factors underlying the behaviour of investment point to a further deterioration in 2002. Thus, the real cost of capital[5] is rising in 2001 – the first increase since 1992 – and will continue to do so in 2002.

[5] This can be proxied using the real long-term interest rate weighted by the relative level of the investment deflator with respect to the GDP deflator.

Graph 2.6

Projects executed (CIS data)

% annual change



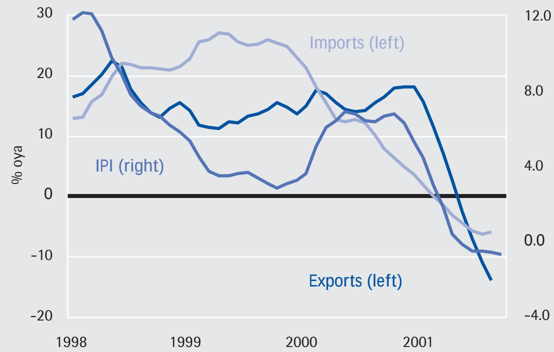
1990 constant pesetas

Source: Ministry of Development

Graph 2.7

Capital goods

(Smoothed data)



Sources: INE, Ministry of Finance and BBVA

Table 2.2. Real cost of capital							
	1996	1997	1998	1999	2000	2001	2002
Level (%)	6.3	5.1	4.2	4.0	3.6	3.8	4.2
Change (pp)	-0.9	-1.2	-0.9	-0.2	-0.4	0.2	0.3

Source: BBVA

Turning to expectations, events in September will further weaken an outlook that was already clearly on the slide since the middle of 2000. In view of these developments, capital goods investment seems likely to register negative annual growth rates in the second half of 2001 and in 2002, when an average fall of 3% is projected.

Competitiveness and world trade are hitting exports

After eight quarters during which exports of goods and services contributed over 2 percentage points per quarter to annual GDP growth, this contribution fell to 1.8 percentage points in the second quarter of 2001. The sharp downturn in world trade since the second quarter of 2001 and the petering out of gains in competitiveness in the Spanish economy are the factors working to check growth in external sales. Moreover, both these factors are likely to remain negative in the short run.

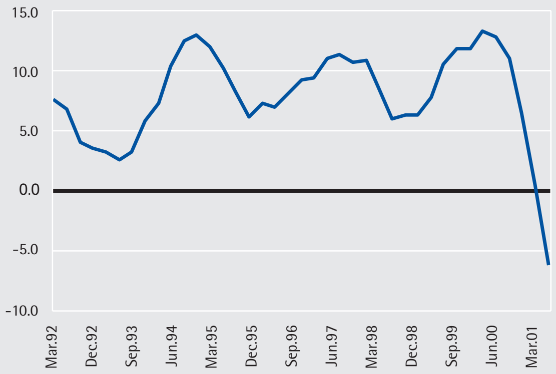
Prospects for world trade growth in 2001 and 2002 have weakened in line with the deteriorating outlook for world growth. Thus, after expanding by close to 12% in 2000, the volume of goods trade in 2001 is expected to grow by less than 1%, before rising to around 2% in 2002[6], less than one-third of the average growth rate over the past 30 years.

Graph 2.8

World trade

G-7 (volume of goods imports)

% oya



Sources: Datastream and BBVA

Table 2.3. Competitiveness				
	Spain-World	Spain-EMU	EMU-World	$/€
1998	1.2	0.2	2.5	1.12
1999	-1.5	1.1	-6.1	1.07
2000	-3.1	1.2	-9.7	0.92
2001	2.1	1.0	2.6	0.90
2002	0.7	0.6	0.2	0.89

Source: BBVA

As far as competitiveness is concerned, the Spanish economy chalked up competitive gains since 1999 because of the continued depreciation of the exchange rate of the euro against the dollar. This factor has masked a deterioration in the competitive position associated with a sustained inflation differential between Spain and EMU.

In 2001 and 2002, however, a slight depreciation of the euro will be insufficient to prevent an appreciation of the real effective exchange rate of EMU vis-à-vis the rest of the world[7]. This, coupled with Spain's continuing inflation differential with EMU, will lead to a loss of competitiveness in the Spanish economy in these years (2.1% and 0.7%, respectively, in 2001 and 2002).

Meanwhile, the weaker growth outlook for tourism revenue as a result of the September 11 attacks[8] will be reflected in a decline in the growth rate of service exports (tourism accounts for close to 60% of external services sales) in 2001, and more noticeably in 2002. Nonetheless, exports of goods and services are expected to grow by 5.7% in 2001, contributing 1.8 percentage points to GDP growth. Growth is then expected to fall back to 3% year-on-year in 2002.

The slowdown in activity is also curbing imports. The expected deceleration in household consumption and the fall in capital goods investment is expected to slow import growth from the 5.2% rate forecast for 2001 to 2.5% in 2002.

[6] The latest forecasts for 2001 and 2002, respectively, are: 0.9% and 1.8% according to the European Commission and 0.3% and 2% according to the OECD.

[7] The effective exchange rate of the euro appreciates by 1.6%, while the price differential of EMU with the rest of the world is of the order of 1%.

[8] While the September 11 attacks constitute a negative shock for the tourism sector, its impact in Spain should be more muted as a consequence of the safe-haven effect linked to the "fear of flying".

Table 2.4. Spain's income account	1998	1999	2000	2001	2002
Gross disposable income (% oya)	6.7	6.8	7.4	5.9	4.8
Gross national saving (% GDP)	22.6	22.2	22.2	22.1	22.2
Net borrowing (-) or lending (+) (% GDP)	0.5	-1.2	-2.6	-1.8	-1.4

Sources: Bank of Spain, INE and BBVA

As a result, external purchases will subtract only 1.7 percentage points from GDP in 2002, while the external sector should make a 0.1-point net positive contribution to GDP growth.

The trade deficit is expected to shrink in 2002, from a projected 6.5% of GDP in 2001, to 5.5%, partly as a result of the decline in oil prices. This will be insufficient, however, to the plug the current account deficit. As a result, the economy will probably have a borrowing requirement of 1.8% of GDP in 2001 and 1.4% in 2002.

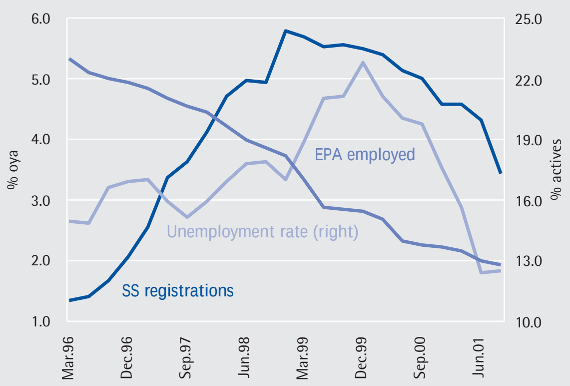
Stronger productivity, but a higher unemployment rate

The rate of job creation in the Spanish economy has been slowing since the beginning of 2000, but in recent months the deterioration has strengthened. Thus, the increase in social security registrations and the fall in registered unemployment in the third quarter of 2001 were the weakest for a third quarter since 1993. The performance of these variables may have been influenced by faster administrative processing of people entering and leaving jobs, as well as by firms reducing labour costs in periods of lower seasonal activity through "temporarily" laying-off part of the workforce.

The Labour Force Survey data have surprised on the upside, however. Third-quarter growth in employment was

Graph 2.9

Employment and unemployment



Sources: INE and BBVA

1.2%, unchanged from the same period of 2000, when the Spanish economy posted an annual rate of growth of 4%, 1.3 percentage points above projected GDP growth for the third quarter of this year.

The most striking performance was that of employment in the services sector, which registered its biggest quarterly rise since 1987, surpassing even the increase recorded by social security registrations in the sector[9]. This performance may have been influenced by the "euro effect", which, by sustaining consumption and residential investment demand, may be affecting employment growth in specific market services activities, such as commercial distribution, the hotel industry and real estate. The unwinding of this effect in 2002 will lead to an even faster slowdown in job creation in this sector in line with the evolution of demand. The deterioration in social security registrations and registered INEM unemployment supports this interpretation. Thus, the quarterly decline in registered unemployment in the services sector was 1.9%, the lowest in the third quarter since 1993.

Employment is nonetheless expected to continue to grow in 2002, though at a much slower rate than in 2001: 1.9% in 2001 and 0.6% in 2002 measured using the EPA labour survey, and 1.9% and 0.4% as calculated using full-time equivalent employment in the National Accounts. However, despite this sharp slowdown, job creation will still continue. And this, despite the fact that GDP growth will be less than 2% next year, the growth rate traditionally taken as the limit below which employment contracts in the Spanish economy. The reforms introduced since 1994 in the labour market may have lowered this limit by a few tenths of a point of GDP, ultimately altering the relationship existing between employment and growth[10].

The slowdown expected for next year in the rate of job creation will be more pronounced than the slowdown in GDP (1.5 and 1.1 percentage points, respectively). This will make room for an increase in productivity growth in the Spanish economy, to 1.3%, the highest rate since 1994.

The growth rate of the labour force is still declining (from 2.3% in Q100 to 0.7% in Q301) in line with the behaviour of the population aged 16-64. The unemployment rate is thus projected to rise to 13.7% in 2002, five tenths of a point higher than in 2001. The small size of this increase – in spite of the sharp slowdown in employment growth –

[9] This is the first time since 1985 that employment growth measured by the EPA labour survey has exceeded that measured by social security registrations in the third quarter of the year.

[10] The Chow test for structural change rejects the hypothesis of no structural changes in the relationship between employment and GDP in 1994.

is due to the “favourable” demographic balance in the expansion of the labour market. The population aged 16-64 recorded an average annual growth rate of 1.2% during the 1980s, much higher than the 0.5% average registered in the 1990s. Low population growth allows increases in employment to reduce unemployment more intensely.

A new EPA in 2002

These projections do not take into account the effect of the changes to the EPA Labour Survey methodology from the first quarter of 2002. These changes aim to make the survey more representative of the current population structure and standardise the definition of unemployment throughout the European Union.

To make the labour force survey more representative of the current population structure, the statistic institute, INE, is to take into account new population projections with a larger number of immigrants[11]. In addition, INE is also going to re-weight the 20-40 year-old age groups so that their relative importance in the survey is more closely matched to their proportion of the total population. *A priori* both changes will entail an increase in absolute population levels, active and inactive persons and employed and unemployed persons. At present, however, it is impossible to quantify this increase or to gauge the exact effect on the unemployment, employment and participation rates.

The definition of unemployment will become more restrictive after these changes, since unemployed people looking for work solely through INEM labour exchanges must have been in contact with them in the four weeks prior to the reference week (formerly, they only had to be in contact every three months), and with the specific aim of looking for a job. On INE estimates, the application of the new definition of unemployment to first-quarter data for 2001 would have reduced the unemployment rate from 13.43% to 10.95%. The participation rate, in turn, would have fallen from 51.31% to 49.88%.

[11] The average annual inflow of immigrants is increased to over 150,000 from the previous 35,000.

INFO XXI Action Plan: scant progress, insufficient information

Spain has made great strides in recent years in the main indicators of the information society (Internet subscribers, electronic commerce and particularly mobile telephony). These undoubted advances are nonetheless seen to be insufficient in any international comparison. By way of example, the volume of funds allocated to R+D in Spain (0.9% of GDP) is only half the EU average.

The undoubted benefits of developing an information society make it desirable for the public sector to play an active role in speeding up the process, removing obstacles and allowing society as a whole to reap the rewards. The EU has explicitly adopted this political commitment in the e-Europe Initiative (Special European Council, Lisbon, March 2000) and its Action Plan (European Council, Santa María de Feira, June 2000).

In this context, the Spanish government approved the INFO XXI Action Plan in January 2001 as the next stage of the INFO XXI Initiative: "An information society for all". The aim of the INFO XXI Initiative, the specific actions of which are set out in the Action Plan, is to promote the development of the new information technologies and encourage their wide adoption and use by the public, companies (especially small and medium-sized companies) and the public administrations. The Action Plan sets out the Spanish government's key projects in this area for the period 2001-2003.

The main lines of action affect three key areas: the information and communication technology sector (ICT), an electronic administration and society as a whole. The table below summarises their main ingredients.

The projected budget for the attainment of these objectives over the three-year period 2001-2003 amounts to 4,958 million euros[1]. Of this total, the government has earmarked 3,606 million euros, or 73%, to set up an electronic administration, while the remaining 1,352 million, under the control of the Ministry of Science and Technology itself, will focus on ICT-promoting policies and the diffusion of the use of the new technologies among companies and the public.

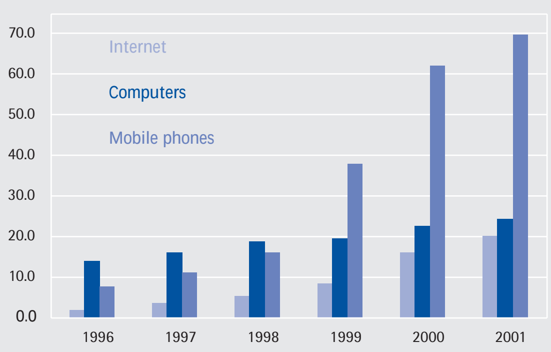
The drive to promote the development and spread of the new technologies in Spain, the definition of the key lines of action – the technology sector, the Public Administration and society as a whole – and a recognition of the need for the central administration (and, within it, all the ministerial departments) to collaborate with the territorial administrations and the private sector show that the government is resolutely committed to the development of an information society. Moreover, in view of the fact that the Action Plan's budget practically doubles the funds allocated to the INFO XXI Initiative (2,524 million euros), it deserves a very positive initial assessment.

Nine months on, however, there is a growing consensus among the leading ICT sector associations (such as the Spanish Association of IT companies, SEDISI, the National Association of Electronic and Telecommunications Industries, ANIEL, and the Multisectoral Association of Spanish Electronic and Communications Companies, ASIMELEC), as well as in specialised investigation centres (the COTEC Foundation), that only modest progress has been made.

The first reason for this is the failure to provide additional information since the Action Plan was presented. The initial problems relating to the lack of a detailed description of most of the policies (when the Action Plan was presented only 21 showcase projects – of varying social impact - out of a total of 332 initiatives were spelt out) have barely been tackled. In addition, fuller information on the allocation of funding and the degree of execution of initiatives is still not available, and the same is true of the situation in relation to negotiations and agreements between the central administration, the territorial administrations and the private sector.

New technologies in Spain (1996-2001)

(Penetration rate)



Note: the 2001 data refer to April/May (computers and Internet) and September (mobile phones).

Source: General Media Study, OECD, Market Commission for Telecommunications and Mobile Communications

Secondly, apart from this information problem, discernible advances in the implementation of the plan have been few and far between. The main projects have concentrated on the first line of action - the ICT sector - in its three areas: regulation, indirect promotion and direct promotion.

With regard to regulatory matters, the outcome is, on balance, unsatisfactory. The liberalisation of the telecommunications market has produced notable results, the clearest sign of which is the extraordinary increase in the penetration of mobile telephony, as well as the arrival in both fixed and mobile telephony of multiple alternatives to the dominant operator Telefónica, the variety of special offers, price reductions and increases in investment. Nonetheless, the problems encountered in developing the project to create "virtual mobile operators" (without networks) – which would generate a more competitive environment – and the fact that Internet is still not a "universal telephony service" – which would provide access to the Web for the whole Spanish population – are questions that remain to be addressed.

[1] Nonetheless, recent statements by officials from the Ministry of Science and Technology indicate that the budget will total over 6,000 million euros.

Yet perhaps the most important weakness lies in the regulation of electronic commerce. The Law on Information Society Services and Electronic Commerce needs to be approved not only because of the obligation to incorporate the EU directive on electronic commerce (2000/31/CE of the European Parliament and Council, June 8, 2000) into Spanish law. By regulating the accountability of service providers, the extent of their obligations and the rights of consumers and users, it is an essential requirement for the development of an information society in Spain. Praiseworthy speedy progress at the outset and a judicious process of elaboration of the law through public consultations can in no way compensate for the delay in its approval in recent months.

The main progress in implementing the INFO XXI Plan has thus been concentrated in indirect policies of promotion through incentives in corporate taxation (Royal Decree 3/2000, June 23 and Royal Decree 6/2000, December 13). The introduction of a tax break for 10% of the investment and expenditure related to the introduction of the new technologies in a company (for an Internet access and presence and the improvement of productive and commercialisation processes), the extension of the tax break for spending on training for employees to that connected with the use of the new technologies and an enhanced tax treatment of venture capital furnish a very favourable tax framework.

