

Spain: 2003 Article IV Consultation—Staff Report; Staff Supplement; 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 2003 Article IV consultation with Spain, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **November 17, 2003**, 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 February 3, 2004.** 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 staff supplement of **March 17, 2004** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its March 19, 2004 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for Spain

The document list below has been or will be separately released.

Selected Issues

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 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Spain

Approved by Michael Deppler and G. Russell Kincaid

February 3, 2004

- Consultation discussions were held in Madrid and Santiago de Compostela during November 5–17, 2003.
- The staff team comprised Messrs. Leipold (head), Hoffmaister, and Ms. García-Escribano (all EUR), and Ms. Dabán (FAD). Messrs. Martí and Moreno (OED) participated in the meetings.
- The team met with Vice-Prime Minister and Minister of Economy Rato, Minister of Finance Montoro, Bank of Spain Deputy Governor Gil, and other senior officials. It also met with representatives of financial institutions, the employers' association, labor unions, and the economic spokespersons of the major political parties. As suggested by the authorities last year, in light of the significant regional dimension in a range of areas, the 2003 mission also included a visit to a regional authority (Galicia), and held related discussions with regional political, financial, and business representatives.
- Spain maintains an exchange system free of restrictions on payments and transfers for current international transactions, except for those imposed and maintained by Spain solely for the preservation of national or international security, and notified to the Fund pursuant to Decision No. 144-(52/51), and has accepted the obligations of Article VIII, Sections 2, 3, and 4 (Appendix I).
- The authorities have indicated their intention to publish this staff report.

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EXECUTIVE SUMMARY

Main developments

The Spanish economy is continuing to do well. The growth differential with the euro area is sizable, job creation has been brisk, and the general government moved into surplus in 2003. Even traditionally weak spots in the labor market are showing signs of improvement.

Growth has relied heavily on domestic demand, with some related risks. The strength of private consumption, along with insufficient competition in some markets, has sustained a continued inflation and cost differential with the euro area, eroding competitiveness. Growth has also been accompanied by a housing price boom and a rapid rise in household indebtedness. Though the consensus central scenario is that of a soft landing, risks of a more disruptive process persist and intensify as long as underlying trends continue unabated.

The stability-orientation of policies has been maintained in the run-up to general elections in March 2004, but several structural challenges remain to be addressed. Fiscal policy has been focused on preserving a general government balance, as legislated in the Budgetary Stability Law (BSL). After substantial earlier progress, further structural reforms—notably with respect to the pension system—have moved to the next legislature.

Policy requirements

Exercising fiscal restraint. Given very easy monetary conditions, re-balancing growth away from domestic demand and reducing inflation will require continued fiscal restraint. The budgeted “zero deficit” target for 2004 implies an untimely fiscal loosening. Firm observance of the BSL’s fiscal framework (centered on a central government expenditure ceiling), along with the full play of automatic stabilizers, should ensure a continued surplus. Beyond that, staff advises a proactive search for further savings under the ceiling and a strict safeguarding of the contingency fund to ensure that fiscal policy maintains a restrictive stance.

Strengthening budget monitoring and transparency. The widening range of financing modalities for public investment (including public-private partnerships) requires a *closer tracking of the public sector’s contingent liabilities*. Furthermore, in a highly decentralized environment, the *monitoring of regional budget execution* needs to be strengthened.

Reviving structural reforms, with a focus on: (i) the pension system to ensure long-term fiscal sustainability; (ii) the working of the housing market and the land supply process to ease related pressures; (iii) the wage-setting system to ensure greater wage differentiation; and (iv) the retail distribution sector to enhance competition thwarted by regional obstacles.

Safeguarding financial sector stability. The proactive supervisory approach that helped the system weather Latin American difficulties needs now to help guard against emerging domestic risks. The recently requested FSAP should be helpful to this end.

I. ECONOMIC BACKGROUND

1. **While not escaping the global slowdown, the Spanish economy has weathered it relatively well, thanks to the strength of domestic demand (Table 1).** After several years of growth in excess of 4 percent, propelled also by the tailwinds of EMU participation, the expansion lost steam in 2001, and growth slowed to 2 percent in 2002. The slowdown reflected euro area weakness and the worldwide slump in tourism, with net exports exerting a drag on activity. But—in contrast to most other EU countries—domestic demand held up well, buoyed by private consumption, public infrastructure spending, and booming construction activity. Output growth thus remained well above the euro-area average, ensuring further real income convergence (Figure 1). In addition, reflecting improved flexibility in labor markets, employment continued expanding. Both these developments contrast with the experience during previous slowdowns, when growth would fall well below the euro-area average in the midst of sizable job losses (Figure 2). Productivity performance, however, has remained lackluster, partly reflecting the success in drawing new, lower-skilled entrants into employment.¹ At the same time, household indebtedness has risen rapidly, amidst a continued housing price boom.

Selected Economic Indicators, 1997-2003
(Real growth rates in percent, unless otherwise noted)

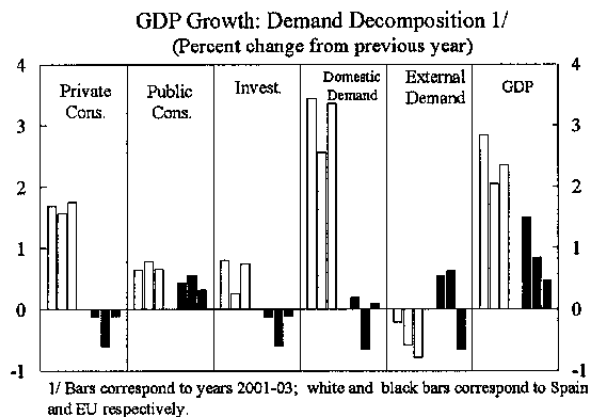
	1997-2000 1/	2001-02 1/	2003: H1 2/	2003Q3 2/
Real GDP	4.2	2.4	2.3	2.4
Final domestic demand	4.8	2.8	3.3	3.4
Net exports 3/	-0.6	-0.4	-1.1	-1.1
Harmonized inflation	2.3	3.2	3.6	3.5
Employment	4.6	2.9	2.5	2.4

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

1/ Annual averages.

2/ Year on year.

3/ Contribution to growth.

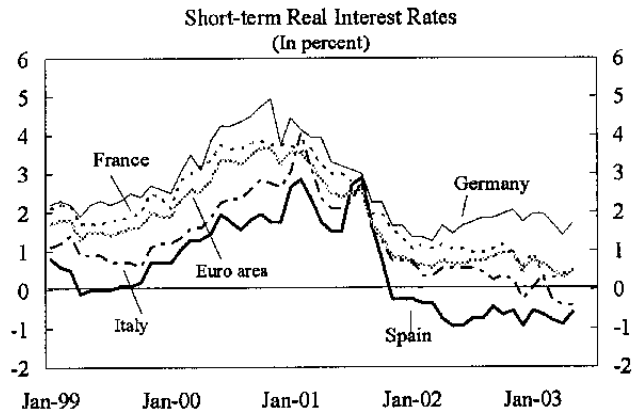


2. **Inflation has declined since late 2002, but the cumulative inflation differential with the euro area has eroded competitiveness.** From around 4 percent in late 2002, inflation declined to 2.7 percent by end-2003. In part, the deceleration in inflation reflected a favorable base effect in domestic energy prices, the end of supply disruptions associated with livestock disease, and the fading of the euro-changeover effects. As a result, the year average inflation differential with the euro area narrowed to 1 percentage point in 2003 (from 1¼ percentage points in 2002—Figure 3). The cumulative differential since EMU qualification in 1997, however, amounts to about 6 percentage points, contributing to a loss in competitiveness relative to other euro-area countries which is also revealed in a relatively

¹ Staff estimates suggest that employment growth accounted for about 1.9 percentage points or roughly half of Spain's growth in the late 1990s; productivity gains accounted for only some 0.5 percentage points, or about half the EU average.

faster rise in unit labor costs (Figure 4). Nevertheless, overall export market shares have held up well to date.

3. **The general government is estimated to have recorded a small surplus in 2003, helping counter very easy monetary conditions.** The strength of social security contributions is estimated to have raised the social security surplus to close to 1 percent of GDP in 2003, more than offsetting a small central government deficit (Table 2). Considerable uncertainty still surrounds the outcome for regional governments: assuming they balance their budgets as required under the BSL, the general government accounts would record a surplus of around ½ percent of GDP in 2003, entailing appreciable fiscal withdrawal. For its part, monetary policy is clearly accommodative, with short-term real interest rates in negative territory for over two years.



4. **The prevailing prospect is for a moderate but sustained recovery in the course of 2004, with a persistent inflation differential versus the euro area.** Staff, official and Consensus projections do not differ markedly. The staff's GDP growth forecast is slightly above that of the authorities for 2003 (2.4 versus 2.3 percent) and slightly below for 2004 (2.8 versus 3 percent). Such a performance—still projected to be largely driven by the strength of domestic demand, with a continued, albeit smaller, drag from net exports—would again appreciably outstrip that expected for the euro area. At the same time, in both staff and official projections, inflation would remain in the order of 2.7 percent in 2004 (as measured by the private consumption deflator in the latter case)—implying a differential of around 1 percentage point with respect to prevailing forecasts for euro area inflation. Inflationary pressures may also emanate from the recent pickup in contractual wage increases (notably in construction and services), and the increasing recourse to wage indexation clauses (see ¶27).

Inflation and Contractual Wage Increases
(in percent)

	2000	2001	2002	2003 /1
Inflation (CPI, e.o.p.)	3.4	3.6	3.5	2.9
Wage Contracts				
Total	3.0	3.5	3.1	3.5
Agriculture	3.4	4.0	3.5	3.5
Industry	2.9	3.4	2.8	3.2
Construction	3.4	4.1	3.5	4.7
Services	2.9	3.3	3.0	3.5

Source: Bank of Spain.
1/ Data through September.

II. REPORT ON THE DISCUSSIONS

5. **The discussions focused on minimizing short-term risks and on identifying the structural reform priorities for the next government.** Over a number of years, policy implementation in Spain has been largely congruent with the tenor of Fund advice (Box 1). The discussions were also marked by broad concurrence, and centered on the requirements imposed by emerging domestic risks and on the reforms needed to strengthen performance going forward. On the first count, the authorities viewed the ebullience of the housing market and rising household indebtedness as driven essentially by fundamental factors and expected a gradual and orderly adjustment. They nonetheless agreed that it was incumbent on policies to minimize any related risks, with the main short-term requirements seen to be continued fiscal restraint, flanked by firm financial sector oversight. On the structural front, the discussions emphasized the need for measures to reform the wage negotiation process, improve the working of the housing market, strengthen competition in sheltered sectors, and place the pension system on a sustainable long-term footing. In addition, staff put greater weight than the authorities on the contingent risks that could arise from the variety of financing arrangements for the large public investment effort, and the related importance of close monitoring and full transparency. Staff saw benefits in Spain undertaking a Financial Sector Assessment Program (FSAP) and a fiscal transparency ROSC, and the authorities have since agreed to both.

Box 1. Spain: Policy Recommendations and Implementation

Policy implementation in Spain has for several years been largely in concert with Fund policy advice, and based on two main pillars: a stability-oriented fiscal policy and structural reforms in labor and product markets. Fiscal consolidation was pursued steadily, was largely expenditure-based, and avoided the procyclical responses that the Fund saw as a potential risk in case of a rigid implementation of the Budgetary Stability Law—in itself a very useful fiscal framework. However, the recommended strengthening of fiscal reporting and monitoring has fallen short of requirements, while comprehensive pension reform—key to long-term fiscal sustainability—has remained largely on the drawing board.

A series of structural reforms have appreciably improved the workings of labor and product markets. Political and institutional constraints have however stood in the way of two long-advocated measures: reform of the wage-setting system to secure greater wage differentiation, and of the land supply and zoning process to improve its responsiveness and transparency. In addition, growing regional responsibilities in several areas have limited the central government's reach, inter alia complicating the implementation of competition policy along the lines recommended by the Fund.

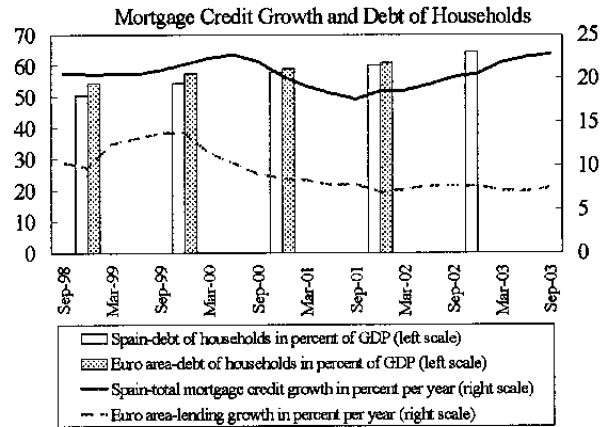
Finally, despite encouragement in this direction, Spain has made no recourse to the Fund's standards and codes initiatives. Recently, however, the authorities have advanced a formal request for a fiscal transparency ROSC and a FSAP; the latter had been pending since the last consultation.

A. Risks to the Outlook and Related Policies

With agreement on the baseline projection, the discussions dwelt on the main risks to this scenario arising from household indebtedness, the housing market boom, and losses in competitiveness.

6. Though household indebtedness has continued to rise rapidly, recently surpassing the EU average, the authorities viewed the related risks to growth as contained.

First, they noted that much of the increase in indebtedness was associated with house purchases, and that—with real estate assets accounting for approximately ¾ of total household wealth—the acquisition of an appreciating asset had generated a significant counterbalancing wealth effect. Second, low mortgage interest rates and a lengthening of maturities had contained households' debt servicing burden, while rising female workforce participation had led to an appreciable increase in the number of two-income households and a related strengthening of debt servicing capacity (Figure 5). Third, there had been hardly any recourse to mortgage equity withdrawal to finance consumption (as in the United States and the United Kingdom), despite the high share of owner-occupied dwellings. Against this background, banks' stress tests indicated that debt servicing strains would arise only in the event of a very rapid rise in interest rates accompanied by worsening unemployment—a scenario generally viewed as unlikely in current circumstances (see further discussion in ¶21).



Share of Owner-Occupied Dwellings (In percent, most recent observation)

Spain	85
Euro area	60
Selected countries:	
France	58
Germany	39
Ireland	78
Italy	69
Netherlands	53

Source: ECB, "Structural Factors in the EU Housing Markets", 2003.

7. The authorities thus viewed the process of increased household indebtedness as a natural shift to the new (EMU-related) environment, although a leveling off in its pace was desirable.

The latter point had been repeatedly made by the Bank of Spain in its public pronouncements, and the authorities had also taken measures designed to diminish risks in the mortgage market (¶22). Beyond such appeals, however, they felt that few policy levers would be effective in the face of very easy financing conditions. While concurring, staff saw some scope for a containment of demand through a phasing out of generous tax incentives for

Structure of Housing Market Occupancy (In percent)

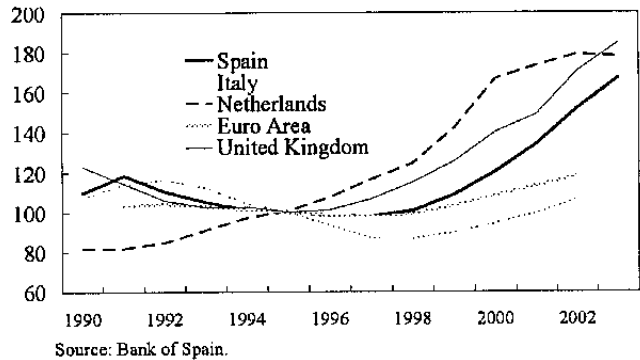
	1991	2001
First home	68.2	68.5
Owner occupied	78.3	82.0
Rental units	15.2	11.5
Other	6.5	6.5
Second home	17.0	16.0
Unoccupied and other	14.8	15.5
Total (millions)	17.2	20.8

Sources: Bank of Spain, and INE.

home ownership.² The authorities were not ready to contemplate such a step, noting that any such change would need to be extremely gradual. They placed the emphasis rather on stimulating the limited supply of rental units, that has been declining since the early 1990's. The authorities were hopeful that existing allowances in the personal income tax and the recently approved tax regimes for rental business activities would revive the rental market.³ In this context, they acknowledged that the legal framework for rental properties also needed to be improved.

8. **House prices continued to rise at double-digit rates for the fifth consecutive year in 2003, but the mission's interlocutors saw the phenomenon as largely driven by market fundamentals.** Both the authorities and market participants underscored a number of structural demand factors behind the house price boom, including demographic trends,⁴ large immigration flows, purchases of second homes, and nonresident demand. The latter's rapid rise, particularly in coastal areas, was attributed to the growing attraction of Spain as a retirement destination for aging populations elsewhere in the euro area, spurred also by the absence (in EMU) of exchange rate risk for such purchasers. These factors, acknowledged also by staff, were seen as providing reasonable reassurance that the boom was unlikely to be a "bubble," even though such calls were intrinsically difficult to make.

