

Spain: 2002 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Spain

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the Article IV consultation with Spain, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **November 11, 2002**, with the officials of Spain on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on January 15, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its February 10, 2003 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for Spain.

The document(s) listed below have been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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SPAIN

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation with Spain

Approved by Michael Deppler and G. Russell Kincaid

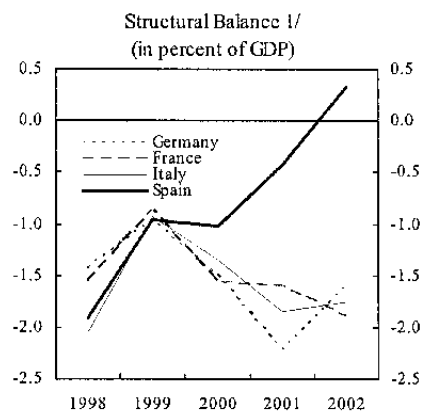
January 15, 2003

- Consultation discussions were held in Madrid during October 30–November 11, 2002.
- The staff team comprised Messrs. Leipold (head), Hoffmaister, and Céspedes (all EU1), and Ms. Dabán (FAD). Mr. Varela (OED) participated in the meetings.
- The team met with Vice-Prime Minister and Minister of Economy Rato, Minister of Finance Montoro, Bank of Spain Governor Caruana, and other senior officials. It also met with representatives of financial institutions, the employers' association, and labor unions, and with the economic spokespersons of the major political parties.
- Spain is a founder member of the euro, maintains an exchange system free of restrictions on payments and transfers for current international transactions and has accepted the obligations of Article VIII, Sections 2, 3, and 4 (Appendix I).
- Spain has subscribed to the Special Data Dissemination Standard.
- The authorities have indicated their intention to publish this staff report.

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I. INTRODUCTION

1. **The 2002 Article IV discussions took place with the government of Prime Minister Aznar entering the final year of its second mandate, having realized substantial structural reforms that have underpinned vigorous growth.** For a number of years now, Spain has pursued policies largely in line with past Fund advice, characterized by a stability-oriented fiscal policy, extensive labor and product market reforms, and the maintenance of wage moderation. The growth and employment pay-offs have been evident, and entailed a significant narrowing of per capita income differentials with the euro area (Table 1 and Figure 1). In addition, by making judicious use of the expansion to improve its underlying fiscal position, Spain succeeded in complying with the Stability and Growth Pact (SGP) commitments as from 2001, in contrast to the experience of other major euro area countries. The new Budgetary Stability Law and permanent financing arrangements with the autonomous communities are serving to strengthen the medium-term fiscal framework, as sought by the Fund. Finally, banking supervision has been proactive and rigorous in the face of potential risks, and the authorities have agreed to undertake a Financial Sector Assessment Program (FSAP).



Source: IMF, *World Economic Outlook*.
1/ Cyclically adjusted fiscal balance, excluding asset sales.

2. **Nonetheless, performance in a number of key areas remains inadequate.** These areas have been the focus of Fund advice going forward: both inflation and unemployment remain high, competitiveness vis-à-vis the euro area has been slipping, and regional income and unemployment dispersion is still pronounced. Much has been achieved to improve the workings of the labor market, but the recommended greater wage differentiation has remained elusive. The Fund has also pressed for a continued, even if gradual, phasing in of pension reforms to meet Spain's comparatively late, but large, demographic shock. While steps have been taken, the reform momentum has been difficult to maintain.

3. **This year will be punctuated by a series of local, regional, and European elections, culminating in general elections in the spring of 2004.** In this setting, a pre-electoral climate is taking hold. Prime Minister Aznar has declared he will not run again, but his successor at the helm of the center-right *Partido Popular* remains to be selected.

II. ECONOMIC BACKGROUND

4. **After a sustained expansion in the late 1990s, Spain has experienced a second year of subdued growth—albeit still well above the euro area average.** This performance owes much to the relative resilience of Spain's domestic demand, in turn due to a comparatively stronger showing of investment, sustained by a continued public infrastructure effort and booming construction activity. Private consumption—after having been the mainstay of the earlier upswing—stood up comparatively less well, as households coped with rising inflation, higher indebtedness, and some fiscal drag. The decline in equity values,

fueled in some cases by the difficulties in Latin America (which otherwise had only a limited direct effect on the Spanish economy), also sapped consumer confidence. Finally, the impact of the trade shock was comparatively pronounced—due primarily to the economy’s exposure to the weakness in tourism (which accounts for 10–12 percent of value added, with a large contingent of German tourists) and possibly to the further loss in competitiveness within Europe (Figure 2).

Selected Economic Indicators, 2001–2003
(Real growth rates in percent, unless otherwise noted)

	2001	2002	2003
Real GDP	2.7	2.0	2.4
Output gap 1/	0.2	-1.0	-1.6
Final domestic demand	2.7	1.9	2.6
Net exports 2/	-0.1	0.0	-0.3
Harmonized inflation	2.8	3.6	3.1
Employment	3.7	1.6	1.9

Sources: *World Economic Outlook* and Fund staff estimates.

1/ In percent of potential GDP.

2/ Contribution to growth.

5. Recent high frequency indicators

suggest that, despite some pickup, growth will remain below potential over the coming period. National accounts data through the third quarter of 2002 suggest that the slowdown in domestic demand may have reached bottom and begun slowly to recover—driven mostly by a gradual strengthening of investment, particularly due to robust construction activity. Private consumption slowed further, with consumer confidence weakening to its lowest level in several years and households appearing intent on reconstituting their savings, in the face also of slower employment growth and steadily rising unemployment. All in all, most projections (including by staff) concur in foreseeing only a rather gradual pickup toward potential growth (estimated at around 3 percent) in the course of 2003, yielding average annual growth of some 2½ percent.

6. Despite the weakening of aggregate demand and the larger output gap, inflation has risen and the inflation differential vis-à-vis the euro area average has widened.

Inflation (HICP) reversed its moderating trend toward late 2001 and has since climbed steadily, reaching a 12-month rate of 4.0 percent in December 2002—corresponding to an inflation differential of 1¾ percentage points with the euro area. While the 12-month rate reflects some temporary factors, average inflation for 2002 is likely to be around 3½ percent, exceeding the euro area average by some 1½ percentage points—in excess of most estimates of any likely by-product of real convergence (see further discussion in ¶13 below).

7. A small general government deficit is now estimated for 2002, due to shortfalls at the regional level; the budget again aims for balance in 2003.

At the time of the discussions, the authorities were counting on achievement of the targeted general government balance in 2002. Latest official estimates now point to a slight deficit (0.2 percent of GDP): a growing social security surplus (0.8 percent of GDP) is expected to counter a small central government deficit and more appreciable slippage by the autonomous communities (a deficit of 0.5 percent of GDP). An overall general government balance is again targeted for 2003 (Table 2). The authorities point, however, to continued uncertainty regarding the autonomous communities’ outcome in 2002 (with firmer data available only in February), and have indicated that the clean up costs for the recent oil spill could weigh appreciably on the 2003 budget.

8. The policy mix is one wherein easy monetary conditions were accompanied in 2002 by appreciable fiscal withdrawal; a similar setting appears in store for 2003.

Monetary conditions are clearly supportive: given Spain's higher inflation, real interest rates are comparatively low—indeed, at an unprecedented low level in recent history—and the common monetary policy was accommodating even before the interest rate reductions of early December 2002. The fiscal policy stance was, in contrast, restrictive, with the estimated budget outcome for 2002 implying a withdrawal of around ½–¾ percentage points of GDP. For 2003, the balanced budget target is, as noted, based on relatively optimistic growth assumptions (3 percent) and, as such, is officially intended to entail a broadly neutral fiscal stance. Under the staff's growth projection, achievement of the target would imply a further fiscal withdrawal (of around ½ percentage point of GDP).

III. REPORT ON THE DISCUSSIONS

9. **With the authorities having achieved notable progress across a broad range of areas, the discussions focused on the main economic priorities for the rest of the present government's mandate.** Within the overall objective of ensuring continued real convergence, the authorities' main economic priorities to the end of the legislature were, first, to safeguard the achievements in the fiscal area, notably by pursuing nominal fiscal balance and implementing the Budgetary Stability Law (BSL), while proceeding with income tax reduction; second, to see through a series of reforms underway, particularly the recently approved modifications to the unemployment benefits regime, gradual changes to the pension system in agreement with the social partners, and the finalization of a series of initiatives to promote entrepreneurial activity and improve corporate governance. Staff supported these objectives but—while acknowledging Spain's considerable progress since EU accession—it also noted that, given an unflattering starting position, important shortcomings persisted (see text table) and needed to be at the center of a continued structural reform effort.

Progress and Lagging Areas
(In percent unless indicated otherwise)

Progress areas	Change 1995 - 2001
Per capita income relative to euro area average	from 63 to 75
Rate of unemployment	from 23 to 10.5
General government deficit (percent of GDP)	from -7 to -0.1
General government debt (percent of GDP)	from 63 to 57
Lagging areas	2001
Inflation	3.6
NAIRU	about 10
Regional unemployment rates (percentage points)	
Range (max-min) 1/	14
Standard deviation	4

1/ This compares to 10, 18, and 22, respectively, for Belgium, Germany, and Italy.

A. Cyclical Outlook

10. **The authorities expressed confidence in the economy's ability to weather the current adverse economic climate and continue to grow appreciably above the EU average.** Official projections place real GDP growth at 2.2 percent in 2002 and 3 percent in 2003, with driving elements of the latter being an estimated ½ percentage point boost to private consumption from income tax cuts and a continued public investment effort. (The 2003 budget incorporates income tax cuts for all brackets, centered particularly on lower incomes, and envisages a 13 percent nominal increase in capital spending.) While staff agreed that a recovery appeared to be in store, it held a less sanguine view of the prospects for private consumption, given households' current financial situation and the depressed state of consumer sentiment. It accordingly projected lower real GDP growth of 2 percent in 2002, picking up to close to 2½ percent in 2003. These projections (in line with the December

Consensus Forecasts) imply a further widening of the output gap in 2003 (to about 1½ percent of potential GDP). The authorities, in reviewing various risks to the outlook, concurred that these were prevalently on the downside and, in the update of the Stability Program presented in late December, a “less favorable” scenario postulates growth of 2 percent in both 2002 and 2003 (Table 3).

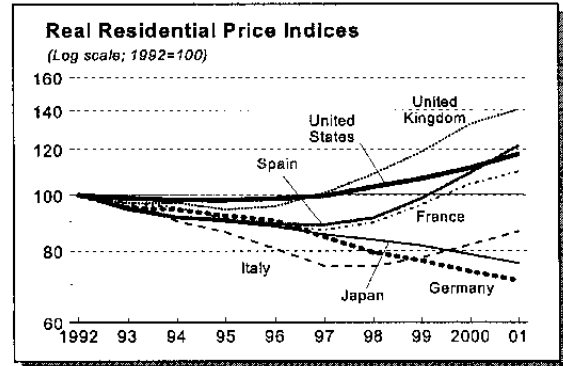
11. **The main shared concern regarded inflation performance and the maintenance of wage moderation.** The authorities attributed a good part (some ¾ percentage points) of the rise in inflation since its low point in late 2001 to a series of one-off factors—including the introduction of the euro, increases in indirect taxes, and oil price rises earlier in 2002. While they anticipated a decline of inflation by the spring of 2003, as these effects receded, they were concerned that social agents would misinterpret the temporary rise in inflation and perpetuate its impact through increased wage demands in the upcoming negotiations. Furthermore, staff noted that the overshooting of the official inflation target (intentionally aligned to the ECB target of 2 percent to lower inflation expectations) risked further entrenching the recourse to backward-looking wage safeguard clauses, which already covered some 75 percent of workers. Staff also expressed concern about the demonstration effect provided by the relatively high wage increase granted to public sector employees—albeit following earlier rigorous moderation in this sector. At the time of writing, there is as yet scant information on the likely outcome of the current wage negotiations: while it appears that wage demands are contained, the recourse to safeguard clauses is likely to become more extensive—as had indeed been signaled by trade unions in the mission’s meetings.

12. **The discussions reviewed a number of downside risks.** As is the case more generally, Spain’s growth prospects are exposed to appreciable downside risks from the current geopolitical environment and potential further pressures on oil prices. The authorities estimated that a sustained 20 percent increase in oil prices would dampen growth by about 0.2 percentage points. In addition, one could not rule out “worse case” scenarios that could reduce global growth by considerably more, with a notable impact on an open economy such as that of Spain. The discussions focused on three other sources of downside risks seen as being particular to Spain, as follows:

- **Household indebtedness:** EMU-related lower interest rates and the boom in mortgage and durable goods loans have pushed household indebtedness to new highs—from around 45 percent of gross disposable income in the pre-EMU period, to close to the euro area average of 80 percent by 2001 (Figure 3). The authorities viewed this adjustment as a normal structural shift to new financing conditions. Staff noted, nonetheless, that the rapidity of the rise in indebtedness could induce consumers to pull in their horns, possibly abruptly, in the face of softer employment prospects.
- **House price “bubble”?** With house prices increasing by double-digit levels for several years, many observers viewed the Spanish housing market as ripe for a correction. To date, however, the housing boom was seen to have provided an important offset to the effect on household wealth provoked by lower equity prices,

especially given a much larger stock of housing wealth relative to that of equities. (Real estate assets account for approximately 70 percent of total household wealth.) By the same token, however, staff remarked that any sudden price correction could have a large impact on consumption.

The authorities were less concerned: while anticipating a leveling off in prices and some possible decline in real terms, they did not view recent developments as reflecting a speculative bubble. Housing values were being driven by fundamentals, notably: increased demand generated by the durable change in financing conditions associated with EMU, the demographic



profile of the Spanish population (younger than in other European countries, with the “baby boom” occurring in 1970–75), rising income levels, and increased housing demand by both immigrants and nonresidents (with a relatively high weight of residential tourism). In addition, staff saw generous tax relief on home purchases as a possible further factor shoring up demand, although such relief had been reduced somewhat over time. On the supply side, staff also pointed to rigidities in the availability of development land, and pressed for measures to address this bottleneck, given also its adverse impact on labor mobility.¹ The authorities agreed, although they assigned somewhat lesser importance to supply constraints (noting that the supply of housing had doubled its historical annual average, to a rate of 500,000 new houses). They also recalled the constitutional difficulties encountered by earlier attempts to reform the laws on land supply. In meetings with parliamentarians, the latter suggested possible scope for a bipartisan approach to this issue.

- ***The fall-out from the difficulties in major Latin American countries:*** the authorities noted that the direct channels through which such difficulties could affect the Spanish economy were limited. Direct trade linkages with Latin America are small (their share in total exports does not exceed 5 percent), while any retrenchment of investment plans by domestic companies exposed to the region would have a minor overall impact (with such companies accounting for only 2–3 percent of total investment). There had of course been an appreciable impact on major banks’ balance sheets (see Section C below), but the observed deceleration in domestic credit growth was seen to reflect both lower credit demand and increased bank caution to domestic risks—the latter being welcome, and in fact encouraged, by banking supervisors. The authorities noted that any risk of credit rationing by major commercial banks,

¹ The supply of development land is controlled by municipalities, whose revenues include property taxes and sales of their land holdings, and who have found it advantageous to limit the supply of land to boost values.

which they considered to be small, was tempered by the prominent role of savings banks and other credit institutions in the financing of the economy. Staff concurred that the direct economic impact of Latin American difficulties had been—and was likely to remain—muted, but the related decline in the equity values of internationally active banks and companies had likely contributed to the weakening of consumer and business confidence, indirectly depressing consumption and investment.

13. **There was considerable uncertainty about the extent to which comparatively higher inflation would affect real convergence.** While the authorities shared staff concerns about the cumulative effect that a persistent inflation differential could have on the economy's competitiveness, they did not view the problem as imminent. First, they noted that Spain had entered EMU at a competitive exchange rate, and pointed to the continued maintenance, or even some gains, in market shares. The relative stability of the current account balance was also viewed as a source of comfort (Table 4). Second, they were confident that the present spike in inflation would recede in early 2003 as the underlying one-off factors were reabsorbed. Third, and most importantly, they felt that the inflation differential could be largely attributed to a benign equilibrating adjustment process within monetary union. They agreed that the available data provided scant support to the Balassa-Samuelson hypothesis, with Spain's productivity relative to the euro area appearing to have fallen in recent years (Box 1). But they noted that extensive data revisions were underway and that, once completed in 2003, they could well yield a more intuitive result on this score. Staff concurred that part of the inflation differential could be deemed a by-product of real convergence,² and there was agreement that, once data revisions were completed, more research would be needed to understand the causes of inflation.