In sharp contrast to these measures, however, the 2001 State Budget Law (Law 13/2000, December 28) provided for an extremely sharp increase in the annual levy on the use of the public radio-electric spectrum, a measure that is particularly onerous for operators of third-generation mobile telephony (UMTS), the star sub-sector of the information society. The levy for each of the four UMTS licences was increased 33-fold (to 163 million euros per licence), based on the increased economic value deriving from the use of the spectrum. In view of the fact that the size of the levy is to be determined annually on the basis of criteria as yet ill-defined, this measure could generate regulatory insecurity. Even with a more concrete definition, however, the fact that companies' initial business plans did not envisage this levy could cast doubts on the viability of the investment projects needed in the sector's network infrastructures and contents.

Finally, as far as programmes of direct promotion (infrastructure, investment and innovation) are concerned, the objectives of the National Plan for Scientific Research, Development and Technological Innovation (R+D+i) are relatively modest. Thus, funding for R+D is projected to rise to 1.3% of GDP in 2003 – substantially below the current EU average of 1.8% and a far cry from the 2.6% of the United States – with considerable private-sector participation (close to two-thirds of the total). Moreover, so far only limited progress has been made with projects involving the collaboration of the central administration, territorial administrations and private sector.

As for the remaining lines of action, their launch is, in general, too recent for a well-grounded assessment of them to be made. Thus, with regard to an electronic administration, for instance, the Integrated Portal for the administrations was presented in August 2001 (to a cautious reception).

The picture for initiatives aimed at society as a whole is little different. Digital training programmes for users and professionals (August 2001), programmes to promote the use of the new technologies in companies (Profit as of April 2001 and Arte/Pyme II, October 2001) and electronic security programmes (computer virus Early Warning Centre, July 2001) have barely got under way.

A first analysis of the 2002 State Budget Law allows us to identify a number of advances in the Action Plan's key areas. First of all, it provides for an increase in funds for R+D+i (7.6%), which amount to 3,791 million euros. Second, the indirect measures in the area of taxation are strengthened. Further improvements are introduced in the tax framework supporting corporate R+D+i (currently, it is one of the most favourable in the OECD). The compensation period for negative tax bases is extended in a move that will benefit high-technology companies, which take longer to become profitable. Investment in fixed assets linked to R+D activities is made tax-deductible and the ceiling on tax breaks for the purchase of patents, licences, know-how and designs has been increased from 300,000 to 500,000 euros. Finally, during parliamentary passage, the levy for UMTS licences was practically reduced to one-eighth, to stand at 21 million euros, a cut justified by the fall in the economic value of the service (current market value of the spectrum and expected profitability). In addition, a commitment was made to keep the levy at this level until 2006, with rises in line with CPI inflation.

To sum up, despite the fact that the results have so far been modest, the INFO Plan XXI is an appropriate framework for the development of an information society. A bigger push is therefore required to reduce the differential that exists not only between Spain and the United States, but also with respect to most of the European Union.

INFO XXI Action Plan

Área	Main contents	Funding
ICT SECTOR		
Regulation	Law on Information Society Services and Electronic Commerce	
Indirect promotion	Fiscal incentives	
Direct promotion	National Plan R+D+i	
	Integrated Portal	*6.7 M€*
ELECTRONIC ADMINISTRATION	Social Security	*7.9 M€*
	Civil Electronic Register	*9.3 M€*
INFORMATION SOCIETY		
Public	Accessibility and digital training	*1.7 M€*
	Training of ICT professionals	*49.6 M€*
Companies	Accessibility: Arte/Pyme II	*90.2 M€*
	SMEs and electronic commerce	*3.7 M€*
Contents	Spanish on the Web	*15.3 M€*

Source: Ministry of Science and Technology

3. Prices and wages

Cooling demand and lower oil prices are reducing inflation

Inflation was running at 3% in October, its lowest rate since March 2000, and seems likely to end the year at 2.7%, down 1.3 percentage points from December 2000. This decline is essentially due to lower energy prices associated with a drop in the cost of crude oil since the start of 2001. This phenomenon has been particularly intense since last May, when a barrel of Brent cost US$28, $6 more than in October and almost $9 more than in November[1]. The energy component of CPI inflation has swung from a positive 6.3% growth rate in January 2001 to a negative 6.8% in October.

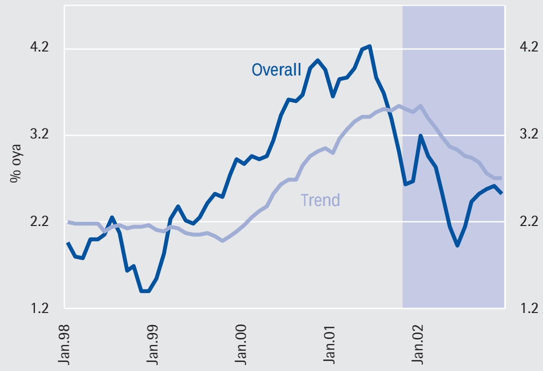
However, the decline in inflation expectations for the Spanish economy in 2002 is mainly due to the lower rate of increase expected for the more stable manufacturing and services CPI components. Food prices, in contrast, are trending upwards because of supply tensions in a number of products.

Inflation in 2001 is expected to be 3.6%, 0.2 points more than in the year 2000. The inflation differential between Spain and EMU as a whole will narrow, however, falling from 1.2 percentage points in 2000 to 1.0 percentage point in 2001, the lowest inflation gap since 1998. Without taking account of the effect of the changes to the method of calculating the price index from January onwards, the projection for 2002 is for average inflation to fall by 1.1 percentage points, to 2.5%. Moreover, an inflation rate below 2% by the middle of next year is not unlikely.

[1] In the same period of 2000, oil prices rose by $5, from US$27.5 to US$32.5.

Graph 3.1

Inflation



Sources: INE and BBVA

Trend inflation is expected to fall in 2002 to 3%, down four tenths of a point from 2001 (see Box "Less tourism in BBVA Trend CPI" in this issue of Situación Spain).

Wage rigidity and collective bargaining

The downward impact on inflation of the slowing of GDP growth to below potential may be curbed by the rigidity of collective wage bargaining, both as a result of the proportion of wage agreements with pay catch-up clauses and the increased importance of wage settlements at above-firm level. Up to October of this year, wage settlements covering 6.8 million salaried employees had been signed, that

Table 3.1.

	Overall CPI			IPSEBENE			Residual CPI			Trend CPI		
	2000	2001	2002	2000	2001	2002	2000	2001	2002	2000	2001	2002
January	2.9	3.7	3.2	2.3	3.1	3.4	5.0	5.4	2.3	2.2	3.0	3.5
February	3.0	3.8	3.0	2.2	3.2	3.4	5.1	5.7	1.7	2.2	3.2	3.4
March	2.9	3.9	2.8	2.1	3.3	3.3	4.7	5.4	1.6	2.3	3.3	3.3
April	3.0	4.0	2.5	2.2	3.4	3.2	4.7	5.6	0.7	2.4	3.4	3.2
May	3.1	4.2	2.1	2.3	3.5	3.2	5.0	6.3	-0.4	2.5	3.4	3.1
June	3.4	4.2	1.9	2.3	3.5	3.1	5.8	6.4	-1.1	2.6	3.4	3.0
July	3.6	3.9	2.1	2.5	3.5	3.1	6.4	4.7	-0.1	2.7	3.5	3.0
August	3.6	3.7	2.4	2.7	3.6	3.2	6.3	3.9	1.1	2.7	3.5	2.9
September	3.7	3.4	2.5	2.7	3.5	3.2	6.1	2.9	1.5	2.8	3.5	2.9
October	4.0	3.0	2.6	2.8	3.7	2.9	7.0	1.4	2.0	3.0	3.5	2.8
November	4.1	2.6	2.6	2.9	3.5	2.9	7.2	0.0	2.4	3.0	3.5	2.7
December	4.0	2.7	2.5	3.0	3.5	2.9	6.6	0.3	2.0	3.0	3.5	2.7
Average	3.4	3.6	2.5	2.5	3.5	3.1	5.8	3.9	1.2	2.6	3.4	3.0

Sources: INE and BBVA forecasts

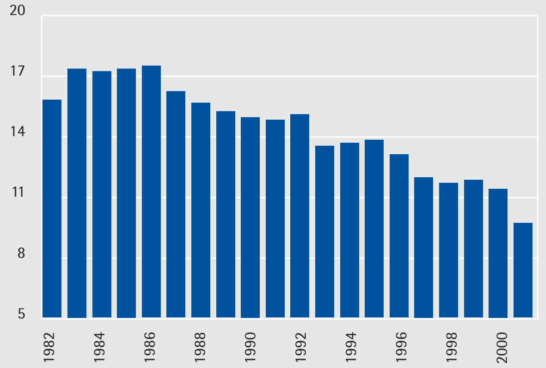
2002 forecasts do not include the methodological changes scheduled for January is 75% of the total salaried employees with collective agreements in 2000. The average increase negotiated for this year is 3.45%, five tenths of a point more than in December 2000, or two tenths less after the year 2000 figures are adjusted for the upward effect of pay catch-up clauses.

Meanwhile, the proportion of settlements at firm level relative to territorial or sectoral settlements is declining steadily. In the early 1990s, close to 15% of workers with collective pay awards were covered by firm-level agreements, compared with an average figure for 1999-2000 of 11% and under 10% in 2001 (with data to September).

Graph 3.2

Workers with firm-level wage agreements

(% of total)



Sources: Ministry of Labour and Social Affairs and BBVA

The social partners are currently negotiating an umbrella agreement for 2002 that will include, in addition to the wage settlement, a number of aspects concerning employment and working time arrangements. A wage settlement that contributes to ease inflation expectations in 2002 would clearly be positive, especially if it averts social tensions and is responsive to productivity performance.

However, even if an agreement is secured, it cannot take the place of the reform needed in the collective bargaining process to reshuffle the items for negotiation at the firm level and higher levels. In this regard, the efficacy of the negotiating process would be enhanced if the negotiation of wages and the distribution of the working day were left at firm level, leaving matters such as work safety, hiring types, limits to working time and classification of professional groups to higher levels (preferably industry-wide at a national level).

This would result in wage increases that better reflect the situation of each firm, particularly as the opt-out clauses from the sectoral wage agreement are subject to legal restrictions (sustained losses, trade union agreement) that can impede recovery in troubled firms.

Less tourism in BBVA Trend CPI

The Consumer Price Index (CPI) reflects the prices of a very broad basket of goods and services, including highly volatile groups such as food and energy. This volatility can alter the inflation picture diagnosed for the economy when the index is affected by transitory changes in relative prices on a scale large enough to affect overall CPI inflation, even though these occur in very specific areas. One example of this would be the variation observed in the prices of certain foodstuffs as a consequence of changes in consumption habits in the wake of the mad cow crisis and foot-and-mouth disease. In addition to overall CPI inflation, it is therefore useful to monitor inflation measures that seek to strip out the more erratic components, identifying the more stable (underlying) components of the price dynamics.

A first approximation in estimating underlying inflation would be to strip out those large groups of products with the greatest volatility from CPI. This is the case of IPSEBENE, the index that excludes non-processed food and energy prices. However, this index still includes certain headings that are relatively erratic or subject to administrative control. BBVA Trend CPI thus removes certain sub-classes with low weights in the CPI basket and high volatility (tourism services, cooking oil and fats), or which are government-regulated (tobacco[1], university education, post and communications), from IPSEBENE.

Changes to hotel industry CPI

In January 2001, the INE re-weighted the components of the CPI basket of goods and services with the aim of making the index more representative of the current structure of Spanish households' expenditure. Along with other improvements relating to the measurement of prices, the INE also included the prices of tourist apartments in the Hotels and Other Lodgings Sub-class Index. This information had not been available previously. As a result, these changes have significantly altered the seasonality and volatility of the original index, including in the BBVA Trend CPI. Thus, the standard deviation of the monthly rates of variation of hotel industry CPI between June and October 2001 is 15 percentage points higher than in the same period of 2000.

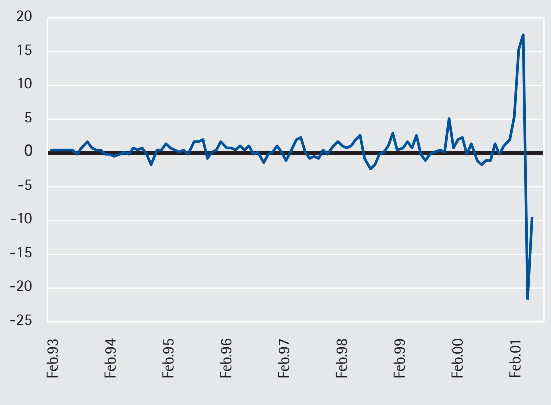
The sudden and substantial change in the seasonality of hotel industry CPI has produced an upward bias in the course of BBVA Trend CPI. Part of the acceleration observed in this index during the summer months was therefore simply the result of the changes noted in hotel industry CPI, which has a weight in the CPI basket of 0.5%. The inflationary tensions existing in the Spanish economy, as measured by BBVA Trend CPI, were thus being overstated.

In order to correct this effect, we have removed the hotel component from BBVA Trend CPI, adapting it more closely to the concept of trend inflation. It is only 0.5 percentage points less representative of CPI, as a result (from the previous 75.3% to 74.8%).

[1] Though no longer subject to government control, the price of tobacco is still excluded from trend CPI in view of the fact that foreseeable fiscal harmonisation in Europe will bring about relatively bigger rises in Spain.

Prices of hotels and other lodgings

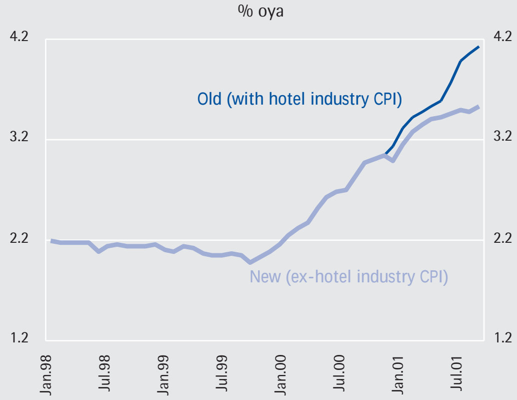
% mom



Source: INE

BBVA Trend Inflation

% oya



Sources: INE and BBVA

4. The public sector

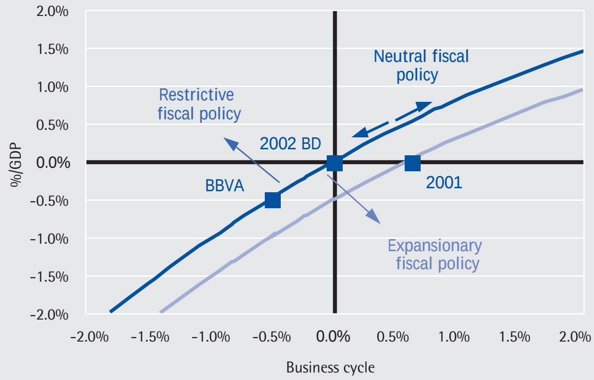
A balanced budget in 2002 is compatible with structural balance

The design of the 2002 State Budget Draft has been shaped by the following factors: i) the upward revision of the central government deficit target for 2001, which shows the difficulty of securing a balanced budget already in 2001; ii) the uncertainty surrounding the intensity of the domestic and international growth slowdown in 2002; and iii) the impact on revenue and expenditure of the agreements approved during the course of 2001 (the financing system for the autonomous regions approved on July 21, the agreement to enhance and develop the social protection system on April 9 and the package of fiscal measures on September 28).

In view of the above, instead of the fiscal surplus targeted for 2002 (0.2% of GDP) in the Stability Programme Update 2000-2004 (2000-04 SP), which was designed assuming a more positive macroeconomic scenario than at present (GDP growth of 3.2%, instead of 2.9% as in the 2002 Budget Draft[1]), the target is now to maintain a balanced budget[2]. In the context of slower growth envisaged in the 2002 Budget Draft, this new target nonetheless guarantees a neutral fiscal policy in 2001. That is to say, the deficit adjusted for the cyclical situation of the economy (the structural deficit) is also eliminated. If a target of fiscal surplus had been maintained against a backdrop of slower growth, fiscal policy would have been restrictive. Even though the 2002 Budget Draft is compatible with a fiscal balance in structural terms, however, if the Spanish economy grows more slowly than the projected 2.9% rate (1.7% according to BBVA Research Department), the operation of the automatic stabilisers will increase the cyclical portion of the deficit, so that the actual deficit will probably be around 0.5% of GDP. This should not be viewed as negative, however, since it is compatible with a correction of the structural component of the deficit, from around the -0.5% of GDP estimated for 2001. Graph 4.1 plots the isodeficit curves, that is, those combinations of public deficit and economic cycle that are compatible with the same size of structural component[3]. It can be seen that a structural balance is possible with both GDP growth of 1.7% and 2.9%, though with a different cyclical deficit in each case. Moreover, the deficit is increasing at a time when most EMU countries are adopting more flexible fiscal targets, a situation that the ECB could attempt to counter with a more restrictive monetary policy in 2002. Given that fiscal policy is the only instrument available to governments to design an appropriate policy-mix, it needs to take account of the foreseeable monetary policy stance that the ECB will adopt.