Real Housing Price Indices, 1990-2003
(1995 = 100)

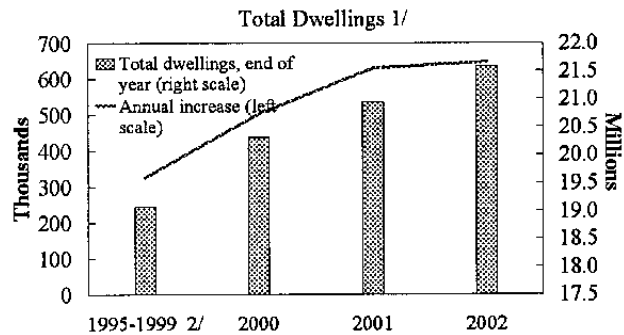


² Various income tax credits are granted on the purchase of a main residence, without any means test. These tax concessions are equivalent to about ½ percent of GDP per year, and—according to OECD estimates—correspond to a reduction in mortgage rates of some 1½ percentage points. In addition, the capital gains regime remains relatively generous.

³ The 2003 reform of the personal income tax included a tax allowance of 50 percent of net rental income and expense deductions for owners who offer residential dwellings for rent. Further tax incentives, designed to favor rental activity for corporations whose exclusive business is residential dwellings, were introduced in late 2003.

⁴ Spain experienced a later "baby boom" (between 1960 and the mid-1970's) than elsewhere in Europe. As home ownership rates rise rapidly between the ages of 20–40, part of the increase in demand is attributed to the population's changing age structure.

9. **At the same time, there was recognition of some overvaluation and of the risks inherent in a persistence of the process.** Bank of Spain analysis (albeit not universally shared) placed house prices at between 8 and 20 percent above their long-run equilibrium level. The authorities pointed to emerging evidence of a gradual easing of house price pressures, including the lengthening of the period that housing units remain on the market. Since the mission, house price increases have indeed moderated slightly. The authorities also expected the vigorous supply response to contribute to contain price pressures, with the annual increase in total dwellings doubling since the turn of the decade (to some 600,000 in 2002). Staff again pointed to the long-standing need to lift the constraints on the supply of developable land.⁵ The authorities, while welcoming the mission's call for a nonpartisan pact on this issue, placed at least equal importance on improving the urban zoning process, viewed as slow and opaque.



1/ As of June 2003, total dwellings amounted to 21.9 millions, an increase of roughly 318 thousands from December 2002.
2/ Annual average.

10. **Finally, staff pointed to the risks of slipping competitiveness, with the effects of the persistent inflation and cost differential reflected in declining export margins.** The authorities countered that export margins remained comfortable—as evidenced by exporters' surveys—and that market shares had held up comparatively well. They agreed, nonetheless, that recent trends could not continue indefinitely without eventually impinging upon export performance, and viewed further euro strength as an appreciable risk.⁶

	2001	2002	2003		
			Q1	Q2	Q3
Export margin	-0.7	-3.1	-3.9	-4.4	-4.5
Exports deflator	2.7	0.2	-0.3	-1.1	-1.3
Unit labor cost	3.4	3.3	3.6	3.3	3.2
Relative profitability of exports 1/	-1.5	-4.4	-4.7	-5.2	-5.2
Exports deflator	2.7	0.0	-0.3	-1.1	-1.3
GDP deflator	4.2	4.4	4.4	4.1	3.9

Source: Bank of Spain.

1/ Assumes a common unit labor cost for the economy.

Looking further ahead, they felt that a reform of the wage-setting system would be key to ensuring the economy's competitiveness over time (see ¶26). The mission also discussed the challenges posed by EU enlargement to Eastern European countries whose work force is both relatively well trained and low cost

⁵ Development land is controlled by municipalities, who have found it fiscally advantageous to limit its supply to boost property values.

⁶ The authorities estimate that a sustained 5 percent appreciation of the euro in nominal effective terms—equivalent to a 13 percent appreciation against the dollar—would dampen growth by about 0.3 percentage points, but stressed that this was likely an upper range.

(Box 2; and Selected Issues paper). The authorities expressed confidence that overall this process would entail more opportunities than costs, acknowledging, nonetheless, that some sectors could face comparatively greater adjustment difficulties—a factor that further highlighted the importance of reforms to increase the economy’s flexibility.

	Wage (EU=100)	Schooling (years)
Spain	73.7	8.1
European Union	100.0	9.5
Czech Republic	12.4	10.7
Hungary	12.4	9.5
Poland	17.2	10.5

Sources: ILO, Eurostat, and the European Economy Group.
1/ Data refer to the manufacturing sector; wage and schooling data are respectively for 2000 and 1999.

Box 2. EU Enlargement and Spain: More Opportunities than Challenges

A background study analyzes the challenges and opportunities for Spain arising from EU enlargement. These are grouped in four areas: international trade, foreign direct investment (FDI), EU structural funds, and migration. A series of estimates—based on a gravity model for international trade—suggest that there is substantial scope for increased trading opportunities between present EU member countries (including Spain) and the group of accession countries. Moreover, the empirical evidence—based on reduced-form models—suggests that, overall, Spain’s exports are not likely to be adversely affected by enlargement, although their composition may vary. In particular, the evidence suggests that a decline in exports of machinery and transportation equipment is possible. Further, the study suggests that Spain’s FDI flows are also unlikely to vary much as a result of enlargement. In contrast, enlargement will—by lowering the average EU income level—significantly reduce Spain’s allocation of EU structural funds over the medium term, with a particularly strong impact for some regions. Lastly, immigration to Spain from accession countries is also set to increase (from a small base), but mass immigration flows associated with enlargement appear unlikely.

The study was presented in two seminars during the consultation, with audiences generally agreeing with the conclusions. There was, nonetheless, a widespread sentiment that the impact of enlargement should not be overstated: trade between the EU and accession countries has already been largely liberalized, and evaluating comparative advantage solely on the basis of countries’ productive structure could be misleading. Indeed, the resilience of Spain’s export market shares was attributed largely to quality differentials. Some more technical aspects of the study were also questioned, particularly the long-run implications of the study’s dynamic model as enlargement could involve a regime change. Finally, interest was expressed in an analysis identifying which sectors of the Spanish economy were likely to benefit from enlargement.

B. Fiscal Policy

The near-term stance

11. There was agreement that Spain’s sustained fiscal adjustment was a cornerstone of its current performance that needed to be preserved. The authorities viewed Spain’s experience since 1996 as a good example of growth-enhancing consolidation, with a deficit reduction of 5½ percentage points of GDP (or 4¼ percentage points in structural terms) accompanied by annual average growth of about 3¼ percent (Box 3). The adjustment, while

Box 3. How was the Budget Balanced?

Spain's fiscal adjustment, aided by EMU qualification, largely meets the requirements of successful consolidation. Persistent fiscal imbalances—with deficits averaging 5 percent of GDP in the early 1990s—have given way to a “close to balance or surplus” outcome since 2001. While EMU participation clearly played an important role in facilitating fiscal adjustment, Spain's fiscal consolidation experience since 1996 scores well on the broader requirements for successful, and expansionary, fiscal corrections. The adjustment is estimated to have been largely structural in nature, and the economy grew vigorously even in the midst of fiscal retrenchment. The pace of underlying adjustment averaged about ½ of a percentage point of GDP per year and—in contrast with experience elsewhere—took place during both the upswing and downswing.

The adjustment was based mostly on structural expenditure cuts, with reductions in primary current spending, as part of the effort to meet the Maastricht criteria, leading also to substantial interest savings.¹ All in all, structural expenditures fell by about ¾ percentage points of GDP from 1996–2003, accounting for the bulk of the consolidation. First, a

major component of the budget—the wage bill—was reduced appreciably. Although this partly reflected a wage freeze (a generally unsustainable avenue), civil service employment was also trimmed. Second, social security and welfare transfers were brought down through reforms that reduced their generosity on a permanent basis (with, for example, an increase in the number of years used to compute the pensionable base salary). Third, capital spending was safeguarded, with budgeted amounts remaining roughly unchanged (though off-budget operations increased; ¶14). Finally, EMU qualification was itself a crucial ingredient, leading to a virtuous circle—oft noted in the literature on expansionary fiscal adjustments—whereby an initial consolidation reduces interest rates, lowers debt servicing costs, sustains economic activity, and paves the way for further consolidation.

Spain: General Government Accounts 1/

	Outcomes		Adjustment		
	1996	2003	Upswing	Slowdown	Total
			1996-2000	2000-03	1996-2003
Total revenues 2/	38.8	39.9	0.3	0.9	1.1
of which: Tax revenues	33.6	36.3	1.9	0.7	2.6
Social contributions	13.2	13.8	0.2	0.5	0.6
Total expenditure	43.7	39.4	-3.9	-0.4	-4.3
Noninterest current expenditure	33.3	32.0	-1.3	0.1	-1.3
Interest payment	5.3	2.6	-2.1	-0.7	-2.8
Capital expenditure	5.1	4.9	-0.5	0.3	-0.2
Primary balance	0.0	2.7	2.3	0.4	2.7
Overall deficit	-4.9	0.5	4.2	1.2	5.4
State	-3.9	-0.4	3.1	0.4	3.5
Territorial governments	-0.6	0.0	0.2	0.4	0.6
Social security	-0.4	0.9	0.9	0.5	1.3
<i>Memorandum items:</i>					
Structural balance	-3.0	1.2	1.8	2.4	4.2
Structural revenues	39.0	40.0	0.0	1.1	1.0
Structural expenditures	42.0	38.8	-1.9	-1.3	-3.2
Public debt (as percentage of GDP)	68.2	50.0	-7.6	-10.6	-18.2
Average interest rate of public debt	8.3	4.7	-3.1	-0.5	-3.6
Real GDP growth 3/	2.4	2.4	3.8	2.4	

1/ In percent of GDP.

2/ Non-tax revenue fell as profitable public enterprises were privatized, and Bank of Spain profits—boosted by extraordinary profits associated with exchange rate operations prior to EMU—declined with the adoption of the euro and following Eurostat guidelines were excluded from public sector revenues.

3/ Refers to annual average in “Adjustment” columns.

Increased revenue collection, which has been resilient, also aided consolidation. Vigorous economic growth boosted corporate tax and VAT collections, more than offsetting cuts in personal income tax rates. The rise in revenues proved to be resilient to the cycle, with tax collection remaining buoyant also during the recent economic slowdown. This partly reflects the emergence of underground activity and the regularization of illegal immigrants, and a related strong increase in social security affiliations.

¹Evidence for OECD countries suggests that expenditure-based adjustments are more durable (and less likely to reduce economic growth) than revenue-based adjustments.

undoubtedly aided by the EMU-related decline in interest rates, also relied on cuts in noninterest current expenditure which paved the way for credible tax relief, and an ensuing virtuous circle of economic growth and buoyant revenue performance. In light of this experience, the authorities saw considerable benefits in close observance of a disciplining fiscal framework, be it the Budgetary Stability Law (BSL) in Spain or the Stability and Growth Pact (SGP) at euro-area level.

12. The 2004 budget's "zero deficit" target would imply fiscal loosening; staff argued rather for fiscal restraint. Given the estimated 2003 surplus, the mission noted that a balanced budget outcome in 2004 would entail a structural deterioration of up to ½ percentage point of GDP. The authorities considered that firm observance of the BSL's framework—centered on a binding central government expenditure ceiling and a contingency fund for unforeseen eventualities—and the full play of automatic stabilizers would likely deliver a continued surplus. Given very easy monetary conditions and the domestic risks discussed above, staff saw merit in a more proactive approach to ensure a restrictive fiscal stance. It thus advocated (i) containing central government spending to below the budget ceiling (by, for example, exploiting the scope provided by a new law on public subsidies to rationalize and reduce such expenditures); (ii) actively pursuing greater cost efficiency and savings in health care, now fully devolved to all the regions (addressing, for example, the high demand for prescription drugs and the recognized abuses of prolonged sick leave); and (iii) firmly safeguarding the contingency fund for truly exceptional circumstances. In response to staff's suggestion to formally change the 2004 budget target, the authorities expressed reluctance out of concern that it could generate undesirable pressures on the "use of the surplus."⁷ Although the fiscal framework was clear on the matter (with fiscal over-performance to be set aside as a priority to reduce public debt or increase the social security reserve fund), pressures had already surfaced for generalized cuts in social security contributions and/or increased social spending. While staff agreed that such pressures should be resisted, it was also necessary to prepare the public to the notion that, with growth resuming with greater vigor, a nominal surplus was required to avoid eroding the underlying fiscal position.

Implementation issues: transparency and monitoring

13. The discussions also centered on issues of fiscal policy implementation, seen by staff to be key to the longer-term success of the BSL's framework. Two requirements appeared most prominent: first, a close tracking and the fullest transparency possible of all contingent liabilities arising from the large public investment effort; and, second, improved monitoring of regional budget execution in a highly decentralized environment. In this light, staff saw merit in Spain undertaking a fiscal transparency ROSC, which the authorities have since requested.

⁷ Accordingly, the update of the Stability Program presented in early January continued to show a balanced budget for 2004.

14. **Staff noted that the widening range of financing modalities for public investment had rendered the assessment of the potential fiscal impact of these operations significantly more complex.** Historically, the bulk of public investment had been carried out by the central government and was thus captured in the standard budget documents. Since the mid-1990s, however, it had been increasingly executed through alternative modalities, including by public enterprises and public entities that are not part of the general government (such as those established to build and manage the railway infrastructure and water works), and that have been financed through loans (some with public sector guarantees) and capital injections. Recourse to public-private partnerships (PPPs) has also expanded.

Spain: Public Investment (ESA-95) and Central Government Off-Budget Public Investment 1/

	1995	2001	2002	2003	2004
Public Investment of the general government (ESA-95)	6.2	4.8	4.9	4.9	4.9
Gross capital formation of the general government	3.8	3.3	3.5	3.5	3.5
Central government	1.6	1.2	1.2	1.1	1.1
Regions and municipalities	2.2	2.2	2.3	2.4	2.4
Capital Transfers to private sector and NFPE	2.4	1.4	1.4	1.4	1.4
o/w capital transfers from the central government to national NFPE	1.0	0.2	0.2	0.2	0.2
Off-Budget financing of central government infrastructure	...	1.4	1.4	1.6	1.9
Gross capital formation of Public Entities for building infrastructures 2/ 3/	...	1.1	1.2	1.4	1.6
Capital injections to Public Entities for building infrastructures 2/	...	0.2	0.2	0.2	0.4
Annuities of turnkey contracts	...	0.1	0.1	0.0	0.0

Sources: 2003 budget and IGAE.

1/ In percent of GDP.

2/ Includes *Gestor de Infraestructuras Ferroviarias (railways)*, *Sociedades Estatales de Agua (water)*, *de Gestión Inmobiliaria (land management)*, *y de Modernización y Construcción de Regadíos (irrigation)*, *RENFE (railways)*, *AENA (airports)*, *Puertos del Estado (harbours) and roads*.

3/ An estimate of the total gross investment of the NFPS, including public entities, can be obtained by adding to this item the ESA-95 public investment of the general government (net of the capital transfers from the central government to national NFPE).

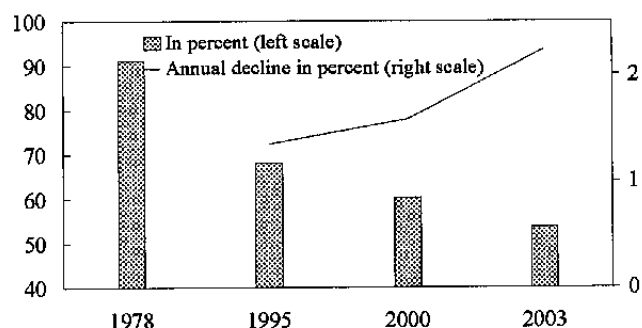
15. **The authorities felt that present budget documentation, along with full observance of Eurostat guidelines, ensured adequate transparency in this area.** They noted that, following the developments described above, budget documentation had been expanded to include a broad coverage of the central government's investment effort (*esfuerzo inversor*, which included capital transfers and investment carried out by state-owned enterprises), that all central government guarantees were fully recorded, and that fiscal accounting and reporting practices complied with Eurostat guidelines. Furthermore, a recently approved law on public concessions (*Ley de Concesiones*) provided an updated framework that regulated PPPs and their operation.⁸

⁸ The law defines PPPs as infrastructure and other projects that are deemed of public interest and whose risks (construction, maintenance, and management) are borne substantially by the private sector. It stipulates that the projects' approval requires a financial viability report that
(continued)

16. **Staff, while welcoming these steps, considered that closer tracking and fuller disclosure remained needed to control the fiscal risks associated with public investment activities.** This was notably the case with regard to PPPs, a potentially useful vehicle which could however entail substantial and difficult-to-assess risks for the public finances, and where effective processes that ensured an adequate transfer of risks to the private sector were thus essential. In the absence of agreed international accounting standards in this area, staff encouraged the authorities to adopt evolving best practices, including comprehensive and timely disclosure of the terms and conditions of private partnerships, that would allow as accurate as possible an assessment of future contractual obligations and government liabilities (explicit or implicit) associated with such projects.⁹ Staff also expressed concern about the growing use by the regions of public sector entities and PPPs to carry out investment, noting that tracking and transparency issues were likely more severe at lower levels of government, as were risks that such off-budget modalities could serve to circumvent BSL deficit constraints.