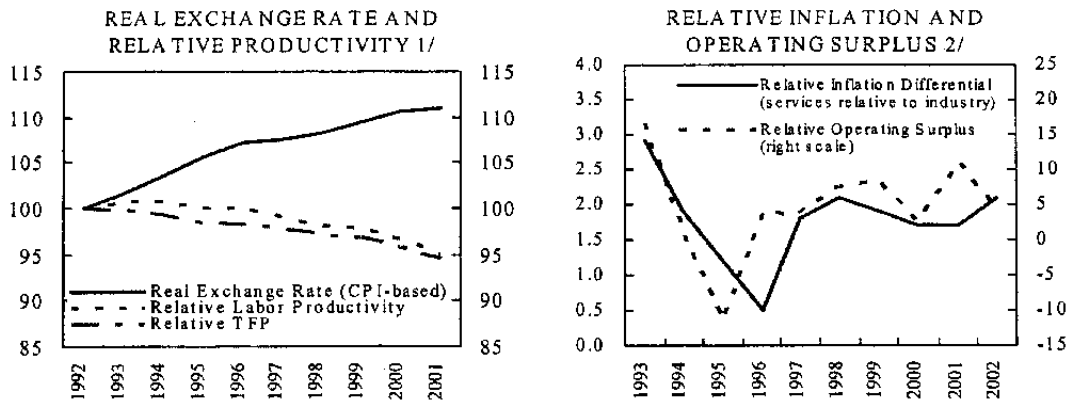
14. **But staff also pressed the need to address the supply rigidities stemming from inadequate competition in specific services sectors, where the convergence process was likely to be prompting relatively stronger demand pressures.** Despite a lack of empirical studies, there was general agreement that the catch-up in income levels was likely to produce an unevenness in the pressure of demand, hitting services and nontraded goods prices harder. In this setting, staff expressed concern about the obstacles to the required supply response in the services sector. In particular, in an effort to protect local markets and small retailers, regions (to whom relative competencies had been devolved) had been imposing increasing barriers to entry in retail distribution and trade. The sector's ability to increase its profit margins—relative to those prevailing in sectors exposed to international competition (notably manufacturing)—was suggestive of inadequate competition as contributing to the stubbornness of inflation (see Box 1).

² Previous analyses have placed this between ¼ and 1 percentage point; see Spain, Country Report No. 02/53 (3/13/02); Monetary and Exchange Rate Policies of the Euro Area—Selected Issues, Country Report No. 02/236 (10/29/02); and European Commission, *Quarterly Report on the Euro Area*, No. IV/2002 (Box 3—Empirical Studies of the Balassa-Samuelson effect).

Box 1. Inflation, Productivity, and Profit Margins

Spain's inflation differential with the euro area average widened to about 1½ percentage points for most of 2002, and has averaged about 1 percentage point in the decade ending in 2002. In consequence, the real exchange rate (both CPI and ULC based) vis-à-vis the EU has shown a steady appreciating trend. The extent to which these developments raise real convergence issues depends on whether equilibrium factors are at play:

- **The Balassa-Samuelson (B-S) effect**—the impact of wage increases on nontraded goods prices caused by relatively higher productivity increases in traded goods—is an often-cited equilibrium explanation for inflation differentials in monetary union. **In Spain, however, labor and total factor productivity relative to the EU have declined** (see figure), and the bulk of empirical studies—Estrada and López-Salido (2001) and Rogers (2001) and references therein—have had difficulties in reconciling the Spanish data with this effect. Currently, productivity and related data shortcomings are being examined, and data revisions are underway.
- **Convergence of nontraded goods prices as income levels rise** is a natural outcome of real convergence. As households become wealthier they demand relatively more services (medical, entertainment, etc.) pressuring nontraded goods prices. This is consistent with non-homothetic preferences, and indeed some empirical evidence suggests that a household's income share of nontraded goods increases as income rises. This effect, however, has received limited empirical attention in the context of monetary union.



Source: European Commission and Bank of Spain.

1/ Spain relative to the European Union.

2/ The relative inflation differential (operating surplus) is defined as the rate of inflation (growth of the operating surplus per unit of value added) of the service sector minus that of the industry sector.

- **Weak competition in the service sector appears to be a feature of the Spanish inflation experience.** The difference between service and manufactured goods inflation has followed closely the evolution of service sector profits relative to those of manufactured goods (see figure). A body of empirical evidence points to the evolution of markups in the non-traded sector as a key element behind the inflation differential—see Andrés, Ortega and Vallés (2002), and references therein. This evidence suggests that supply-side rigidities in services have indeed inhibited effective competition. Moreover, in this context **backward-looking clauses in wage contracts can contribute to the persistence of the inflation differential**, as noted in Benigno and López-Salido (2002) and Galí and López-Salido (2001).

These trends could hinder the economy's ability to continue coping with an international environment that promises intensified competition as EU enlargement proceeds. Nonetheless, a **definitive judgment on the extent to which the inflation differential may be attributed to a benign equilibrating phenomenon will need to await the results of data revisions expected in 2003.**

B. Fiscal Policy

15. **With the general government close to balance in 2001–02 and with a “zero deficit” again targeted for 2003, the fiscal discussions focused on the conduct of policy under the new Budgetary Stability Law.** The Law mandates budget balance at the various levels of government.³ The authorities placed primary emphasis on the disciplining effect of this requirement, and viewed the restraining role of a clear fiscal target (“zero deficit”) for all levels of government as an over-riding consideration. This was especially the case in the current transitional phase to new arrangements and in the first year of application of the BSL. They were consequently wary of formulations such as those used by staff (notably its advocacy of a “flexible” i.e., cyclically sensitive implementation of the BSL). They furthermore noted that the simplicity of the “zero deficit” target had evident appeal and, according to polls, considerable public support. Accordingly, in 2002, they had pursued this target unwaveringly, largely irrespective of changes in growth prospects. Although some slippage at the regional level is now estimated to have entailed a small overall deficit, this policy stance resulted—in the staff’s calculations—in an appreciable withdrawal of fiscal stimulus (text table and Figure 4).

Budget and Outcomes, 2000–03				
	GDP growth	Gen. Govt. Balance	Structural Balance 1/	Implied adjustment 2/
2000				
Outcome	4.2	-0.6	-1.0	--
2001				
Budget	3.6	0.0	-0.7	0.3
Outcome	2.7	-0.1	-0.4	0.6
2002				
Budget	2.9	0.0	0.0	0.4
Authorities	2.2	-0.2	0.1	0.5
Staff	2.0	-0.2	0.3	0.7
2003				
Budget	3.0	0.0	0.0	0.0
Staff	2.4	-0.3	0.6	0.3

1/ Staff estimates.

2/ Change in structural balance.

16. **Staff appreciated the importance of ensuring overall fiscal discipline, but also drew attention to the need to be responsive to cyclical developments.** It fully agreed that cyclical flexibility should not be misconstrued as a license for fiscal laxity, and that it was important to observe the newly introduced ceilings on central government spending. At the same time, it cautioned against an undue focus on nominal fiscal targets, noting that the vicissitudes of the SGP illustrated the potential shortcomings—both in upswings and

³ The law covers the central government, social security, the territorial authorities (which include the autonomous communities, or regions, and municipalities) and public enterprises. All public entities must formulate and execute budgets in balance or surplus, with a 12-year transition period for the central government and the social security fund, during which the requirement applies to their consolidated budget. For further details, see Spain, Country Report No. 02/53 (3/13/02).

downswings—of such a focus. Staff also presented empirical results that illustrated the magnifying impact of a fixed nominal budget target on Spain’s already high output volatility (Box 2 and Selected Issues paper). It accordingly encouraged the authorities to use the flexibility available under the Law (i.e., the possibility of departing from budget balance in “exceptional circumstances,” subject to the presentation of a viable three-year adjustment plan) to take appropriate account of cyclical developments.

17. **The authorities explained their firm adherence to the “zero deficit” target and related wariness vis-à-vis the full play of automatic stabilizers on various grounds.** They did not disagree that Spain’s achievement of the SGP commitments provided scope for the use of automatic stabilizers. The updated Stability Program indeed postulates a different fiscal path under a lower growth scenario (i.e., a deficit of 0.4 percent of GDP in 2003 if growth were 2 percent—instead of the central scenario’s 3 percent—Table 3). Nevertheless, in addition to the above-noted emphasis on the BSL’s disciplining function, the authorities pointed to other factors underlying their guardedness with respect to the role of automatic stabilizers. First, they noted that the well-known difficulties in estimating cyclically adjusted balances were compounded in Spain by a number of ongoing structural shifts (among which, for example, the regularization of a large number of immigrant workers, making for a surprising buoyancy of social security receipts in the midst of the economic slowdown). Second, they noted, the July 2002 ECOFIN Council had recognized these difficulties and exempted Spain from moving to a production function method to estimate the structural balance.⁴ Third, they explained that the 2002 budget had been based on clearly cautious revenue projections, so that achievement of the target (then apparently at hand) had not required any discretionary action despite significantly lower-than-anticipated growth.⁵ A similar safety margin had been built into the 2003 budget. Regarding the latter, staff noted that, under its less sanguine growth projection, the emergence of a small general government deficit resulting from purely cyclical factors (around ½ percent of GDP) would be consistent with the budget’s intended neutral stance. With the further relaxation of monetary policy since the mission, the fiscal withdrawal implied by the balanced budget target would not be problematic per se. In the staff’s view, however, the persistent inflation differential needed to

⁴ The Council agreed that, for Spain, the Hodrick-Prescott (HP) filter will be used to assess the 2002 Stability Program, given fairly significant differences (in the order of 0.5 percentage points in 2001–02) with respect to the results obtained using the production function approach. For details, see European Commission, *Production Function Approach to Calculating Potential Growth and Output Gaps*, Economic Paper No. 176, September 2002.

⁵ The 2002 outcome had also, albeit to a lesser extent, been helped by the buoyancy of corporate income taxes, reflecting incentives provided to reinvest capital gains. Furthermore, although real GDP growth had fallen short of the budget assumptions, a higher-than-assumed GDP deflator contributed to an increase in nominal GDP broadly in line with the budget projections—a combination recognized to be undesirable, but that had nonetheless helped contain deviations from budget targets.

Box 2. The Macroeconomic Effect of Fiscal Shocks in Spain

A background study for the consultation illustrates the higher output volatility in Spain in the 1990s compared with other advanced economies, and the extent to which pursuing a fixed nominal budget target would further increase such volatility. Specifically, Spain's average (absolute value) output gap is among the highest in the OECD. Likewise, the standard deviations of output growth, private consumption, and investment rank among the highest in euro area countries. The empirical evidence suggests that a tax cut (or an increase in public spending, both of a size corresponding to historical experience) leads to an expansion of output that develops over the course of a year to six quarters, with investment responding more forcefully than private consumption. Also, the evidence—consistent with the Keynesian view of fiscal policy—indicates that the pursuit of a nominal budget target would, by curbing the automatic stabilizers, contribute to exacerbating output shocks. In the case of Spain, this adverse effect mainly reflects the suppression of the counter-cyclical impact exercised by stabilizers on the revenue side.

The staff study was presented in a seminar during the consultation, with the authorities and participants making the following main points:

- **EU entry has entailed important changes in the characteristics of cyclical developments.** These were attributed to a reduction in the uncertainty of macroeconomic policies and economic prospects, and to Spain's greater integration in Europe. Thus, Spain's standing among OECD countries with the highest volatility is likely to have changed.
- **Even taking the greater volatility at face value, the role of fiscal policy is unclear.** By focusing on fiscal policy, the staff study seems to argue implicitly that fiscal policy had contributed to the higher observed macroeconomic volatility. Seminar participants noted that structural features (such as labor market rigidities) were more likely to underlie the economy's volatility. Also, the greater importance of the agricultural and tourism sectors in Spain entails a relatively greater exposure to supply and external shocks.
- **Moreover, the substantial fiscal consolidation of the past decade has crowded-in investment and provided a boost to economic growth.** Although the econometric methodology is useful to examine business cycles and the dynamic impact of fiscal policy, it does not account for the medium-term impact of fiscal policy. Seminar participants noted that fiscal consolidation—effected in tandem with the drive to EMU membership—had reduced real interest rates dramatically, stimulating a host of investment projects. These effects are likely to reduce the overall volatility of the economy and are not captured by the empirical evidence discussed.

Staff agreed that output volatility had fallen significantly in recent years—placing it closer to the EU average—but it remained above that of other major European countries. Also, the study should not be viewed as an indictment of fiscal policy, and structural characteristics are indeed likely to be an important factor underlying volatility. **Still, it is unlikely that these considerations eliminate the beneficial effects of a cyclically sensitive implementation of fiscal policy under the Budgetary Stability Law, allowing full play of automatic stabilizers to cushion cyclical fluctuations.**

be addressed through a continued pursuit of the structural reform agenda, discussed further below.

18. **The authorities noted that 2003 would be a milestone year for the new fiscal framework, with the first budget to be drawn up under the BSL and further steps in devolution.** The year would see the completion of the transition to the permanent financing arrangement for autonomous communities, the full decentralization of health services, and the introduction of a new financing system for municipalities.⁶ In addition, the authorities pointed to two key features of the budget. First, a further reform of the personal income tax, which went beyond a mere cut in rates (in an amount equivalent to about ½ percentage point of GDP) and aimed to provide supply-side incentives (affecting, for example, female labor market participation and geographical labor mobility); and second, a continued strong public investment effort to meet Spain's substantial infrastructure needs, raising the share of public capital spending in GDP to over 5 percent.

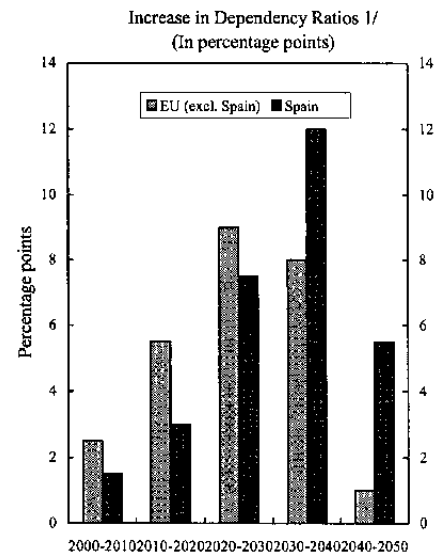
19. **Given the various innovations under way, there was recognition of the importance of careful monitoring and fiscal transparency.** There was agreement on the pressing need to improve the timeliness of information on the execution of regional budgets. With the devolution of health care to regions, the central government would account for no more than 40 percent of public expenditures, and yet—other than debt figures published by the Bank of Spain—there was no in-year information on the evolution of regional budgets. The authorities were in the process of strengthening regional reporting requirements, as stipulated by the BSL, and aimed to bring these efforts to fruition in the course of 2003. A second issue concerned the significant proportion of public investment carried out by public entities outside the general government, partly financed through capital injections. Staff pressed that the transactions and accounts of all such entities should be fully transparent and available on a timely basis, so as to rapidly reveal any risk of future debt liabilities. The authorities noted that such operations met Eurostat standards and were reported in budget documents, and provided data reconciling the discrepancy between the evolution of the deficits and the public debt stocks.⁷ Finally, staff noted that the considerable prudence exercised in the estimation of revenues—which the authorities defended as cautious budgeting and a means to contain expenditure pressures—complicated the assessment of the budget (already affected by the inherently difficult comparability problems arising from the shifts in financing and competencies). In its view, transparency required a closer consistency between revenue estimates and the budget's underlying economic assumptions.

⁶ Autonomous communities are to receive (among others) one-third of personal income taxes collected in their jurisdictions and 35 percent of VAT receipts; other revenues have been earmarked for municipalities.

⁷ Though still small, this discrepancy has increased in recent years: specifically, the change in gross public debt was 1 percentage point of GDP higher than the cumulative fiscal deficit (net borrowing) over the 1998–2000 period.

The demographic shock

20. **With the budget broadly in balance, the issue now was to define an appropriate medium- to longer-term fiscal objective in light of population aging.** The authorities stressed the difficulties of long-term population projections, compounded in Spain by the uncertainty of immigration flows (on which further work was underway). Nonetheless, it was evident that Spain's demographic shock exhibited two special features compared with other EU countries: it would start unusually late (after 2020), but it was—given low fertility rates and high life expectancy—set to be unusually deep. The authorities saw the former feature as allowing for a gradual approach to social security reform, in a consensual process with social partners. Staff agreed, but noted also that the magnitude of the demographic shock indicated that the reform process could be gradual only if it started early enough, was continuous, and sufficiently ambitious. Following on the 2001 reforms (centered on incentives for workers to stay longer in the work force), little further action had been taken. The authorities—without prejudging the results of talks with the social partners—were hopeful that these would mark further progress in 2003, possibly including a strengthening of the link between contributions and benefits. Staff noted that gradually raising the effective retirement age by some five years, would, in tandem with stronger incentives to forego early retirement, have a major impact.



Sources: Bank of Spain; and Social Security Agency.

1/ The dependency ratio (number of pensioners over contributors) in Spain was about 50 percent in 2001.

21. **Provided social security reform was sufficiently ambitious, a small budget surplus would be an appropriate medium-term fiscal objective for Spain.** There was general agreement that a moderate general government surplus, in the order of $\frac{1}{2}$ percentage point of GDP over the cycle, would contribute appropriately—along with entitlement reform—to addressing aging pressures by reducing public debt.⁸ An added benefit of such a target, staff noted, would be to provide some cushion for cyclical fluctuations, while adhering to the letter of the BSL. Staff developed debt sustainability scenarios (Table 5) showing a public debt profile that is robust to aging pressures through the end of the decade, but rising sharply after 2020 as the demographic shock takes hold. Likewise, the stress tests suggest

⁸ Maintaining a surplus of $\frac{1}{2}$ percent of GDP beginning in 2007—by gradually cutting non-pension spending up to 2.5 percent of GDP in 2020—would reduce public debt to 15 percent of GDP by 2020. The latest Stability Program foresees a move into surplus in 2005-06 (0.2 percent of GDP in the latter year) under its central growth scenario of 3 percent throughout the period.

that the debt profile does not appear to be vulnerable to potential macroeconomic distress.⁹ These numbers are illustrative of the pressures facing fiscal accounts in the baseline scenario, i.e., a passive projection. In practice, adherence to the policy commitments under the SGP and the BSL would prevent debt ratios from rising as shown in Table 5 but, in the absence of pension reforms, would require significant cuts in non-pension spending.