Graph 4.1

Fiscal surplus and cycle in Spain



Source: BBVA

The central government deficit will be higher than targeted in 2001

A variety of factors (slower real growth, mad cow disease, foot-and-mouth disease, fishing sector restructuring, compensation to the sectors worst hit by the rise in oil prices) are interfering with the budget outturn in 2001. The performance of the central government accounts in the first ten months of the year (borrowing needs stood at 0.66% of GDP, a similar figure to last year's 0.67% in the same period) is reflecting the negative impact on tax revenue of slower economic growth and justifies the government's decision to revise up the central government deficit target for 2001, to 0.5% of GDP, from an initial target of 0.3% (compared with a deficit of 0.6% in 2000). As a result, the primary surplus is unlikely to record any improvement, holding steady at around last year's 2.1% of GDP in National Accounts terms. In spite of the upward revision, the target of a balanced budget for the public sector as a whole in 2001 has been left unchanged. The increase in the central government deficit is offset by a bigger social security surplus, while the territorial administrations achieve the target set out in the 2000-04 SP. Bearing in mind that the deficit of the territorial administrations amounted to 0.3% of GDP in 2000, instead of 0.1% of GDP as targeted in the 2000-04 SP, the risk that they will miss the target is far from negligible.

[1] The Ministry of Economy has announced that it will review the 2002 growth forecast for the Spanish economy in an ECOFIN Council. Both the European Commission and the IMF have recently revised down their growth forecast for 2002, from 3.3% and 2.9% year-on-year, respectively, to 2% and 2.3%.

[2] According to Ministry of Economy estimates in the Stability Programme Update 2000-2004, if real GDP growth is half a point slower than assumed in the baseline scenario, the public sector deficit would increase by 0.2-0.3 percentage points of GDP.

[3] See Box "Budget surplus and the economic cycle", Situación Spain, October 2000, BBVA.

Table 4.1. Déficit (-)/Surplus (+)

(%/GDP)	1998	1999	2000	2001 2000-04 SP	2001 2002 BD	2002 2000-04 SP	2002 2002 BD
Cen. gov.	-2.2	-1.1	-0.6	-0.3	-0.5	-0.1	-0.5
Soc. sec.	-0.1	0.1	0.5	0.3	0.5	0.3	0.5
Territ. adm.	-0.3	-0.2	-0.3	0.0	0.0	0.0	0.0
Aut. gov.	-2.6	-1.2	-0.3	0.0	0.0	0.2	0.0
(%/GDP)				Debt			
Aut. gov.	64.7	63.4	60.6	58.9	57.0	56.6	55.0

Note: 2000-04 SP, Stability Programme Update 2000-2004
Source: Ministry of Finance

With regard to the central government, weak growth in taxes on production and imports (2.8% in National Accounts terms) and higher current payments excluding interest (5.3% year-on-year) account for the negative course of the budget outturn in the first ten months of the year. In contrast to previous years, in which a significant revenue overshoot[4] (linked to higher-than-expected growth and the recurring under-estimation of budgeted revenue) compensated for higher spending growth, the initial projection of revenue and expenditure, in cash balance terms, envisaged in the 2002 Budget Draft implies that the deficit will overshoot the initial target.

Table 4.2 displays the deviations (in millions of euros) from target observed in recent years. As regards revenue, the evolution of the deviations in indirect taxes since 1999 clearly reflects the loss of momentum in private consumption and imports after the peak reached that year. According to the government's initial projection, indirect tax revenue will be around 1,288 million euros (0.2% of GDP) lower than initially projected. This decline should be offset by faster growth in direct tax revenue, specifically in IRPF personal income tax receipts[5], reflecting continued high growth in salaried-employee compensation (around 6.5% year-on-year). Corporation tax, in contrast, is reflecting the slowdown in corporate earnings signalled by the Bank of Spain's Central Balance Sheet Office (gross operating profits in the first nine months of the year were up by 4.7% year-on-year, compared with 8.8% in the same period of last year). As a result of the divergent performances of direct and indirect taxes, tax receipts are likely to register slightly higher growth than projected in the 2002 Budget Draft (6.6% and 6.1% year-on-year, respectively). This implies that revenue will rise sharply in the last two months of the year, after a 4.1% cumulative rate in the fist ten months of the year. Given that the government also foresees higher non-tax revenue than budgeted – because of higher profits at the Bank of Spain (almost 1,800 million euros above budget) – according to the initial projection, revenue in 2001 is expected to finally grow by 5.3%, as against a budgeted rate of 3.4%. The strong revenue performance forecast for the latter part of the year is also reflected in the National Accounts, with revenue expected to expand by 6% in 2001, compared with a 4.5% increase in the first ten months of the year. Payment of the 2001 radio spectrum levy (461.5 million euros or 76,814 billion pesetas) by Telefónica and Vodafone on November 26 will boost revenue, following the government's decision to reduce the levy payment for use of the spectrum in 2002 by 75% in comparison with the figure for 2001 (a 60% cut was initially envisaged in the 2002 Budget Draft). In spite of this, a number of factors suggest that projected revenue growth is still slightly optimistic: i) economic growth in 2001 could be slower than the 3% rate assumed in the 2002 Budget Draft; ii) having fallen by 0.2% in the first ten months of the year (including the annual payment corresponding to fiscal year 2000), corporation tax revenue is unlikely to grow by the 5% rate projected for 2001; and iii) VAT receipts will be adversely affected by the decline in the price of petrol (a rise of 21 pesetas/litre in 2000 boosted VAT receipts by some 600 million euros in comparison with 1999). The 2001 revenue outturn could therefore finally be lower than the budgets project.

Table 4.2. Revenue deviations from budget

Millions of euros	1998 1998 outturn/ 1998 budget	1999 1999 outturn/ 1999 budget	2000 2000 outturn/ 2000 budget	2001 2001 initial 2001 budget
IRPF	-1898.6	-551.1	1172.0	1827.7
Corporation tax	2705.2	2128.8	1801.8	-90.1
DIRECT TAXES	812.0	2386.0	3273.7	1740.2
VAT	-52.9	1844.5	-598.0	-1135.9
Special taxes	503.6	620.2	250.6	-163.5
Others	221.8	99.8	183.3	11.5
INDIRECT TAXES	672.5	2564.5	-164.1	-1288.0
EXCISE DUTIES AND OTHER REV.	1776.6	244.6	-227.2	-121.7
STAMP DUTY	2354.7	2057.3	2605.8	2065.8
TOTAL	5181.2	5522.7	6160.8	2330.8
TAX REVENUE	1484.5	4950.5	3109.6	452.2
OTHER REVENUE	3696.7	572.2	3051.2	1878.6

Source: Ministry of Finance

[4] In the case of tax receipts, according to the initial projection contained in the 2002 Budget Draft, this overshoot amounted to 484 million euros in 1998, 4,950 million in 1999, 3,110 million in 2000 and 452 million in 2001.

[5] Not deflating the tax schedule, allowances and, in particular, the IRPF living standard minimum has helped to increase revenue.

Table 4.3. Expenditure deviations from budget

Millions of euros	1998 1998 outturn/ 1998 budget	1999 1999 outturn/ 1999 budget	2000 2000 outturn/ 2000 budget	2001 2001 initial 2001 budget
Financial expenditure	862.2	820.2	851.1	965.1
Current transfers	848.2	2380.8	2747.7	2104.6
CURRENT TRANSACTIONS	2054.8	2855.8	2831.1	3507.1
CAPITAL TRANSACTIONS	1006.4	477.0	-516.5	-343.7
TOTAL	3061.2	3332.8	2314.6	3163.4
NON-INTEREST EXPEND.	2105.9	2512.6	1463.5	2198.4
NON-INTEREST CURRENT EXPENDITURE	1192.7	2035.6	1980.0	2542.1

Source: Ministry of Finance

As far as spending is concerned, the initial projection presented by the government envisages an overshoot in 2001 of some 3,163.4 million euros, far higher than the overshoot of 2,314.6 million registered in 2000. This means that central government spending growth in 2001, in cash balance terms, is likely to be much faster than expected (5.3% year-on-year, instead of 2.5%). These figures confirm the difficulties encountered in controlling current spending, which is where most of the overshoot is occurring. In fact, current spending (ex-interest) could grow by 5.7% year-on-year in 2001, instead of 2.9% as expected, thereby accounting for 84.4% of the total deviation in expenditure. This increase is attributable to transfers to both the autonomous regions (up by 8.1% in the first ten months of the year, instead of 4.7% as forecast) and the social security system to fund health care (6.7% growth instead of 6.3% over the same period). In addition, a 1,7% increase in interest payments confirms that gains derived from the reduction in interest rates are petering out, despite the positive impact of the Treasury's programme of debt swaps and repurchases. As occurred in 2000, capital transactions in the initial projection, in cash terms, are rising more slowly than envisaged in the budget (7.9% and 9.2%, respectively). In addition, at September 31 payments effected represented only 87.2% of total assumed obligations in capital transactions, compared with 95.7% for current transactions, showing the slow pace of execution of investment programmes. If this speeds up in the final months of the year, the initial projection for spending released by the government could be underestimated.

Even after the upward revision of the central government deficit for 2001, therefore, the optimistic forecast for receipts on which this revision is based means that a slightly higher central government deficit cannot be ruled out.

Optimistic macroeconomic framework

The macroeconomic framework assumed in the 2002 Budget Draft appears to be very optimistic. This is highly significant because the public deficit has a substantial cyclical component, since receipts increase and spending falls in expansion phases and vice-versa in contraction phases. Therefore, if the economy under-performs the scenario envisaged in the budget, some overshooting of the target may be expected.

Table 4.4 shows a comparison of the macroeconomic scenarios for 2002 projected by the government's economic team and BBVA Research Department. The Spanish economy slows next year in both cases, though the slowdown projected by BBVA Research Department is more pronounced as a result of a sharper fall-off in domestic demand. In addition, the government's growth projection does not appear to reflect either the considerable uncertainty surrounding the international environment in the aftermath of the September 11

Table 4.4. Macroeconomic scenario

		BBVA		PPGE02	
	2000	2001	2002	2001	2002
GDP and components (% oya)					
Final consumption	4.0	2.7	2.1	2.5	2.3
Final household consumption (1)	4.0	2.6	1.8	2.5	2.4
Final public consumption	4.0	2.9	3.0	2.3	2.0
GFCF	5.7	2.7	-0.2	3.6	4.1
Capital goods	5.1	0.0	-3.0	1.0	4.0
Construction	6.2	5.2	2.0	5.9	4.2
Inventories (*)	-0.1	0.0		0.1	0.0
Domestic demand	4.2	2.7	1.6	2.8	2.8
Exports	9.6	5.7	3.0	7.8	7.1
Imports	9.8	5.2	2.5	6.9	6.4
Net exports (*)	-0.2	0.1	0.1	0.1	0.1
Real GDP	4.1	2.8	1.7	3.0	2.9
Nominal GDP	7.7	6.8	4.6	6.9	5.9
Prices and costs (%)	2000	2001	2002	2001	2002
GDP deflator	3.4	3.9	2.9	3.8	2.9
Household consumption deflator	3.2	3.5	3.2	3.6	2.8
Employee compensation	3.4	4.0	3.8	3.7	3.5
Unit labour costs	2.4	3.1	2.6	2.9	2.4
Labour market					
Full-time employment	3.1	1.9	0.4	2.1	1.8
Change (000s)	452.3	286.6	61.5	324.2	277.3
Unemployment rate (EPA)	14.1	13.2	13.7	12.7	11.5
Productivity	1.0	0.9	1.3	0.9	1.1

Source: BBVA and Ministry of Finance

terrorist attacks or the unwinding of a possible "euro effect" fuelling consumption and construction in 2001.

The different growth projections mean that the job creation rate contained in the 2002 Budget Draft is much higher than the one assumed by BBVA Research Department. Reflecting this, the unemployment rate falls in the government's scenario, but rises in our scenario, thus affecting, among other headings, the funds allocated to cover unemployment benefits.

Turning to prices, lower demand pressure and a fall in the price of oil should help to slow inflation in 2002, despite the continuation of relatively high wages growth. The positive inflation surprises in recent years (actual inflation was higher than the government's 2% target), coupled with modest gains in purchasing power in 2000-2001 and the widespread use of wage-indexing clauses, suggest that wages growth will exceed inflation in 2002.

Consequently, the GDP deflator is expected to grow by close to 2.9% in 2002 under both scenarios. This implies that nominal GDP could grow by less in 2002 than the 5.9% rate assumed in the 2002 Budget Draft (4.6% according to BBVA Research Department), adversely affecting tax revenue.

In sum, the macroeconomic framework seems optimistic in its projections for growth and hence for job creation. In so far as this scenario forms the basis for estimating the revenue and expenditure figures contained in the budget for 2002, the likelihood of deviations from these figures is far from negligible.

Limited impact of the package of fiscal measures

The package of fiscal measures approved by the Council of Ministers on October 28 will have a limited impact on activity, while some measures may even have unwanted effects. In this regard, the measures pertaining to a widening of the definition of small and medium sized companies (the turnover limit has been increased from 3 million euros to 5 million euros), and hence of the sector entitled to a reduced rate of corporation tax (30%), and greater tax breaks for investment in R+D should be noted. The former measure, which was introduced to compensate small companies for their higher administrative and financial costs, discourages risk-taking and still encourages under-billing. It would be preferable therefore to pursue this goal through structural reforms geared to simplifying administrative procedures and promoting venture capital, rather than through fiscal measures. With regard to the tax breaks for R+D, investment in this heading in Spain receives a favourable tax treatment, both compared with other countries and in relation to the tax treatment of investment in training. Hence, if the government wished to modify the tax treatment of investment, it would have been desirable to enhance the tax treatment of spending on training, as this would contribute to a better match between workers' skills and the needs of companies. The impact of these measures, in terms of greater tax breaks and lower corporation tax receipts, on the 2002 budget is limited, since the planned tax breaks correspond to the period in which the annual tax payment is made, not to the period in which withholdings and other payments on account are effected.

As regards the other measures, the two with the biggest potential impact on activity are the reduction in the tax on reinvested earnings, from 35% to 18%, and the extension from 10 to 20 years of the amortisation period for goodwill. The implementation of the former measure, through a 17% deduction in the total tax liability, compared with the present situation in which payment can be spread over 10 years and an effective tax rate of 25%, could lead to companies being unable to reap the full benefits of the new system because profits in a given year prevent them from doing so. Its impact on activity in the current phase of deceleration and falling corporate earnings will therefore be modest. For its part, the extension of the goodwill amortisation period implies a reduction in tax allowances per year and hence an increase in tax payable and higher receipts. In contrast, the extension of the tax allowance for amortisation in 20 years to goodwill deriving from foreign share purchases is a positive move. Given the significant increase registered by Spanish foreign direct investment overseas, back-dating this measure would represent a considerable fiscal saving for companies that have undertaken major investments.

The impact of the package of fiscal measures on the 2002 budget will therefore be small and its effect on investment decisions will depend on whether companies view the measures as permanent or transitory. Only in the former case will the package of measures boost investment, in so far as it affects the cost of capital by reducing the present value of the tax liability.

The new regional financing system changes the revenue and expenditure structure, making the 2002 Draft Budget hard to assess

The entry into force of the new regional financing system significantly affects the structure of revenue and expenditure of both the central government and the social security system. This is apparent in an 11.7% decline in tax revenue in 2002 in the consolidated budget[6] and a 3.5%

fall in current spending (ex-interest), largely reflecting the transfer of health care and social services to those autonomous regions (Article 151 regions) that took responsibility for them at the end of 2001[7] and the suppression of central government transfers to the social security system via INSALUD (the central health care agency) and IMSERSO (the Institute for Migration and Social Services). Given the absence of official data on the impact of the new system on the 2002 budget, we have attempted to produce homogeneous series using the information available. This is essential for a correct assessment of the 2002 Budget Draft. To do so, we have reconstructed the revenue and expenditure figures of the 2001 budget, assuming that the new regional financing system was already in force that year[8]. Table 4.5 presents the key consolidated budget figures for the year 2002 and a comparison of them with the 2001 budget both before and after correction (the former correspond to the initial projection presented in the 2002 Draft Budget). The results obtained from a comparison of the 2002 budget with that for 2001, as presented in the 2002 Budget Draft, differ greatly from those that emerge from a comparison based on a homogeneous budget (corrected for the impact of the new regional financing system).

[6] The decline in revenue reflects the assignment of new taxes to the autonomous regions: 33% of the IRPF tax schedule, 35% of territorial VAT revenue, 40% of special taxes on production and 100% of the tax on electricity and certain means of transport. Finally, during the parliamentary passage of the 2002 Budget Draft, the Fiscal and Financial Policy Council decided to create a new tax on hydrocarbons. This new tax, the revenue from which is to be allocated entirely to finance health care, will have two tranches: a national tranche of four pesetas/litre as of January 2002 (expected to boost revenue by 136 billion pesetas), to which must be added 16% VAT, and a regional tranche over which the autonomous regions will have regulatory powers (the surcharge, if established, will amount to 1.6 pesetas the first year, rising by 1.2 pesetas in subsequent years to a maximum of 4 pesetas in 2004). Under the 1997-2001 financing system, revenue from transfers represented around 80% of the regions' total revenue. This percentage will fall significantly under the new regime.