17. **There was agreement on the importance, in a highly devolved fiscal environment, of regional reporting systems that produce timely data.** The authorities noted that the pace of decentralization of public spending had increased dramatically in the past three years. Indeed, with the complete devolution of health spending to the regional governments, Spain had become one of the most fiscally decentralized economies in Europe. The authorities concurred on the importance of timely information on regional budget execution, and to this end an

Share of Central Government in General Government Expenditure



Share of Expenditure by Level of Government

	Consolidated Central Government	State, Regional or Provincial Governments	Local Governments
Spain, 2002 1/	52.6	33.9	13.5
Austria, 1999	68.9	15.7	15.4
Germany, 1998	62.5	23.7	13.9
Switzerland, 1999	52.6	28.0	19.4
France, 1997	82.5	...	17.5
Italy, 1999	75.6	...	24.4

Sources: Government Finance Statistics Yearbook 2001; Ministry of Economics, and Fund staff estimates.

1/ Assumes that all health spending managed by the central government, which represented 1.7 percent of GDP was transferred to the regions

sets both minimum and maximum returns on the investment, and provides that, whenever these fall outside the agreed range, the contract's terms and conditions can be revised.

⁹ These issues will be taken up in detail and from a multilateral perspective in a Board paper under preparation on Public Investment and Fiscal Policy. An accompanying background paper (on Fiscal Aspects of Public-Private Partnerships) will contain details on country experiences with PPPs (including Spain).

agreement requiring quarterly reporting had been concluded with the regions in early 2003. But implementation issues persisted, so that the 2003 outcome for the regional budgets would not be known until February 2004. The authorities were committed to secure further progress on this front, which staff noted should include timely public release of the information gathered.

Long-term fiscal sustainability¹⁰

18. **While a medium-term fiscal surplus appears at hand, comprehensive pension reform—the other element required to ensure long-term fiscal sustainability—has continued to be postponed.** Although long-term population projections are plagued by the usual uncertainties (exacerbated in Spain by the prominent role of immigration), available studies consistently indicate that, while Spain's demographic shock occurs later than elsewhere in Europe (peaking after 2020), it is relatively more pronounced (with age-related expenditure increases roughly 60 percent larger than the EU average excluding Spain). The authorities confirmed their intention of maintaining a small fiscal surplus over the medium term.¹¹ They also pointed to the growing endowments to the social security reserve fund, in excess of earlier targets. However, following initial steps in 1997, progress on pension reform in the context of the relevant tripartite commission (*Pacto de Toledo*) had stalled.

19. **Staff stressed that net debt reduction, while welcome, was not a substitute for pension reform, which needed to regain momentum in the next legislature.** The authorities, while concurring with the thrust of the staff's recommendation, countered staff's critique of the *Pacto de Toledo* process by stressing the importance of the related agreement not to raise pension reform as an electoral issue, thereby keeping this key question out of the political arena. They also noted that the recent renewal of the *Pacto* had reaffirmed the relevance of the original recommendations made in 1997 (Table 4), thus pointing the way forward. Staff advised that emphasis be placed on gradually raising the effective retirement age, via stronger incentives to forego early retirement, and on strengthening the link between contributions and benefits, reviving an earlier proposal to raise the period used to compute the pensionable base salary from 15 years to the entire work life.

¹⁰ Staff updated its debt sustainability exercise, which remains qualitatively unchanged from that in Spain, Country Report No. 03/40 (1/15/03) and is consequently not reproduced here.

¹¹ The 2004 budget documents, based on the assumption of a "zero deficit" in both 2003 and 2004, postulate the emergence of a small surplus in 2005 and 2006 (0.2 percent of GDP in the latter year). Staff recommended that the update of the Stability Program, then under preparation, build upon the improved starting position expected for 2003. In the event, the update of early January 2004 (Table 3) kept these numbers unchanged, while including a further small increase in the surplus in the outer year (0.3 percent of GDP in 2007).

C. Banking Sector Developments¹²

20. After a trying two years—with substantial declines in profits associated with investments in some Latin American countries—the banking sector staged a come-back in 2003. Earnings of Spain's two major banks (Santander Central Hispano—SCH, and Banco Bilbao Vizcaya Argentaria—BBVA) were severely affected by developments in Argentina and some other Latin American countries in 2002; though these banks remained profitable, their profits declined by some 27 and 9½ percent respectively. With the situation in Latin America stabilizing, the banking system experienced a marked turnaround in 2003. Profits in the five major banking groups (including SCH and BBVA) recovered strongly, on the back of a sharp increase in domestic business, with stock market valuations also improving and exhibiting lower volatility (Figure 6). Both the authorities and market participants viewed the banking system's Latin American difficulties to be now largely over.

21. Supervisors' attention had turned to domestic risks in the mortgage market, which they viewed as manageable. Total mortgage credit has been growing rapidly (by 22¾ percent in the 12 months to October 2003) and is mainly at variable interest rates. The authorities nonetheless thought the risks remained contained:

- Banks' starting position was strong, with a very low incidence of doubtful assets, which were in any case highly provisioned. The Bank of Spain also closely monitored forward-looking indicators of potential debt-servicing difficulties, and these remained reassuring.

- With credit expansion driven primarily by mortgage lending—typically with a loan-to-value ratio of 80 percent, and much lower for second homes—rather than consumer lending, banks' risks were judged to be comparatively well covered. It was however recognized that the valuation of these assets could suffer under conditions of generalized stress.

	1997	2002
Total (in percent of GDP)	31.2	55.7
(share of total credit)	42.7	52.2
Share contracted at:		
Fixed rate	14.2	2.4
Variable rate	85.8	97.7

Source: Economic Bulletin, Bank of Spain, July-August 2003.

Deposit Institutions: Doubtful Credit and Provisioning

	1999	2000	2001	2002
Doubtful assets and guarantees	6,099	5,772	6,270	7,501
Of which: past due				
Mortgage	701	456	464	630
Non-mortgage	2,677	2,130	2,408	3,060
Provisions	8,859	10,233	12,768	15,273
Specific	4,471	3,624	3,588	4,182
General	4,388	5,425	6,064	6,625
Statistical	...	1,184	3,117	4,466
Total exposures 1/	535,320	629,194	708,601	776,843
Write-offs	20,919	21,098	21,157	20,391
Of which: write-offs during the year	2,381	2,082	1,601	1,783
Ratios (percent)				
Doubtful/total exposures	1.14	0.92	0.88	0.97
Provisions/doubtful exposures	145.25	177.29	203.64	203.61

Source: Bank of Spain

1/ All assets and guarantees, excluding those not requiring provisions: exposure to general government, trading portfolio and covered country-risk exposures.

¹² References to the banking sector include the savings banks (*cajas de ahorro*).

- Although the securitized portion of banks' mortgage portfolio remained small (under 5 percent), it was increasing rapidly, thus contributing to reduce bank exposure.

In sum, both the supervisory authorities and market participants noted that stress tests indicated that—under most plausible scenarios—an increase in interest rates would not have a potent effect on households' ability to repay nor on deposit institutions' nonperforming loans. As noted above (§6), difficulties emerged only in the event of a rapid, steep rise in interest rates (in the order of 4–5 percentage points over a relatively short time span) accompanied by a deteriorating employment situation, a scenario that was generally viewed as improbable in the near term. Stress tests involving a decline in housing prices also did not reveal systemic difficulties

22. **There was nonetheless concurrence on the need for continued vigilance over mortgage market developments, with staff probing other possible policy responses.** The authorities felt that the Bank of Spain's prudential controls on mortgage lending were operating adequately and that any further tightening of such controls would be unjustified and could have adverse side-effects on financial intermediation. They placed the emphasis rather on continued vigilance, accompanied by moral suasion, to ensure that credit institutions exercised adequate caution and had in place effective credit approval and monitoring processes—which was viewed to be generally the case. Staff enquired about the reasons for the overwhelming predominance of variable rate mortgages, at a time when interest rates could be seen as bottoming out. The consensus (official and market) view was that the phenomenon was essentially market-driven, reflecting the attractiveness of very low variable rates, rather than any institutional or regulatory feature that constrained the supply or raised the cost of fixed-rate lending. Indeed, several credit institutions had launched an active campaign to promote fixed-rate loans in the course of 2003, but had met with virtually no demand. For their part, the authorities had actively sought to raise the public's awareness of potential interest rate risks, and had taken measures to reduce the cost of mortgage refinancing.¹³ Banks had also been required to offer the option of an interest rate cap as protection against future interest rate increases—again meeting with scant demand. All in all, it was felt that demand for fixed-rate loans would emerge only once the interest rate cycle had begun to turn.

23. **The mission enquired about progress in strengthening governance in the savings bank sector.** The authorities noted that the Spanish *cajas de ahorro* distinguish themselves from similar institutions in some other countries for the strength of their financial profile, economic results, and regional franchises. Analysts concur that the *cajas'* focus on retail

¹³ In 1994, the *Ley de Subrogaciones* introduced a 1 percent cap on prepayment penalties for variable-rate loans. In April 2003, the cap was reduced to ½ percent, further lowering the effective refinancing costs. The cap applies both to changes in contractual parties, either of the lending institution (*subrogación activa*) or the borrower (*subrogación pasiva*), and to changes in the loan's terms (*novaciones*).

business, mainly (but not only) in their geographical areas of origin, has allowed them to play a dynamic role in increasing competition and diversification of the Spanish financial system. At the same time, it was recognized that the structure and goals of the *cajas* as not-for-profit foundations with links to local governments raised delicate governance issues. These had been addressed, at least in part, by the *Ley Financiera* of 2002, which had introduced improvements in the *cajas*' governing bodies and a new financing instrument (*cuotas participativas*),¹⁴ which was inter alia intended to strengthen market discipline over the management of individual savings banks. However, no such instruments had as yet been issued, as their regulations were still being developed. Market participants generally downplayed expectations about the *cuotas*' potential role, noting that—compared to subordinated debt—they were a relatively costly and complex way to raise capital (requiring a difficult evaluation of the current “market value” of a *caja*). In this area, the authorities also noted that a new Transparency Law applied to savings banks as well, requiring them to produce annual “good governance” reports (§31). Staff welcomed these efforts, and stressed the need for continued vigilance to avoid all instances—real or perceived—of external influence over the *cajas*.

24. **At the time of the last consultation, the Board welcomed Spain's intention to participate in the FSAP.** During the mission, the authorities declared their readiness to formally request such participation, which they have since done.

D. Labor and Product Markets

Labor markets

25. **Although unemployment has been halved since the mid-1990's, it remains high and a number of rigidities persist.** Earlier reforms have significantly increased the flexibility of the labor market, allowing for vigorous employment creation and a sharp decline in unemployment—to however a still high rate of 11¼ percent. The authorities noted that this performance did not yet reflect the hoped-for positive impact of the end-2002 changes to the unemployment benefits system, designed to promote active job search and greater geographical mobility; staff pressed for early, concrete progress in the reform's implementation. The discussions focused on deficiencies in the wage-setting process, the adverse effects of indexation clauses, and the rigidity of open-ended contracts.

¹⁴ These are a nonvoting “stocks” that would strengthen the capital structure of *cajas*, as they qualify as Tier 1; by being priced in the market, they could also provide a disciplining device.

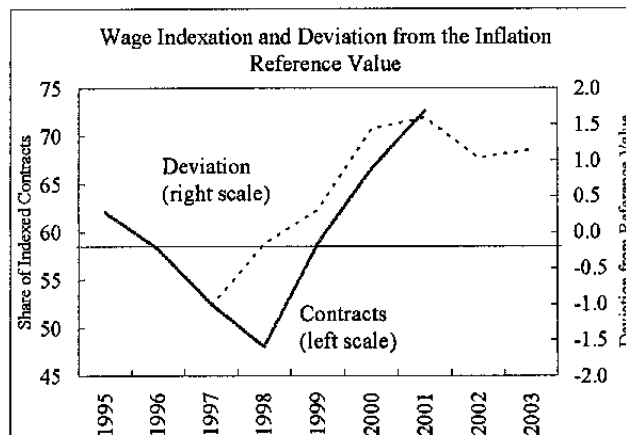
26. **The authorities placed particular importance on a reform of the collective wage bargaining system.** Collective wage agreements signed at the sectoral level cover the bulk of workers, with firm-level agreements representing only a small fraction of the total.¹⁵ Such an “intermediate”

	Share of workers covered		Wage increases		
	Sectoral		Firm	Sectoral	Firm
	Provincial	National			
1990	54.7	26.1	15.0	...	...
1995	55.3	27.1	14.1	4.0	3.7
2000	52.9	26.8	12.1	3.8	3.5
2001	54.3	24.6	11.7	3.8	3.1
2002	55.8	23.9	10.9	3.9	3.6

Sources: Bank of Spain and Labor Ministry.

collective bargaining system does not allow the wage-setting process to reflect the financial and productivity conditions of individual firms as would be the case in a decentralized system, nor does it internalize economy-wide considerations in the manner of a fully centralized system. The result is a marked homogeneity in wage increases across regions and a high degree of wage compression across skill levels, reducing job opportunities for low-skill workers, blunting incentives for human capital accumulation, and discouraging labor mobility. Although reforms of the wage bargaining framework have been proposed periodically, they have regularly foundered in the face of trade union opposition and scant interest also on the part of the employers’ federation. The authorities (and staff) nonetheless felt that a renewed effort, in concertation with the social partners, should be made in the next legislature.

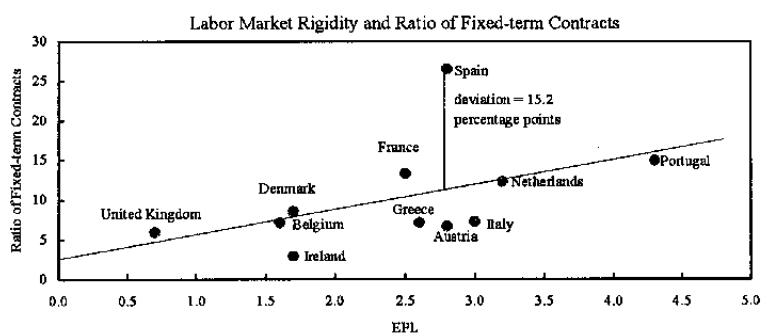
27. **The increasingly widespread recourse to wage indexation clauses has contributed to the persistence of inflation shocks.** The temporary upward spike in inflation at end-2002 had, for example, led to second-round effects through the play of such backward-looking clauses. The authorities stressed that safeguarding competitiveness required changes to this system. Staff agreed, but also thought that a phasing out of wage indexation would likely require a reference value for wage negotiations that was seen to be a realistic reflection of expected inflation. The persistent overshooting of this reference value (set at 2 percent in recent years) since 1999 had been accompanied



¹⁵ The authorities noted that the decline in firm-level contracts shown in the data is a likely overestimate. With inflation declining in the 1990’s, an increasing number of firm-level contracts were simply carried forward to the following year, and thus not reported. This however reflects another aspect of the system viewed critically by staff: the practice (known as *ultra actividad*) whereby, in the absence of negotiations or agreement, a contract’s provisions remain in effect indefinitely—a practice that inhibits a broader social dialogue on key issues (work organization, productivity improvements, firm-level pension schemes, etc.).

by a sharp rise in the share of indexed contracts. In this connection, the authorities clarified that the reference value adopted by the social partners in their negotiations could not be traced to an official inflation “objective.” Indeed, consistently with participation in EMU, no such objective was set (other than the assumption used in the budget to revalue pensions and some other benefits); in any event, the authorities felt that any official designation of a reference value for wage negotiations would simply reinforce the social partners’ proclivity to focus such negotiations on price rather than productivity developments.

28. **The continued rigidity and high dismissal costs of open-ended contracts were seen by staff to underlie the widespread use of fixed-term contracts in Spain.** With fixed-term contracts accounting for about 28 percent of employment, Spain is an outlier in Europe. Despite having a similar degree of labor market rigidity as Austria and Italy (as proxied by the OECD’s measurement of employment protection legislation, EPL), its share of fixed-term contracts is significantly



more than 15 percentage points versus Italy and Austria. The mission’s interlocutors offered different interpretations, including the prominent role of the construction sector (where two-thirds of workers are on fixed-term contracts), the widespread recourse to subcontracting in various

sectors, the increasing use of fixed-term contracts as a probation period for first-time job seekers, and the practice of stringing along successive fixed-term contracts.¹⁶ But there was general (albeit not universal) agreement that the root cause of the phenomenon lay in the wedge in dismissal costs between fixed-term and open-ended contracts; as such, staff noted, it was simply a market response to an institutional rigidity. Indeed, the creation in 1997 of a low-cost open-ended contract (*contrato de fomento*), with lower dismissal costs and reduced social security contributions, had led to a decline in the share of fixed-term contracts and pointed the way for future reform.

Product markets

29. **Competition in network industries has improved, but the authorities recognized the need for proactive enforcement of competition policy in sectors where concentration remains high.** The authorities noted that continued progress under the ambitious

¹⁶ Labor unions argued that the incidence of *temporalidad* (“temporariness”) has led to higher work-related accidents, with comparatively high accident rates in construction. Also, the precariousness of fixed-term employment was seen to reduce the incentives for human capital accumulation, contributing to Spain’s relatively low education indicators.