C. Developments in the Financial Sector

22. **The authorities noted that the banking sector remained profitable and well capitalized, and that strict supervision had ensured its resilience during a difficult period.** The discussions with supervisory authorities and market participants confirmed that major Spanish banks had weathered the difficulties stemming from their investments in Latin America reasonably well. Such resilience was attributed to their strong starting positions, with capitalization (BIS ratio of 13 percent) and profit ratios (ROE of 17 percent) exceeding those of the average European bank (BIS and ROE of 11 and 16 percent, respectively), as well as high efficiency ratios. In addition, banks enjoyed strong domestic franchises and diversified activities, centered on relatively low-risk domestic retail markets, with little exposure to IT or insurance sectors. The mission’s interlocutors noted that these underlying strengths were reinforced by the strict prudential and supervisory approach of the Bank of Spain, which had played an active role in promoting conservative risk management practices. Indeed, the mission found considerable market appreciation for the Bank of Spain’s supervisory role, in a climate of close cooperation between supervisors and market participants.

23. **In this setting, major banks had been able to deal with the difficulties stemming from Latin America, with the main casualty being a reduction in profit growth.** Spanish banks’ direct exposure to Latin America is sizable (Box 3). Their consolidated foreign claims in the region amount to US\$157 billion (32 percent of the total), and are concentrated mainly in Mexico, followed at a considerable distance by Brazil, Chile, and Argentina. Spanish banks’ foreign direct investment in the region is also substantial (in excess of US\$20 billion). Banks are furthermore exposed indirectly to Latin America through their business with Spanish companies that are active in the region—although, the authorities noted, such exposure was relatively limited. Loan exposures to Latin America have been provisioned according to fairly strict requirements,

	In billions of US\$	In percent
Total	491.9	100.0
<i>Of which:</i>		
Spain	157.2	32.0
United States	130.7	26.6
Germany	34.2	6.9

Source: BIS

⁹ In the worse case scenario (stress test 1, assuming real interest rates, output growth, and primary balance are equal to their averages in the decade ending in 2002) the debt-to-GDP ratio would remain unchanged by the end of the decade. The baseline scenario reflects—as detailed in the updated 2002–06 Stability Program—the current population projections and immigration trends, and an increase in pension expenditures to reach some 12 percent of GDP by 2040. Also, the scenario assumes unchanged levels (as percent of GDP) of all other spending and revenues from 2006.

Box 3. Exposure to Latin America

Spanish banks' direct exposure to Latin America is sizable: the region generates about one-third of net earnings, and constitutes about a third of group loans and deposits. Market reports indicate that the two largest banks (Banco Bilbao Vizcaya Argentaria-BBVA and Santander Central Hispano-SCH) have invested between US\$20–25 billion in building a banking network in the region. In some countries—Chile, Colombia, Mexico, and Peru—they account for 20 percent or more of the commercial banking market. The Spanish banking sector's consolidated foreign claims in the region amount to US\$157 billion (32 percent of the total, slightly above the U.S. share of 26½ percent). They are concentrated mainly in Mexico (56 percent of Spain's total exposure to the region) followed by Brazil and Chile (13 percent each), and Argentina (6½ percent). Spanish banks' vulnerability to liquidity pressures in their overseas subsidiaries, and the potential costs of recapitalization over the medium-term (as opposed to a write-off) could, if incurred, far exceed their direct investments and may have adverse ratings consequences.

Spanish and International Consolidated Foreign Claims on Latin America
(end-June 2002)

	Argentina		Brazil		Chile		Colombia	
	In billions of US\$	In percent	In billions of US\$	In percent	In billions of US\$	In percent	In billions of US\$	In percent
Spain	10.1	24.0	20.8	16.8	20.8	48.2	4.4	29.4
United States	10.7	25.4	29.6	23.9	7.1	16.5	3.6	24.1
Germany	4.8	11.4	11.2	9.0	3.7	8.7	1.6	10.5
Total	42.1	100.0	123.9	100.0	43.1	100.0	15.1	100.0

	Mexico		Peru		Uruguay		Venezuela	
	In billions of US\$	In percent	In billions of US\$	In percent	In billions of US\$	In percent	In billions of US\$	In percent
Spain	87.5	43.4	4.5	31.1	0.9	16.9	5.6	31.1
United States	65.3	32.4	2.0	13.8	1.4	26.3	2.7	15.2
Germany	6.6	3.3	1.0	6.8	0.7	12.9	1.8	10.0
Total	201.6	100.0	14.4	100.0	5.2	100.0	18.1	100.0

Sources: BIS; and Bank of Spain.

Note: Includes local claims of reporting banks' foreign affiliates denominated in local currency amounting to a total US\$117.5 billion.

including via the “forward-looking” provisioning introduced in 2001.¹⁰ The value of the banking sector’s investments in Argentina has also been adjusted downward to reflect the peso’s devaluation, and acquisitions (book value and goodwill) have also been fully amortized under an accelerated timetable. All in all, the major banks involved had thus been able to absorb the Argentine crisis while remaining profitable, with timely reassessments of earnings prospects helping to avoid market surprises. These results had been achieved, the authorities noted, despite developments in Argentina that had been significantly more adverse than initially anticipated. Nonetheless, given their greater exposure, major Spanish banks’ equity valuations had suffered relative to those of European and U.S. banks (Figure 5).

24. A similar proactive approach was being pursued to deal with other potential risks, and the authorities were confident that the situation would remain manageable. Although a deterioration of financial conditions in Brazil would put considerable pressure on banks’ balance sheets, the authorities were of the view (shared by most market analysts) that—barring a generalization of the risks to much of Latin America—the impact on the Spanish banking sector would remain manageable. For their part, major banks reiterated their interest in remaining in Latin America for the long haul. All in all, the discussions provided reasonable reassurance that, under currently plausible scenarios, events in Latin America were not poised to raise systemic risks for the Spanish banking system. On the domestic front, concerns, shared by staff, centered on the risks posed by the rapid rise in mortgage lending and the related increase in household indebtedness. Such risks were however viewed as tempered by a lesser increase in the related financial burden (due to lower interest rates, longer average repayment terms, and the greater prevalence of two-income families). Nonetheless, the Bank of Spain had been vocal in its calls for caution with respect to mortgage lending and welcomed recent signs of deceleration in its growth. In this context, the authorities agreed to undertake a FSAP at a mutually determined time.

25. The authorities also pointed to recent legislation modifying important aspects of the status and capital structure of the savings banks. The *cajas de ahorro* segment of the banking sector consists of a large number of mostly small- and medium-sized institutions that concentrate on retail business. Their activities, characterized by geographical focus and close client relations, were seen to provide the system with an important element of risk

¹⁰ Specific provisioning for nonperforming loans (NPL’s) follows a complex set of rules and regulations, reflecting the calendar that governs the classification of NPL. Generally, only payments (principal and interest) portion of the loan that are 90 days past due are considered delinquent. However, the entire loan is reclassified as non-performing when either overdue payments reach 25 percent of the outstanding loan amount, or if these payments are significantly overdue, i.e., 6 months for households and 12 months for corporates. In addition, Spanish financial regulations require both generic and statistical provisioning. The former is 1 percent of the outstanding loan balance, the latter is a forward-looking element to smooth provisioning over the economic cycle.

diversification. Nonetheless, their particular status (not-for-profit foundations), ownership structure, and close ties to local and regional governments had long been seen as posing “level-playing-field” and governance issues. Following a protracted process, adjustments had recently been made to their statutory framework. These had been designed to reduce political presence in the savings banks’ governing bodies and to allow the *cajas* to issue a form of nonvoting “stock” (*cuotas participativas*). These instruments will provide holders with a right to a share of the profits and are to be listed on the stock exchange. Besides endowing the *cajas* with a means to strengthen their capital structure (the new instruments qualify as Tier 1 capital), the *cuotas* are intended to provide a market assessment of individual savings banks’ management performance. Staff noted that the degree to which such market discipline would indeed be effective will, however, depend on the extent to which these instruments would be perceived, and in practice behave, as variable return instruments entailing capital risk—a matter on which some market participants harbored doubts.

D. Labor and Product Markets

Labor markets

26. **Staff commended the much improved performance of the labor market—with unprecedented job creation even during the slowdown—and discussions focused on recent initiatives and remaining needs to address a still high level of unemployment** (Figure 6). Following on a series of reforms, the major recent labor market initiative concerned changes to the unemployment benefits system to promote a “return-to-work” orientation and greater geographical mobility. The initial reform proposals, which had met with considerable trade union opposition, were modified in the course of 2002, but the authorities were satisfied that their main elements had been preserved. Active job search is to be promoted through an “activity contract” (*compromiso de actividad*), setting out the worker’s right to receive personalized service and training through the public employment office, but also establishing loss of benefits (after 100 days from the date of lay-off) in case of nonparticipation in such training or refusal to accept a suitable job within a 30 kilometer radius. The reform also contains provisions covering dismissal costs, which employers saw as reducing the uncertainty attached to the traditionally protracted judicial process, but as leaving the high level of such costs largely unaffected. A final important element of the reform—still facing strong trade union opposition—concerns the phasing out of the rural employment subsidy, which has long acted as an impediment to labor mobility out of agriculture in the beneficiary regions (Andalucia and Extremadura).

27. **The staff welcomed the reform’s “return-to-work” emphasis and supported the phasing out of the rural employment subsidy.** It noted that experience elsewhere suggested that the success of such reforms lies in their practical implementation, i.e., in the capacity of the public employment services both to assist active job search and to suspend benefits when required. It would be accordingly important to modernize the public employment office and monitor experience, making adaptations as needed as the new system is implemented.

28. **As to next steps in labor market reform, there was agreement on the need for changes in Spain's collective bargaining system.** Various features of the system were seen to be in need of reform. First, a level of negotiation centered on sectoral agreements had led to a high homogeneity of wage increases across sectors and firms, exacerbating regional unemployment problems. Although individual firms could in principle opt-out of such agreements, the authorities noted that this was extremely rare in practice. A second issue of shared concern regarded the continued and widespread recourse to backward-looking wage indexation clauses. Overcoming resistance to phasing them out would however, staff noted, require that the reference value for wage negotiations be seen as a reasonably realistic reflection of expected inflation. Finally, staff was critical of the practice whereby, in the absence of negotiations or agreement, a labor contract's provisions remain in effect indefinitely (known as *ultra actividad*). This was a serious disincentive to broader discussions, focusing negotiations almost exclusively on the salary increase, at the expense of other key issues (e.g., the flexibility of work organization, productivity improvements, training, etc.). The authorities also viewed this practice as inhibiting a broad social dialogue, but noted that legal complexities risked standing in the way of substantive changes.

Product markets

29. **Progress in reforming product markets is well-advanced, in keeping with an ambitious plan adopted in 2000, but effective competition in certain key network sectors remains elusive.** Spain's record in transposing internal market legislation is among the best in the EU and it ranks favorably under a set of OECD measures of product market liberalization (Table 6). Nonetheless, in key network services, competition remains low with, for example, a still large market share of incumbents in fixed telecommunication and gas, and a reduced number of operators in the wholesale market for electricity. The authorities recognized these limitations, and reaffirmed their commitment to enhancing competition—recently, for example, taking major electrical companies to the Competition Tribunal for alleged price-fixing behavior. They also noted, however, that further progress in this area was partly dependent on greater liberalization throughout Europe, with underlying concern about entry by entities that still enjoy a virtual monopoly in their home markets.

30. **There was shared concern about the obstacles to effective competition arising from initiatives by the regions, notably in retail trade and distribution.** A number of regional and local entities have made increasing recourse to a variety of barriers to entry and competition in retail distribution and trade. Such barriers range from outright prohibitions for super or hypermarkets, complex regulations, overlapping and discretionary licensing requirements, and limitations to opening hours. Staff called for the removal of all such obstacles, given also their above-noted role in upholding supply rigidities in a sector that was likely subject to relatively greater demand pressures in the convergence process. In a similar vein, staff noted the risks to the coherence of national competition policy posed by the creation of new competition tribunals at the regional level. The authorities responded that it was unlikely that all regions would set up such tribunals, and also pointed to the creation of a Council for the Defense of Competition—encompassing regional competition authorities—to ensure overall coordination. Nonetheless, while largely agreeing with the points raised by

staff, the authorities noted the difficulties posed by the devolution of the relative competencies to regional and local authorities. In this regard, they welcomed staff's call for greater "co-responsibility" of the regions in this area (akin to that in the fiscal area), and suggested that future consultation discussions engage selected regional authorities.

31. **Various initiatives were underway to promote entrepreneurial activity and improve corporate governance.** Among the former, the authorities highlighted first, a draft law (*Ley de Nueva Empresa*) designed to lighten the administrative burden in the setting up of new companies, reducing the related time and costs; and second, a new bankruptcy law, modernizing a severely outdated regime that provided virtually no relief to enterprises in distress, often leaving small- and medium-sized firms with no option other than closure. On corporate governance, a special Commission (*Comisión Aldama*) was at work to reflect the recommendations made at EU level (by the High Level Group of Company Law Experts), and was expected to report by early 2003. Relatedly, a working group is due to elaborate a White Book with specific recommendations to align Spanish accounting practices to international standards and relevant EU directives.

E. Other Issues

32. **The authorities reaffirmed their strong commitment to efforts to counter money laundering and the financing of terrorism.** Spain is a FATF member subject to mutual evaluations and has an extensive system of legislation and regulations for anti-money laundering and combating the financing of terrorism (AML/CFT). Supporting institutional capacity and arrangements for international cooperation are also generally well-developed. The authorities, who responded in detail to the Fund's questionnaire on AML/CFT issues, expect that legislation further refining provisions in this area will be passed early in 2003. They expected Spain to be in full compliance with the EU's anti-money laundering directive by June 2003, and noted that Spain has provided technical assistance to a number of countries to help them develop their AML/CFT capacity.

33. **The authorities expressed Spain's support for trade liberalization vis-à-vis the least developed countries and for the success of the Doha round.** They reaffirmed their support for the "Everything But Arms" initiative and pointed to the ambitious objectives that Spain had presented at the outset of the Doha trade conference. In this regard, they noted Spain's commitment to ensure that the Doha round be an effective instrument in promoting sustainable economic development, reflecting the interests of all countries within a balanced agreement. On reforming the Common Agricultural Policy (CAP), while having reservations vis-à-vis some of the European Commission's proposals under the midterm review, they expressed openness to examining all proposals that would be put on the table. With regard to the reform's possible impact on Spain, they felt that the details were as yet insufficiently specified to arrive at any reliable assessment. Staff illustrative simulations suggest that trade liberalization in agriculture would have an expansionary effect on Spanish output and consumption as the allocation of resources improved, although not without some retrenchment in employment in some agricultural sectors. The authorities noted, in this regard, that the modifications would include a second pillar aimed at strengthening rural development, which would help transition costs for Spain.

34. Provisional figures for 2001 indicate a sharp increase in **Spain's ODA**, to a level equivalent to about 0.3 percent of GNI (12th among Development Assistance Committee (DAC) countries). A large share of Spain's ODA goes to low-income countries in Latin America. A recent DAC Peer Review noted the relatively high share of loans in Spain's ODA and recommended that this policy be reviewed in light of the enhanced HIPC initiative and efforts to restore debt sustainability. Spain has been an active partner in the **Fund's poverty reduction efforts**, contributing to the PRGF and HIPC initiatives.

IV. STAFF APPRAISAL

35. **Spain's recent economic performance stands as testimony to the pay-off of sound policies across a broad swath.** A stability-oriented fiscal policy, extensive product and labor market reforms, and continued wage moderation have led to a remarkably high output and employment growth during the latest upswing. Despite the current deceleration, real GDP growth is set to remain well above that of the euro area in 2002–03. More telling still, employment has continued to expand even as the economy has cooled—an experience that stands in marked contrast to earlier slowdowns, when growth would fall below the EU average in the midst of sizable job destruction. For its part, a prudent supervisory approach has contributed to banking sector resilience through difficult times.

36. **These positive results provide the best motivation for continued resolute action on the structural front, essential to future prospects.** Despite the notable progress achieved, performance in a number of key areas remains unfavorable. As the stimulus of EMU-related lower interest rates fades, and with enlargement due to bring new competitors and reduce EU transfers, continued real convergence depends critically on placing growth prospects on a firmer medium-term footing. This will require, in particular, lifting remaining obstacles to strong employment growth throughout Spain and increasing competition in key sectors, in concert with the territorial authorities.

37. **Short-term growth prospects are relatively favorable, although economic activity is likely to remain below potential and risks are on the downside.** Highly supportive monetary conditions and income tax cuts appear set to sustain a gradual pickup in activity in the course of 2003. Nonetheless, apart from the uncertain external environment, Spain faces a number of country-specific downside risks, arising from households' increased indebtedness, the boom in housing prices, and the greater exposure to Latin America. In all of these areas, there are grounds for confidence that the likelihood of significantly adverse economic repercussions for Spain is relatively low. Of greater concern, albeit for the medium term, is the cumulative effect of a persistently large inflation differential with the euro area.