[7] After completion of the transfer of health competences to all the ordinary-regime autonomous regions, regional spending will account for around 40% of total public sector spending, as against 30% at present.

[8] A comprehensive analysis of the new regional financing system and its impact on central government expenditure and revenue can be found in the Box "The new regional financing system", in this section.

No tax revenue cushion

With regard to revenue, the corrected budget figures show (with only a small margin of error[9]) that tax receipts will probably grow at an annual rate of 6.5% in 2002, a higher rate of growth than the nominal growth rate of the economy assumed in the macroeconomic scenario for the 2002 Budget Draft (5.9%). Social security contributions, meanwhile, will probably rise by 5.6%. This implies that tax pressure remains virtually unchanged in 2002 in spite of the economic slowdown. In contrast to other years in which the budgeted revenue estimate was much lower than the figure considered compatible with economic growth, the 2002 estimate is more attuned to reality, thereby reducing the cushion that the government has had in recent years to cope with spending overshoots. If nominal GDP grows in line with the 4.6% rate projected by BBVA Research Department, tax revenue, from both direct and indirect taxes and social security contributions, will therefore be lower than envisaged in the 2002 Budget Draft[10].

[9] This error arises because the territorial share of revenue from VAT and special taxes on production will be computed on the basis of a consumption index produced by INE, whereas this exercise uses an index compiled by BBVA Research Department (see footnote 6).

[10] Starting with the historical elasticities of fiscal revenue to GDP, it is found that, in the absence of regulatory changes, a 1-point deceleration can reduce revenue by around 1,200 million euros (200 billion pesetas), or the equivalent of 0.2% of GDP.

Table 4.5. Consolidated budget for non-financial revenue and expenditure (cash basis)

Millons of euros	2001 Initial budget (1)	%/GDP	2001 Initial projection (2)	%/GDP	2001 Corrected initial proj. (3)	%/GDP	2002 (4)	%/GDP	% oya (4)/(1)	% oya (4)/(2)	% oya (4)/(3)
Revenue	207604.3	31.9	210887.5	32.4	191776.4	29.5	202290.0	29.4	-2.6	-4.1	5.5
Tax revenue	108962.7	16.7	109414.9	16.8	90303.8	13.9	96161.9	14.0	-11.7	-12.1	6.5
Social security contrib.	76955.8	11.8	79143.8	12.2	79143.8	12.2	83583.0	12.1	8.6	5.6	5.6
Others	21685.9	3.3	22328.8	3.4	22328.8	3.4	22545.1	3.3	4.0	1.0	1.0
Expenditure	207407.7	31.9	210690.9	32.4	193077.6	29.7	202697.5	29.4	-2.3	-3.8	5.0
Interest	17152.4	2.6	18011.1	2.8	18011.1	2.8	17841.8	2.6	4.0	-0.9	-0.9
Capital expenditure	15133.1	2.3	14933.1	2.3	14933.1	2.3	16029.4	2.3	5.9	7.3	7.3
Ex-interest	175122.2	26.9	177746.7	27.3	160133.4	24.6	168826.3	24.5	-3.6	-5.0	5.4
Cash deficit	196.7	0.0	196.7	0.0	-1301.2	-0.2	-407.5	-0.1	-307.2	-307.2	-68.7
Primary surplus	17349.1	2.7	18207.8	2.8	16709.9	2.6	17434.3	2.5	0.5	-4.2	4.3
Fiscal pressure	185918.5	28.6	188558.8	29.0	169447.6	26.0	179744.9	26.1	-3.3	-4.7	6.1

Source: BBVA and Ministry of Finance

Specifically, it seems likely that employment will grow by only 0.4% in 2002, instead of 1.8% as forecast by the government. In this case, revenue from social security contributions would be under budget by at least 500 million euros (0.07% of GDP). In addition, profits at the bank of Spain are also likely to be lower in 2002. While several revenue-boosting measures have admittedly been approved during the parliamentary passage of the 2002 Budget Draft (a new 4 pesetas/litre tax on petrol[11] and a tax hike on alcoholic beverages - 8% for spirits and 5.75% for beer), the impact on final revenue is very small. Moreover, the decision to reduce the radio spectrum levy by 75% in 2002, instead of 65% as envisaged in the 2002 Budget Draft, will cut revenue by around 90 million euros.

And some spending headings look under-funded

Meanwhile, spending growth of 5%, while lower than the nominal rate of GDP growth on which the 2002 Budget Draft is based (5.9%), is still much higher than the projected rate of inflation (2.5%). Spending on capital transactions registers the strongest growth (8.9% year-on-year), testifying to the priority given to this heading in the 2002 Budget Draft, while growth in current spending (ex-interest) remains at a very high 5.2%. This, despite the fact that funds allocated to cover pension payments, temporary disability and unemployment benefits appear to be underestimated. In the first case, the budget allocation for maintaining purchasing power in 2002 is small: actual inflation is expected to exceed the 2% target by around half a percentage point. Meanwhile, the funds earmarked in the 2002 Budget Draft to cover temporary disability and unemployment benefits in 2002 are lower than the allocations that these headings will finally absorb in 2001 (by 0.2% and 1.1%, respectively)[12]. This projection is unlikely to be realised in a scenario of slower economic growth and an increase in the number of registered unemployed for the first time since 1994 (6.5% year-on-year). There is also limited scope for reducing projected interest payments. On the one hand, the 2002 Budget Draft envisages a reduction of only 0.9%, implying an increase of 4% when interest payments are corrected for the impact of the cost of debt repurchase programmes conducted in 2001. On the other hand, given the fall in average issue rates and the longer average life of government debt, the impact on the debt-service burden of a further reduction in interest rates in 2002 would be limited. For instance, a one-point parallel downward shift of the yield curve from current rates would reduce the interest spending projected for 2002 by around 360 million euros, the equivalent of only 0.05% of GDP. This is much lower than the amount that would be needed to continue advancing with the recent programme of debts swaps (some 900 million euros). The scope provided by adjustment in this heading for funding other spending policies may therefore be said to no longer exist.

In contrast, the parliamentary modification involving the transfer to the autonomous regions of the national tranche of revenue raised from the new fuel tax (4 pesetas/litre) to finance health care is going to reduce central government transfers to the regions through the new Sufficiency Fund by the same amount. Transfers are thus likely to be around 817 million euros (136 billion pesetas or 0.1% of GDP) lower than initially budgeted in the 2002 Budget Draft.

However, the 2002 Budget Draft fails to take due consideration of the impact of the agreements approved in 2001 and to address some of the legacy of problems from the past. Chief among the former is the agreement to enhance and develop the social protection system. While progress has been made in the assumption by central government of the cost of the supplement to the minimum pension and in increasing the resources of the reserve fund[13], the spending figures do not appear to take account of the total impact of the larger number of workers entitled to lower social security contributions or the improvement in widow's and orphan's pensions[14]. The total cost of these measures estimated by the government during parliamentary passage of the 2002 Budget Draft amounts to 552 million euros (91.9 billion pesetas). As for the traditional problems, the most noteworthy are the following: i) RTVE (state television) debt, which is expected to rise by a further 768 million euros in 2002, to stand at 5,409 million at year-end; ii) full payment of compensation for the "colza oil" syndrome; iii) the externalisation of labour obligations

[11] The revenue raised by this tax on retail sales of hydrocarbons will be assigned to the autonomous regions to finance health care (some 136 billion pesetas), thereby reducing the Sufficiency Fund, that is, central government transfers to the regions by the same amount. While this tax will thus have no direct impact on central government revenue (only through the 16% VAT that is applied to the special tax), it will have an impact on central government expenditure projected in the 2002 Budget Draft.

[12] Temporary disability expenditure rose by around 11% in the first eight months of the year, and so it may exceed the budgeted amount for 2001 by some 480 million euros (80 billion pesetas). Likewise, unemployment benefit expenditure could be over budget by some 1,200 million euros (200 billion pesetas).

[13] The central government will assume some 427 million euros of spending items attached to the social security system in 2002. 121.5 million of these correspond to the assumption of the health care and social services of the Social Institute of the Marine and 306 million will finance part of the supplement to minimum pensions (97.9 million in 2001). As regards the reserve fund, the endowment projected for 2002 amounts to 175 billion pesetas (300 billion in 2001), which, added to the 404 billion at end-2001, will increase the fund's resources to 580 billion pesetas at end-2002.

[14] See Box "Pension reform is put back", Situación Spain, June 2001, BBVA.

arising from industrial restructuring plans in the 1980s (almost 8,000 million euros); iv) the continued granting of collateral and credit to public enterprises (the funds earmarked to authorise borrowing operations by public enterprises and agencies are left unchanged at 991.6 million euros, or 0.9% of GDP)[15]; and v) no limits are placed on debt issuance, leaving the door open to finance budget modifications through debt issues, rather than a downward adjustment of other spending headings.

In sum, the balanced budget envisaged in the 2002 Budget Draft is to be attained through the combination of a strong tax revenue performance and the containment of public spending. Nonetheless, the risks of a sharper-than-expected slowdown in economic growth adversely affecting tax revenue and driving up spending as the automatic stabilisers begin to function are far from negligible. This, coupled with low allocations in a number of spending headings, suggests that the public sector deficit in 2002 could amount to 0.5% of GDP, as a result of both a larger central government deficit (see Box "The 2002 State Budget Draft" in this section) and a lower social security surplus.

Despite the improvement, there is little scope to boost productivity

An alternative way to analyse whether the 2002 Budget Draft advances in the right direction is to assess its priorities. To do so, it is necessary to examine spending from a functional viewpoint. Because of the difficulty of producing a projection for spending policy outturns for 2001, this analysis is undertaken using budgeted data, suitably corrected for the impact of the new regional financing system. This shows that social expenditure absorbs more than half (51%) of the increase projected in total spending for 2002, meaning that as a share of GDP it remains unchanged at around 16%[16]. Within social expenditure, pensions and unemployment are the headings that swallow up the bulk of the projected increase, while funds for health care financing decline as the new regional financing system takes effect. If the projected increase in spending on interest payments and transfers to the territorial administrations and the European Union is added to this, spending obligations are found to absorb around 79.2% of the projected spending increase in the 2002 Budget Draft. It is evident from this that the government has little scope for applying productivity-oriented policies. In fact, the funds allocated to R+D and infrastructure development make up only 8.3% of the increase in consolidated spending, representing 2% of GDP. Both spending items grow faster than total spending and nominal GDP, however, thus confirming the priority given to them in the 2002 Budget Draft. Specifically, combining the investment drive of the central government and investment undertaken by the corporate public sector, public investment is forecast to grow by 9.3% in 2002. Thus, although the priorities of the 2002 Budget Draft are oriented in the right direction, the volume of spending obligations is such that, when a balanced budget restriction is imposed, limited funds are available for other spending policies.

Moreover, without regulatory changes, spending obligations are set to increase in the long term

In the medium and long term, the situation could be worsened by the impact of the following factors on the public sector; i) the gradual population ageing process; ii) a proper control of public enterprises and agencies, which would increase the public deficit by over 0.5% of GDP (on the basis of ESA-95 methodology); iii) the foreseeable reduction in EU structural funds after enlargement towards Central and Eastern European countries; and iv) the impact on tax revenue of the fiscal reform planned for 2003 (IRPF and IAE). The scope to strengthen the public spending headings that would enhance the productivity of the Spanish economy and support the process of real convergence with Europe, while guaranteeing at least a balanced budget in the long term, as mandated by the Fiscal Stability Law, is therefore limited.

Continuing reduction in public debt: 55% of GDP in 2002

The balanced budget, in National Accounts terms, projected in the 2002 Budget Draft is compatible with a slight cash-based deficit. This, together with the net change in financial assets, debt maturing in 2002 (50 billion euros, as against 54.601 billion in 2000) and the expected increase in the balance of the Treasury's account at the Bank of Spain to handle a significant volume of debt maturing in January 2003 (6 billion euros), should take central government borrowing needs to around 65 billion euros (compared with a projected 61.8 billion for 2001). As a result, the outstanding debt of the central government is expected to be around 321 billion euros at end-2002, 5% higher than at end-2001. This im-

[15] In keeping with ESA-95 rules, public enterprises and agencies must be integrated with the central government for the purpose of determining their lending or borrowing position. This would increase the deficit by over half a point of GDP.

[16] Expenditure as a percentage of GDP falls as a consequence of the new regional financing system, since the autonomous regions that have assumed responsibility for health care finance this expenditure directly from the new taxes assigned, rather than through direct transfers from the social security system. Thus, social expenditure represented 18.1% of GDP in the 2001 State Budget, but only 15.9% if the transferred health care responsibilities are excluded.

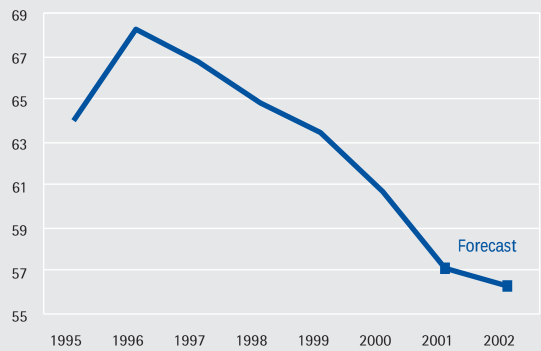
plies a decline in the debt-to-GDP ratio from 48% to 47%. The government also expects the debt of the territorial administrations to fall in terms of GDP, taking the public sector debt down from 57% at end-2001 to 55%, thereby complying with the Maastricht Treaty. The projected adjustment of the public debt is therefore also underpinned by the favourable debt performance of the territorial administrations.

However, if nominal GDP grows by 4.6% and the public sector deficit is close to 0.5% of GDP, the public debt is likely to remain at around 56.2% of GDP (which would still be compliant with the Maastricht Treaty). While this must be viewed as positive, if all the proceeds from privatisation had been used to retire public debt, the debt-to-GDP ratio would have fallen to below 60% back in 1999.

Graph 4.2

Public debt

% of GDP



Sources: Ministry of Finance and BBVA

The 2002 State Budget Draft

The central government deficit target in the 2002 Budget Draft, in National Accounts terms, has been revised up from the target initially projected in the Stability Programme Update 2000-04, from 0.1% to 0.5% of GDP. The reasons behind the revision are the deceleration in economic growth and non-compliance with the target for 2001 linked to cyclical developments.

The entry into force of the new regional financing system changes the structure of the central government's expenditure and revenue[1], making a correct assessment of the 2002 Budget Draft difficult because of the break in the homogeneity of the series. In order to assess the impact of the new regional financing system on central government finances, we have compared the revenue and expenditure recorded in 2001 with that which would have been observed if the new system had already been in place in that year. We find that; i) the central government deficit would have been approximately three tenths of a point higher than the actual deficit[2], at 0.7% of GDP; and ii) the primary surplus would be around 2% of GDP, as against 2.4% with the old financing system. The size of these changes shows that corrected data are needed to avoid drawing the erroneous conclusions that might result from a simple comparison of the figures presented in the 2002 Budget Draft.

A comparison of the homogeneous figures yields that the central government deficit of 0.5% of GDP projected for 2002 is attained with annual growth rates of revenue and expenditure of 4.7% and 3.6%, respectively. In order to gauge the extent to which a less favourable macroeconomic scenario than the one projected in the 2002 Budget Draft would affect the central government deficit, it is necessary first to analyse whether the 2002 Budget Draft's revenue and expenditure figures are compatible with the GDP growth rate assumed by the government.

Central government revenue and expenditure (cash basis)

	2001			2002			
	(y/y) Forecast	(y/y) Initial	(%/GDP)	Euros mn. 2001 Budget	(y/y) 2002 Budget	(y/y) Corrected	(%/GDP)
Revenue	3.3	5.3	19.2	108824.3	-13.0	4.7	15.8
Tax revenue	6.1	6.6	16.8	96161.9	-12.1	6.5	14.0
-Direct	5.4	8.8	8.6	50673.1	-9.4	6.0	7.4
- Indirect	6.9	4.4	8.2	45488.8	-15.0	7.1	6.6
Stamp duty	-39.1	-5.4	0.9	4418.8	-23.9	-23.9	0.6
Current transfers	-3.8	-0.9	0.9	4173.0	-29.4	7.8	0.6
Expenditure	2.7	5.3	19.6	112586.9	-11.7	3.6	16.3
Current	1.8	5.0	17.6	98762.5	-13.9	3.2	14.3
-Interest	-3.8	1.7	2.8	17736.0	-1.5	-1.5	2.6
-Current (ex-interest)	2.9	5.7	14.9	81026.5	-16.1	4.3	11.8
Current transfers	3.4	6.3	11.9	61182.0	-21.0	4.5	8.9
Capital	10.8	7.9	2.0	13824.4	7.2	7.2	2.0

Sources: BBVA and Ministry of Finance

On the basis of the revenue projection for 2001 contained in the 2002 Budget Draft, which is assumed not to register any significant deviation from the final projection, corrected for the impact of the new regional financing system, and taking

[1] The transfer of a basket of taxes (33% of the IRPF tax rate schedule, 35% of VAT, 40% of special taxes on production and 100% of taxes on specific means of transport and electricity) is going to reduce the tax revenue of central government, and the increase in devolved responsibilities is going to reduce transfers to the social security system to finance health care and social services. The creation of a new petrol tax (4 pesetas/litre in the national tranche as of January 1, 2002 will barely affect central government revenue (only through the application of 16% VAT) since the revenue raised will be transferred to the autonomous regions to finance health care. This new tax will have a regional tranche over which the regions will have regulatory powers to increase the tax by 1.6 pesetas the first year and 1.2 pesetas the two next years up to a maximum of 4 pesetas in 2004.

