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Table of Contents

Executive Summary	1	Part II	
Part I		Chapter I	
The Economic and Financial Situation		The Price Wage Formation Process and	
in Spain	3	Labour Market Constraints	25
0. Introduction	3	Chapter II	
1. Supply-side performance and challenges	3	Competitiveness and External Performance	
2. Problems of stabilization	7	in the Catching-up Process	40
3. The pursuit of convergence as		Chapter III	
EMU progresses	11	Public Finance and Fiscal Reform	53
4. Summary and conclusion	13	Chapter IV	
Statistical Annex	14	Regime Applicable to Capital Movements	66
		Chapter V	
		The Financial System	68
		Chapter VI	
		The Conduct of Monetary Policy in Spain	77
		Chapter VII	
		Regional Disequilibria: Unbalanced Regional	
		Growth, Asymmetries and Consequences	84

Table of Graphs and Tables

Part I	Statistical Annex
Graph 1: Spain: GDP per Capita PPS, EUR12 = 100 3	Table 1: Final uses of goods and services and other key aggregates of the Spanish economy 14
Graph 2: Shares of GDP at Factor Cost 4	Table 2: Final uses of goods and services 15
Graph 3: Net Return on Net Capital Stock Total Economy (1973 = 100) 4	Table 3: Employment evolution 16
Graph 4: Nominal compensation per employee 5	Table 4: Prices (yearly changes in %) . . 17
Graph 5: GDP per person employed 5	Table 5: Contribution of the change (%) of the price deflator of total final uses 18
Graph 6: Real effective exchange rates ULC total economy and export deflator 5	Table 6: The balance of payments in Spain (as % of GDP) 18
Graph 7: Components of Domestic Demand: Contribution to real GDP Growth 7	Table 7: Imports and exports in volume terms (% annual growth) 19
Graph 8: Private Sector: Gross Saving and Investment 7	Table 8: Geographical breakdown of goods trade 19
Graph 9: Net Lending (+) or net borrowing (-) by sector 7	Table 9: Geographical breakdown of Spanish intra-community trade . 20
Graph 10: Real domestic demand & imports of goods 8	Table 10: Degree of openness , import penetration, and export activity in Spain and in the EC countries 21
Graph 11: Inflation by sector 8	Table 11: Nominal and effective exchange rates (index 1980 = 100) 22
Graph 12: Contribution to the change in the price deflator of total final uses (%) 8	Table 12: Receipts and expenditure of general government 22
Graph 13: Net lending or net borrowing of general government 9	Table 13: Monetary and credit indicators . 23
Graph 14: Bilateral spread between the Peseta and the weakest ERM currency . .10	Table 14: Counterparts of money creation . 23
	Table 15: Interest rates 24

Table 16: Economic performance relative to EUR-7 24

Part II

Chapter I

Graph 1: Change in wages, prices and unemployment rate 32

Graph 2: Contribution to the change in the price deflator of total final uses (%) 32

Table 1: Recruitment under the employment promotion programmes (EPP)

Table 2: Growth in total and temporary employment 34

Table 3: Temporary employment as a proportion of total wage-earners, total and by sector 35

Table 4: Employment growth 35

Table 5: Employers' social security contributions as a percentage of total taxation 35

Table 6: Unemployment rates by age group, 1989 35

Table 7: Changes in participation rates for men aged 55 and over. Spain, the Member States and international comparisons 36

Table 8: Principal characteristics of activity of those aged 14-24, 1989 36

Table 9: Unfilled job vacancies and skill shortages 36

Table 10: Education and training Information relates to education and training experiences during the four weeks preceding survey 37

Table 11: Participation rates and levels of education 37

Table 12: Part-time employees as a proportion of total employees, 1989 38

Table 13: Persons in employment by professional status, 1989 38

Table 14: Concentration of family working and self employment, by sector, 1989 38

Table 15: Persons in employment, by professional status and by age-group, 1989 39

Table 16: Nominal and real unit labour costs (% average growth) 39

Table 17: Contributions to the change of the price deflator of total final uses (%) 39

Chapter II

Table 1: The balance of payments in Spain (% of GDP) 41

Table 2: Degree of openness, import penetration, and export activity in Spain and in the EC countries 42