38. **Alone among the larger euro area countries, Spain has brought its fiscal accounts in compliance with the SGP commitments.** This contribution to the smooth workings of EMU is most welcome, as is the new Budgetary Stability Law, which is designed to lock in the gains achieved in fiscal consolidation by mandating budget balance at all levels of government. As devolution advances, the authorities' emphasis on fostering fiscal co-responsibility and instilling fiscal discipline throughout Spain is well-placed.

39. **Going forward, there is a need to guard against the risk of unduly pro-cyclical policies under the Budgetary Stability Law.** Under current prospects, given very easy monetary conditions, the withdrawal of fiscal stimulus implied by the official “zero deficit” target for 2003 would not be problematic from a macroeconomic perspective. But, over time, it is important to avoid implementing the Budgetary Stability Law in a manner that is unduly procyclical. In this regard, the Law’s focus on a nominal target that is not contingent on growth outcomes is not a cyclically robust framework over time. Furthermore, policy-makers at all levels should be prepared for the prospect that, once growth resumes with greater vigor, nominal surpluses would be required to avoid eroding the underlying fiscal improvement. In sum, well-considered cyclical flexibility in the implementation of fiscal policy under the BSL would provide the best guarantee for safeguarding fiscal consolidation, in both good and bad times, and a sustainable basis for building fiscal co-responsibility with the regions.

40. **Given the fiscal innovations being introduced, careful monitoring and transparency are of the essence.** There is, first, a pressing need to address the lack of timely information on the execution of the regional budgets—a shortcoming that continues to affect estimates of the 2002 outcome. Efforts to implement strengthened reporting requirements should thus be stepped up and come to rapid fruition. Second, given the growing proportion of public investment being carried out by public entities outside the general government, it is important for accountability and monitoring to ensure that their financial accounts are fully transparent and available on a timely basis.

41. **Longer-run fiscal challenges are considerable and still largely unaddressed.** There is agreement that, while Spain’s demographic shock will occur comparatively later, it is also set to be deeper. In preparing to deal with this shock, fiscal consolidation has advanced but pension reform has lagged. The contribution of the former can and should progress further, with a small surplus (in the order of ½ percentage point of GDP over the cycle) appearing to be an appropriate medium-term fiscal objective. But its adequacy is also contingent on substantive pension reform, and the talks with social partners in 2003 should lead to gradual but far-reaching changes that start early and can be phased in over time, avoiding more painful changes later. A powerful impact can in particular be had by gradually raising the effective retirement age, via stronger incentives to forego early retirement and a strengthening of the link between contributions and benefits.

42. **In the banking sector, the salient feature is the resilience it has shown during a difficult period.** This outcome reflects the banking sector’s strong starting position in terms of capitalization, provisioning, efficiency, and profitability, based on a vibrant domestic franchise, and is also the result of the Bank of Spain’s active promotion of conservative risk management practices. Although external risks remain, especially in the event of more extreme scenarios, the banking system’s overall sound position and the continuation of a vigilant supervisory approach provide reasonable assurance—reflected also in analysts’ assessments—that such risks will remain manageable. This seems to hold also for potential domestic risks, notably some price correction in the housing market; a further deceleration in the growth of mortgage lending would however be desirable. In this context, Spain’s readiness to undertake an Financial Sector Assessment Program (FSAP) is warmly welcome.

43. **The improved performance of the labor market has been a heartening feature of recent years.** Spain however still lags the rest of Europe in key indicators of labor market performance, and the government's continued attention to labor market issues, expressed most recently in the reform of the unemployment benefits system, is thus welcome. The most significant labor market issue that the social partners and the government should now address is that of the organization of Spain's collective bargaining system. There are three features of this system that merit revision: first, the need for greater wage differentiation, as one element in addressing the marked regional disparity in unemployment; second, the widespread existence of backward-looking wage safeguard clauses, a heritage of a high-inflation past that does not sit well with the requirements of monetary union; and third, the practice whereby, in the absence of agreement, a contract's provisions remain in effect indefinitely—with negotiations thus focusing almost exclusively on the salary increase, impoverishing the content of collective bargaining. The social partners are encouraged, while pursuing a new, moderate collective wage agreement for 2003, to enlarge their discussions to embrace the issues noted above.

44. **In goods and services markets, there is an increasing sub-national dimension.** It is nonetheless evident that a nationally coherent policy affecting such markets is crucial to enhancing Spain's overall economic performance, and avoiding that a policy intention of liberalization and deregulation at the central level be foiled at other levels. The same model of co-responsibility that imbues the fiscal agreement should thus be extended to goods and services markets. As a priority, the numerous barriers to more effective competition in retail distribution and trade need to be lifted. In a similar vein, the difficult but crucial issue of land supply needs to be revisited. In network services, liberalization has advanced but competition needs to be further enhanced in certain key sectors that remain dominated by incumbents.

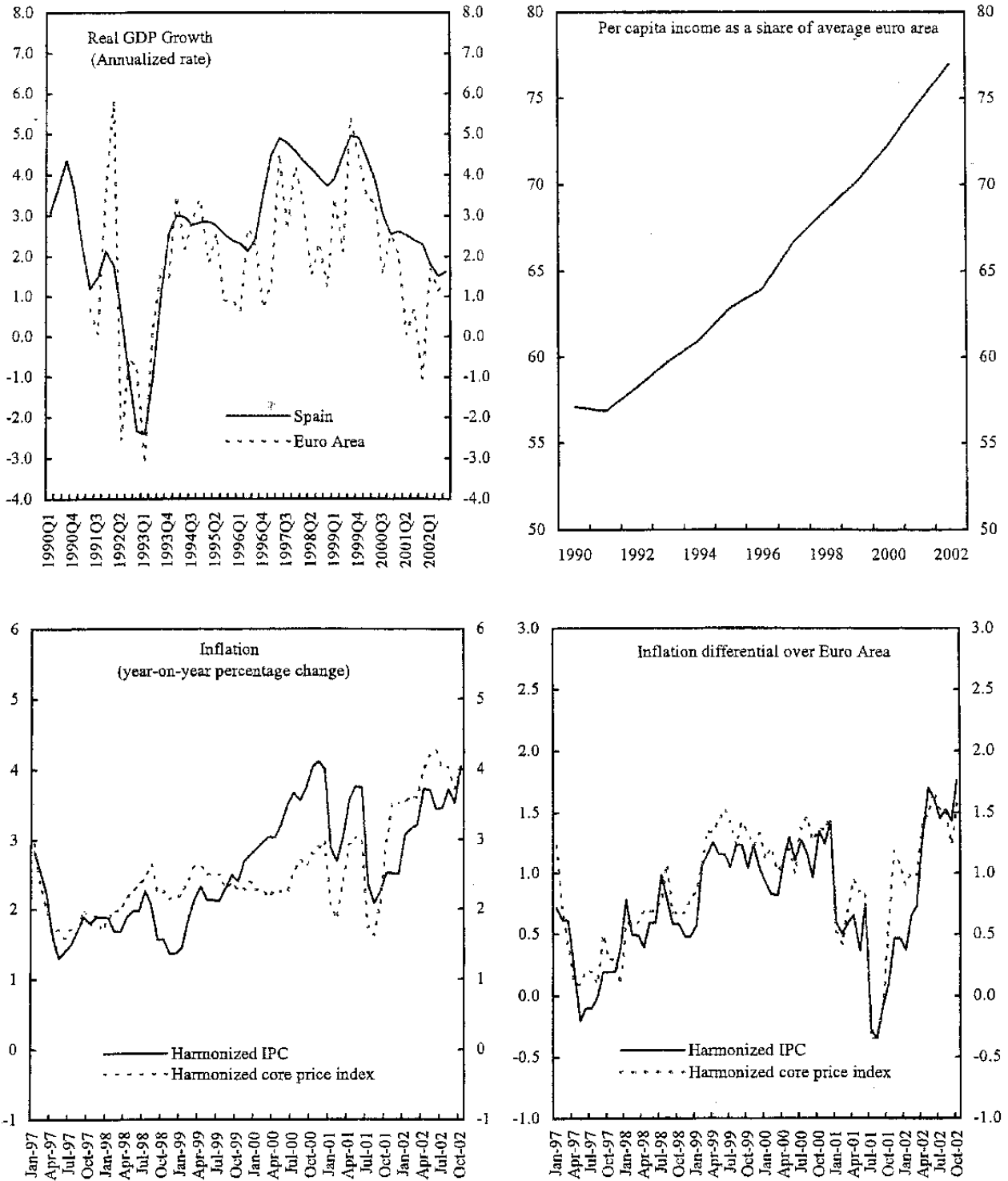
45. **Spain is well-advanced in its reflections on corporate governance and accounting rules and principles.** The initiatives in these areas are welcome. Spain has also advanced commendably in the implementation of measures to counter money laundering and combat terrorist financing.

46. Spain is encouraged to build on the increase in **ODA** in 2001 and progress further toward the 0.7 percent of GNP benchmark; its contribution to the Fund's initiatives for its poorest members is also valued. Finally, staff welcomes Spain's support for **trade** liberalization vis-à-vis the least developed countries and its commitment to the success of the Doha round. In this regard, the authorities are encouraged to work in favor of the related internal reforms of the CAP in the midterm review. While in pure budgetary terms Spain is a net beneficiary of the CAP, liberalization is likely to benefit Spanish consumers and the economy as a whole.

47. Spain's **data** are adequate for effective surveillance, although the quality of productivity data and the timeliness of regional fiscal data need to be improved (Appendix II).

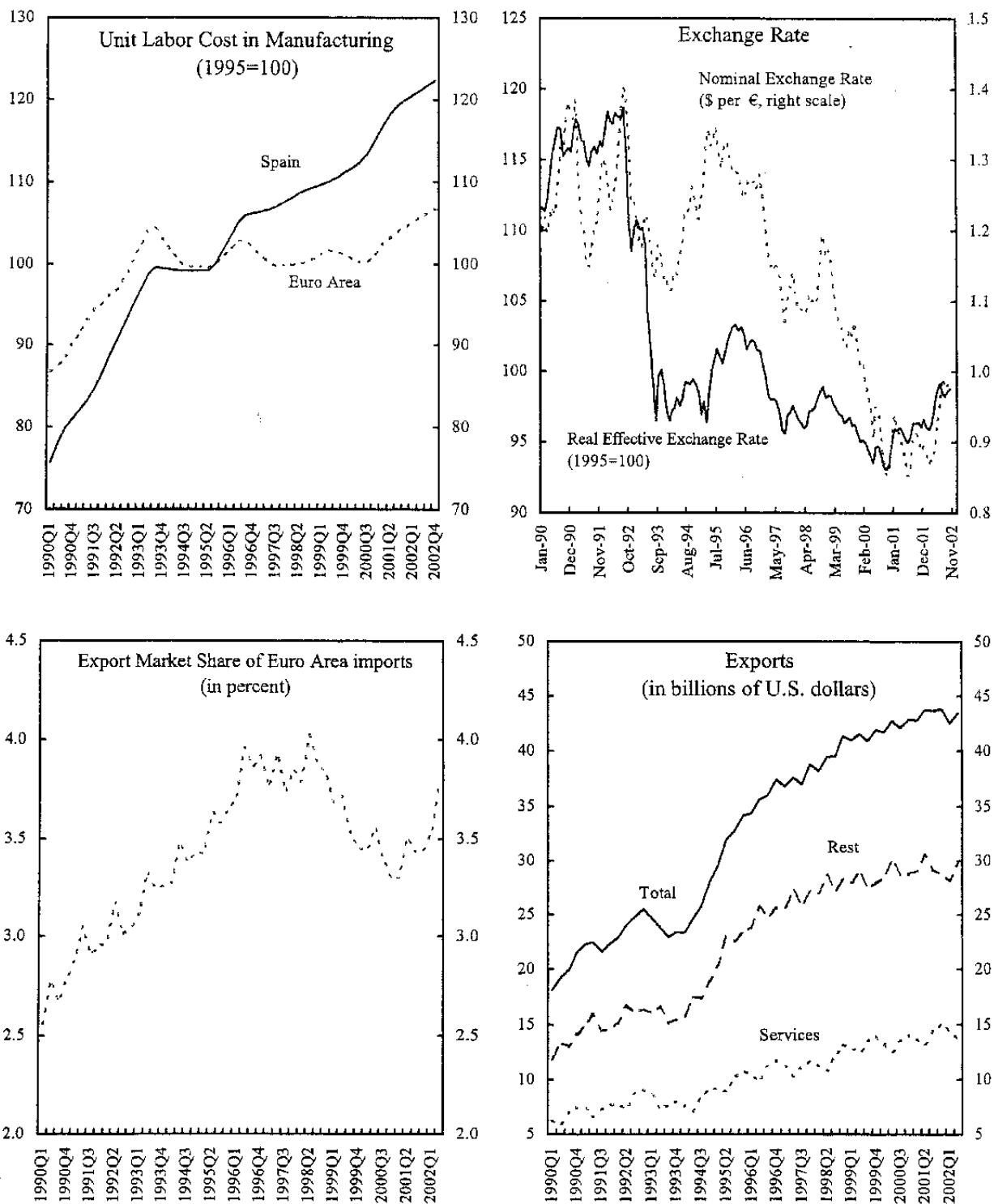
48. It is recommended that the next consultation be held on the standard 12-month cycle.

Figure 1. Spain: Nominal and Real Convergence, 1990-2002



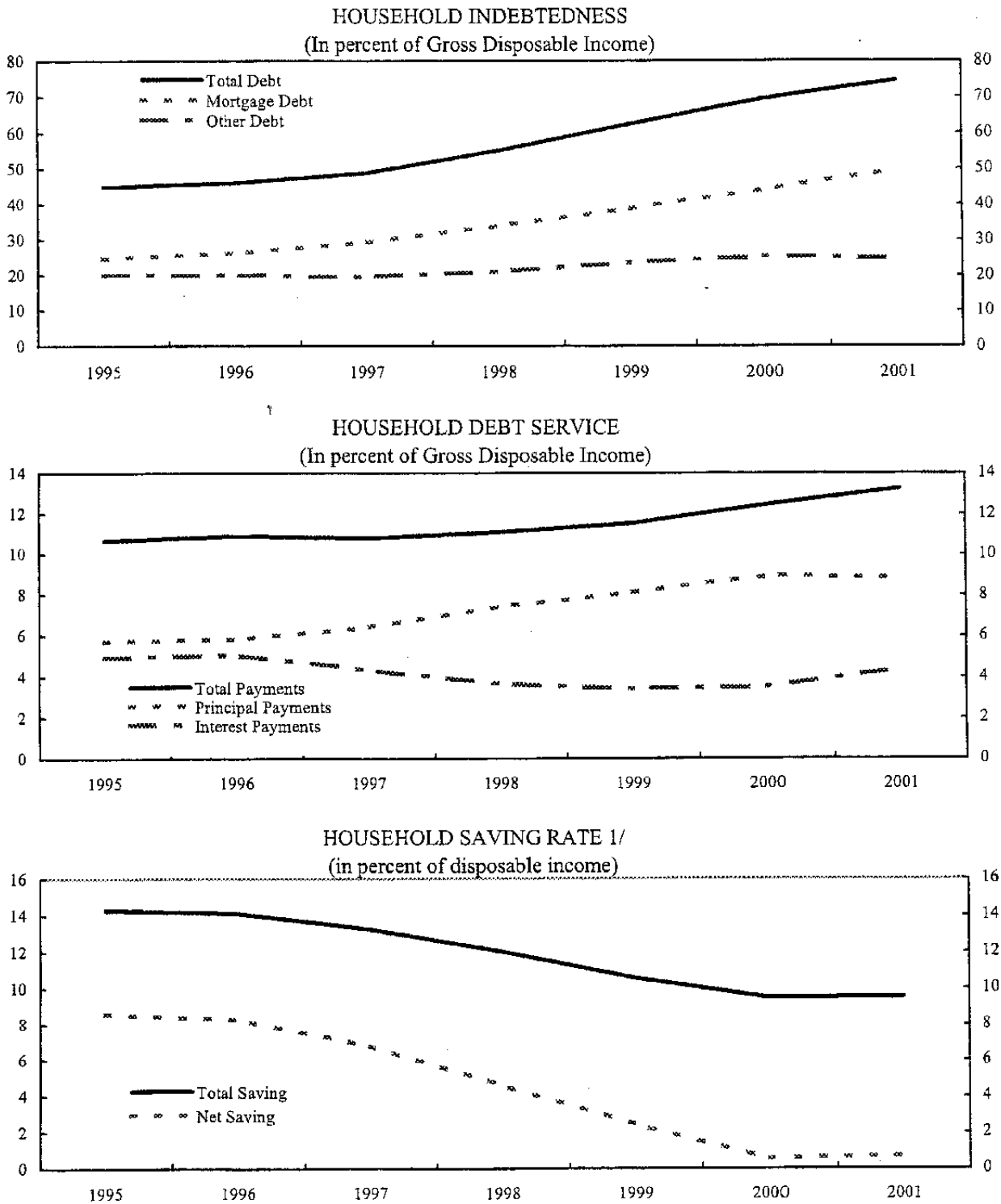
Sources: IMF, *World Economic Outlook*; World Bank, *World Development Indicators*; Organization for Economic Cooperation and Development; and Eurostat.