[2] This is because of an initial restriction which imposes that no autonomous region shall receive less under the new system in the base year (1999) than with the former system. In fact, the modulation clauses and the guarantees of the new system suggest that in 1999 it will assign around 1,800 million euros (300 billion pesetas or 0.3% of GDP) more to the regions than would correspond to them under the 1997-2001 system. See Box "The new regional financing system" in this section.

account of the historical elasticities of the different revenue headings to nominal GDP growth, it is immediately clear whether the revenue projection for 2002 is compatible with the macroeconomic scenario or whether, on the contrary, the revenue figures are underestimated in order to have a cushion with which to compensate any foreseeable overshooting on the expenditure side. From this exercise[3] it emerges that the tax revenue projection is in line with that which would result from the nominal growth rate of 5.9% assumed in the 2002 Budget Draft. At a more disaggregated level, however, it is found that indirect tax receipts may be overestimated and direct tax receipts underestimated. Hence, if the economy grows in line with the 4.6% estimated by BBVA Research Department, tax revenue would be lower than reflected in the 2002 Budget Draft. The impact on central government revenue of the hike in the special tax on spirits (8%) and beer (5.75% and the new tax on petrol (4 pesetas/litre in the national tranche) approved during the parliamentary passage of the 2002 Budget Draft and the law accompanying the budget is going to be moderate. The former measure will increase revenue by around 84 million euros (an amount comparable to the reduction in revenue expected after the decision to cut the radio spectrum levy by 75% with respect to its level in 2001, instead of by 65% as initially projected in the 2002 Budget Draft). The latter measure, meanwhile, will have virtually no impact because of the government's decision to transfer the revenue raised to the autonomous regions to finance health care. However, given that this transfer signifies an increase in the fiscal capacity of each autonomous region, it will reduce the Sufficiency Fund by the same amount.

As regards expenditure, while a projected annual growth rate of 3.6% may seem modest[4], it is still higher than the growth rate of the GDP deflator (2.9%). An analysis by type of expenditure reveals the following: i) current expenditure excluding interest payments continues to grow briskly, at 4.3%, well above the growth rate projected for this heading in 2001 (2.9%), thereby confirming the downward rigidity of a significant part of expenditure; ii) funds for interest payments – excluding the cost of early debt redemptions – rise by 4% (if the debt repurchase programme continues in 2002, this heading could be under-funded by around 900 million euros, and this would not be offset by the positive impact of lower interest rates – 290 million euros); iii) a number of expenditure headings could be underestimated ("colza oil" syndrome, retirement pensions, justice system reform, the Spanish EU presidency). Nonetheless, lower transfers to the autonomous regions via the Sufficiency Fund owing to the creation of the new tax on petrol (817.4 million euros, or around 0.1% of GDP) should check the overshoot in central government spending.

The prospect of a less favourable macroeconomic scenario than the one on which the revenue and spending projections for 2002 are based suggests that final revenue will be lower than budgeted. This, in addition to the insufficient funding for a number of spending headings, means that the central government deficit targeted for 2002 looks difficult to attain. However, in view of the fact that this deficit would be largely caused by cyclical factors, as a consequence of the operation of the automatic stabilisers, it would not be advisable to attempt to offset it through a cut in public investment, with the associated negative implications for productivity and long-term growth.

Central government budget (cash basis)

(%/GDP)	2000 Outturn	2001 Initial projection	2001 Corrected	2002 Budget
Revenue	19.5	19.2	16.0	15.8
Tax revenue	16.9	16.8	13.9	14.0
Expenditure	19.9	19.6	16.7	16.3
Current transfers	12.0	11.9	9.0	8.9
Cash deficit	-0.4	-0.4	-0.7	-0.5
Primary surplus	2.5	2.4	2.0	2.0

Source: BBVA and Ministry of Finance

[3] We have allowed for non-deflation of the IRPF tax rate schedule, as well as the regulatory changes introduced in the taxes levied on tobacco (the specific tax increases by 0.018 euros a packet), motorways (VAT increases from 7% to 16%) and bottled butane gas (VAT increases from 7% to 16%).

[4] This rate is corrected for both the effect on transfers of the new regional financing system and progress with the separation of the sources of financing of the social security system (progressive assumption of supplements to minimum pensions – 306.35 million euros compared with 97.89 million in 2001) and full assumption by central government of the provision of the health and social services of the Social Institute of the Marine).

The new regional financing system

The process of decentralisation in the Spanish public sector has been advancing steadily since the enactment of the first autonomy charters, leading to a radical change in the distribution of public spending at the different levels of government. In 1998, regional expenditure already accounted for 24.3% of the total, and, with the transfers completed since then, this figure had risen to over 30% by 2000. However, this distribution of spending has not been accompanied to the same extent by effective fiscal co-responsibility for the autonomous regions, the revenue regimes of which are still heavily reliant on central government transfers. The result is a loss of transparency for ordinary citizens in relation to the real cost of the system of autonomies and the policies applied by their respective governments.

For those autonomous regions that accepted the regime for the five-year period 1997-2001, the system in force until 2001 is the result of the development of the different systems since the actual cost stage was initiated in 1981. In the latest phase, however, two different financing systems have co-existed: one for those autonomous regions with responsibility for health care and those that do not but which accepted the system, and a modified version of the previous system (1991-1996) for the three regions that did not accept the 1997-2001 system. For the regions that accepted it, the system until 2001 was made up of three financing blocks: common responsibilities financed through transferred taxes and levies, the share of State revenue (PIE) and 15% of the IRPF personal income tax rate schedule, health care and social services (the latter two financed mainly through social security transfers). The system also preserved the Inter-Territorial Compensation Fund and the specific fund for temporary disability, and a minimum revenue guarantee. Specifically, IRPF resources (both the tax rate schedule and the share in the territorial revenue from this tax[1]) and the guaranteed increase in the PIE had to rise, at a minimum, in line with the growth of State nominal GDP (having removed the ceiling linked to the growth in State tax revenue). In addition, the initial level of resources was guaranteed to be equal to that obtained under the old system. And the principles of financial solidarity across regions and of resource sufficiency for the provision of public services meant that the growth of the resources of each autonomous region could not be less than 90% of the resources of the regions as a whole, nor could financing per inhabitant be lower than 90% of the average. Health care funding through social security transfers was guaranteed to grow at least at the same rate as State nominal GDP.

The new financing system, which is intended to be a definitive system instead of expiring after five years like its predecessors, is aimed at resolving these problems. The view is that, with the transfer of health care, social services and education to all the autonomous regions, the process of transfers has been completed, and the aim is to design a new financing system that grants increased fiscal autonomy to the regions. However, insufficient regulatory powers over taxes, together with the guarantee mechanisms for minimum revenue (in the case of health care), will lead to less tangible fiscal co-responsibility in the new system than was intended.

Financing needs

In order to obtain the overall financing needs of the system, the cost of common responsibilities in 1999 (subtracting specific responsibilities and adding those which, though not transferred in 1999, will be transferred in 2002), the cost of health care and the cost of social services are summed. The distribution by region is carried out by means of different mechanisms. For common responsibilities, the total amount is shared taking into account the population (94%), area (4.2%), geographical dispersion (1.2%) and insularity (0.6%), subject to a minimum assignation of 39.66 million euros for each autonomous region, and a fund to compensate for low population density (48.08 million euros). In addition, there exists a Relative Income Fund which is distributed among regions with lower than average income (150.25 million euros). An initial restriction imposes that, aside from the Relative Income Fund, financing resources should at least be equal to the amount that each region obtained in 1999 from the regional IRPF tax rate schedule, the share in the territorial revenue of this tax, the PIE and other levies and taxes ceded with regulatory responsibilities in 1999.

The portion corresponding to health care is distributed in accordance with the covered population (65%), the population aged 65+ (24.5%) and insularity (0.5%). And the block corresponding to social services is distributed on the basis of the covered population. In both cases, however, the financing received in the base year should at least be equal to that obtained under the previous system. The sum of these three blocks plus the value in the base year of non-homogeneous responsibilities (previously deducted) make up the overall financing needs of the system. Briefly put, the calculation of the financing needs attaches a greater weight to the resident population of each region than the previous system.

Financing sources

The system that will take effect in 2002 aims to increase fiscal co-responsibility, enhance transparency, secure budgetary stability and guarantee the principles of financial solidarity and resource sufficiency. Accordingly, the new system assigns the following new tax resources to the autonomous regions: i) a regional tax rate schedule equivalent to 33% of IRPF, with regulatory powers over the tax rate schedule and allowances[2]; ii) 35% of VAT revenue; iii) 40% of special tax revenue; and iv) 100% of revenue raised by the tax on electricity and the special tax on specific means of transport. The last two and VAT will only be effectively ceded when health care responsibilities have been assumed, however. For IRPF, revenue is distributed on the basis of the fiscal residency of taxpayers; for VAT, and the taxes on spirits, beer, wine, fuel, and tobacco, the variable used is a consumption index for each region to be compiled by the INE; and for electricity, net energy consumption is used; finally, for the tax on specific means of transport, the effective territorial revenue will be used. For special taxes and VAT, however, only the revenue is ceded, not management or regulatory powers. The table below presents the resources that would have corresponded to each autonomous region if these taxes had already been assigned in 2001.

[1] The regions had a degree of regulatory power over the regional tax rate schedule in relation to rates and allowances.
[2] For the autonomous regions that accepted the 1997-2001 system, 15% had already been ceded. For those that did not accept it, the full transfer of 33% will now be implemented.

These taxes are therefore added to the wealth tax, the tax on property transfers and documented legal acts, inheritance and gift tax, and the tax on gaming and to the taxes levied on services already transferred, over which regulatory powers have, in contrast, been increased. Taken together, these taxes form the "homogeneous fiscal autonomy" of the autonomous region, which shall be compared with the "homogeneous financing needs". The difference between both concepts is the so-called Sufficiency Fund, which has an endowment of some 20,043 million euros in 2002 (19,227 million if the new fuel tax currently being debated in parliament is finally deducted) and is aimed at satisfying the principles of resource sufficiency and solidarity. The evolution of the sufficiency fund, if positive for the region, is equal to the evolution of the ITEn, that is, the State revenue tranche of taxes assigned in this reform plus State IRPF revenue. If the Fund is negative, its evolution is determined by the change in the regional revenue tranche of the same taxes.

Overall, fiscal co-responsibility increases because the regions have greater regulatory powers over the taxes ceded, and because regulatory power over IRPF affects a larger portion of its revenue than previously. And, in the new system, the revenue dynamics of the autonomous regions depend to a greater extent upon the tax revenue performance of the region itself, which is undoubtedly a step in the right direction. On the one hand, it facilitates the calculation of revenue projections for each region and, on the other hand, it increases transparency for the taxpayer. Nonetheless, the limited regulatory autonomy, the linking of the Sufficiency Fund to the State revenue performance, the obligation to increase health services financing in line with the evolution of the ITEn, and the State guarantee that funding for health care will track nominal GDP during the first three years mean that the advance in fiscal co-responsibility must still be regarded as insufficient. Indeed, the lack of regulatory power is reflected by the fact that it is the government that can and, indeed, is increasing the special taxes (currently at the parliamentary stage) whose revenue has been transferred, rather than the autonomous regions, and also by the fact that the increase is earmarked for a specific purpose.

Distribution of direct and indirect taxes

	IRPF			VAT	Fuel	Special taxes on spirits, beer, intermediate products and tobacco	Specific means of transport	Electricity
1997-2001	Common regime, system accepted: 85% State, 15% A. Region	Common regime, system NOT accepted: 100% State		100% State	100% State	100% State	100% State	100% State
New system	State: 66%		% A.region	35	40	40	100	100

Increase in fiscal autonomy of the autonomous regions associated with the new taxes (in 2001)

Millions of euros

	IRPF	VAT	Fuel	Alcohol	Other special taxes	Specific means of transport	Electricity	Total increase
Andalucía	1,247	1,603	483	40	242	188	100	3,904
Aragón	379	441	133	11	67	31	26	1,088
Asturias	302	294	89	7	44	25	32	792
Baleares	259	346	104	9	52	52	15	838
Canarias	400	493	149	12	74	62	22	1,212
Cantabria	247	164	50	4	25	15	12	517
C. y León	475	429	129	11	65	55	45	1,208
C.-La Mancha	268	724	218	18	109	35	26	1,398
Cataluña	3,292	2,499	753	62	378	227	136	7,347
C. Valenciana	1,073	1,321	398	33	200	147	76	3,247
Extremadura	174	237	71	6	36	18	12	554
Galicia	523	725	218	18	109	69	57	1,719
Madrid	4,534	2,578	777	64	389	263	84	8,689
Murcia	153	281	85	7	42	34	12	613
La Rioja	75	101	30	3	15	7	5	236
Ceuta	7	18	6	0	3	2	1	36
Melilla	6	18	6	0	3	2	0	35
Total	13,413	12,270	3,696	306	1,854	1,232	662	33,435

Source: BBVA

Note: The territorial distribution of the special taxes in the new system will be based on a consumption index to be compiled by the INE. As this was not available, we have opted to apply, as a proxy for this index, the net internal income of the regions affected by this financing system. For specific means of transport, we used car registrations in 2000, and for electricity, net territorial power usage.

The new tax on retail petrol sales: an assessment

Decisions that affect the tax system are of considerable importance because of their implications in terms of efficiency and equity. On the one hand, they alter the consumption and investment decisions of the economic agents (distorting resource allocation) and, on the other, they affect the welfare of individuals inasmuch as they modify the redistributive capacity of the tax system. For this reason, the search for an optimal combination of taxes that allows maximum cost efficiency and the attainment of equity objectives has long been a source of debate.

Developments in international tax regimes in recent decades reflect a relative increase in indirect taxation, a trend justified by the need for cost-efficient tax collection, whereas equity objectives need to be attained through appropriate public spending policies.

The government's decision to create a tax on retail petrol sales (composed of both state and regional tranches) has met with criticism from all sides (the employers' organisation, trade unions, political parties...). The special tax on petrol is one of the most representative of the indirect taxes, both because of its revenue-collection capacity and its social and political implications. Nonetheless, it is impossible to make an assessment of this measure without taking due consideration of multiple factors, of both a structural and cyclical nature.

Structural factors

Here, it is worth noting that:

a) it implies a shift towards a tax system with a greater share of indirect taxation and hence with less distortions in terms of efficiency.

b) it penalises in an optimal fashion the externalities generated by the consumption of fuels (atmospheric pollution, traffic congestion in cities and spending on road repairs – mainly non-toll motorways).

c) it represents a further step towards the inevitable fiscal harmonisation with the European Union in the area of energy taxation (see table)[1]. In fact, in the Transport White Book prepared by the European Commission, it is proposed that fuel taxes be harmonised to at least a level above the current EU average. This would imply sharp tax hikes in Spain, of around 12 pesetas/litre on diesel and 19 pesetas/litre on unleaded petrol.

Cyclical factors

While international trends in taxation and harmonisation with the European Union clearly support the government's decision to increase petrol tax, a group of cyclical factors may call into question the appropriateness of the timing of its introduction. These include the following:

a) a modification of the special taxes introduces changes to the relative prices of goods and therefore affects consumption and investment decisions. What is important is thus the distortions introduced in the allocation of income, not its impact on inflation, which, in any case, will be moderate (around 0.2 tenths of a point in January 2002).

b) in a context of marked economic slowdown, it may be inappropriate to adopt restrictive fiscal policy measures that increase tax pressure on the economic agents.