Graph 1: Product breakdown of non-energy imports Contrib. of non energy imports growth 43

Graph 2: Prod.breakdown of consumption imports Contrib. of consumption imports growth 43

Table 3: Spanish competitiveness between 1985 - 1991 44

Graph 3: Nominal effective exchange rates 45

Graph 4: Inflation by sector (% average annual rate) 45

Table 4: Invisible balance (% of GDP) 46

Graph 5: Tourism performance 46

Graph 6:	Saving and investment gap47	Table 10:	Central Government Debt (Distribution of outstanding debt according to the conditions of the issue) 63
Table 5:	Current and capital account balances (% of GDP)47	Table 11:	Central Government Debt (Outstanding debt at the end of the period) 64
Graph 7:	Current account's permanent finance (% of GDP)48	Table 12:	Public Debt of Central Government: Average residual life maturity of outstanding balances on 31 December 65
Table 6:	Net external financial position (December 1986 - September 1991, bn. \$)48		
Table 7:	Sectorial breakdown of direct foreign investment (% of total) . .50		
Chapter III			
Table 1:	Government revenue and expenditure (as % of GDP)54	Chapter V	
Graph 1:	Net lending or net borrowing of general government cyclically adjusted55	Table 1:	Spanish banks' profitability ratios 70
Table 2:	Increase in pensions, wages and income tax allowances and thresholds (% change)55	Table 2:	Comparative importance of Spanish credit institutions (measured by total assets) 71
Table 3:	Overruns on the state budget (non-financial payments)56	Table 3:	Structure of balance sheets of banking institutions 71
Table 4:	Breakdown of general government net lending or net borrowing . . .57	Table 4:	Structural data for the stock exchange in 1989 72
Graph 2:	Net lending or net borrowing of general government57	Table 5:	New liabilities of non-financial enterprises and households . . . 73
Table 5:	Financial assets and liabilities . .58	Table 6:	New liabilities of non-financial enterprises Public issues through the stock markets 73
Table 6:	Compliance with tax laws (Figures declared as a percentage of theoretical tax base)58	Graph 1:	Institutional Structure of the Spanish Stock Markets 75
Graph 3:	Fiscal pressure EUR-9 = 10058	Chapter VI	
Table 7:	Structure of taxes (%)59	Table 1:	Monetary and credit indicators . 80
Table 8:	Receipts and expenditure of general government63	Graph 1:	Nominal short-term interest rates differentials 81
Table 9:	Table of flows63	Graph 2:	Bilateral spread between the Peseta and the weakest erm currency . . 82

Chapter VII

Table 1 :	GDP per head with respect to EC, in pps	91	Table 7 :	Increase in training places required for adolescents aged 15-19 (% of places available in 1985) .	97
Table 2:	Investment in manufacturing, 1985-1987%	92	Table 8:	Distribution of the Fondo de Compensación Interterritorial in Objective 1 regions	98
Table 3:	Foreign and public investment, . .	93	Table 9:	Community Support Frameworks, MECU, 1989 prices	98
Table 4:	Level and structure of un- employment (1990)	94	Table 10:	Community grants in the objective 1 CSF, by axis	99
Table 5:	Population movements and activity rates	95	Figure 1:	Spain: Comunidades Autónomas	100
Table 6:	Structure of regional employment	96			

EXECUTIVE SUMMARY

In the second half of the eighties, the Spanish economy achieved among the fastest rates of GDP and investment growth within the Community. During this period, the country has made major progress in industrial reorganisation, in reforming and starting to open up the financial sector, and in liberalizing capital flows. It has also entered the ERM, albeit with wide margins.

Foreign capital inflows have been heavily encouraged by the twin factors of strong perceived opportunities for real investment and high rates of interest. That has been both necessary and appropriate in a period of demand dynamism characteristic of an economy engaged, after a painful readjustment between the mid-70s and the mid-80s, in a process of real convergence. Nevertheless, the spurt in growth in recent years has not yet restored the relative income level (*vis-à-vis* EC partners) of the early 1970s. But this strong real catching-up process caused inflationary pressures from the demand side which, taking account of the remaining rigidities in the economy, in due course have also become evident on the costs side.