Figure 2. Spain: Competitiveness and Exports, 1990-2002



Sources: IMF, *International Financial Statistics*; IMF, *Direction of Trade*; and Organization for Economic Cooperation and Development.

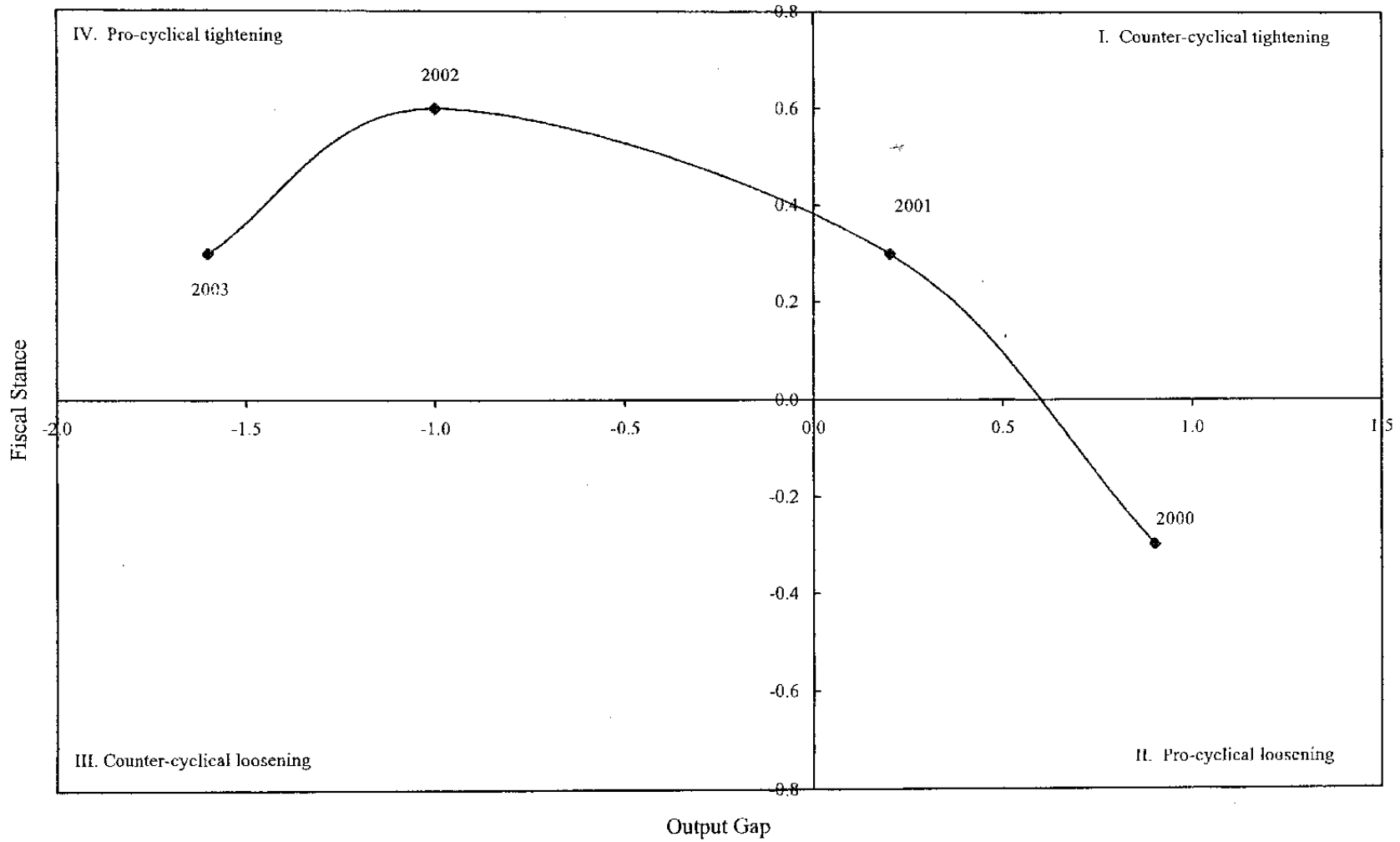
Figure 3. Spain: Household Debt and Savings, 1995-2001



Source: Bank of Spain.

1/ Net saving equals total saving less principal payments.

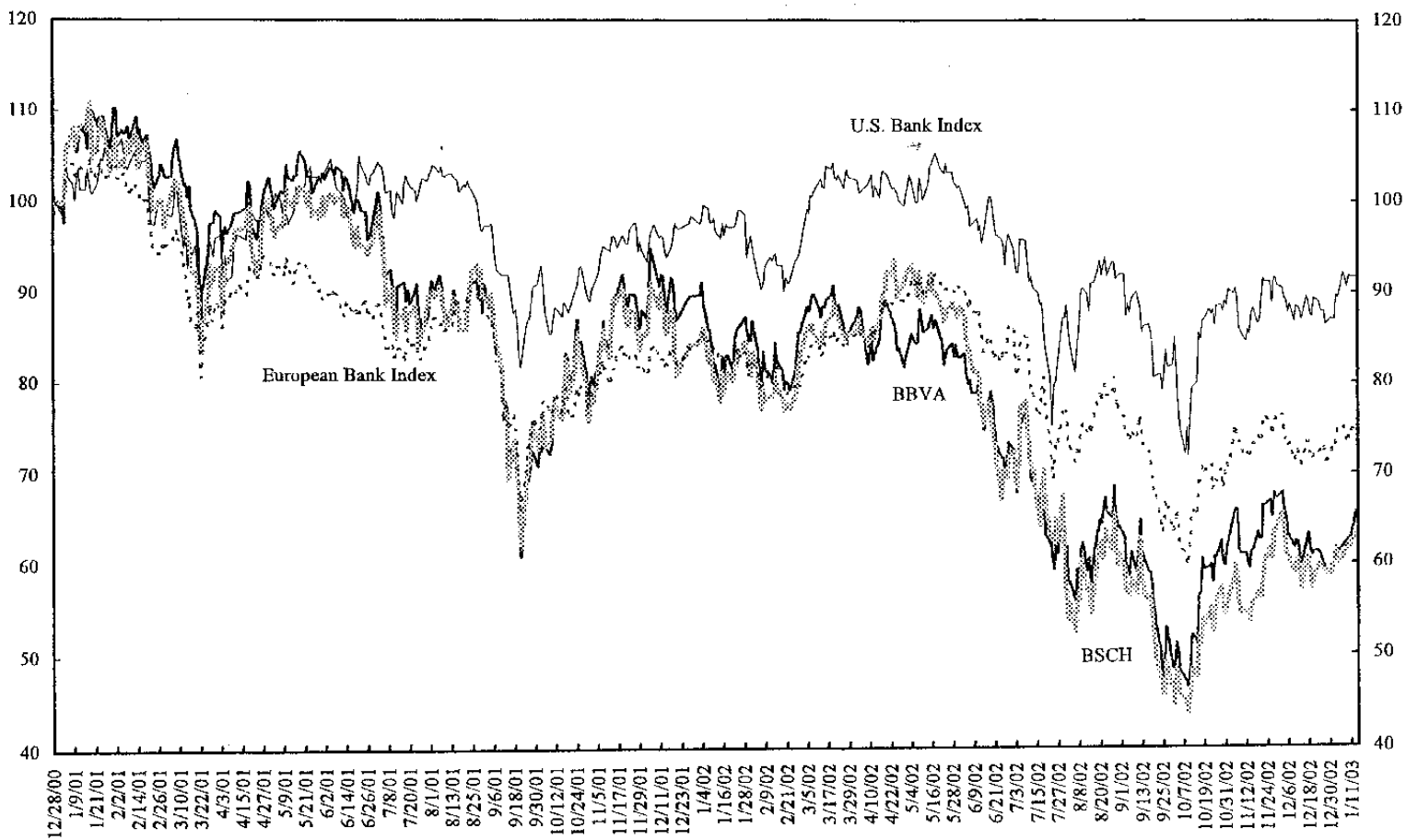
Figure 4. Spain: Fiscal Stance, 2000-03 1/



Source: IMF, *World Economic Outlook*.

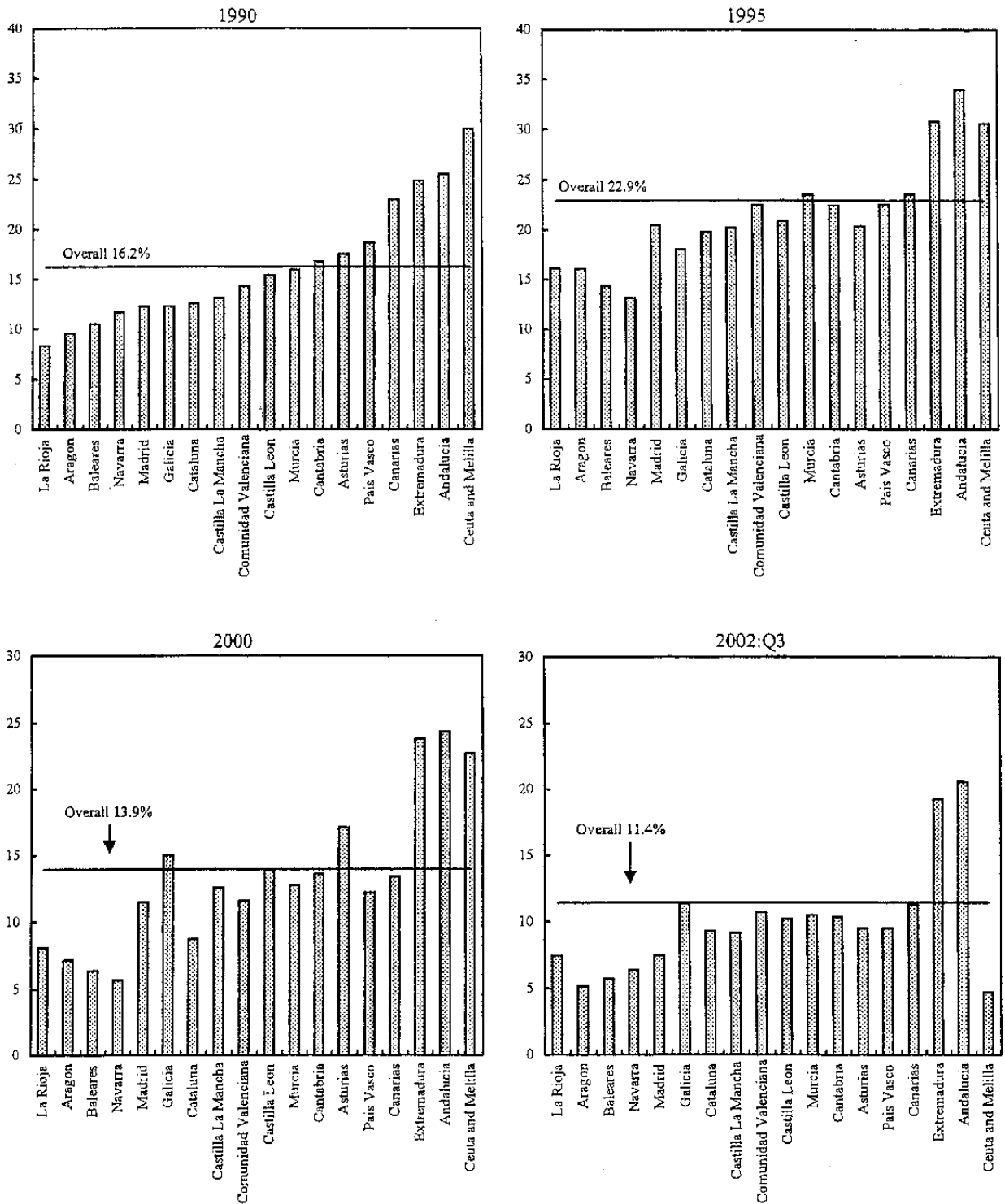
1/ Measured by the change in the structural primary balance.

Figure 5. Spanish, European, and U.S. Bank Stock Indices, 2000-03
 (100=December 31, 2000)



Sources: Bloomberg and Datastream.

Figure 6. Spain: Unemployment by Regions, 1990-2002



Source: Bank of Spain.

Table 1. Spain: Main Economic Indicators, 1998-2003 1/

	1998	1999	2000	2001	Forecast	
					2002	2003
Demand and supply in constant prices						
Gross domestic product	4.3	4.2	4.2	2.7	2.0	2.4
Private consumption	4.4	4.7	3.9	2.5	1.8	2.2
Public consumption	3.7	4.2	5.0	3.1	3.1	3.0
Gross fixed investment	10.0	8.7	5.7	3.2	1.4	3.4
Equipment investment	12.6	8.4	5.1	0.3	-2.3	2.0
Construction investment	7.8	9.0	6.2	5.8	4.5	4.5
Stockbuilding 2/	0.2	0.1	-0.1	0.0	0.0	0.0
Total domestic demand	5.7	5.6	4.4	2.7	1.9	2.6
Exports of goods and services	8.2	7.7	10.0	3.4	1.0	3.3
Imports of goods and services	13.2	12.7	10.6	3.5	0.9	3.9
Output gap (percent of potential)	-0.8	0.0	0.9	0.2	-1.0	-1.6
Private credit growth	16.5	15.4	17.2	11.8	14.1 3/	...
Prices						
GDP deflator	2.4	2.7	3.5	4.2	4.1	3.7
HICP (average) 4/	1.8	2.2	3.5	2.8	3.6	3.1
CPI (average) 4/	1.8	2.3	3.4	3.6	3.1	3.1
Employment and wages						
Unemployment rate (in percent)	18.7	15.7	13.9	10.5	11.2	11.0
Unit labor cost (average)	1.4	1.7	1.9	2.5	1.9 5/	...
Wage growth	2.6	2.7	3.7	3.7	...	...
Employment growth	4.1	5.5	5.5	3.7	1.6	1.9
Personal sector						
Household savings (percent of disposable income)	12.2	10.8	9.6	9.8	...	...
Balance of payments (percent of GDP)						
Trade balance	-3.5	-5.1	-6.2	-5.4	-5.0	-4.9
Current account balance	-0.5	-2.3	-3.4	-2.6	-2.0	-2.0
Official reserves excl. gold (US\$ billions)	56.2	33.9	31.8	30.3	32.3	34.4
Nominal effective rate (1990=100)	76.2	74.7	71.9	72.3	73.6 3/	...
Real effective rate (1990=100)	84.9	84.2	82.1	83.6	86.1 3/	...
Public finance (percent of GDP)						
General government balance	-2.7	-1.1	-0.6	-0.1	-0.2	-0.3
Primary balance	1.3	2.2	2.5	2.7	2.5	2.5
Structural balance	-1.9	-1.0	-1.0	-0.4	0.3	0.6
Structural primary balance	2.1	2.4	2.1	2.4	3.0	3.3
General government debt	64.6	63.1	60.4	57.2	55.7	53.8

Sources: World Economic Outlook; Information Notice System and Fund staff estimates.

1/ Figures for 2002-03 are Fund staff projections.

2/ Change as percentage of previous year's GDP.

3/ As of October 2002.

4/ Year-on-year percentage change.

5/ As of November 2002.

Table 2. Spain: Fiscal Accounts, 1998-2003
(In percent of GDP)

	1998	1999	2000	2001	Proj.	
					2002	2003
Current revenues	37.7	38.3	38.5	38.6	38.3	38.0
Indirect taxes	11.1	11.7	11.7	11.4	11.4	11.3
Direct taxes	10.2	10.2	10.5	10.5	10.4	10.2
Social security contributions	13.0	13.1	13.3	13.6	13.6	13.6
Other current revenues	3.4	3.3	2.9	3.1	3.0	2.9
<i>Of which</i> : interest revenues	0.3	0.2	0.2	0.3	0.3	0.1
Current expenditures	36.5	35.4	35.2	34.7	34.7	34.4
Public consumption	17.5	17.4	17.6	17.5	17.6	17.3
Current transfers	12.8	12.4	12.3	12.3	12.3	12.3
Interest payments	4.3	3.5	3.3	3.1	3.0	2.9
Subsidies	1.1	1.2	1.2	1.1	1.1	1.1
Other current expenditures	0.9	0.9	0.8	0.8	0.8	0.8
Current balance	1.2	2.9	3.3	3.9	3.7	3.6
Capital revenues	1.4	1.4	1.2	1.2	1.2	1.2
Gross fixed capital formation	3.3	3.5	3.2	3.4	3.4	3.6
Capital transfers and other	1.9	2.0	1.8	1.8	1.7	1.6
Primary balance	1.3	2.2	2.5	2.7	2.5	2.5
Overall balance	-2.7	-1.1	-0.6	-0.1	-0.2	-0.3
Government debt	64.6	63.1	60.4	57.2	55.7	53.8
Memorandum items:						
Structural primary balance 1/	2.1	2.4	2.1	2.4	3.0	3.3
Structural balance 1/	-1.9	-1.0	-1.0	-0.4	0.3	0.6
Structural expenditure	41.0	40.7	40.5	40.3	39.3	38.8
Structural revenue	39.1	39.7	39.6	39.8	39.7	39.4

Sources: Cuentas Financieras, Bank of Spain; Intervencion General de la Administracion del Estado; and Fund staff projections.