30. liberalization plan initiated in 2000 had strengthened competition in key product markets. Prices in most sectors had declined markedly and were below the euro-area average (Figure 7). Key recent achievements were the full liberalization of the electricity and gas markets as from January 1, 2003 (with provider choice extended to all retail consumers), and progress in increasing the number of gasoline distribution points and enhancing pricing transparency, with the emergence of somewhat greater (but still limited) price differentiation. The authorities countered staff's contention that incumbents continued to enjoy a large and often dominant market share in key network industries by pointing to the increase in the number of operators to levels that compared well with other main European countries. They had nonetheless been proactive in addressing cases of price-fixing or other noncompetitive behavior, and favored a vigorous enforcement of competition law. In this context, the Competition Tribunal (*Tribunal de Defensa de la Competencia*) had been endowed with a new, fully autonomous statute and increased resources.

31. **The obstacles to effective competition arising from initiatives by the regions in retail trade and distribution were of particular concern.** An in-depth report by the Competition Tribunal had exposed the extent to which a host of restrictive norms taken by regional and local authorities stifled competition in retailing. Such norms ranged from overlapping and

discretionary licensing requirements to outright prohibitions on the establishment of large-scale outlets (in 10 of the 17 regions). The authorities fully agreed with staff on the adverse effects of such norms, but—short of action where there were possible constitutional breaches—the central government could not intervene in a matter of regional competency. In this light, the authorities welcomed the mission's efforts, in its contacts with regional authorities and political representatives, to draw attention to the cost of such barriers for the concerned regions themselves, in terms ultimately of their relative attractiveness for investors, consumer welfare, and economic performance (Box 4).

	Legal Barriers to Retail Distribution by Region							Index (number of barriers)
	Type of barrier							
	1	2	3	4	5	6	7	
Andalucía	x			x			x	3
Aragón	x						x	2
Asturias				x	x		x	3
Baleares	x	x	x				x	4
Canarias	x						x	2
Cantabria				x			x	2
Castilla-la Mancha								0
Castilla-León	x						x	2
Cataluña	x				x	x	x	4
Comunidad de Madrid	x			x	x			3
Comunidad Valenciana	x							1
Extremadura	x							1
Galicia	x							1
La Rioja	x							1
Murcia	x			x				2
Navarra	x			x	x		x	4
País Vasco	x	x	x				x	4
Average								2.3

Note. The seven barriers correspond respectively to: (1) definition of the large retail establishment based on its location; (2) multiple often arbitrary criteria used in the determining whether an establishment is large; (3) considering an establishment is large when 25 percent of its ownership is a large firm; (4) discriminatory treatment for discount establishments; (5) limits on establishment and transfer of ownership of small firms; (6) requiring a financial viability plan for commercial establishments; and (7) outright bans on large retail establishments.

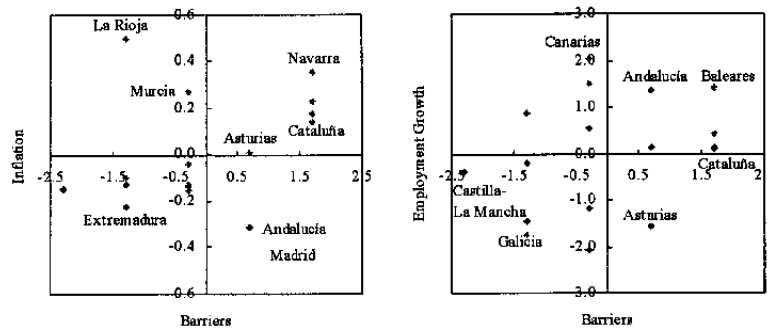
Source: Tribunal de Defensa de la Competencia.

32. **The authorities reported on various initiatives to improve corporate governance and modernize the business environment.** Among these, they noted in particular a new Transparency Law, approved in July 2003, that increases the minimum information that

Box 4. A Tentative Assessment of the Costs of Regional Restrictions

Available data confirm that limiting competition harms local consumers via higher than average inflation. Although, in principle, restrictions should be reflected in price level rather than inflation rate differentials, in the case at hand it appears that the process of imposing barriers has fueled a protracted “price level effect” reflected in the data as higher inflation. Indeed, a number of barriers above (below) the regional average is associated with above (below) average inflation in 13 of the 17 regions. Also, barriers create an unfriendly environment that can divert investment from the region, lowering employment opportunities. Evidence for lower employment, however, does not immediately emerge from simple visual inspection of the raw data.

Regional Restrictions and Economic Performance
(Deviation from regional average, 1995-2001)



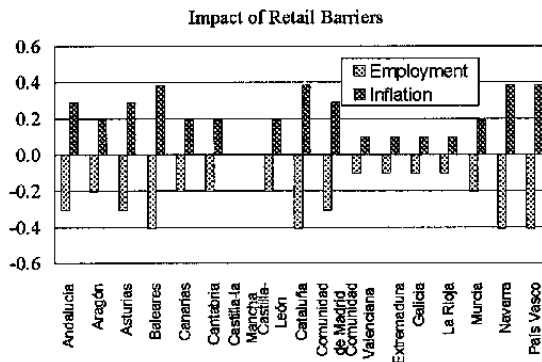
Source: Tribunal de Defensa de la Competencia; Eurostat; and INE.

Regression analysis, however, confirms the adverse effects of anticompetitive policies on both inflation and employment. Panel regression was used to provide a closer look at the data for the 17 regions from 1995–2001, and quantify the costs of restrictive norms. An AR(1) model—accounting for both regional idiosyncratic effects and common time trends—was extended by adding an index of the anticompetitive barriers of the regions (see text table in ¶30). Estimates for inflation (π) and the log of employment (e) follow:

$$\pi_{i,t} = \gamma_i + \kappa_i + 0.006 \times \pi_{i,t-1} + 0.096^* \times Barrier_i + \mu_{i,t}^\pi, \quad r_{ADJ}^2 = 0.89$$

$$e_{i,t} = \gamma_i + \kappa_i + 0.695^* \times e_{i,t-1} - 0.031^* \times Barrier_i + \mu_{i,t}^e, \quad r_{ADJ}^2 = 0.99$$

with statistical significance at 1 percent indicated by *. The results suggest that, on average, imposing one of the seven types of barriers identified in the Competition Tribunal’s report increases inflation and lowers employment in the long-run respectively by 0.1 percentage point and 10 percent; the costs are much higher for the most restrictive regions (Baleares, Cataluña, Navarra, and País Vasco).



listed companies must provide, including the requirement to publish governance guidelines and an annual report on corporate governance, and adopt internal regulations for the operation of their board and management that adhere to good governance principles. Since the mission, the authorities have brought forward the implementation of some of these requirements. In other areas, a new bankruptcy law modernized procedures that were viewed as archaic, providing effective protection for the firm and orderly procedures that ensured equal treatment for debtors. Finally, a new company law significantly simplified administrative procedures to establish a new firm.

E. Other Issues

33. **The authorities pointed to two concrete steps in 2003 reflecting their commitment to counter money laundering (AML) and the financing of terrorism (CFT).** First, Spain's AML framework was strengthened by the adoption, in July 2003, of new provisions fully implementing the 2001 EU Directive. The provisions extend the definition of money laundering offenses to cover all serious offenses; prescribe customer due diligence and suspicious transaction reporting duties for lawyers, notaries, auditors, and accountants; and require financial institutions and other reporting entities to adopt "reasonable measures" to verify their customers' professional or economic activities. Second, a comprehensive CFT law was adopted in May 2003, establishing a Commission for the Oversight of Terrorist Financing, which is empowered to block or freeze a wide range of assets and transactions when "the transaction, movement or operation is performed for the purpose, or on the occasion of perpetrating terrorist activities, or for contributing to the goals pursued by terrorist groups or organizations."

34. **In the trade area, the authorities maintained cautious optimism about prospects for the Doha round.** They viewed the outcome of the Cancún Ministerial Conference as a regrettable setback that should not, however, imperil the round's prospects. The time should be used to garner political support and ensure that the round reflects the interests of all countries within a balanced agreement. While taking the view that agriculture should not become the sole focus of attention, and pointing to the positive aspects of the EU agreement on reform of the Common Agricultural Policy (CAP), they acknowledged a need for flexibility on the issue. Staff noted that Spain, as a large beneficiary of CAP transfers,¹⁷ could play a key role in working toward the elimination of remaining distortions. Finally, in response to staff questions about a possible drift to bilateralism or regionalism, the authorities noted that such accords were not necessarily negative, provided they were not viewed as alternatives to a multilateral approach.

35. Provisional figures for 2003 indicate a slight increase in **Spain's ODA** to a level equivalent to about 0.3 percent of GNP. Spain has been an active partner in the **Fund's poverty reduction efforts**, contributing to the PRGF and HIPC initiatives.

¹⁷ Spain receives an average of 1 percent of GDP in CAP guarantee funds on an annual basis.

III. STAFF APPRAISAL

36. **Spain's economic performance during the latest slowdown is testimony to the rewards of sound policies.** While European economies languished, growth in Spain proved resilient and rich in job creation. Real convergence continued, in marked contrast to previous slowdowns. Although EMU participation and the related decline in interest rates played a key role in this performance, a stability-oriented fiscal policy (in observance of the Stability and Growth Pact and of Spain's own Budgetary Stability Law), centered on expenditure-based fiscal consolidation that created scope for tax relief, and the pursuit of structural reforms were also essential ingredients.

37. **Sustaining this performance will, however, require containing some emerging risks.** First, the strength of domestic demand, along with insufficient competition in certain markets, has sustained a persistent inflation differential with the euro area. In turn, shortcomings in the wage-setting process have transmitted this differential to labor costs, eroding competitiveness. Second, recent growth has been accompanied by a rapid rise in household indebtedness amidst buoyant housing prices. While these trends are driven by some structural demand factors and the related risks do not appear imminent, the longer the underlying processes continue unabated, the greater the potential for an adverse fall-out. It is the task of policies to minimize this risk and facilitate a soft landing. Furthermore, with the impulse from EMU participation waning and competition from the accession countries intensifying, further structural reforms will be needed to enhance the economy's flexibility and supply side response.

38. **With monetary conditions in Spain being overly easy, fiscal policy must maintain an appropriately restrictive stance.** It has commendably done so in recent years, leading to an estimated general government surplus in 2003. On the heels of this result, the budgeted "zero deficit" for 2004 implies an untimely stimulus. The framework provided by the BSL—notably the ceiling on central government expenditure—and the play of automatic stabilizers will likely generate a better-than-targeted result. But budget execution should go further, actively seeking expenditure savings wherever feasible, so as to contain central government expenditures to below the budget ceiling. At the same time, the contingency fund should be carefully safeguarded for truly exceptional eventualities. And progress is urgently needed toward more timely monitoring of the execution of regional budgets, to ensure that the autonomous communities contribute to the desirable restrictive fiscal stance, especially in light of the full devolution of health care spending since 2003.

39. **Public sector infrastructure spending has supported both short- and longer-term growth, but its expansion calls for strengthened monitoring of associated fiscal commitments and risks.** The budget documents have been helpfully expanded to include information on investment carried out by state-owned nonfinancial enterprises and entities, and the accounting of such operations is in line with Eurostat guidelines. But this does not suffice. Loans, capital injections, and guarantees to these enterprises and entities constitute a potential, and at times difficult to assess, fiscal risk. Moreover, the reliance on private sector participation—in itself a useful instrument, increasingly used throughout Europe—can also

obscure the public sector's liabilities in the projects concerned and requires clarity over the division of risks between the public and private sectors. As the assumption of contingent liabilities increases with the recourse to these modalities, including by the regions, so does the need for close monitoring and control of all possible future calls on the public purse. Spain's recent request for a fiscal transparency ROSC is welcome.

40. **While fiscal adjustment has been significant, the achievement of longer-term fiscal sustainability also requires substantive pension reform.** Fiscal consolidation is clearly an essential ingredient in dealing with the future costs of aging, and has contributed importantly to reducing public sector debt and raising the social security reserve fund. But net debt reduction is not a substitute for pension reform, and the latter will need to figure prominently in the new government's agenda. The recently renewed *Pacto de Toledo* provides a useful framework that should be promptly translated into a specific set of measures, centered on gradually raising the effective retirement age and strengthening the link between contributions and benefits.

41. **Safeguarding external competitiveness requires a wage-setting process that ensures greater productivity-based wage differentiation.** There is a need to move away from a system that generates a high homogeneity of wage increases and that is heavily focused on an inflation reference value and with insufficient attention to relative productivity. This feature is reinforced by the extensive use of indexation clauses. Such practices are at odds with successful performance in EMU. Discussions on this issue with the social partners should be resumed at the earliest opportunity. In the related process of social concertation, it would be useful also to further reduce the rigidity of open-ended contracts, which lies behind the high incidence of fixed-term employment.

42. **In product markets, the main issues remain the degree of effective competition in network industries, the restrictive norms burdening retail distribution, and the constraints on the supply of developable land.** In key network industries, the fruits of earlier liberalization are evident, with consumers benefiting directly from increased competition and resulting lower prices, but a further strengthening of competition remains needed in certain markets. In retail distribution, the harmful restrictive barriers instituted by regional governments should be rolled back, in the ultimate interest of local consumers and the regions' own economic performance. Finally, there has long been a patent need—now further highlighted by developments in the housing market—to improve the supply of developable land. Although the constraints arising from the present system are widely acknowledged, the issue's links to municipality financing have stood in the way of change. Reform will thus likely need a nonpartisan pact on the issue, which should be decisively pursued in the new legislature, and include also the promotion of greater transparency in the urban zoning process. In the housing market more generally, the very generous tax relief favoring home ownership is distortionary, weighs on the budget, and merits revision.

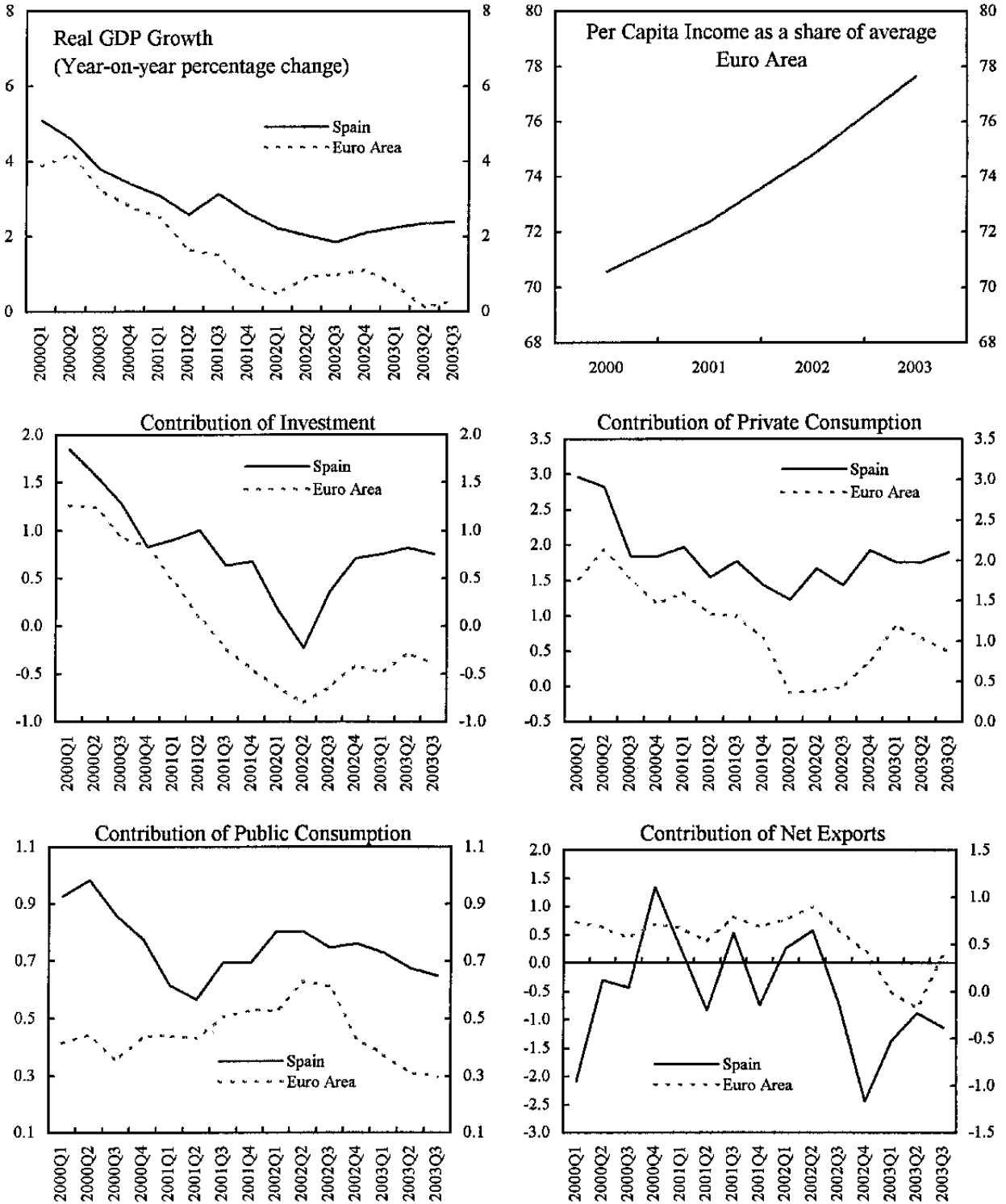
43. **In the banking sector, the proactive supervisory approach that contributed to the resilience to developments in some Latin American countries needs now to help guard against emerging domestic risks.** The speed and extent of the turnaround in the financial health of banks in 2003 has been pronounced, and the Spanish banking system continues to exhibit high levels of solvency, profitability, and efficiency. But the rapid expansion of credit and household indebtedness raises new concerns. In this context, the Bank of Spain's proactive supervisory approach and the authorities' efforts to raise the public's awareness of potential interest rate risks and to reduce the costs of mortgage refinancing are well placed. Both Spain and the international community stand to derive useful lessons from the conduct of a Financial Sector Assessment Program (FSAP), and the authorities' recent request in this sense is welcome.