Despite genuine supply-side improvements a number of structural deficiencies persist, particularly in the labour market, in the public finances and in an inadequately competitive structure of many sectors, most notably services, including financial services.

Fast growth of output in Spain has engendered impressive gains in employment (very largely temporary-contract employment) and an increase in participation rates. Nonetheless, the unemployment rate, while well below the peak of 22% reached in 1985, is still at a level (around 16%) much higher than in most other Community countries. Moreover, rapid employment expansion has been associated with mediocre growth in productivity. Inflation, which was below 5% in 1987, peaked at more than 7% last year and, currently at around 5.5% remains clearly out of line with inflation rates in the original narrow-band ERM countries. A notable feature of inflation performance in Spain has been the wide disparity between inflation in industrial goods (where inflation convergence with narrow-band countries has already been achieved) and services, where particularly high rates of increase in prices have been recorded recently.

At least part of the observed behaviour of relative inflation in services sectors in the recent past can probably be ascribed to macroeconomic factors - a demand boom outstripping current domestic supply potential. Nonetheless, there is clearly an underlying structural problem in services in Spain: insufficient competition combined with - or even created by - the regulatory public policies pursued in areas such as health, transport and communications has led to an inefficient allocation of resources in the economy as a whole and has thereby reduced the volume of output and employment consistent

with any given rate of overall inflation. Thus structural factors almost certainly contributed to the acceleration in overall inflation in Spain in 1988/90 as output and employment increased faster than the short-term capacity of the economy to grow without strains.

Domestic demand was growing fast and progressively in excess of output leading to a trade and current account balance deterioration. Public savings did not increase enough to compensate for the reduced saving rate of the households, resulting in insufficient domestic savings to finance the strong investment process.

The restrictive measures adopted in 1989 together with a further worsening in expectations in reaction to the Gulf crisis allowed a slowdown in domestic demand which halted the growth in the trade deficit and stabilized the inflation rate, despite the temporary effect of oil price increases.

Nevertheless, some confidence about moderation of disequilibria, combined with the optimism associated with the special events of 1992, could restore the economy to a temporary new expansionary path.

The main goal for the economic authorities has been and should be to maintain investors confidence in prospects for the economy. That means that improved economic efficiency should be translated into productivity, and external competitiveness gains, to allow a non-inflationary and sustained path of economic growth.

A policy of wage moderation would contribute to avoiding the risk of a re-emergence of overheating in the economy. But, an incomes policy will not be effective in restraining inflation if the growth of aggregate demand is excessive. In this respect, a slowdown in real wage costs would reduce the pressure on demand through a reduction in the real disposable incomes of households and would positively affect the cost formation process. In a dual labour market such as exists in Spain, where wages are set in the permanent segment of the market, an incomes policy presumably has a more institutional aim: to ensure, whether by persuasion or by legal compulsion, a degree of wage moderation that the non-competitive structure of the labour market is unable to produce. But it cannot replace the required reform of the labour market.

On the other hand, a policy of global wage moderation might prove to be ineffective in damping inflation since employers would be more ready to widen profits by simply increasing prices in a context of booming demand. In this respect, the slowdown of demand in 1991 has forced some moderation.

Monetary policy has faced significant constraints. Conditions of strong external confidence and high interest rates have encouraged substantial capital inflows and have created the well-known dilemma between allowing the peseta to ap-

preciate at the expense of preserving exchange rate stability (near the top of the ERM wide band) or continuing reducing interest rates, with the risk of an undesired domestic demand expansion. As Stage 2 of EMU approaches, the possibility of an independent Spanish monetary policy response would be further limited. But, as long as full nominal convergence has not been achieved, monetary policy, although subject to constraints, should remain restrictive.

Therefore, a major contribution from budgetary policy might be required. However, there would clearly be both practical

limitations and drawbacks to an active countercyclical use of fiscal policy. What is more, the key issue for fiscal policy will not only be its role as a demand stabilizer but rather its impact on the supply side through the implementation of tax reform (lowering corporation tax relief, reducing the direct tax burden on households, limiting tax fraud and indirect tax harmonization) and the reshaping of public expenditure (lower current expenditure and sustained public investment).