Indirect fuel taxation in the European Union (November 2001)

	Special taxes		VAT	
Euros/1000 litres	Unleaded petrol 95	Diesel	Unleaded petrol 95	Diesel
Belgium	507.2	209.0	161.0	204.3
Denmark	533.8	369.7	201.6	159.2
Germany	593.1	409.0	129.9	110.4
Greece	296.4	243.6	109.7	95.9
Spain	371.7	269.9	101.6	90.0
France	573.9	376.4	155.9	122.5
Ireland	348.5	249.1	136.9	123.0
Italy	520.3	381.7	161.8	136.5
Luxembourg	372.1	252.9	77.0	78.5
Holland	608.3	345.3	170.8	122.7
Austria	414.3	290.3	138.1	118.8
Portugal	289.3	245.9	132.6	94.2
Finland	559.7	304.7	189.3	144.1
Sweden	473.5	319.8	190.1	159.6
United Kingdom	730.4	730.4	172.6	186.1
UE	479.5	333.2	148.6	129.7

Note: Data are not corrected for purchasing power parity.

Source: European Commission

Objective and fiscal co-responsibility

In addition to the structural cyclical factors noted above, there are two further aspects that should be taken into account when assessing the tax. The first concerns the allocation of a tax on consumption to cover a specific objective, such as health care, and the second relates to its impact on the degree of fiscal co-responsibility of the autonomous regions. With regard to allocation of the revenue collected, according to EU regulations, other indirect taxes can be levied on goods subject to special taxes only if they have a specific objective[2]. Compliance with this rule therefore explains why the new tax is earmarked for a specific purpose. In concrete, the possibility exists to allocate the new resources to fund health care or environmental measures. But they could also be earmarked for repairs to the road and motorway network.

With regard to its impact on the degree of co-responsibility, in view of the degree of decentralisation in public spending, it is desirable to grant greater regulatory powers to the regions. The creation of a regional tranche in the new tax is therefore a step in the right direction.

[1] A comparison of these figures does not allow conclusions to be drawn in relation to the fiscal effort of each country. For that purpose, the figures would need to be corrected for purchasing power parity.

[2] Article 3 of Council directive 92/12/EEC of February 25, 1992.

5. The financial system

Slowing credit growth after a long period of expansion

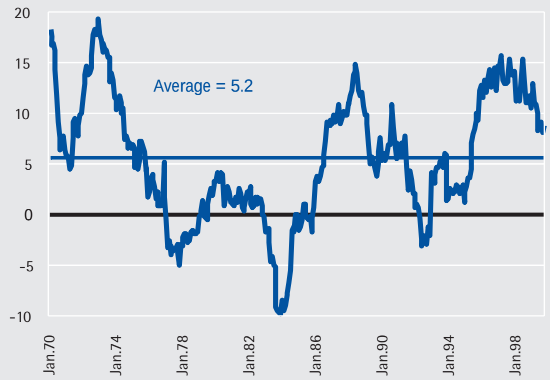
Credit to the private sector in Spain has experienced a pronounced expansion since the middle of 1996. This period of growth has been the longest-running for the last 40 years, with credit as a percentage of GDP increasing from 67% at the end of 1996 to 93% in the first half of 2001.

However, the growth rate of credit has slowed in the course of this year, a trend that is very likely to continue in 2002.

Graph 5.1

Real growth in lending by banks and savings banks

(% oya)



Sources: Bank of Spain and BBVA

The composition of credit

An analysis of the composition of credit provides some insight into both the expansion and later deceleration. The strong momentum of bank lending in the past few years is largely attributable to the strength of the property market. Mortgage lending in bank balance sheets has shown sustained rates of growth over 20% in recent years, whereas the evolution of other lending has been much more moderate and sensitive to the economic slowdown.

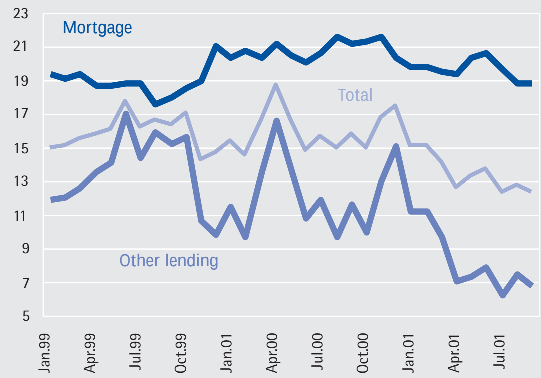
As a result, the property market already represents some 40% of the total lending by financial institutions, mortgage lending being the most important, with 82% of credit to the sector.

As a result, during this economic expansion there has been a shift in the market structure of bank lending. Savings banks, which are much more oriented towards lending to households, have seen their market share rise by 5 percentage points. Currently, mortgage lending represents

Graph 5.2

Lending in the balance sheet

(Banks and savings banks)



Source: Bank of Spain

some 62% of the total lending by savings banks, as against 39% for banks.

The increasing importance of savings banks in the market is also the result of a major investment in new branches. Savings banks have opened more than 14,000 branches over the last four years (14% of today's network of savings banks). This contrasts sharply with the closure of branches by banks (15,245 since 1996), particularly as a result of network restructuring by the large financial groups created in the latest mergers.

Supply and demand factors account for the expansion

The sharp expansion in lending observed during the last four years is due to both demand and supply factors. Among the former, the main determinants to note are the structural change in interest rates resulting from Spain's entry into EMU and, as mentioned earlier, the strength of the property sector. In fact, the other determinants of demand for credit – those linked to economic activity such as consumption and investment – have grown more slowly than in previous periods of notable credit growth (the early 1970s and late 1990s).

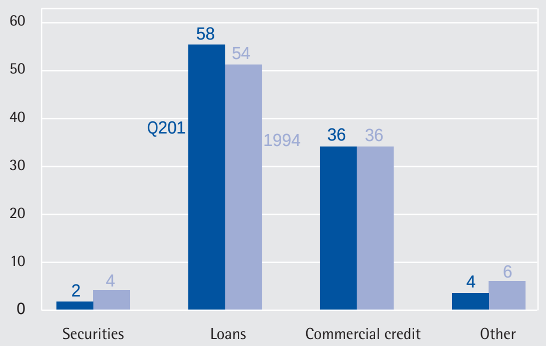
The structural shift in interest rates seems therefore to have increased the elasticity between interest rates and demand for credit. The correlation of these two variables between the years 1980-2001 was –0.5, compared with –0.85 since 1995.

Alternative sources of financing

A look at the use of alternative sources of financing, both for households and non-financial companies, shows

Graph 5.3

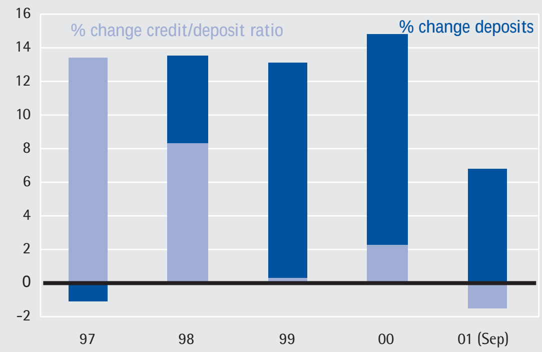
Composition of household and company financing



Source: Bank of Spain

Graph 5.4

Bank lending growth



Sources: Bank of Spain and BBVA

that the importance of loans has increased relative to the others.

The increased importance of loans in households' total borrowing (from 73% in 1994 to 80% today) is largely due to the expansion in mortgage lending. Loans for house purchases and renovations account for half of total household borrowing. The level of household indebtedness has risen from 28% of total assets in 1998 to 34% in the second quarter of this year.

The share of lending in the composition of financing has also increased in the case of non-financial companies. Lending increased from 45% of the total in 1994 to 48% in the first half of 2001. In contrast, commercial credits and issues of securities, in particular, have fallen sharply over the past year, especially long-term bond placements.

Companies are nevertheless in a healthier position than households to cope with the economic downturn. In fact, credit to companies began to slow already at the end of last year and early this year. Despite increased financial expenditure and indebtedness, corporate earnings have risen. In the third quarter of 2001, companies as a whole had a positive leverage ratio (earnings as a percentage of borrowing costs) of 3.1%, which shows that firms are well-positioned for the change in the cycle.

Price effects

During this expansion, the composition of the financing of financial institutions, taken to be the total liquid resources that allow institutions to satisfy demand for credit, has changed considerably.

Credit growth can be proxied by the percentage change in the ratio of credit to deposits and the percentage change in deposits.

Under normal circumstances, deposits are the cheapest financing instrument, in contrast to alternative sources such as the interbank market or ECB liquidity tenders. This breakdown therefore allows us to analyse whether credit growth is being financed through the more traditional resources of bank borrowing or whether, on the contrary, banks are tapping more expensive sources of funding.

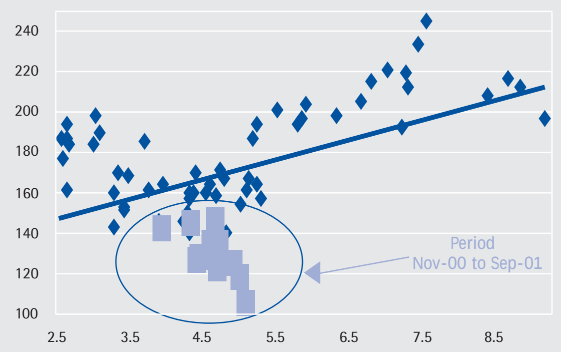
As shown in Graph 5.4, during 1997 and 1998, the expansion in lending was financed with a higher leverage of banks in relation to deposits. More recently, in contrast, the increased resources for the allocation of credit have come from deposits, leading to cheaper financing for credit institutions.

As far as lending rates are concerned, the increase in competition in the financial system over the past few years has exerted downward pressure on core business margins. In addition, improved risk-management control has made it possible to adjust credit risk premia to a greater degree, leading to a reduction in the differential between lending rates and benchmark rates, most notably in banks.

As Graph 5.5 shows, the differential of the synthetic bank lending rate with respect to the 3-month Mibor rate has been at relatively low levels for the past year in comparison with previous years in which market rates were at similar levels.

Graph 5.5

Differential of synthetic bank lending rate with respect to 3-month MIBOR rate (Dec-94-Sep-01)



Sources: Bank of Spain and BBVA

Factors governing credit in the period ahead

The economic slowdown and a decline in corporate and, in particular, household wealth should have a moderating impact on credit demand and supply.

The influx of hoarded money associated with the imminent introduction of the euro (the "euro effect") should sustain demand for mortgage credit until the end of the year. This would lead to a higher growth rate of credit this year, but a sharper slowdown in 2002.

In 2002, the economic downturn, which will make itself felt most strongly in the property sector, will continue to exert downward pressure on demand for credit. This impact will nonetheless be muted by the evolution of real interest rates, which should remain stable at very low levels.

On the supply side, in view of the slowdown in economic growth, less solvent demand and the prospect of a moderate rise in bad debts, the financial institutions will tend to apply more stringent credit standards.

It is also important to note, however, that financial institutions are well equipped to cope with the change in the cycle thanks to historically very low levels of bad debt ratios and strong loan loss provisioning.

Table 5.1. Financial variables

(% oya, unless otherwise indicated)

	1999*	2000*	June	July	August	September	Balance (mm €)
Credit to private sector	15.2	17.3	13.9	12.8	12.9	12.9	603
Sight and savings deposits	3.9	5.7	6.7	5.6	6.2	7.0	244
Term deposits	25.4	24.7	22.7	21.5	21.3	20.3	193
Bad debt ratio	1.25	1.24	1.18	1.20	1.22	1.19	n.a.
Net assets in investment funds	1.2	-11.2	-9.6	-9.4	-11.5	-12.8	169
Net assets in pension funds	16.3	19.8	19.3	–	–	15.9	39

* end-year

Source: Bank of Spain and Inverco

Is there a *euro effect* in the Spanish economy?

Manuel Balmaseda*, Carmen Hernansanz* and Miguel Sebastián *

1. Introduction

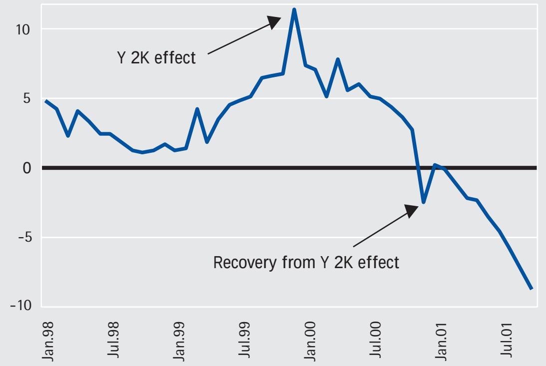
At the end of 1999, the stock of cash in circulation in Spain amounted to some 10,200 billion pesetas. By the end of October of this year, it was 8,800 billion. Since the third quarter of 2000, the rate of deceleration in cash in circulation has been increasing, and rates of change have turned negative, most notably since the start of 2001 (see Graph 1). This phenomenon is not confined to Spain, however. Stocks of banknotes and coins in circulation are also declining in other EMU countries, such as Holland, France and Germany. A variety of reasons may lie behind this development. In the case of Germany, the largest EMU economy, one contributing factor could be the exchange of D-Marks held by non-EMU residents into alternative currencies to the euro, particularly the dollar. That is to say, residents of Eastern Europe are changing their D-Mark cash holdings into dollar banknotes in order to avoid the physical changeover in the two weeks programmed by the German government for the exchange of banknotes. This type of effect has no real impact on the German economy because it is simply a change in the denomination of money balances and, moreover, it is occurring outside Germany. The decline in cash in Spain cannot be attributed to the same cause, however, since the use of the peseta as a medium of exchange or reserve currency in other countries is practically non-existent.

What determinants might lie behind the fall in cash in Spain? To analyse this question, we must first review the demand and supply factors governing the stock of banknotes in circulation. These include the issuance policy of the Bank of Spain, the economic growth performance and preferences for cash as a means of payment[1].

Graph 1

Cash in circulation

% change oya



Source: Bank of Spain

On the supply side, one might imagine that the fall in the stock of notes and coins is the result of a deliberate policy by the Bank of Spain to gradually reduce the amount of cash in the system, and, in this way, lower the costs of the physical changeover to the new currency. Far from it. The Spanish Central Bank is adopting a completely passive attitude in relation to the demand for notes and coins. Indeed, the Bank of Spain has recently acknowledged that the fall in cash is linked to a decline in demand and that this phenomenon therefore bears no relation to its policy for the supply of notes and coins[2].

The explanation therefore lies wholly in demand factors. That is to say, in a decline in the preference for cash. In such circumstances, the next alternative explanation of the fall in cash held by the economic agents in Spain would be the existence of some factor that is leading them to demand a smaller amount of banknotes and coins to pay for their transactions. One possibility would be to explain this in terms of economic growth, since cash has a positive elasticity with respect to GDP. When transactions of goods and services in an economy increase, the nominal stock of notes and coins needed to pay for these transactions must also rise. The annual growth rate of nominal GDP in the first half of 2001 was 7.2%, however, so that, in the absence of other factors, cash should not only not be falling, but should have increased to finance this higher growth in nominal economic transactions.

The possibility of a sudden shift in preferences for cash as a means of payment appears to make little sense, either. On the contrary, the use of banknotes in economic transactions has actually increased. The only coherent explanation therefore lies in a return to circulation of cash that was previously hoarded. That is, demand for "new" cash has fallen, precisely because there has been an influx of

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[1] As clarification, it is worth noting that, in this last case, the immediate financial counterpart of the reduction in cash is an increase in the bank balances of those that receive the cash entering the economy in exchange for goods and services offered.

[2] Bank of Spain Statistics Bulletin, Quarterly Report on the Spanish Economy (October 2001).

hoarded banknotes re-entering the economy. Given the absence of alternative determinants, and bearing in mind that the introduction of euro notes and coins at the beginning of 2002 is the most important monetary phenomenon on the horizon, it is reasonable to assume, finally, that recent cash developments are closely linked to some determinant of demand that is affected precisely by the imminent switch from peseta to euro banknotes. This line of thinking points, in particular, to two possible mechanisms.

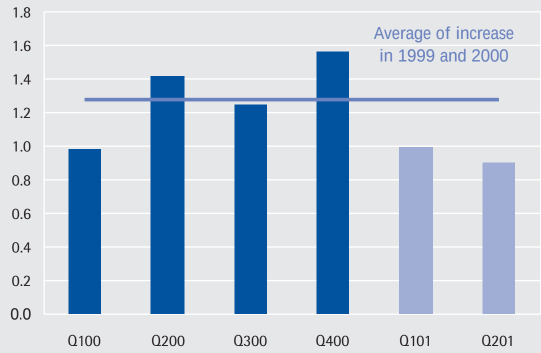
First of all, the proximity of the euro changeover could be prompting the economic agents to substitute cash by other alternative means of payment in their normal purchases, with a view to reducing their money holdings and lowering the cost of transition to the euro. This is unlikely to be the most plausible explanation for the fall in cash in circulation for two reasons, however. One is that cash in circulation was already slowing at the end of 2000, too early it would seem for such a decision. Further, there have been no conversions of deposits into euros or intense preparations by consumers. To cite two examples of the lack of advance preparation by the Spanish public for the entry into circulation of the new currency, in October of this year, only 36% of Spaniards had made an effort to memorise some prices in euros and only 45% knew until which date the peseta can still be used for payment in shops[3]. The other is that purchases using credit or debit cards have also slowed slightly in comparison with their recent development. If consumers had decided to use this means of payment more often in their normal purchases, the rising trend shown by the penetration of card payments as a percentage of final household consumption would have accelerated. On the contrary, the rate of increase in card payments as a percentage of total payments by Spanish households has been slowing since the beginning of 2001. The average rise in 2001 is 0.9 percentage points, as against 1.3 percentage points on average in the period 1999-2000 (see Graph 2).