44. Spain is encouraged to build on the increase in **ODA** in 2003 and progress further toward the 0.7 percent of GNP benchmark. Spain's support for **trade liberalization** vis-à-vis the least developed countries is welcome, and the authorities are encouraged to work actively toward the success of the Doha round, including through the needed flexibility on agricultural trade issues.

45. Spain's **data** are adequate for effective surveillance, although the quality of productivity data and the frequency and timeliness of regional fiscal data need to be improved (Appendix II). The authorities are also encouraged to extend the best practice of pre-announced release calendars to all key data (including, for example, the fiscal accounts and external trade statistics).

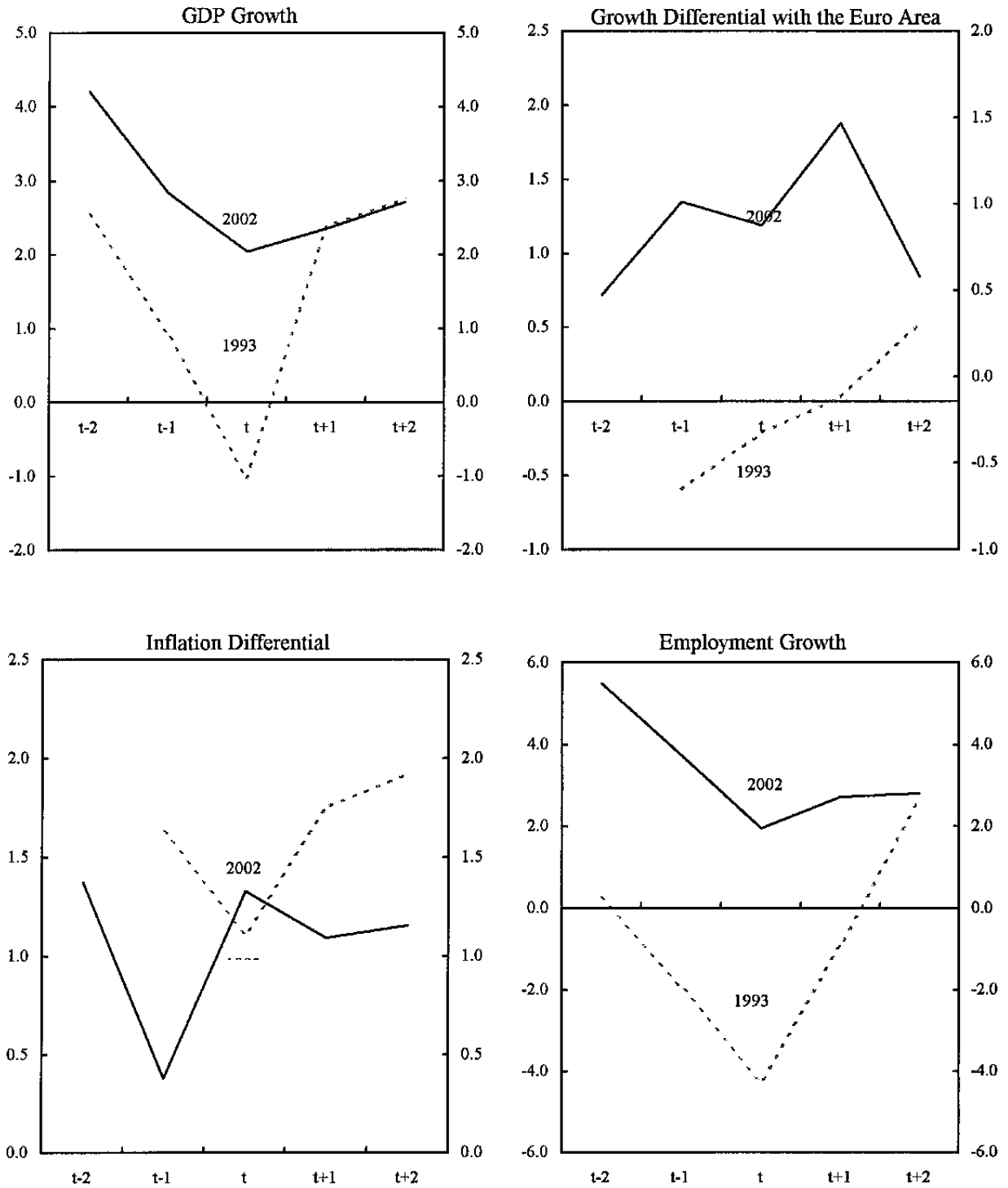
46. It is recommended that the **next consultation** be held on the standard 12-month cycle.

Figure 1. Spain: Real Sector, 2000-03



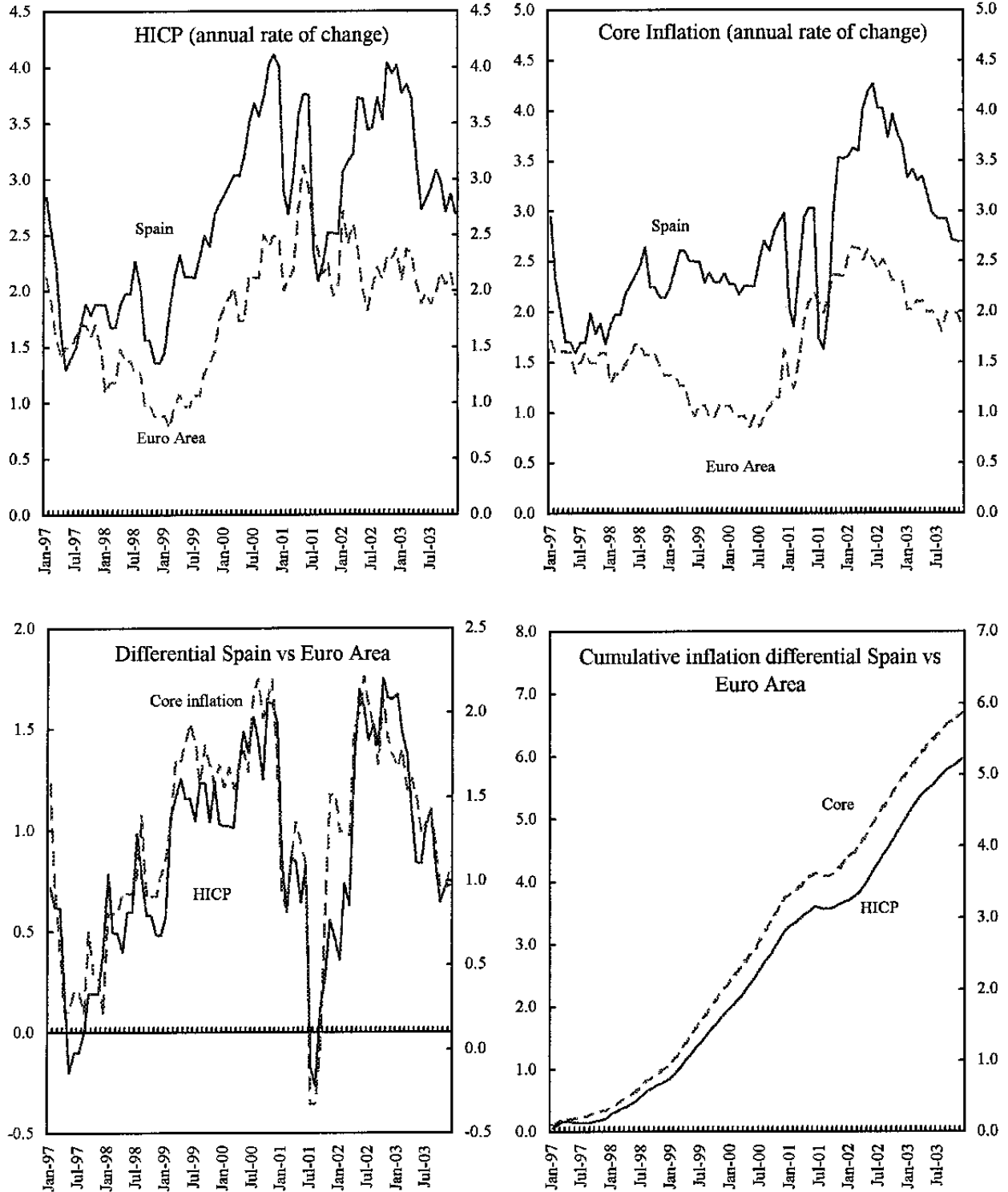
Sources: Bank of Spain; and Eurostat.

Figure 2. Spain: Cyclical Downturns, 2002 vs. 1993



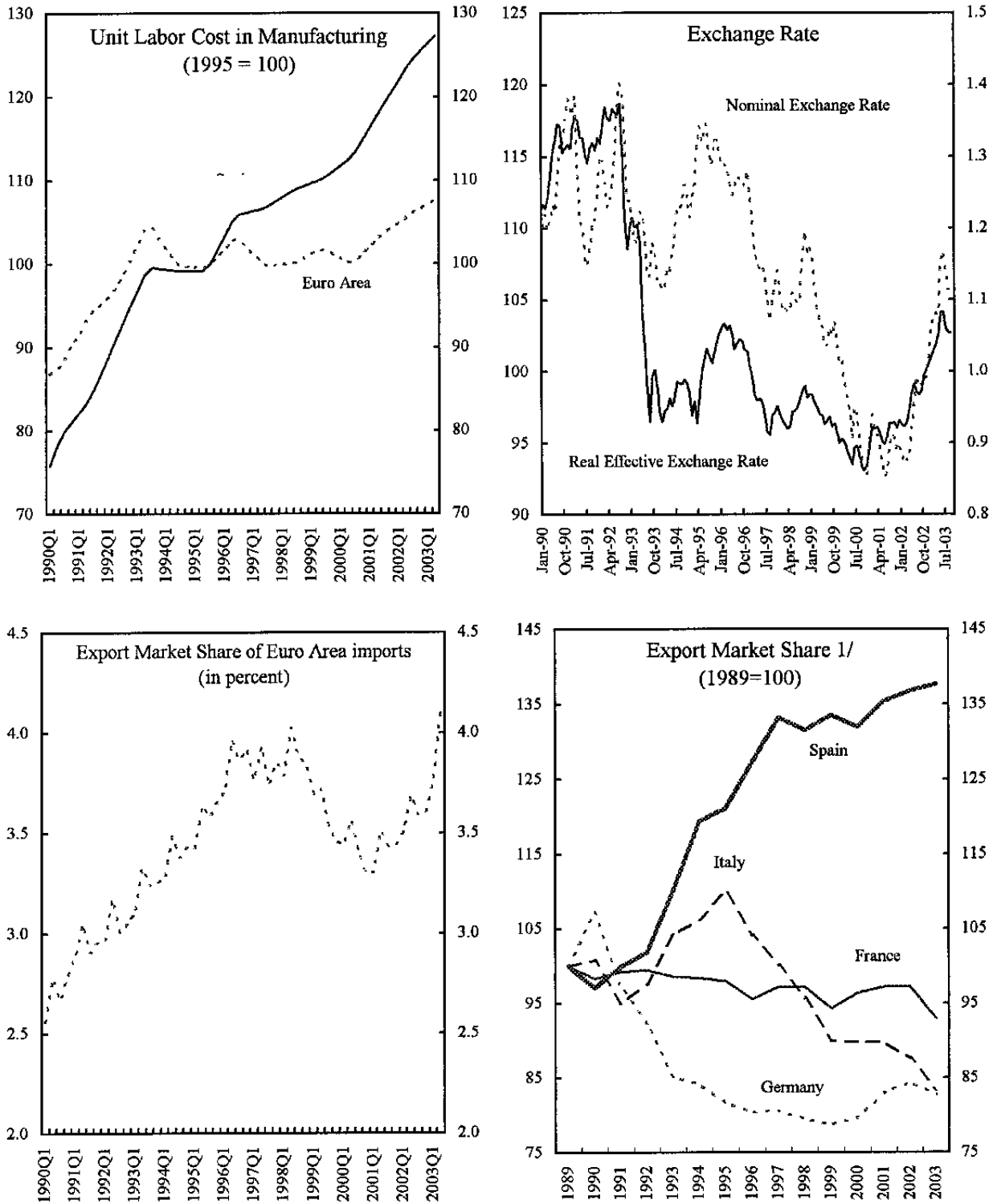
Sources: Bank of Spain; and IMF, *World Economic Outlook*.

Figure 3. Spain: Headline and Core Inflation, 1997-2003



Source: Eurostat.

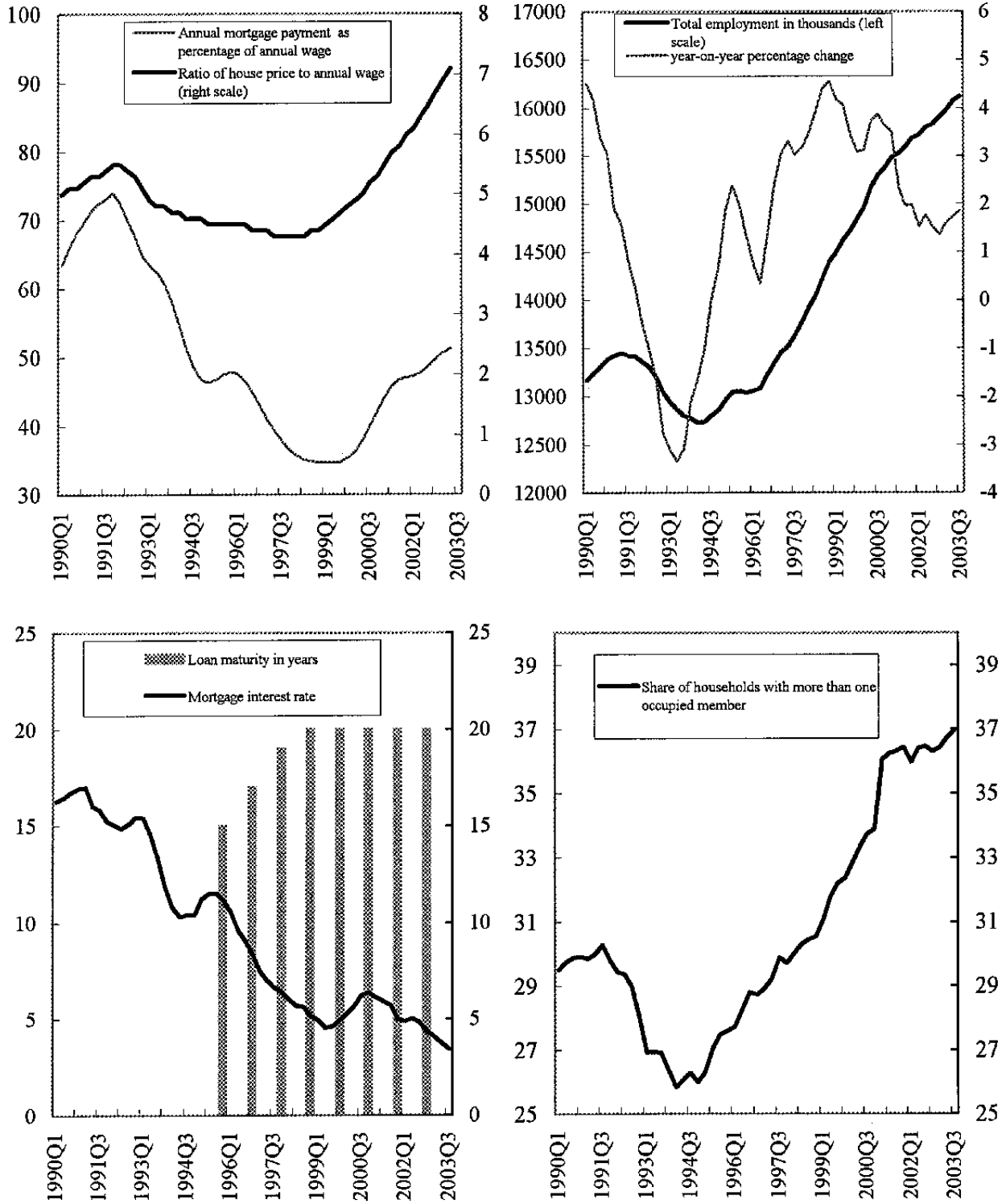
Figure 4. Spain: Competitiveness and Exports, 1990-2003



Sources: IMF, *International Financial Statistics*, *Direction of Trade*, and *World Economic Outlook*; Bank of Italy; ISTAT; and Organization for Economic Cooperation and Development.