PART I THE ECONOMIC AND FINANCIAL SITUATION IN SPAIN

0. Introduction

The Spanish economy, after a long-drawn-out and difficult period of adjustment in the 1970s and early 1980s, showed considerable dynamism in the second half of 1980s, with strong growth in employment, output and - in particular - investment, much of it financed by capital inflows. This dynamism has partly reversed the previous steep fall in income levels in Spain relative to those in the Community as a whole, but the country's income levels are still around 20% lower than the EC average.

The recent period of dynamism has since 1988 been associated with a rising real exchange rate and the emergence of a large current account deficit more than matched by capital inflows - but also with an overheating economy and an increase in the inflation rate that only began to turn down somewhat after spring 1990.

This study seeks to analyse and explain these developments in terms both of private sector behaviour and of economic policies, and to assess the challenges faced by the Spanish economy as it moves towards 1994 and the second stage of EMU.

The first part reviews the supply-side factors underlying Spain's recovery, from the mid-1980s, after a very difficult decade. It concludes that genuine supply-side improvements have taken place, even though they have not as yet been reflected in a sharp acceleration in productivity. It also points, however, to a number of persisting structural deficiencies. The second part analyses the problem of macroeconomic stabilization - in terms of demand, activity and inflation - under the impact of supply-side developments and in the presence of constraints on policy. A following section assesses the prospects for the current cycle to enter a new phase in which nominal disequilibrium can be reduced while avoiding too sharp a slowdown in activity so that earlier investment bears fruit in higher productivity and an adequate return to foreign and domestic investors. An improvement in competitiveness via greater mastery of domestic cost increases, coupled with an adequate budgetary policy, is identified as the key to achieving the degree of nominal convergence necessary for Spain to enter Stage 2 with confidence. However, as the penultimate section of the report recalls, the process - inevitably a long one - of Spanish real convergence is likely to generate new cycles in demand. The study reflects on the policies available to react to such cycles, and points to the choices that will have to be made in facing the challenge of carrying the catching-up process forward while achieving the degree of nominal convergence necessary for future stages of EMU.

1. Supply-side performance and challenges

The Spanish economy underwent a painful adjustment after 1974....

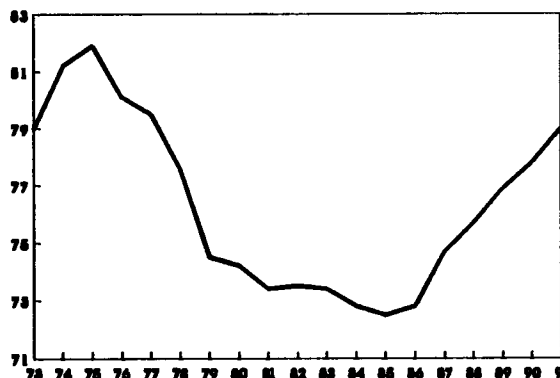
From 1986 to 1990 the growth of the Spanish economy (4.5% per year on average) was among the highest in the Community. The boom in investment and employment characterised this period, during which GDP per head caught-up five percentage points compared to the EC average.

Nevertheless the present situation only represents a return to the relative levels of the first half of the 1970s. Between 1975 and 1984, Spain lived through an exceptionally long and deep economic crisis. A new political and economic model was taking shape at a time when the economy was suffering the impact of the two oil shocks. Over ten years, fixed investment fell 22 %, employment declined 15 %, consumption suffered a long stagnation and GDP per head lost ten percentage points relative to the EC average.

During this period the Spanish economy was still characterised by widespread non-market behaviour of economic agents, trying to avoid competition and asking for public subsidies, a high degree of protectionism and large institutional rigidities in different markets.

As the unemployment rate grew from 3 % in 1974 to 22 % in 1985, the public sector tried to maintain social cohesion and support the costs of reorganisation of the industrial and fin-

Graph 1: Spain: GDP per Capita PPS, EUR12 = 100



Commission Forecast Oct-Nov 91 for 1991
Source: Commission Services.

ancial sectors. The general government deficit, close to zero in the first half of the 1970s, reached some 7 % of GDP in 1985. Gross public debt rose from 12 % of GDP in 1974 to 45 % in 1985.

... but the ground was being prepared

At the end of 1982 the new government, enjoying a large majority and initially backed by the trade unions, implemented a stability-oriented economic strategy in order to regain domestic and external confidence.