1/ Excludes 0.1 percent of GDP received from the auction of mobile telephone licenses in 2000.

Table 3. Spain: Updated Stability Program, 2002–06

(In percent of GDP, unless otherwise indicated)

	2002	Program			2006
		2003	2004	2005	
General government (in % of GDP) 1/					
Revenue	39.8	39.8	39.8	39.8	39.8
Expenditure	40.1	39.8	39.7	39.7	39.6
Current expenditure	34.7	34.5	34.3	34.1	33.9
Capital expenditure	5.4	5.4	5.5	5.6	5.7
Balance	-0.2	0.0	0.0	0.1	0.2
State	-0.6	-0.5	-0.4	-0.3	-0.2
Social security	0.8	0.5	0.4	0.4	0.4
Territorial governments	-0.4	0.0	0.0	0.0	0.0
Gross debt	55.2	53.1	51.0	49.0	46.9
Primary balance	2.7	2.8	2.7	2.7	2.7
Macroeconomic scenario (growth rates)					
Real GDP	2.2	3.0	3.0	3.0	3.0
Private consumption	1.9	2.9	2.9	2.9	2.9
Public consumption	3.0	3.0	3.0	3.0	3.0
Gross fixed capital formation	1.8	3.8	3.5	3.5	3.5
Domestic demand	2.1	3.1	3.1	3.1	3.1
Exports	1.8	4.0	7.3	7.3	7.3
Imports	1.7	4.4	7.3	7.3	7.3
Other variables					
GDP deflator	3.5	2.8	2.8	2.8	2.8
Private consumption deflator	3.5	3.1	2.5	2.5	2.5
Employment	1.1	1.8	1.8	1.8	1.8
Authorities' low-growth scenario					
Real GDP (growth rate)	2.0	2.0	2.5	2.5	2.5
General government balance	-0.2	-0.4	-0.3	-0.2	0.0
Gross debt	55.2	54.1	52.6	51.1	49.5

Source: Data provided by the Spanish authorities.

1/ On an ESA95 basis.

Table 4. Spain: Balance of Payments, 1998-2002
(in percent of GDP)

	1998	1999	2000	2001	2002 Jan.-June
Trade in goods balance	-3.5	-5.1	-6.2	-5.4	-4.2
Exports of goods (fob)	19.0	18.7	20.7	20.2	19.5
Imports of good (fob)	22.5	23.8	26.9	25.6	23.7
Tourism balance	4.2	4.5	4.6	4.6	3.6
Receipts	5.1	5.4	5.5	5.6	4.5
Payments	0.9	0.9	1.0	1.0	0.9
Non tourism services balance	-0.5	-0.7	-0.6	-0.4	-0.3
Receipts	3.3	3.5	4.0	4.3	4.2
Payments	3.8	4.2	4.6	4.8	4.6
External balance of goods and services	0.2	-1.2	-2.2	-1.2	-0.9
Net factor income	-1.3	-1.6	-1.5	-1.6	-1.7
Net current transfers	0.6	0.5	0.3	0.3	0.5
Current account balance	-0.5	-2.3	-3.4	-2.6	-2.1
Net capital transfers	1.1	1.2	0.8	0.9	1.2
Acquisitions less disposals of non-financial non-produced assets	0.0	0.0	0.0	0.0	0.1
Capital Account	1.1	1.2	0.8	1.0	1.2
Net lending or net borrowing of the nation	0.6	-1.2	-2.6	-1.7	-1.0
Financial Account	0.0	2.0	3.5	2.9	2.7
<i>of which:</i> Direct Investment (net)	-1.2	-4.4	-3.1	-1.0	0.8
Portfolio Investment (net)	-4.5	-0.2	-0.2	-2.7	-1.9

Source: Bank of Spain.

Table 5. Spain: Public Sector Debt Sustainability Framework, 1997-2007

	Actual		Projections									
	2000	2001	2002	2003	2004	2005	2006	2007	2010	2020	2030	2040
I. Baseline medium-term projections												
1. Public debt/revenues 1/	152.2	143.6	140.8	137.2	129.8	123.8	117.2	110.9	95.8	88.8	150.6	313.3
2. Public debt/GDP	60.4	57.2	55.7	53.8	51.0	48.2	45.6	43.2	36.8	32.9	55.1	113.6
3. Change in public debt/GDP 2/	-2.7	-3.1	-1.5	-1.9	-2.8	-2.7	-2.6	-2.4	-2.0	0.4	3.1	7.3
4. Net debt-creating flows/GDP (5+6)	-3.8	-3.5	-2.8	-2.8	-2.7	-2.6	-2.5	-2.3	-1.7	0.4	2.9	6.7
5. Overall deficit, excluding net interest payments/GDP (=primary deficit)	-2.5	-2.7	-2.5	-2.5	-2.4	-2.3	-2.4	-2.3	-1.9	0.4	3.1	7.1
Revenue and grants/GDP	39.7	39.9	39.6	39.2	39.3	39.0	38.9	38.9	38.4	37.0	36.6	36.3
Noninterest expenditure/GDP	37.0	36.9	36.8	36.6	36.8	36.5	36.4	36.5	36.4	37.3	39.6	43.4
6. $((r - \pi) - g(1 + \pi)) / (1 + g + \pi + g\pi)$ debt/GDP (8/7) 3/	-1.3	-0.8	-0.3	-0.3	-0.3	-0.3	-0.1	0.0	0.3	0.1	-0.2	-0.4
7. Adjustment factor: $1 + g + \pi + g\pi$	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
8. $((r - \pi) - g(1 + \pi))$ debt/GDP (9+10)	-1.4	-0.9	-0.3	-0.4	-0.4	-0.3	-0.1	-0.1	0.3	0.1	-0.2	-0.5
9. $(r - \pi)$ times debt/GDP	1.3	0.8	0.8	1.0	1.5	1.5	1.6	1.5	1.5	1.1	1.5	2.9
10. minus $g(1 + \pi)$ times debt/GDP	-2.7	-1.7	-1.2	-1.4	-1.9	-1.9	-1.7	-1.5	-1.2	-1.0	-1.6	-3.3
11. Residual, including asset changes, privatization receipts (negative), and valuation changes in external debt /GDP (3-4)	1.0	0.4	1.3	0.9	-0.1	-0.1	-0.1	-0.1	-0.3	0.0	0.2	0.6
Memorandum items: Key macro and external assumptions												
Nominal GDP (in local currency)	609	650	692	734	780	829	879	931	1,104	1,910	3,307	5,724
Real GDP growth (in % per year)	4.2	2.7	2.0	2.4	3.4	3.6	3.5	3.3	3.1	3.1	3.1	3.1
Consumer price index (change, in % per year)	3.5	2.8	3.6	3.1	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
GDP deflator (change, in % per year)	3.5	4.2	4.1	3.7	2.7	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Average real interest rate (nominal rate minus change in GDP deflator, in %)	2.1	1.4	1.4	1.9	2.8	3.0	3.3	3.3	3.4	3.4	3.4	3.4
Growth of revenues (deflated by GDP deflator, in % per year)	3.9	3.0	1.4	1.5	3.5	2.8	3.4	3.3	2.3	2.9	3.0	3.0
Growth of noninterest expenditure (deflated by GDP deflator, in % per year)	3.0	2.2	2.0	1.9	3.9	2.9	3.2	3.5	2.4	3.1	3.3	3.5
II. Stress tests												
1. If real interest rate, real GDP growth rate, and primary balance (in % of GDP) in 2003-2040 are equal to their average in the decade ending in 2002.			55.7	57.8	58.9	60.0	61.2	62.5	55.5	51.1	75.3	139.1
2. If real interest rate in 2003 and 2004 is average plus two standard deviations, others at baseline			55.7	61.1	65.7	62.9	60.2	57.8	50.8	46.2	70.4	134.0
3. If real GDP growth rate in 2003 and 2004 is average minus two standard deviations, others at baseline			55.7	55.6	55.0	52.2	49.6	47.1	40.1	35.4	59.3	122.7
4. If primary balance (in % of GDP) in 2003 and 2004 is average minus two standard deviations, others at baseline			55.7	59.0	61.3	58.5	55.9	53.4	46.4	41.8	65.8	129.4
5. Combination of 2-4 using one standard deviation shocks			55.7	63.0	70.0	67.1	64.5	62.0	55.0	50.6	74.8	138.5
6. One time 30% real depreciation in 2003, others at baseline 4/			55.7	53.8	51.0	48.2	45.6	43.2	36.1	31.3	55.1	118.5
7. If debt ratio in 2003 rises by (additional) 10% of GDP, others at baseline			55.7	63.8	60.9	58.1	55.4	53.0	46.0	41.4	65.4	129.0
Memorandum items:												
Primary deficit (in % of GDP, average of past ten years)			-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Primary deficit (in % of GDP, standard deviation of past ten years)			1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Real interest rate (nominal rate minus change in GDP deflator, average of past ten years)			6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1
Real interest rate (nominal rate minus change in GDP deflator, standard deviation of past ten years)			4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9
Nominal interest rate (average of past ten years)			7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7
Nominal interest rate (standard deviation of past ten years)			1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Real GDP growth rate (average of past ten years)			2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Real GDP growth rate (standard deviation of past ten years)			1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
GDP deflator (average of past ten years)			1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
GDP deflator (standard deviation of past ten years)			3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9

1/ General government. Projections are based on current benefits and contributions to the pension system; population projections reflect immigration of 160,000 people annually through 2020.

2/ For comparability with previous years, the calculation of the change in 2010, 2020, 2030, and 2040 corresponds to the change from the previous year, respectively 2009, 2019, 2029, and 2039.

3/ Defined as: r = interest rate; π = GDP deflator, growth rate; g = real GDP growth rate.

4/ Real appreciation is approximated by nominal appreciation against U.S. dollar plus increase in domestic GDP deflator.

Table 6. Product Market Regulation in Spain and Other Selected Economies, 1998 1/

	Spain	Italy	France	Germany	Ireland	United Kingdom	United States
Product market regulation	1.6	2.3	2.1	1.4	0.8	0.5	1.0
State control							
Overall	2.6	3.9	2.6	1.8	0.9	0.6	0.9
Scope of public enterprise sector	4.0	5.3	3.8	1.8	1.8	0.0	2.0
Size of public enterprise sector	0.8	2.3	2.6	1.4	1.4	0.0	0.0
Special voting rights	4.0	6.0	3.0	2.0	0.0	0.0	2.0
Control of public enterprises by legislative bodies	0.0	5.3	0.0	0.0	1.5	0.0	0.0
Use of command and control regulation	4.6	3.1	4.8	3.4	0.0	2.3	1.1
Price controls	1.8	2.2	0.9	1.7	1.0	0.6	0.0
Barriers to entrepreneurship							
Overall	1.8	2.7	2.7	2.1	1.2	0.5	1.3
Licences and permit system	2.0	0.0	4.0	4.0	4.0	0.0	4.0
Communication and simplification of rules and procedures	0.3	0.8	0.9	1.3	0.6	0.0	0.6
Administrative burdens for corporations	3.8	5.3	3.3	2.5	1.5	0.8	0.5
Administrative burdens for sole proprietor firms	1.8	4.3	3.8	3.3	0.8	1.3	1.3
Sector specific administrative burdens	3.3	4.5	3.6	2.3	0.3	0.4	0.5
Legal barriers to entry	0.5	3.0	2.0	0.5	0.7	1.3	1.0
Antitrust exemptions	0.0	1.3	1.1	0.0	0.0	0.0	1.3
Barriers to trade and investment							
Overall	0.7	0.5	1.0	0.5	0.4	0.4	0.9
Ownership barriers	0.0	0.0	1.8	0.0	0.0	0.0	2.2
Discriminatory procedures	0.3	0.3	0.5	0.5	0.0	0.0	0.3
Regulatory barriers	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Tariffs	2.0	2.0	2.0	2.0	2.0	2.0	1.0
Economic regulation							
Overall	2.1	3.5	2.3	1.4	0.8	0.6	1.0
Regulation of economic structure	1.6	3.9	2.3	1.0	1.2	0.4	1.0
Regulation of economic behaviour	3.5	4.1	3.2	2.3	0.4	0.9	1.2
Regulation of competition	0.8	2.0	1.3	0.7	0.5	0.3	0.8
Administrative regulation							
Overall	2.3	3.0	3.1	2.7	1.5	0.5	1.2
Administrative burdens of startups	2.9	4.6	3.5	2.7	0.9	0.8	0.7
Regulatory and administrative opacity	1.2	0.6	2.6	2.7	2.3	0.1	2.0

Source: OECD.

1/ Scale of 0 to 6 from the least to the most restrictive.

Table 7. Spain: Indicators of External and Financial Vulnerability 1/

(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	
					Latest observation	Date of observation
External indicators 1/						
Exports (annual percent change, in U.S. dollars)	6.5	3.2	2.3	3.1	3.0	Aug.
Imports (annual percent change, in U.S. dollars)	10.5	8.8	5.1	0.0	-1.0	Aug.
Terms of trade (annual percent change)	3.8	1.7	-2.2	3.2	...	...
Current account balance (settlements basis)	-0.5	-2.3	-3.4	-2.6	-3.1	June
Capital and financial account balance	1.1	3.1	4.3	3.7	4.2	June
<i>Of which</i> : Inward portfolio investment (debt securities etc.)	2.3	6.6	12.2	5.9	-0.5	June
Inward foreign direct investment	1.6	2.3	7.8	4.7	0.3	June
Other investment liabilities (net)	3.1	2.5	6.9	8.1	3.5	June
Official reserves (in billions of U.S. dollars, end-of-period) 2/	56.2	33.9	31.8	30.3	32.4	Oct.
Broad money to reserves	9.5	10.1	...	...	...	...
Central Bank foreign liabilities (in billions of U.S. dollars) 2/	70.5	80.9	86.1	76.3	69.7	Oct.
Foreign assets of the financial sector (in billions of U.S. dollars)	208.6	266.1	361.8	396.0	366.1	Oct.
Foreign liabilities of the financial sector (in billions of U.S. dollars)	350.8	441.8	585.2	648.2	616.5	Oct.
Official reserves in months of imports 2/	2.5	2.2	2.0	2.1	2.2	Aug.
Total external debt	24.5	30.6	34.5	31.6	39.5	June
<i>Of which</i> : General government debt	16.3	18.9	23.1	23.5	22.8	June
Total external debt to exports (ratio)	1.3	1.7	0.9	0.9	1.1	June
Exchange rate (per U.S. dollars, period average)	0.9	0.9	1.1	1.1	1.0	Nov.
Financial market indicators						
Public sector debt (Maastricht definition)	64.6	63.1	60.4	57.2	...	...
Three-month treasury bill yield	3.8	3.0	4.6	3.9	3.0	Oct.
Three-month treasury bill yield (real)	2.0	0.8	1.1	1.1	-0.8	Oct.
Stock market index	286.1	309.1	330.0	270.3	205.0	Nov.
Share prices of financial institutions	336.3	355.1	413.8	402.1	310.3	Nov.
Spread of three-month treasury bills with Germany (percentage points, end-of-period)	0.4	0.1	0.3	0.3	0.4	Oct.
Financial sector risk indicators						
Share of foreign exchange loans in total lending (in percent)	7.2	6.7	7.1	7.0	11.6	Oct.
Share of foreign deposits in total deposits (in percent)	7.7	22.9	25.1	25.0	25.8	Oct.
Share of real estate sector in private credit	28.4	29.1	30.3	31.6	33.0	Sept.
Share of nonperforming loans in total loans	2.0	1.5	1.2	1.2	1.2	Sept.
Share of nonperforming loans in total assets	0.9	0.7	0.6	0.6	0.6	Sept.
Risk-based capital asset ratio (national definition) 3/	11.5	11.1	10.4	10.5	10.3	June

Sources: Bank of Spain, Economic Bulletin and Statistical Bulletin; data provided by the authorities; and IMF, International Financial Statistics.

1/ The interpretation of some indicators is affected by the launch of monetary union in 1999.

2/ Reserves and foreign liabilities refer to the Bank of Spain, both before and after EMU.

3/ Data for June 2002 does not account for accrued profits, and is not comparable with the annual data.

FUND RELATIONS

(As of December 31, 2002)

I. **Membership Status:** Spain became a member of the Fund on September 15, 1958. On July 15, 1986, Spain accepted the obligations of Article VIII Sections 2, 3, and 4 of the Articles of Agreement.

II. General Resources Account:	SDR Million	% Quota
Quota	3,048.90	100.0
Fund holdings of currency	1,878.16	61.6
Reserve tranche position	1,170.75	38.4

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	298.81	100.0
Holdings	260.06	87.03

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:**

Type	Approval Date	Expira- tion Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	2/06/78	2/05/79	143.19	0.0

VI. **Projected Obligations to Fund:** None

VII. **Exchange Rate Arrangement:**

Spain entered the final stage of European Economic and Monetary Union on January 1, 1999, at a rate of 166.386 Spanish pesetas per euro. Under the arrangement, internal exchange rates with respect to the national currencies of EMU participants were fixed to the euro on January 1, 1999, whereas the external exchange rate of the euro is market-determined.

VIII. **Article IV Consultations:**

The last Article IV consultation was concluded on February 1, 2002. Spain is on the standard 12-month consultation cycle.