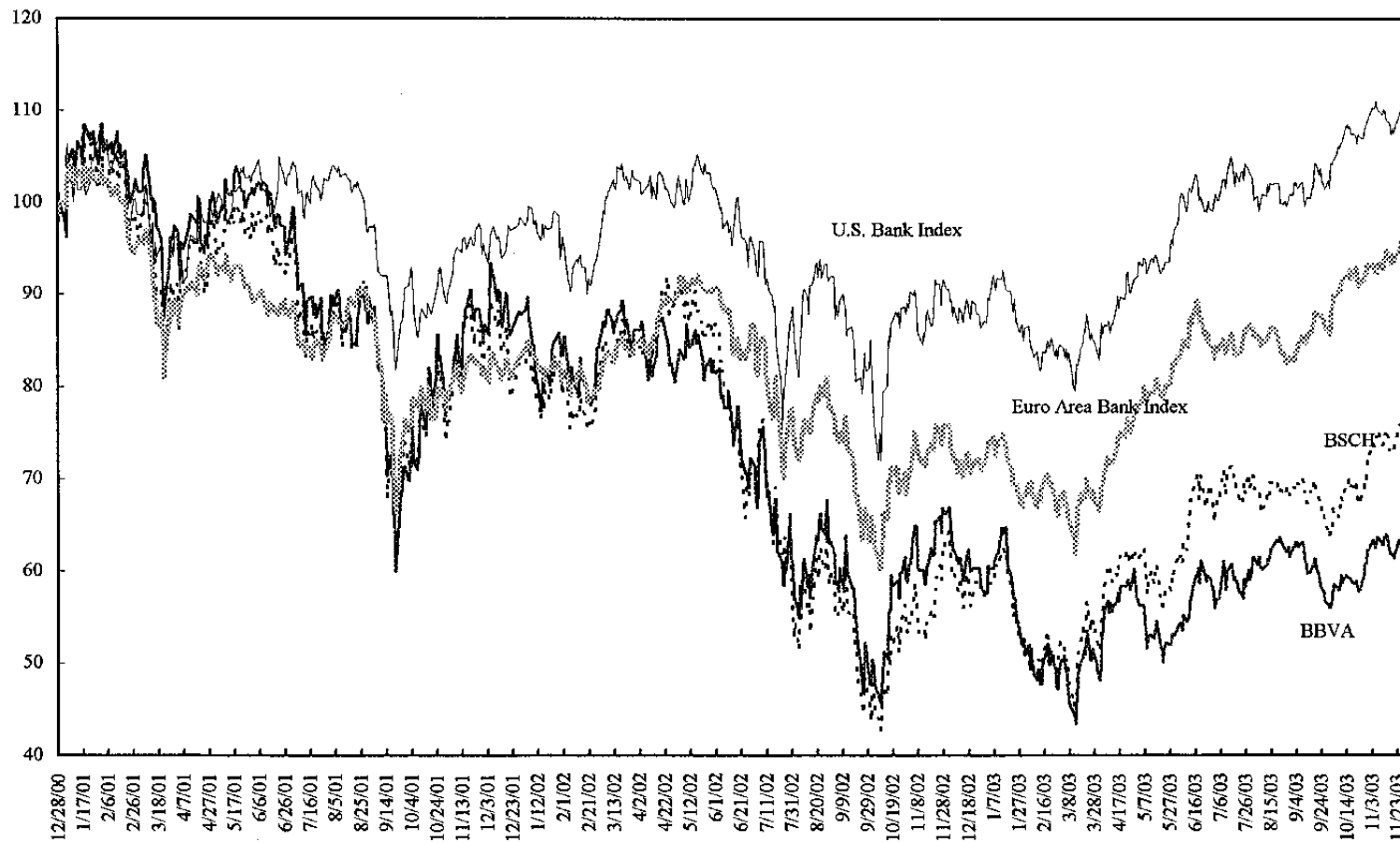
1/ As measured by real growth of exports of goods and nonfactor services less growth of import demand in partner countries.

Figure 5. Spain: Housing Market, 1990-2003



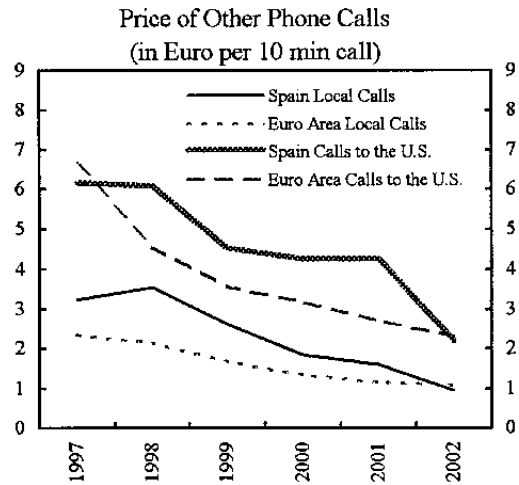
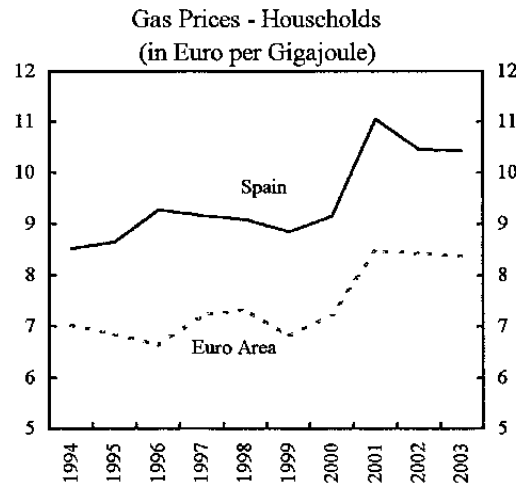
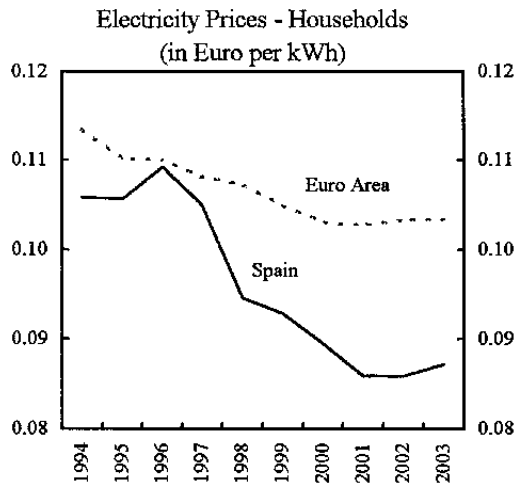
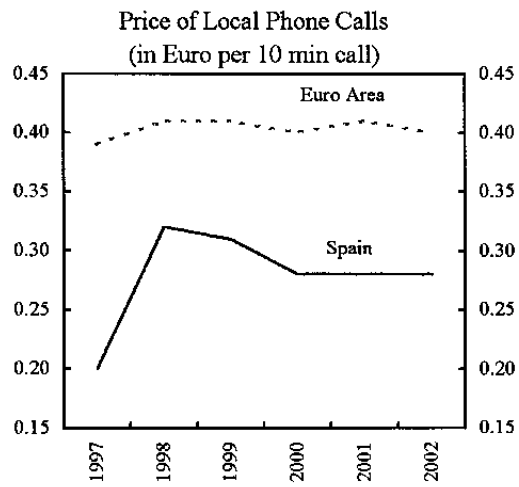
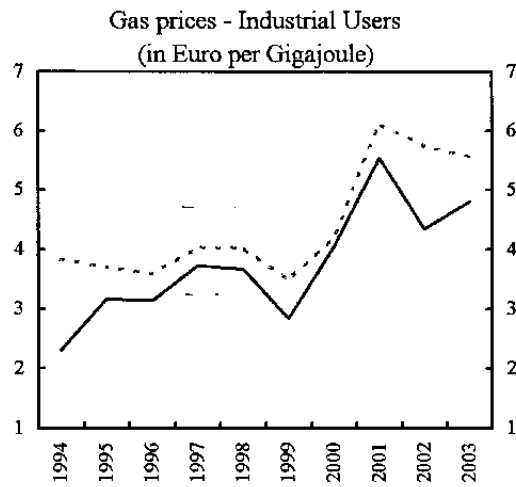
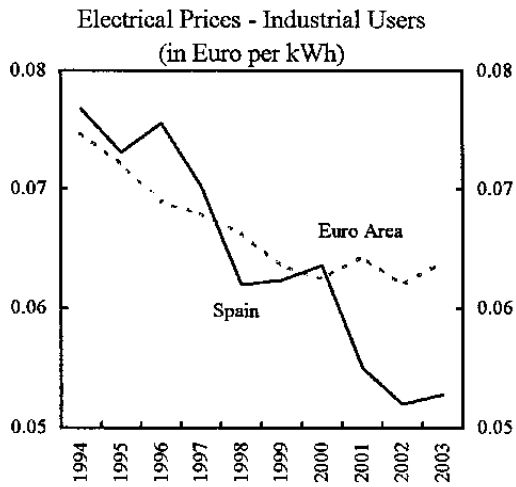
Source: Bank of Spain.

Figure 6. Spanish, European and U.S. Bank Stock Indices, 2000-03
 (100=December 31, 2000)



Sources: Bloomberg and Datastream.

Figure 7. Power and Telecommunication Prices, 1994-2003



Source: Eurostat.

Table 1. Spain: Main Economic Indicators, 1998-2004 1/

	1998	1999	2000	2001	2002	Forecast	
						2003	2004
Demand and supply in constant prices							
Gross domestic product	4.3	4.2	4.2	2.8	2.0	2.4	2.8
Private consumption	4.4	4.7	4.0	2.8	2.6	3.0	3.1
Public consumption	3.7	4.2	5.1	3.6	4.4	3.6	3.1
Gross fixed investment	10.0	8.8	5.7	3.3	1.0	3.1	3.6
Equipment investment	12.6	8.6	5.1	0.4	-2.7	2.3	3.5
Construction investment	7.8	9.0	6.1	5.8	4.2	3.7	3.7
Stockbuilding (contribution to growth) 2/	0.2	0.1	-0.1	-0.1	0.0	0.0	0.2
Total domestic demand	5.7	5.6	4.5	3.0	2.6	3.1	3.4
Net exports (contribution to growth) 2/	-1.3	-1.4	-0.4	-0.2	-0.6	-0.8	-0.7
Exports of goods and services	8.2	7.7	10.0	3.6	0.0	4.4	3.8
Imports of goods and services	13.2	12.6	10.6	4.0	1.8	6.5	5.6
Potential output growth	3.3	3.4	3.3	3.4	3.2	3.0	3.0
Output gap (percent of potential)	-0.8	0.0	0.9	0.4	-0.7	-1.3	-1.5
Private credit growth	16.5	15.4	17.2	11.8	12.3	13.3 5/	...
Prices							
GDP deflator	2.4	2.7	3.5	4.2	4.4	4.0	3.7
HICP (average) 3/	1.8	2.2	3.5	2.8	3.6	3.1	2.7
CPI (average) 3/	1.8	2.3	3.4	3.6	3.1	2.9	2.7
Employment and wages							
Unemployment rate (in percent)	18.7	15.7	13.9	10.5	11.4	11.2	10.6
Unit labor cost in manufacturing (growth rate)	1.9	1.2	2.4	4.0	2.9	2.2	3.1
Wage growth	2.6	2.7	3.7	3.7	3.8	3.5 5/	...
Employment growth	4.1	5.5	5.5	3.7	2.0	2.7	2.8
Labor participation rate (in percent) 4/							
Total	52.0	52.5	53.6	52.9	54.0	55.3 5/	...
Male	65.5	65.8	66.6	66.2	66.9	67.8 5/	...
Female	39.2	39.9	41.3	40.3	41.8	43.5 5/	...
Personal sector							
Household savings (percent of disposable income)	12.2	11.2	10.8	10.3	10.6	10.7	11.0
Balance of payments (percent of GDP)							
Trade balance	-3.5	-5.1	-6.2	-5.6	-5.0	-5.3	-5.6
Current account balance	-0.5	-2.3	-3.4	-2.8	-2.4	-2.4	-2.9
Nominal effective rate (1990=100)	76.2	74.7	71.9	72.3	74.2	76.1 5/	...
Real effective rate (1990=100)	84.9	84.2	82.1	83.6	87.6	90.4 5/	...
Public finance (percent of GDP)							
General government balance	-3.0	-1.2	-0.8	-0.3	0.1	0.5	0.5
Primary balance	1.0	2.2	2.3	2.6	2.6	2.7	2.6
Structural balance	-2.3	-1.0	-1.2	-0.7	0.5	1.2	1.4
Structural primary balance	1.7	2.3	1.9	2.2	3.0	3.5	3.5
General government debt	64.6	63.1	60.6	57.1	53.8	50.0	46.5

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

1/ Figures for 2003-04 are Fund staff projections.

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

3/ Year-on-year percentage change.

4/ Based on national definition, i.e., the labor force is defined as people older than 16.

5/ As of October 2003.

Table 2. Spain: Fiscal Accounts, 1998-2004
(In percent of GDP)

	1998	1999	2000	2001	2002	Proj.	
						2003 1/	2004
Current Revenues	37.7	38.3	38.5	38.7	39.1	39.2	39.1
Indirect taxes	11.1	11.7	11.7	11.4	11.6	11.7	11.7
Direct taxes	10.2	10.2	10.5	10.5	10.9	10.8	10.7
Social security contributions	13.0	13.1	13.3	13.6	13.6	13.8	13.8
Other current revenues	3.4	3.3	2.9	3.2	2.9	2.9	2.9
Current expenditures	36.5	35.4	35.2	34.8	34.8	34.6	34.4
Public consumption	17.1	17.1	17.2	17.2	17.3	17.3	17.2
Current transfers	12.8	12.4	12.3	12.2	12.3	12.3	12.4
Interest payments	4.3	3.5	3.3	3.1	2.8	2.6	2.4
Other current expenditures	1.2	1.2	1.2	1.2	1.3	1.3	1.3
Current balance	1.2	2.9	3.3	3.9	4.3	4.6	4.7
Gross fixed capital formation	3.3	3.5	3.1	3.3	3.5	3.5	3.5
Capital transfers and other	1.5	1.3	1.4	1.4	1.4	1.4	1.4
Primary balance	1.0	2.2	2.3	2.6	2.6	2.7	2.6
Overall balance	-3.0	-1.2	-0.8	-0.3	0.1	0.5	0.5
Central government	-2.4	-1.1	-0.9	-0.5	-0.4	-0.4	-0.3
Territorial governments	-0.3	-0.2	-0.4	-0.5	-0.3	0.0	0.0
Social security	-0.3	0.1	0.4	0.8	0.8	0.9	0.8
Government debt	64.6	63.1	60.6	57.1	53.8	50.0	46.5
<i>Memorandum items:</i>							
Structural primary balance 2/	1.7	2.3	1.9	2.2	3.0	3.5	3.5
Structural balance 2/	-2.3	-1.0	-1.2	-0.7	0.5	1.2	1.4
Structural expenditure	40.7	40.0	40.1	39.9	39.3	38.8	38.5
Structural revenue	38.4	39.0	38.9	39.2	39.8	40.0	40.0

Sources: *Cuentas Financieras*, Bank of Spain; *Intervención General de la Administración del Estado*; and Fund staff projections.

1/ Assumes territorial governments are in balance as required by the Budgetary Stability Law.

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

Table 3. Spain: Updated Stability Program, 2002–07

(In percent of GDP, unless otherwise indicated)

	2002	Program				
		2003	2004	2005	2006	2007
General government (in percent of GDP) 1/						
Revenue	39.8	40.0	40.0	40.0	40.0	40.0
Expenditure	39.7	39.6	40.0	39.9	39.8	39.7
Current expenditure	34.8	34.6	34.7	34.6	34.4	34.2
Capital expenditure	4.9	5.0	5.2	5.3	5.4	5.4
Balance	0.1	0.5	0.0	0.1	0.2	0.3
Central Government	-0.4	-0.4	-0.4	-0.3	-0.2	-0.1
Social security	0.8	0.9	0.4	0.4	0.4	0.4
Territorial governments	-0.3	0.0	0.0	0.0	0.0	0.0
Gross debt	54.5	51.8	49.6	47.7	45.7	43.8
Primary balance	2.8	3.0	2.6	2.5	2.6	2.6
Macroeconomic scenario (growth rates)						
Real GDP	2.0	2.3	3.0	3.0	3.0	3.0
Private consumption	2.6	3.0	3.1	3.0	3.0	3.0
Public consumption	4.4	3.6	2.9	2.8	2.8	2.8
Gross fixed capital formation	1.1	3.1	3.9	3.9	3.9	3.9
Domestic demand	2.6	3.1	3.3	3.2	3.2	3.2
Exports	0.0	4.4	6.3	7.0	7.0	7.0
Imports	1.8	6.6	7.0	7.2	7.2	7.2
Other variables						
GDP deflator	4.4	4.0	2.9	2.6	2.6	2.6
Private consumption deflator	3.5	3.2	2.7	2.4	2.4	2.4
Employment	1.5	1.8	1.9	2.1	2.1	2.1
Authorities' low-growth scenario						
Real GDP (growth rate)	...	2.3	2.5	2.5	2.5	2.5
General government balance	...	0.5	-0.1	0.0	0.0	0.1
Gross debt	...	51.8	50.0	48.4	46.9	45.4

Source: *Actualización del Programa de Estabilidad, España 2003-07*.