The decline in demand for notes and coins and the less intense use of credit and debit cards therefore suggest that the fall in cash in the build-up to the introduction of euro notes and coins is due to peseta banknotes previously outside the circuit of transactions returning to circulation. To put it another way, this explanation suggests that the economic agents are "recycling" the cash they had hoarded or held as a store of value. Cash which was thus not being used to finance the consumption

Graph 2

Increase in card penetration

Card payments/private consumption



Source: Visa España SC

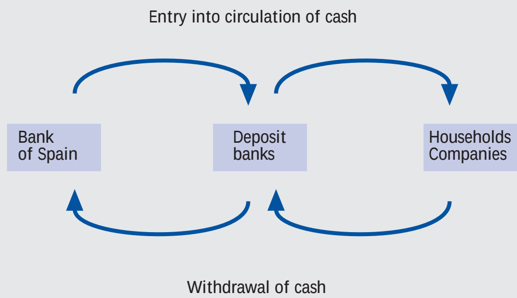
and investment transactions of households and firms; that is, not being used as a means of payment prior to now.

The commercial banks are the channel through which banknotes and coins enter circulation. This fall in demand for cash therefore has its counterpart in lower than normal withdrawals of banknotes from these institutions by the households and companies using hoards of cash. In order to hold their liquid reserves at customary levels, the deposit banks in turn withdraw banknotes and coins not demanded by their customers and return them to the Bank of Spain. This is how cash "disappears" from circulation. It is important to bear in mind that the immediate counterpart of the fall in cash is an increase in bank deposit balances above that which would be normal in other circumstances.

In industrial economies with highly-developed banking systems such as the EMU, banknotes and coins are not generally used as a store of value because of the opportu-

Diagram 1

Entry into circulation and withdrawal of banknotes



[3] European Commission, Flash Eurobarometer 98/5, October 2001.

nity cost arising from the existence of alternative investments and the loss of purchasing power caused by inflation. As a result, while some agents may use cash as a store of value, it is essentially used as a means of payment. Nonetheless, in all economies there are transactions which, largely for tax reasons, take place outside the official circuit and which are therefore generally settled in cash. Some papers that have attempted to assess the magnitude of this effect in Spain put it at between 20% and 44% of cash, which, in relation to cash in circulation at the end of 2000, is the equivalent of 2-4,000 billion pesetas[4].

The aim of this article is to evaluate the potential impact of this phenomenon on Spanish economic activity. To do so, Section 2 presents two approaches for measuring the influx of cash. Section 3 estimates the impact of this effect on economic growth in 2001 and 2002. The final section of the article concludes.

2. Measurement of the influx of cash

In order to assess the impact of this phenomenon on the Spanish economy, we have first sought to measure it using two alternative approaches. First of all, we used a simplified version of the quantity theory of money. Secondly, we used a straightforward econometric model to estimate the demand for banknotes in Spain.

a) Estimation using the "quantity equation"

The most straightforward way to measure the influx of cash is to use the quantity equation of money:

$$M^*V = P^*Y, \qquad (1)$$

It should be noted that this equality, which is really an *ex post* identity, assumes that cash is basically an instrument for the execution of real transactions in this equation, where M is the representative monetary aggregate (in this case, M0, cash in circulation), V is the velocity of circulation of money, P is the GDP deflator and Y is real GDP. Taking logarithms and using temporary rates of variation, the quantity equation of money can be expressed as follows:

$$\Delta m + \Delta v = \Delta p + \Delta y \qquad (2)$$

It must be stressed that if the velocity of circulation of money is assumed to be constant ($\Delta v=0$), the quantity equation states that cash should increase in line with nominal GDP. Note this fact, because the recent divergence between the growth rate of nominal GDP and cash will be our indicator that demand for cash has departed from the transaction motive assumed by the quantity equation.

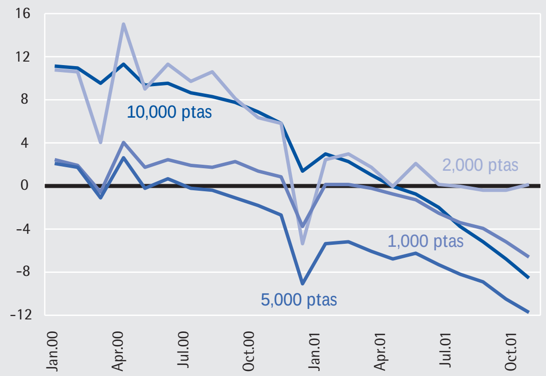
With a view to using the above equation to measure the influx of hoarded cash, we have opted to employ the stock of banknotes in circulation as the monetary aggregate instead of all cash. The economic argument underpinning this decision is that cash hoards and hence the influx of cash must take the form of banknotes, rather than coins, given the higher unit values of the former. In fact, a further empirical indicator that supports the idea of the existence of a "cash-influx effect" is the bigger fall registered by large-denomination notes (10,000 and 5,000 pesetas), which are more effective for "storing value", compared with that observed for low-denomination notes (2,000 and 1,000 pesetas). By October 2001, the number of 10,000 and 5,000 peseta banknotes in circulation had fallen by 8.6% and 11.8%, respectively, whereas the number of 2,000 peseta banknotes was unchanged from year-earlier levels.

In view of the above, we shall now look specifically at what the recent behaviour of notes in circulation should have been for transactional purposes alone. To do so, we take account of the fact that the nominal GDP growth rate of the Spanish economy between September 2000 and September 2001 is estimated to have been 7.1%[5]. With these assumptions, substituting in equation (2), the im-

Graph 3

Number of banknotes

% change oya



Source: Bank of Spain

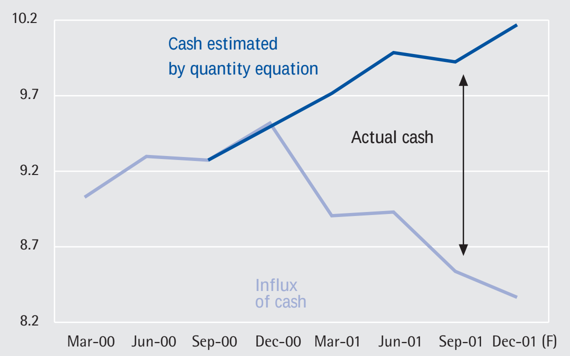
[4] See Jareño and Delrieu (1991).

[5] If nominal GDP growth of 6.7% is assumed for the third quarter of 2001.

Graph 4

Estimation of cash influx

Billions of pesetas



Source: BBVA

mediate conclusion is that the stock of notes in circulation in September of this year should "theoretically" have amounted to 9,900 billion pesetas, a figure that exceeds the volume of notes in circulation actually observed by some 1,400 billion. Also, if recent trends in cash continue until the end of 2001, the stock of notes in circulation would be 12% lower in December than a year earlier. Estimated in this way, the influx of cash would therefore amount to 1,800 billion pesetas for the whole of this year (see Graph 4).

This method of calculation may lack precision for a variety of reasons, however. The first of these is that the assumption that the velocity of circulation of money is constant is, in general, restrictive. As alternative means of payment are developed, this variable tends to trend downwards. In other words, the preference for liquidity diminishes and more transactions are financed by the same quantity of notes and coins.

A second reason for re-examining the estimation, related in any case to that just given, refers to the assumption of a unitary elasticity of cash with respect to GDP. This is not necessarily the case, as reflected in the empirical literature on demand for cash[6]. In fact, the results that emerge in Spain suggest that this variable tends to be higher than unity. This shows that, as regards cash holdings, motives other than strictly transactional motives are at work, something particularly evident in economies such as that of Spain in which the underground economy is relatively large. Finally, it should also be noted that this simple model may not be capturing the effect of additional explanatory variables, such as, for instance, interest rates, which determine the opportunity cost of holding cash. Accordingly, the next section presents estimates obtained using a rather more sophisticated model.

b) Estimation using a model for demand for banknotes

In order to provide a more accurate measurement of the total amount of cash that may be entering the economy, we have adopted an econometric approach. The idea is to estimate a model for the demand for banknotes in Spain up to the third quarter of 2000[7] on the basis of a more sophisticated model than the previous one, extrapolating the recent evolution of cash from then onwards bearing in mind the value of the dependent variables actually observed. As before, the aim is to obtain a theoretical demand for cash. The magnitude of the influx of cash is obtained as the residual between the extrapolated stock of cash and the actual value[8].

The results of this model are displayed in Table 1 and Graph 5. The variable to explain is the logarithm of the volume of notes in circulation in Spain in real terms[9]. In the long run, the demand for notes in real terms depends solely on real GDP in logarithms[10], which, as was expected, exhibits an elasticity above unity. In the short run, the explanatory variables seek to correct the behaviour of cash for a series of transitory effects. The "Bill amortisation" variable reflects the impact of the redemption of Treasury bills between June 1990 and March 1993[11], making it a truncated trend between these dates. "Effect 2000" captures the increase in liquidity stemming from the proximity of the Y2K effect and Seasonality 1Q, 2Q, 3Q are variables that capture the significant seasonality of the dependent variable.

Graph 6 presents the extrapolations made using the model from the fourth quarter of 2000 onwards. Clearly, the path of demand for notes generated by the model departs gradually from the actual data. Graph 7 displays this deviation in current pesetas. According to the model, between the fourth quarter of 2000, when the effect first

[6] Jareño and Delrieu (1991) find an elasticity above 1 when they do not correct for fiscal shocks. Quirós (1990) also notes this effect.

[7] The fourth quarter of 2000 was chosen as the point of departure for the simulation because it is from this period on that observed cash is over two standard deviations from the simulation one period forward.

[8] A normal residual estimated on the basis of confidence bands is eliminated.

[9] We opted for an estimation in real terms, thereby reflecting that the elasticity of the nominal stock of notes to prices is equal to unity. That is, the assumption of the absence of monetary illusion is imposed on the model.

[10] Several tests were carried out with interest rates and variables capturing the effect of financial innovation but they were not statistically significant.

[11] Treasury Bills were fiscally-opaque government securities in which part of the influx of cash was deposited. Their maturity gave rise to a period of sharp increases in cash.

Table 1. Estimated model

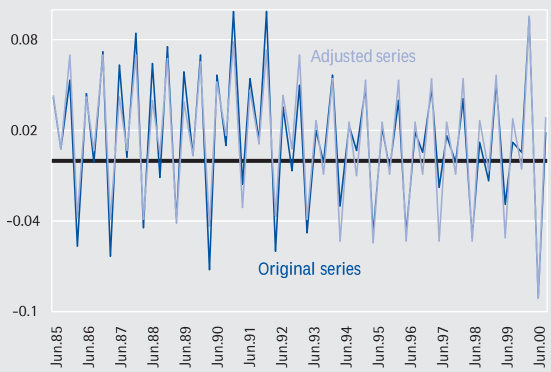
Dependent variable: banknotes in circulation in real terms
Estimation period: 1985: 01-2000:03

	Coefficient	T-ratio
Error correction mechanism	-0.046	-3.6
Real GDP	1.116	163.8
Bill amortisation	0.014	3.1
Y2K effect	0.038	3.6
Seasonality 1Q	-0.057	-16.8
Seasonality 2Q	-0.036	-9.6
Seasonality 3Q	-0.049	-14.8
R^2	0.91	
DW	2.41	
Standard error	0.0146	

Source: BBVA
All variables are in increases except real GDP and the error correction mechanism

Graph 5

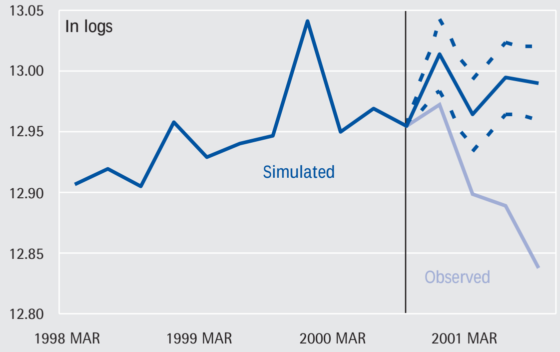
The model's fit



Source: BBVA

Graph 6

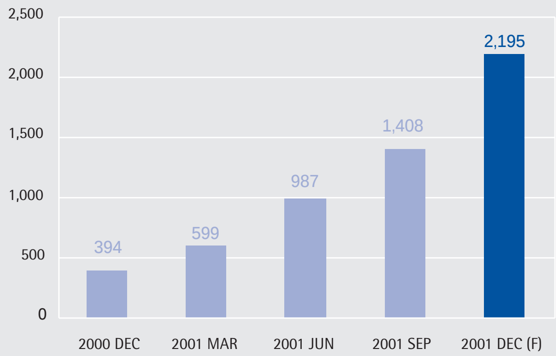
Banknotes in circulation in real terms



Source: BBVA

Graph 7

Estimation of cumulative influx of cash



Source: BBVA

became visible, and the third quarter of 2001, the influx of cash amounts to 1,400 billion pesetas. Of this amount, almost 400 billion pesetas had already entered the economy by the end of 2000, so that, between then and the third quarter of 2001, some 1,000 billion pesetas can be estimated to have entered the economy.

These results are compatible with those obtained using the quantity equation. If the extrapolation made using the above model for the total influx of cash in 2001 is taken as valid, around 800 billion pesetas could be re-entering the economy as a means of payment in the final quarter of 2001. Also, if these projections are confirmed, by the start of 2002 when the euro enters into circulation, there will have been an influx of around 2,200 billion pesetas, which at October 2001 represents some 25% of total cash. On the basis of the estimates noted above for hoarded cash in Spain, 800 billion pesetas at the most would still remain to be changed into euros.

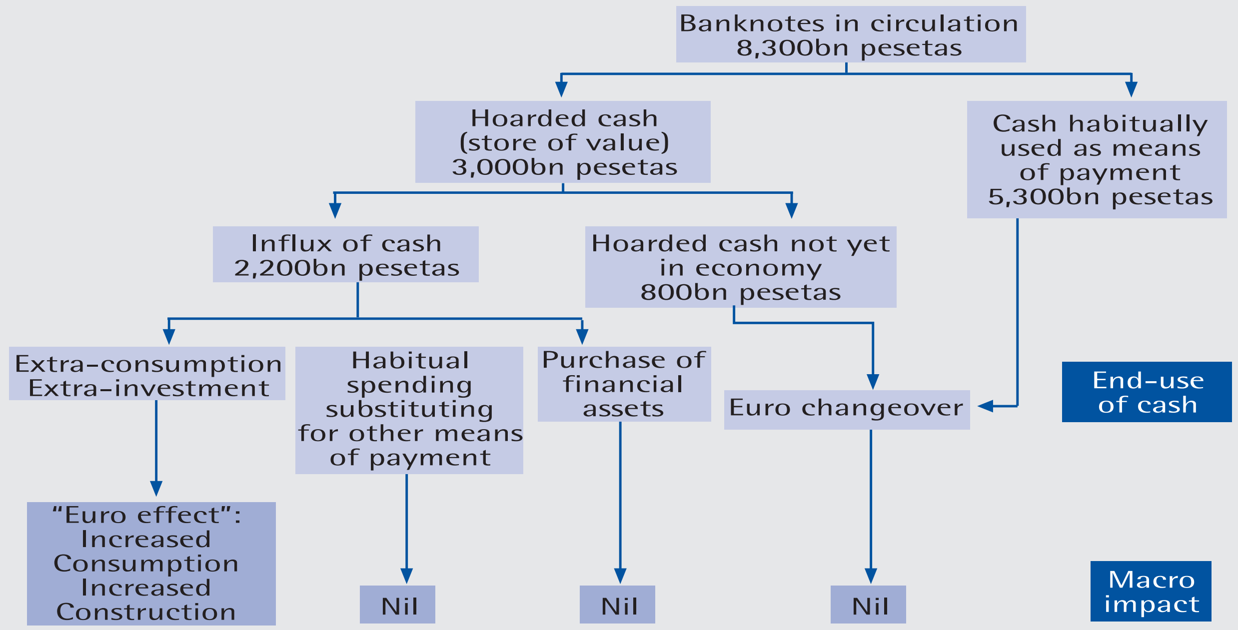
3. Impact of the cash influx on the Spanish economy: the "euro effect"

The key to gauging the possible impact of the influx of cash on Spanish economic developments lies in determining what type of purchases are being made with the banknotes coming out of storage (Diagram 2). If this cash is being used to purchase habitual goods and services, the impact on domestic demand and hence on economic growth would be nil. That is to say, we would only be witnessing a monetary phenomenon linked to a change in the means of payment used resulting from a shift in preferences between different means of payment. Likewise, if the economic agents are choosing to shift this cash into alternative financial assets, there would be no direct impact on the main macroeconomic aggregates.