STATISTICAL ISSUES

Areas for improvement include:

- *General government.* The reconciliation of cash and accrual general government data is unclear. Details of these calculations would enhance monitoring at higher frequencies.
- *Territorial governments.* The details and timeliness of budgets and fiscal outcomes are wanting. The importance of monitoring fiscal developments at the territorial level is heightened by recent deviations from their fiscal targets, and is essential for the Budgetary Stability Law.
- *Employment and productivity data.* Two different measures of unemployment are reported by the authorities (so-called “registered” and “survey” unemployment), which vary substantially. Data on employment growth are distorted by the flow of workers from the informal to the formal labor force, which complicates the calculation of productivity growth and hence unit labor costs.
- *National Accounts.* These and fiscal data have been revised in line with the 1995 version of the European System of Accounts, but pre-1995 data remain to be revised.

Spain: Core Statistical Indicators
(As of January 14, 2002)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/Imports	Current Account Balance	Overall Government Balance 1/	GDP/GNP	External Debt 2/
Date of Latest Observation	1/14/03	11/30/02	12/31/02	11/30/02	1/14/03	12/2002	9/2002	9/2002	2001	Q3/2002	Q2/2002
Date Received	1/14/03	12/16/02	1/13/02	12/30/02	1/14/03	1/14/03	12/11/02	12/11/02	3/15/02	12/10/02	11/29/02
Frequency of Data	Daily	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annual	Quarterly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annual	Quarterly	Quarterly
Source of Update	Central bank; Reuters	Central bank; Reuters	Central bank	Central bank; Reuters	Central bank; Reuters	National Institute of Statistics; Reuters	Central bank; Reuters	Central bank; Reuters	Ministry of Finance	National Institute of Statistics; Reuters	Central bank
Mode of Reporting	Electronic	Electronic, tape and publication	Electronic, tape and publication	Electronic, tape and publication	Electronic, tape and publication	Electronic and publication	Electronic, tape and publication	Electronic, tape and publication	Tape and publication	Electronic, tape and publication	Electronic, tape and publication
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annual	Quarterly	Quarterly

1/ Central government balance is released to the press monthly, about three weeks after the end of the month, and published by the Ministry of Finance.

2/ Spanish government debt held by nonresidents is released to the press weekly by the central bank and drawn by staff from Reuters.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 03/19
FOR IMMEDIATE RELEASE
February 26, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Spain

On February 10, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Spain.¹

Background

After a sustained expansion in the late 1990s, Spain experienced a second year of subdued growth in 2002—albeit at a rate still well above the euro area average. This was largely due to the relative resilience of Spain's domestic demand, which in turn was supported by a comparatively stronger showing of investment, sustained by booming construction activity and a continued public infrastructure effort. After having been the mainstay of the earlier upswing, private consumption lost momentum, as households coped with rising inflation and higher indebtedness. The decline in equity values, fueled in some cases by the difficulties in Latin America (which otherwise had a limited direct effect on the Spanish economy), also sapped consumer confidence. Despite the weakening of aggregate demand, inflation (HICP) has climbed steadily since late 2001 to an annual average inflation of over 3.5 percent in 2002—exceeding the euro area average by some 1.5 percentage points, above most estimates of any likely by-product of real convergence.

National accounts data indicate that the slowdown in domestic demand may have bottomed out in the third quarter of 2002, and a slow recovery appears underway. Most projections (including

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the February 10, 2003 Executive Board discussion based on the staff report.

by staff) foresee a gradual pickup in the course of this year—helped by income tax cuts and a continued public investment effort in the 2003 budget—projected to yield an average annual growth of some 2.5 percent (versus a budget assumption of 3 percent). The outlook is, however, characterized by appreciable downside risks.

The sustained gains in fiscal consolidation (with achievement of the Stability and Growth Pact (SGP) requirements already in 2001) were maintained in 2002, despite the economic slowdown. Preliminary estimates point to a small deficit in 2002 due to shortfalls at the regional level. The 2003 budget—the first to be drawn up under the new Budgetary Stability Law (BSL)—again aims for a balanced budget, in keeping with the Law. Under the staff's growth projection, this would imply some further fiscal withdrawal of stimulus countering a monetary policy stance that, from Spain's perspective, is highly accommodative.

In the banking sector, major banks have been able to deal reasonably well with the difficulties stemming from Latin America, with the main casualty being a reduction in profit growth.

Following a series of earlier structural reforms, labor market performance has improved notably, with continued job creation even during the slowdown. The main recent labor market initiative modifies the unemployment benefits system to promote a "return-to-work" orientation and greater geographical mobility. It also includes a phasing out of the rural employment subsidy. However, the level and dispersion of unemployment remain high, wage differentiation is low, and recourse to wage indexation is widespread. Product market reform has advanced, but in key network services effective competition remains low given the still dominant position of a few operators. In retail trade and distribution, a number of regional and local entities have made increasing recourse to a variety of barriers to entry and competition, upholding supply rigidities in a sector subject to comparatively stronger demand pressures as Spain's income levels converge toward the EU average.

Executive Board Assessment

Directors commended Spain's pursuit of sound macroeconomic policies and structural reforms, which has contributed to a significant narrowing of the per capita income differential with the euro area average. A particularly welcome development is the continued growth in employment even during the current economic slowdown. Directors also noted that Spain had made judicious use of the earlier expansion to improve its underlying fiscal position, and has been in compliance with the Stability and Growth Pact (SGP) fiscal balance commitment since 2001. In addition, prudent financial supervision has contributed to the resilience of the banking sector in difficult times. Directors saw these positive results as a powerful incentive for continued resolute action on the structural front to address remaining challenges. This will need to include policies to prepare for population aging, further reduce unemployment, and ensure long-term competitiveness and growth prospects.

Directors considered that, in view of its sound policy setting and improved economic resilience, Spain is comparatively well-placed to weather the current weakness in the world economy, and to register another year of above euro area average growth in 2003.

Although a number of country-specific risks—including households' increased indebtedness, the boom in housing prices, and the exposure to Latin America—will warrant the authorities' continued vigilance, Directors generally saw these risks as relatively low and manageable. Barring a deterioration of global economic conditions, they expected the supportive monetary conditions and recent income tax cuts to sustain a gradual pickup in activity during the course of the year.

Directors noted that the persistence of an inflation differential vis-à-vis the rest of the euro area remains a source of concern. While recognizing that a series of one-off factors have contributed to the recent rise in inflation, and that part of the differential may be a by-product of real convergence, Directors nevertheless cautioned that the accumulation of a persistent inflation differential would, over time, weaken the economy's competitiveness. They looked forward to further improvements in economic data that will allow careful analysis of the underlying causes of Spain's comparatively higher inflation. Directors welcomed the assurance that wage moderation will be continued in 2003, and recommended that the authorities explore—in concert with the social partners—the scope for phasing out backward-looking wage indexation, and that they continue to implement structural reforms that will enhance competition and promote the supply response to demand pressures arising in specific sectors.

Directors commended the authorities' exemplary record on fiscal consolidation, which has been a pillar of Spain's successful economic strategy in recent years, and has provided room for a reduction in the income tax burden and an increase in capital spending. They welcomed the new Budgetary Stability Law which, by mandating budget balance at all levels of government, will foster fiscal co-responsibility and consolidate a culture of fiscal discipline throughout Spain. This is essential given the devolution process that has taken place. While the small fiscal withdrawal implied by a balanced budget target in 2003 was not seen as problematic, given very easy monetary conditions, Directors cautioned that, going forward, it will be important to avoid implementing the Budgetary Stability Law in a manner that is unduly procyclical. They welcomed, in this regard, the authorities' assurance to remain vigilant, and urged them to use the flexibility provided under the Law to take appropriate account of cyclical developments. Directors encouraged the authorities to improve fiscal monitoring and transparency, in particular by ensuring timely information on the execution of regional budgets and a closer consistency between the budget's economic assumptions and its revenue estimates.

Directors noted that, even though the demographic shock will occur comparatively late in Spain, it is also set to be deeper. They therefore saw considerable merit in the early formulation of a strategy that will allow needed reforms to be phased in gradually over time. In particular, they highlighted the need for a sufficiently ambitious pension reform to complement the objective of achieving a small fiscal surplus over the medium term, and thereby place the fiscal accounts on a sustainable long-term footing. Directors encouraged the authorities to make strong efforts to mobilize political and social support for substantive

pension reforms in their negotiations with the social partners this year. They highlighted, in particular, the importance of reforms that would include further steps toward eliminating incentives for early retirement and strengthening the link between contributions and benefits.

Directors welcomed the resilience shown by the banking sector in the face of the difficulties stemming from their investments in certain Latin American countries. Directors noted that strong starting positions together with strict prudential supervision and the promotion of conservative risk management by the Bank of Spain have contributed to Spanish banks remaining profitable, well-capitalized, and cost-efficient. They also supported efforts to improve the statutory framework of the savings banks. Going forward, Directors stressed the need for continued prudence and vigilance, including with respect to risks stemming from the rapid rise in mortgage lending and household indebtedness. Directors welcomed Spain's decision to participate in the Financial Sector Assessment Program (FSAP). They also commended the authorities' strong commitment to combat money laundering and the financing of terrorism, and looked forward to the implementation of new comprehensive legislation in this area.

Directors were encouraged by Spain's record on labor market reform, which has contributed to strong employment growth in recent years. With unemployment remaining high and exhibiting wide regional variation, the authorities' continued close attention to labor market issues remains nevertheless important. The "return-to-work" emphasis of the recent reform of the unemployment benefits system is well-placed and, as next steps, Directors recommended a revision of Spain's collective bargaining system to promote greater wage dispersion and to broaden the scope of negotiations beyond their almost exclusive focus on the salary increase. Several Directors welcomed the phasing out of the rural employment subsidy.

Directors also viewed favorably the ongoing structural reforms in a wide range of other areas. In product markets, they encouraged the authorities to build on the progress achieved to date by taking further firm action to foster competition in key network services, which are still largely dominated by a few operators. In retail distribution and trade, the priority should be to lift the obstacles to entry and other measures thwarting effective competition, imposed by a number of regional and local entities. The authorities were also encouraged to take steps to remove remaining rigidities in the supply of land and in the housing market. A number of Directors highlighted the importance of preparing for the macroeconomic and structural implications for Spain's medium term outlook and competitiveness that will arise from the enlargement of the European Union.

Directors welcomed Spain's contribution to the Fund's initiatives for its poorest members. They encouraged continued efforts to increase its official development assistance toward the U.N. target. Directors also welcomed Spain's support for trade liberalization and its commitment to the success of the Doha round, and a number of Directors encouraged the

authorities, in this context, to work in favor of a substantive reform of the EU's Common Agricultural Policy in the midterm review.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with Spain is also available.

Spain: Selected Economic Indicators, 1998–2003 1/

	1998	1999	2000	2001	2002	2003
Real economy (change in percent)						
Real GDP	4.3	4.2	4.2	2.7	2.0	2.4
Domestic demand	5.7	5.6	4.4	2.7	1.9	2.6
HICP (average)	1.8	2.2	3.5	2.8	3.6	3.1
Unemployment rate (in percent)	18.7	15.7	13.9	10.5	11.2	11.0
Public finances (general government; in percent of GDP) 2/						
Overall balance	-2.7	-1.1	-0.6	-0.1	-0.2	-0.3
Primary balance	1.3	2.2	2.5	2.7	2.5	2.5
Interest rates						
Money market rate	4.3	2.7	4.0	4.2	3.5	
Government bond yield	4.8	4.7	5.6	4.7	5.0	
Balance of payments (in percent of GDP)						
Trade balance	-3.5	-5.1	-6.2	-5.4	-5.0	-4.9
Current account	-0.5	-2.3	-3.4	-2.6	-2.0	-2.0
Fund position (as of December 31, 2002)						
Holdings of currency (in percent of quota)					61.60	
Holdings of SDRs (in percent of allocation)					87.03	
Quota (in millions of SDR)					3,048.90	
Exchange rate						
Exchange rate regime						
Present rate (January 14, 2003)						
Nominal effective exchange rate (1990=100)	76.2	74.7	71.9	72.3	73.6	3/
Real effective exchange rate (1990=100)	84.9	84.2	82.1	83.6	86.1	3/

Sources: *World Economic Outlook: Information Notice System*; and IMF staff estimates.

1/ Figures for 2002–2003 are IMF staff projections.

2/ Maastricht basis.

3/ As of October 2002.

**Statement by Hernán Oyarzábal, Executive Director for Spain
and Fernando Varela, Advisor to Executive Director
February 10, 2003**

At the outset, I would like to thank the staff both for the constructive dialogue during the IMF mission to Madrid and for the excellent papers presented for the Article IV consultation with Spain. The well-written staff report provides an insightful and balanced description of the current situation of the Spanish economy and very valuable suggestions on different key issues. The selected issues paper deals with several interesting questions of policy analysis that are most relevant in the current policy debate in Spain.

The implementation of a stable and sound macroeconomic policy and a firm commitment towards structural reforms by the Spanish government, combined with wage moderation, has led to major economic achievements in the last few years in terms of growth, economic resilience, reduction of unemployment, fiscal consolidation, debt reduction and increased economic efficiency.

There are, nevertheless, several areas where Spain must continue to make progress. The government is very much aware of this and is fully committed to remain vigilant and to continue implementing an economic policy oriented to stability, the promotion of sustainable growth in the middle and long run and further liberalization of labor and product markets.

Economic performance and outlook

After growing several years at an annual rate of over 4 percent, the Spanish economy, in line with other advanced industrialized nations, entered during 2001 in a slowdown phase, with a growth rate of 2.7 percent. In 2002, the estimated expansion rate of the Spanish authorities will be around 2.0 percent, mainly due to adverse external factors and weakening domestic demand, particularly in private consumption and equipment investment.

After meeting the Stability and Growth Pact commitments in 2001, fiscal consolidation has continued. The estimated overall deficit will probably be around -0.2 percent, a figure that strikes a clear contrast to the -3.2 percent five years ago and a -7 percent in 1995. The current account continues to have a moderate deficit of 2 percent of GDP while the external sector contribution in 2002 might have been just slightly negative, at -0.1 percent.

Contrary to previous cycles, the economy has shown during 2002 strong resilience. There continues to be a positive growth differential with the EU average growth rate of around 1 percent, facilitating further progress in the process of real convergence with the most advanced EU nations. Moreover, in spite of the slowdown, the economy has continued to create employment in 2002 at a rate of 1.6 percent, to a total of 175,000 full-time jobs. Notwithstanding this, the unemployment rate is likely to increase from 10.5 to 11.4 percent, basically due to a methodological change in the labor force survey which redefines the concept of jobless, and to the incorporation of new participants in the labor force.

For 2003, the official growth rate estimate is 3 percent, driven by an increase of 3.2 percent of domestic demand and a negative net external contribution of 0.2 percent. Private consumption will be boosted by personal income tax cuts that have come into force last January. It is estimated that this cut will save taxpayers around Euro 3.6 billion in 2003, adding 0.5 percent to GDP growth, and helping create 65,000 new jobs. In addition, government consumption is projected to increase around 3 percent, approximately at the same rate as the average of the past few years.

While construction investment will continue its expansion at a similar rate as in 2002, equipment investment should strengthen substantially throughout 2003 if the recovery is confirmed and in view both of the solid corporate earnings of the past few years and the prevailing low real interest rates.

In any event, the official growth estimate of 3 percent for 2003, somewhat higher than the staff's estimate of 2.4 percent, is predicated on the evolution of the world economy and particularly on the performance of the U.S. and the largest European countries, as well as on the uncertainties surrounding the political arena and its potential consequences on the oil prices.

There are also some domestic downside risks, as indicated by the staff. However, our Spanish authorities remain confident that there is a low probability that these risks could materialize. Household indebtedness, which is close to the EU average of 80 percent of gross disposable income, is within manageable limits, particularly given the current monetary conditions which are not expected to undergo drastic changes in the foreseeable future. Likewise, an abrupt development in the real estate market is highly unlikely. If anything, there might be a few price corrections, most probably in the form of a decline in real terms, but housing demand continues to be quite strong. Finally, both direct and indirect effects of the economic evolution of Latin America have had a negligible impact on the Spanish economy. Trade with that region is rather small and the investment share of companies operating in LA is also very low. The staff points to a possible effect on consumer and business confidence through the equity values of companies that have invested in LA. We believe this effect should be very small if not nil, given the overall evolution of the Spanish stock exchange that has followed or even outperformed other major financial markets in Europe and the U.S.

Inflation wages and competitiveness

Inflation has accelerated during 2002, particularly since August, reaching last December a 12-month rate of 4.0 percent. However, the average inflation for 2002 will be around 3.5 percent, with an estimated differential with the Euro area of 1.5 percentage points. In the opinion of the Spanish authorities, the acceleration of inflation in 2002 is explained by several one-off factors. First of all, the indirect tax increase enacted at the beginning of 2002, that could have contributed a 0.4 percent to the CPI increase. Secondly, a methodological change on CPI statistical calculations that has affected a number of items of personal consumption. This factor could explain an additional 0.2 percent. Finally, the introduction of

the Euro might have had a slightly stronger effect in Spain than in the rest of the Euro zone, due to the fixed exchange rate with the peseta and the likely rounding-off effect, contributing to the price rise probably somewhat over 0.2 percent. Oil price increases have also had an impact, as well as the adverse weather that has affected certain agricultural products.