After the devaluation of the peseta (December 1982), a more stringent monetary policy was implemented and an acceleration of the restructuring of the industrial and financial systems took place. The latter, together with the policy of wage moderation, led to both an improvement in productivity and a sharp deceleration in unit labour costs. This, in turn, resulted in a strong recovery of the gross operating surplus permitting an improvement in the financial situation of companies, and paved the way for a boost to investment.

Moreover the apparent rate of return in the Spanish economy has risen much faster than the EC average since 1984.

The business climate benefited from worldwide economic expansion, the prospect of EC entry, lower real interest rates and the 1986 fall in oil prices. Moreover the trend toward economic liberalisation gained momentum with the supply-side economic reforms enacted in 1984-1986, notably in the field of financial and exchange controls and labour market legislation¹.

EC entry led to the phased dismantling of external tariffs and to the introduction of the VAT, with an implicit widening of the tax base. As a result of some expenditure moderation and

increasing receipts, the general government deficit fell about 4 percentage points, in terms of GDP, to 3.2 % in 1987.

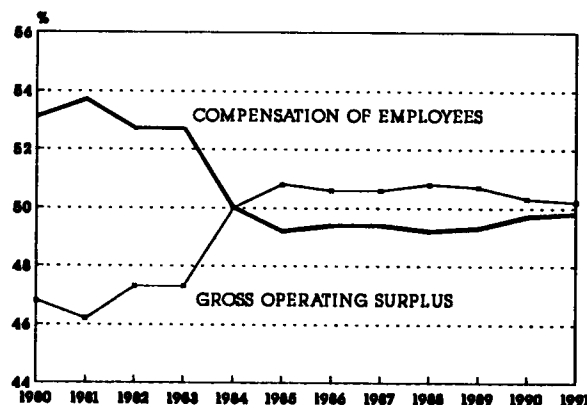
These changes under way considerably increased the attractiveness of the Spanish economy for foreign investors not only as a platform to reach the wider EC market (typical of US and Japanese investments), but also as a domestic market in itself with an enormous potential growth and high prospect of profitability. Foreign direct investment increased its role in sustaining rapid economic growth and in modernizing industrial structures, business management and know-how.

... for a major supply-side improvement ...

During the six years to 1990, Spain achieved an impressive investment performance (+ 80% in real terms partially supported by a four-fold increase in imports of capital goods), which laid the foundations for a strengthening of the productive base and for an acceleration of potential growth. In this period the manufacturing sector modernised its productive structure, even reorienting to some degree towards activities with higher capital content, new areas of specialization and diversification of products, and becoming more involved in intra-industry EC trade.

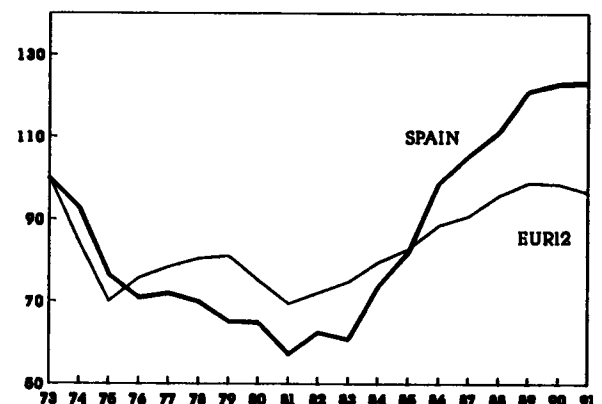
The good results in recent years have permitted a strengthening of the financial structure of the enterprise sector. The self-financing rate rose by 20 percentage points between 1983 and 1988 and the dependence on bank credit has been substantially reduced. Thus, in spite of a reduction in profits in 1990 and 1991 Spanish enterprises remain in a financial position which is much more solid than some years ago and comparable to European competitors.