Conversely, it may be that, taking advantage of the need to convert peseta cash hoards into euros, the economic

Diagram 2

The "euro effect" is only a small percentage of the influx of cash



agents are making additional purchases or investments or bringing forward spending decisions over and above those they would have made if the peseta was not going to lose discharging power as a means of payment as of March 2002. This is what we refer to as the "euro effect".

The "euro effect" is essentially making itself felt on two demand components: private consumption and residential investment. In both cases, the impact of the influx of cash consists in the bringing forward of spending decisions in response to the uncertainty relating to the euro changeover in January 2002. This has contributed to keep both consumption and residential investment at relatively high levels during 2001 in spite of a weakening economic environment. That is, the momentum shown by consumption and residential investment does not correspond to the factors governing the behaviour of these variables (household income, wealth, borrowing capacity, employment, etc.). This has led to a degree of overheating in the economy and rising consumer and house prices as a result of demand pressures. However, the euro changeover does not entail any increase in households' wealth, and so robust consumption growth in 2001 will therefore have its negative counterpart in the years ahead, and in 2002 in particular. The impact of the unwinding of the "euro effect" on the behaviour of consumption will be twofold. On the one hand, consumption will return to a sustainable growth path as determined by economic fundamentals. But, in addition, the extra consumption seen in 2000 and 2001 will be deducted from consumption in future years. That is, early purchases of goods in 2001, instead of in 2002 as planned, because of the "euro effect", not only increases consumption in 2001, but will also probably reduce consumption in 2002, since these purchases will not be repeated. And the more durable this consumption is, both with regard to consumption and investment (cars, household goods, houses, etc.), the greater this effect will be.

As far as specific consumption developments are concerned, the "euro effect" translates into stronger growth in 2000 and 2001 and lower growth in 2002. The existence of this effect is difficult to prove, though circumstantial evidence exists that suggests it is operating in this way. Durable goods consumption is continuing to grow more strongly than the current deterioration in expectations and activity would warrant. Thus, car registrations were up by 3.4% in Spain in the first ten months of the year from the corresponding period of last year, with, moreover, accelerating quarterly growth rates and above-average rises in the luxury car market. Although certain "special" factors may be supporting the brisk growth in registrations (Prever Plan, manufacturers' sales policies, cheaper financing), they do not appear sufficient to explain the sharp increases observed, especially in the light of the deterioration in consumer expectations. This is the first time since 1991 that a rise in car

Table 2. Cumulative growth

Jan-Sep 2001/Jan-Sept 2000

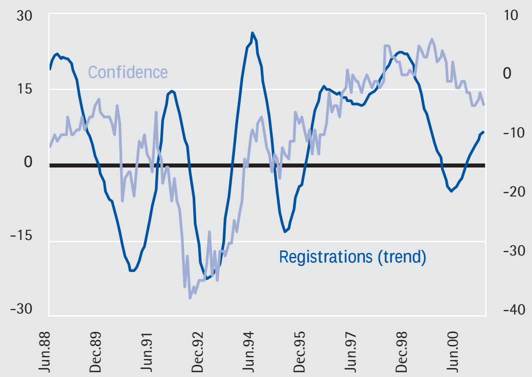
MAKE *	%
MERCEDES	35.6%
AUDI	18.2%
VOLKSWAGEN	16.0%
B.M.W.	12.3%
OPEL	11.8%
FORD	6.6%
NISSAN	4.7%
PEUGEOT	4.6%
HYUNDAI	0.2%
RENAULT	-0.9%
CITROEN	-3.1%
SEAT	-4.4%
FIAT	-6.6%

* Makes with sales of over 20,000 vehicles in 2001
Source: ANFAC

Graph 8

Car registrations and consumer confidence

% oya



Sources: European Commission, ANFAC and BBVA

sales has coincided with a decline in consumer confidence. And this trend is common to all durable goods, not just car sales.

As noted earlier, the stimulus to consumption from the "euro effect" in 2000 and 2001 will have to be offset by belt-tightening at some future stage (economic agents' wealth is not increased by a currency changeover). There can be no permanent increase in consumption unless permanent income changes. The reduction in future consumption should show up, and gradually weaken, in the coming years. Even if the level of consumption in 2002 were not reduced by the "euro effect", however, consumption growth would fall because of comparison with the higher levels of previous years (the "level effect"). This would represent the minimum impact of the "euro effect" on consumption in 2002. However, the uncertainty generated by the currency changeover may mean that consumption decisions from future years have been effected in 2001 (the "bringing-forward effect"). In the most extreme case of this effect, all the extra spending in these years corresponds to 2002 consumption, meaning that consumption in 2002 would decline by the same amount as the "extra" spending[12]. Such a scenario would coincide with the maximum impact of the "euro effect" on consumption. Both scenarios are shown in Graphs 9 and 10[13].

In order to analyse the impact of the influx of cash on activity, we have assumed that, at most, half of the total influx has resulted in increased spending by the economic agents (the "euro effect"), while the remaining 50% has

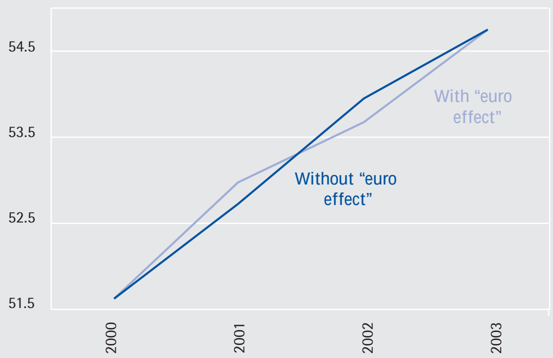
[12] In this case, consumption growth in 2003 will be higher than corresponds to the "normal" growth path of consumption. This results from the "level effect" on comparing 2002 and 2003.

[13] To simplify, the graphs do not take account of the "euro effect" in 2000.

Graph 9

"Euro effect" on consumption: maximum effect in 2002

Billions of pesetas

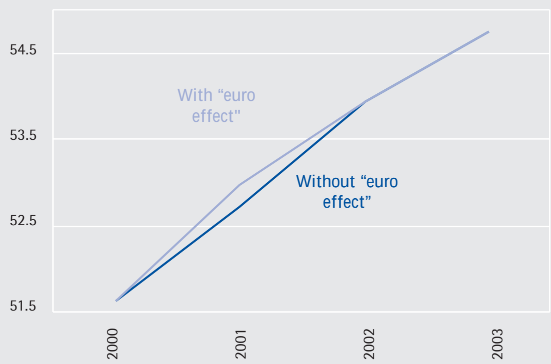


Sources: INE and BBVA

Graph 10

"Euro effect" on consumption: minimum effect in 2002

Billions of pesetas



Sources: INE and BBVA

Table 3. Sensitivity of private consumption to "euro effect"

% of total influx of cash	Billions of pesetas		Consumption growth in 2002	
	"Euro effect"	Consumption (1/3)	Maximum	Minimum
0	0	0	2.3%	2.3%
25%	555	185	2.0%	1.6%
50%	1,110	370	1.8%	1.0%
75%	1,665	555	1.4%	0.4%
100%	2,220	740	1.1%	-0.3%

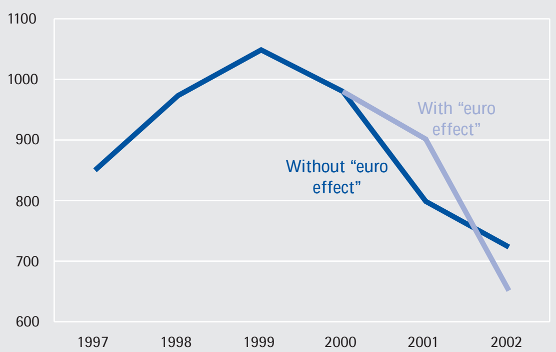
Source: BBVA

been devoted to habitual spending and so will have no impact on the economy. This implies that, of the 400 billion and 1,800 billion pesetas entering the economy in 2000 and 2001, respectively, 200 billion and 900 billion pesetas were used for above-normal spending. We also assume that one-third of the "euro effect", 66 billion pesetas in 2000 and 300 billion in 2001, has been spent on extra-consumption, while the remaining two-thirds, 134 billion and 600 billion pesetas in 2000 and 2001, respectively, have been invested in housing. This additional flow to consumption represents 0.1% of consumption growth in 2000 and 0.5% extra in 2001. The impact in 2002 will depend, as noted above, on how much spending has been brought forward. The maximum impact – all the cash influx corresponds to the "bringing-forward effect" – could bring about a deceleration in consumption of around 1% relative to the baseline scenario. The minimum impact - corresponding to the "level effect" - would imply a slowdown in consumption of 0.6% with respect to the baseline scenario. Therefore, if private consumption grows by around 2.6% in 2001, its expansion in 2002 would be under 2% even if it sustains the same underlying growth rate. Note that the estimation of this impact is very sensitive to the proportion of the influx of cash that corresponds to the "euro effect", as can be seen in Table 3.

Graph 11

Property transactions

(thousands)



Source: BBVA

The macroeconomic scenario is based on the assumption that the "euro effect" is going to be around 25-50% of the total influx of cash and that the full negative impact will not be felt in 2002, but rather be diluted over other years. Contributing to this will be the fact that the euro changeover will not be completed until the second quarter of 2002.

As far as residential investment is concerned, the "euro effect" has contributed to robust growth in the sector in 2001 and, in particular, to a steady increase in prices. The influx of cash has led to a greater number of property transactions and also stronger momentum in house building since the middle of 2000. The 740 billion pesetas of extra cash flowing into property investment has represented a boost (direct or induced) of some 12% of total sales. This considerable stimulus to housing demand provided by the "euro effect" has represented, in absolute terms, a total of 100,000 of the 900,000 transactions estimated for 2001. The disappearance of this stimulus in 2002 will probably lead to a fall in house sales of around 75,000, which, together with the deterioration in activity, is expected to result in a decline of some 225,000 transactions. The result will be a decline in house-building, which, having been one of the pillars of the recent economic expansion, with growth rates of 8.6% in 2000 and 4% in 2001, will probably record a negative growth rate of –2% in 2002.

Conclusions

The fall in cash in circulation in Spain seems to be related to a phenomenon involving previously hoarded cash entering the economy. Around 1,400 billion pesetas are estimated to have re-entered the economy between the fourth quarter of 2000 and the third quarter of 2001 (400 billion in the fourth quarter of 2000 and 1,000 billion in the first three quarters of 2001). There are reasons to believe that part of this money is being used to make early purchases or to consume and invest more than Spanish households had planned. If that is indeed the case, this "euro effect" would push up consumption and investment in 2001 to growth rates that are relatively high for the cyclical position of the Spanish economy. Conversely, the unwinding of this phenomenon in 2002 would cause these variables to decelerate after the bringing-forward of purchases and property investment associated with the euro changeover have petered out.

It is important to highlight that, contrary to what some mistakenly believe, the consumption and house purchase transactions originating from this effect are not being paid for with black money. If this were so, these transactions would be part of the underground economy. On the contrary, they are transactions that form part of GDP, consumption and investment, and hence transparent from a fiscal viewpoint. In no way are we suggesting that salesmen of luxury cars and new houses are making "black" transactions. Nor even that they are accepting black money. We are simply saying that they are accepting banknotes. Banknotes in fiscally transparent transactions.

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Spain: Main economic indicators

(% year-on-year change, unless otherwise stated) - October 2001

	2000	2001 (1)	August	September	October	Latest figure	One year ago	Trend
Industrial production (seasonally-adjusted)	4.4	-0.8	3.3	-0.7		-0.7	2.5	-
Business confidence index (net balance)	2.5	-4.2	-6.0	-5.3		-5.3	3.3	-
CU (3)	80.7	79.5	78.7	78.7	78.7	78.7	81.2	-
Electricity consumption (4)	6.5	6.2	8.4	4.3	4.7	4.7	5.8	-
Cement consumption	10.9	10.0	8.4	-0.3	21.1	21.1	13.8	-
Car registrations	-1.8	3.5	5.7	-0.6	13.0	13.0	-11.6	-
Consumer confidence index (2)	2.3	-3.2	-4.0	-3.0	-5.0	-5.0	-1.0	-
CPI (overall)	3.4	3.8	3.7	3.4	3.0	3.0	4.0	-
Producer prices	5.4	2.5	1.6	0.6		0.6	5.5	-
Wage agreements (5)	3.7	3.4	3.5	3.5	3.5	3.5	3.7	=
Money supply (households and NPISH)	2.6	1.5	6.1			6.1	1.6	+
Domestic private sector credit	18.8	18.5	15.6			15.6	18.2	-
Social security registrations	5.0	4.0	3.5	3.0	3.3	3.3	4.4	-
Registered unemployment (6)	-94.1	-36.6	-28.6	-12.9	9.9	9.9	-61.5	-
Unemployment rate (3)	14.1	13.1	12.8	12.8		12.8	13.7	-
Employment (qtr.) (3)(6)	656.3	307.5	262.7	262.7		262.7	669.8	-
Current account balance (7)	-18958.8	-9007.8	47.0			47.0	-1225.4	-
Trade balance (7)	-43038.8	-27532.9	-3697.0			-3697.0	-3801.3	-
State cash balance (7)	-404.5	-208.6	-1764.5	-1649.4	-208.6	-208.6	-44.9	-

(1) Available to date. (2) Balance of replies (%). (3) Quarterly data for quarter ending in month specified. (4) Corrected for calendar effects and temperature. (5) Year-to-date. (6) Year-on-year in '000s. (7) Balance in millions of euros.

International situation: Forecast summary

	Real GDP (% average)				Inflation (% average)			
	1999	2000	2001	2002	1999	2000	2001	2002
US	4.1	4.1	1.1	0.8	2.2	3.4	2.8	1.4
EMU	2.6	3.4	1.5	1.3	1.1	2.3	2.6	1.8
Japan	0.8	1.5	-0.7	-0.8	-0.3	-0.7	-0.8	-0.7

	Fiscal balance (% of GDP)				Current account balance (% of GDP)			
	1999	2000	2001	2002	1999	2000	2001	2002
US	1.4	2.4	1.2	0.2	-3.5	-4.5	-3.3	-2.7
EMU	-1.3	-0.8	-1.1	-1.4	-0.2	-0.7	-0.3	-0.3
Japan	-9.0	-8.9	-8.5	-8.5	2.5	2.6	2.4	2.5

	Official interest rate (%)*				Exchange rate (vs. $)*			
	A fecha de cierre	Mar-02	Jun-02	Dec-02	A fecha de cierre	Mar-02	Jun-02	Dec-02
US	2.00	1.75	1.75	2.50				
EMU	3.25	3.00	3.00	3.00	0.89	0.90	0.90	0.86
Japan	0.10	0.10	0.10	0.10	123	122	125	128

* End of period

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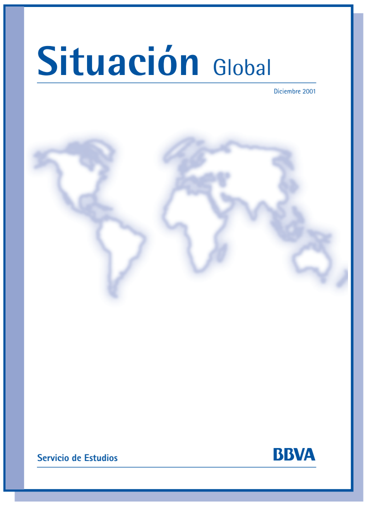

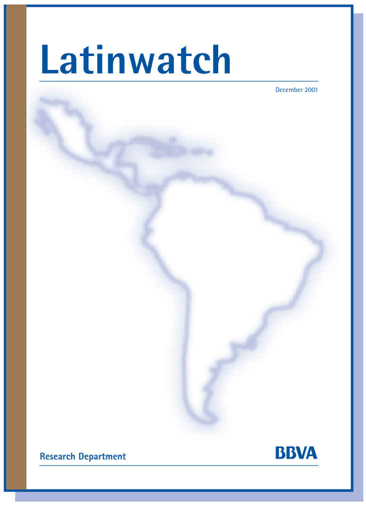

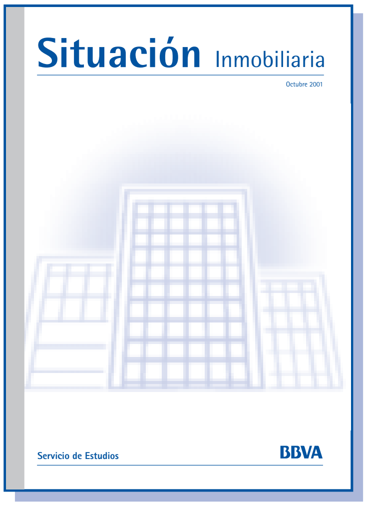

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