1/ On an ESA95 basis.

Table 4. Spain: Main Recommendations of the Pacto de Toledo 1/

Original Recommendation (1997)	Renewal of Original Recommendations (2003) 2/
1. Gradually moving to a system where social security contributions finance contributive benefits.	1. Moving to a system where social security contributions finance contributive benefits.
2. Building up of a reserve fund.	2. Earmarking the social security surplus to build up the reserve fund.
3. Aligning social security contribution with real salaries.	3. Continued efforts on aligning social security contribution bases with real salaries.
4. Aligning benefits and contribution among regimes.	4. Equalizing benefits and contribution among regimes.
5. Strengthening efforts on collecting social security contributions and reducing fraud.	5. Combating illegal immigration (including in the informal labor market) and reducing arrears on social contribution collection.
6. Streamlining and integration of special regimes.	6. Establishing a single general and a self-employed regimes.
7. Improving social security management practices.	7. Strengthening e-government, dissemination of information on the social security system, and control.
8. Scaling down social security contributions.	8. Scaling down social security contributions with an emphasis on women and older workers.
9. Improving the income distribution and contributive functions of the social security system.	9. Reducing the gap between the legal and the effective retirement age and aligning contributions with benefits.
10. Flexibilizing the retirement age and allowing retired people to continue in the work force.	10. Streamlining social security contributions of older workers and retired people.
11. Maintaining the purchasing power of pensions.	11. Maintaining the purchasing power of pensions and increasing minimum pensions in line with availability of resources.
12. Increasing survivor pensions.	12. Increasing survivor pensions, especially in the case of lack of other source of income and elderly people.
13. Strengthening management of temporary and permanent compensation for invalidity.	13. Strengthening management of temporary and permanent compensation for invalidity.
14. Promoting individual and collective pension plans (second and third pillars).	14. Promoting individual and collective pension plans (second and third pillars) and their inclusion in collective negotiation.

Sources: *Informe sobre la Ponencia para el Analisis de los Problemas Estructurales del Sistema de Seguridad Social y de las Principales Reformas que deberan acometerse.*

1/ The Toledo Pact is a set of recommendations for the reform of the pension system, presented by a parliamentary commission for the first time in March 1995, which provides for a progressive consensual approach to pension reform and regular reviews.

2/ Additional recommendations made are as follows: (i) strengthening benefits for part-time and time-bound contracts; (ii) promoting the conciliation of professional and family obligations for women; (iii) assessing and restructuring the social protection of dependent people (survivors, handicapped and elderly people, etc.); (iv) fighting social and professional discrimination of handicapped people; and (v) guaranteeing that immigrants fully enjoy benefits and observe obligations of the social security system.

Table 5. Spain: Indicators of External and Financial Vulnerability, 1999-2003 1/
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	
					Latest observation	Date of observation
External indicators 1/						
Exports (annual percent change, in U.S. dollars)	3.2	2.3	3.4	6.8	-1.8	Aug.
Imports (annual percent change, in U.S. dollars)	8.8	5.1	0.9	6.4	2.6	Aug.
Terms of trade (annual percent change)	1.7	-2.2	2.6	1.1	...	...
Current account balance (settlements basis)	-2.3	-3.4	-2.8	-2.4	-2.9	Jun.
Capital and financial account balance	3.1	4.3	3.9	3.4	4.1	Jun.
<i>Of which</i> : Inward portfolio investment (debt securities, etc.)	6.6	12.2	5.8	6.0	-2.0	Aug.
Inward foreign direct investment	2.3	7.8	6.0	3.6	0.9	Aug.
Other investment liabilities (net)	2.5	6.9	8.5	2.5	5.2	Aug.
Official reserves (in U.S. dollars, billions, end-of-period) 2/	33.9	31.8	30.3	35.3	23.4	Oct.
Central Bank foreign liabilities (in U.S. dollars, billions) 2/	80.9	86.1	76.3	78.1	86.2	Oct.
Foreign assets of the financial sector (in U.S. dollars, billions)	266.1	361.8	395.9	389.9	451.9	Oct.
Foreign liabilities of the financial sector (in U.S. dollars, billions)	441.8	585.2	648.2	664.7	831.7	Oct.
Official reserves in months of imports 2/	2.2	2.0	2.3	2.3	1.4	Aug.
Total external debt	30.6	34.3	32.3	28.6	...	...
<i>Of which</i> : General government debt	18.9	23.1	23.5	22.8	...	...
Total external debt to exports (ratio)	1.7	0.9	0.9	0.8	...	...
Exchange rate (per U.S. dollars, period average)	0.9	1.1	1.1	1.1	0.8	Dic
Financial market indicators						
Public sector debt (Maastricht definition)	63.1	60.6	57.1	53.8	...	...
3-month T-bill yield	3.0	4.6	3.9	3.3	2.2	Oct.
3-month T-bill yield (real)	0.8	1.1	1.1	-0.2	-0.4	Oct.
Stock market index	309.1	330.0	270.3	215.7	259.5	Nov.
Share prices of financial institutions	355.1	413.8	402.1	389.5	363.6	Oct.
Spread of 3-month T-bills with Germany (percentage points, end-of-period)	0.1	0.3	0.3	0.4	0.2	Oct.
Financial soundness indicators (core set)						
Regulatory capital to risk-weighted assets	12.6	12.4	12.9	12.5	12.4	Jun.
Regulatory Tier I capital to risk-weighted assets	9.4	9.0	8.9	8.6	8.6	Jun.
Nonperforming loans net of provisions to Tier I capital	15.3	-2.2	1.0	3.9	4.4	Jun.
Nonperforming loans net of provisions to total capital	-3.6	-9.3	-8.5	-7.6	-8.1	Jun.
Sectoral distribution of loans to resident total	72.7	65.7	67.7	73.2	74.9	Jun.
<i>Interbank and central bank</i>	10.9	8.1	7.8	7.1	7.3	Jun.
<i>General government</i>	13.8	11.3	11.2	11.4	11.6	Jun.
<i>Other sectors</i>	48.0	46.3	48.6	54.7	56.0	Jun.
Sectoral distribution of loans to nonresident total	27.3	34.3	32.3	26.8	25.1	Jun.
<i>Interbank and central bank</i>	11.1	10.8	10.6	9.7	8.5	Jun.
<i>General government</i>	4.9	9.5	8.0	5.8	5.3	Jun.
<i>Other sectors</i>	11.3	14.1	13.7	11.3	11.3	Jun.
Return on assets	0.99	1.04	0.97	0.87	0.98	Jun.
Return on equity	18.30	18.51	16.46	14.60	16.64	Jun.
Interest margin to gross income	70.23	68.77	70.57	71.20	69.24	Jun.
Noninterest expense to gross income	64.76	62.97	60.31	59.10	56.89	Jun.
Liquid assets to total assets (liquid asset ratio)	39.2	37.2	35.5	33.0	32.1	Jun.
Liquid assets to short-term liabilities	75.4	78.0	76.0	71.5	69.7	Jun.
Net open position in foreign exchange to Tier I capital	22.1	23.5	23.1	12.9	8.1	Jun.

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.

Table 6. Spain: Balance of Payments, 1997-2003

	1997	1998	1999	2000	2001	2002	2003 H1
	(In billions of euros)						
Current account balance	2.2	-2.6	-13.1	-21.0	-18.3	-16.6	-9.6
Trade balance	5.8	1.1	-7.1	-13.5	-9.3	-8.6	-16.3
Exports of goods	94.1	100.4	105.7	126.1	131.7	133.2	71.7
Imports of goods	105.9	118.9	134.3	163.8	168.1	167.9	88.0
Balance of non-factor services	17.6	19.6	21.5	24.2	27.1	26.1	11.7
Balance of factor income	-5.95	-6.75	-8.90	-8.98	-10.88	-10.47	-6.2
Balance of current transfers	2.4	3.0	2.9	1.5	1.8	2.4	1.2
Balance of capital and financial account	2.8	5.6	17.8	26.5	25.6	23.7	12.6
Foreign direct investment	-5.4	-6.4	-24.7	-18.6	-5.7	2.9	6.3
Portfolio	-3.3	-23.7	-1.4	-1.4	-19.8	6.0	-21.3
Other investment	16.2	17.7	16.2	38.0	43.7	10.5	18.8
Capital transfers	5.7	5.7	6.7	5.2	5.9	7.9	4.3
Reserve assets	-10.4	12.2	21.0	3.3	1.6	-3.6	4.6
Errors and omissions	-5.1	-3.0	-4.7	-5.5	-7.3	-7.0	-3.0
	(In percent of GDP)						
Current account balance	0.5	-0.5	-2.3	-3.4	-2.8	-2.4	-2.6
Trade balance	1.2	0.2	-1.2	-2.2	-1.4	-1.2	-4.5
Exports of goods	19.0	19.0	18.7	20.7	20.2	19.1	19.7
Imports of goods	21.4	22.5	23.8	26.9	25.7	24.1	24.1
Balance of non-factor services	3.6	3.7	3.8	4.0	4.2	3.8	3.2
Balance of factor income	-1.2	-1.3	-1.6	-1.5	-1.7	-1.5	-1.7
Balance of current transfers	0.5	0.6	0.5	0.3	0.3	0.3	0.3
Balance of capital and financial account	0.6	1.1	3.1	4.3	3.9	3.4	3.5
Foreign direct investment	-1.1	-1.2	-4.4	-3.1	-0.9	0.4	1.7
Portfolio	-0.7	-4.5	-0.2	-0.2	-3.0	0.9	-5.9
Other investment	4.4	4.4	4.1	7.1	7.6	2.6	5.2
Reserve assets	-2.1	2.3	3.7	0.5	0.2	-0.5	1.2
Errors and omissions	-1.0	-0.6	-0.8	-0.9	-1.1	-1.0	-0.8

Sources: IMF, *World Economic Outlook*; and Fund staff projections.

SPAIN: FUND RELATIONS

(As of December 31, 2003)

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	3,048.9	100.0
Fund holdings of currency	1,795.6	58.9
Reserve position in Fund	1,253.4	41.1
III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	298.8	100.0
Holdings	278.0	93.1

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	143.2	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.

Spain maintains exchange restrictions with respect to: Burma/Myanmar; Mr. Milosevic and persons associated with him; Iraq; certain persons and entities with a view to combating terrorism; Osama bin Laden, the Al-Qaeda network and the Taliban; and Zimbabwe pursuant respectively to European Council Regulations (EC) Nos. 1081/2000, 2488/2000, 1210/2003, 2580/2001, 881/2002 and 310/2002 solely for the preservation of national or international security; those exchange restrictions have been notified to the Fund in accordance with Executive Board Decision No. 144-(52/51).

VIII. Article IV Consultations:

The last Article IV consultation was concluded on February 10, 2003. Spain is on the standard 12-month consultation cycle.

SPAIN: STATISTICAL ISSUES

Areas for improvement include:

- *General government.* Historical revisions, preliminary estimates, and planned fiscal accounts data should be made available to the public shortly after being sent to Eurostat in March and September. In addition, major revisions should be fully documented. 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. Also, the lack of higher frequency data impedes the publication of quarterly general government data.
- *Labor market.* Two different measures of unemployment are reported by the authorities (so-called “registered” and “survey” unemployment), which vary substantially reflecting different statistical methods. 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.
- *International trade.* In line with best practices, a pre-announced release calendar for these data should be published.

Spain: Core Statistical Indicators

(As of January 21, 2004)

	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	1/21/04	12/31/03	12/31/03	11/28/03	12/31/03	12/2003	10/2003	10/2003	2002	Q3/2003	Q3/2003
Date Received	1/21/04	1/15/04	1/15/04	12/31/03	1/15/04	1/15/04	1/15/04	1/15/04	3/14/03	12/2003	10/31/03
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

SPAIN

**Staff Report for the 2003 Article IV Consultation
Supplementary Information**

Prepared by the European Department

(In consultation with the Policy Development and Review Department)

Approved by Michael Deppler and G. Russell Kincaid

March 17, 2004

- 1. This supplement to the staff report for the 2003 Article IV consultation with Spain provides an update on recent developments**, which do not change the thrust of the staff appraisal. The most significant events since the issuance of the staff report have been the terrorist attacks of March 11 in Madrid, and the victory by the opposition Socialist Party (PSOE) in the general elections of March 14. The PSOE fell short of an absolute majority, requiring the support of smaller parties. Despite differences in electoral platforms, and differing priorities in terms of structural reforms, most observers do not expect a significant shift in the course of macroeconomic policy, particularly as regards the stability-orientation of fiscal policy, which has gained broad support in recent years.
- 2. It is too early to make a meaningful assessment of the attack's potential economic impact.** The immediate effect has been a weakening of the Spanish equity market, reflecting the adverse impact on confidence and an increase in risk aversion. The key tourism sector is also expected to be affected. Most analysts are of the view, however, that such effects will be relatively short-lived and, although the balance of risks has clearly shifted, staff is not at this stage revising its GDP growth forecast for 2004 (2.8 percent).
- 3. Economic indicators for the fourth quarter continue to point to a gradual, domestic demand-led recovery with receding inflation.** Although GDP growth in 2003 was in line with expectations, its composition was somewhat different (Table 1). Domestic demand growth came in even stronger than expected, buoyed by private and public consumption and construction activity. For its part, the larger negative external contribution reflected both weaker export performance and stronger growth in imports. In the labor market, employment growth remained robust. Partly reflecting a base effect, inflation moderated appreciably in early 2004, with the 12-month increase in the harmonized price index averaging 2¼ percent in January and February.

4. **The general government accounts registered a slight surplus in 2003** (Table 2). The surplus—at 0.3 percent of GDP—was somewhat smaller than expected earlier despite a better showing of the social security accounts. The strength of social security contributions is estimated to have raised the social security surplus to 1 percent of GDP. But this improvement was more than offset by the weaker outcome for the territorial governments, whose deficit of 0.3 percent of GDP fell short of the legally mandated “zero deficit” under the Budgetary Stability Law.

5. **House prices and mortgage credit have continued to expand at a rapid clip.** Following a short-lived slowdown, house price increases returned to the rapid pace set in the first half of the year, bringing the annual increase for 2003 to 17 percent—the highest in over a decade. Mortgage credit also continued to expand rapidly, by over 23 percent (year-on-year) in the fourth quarter, with the outstanding stock reaching 63 percent of GDP. Total household indebtedness now exceeds the EU average, but remains well below levels in the United Kingdom and the United States.

Table 1. Spain: Main Economic Indicators, 1998-2004 1/

	1998	1999	2000	2001	2002	Estimates 2003	Projections 2004
Demand and supply in constant prices							
Gross domestic product	4.3	4.2	4.2	2.8	2.0	2.4	2.8
Private consumption	4.4	4.7	4.0	2.8	2.6	3.0	3.1
Public consumption	3.7	4.2	5.1	3.6	4.4	4.6	3.1
Gross fixed investment	10.0	8.8	5.7	3.3	1.0	3.0	3.6
Equipment investment	12.6	8.6	5.1	0.4	-2.7	2.2	3.5
Construction investment	7.8	9.0	6.1	5.8	4.2	3.7	3.7
Stockbuilding (contribution to growth) 2/	0.2	0.1	-0.1	-0.1	0.0	0.0	0.2
Total domestic demand	5.7	5.6	4.5	3.0	2.6	3.3	3.4
Net exports (contribution to growth) 2/	-1.3	-1.4	-0.4	-0.2	-0.6	-1.0	-0.7
Exports of goods and services	8.2	7.7	10.0	3.6	0.0	4.0	3.8
Imports of goods and services	13.2	12.6	10.6	4.0	1.8	6.7	5.6
Potential output growth	3.3	3.4	3.3	3.4	3.2	3.0	3.0
Output gap (percent of potential)	-0.8	0.0	0.9	0.4	-0.7	-1.2	-1.5
Private credit growth	16.5	15.4	17.2	11.8	12.3	14.2	...
Prices							
GDP deflator	2.4	2.7	3.5	4.2	4.4	4.2	3.9
HICP (average) 3/	1.8	2.2	3.5	2.8	3.6	3.1	2.7
CPI (average) 3/	1.8	2.3	3.4	3.6	3.1	3.0	2.7
Employment and wages							
Unemployment rate (in percent)	18.7	15.7	13.9	10.5	11.4	11.3	10.8
Unit labor cost in manufacturing (growth rate)	1.9	1.2	2.4	4.0	2.9	2.2	3.1
Wage growth	2.6	2.7	3.7	3.7	3.8	3.4	...
Employment growth	4.1	5.5	5.5	3.7	2.0	2.7	2.7
Labor participation rate (in percent) 4/							
Total	52.0	52.5	53.6	52.9	54.0	55.1	...
Male	65.5	65.8	66.6	66.2	66.9	67.5	...
Female	39.2	39.9	41.3	40.3	41.8	43.3	...
Personal sector							
Household savings (percent of disposable income)	12.2	11.2	10.8	10.3	10.6	10.7	11.0
Balance of payments (percent of GDP)							
Trade balance	-3.5	-5.1	-6.2	-5.6	-5.0	-5.3	-5.7
Current account balance	-0.5	-2.3	-3.4	-2.8	-2.4	-2.5	-2.9
Nominal effective rate (1990=100)	76.2	74.7	71.9	72.3	74.2	76.0 5/	...
Real effective rate (1990=100)	84.9	84.2	82.1	83.6	87.6	90.6 5/	...
Public finance (percent of GDP)							
General government balance	-3.0	-1.2	-0.8	-0.3	0.1	0.3	0.4
Primary balance	1.0	2.2	2.3	2.6	2.6	2.5	2.5
Structural balance	-2.3	-1.0	-1.2	-0.7	0.5	1.0	1.3
Structural primary balance	1.7	2.3	1.9	2.2	3.0	3.2	3.4
General government debt	64.6	63.1	60.6	57.1	53.8	50.8	47.2

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

1/ Figures for 2004 are Fund staff projections.