Given the temporary nature of these one-off factors, the inflation rate is expected to come back to a more subdued level in 2003. In this regard, the evolution of food prices has shown already a substantial improvement, particularly in December, pointing to that direction.

Regarding the inflation differential with the Euro zone, apart from the apparently temporary widening undergone in 2002, the main question is whether such differential could be attributed to benign or equilibrating factors, or on the contrary, it is caused by excess of demand or supply-side rigidities. We fully agree with the staff conclusion that more research is needed to reach a definite conclusion on the underlying causes of the persistent inflation differential with the Euro area. The staff recognizes that the inflation differential attributed to benign causes varies between $\frac{1}{4}$ and 1 percentage point. Being the average differential inflation of about 1 percent in the period 1992-2002, the Spanish authorities believe that it is basically responding to equilibrating factors: the Balassa-Samuelson effect and a change in the demand of services, as a result of increases in income. The National Accounting Institute is introducing some methodological changes in the calculation of GDP as well as some statistical improvements to measure productivity that might substantially affect the empirical studies around the Balassa-Samuelson effect.

Nevertheless, there is no room for complacency. The authorities have a strong commitment towards eliminating any source of supply-side rigidities. The staff suggests that competition in the service sector should be improved, particularly among small retailers and local markets. Further to the measures that are commented under "Structural reforms" later on, the government has taken careful note of this opinion and has started to carefully study the functioning of distribution channels and its possible role in creating inflation pressures.

As regards wage moderation, it has been a relevant factor underlying the good performance of the Spanish economy in recent years, and it is highly likely that it will continue to be so in the future. The average wage increase in 2002 was 3.1 percent. The collective negotiation agreement for 2003 is about to be signed by the social partners reiterating the same basic sound principles that prevailed in 2002. Available data on productivity is not consistent with the overall economic performance. This inconsistency is fundamentally explained by the gradual absorption of the excess of supply in the labor market, the intense creation of employment, particularly on services and construction, which are sectors with low productivity levels, and probably accounting practices that need to be revised. However, indirect measures, such as the quota share with the main trade partners, show that competitiveness of Spanish products is maintained. From 1996 to 2002 the overall Spanish export quota to the Euro area remains at 8 percent. The disaggregated data with the main partners, Germany, France, Italy, the U.K. and Portugal, confirms this trend.

Role and scope of fiscal policy

The government believes that the main role of fiscal policy is to support long-term growth by creating a stable and predictable macroeconomic framework through a firm commitment to budget discipline. Following that guideline, fiscal policy in Spain is conducted within a framework based on three pillars:

- Firstly, the adherence and strict compliance with the Stability and Growth Pact (SGP) at the European level.
- Secondly, the internal Budgetary Stability Law (BSL) enacted in January 2002, that will start to be implemented in the 2003 budget. This law is based on four principles of fiscal policy: transparency, fiscal responsibility, limits on central government spending growth, and fiscal discipline. It obliges each branch of the government to be in balance or surplus, except under extraordinary circumstances.
- Thirdly, the Financing Arrangement with the Autonomous Communities (regional governments) that extends to these entities the responsibility on fiscal consolidation while providing for their revenue sufficiency.

Within this framework of strict and predictable fiscal rules, there is no much room for the use of fiscal policy in a proactive way, nor is it desirable. However, there is some scope to remain sensible to economic fluctuations in the short run. In case of a slowdown, fiscal policy could be allowed to react through the operation of the automatic stabilizers, without jeopardizing the principle of budget soundness. Moreover, both revenues and expenditures should be used to increase economic efficiency and to support appropriate decisions by economic agents on savings, investments and employment. Finally, in cases of extraordinary need, the flexibility embedded in the BSL can be used provided that a plan to return to a balanced position is submitted.

While supporting this framework, the staff suggests in its report that the implementation of fiscal policy under the BSL should be sufficiently flexible in order to be more responsive to changes in economic activity. Additionally, the selected issues paper provides some evidence of the positive impact of fiscal policy in economic activity.

The Spanish government appreciates these constructive comments. But, while agreeing that is necessary to take into account the position of the economy in the business cycle when setting the fiscal policy stance, the authorities emphasize that it is very important to continue implementing strictly the SGP and the BSL at the moment in Spain for the following reasons:

- The BSL will start to be implemented in 2003. It is necessary to demonstrate a firm commitment to it in order to strengthen fiscal credibility. Although there has been a drastic change in the public acceptance of the new role of fiscal policy, it is still a relative recent phenomenon in Spain that must be consolidated further.

- The fiscal austerity process in Spain, started in 1997, shows that fiscal retrenchment can have positive effects on activity, mainly through a crowding in of private investment.
- Finally, as shown by the current cycle, it is highly likely—as well as desirable—that in the new setting of macroeconomic policies within the EU, output volatility will diminish and consequently the need for an alleged proactive fiscal policy.

All in all, our Spanish authorities agree with staff on the need to remain vigilant of the evolution of the cycle and also on the strategy of building a small fiscal surplus in future years, not only to create a buffer for responding to economic fluctuations, but also to be better prepared for future contingencies such as the demographic shock. In this vein, the Stability Program of Spain contemplates a fiscal surplus of 0.2 percent starting in 2005-2006.

Fiscal stance and policy mix

For 2003, the government has decided to continue implementing a neutral fiscal policy in full compliance with the SGP and the BSL, that combined with the current monetary policy—the “very easy monetary conditions” in the staff’s words—will produce an overall expansionary effect. This policy mix should provide some support in the current process of real convergence with other European nations, while contributing to the overall macroeconomic stability in the Euro area. In line with this, the 2003 budget contemplates a zero nominal deficit, though the low growth scenario of 2.0 percent included in the Stability Program foresees a -0.4 percent nominal deficit. According to our Spanish authorities’ output gap methodology, this nominal deficit will still be compatible with a basically constant structural balance with respect to 2002 (estimated to be at 0.3 percent).

Staff views differ in that with a lower growth rate of 2.4 percent, there will be a structural surplus in 2003 of 0.6 percent, and hence, a withdrawal of fiscal impulse of 0.3 percent. In any event, we agree with the staff opinion that even in the case that the final balance target is achieved, under the less optimistic scenario of 2.0 percent growth, an eventual fiscal withdrawal will not be problematic at all when combined with the current stance of monetary policy.

On the revenue side, the objective is to increase the efficiency of taxation and to incentivate employment and household savings and investment. To this end, a second step of the personal income tax reform started in January 2003, contemplating an across-the-board reduction in taxes specially benefiting the lowest income groups and lighter taxations of salary income via larger reductions for earned income, as well as several incentives to increase labor market participation. On the expenditure side, the objective is to continue to raise the economy’s stock of physical human and technological capital, giving priority to public investment in infrastructure and research.

In paragraph 19, the staff makes three suggestions to improve monitoring and fiscal transparency. Regarding the execution of regional budgets, it should be noted that following the BSL, in 2003 all these regional entities have agreed to comply with the zero deficit rule

and to eliminate slippages produced in 2002. The BSL contains different measures to penalize noncompliance through shared responsibility on possible financial implications, peer pressure through the Council of Financial and Fiscal Policy, the authorization by the central government of any new credit or debt issues by the regional governments, and the need to have a plan to return to a balanced fiscal position in case of a deficit. On the information about the execution of regional budgets, besides the compulsory reports to their own Parliaments and accounting tribunals, a new framework will be established to provide and share information among the autonomous communities and central government in compliance with the BSL.

With regard to the public investment by public entities outside the general government, it should be stated that it is a normal budgetary practice in full compliance with the Eurostat regulations. There is full and transparent information on the activity of these public entities, that is included in the annual budget. Definite data is published after the debate in the Parliament and three reports are prepared annually on the execution of the budget including all public entities.

Finally, on the estimation of revenues in the 2003 budget, the government believes that it has been designed appropriately with due regard to the uncertainties in the international economy. The calculation has been consistent with the baseline macroeconomic scenario of the Stability Program and with due consideration of the reform of the personal income tax. It should be taken into account that the outcome of this reform is subject to considerable uncertainty at this stage, particularly the calculation of the positive impact on revenues stemming from the expansion of the tax base brought about by the economic recovery and the effects of the reform itself.

Demographic shock

As mentioned, the quality and sustainability of public finances is a pivotal feature of the government's economic policy. The strategy in this regard rests on the firm commitment to budgetary stability and the ensuing public debt reduction, and a set of policy measures in response to the challenge of population aging. These measures are the reform of the public pension system; the development of a second and a third pillar of pensions; the strict control and streamlining of health spending; and finally, steps to increase labor market participation.

Different measures are being implemented to reform the public pension system, which is seen as a gradual but ongoing process, based on the consensus of the affected parties. The process started with the Parliament commission called "Toledo Pact" created in 1995, that meets periodically. Recent measures include the Law on Measures to Establish a Phased and Flexible Retirement System approved in 2002, which sets up incentives for employers and workers in support of remaining active for a longer time; measures to fight fraud within the system, and the establishment of a Reserve Fund that by 2002 had already reached 1 percent of GDP, the target set for 2004. Negotiations have started with the social partners to establish a closer relationship between contributions and benefits by lengthening the period of social contributions to get access to a pension.

We welcome the debt sustainability analysis made by staff while noting that it offers a very sound and robust image of the Spanish fiscal accounts. It should be stressed, however, that this debt sustainability analysis is based on passive projections as if there were neither further changes in the budget balance or in the demographic trends, nor new measures to reform or supplement the public pension system, when in fact further measures are expected.

Financial sector

The government agrees with the staff that the Spanish financial sector is very strong and it enjoys high ratios of capitalization, solvency, efficiency and profitability, with very low levels of NPL and cautious provisioning. This situation is reinforced by close and prudent supervision.

The staff confirms the resilience of those Spanish banks that have invested in Latin America. While welcoming this conclusion, we note that only two major banks out of 369 existing financial institutions in Spain have developed a consistent investment pattern in LA, though they account for an important share of the financial activity in Spain (26 percent of deposits and 30 percent of loans). Their FDI exposure in LA amounts to US\$19.8 billion, with 90 percent concentrated in the three countries with investment grade (Mexico, Chile and Puerto Rico) and Brazil. Cross-border risk is US\$16.8 billion, with 84 percent centered in Mexico (46 percent), Argentina (14 percent), and Chile and Brazil (both with 12 percent).

The BIS data includes FDI, cross-border risk and local claims. It is important to distinguish between **local claims nominated in local currencies**, and **international claims**—FDI plus cross-border risk—as they have a totally different economic and financial meaning. The former implies a much smaller risk since there is no transfer risk and it is placed in subsidiaries. The latter, which accounts for US\$40 billion out of a total of US\$157 billion, is the most relevant variable to measure the cross-border exposure. The international claims of Spanish banks in LA account for a 16 percent of total, substantially below the 22 percent of U.S. claims, and close to the German position of 12.9 percent. Therefore, the real risk for the Spanish banks is substantially lower than the one conveyed in Box 3. Also, it is clear that vulnerability to liquidity pressures stemming from their foreign subsidiaries is small, and it seems highly unlikely that it may have any consequence on the ratings even under very stressful circumstances. We will welcome if staff could clarify its views on this issue.

The Spanish banks have fully provisioned all direct investment in Argentina, including book value and goodwill pending of amortization. Most of their cross-border risk has also been provisioned. As for the rest of investments in the region, the goodwill has been amortized at an accelerated schedule accounting to roughly 50 percent at the end of last year.

We agree with staff that the only effect of developments in LA on the two Spanish banks has been a reduction of profits and changes in their equity valuation that we believe is temporary. Their solvency, capitalization, overall profitability and efficiency have not been affected. Figure 5 shows the evolution of quotations relative to European and U.S. banks. We think

they should be compared with other banks of similar characteristics, large international banks with which they would show a rather similar performance.

On internal credit, total financing by non-financial corporations has slowed down in 2002 (with year-to-year growth rates of 18.1 percent, 14.6 percent and 14 percent in the first three quarters), but it continues to increase strongly. Financing to households has hovered around 14 percent without decelerating. It is clear that there are no signs of any risk of internal credit rationing.

Labor markets

During 2002 the government has made further efforts to increase flexibility and to improve the performance of the labor market, which are summarized in the staff report. It should be noted that the measures to phase out the agricultural subsidies to agricultural workers in Andalucía and Extremadura have been completed. Moreover, in line with the staff proposal, the resources of the public employment services have been substantially increased in the 2003 budget, particularly to hire more personnel, and additional steps are being taken to increase their efficiency.

The government has been actively promoting changes in the collective bargaining system. However, this is a task mainly for the social partners, as noted by staff, and it should be based on a broad consensus. The government is incentivating this process but further dialogue is needed. Regarding the safeguard clauses, they are deeply entrenched in the bargaining practices and it will very difficult to remove them, although probably they will lose significance as the Spanish inflation converges with the EU average. In the meanwhile, it should be recognized that they have contributed to moderate wage demands in the past. The so-called "*ultra actividad*" is an additional element of rigidity in the bargaining process. We agree with staff that a more flexible approach should be granted in order to enlarge the scope of the negotiations, but again, changing this aspect is very much in the hands of the social partners rather than in the government's.

Structural reforms

Increasing the liberalization and competitiveness of the product markets is a top priority for Spain. During 2002, additional efforts have been made to advance in the structural reforms front. While holding the EU Presidency last year, Spain set structural reforms as one of the priorities, resulting in the reinforcement of the Lisbon Strategy at the Barcelona European Council. Internally, the government has continued with the ongoing process of implementation of the structural reforms package launched in June 2000. Additionally new legislative initiatives have been started to improve the entrepreneurial environment and competition policy.

The focus of liberalization in 2002 has been network industries in recognition of their strategic role in determining the competitiveness of the Spanish economy. In telecommunications, a series of measures have been taken to improve the conditions for

interconnection with the incumbents' lines, to favor a general reduction of tariffs for local loop access services, and to reform public procurement procedures to attract as many operators as possible. In the energy sector the government has set up the framework to ensure full liberalization of electricity consumption, and gas supply starting in January 2003. Liberalization efforts have resulted in lower prices and increased number of operators in these network industries.

The staff points to the existence of some competition restricting practices arising from initiatives by the regions in retail trade and distribution. The government, which is responsible for setting the general legal framework, is taking steps to address this problem. Firstly, it has set a number of compulsory minimum requirements to gradually liberalize opening hours. Secondly, the Competition Tribunal will prepare a report on the possible existence of obstacles to effective competition on commercial distribution stemming from legal measures taken by the regions. The final aim will be to reach a pact with the regions to guarantee full competition in this sector.

The autonomy and independence of the Competition Tribunal has been strengthened by transforming it into an autonomous institution and increasing its budget. Also, the regions will be able to create their own institutions to foster competition, which will bring more resources and closer scrutiny to undesired market practices. We do not think that this step will put at risk the coherence of national competition policy, if sufficient coordination among different bodies at central and regional levels is established, as contemplated in the law. Further to the creation of the Council for the Defense for Competition mentioned by staff, the administrative procedures are unified and set at the national level. Also, the central institution, the Competition Tribunal, can participate in any of the procedures opened by the tribunals at the regional level.

On entrepreneurial activity, the New Enterprise Law, which will facilitate the creation of new companies by simplifying registration formalities and accounting procedures, has already been approved by Congress and submitted to the Senate. Additionally, a new bankruptcy law is in the pipeline. This law will update and unify current legislation and will introduce the possibility of partial sale of viable parts of the company, as well as changes in the penal responsibility of the entrepreneur. Regarding corporate governance, the government has asked a special commission of experts (Comisión Aldama) to report on measures to improve governance issues. The report was published this past January and puts the accent on several transparency measures, which are being studied by the government to translate them into possible policy measures.

Other issues

Spain is strongly committed to fighting against money laundering and combating the financing of terrorism. Spain is an FATF member and has played a proactive role on AML/CFT issues providing third countries with technical assistance on this area. The government has already submitted to Congress a new legislation on capital movements and anti-money laundering issues, which provides a more clear framework by refining previous

legislations to include already assumed EU compromises. The new law also typifies more clearly the information requirements and omission sanctions on capital movements. Additionally a new comprehensive legislation on AML-CFT is in the process of approval. Spain supports the success of the Doha round and is committed to a further liberalization of trade with least developed countries as a key instrument in promoting sustained economic development. Trade negotiations will be carried out within the framework of the Common Commercial Policy. Concerning the Common Agricultural Policy, Spain maintains an open position to discuss and to make progress in the reform process initiated within the EU.

Regarding statistical issues, new measures will improve National Accounts and data dissemination on territorial governments. The National Statistics Institute (INE) has reviewed its National Accounts system to improve their reliability and comparability. The new series will use as base the year 2000 and will be gradually published between 2003 (series since 1995) and 2004 (series since 1980). The Budgetary Stability Law contemplates a public information center, that will provide information on the indebtedness of territorial governments in order to monitor their compliance with the law.

Finally, with regard to the share of loans in Spain's ODA, it should be noted their decreased participation from 15 percent in 2000 to 9.2 percent in 2002. The proportion of conventional concessional loans is even lower, 6.4 percent in 2002, while the weight of the microcredits has risen recently to 2.8 percent of the total, which is seen by DAC and recipient countries as a positive development.