Graph 2: Shares of GDP at Factor Cost



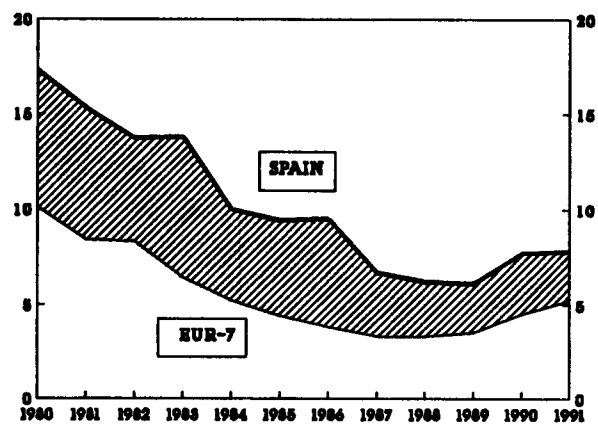
Source: Commission Services. Forecasts Oct.-Nov. 91 for 1991

Graph 3: Net Return on Net Capital Stock Total Economy (1973 = 100)

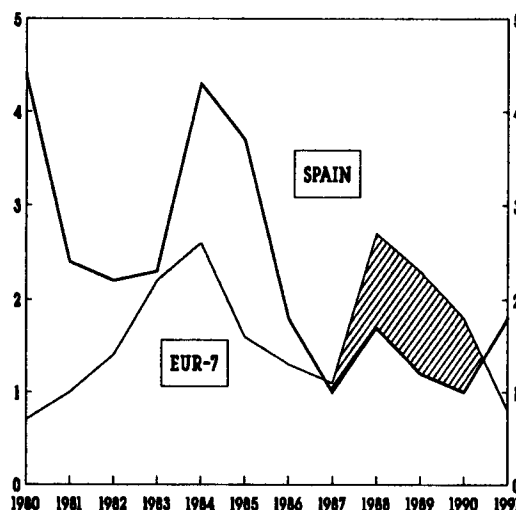


¹ Temporary contracts were introduced and an easing in the lay-off conditions attached to these contracts.

Graph 4: Nominal compensation per employee (annual percentage change)



Graph 5: GDP per person employed (constant prices, annual % change)



Source: Commission Services. Forecasts Oct.-Nov. 91 for 1991
EUR-7: B, DK, D, F, IRL, L, NL

The improved business climate resulted in a large increase in employment (+15% in the six years to 1990), but it was accompanied by a sharp increase in labour market participation and an increase in the potential labour force. In consequence, the unemployment rate fell slowly and has now stabilised around 16%, but without any apparent moderating influence on the wage formation process.

The main feature of the rise in employment has been a remarkable increase in temporary-contract workers, especially in the service sector. Between 1987 and 1990, 87% of total new employment was located in the service sector; 85% of it comprised temporary workers. That fact has had a double effect. First, the presence of a high share of temporary workers means that firms have been able to moderate average compensation per worker during a period when economic activity has accelerated rapidly. Second, temporary workers have expanded employment mainly in low-wage jobs in the service sector, pulling down the average.

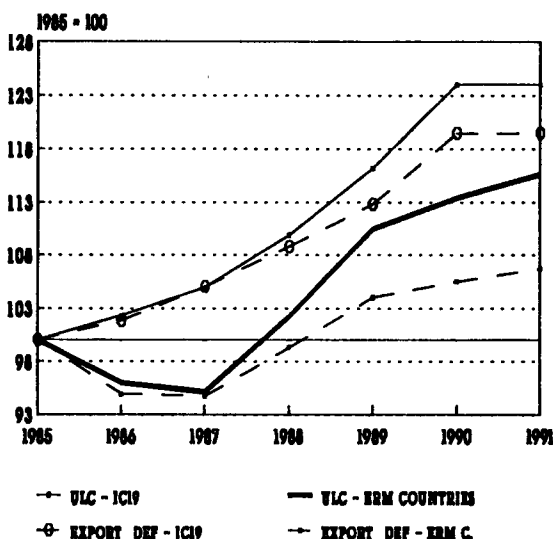
At the same time, a bigger increase of employment in the service sector, which is traditionally labour-intensive, than in the industrial sector explains why aggregate productivity growth in the upturn has been modest.

Unit labour costs have been growing faster than in those countries in the narrow band of the ERM since 1979. In terms of external competitiveness, higher growth of unit labour costs together with the nominal appreciation of the peseta meant a substantial appreciation of the real exchange rate and, therefore, a loss of competitiveness of Spanish goods and services in the external market, especially against all industrial countries (namely due to the US dollar fall).

In spite of the current productivity differentials, Spain's lower level of labour costs, compared with those of EUR 7,

still make it attractive for foreign investment. Moreover, an appreciation of the real exchange rate (or, in other words, a reduction in competitiveness) is a feature of a "catching-up" process.

Graph 6: Real effective exchange rates ULC total economy and exporte deflator



ERM = narrow band; ICI9 = 19 industr. countries.

Source: Commission Services. Forecasts Oct.-Nov 91 for 1991.

..... that still needs to be carried further.

Although great efforts have been made to eliminate rigidities, some important structural constraints still exist

- The need for investment in infrastructure and social services is still very high. Combined with this is a need for technological innovation, management modernization and rationalization of the size of firms to be maintained.
- The opening-up of the economy as a result of Spain joining the EC has seen import penetration rise. The share of output going for export has remained at a low level in spite of gains in EC markets.
- The greater opening-up has not affected all productive sectors to the same extent. The service sector, except for tourism, remains quite closed. The lack of external competition in the service sector allows the existence of a wide divergence of product prices and inflation as between tradeables and non-tradeables. The persistence of a high core of inflation pressures from services affects the whole of the economy through the indexation of salaries to a global measure of inflation.
- The expansion in the number of temporary workers since 1985 has actually magnified the degree of segmentation in the labour market. The rigidities are mostly embedded in that part of the market where permanent workers predominate; they explain why nominal wages have not responded to comparatively high levels of unemployment and, at the same time, contribute to the persistence of that level of unemployment. The principal features are : evidence of mismatch, the difficulty of new entrants especially young workers in penetrating the permanent sector of the labour market, reduced job search, and the compression of regional pay differentials.
- From the regional side, the problems of finding a job in low activity regions, and the obstacles to formal employment creation in the private sector in those regions, are exacerbated by the structure of collective bargaining. National collective bargaining tends to be conducted within the high activity regions; the transmission of national wage settlements from high-activity to lower-activity regions leads to a comparatively low degree of dispersion in regional wage

differentials. But unlike experience in some other European countries, a more centralized collective bargaining has not contributed to some disciplinary effect in wages growth. In terms of output levels, the recent upswing in economic activity has failed to produce a trend towards regional convergence. The diversity of performance between backward and prosperous regions has not been corrected. This represents a fiscal burden and limits the potential market of the growing regions.

- Although a significant reduction has been achieved, the general government deficit has persisted. At the same time, regional administrations have also had increasingly imbalanced accounts which have been an additional obstacle to reducing the overall deficit. As regards expenditure, the possibility of exceeding budgetary limits, the high level of subsidies to public enterprises and a lack of efficient control over expenditures are the principal features that still exist. On the revenues side, the extensive fiscal fraud and the long delays in achieving a consolidated tax system are the main structural problems.
- From the comparison of Spanish financial institutions with those in other countries, they seem to have had traditionally higher than average intermediation margins. The multiplicity of banks and overbranching involve diseconomies of scale. This, combined with overstaffing, has maintained the cost of channelling resources at a high level. However, the intensification of banking competition has caused, since 1990, a substantial decline in intermediation margins.
- The role of the Spanish Stock Exchange in channelling private sector savings towards investment projects is a modest one. Moreover, the low level of market capitalization (primary market) and the very limited volume of transactions (secondary market) denote a clear lack of development in the Spanish bond market, with the exception of the public debt market organized by the Bank of Spain.

These factors taken together are both symptoms and causes of the persistent gap between real incomes in Spain and those in the richer member countries of the Community.

2. Problems of stabilization

An improvement in supply prospects led to saving-investment imbalance...

From the first half of 1988 onwards the Spanish economy started to show signs of overheating which became more obvious in the following year. From 1986 to mid-1990, domestic demand has been growing fast and progressively in excess of output, reflected in a trade balance deterioration and, from Spring 1988, causing a rise in inflation. Buoyant domestic demand was pushed upwards not only by very strong investment but also by private and public consumption.

The high rate of employment creation, associated with accelerated economic growth, was reflected in a sustained rise in household disposable income. This upward trend was reinforced by increases in non-labour income also. In addition, asset inflation resulted in a significant "wealth effect" for asset holders, while simultaneously diverting household expenditure flows from investment into consumption goods. Finally, as consumer expectations turned markedly positive, after several years of depressed economic conditions, the household saving rate fell.

... and the economy overheated...

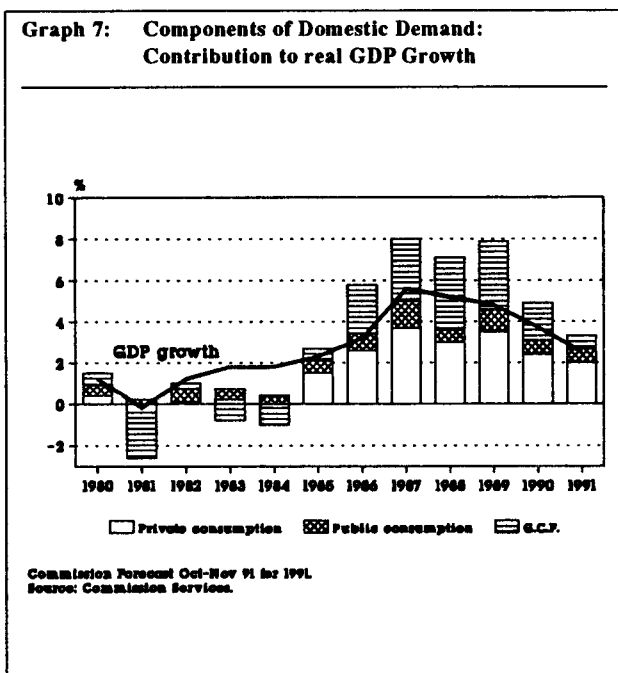
The incapacity of domestic saving to finance the strong investment caused a growing current account deficit. The ending of the period of budgetary adjustment meant that public saving did not increase enough to compensate for the reduced household saving rate.

The presence of very strong domestic demand, while constraints from productivity capacity left indigenous supply unable to respond and to adapt quickly to the new requirements of the domestic market, caused a switch to external sources. Thus, the shift in internal demand towards imported goods sharply increased the trade and current account deficits. A substantial fall in tourism receipts (from 5.2% of GDP in 1986 to 3.8% in 1990) further aggravated the deficit in the current account balance.

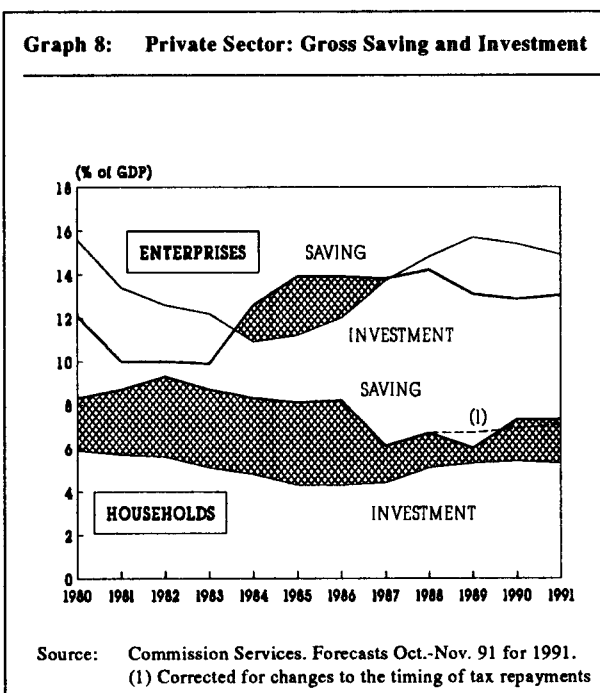
At the same time as domestic demand was growing clearly faster than that of Spain's main trading partners, the reappearance of accelerating inflation in the second half of 1988 together with a significant nominal appreciation of the peseta caused a substantial loss of external competitiveness which negatively affected trade in goods and services.

On the other hand, one of the main underlying factors behind the current inflationary process is the pressure from domestic demand on services. That sector, which still remains very closed to external competition, is able to transmit excess de-

Graph 7: Components of Domestic Demand: Contribution to real GDP Growth



Graph 8: Private Sector: Gross Saving and Investment



Graph 9: Net Lending (+) or net borrowing (-) by sector