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

3/ Year-on-year percentage change.

4/ Based on national definition, i.e., the labor force is defined as people older than 16.

5/ As of November 2003.

Table 2. Spain: Fiscal Accounts, 1998-2004
(In percent of GDP)

	1998	1999	2000	2001	Estimates		Projections
					2002	2003	2004
Current Revenues	37.7	38.3	38.5	38.7	39.1	39.2	39.1
Indirect taxes	11.1	11.7	11.7	11.4	11.6	11.7	11.7
Direct taxes	10.2	10.2	10.5	10.5	10.9	10.8	10.7
Social security contributions	13.0	13.1	13.3	13.6	13.6	13.8	13.8
Other current revenues	3.4	3.3	2.9	3.2	2.9	2.9	2.9
Current expenditures	36.5	35.4	35.2	34.8	34.8	34.7	34.5
Public consumption	17.1	17.1	17.2	17.2	17.3	17.4	17.3
Current transfers	12.8	12.4	12.3	12.2	12.3	12.3	12.4
Interest payments	4.3	3.5	3.3	3.1	2.8	2.5	2.4
Other current expenditures	1.2	1.2	1.2	1.2	1.3	1.3	1.3
Current balance	1.2	2.9	3.3	3.9	4.3	4.5	4.6
Gross fixed capital formation	3.3	3.5	3.1	3.3	3.5	3.5	3.5
Capital transfers and other	1.5	1.3	1.4	1.4	1.4	1.4	1.4
Primary balance	1.0	2.2	2.3	2.6	2.6	2.5	2.5
Overall balance	-3.0	-1.2	-0.8	-0.3	0.1	0.3	0.4
Central government	-2.4	-1.1	-0.9	-0.5	-0.4	-0.4	-0.4
Territorial governments	-0.3	-0.2	-0.4	-0.5	-0.3	-0.3	0.0
Social security	-0.3	0.1	0.4	0.8	0.8	1.0	0.8
Government debt	64.6	63.1	60.6	57.1	53.8	50.8	47.2
<i>Memorandum items:</i>							
Structural primary balance 1/	1.7	2.3	1.9	2.2	3.0	3.3	3.4
Structural balance 1/	-2.3	-1.0	-1.2	-0.7	0.5	1.0	1.3
Structural expenditure	40.7	40.0	40.1	39.9	39.3	39.0	38.7
Structural revenue	38.4	39.0	38.9	39.2	39.8	40.0	40.0

Sources: *Cuentas Financieras*, Bank of Spain; *Intervención General de la Administración del Estado*; and Fund staff projections.

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



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 04/31
FOR IMMEDIATE RELEASE
April 2, 2004

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

IMF Concludes 2003 Article IV Consultation with Spain

On March 19, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Spain.¹

Background

While not escaping the global slowdown, the Spanish economy has weathered it relatively well thanks to the strength of domestic demand. After several years of growth in excess of 4 percent, partly propelled by the tailwinds of EMU participation, the expansion lost steam in 2001 and growth slowed to 2½ percent in 2003. The slowdown reflected euro area weakness and the worldwide slump in tourism. But domestic demand held up well, buoyed by private consumption, public infrastructure spending, and booming construction activity. Output growth thus remained well above the euro-area average, ensuring further real income convergence. In addition, as labor market flexibility improved, employment continued expanding. These developments contrast with previous slowdowns, when growth would fall well below the euro-area average with sizable job losses. Productivity performance, however, has remained lackluster, partly reflecting the success in drawing new, lower-skilled entrants into employment. Concurrently, household indebtedness rose rapidly, amidst a continued housing price boom.

Inflation and its margin over the euro area have declined since late 2002, but the cumulative inflation differential with the euro area, transmitted to labor costs via widespread indexation mechanisms, has eroded competitiveness. While overall export market shares have held up well, export margins have come under increasing pressure.

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.

Gains in fiscal consolidation were maintained in 2003, with the general government recording a small surplus (0.3 percent of GDP) and helping to counter very easy monetary conditions. For 2004, the budget target of a “zero deficit”—formulated when that was the expected outcome for 2003—would imply some fiscal loosening. For its part, monetary policy from Spain’s perspective is clearly accommodative, with short-term real interest rates in negative territory for over two years.

Despite the uncertainty generated by the recent terrorist attacks, the prevailing prospect is that of a moderate but sustained recovery, with growth projected slightly below 3 percent in 2004. Such a performance—predicated to be largely driven by the strength of domestic demand, with a continued, albeit smaller, drag from net exports—would again appreciably outstrip that expected for the euro area. Inflation is projected to remain in the order of 2.7 percent, implying a differential of around 1 percentage point with respect to euro area inflation forecasts.

After a trying two years—with substantial declines in profits associated with investments in Latin America—the banking sector staged a come back in 2003, and exhibits comparatively strong key indicators. Market participants generally view domestic risks from the sector’s exposure to the housing market as manageable.

On the structural front, following reform of the unemployment benefits system at end-2002, main measures in 2003 concerned the full liberalization of the electricity and gas markets, initiatives to improve corporate governance and modernize the business environment, and new steps to counter money laundering and the financing of terrorism. Some other long-standing issues, however, including pension reform, the wage negotiating framework, and the land supply process, remain to be addressed.

Executive Board Assessment

Executive Directors expressed their profound sympathy and solidarity with the Spanish people and authorities in the face of the terrorist attacks of March 11 in Madrid.

Directors commended Spain’s pursuit of stability-oriented macroeconomic policies and structural reforms which have secured a continued rise in per capita income, sustained job creation, and strengthened economic resilience. This performance is particularly noteworthy at a time of economic weakness elsewhere in Europe, and, in general, in the world economy. The exemplary pursuit of fiscal adjustment, in observance of Spain’s Budgetary Stability Law and of the EU’s Stability and Growth Pact, has appropriately focused on structural expenditure reductions. Against this background, Spain’s short-term growth prospects remain favorable, despite the uncertainty caused by recent events.

To sustain this strong economic performance in the period ahead, Directors saw as priorities for the new government to take timely action to contain some emerging domestic risks and to pursue the structural reform agenda with determination. On the domestic front, there was general agreement that the boom in housing prices and rising household indebtedness—although driven by structural factors and not posing an imminent risk—cannot continue unabated without increasing the potential for an adverse fallout. To minimize this risk and

facilitate a soft landing will require continued fiscal restraint and firm financial sector oversight. Decisive efforts will also be needed to press ahead with structural reforms in product and labor markets, as this will be key to address Spain's continued price differential with the euro area, enhance the economy's flexibility and supply-side response, and ensure competitiveness in an enlarged European Union.

With euro area monetary conditions being easy from Spain's perspective, Directors stressed that fiscal policy will need to remain appropriately restrictive. They welcomed the achievement of a small general government surplus in 2003, but noted that, in light of this result, the budgeted "zero deficit" for 2004 would imply a small fiscal stimulus. Most Directors encouraged the new government to aim for a better-than-budgeted result, availing itself of the useful framework provided by the Budgetary Stability Law. This should be achieved by keeping central government spending below the budget ceiling, carefully safeguarding the contingency fund for truly exceptional circumstances, and strengthening the monitoring of regional budget execution. Efforts to ensure the timely reporting of regional fiscal data will be important in this regard.

Directors welcomed the positive role that public infrastructure spending has played in supporting economic activity and growth potential, within the general context of fiscal consolidation. The widening range of financing modalities, with a growing share of investment carried out by public enterprises and through public-private partnerships, however, calls for strengthened monitoring and transparent quantification of the potential fiscal implications of these operations. Directors welcomed the expanded information in budget documents on investment carried out by state-owned nonfinancial enterprises and entities. They encouraged further steps toward closer tracking and fuller disclosure of all public contingent liabilities associated with public investment activities. The fiscal transparency ROSC, requested by the Spanish authorities, should provide timely guidance in this respect.

While welcoming the reduction in public sector debt and the strengthening of the social security reserve fund, Directors stressed that long-term fiscal sustainability will also need to be supported by comprehensive pension reform. They encouraged the new government to place pension reform high on its policy agenda with a view to translating the renewed *Pacto de Toledo* into a specific set of measures. These measures should be centered on gradually raising the effective retirement age and strengthening the link between contributions and benefits.

Directors noted that safeguarding external competitiveness, further improving the productivity and employment outlook, and reducing remaining price and cost differentials with the euro area will require sustained further reform efforts in labor and product markets. In particular, they highlighted the importance of moving toward a wage-setting process that is more attentive to productivity developments, including by scaling back the current widespread recourse to wage indexation clauses. In the process of social dialogue on this issue, Directors also encouraged the authorities to pursue steps to reduce the rigidity of open-ended employment contracts, noting that this rigidity has contributed to the high incidence of fixed-term employment. Directors also encouraged efforts to strengthen human capital and research and development.

In goods and services markets, Directors encouraged the authorities to build on the progress achieved to date through a vigorous enforcement of competition policy. In key network

industries, much progress has already been made in strengthening competition, although in some sectors there remains scope for further improvements. In retail trade and distribution, Directors called for the removal of restrictive barriers on the part of regional governments, noting that this will ultimately be in the best interest of local consumers and the regions' own economic performance. Directors also encouraged the authorities to take steps to alleviate the long-standing constraints on the supply of developable land and promote greater transparency in the urban zoning process. They also called for a revision of the generous tax relief favoring home ownership, to help dampen the booming housing market.

Directors commended the prudent supervisory approach, which has allowed the banking sector to weather adverse external developments in 2001–02 and record a strong comeback in 2003, with high levels of solvency, profitability, and efficiency. Nonetheless, continued vigilance is needed in the face of the rapid expansion of credit and household indebtedness. Directors welcomed the steps to reduce the cost of mortgage refinancing and the authorities' efforts to raise the public's awareness of potential interest rate risks, as well as Spain's recent request for a Financial Sector Assessment Program (FSAP). They commended Spain's commitment to counter money laundering and the financing of terrorism, including the new comprehensive legislation in this area.

Directors welcomed the recent increase in Spain's official development assistance, and looked forward to further increases in the years ahead. They welcomed Spain's support for trade liberalization vis-à-vis the least developed countries, and encouraged the authorities to work actively toward the success of the Doha round.

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 2003 Article IV Consultation is also available.

Spain: Selected Economic Indicators, 1999–2004 1/

	1999	2000	2001	2002	2003	2004
Real economy (change in percent)						
Real GDP	4.2	4.2	2.8	2.0	2.4	2.8
Domestic demand	5.6	4.5	3.0	2.6	3.3	3.4
HICP (average)	2.2	3.5	2.8	3.6	3.1	2.7
Unemployment rate (in percent)	15.7	13.9	10.5	11.4	11.3	10.8
Public finances (general government; in percent of GDP) 2/						
Overall balance	-1.2	-0.8	-0.3	0.1	0.3	0.4
Primary balance	2.2	2.3	2.6	2.6	2.5	2.5
Interest rates						
Money market rate	2.7	4.0	4.2	3.3	4.3	...
Government bond yield	4.7	5.6	4.7	5.0	4.8	...
Balance of payments (in percent of GDP)						
Trade balance	-5.1	-6.2	-5.6	-5.0	-5.3	-5.7
Current account	-2.3	-3.4	-2.8	-2.4	-2.5	-2.9
Fund position (as of January 31, 2004)						
Holdings of currency (in percent of quota)					58.89	
Holdings of SDRs (in percent of allocation)					93.15	
Quota (in millions of SDR)					3,048.90	
Exchange rate						
Exchange rate regime						Euro Area Member
Present rate (March 19, 2004)						US\$ 1.2344 per euro
Nominal effective exchange rate (1990=100)	74.7	71.9	72.3	74.2	75.9	
Real effective exchange rate (1990=100)	84.2	82.1	83.6	87.6	89.9	

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

1/ Figures for 2003–2004 are IMF staff projections.

2/ Maastricht basis.

**Statement by Luis Martí, Executive Director for Spain
March 19, 2004**

The authorities appreciate the frank talks held with the staff during the mission to Spain last November. The staff's views were perceptive and stimulating, and policymaking can only be enriched by the debate. We are basically in agreement with the analysis made in the Report, and will limit this statement to a few additional comments.

Closing 2003

The Spanish *GDP* grew 2.4 percent in 2003, sustained by a buoyant construction sector and strong consumer demand. Growth in Q4/2003 was somewhat higher at an annualized rate of 2.8 percent, and the authorities expect that private consumption, investment, and a lesser external drag (thanks to recovery in the EU market) will boost growth to 3 percent in 2004.

Inflation at 2.6 percent remains above the eurozone average, although the differential has been narrowing over time. The latest figure for January brought down the differential to just four decimal points above HCPI, and the latest figure for February shows a lower CPI yet, at a yoy rate of 2.1 percent.

The *fiscal stance* was conservative, in line with the structural adjustment policy implemented since 1997. The general government posted a surplus of 0.3 percent GDP, derived from 0.6 percent surplus in the central government accounts and an overall deficit of 0.3 percent in the budget of regional and local governments. The fears of staff that a zero budget in 2004 would imply a too expansive impulse are based on the initial estimate that the regional and local governments would close in balance. If at all expansive, therefore, the impact would now be weaker. The authorities are also confident that, in view of the current demographic developments, the surplus in social security will come out higher than forecast.

The trend is downward, but *unemployment* is still too high in Spain, 11.2 percent at year's end. Growth, however, has mostly been job-led. Labor-deepening accounts for more than 485,000 new jobs created in 2003, which may go a long way towards explaining the low figures recorded for productivity. In fact, employment growth accounts for about 4/5 of real GDP growth in each of the last four years.

Fostering competition: what's done, what remains to be done...

The authorities have promoted *effective competition* in critical areas of the economy. Positive effects for consumers are already obvious in the pronounced fall of prices brought about in the fiercely competitive telecoms industry. The power sector is now private and entirely liberalized. Industrial and domestic customers are for the first time ever in Spain free to choose supplier. Prices—which used to be among the highest in Europe—are already on the way down, although the full benefits will only be felt when consumers become aware of their rights and learn on a practical level to interact with suppliers and select the best offers (as they do in any other product market). An integrated Iberian market, offering the advantage of

a wider economic dimension, must sharpen competition and is expected to become operational in the course of 2004. Natural gas is also no longer a monopoly in Spain. Would-be suppliers enjoy guaranteed access to the existing gasline network across the country. So much for *network industries*. There is now a separate regulatory agency for each of these markets. Within the framework of competition law, the authorities are nowadays addressing frequently—often ex officio—cases of noncompetitive behavior, i.e., price-rigging among operators.

The competitive situation in retail distribution, however, has evolved unevenly. The licensing and regulatory authority is entirely in the hands of regional governments and the stance of each—open or restrictive—toward the barriers to establishment, as shown by the Report in [30], marks the degree of effective competition in the different regional markets.

Public finances in the long term: changing demography and ongoing reforms

The staff correctly mentions that the demographic shock will occur later in Spain than elsewhere in Europe. But the demographic dynamics are changing rapidly and the ongoing statistical revision is already suggesting a somewhat more favorable scenario than so far envisaged and, consequently, less burdensome age-related expenditure. Updated estimates for pensions now show an increase of just 4.1 percentage points over GDP in public age-related spending for the period 2000-2050. This moderate increase is below the EU average, excluding Spain, and if confirmed, would revise substantially downwards the previous estimate of 7.4 percentage points. This is of course an area where estimates need to be reviewed every so often to take account of demographic developments.

This more encouraging outlook does not mean that the problem can be obviated or that it will simply go away. The authorities are aware of the importance of safeguarding the long-term sustainability of public finances in spite of the budgetary burden of an aging population. Their strategy tries to integrate a firm commitment to budget stability, reforms in the labor market, and policy measures in the pension field.

Spain's *budget stability* and primary surpluses have allowed the general government debt in terms of GDP to fall from 68.1 percent in 1996 to 50.8 percent in 2003, and this ratio is expected to decrease further to 43.8 percent in 2007. The debt service—also helped by low interest rates—has followed a similar declining path from 5.3 percent in 1996 to 2.5 percent in 2003. The framework of budgetary stability has also made room for additional endowments to the Reserve Fund of the Social Security. A little above 3 billion euros were initially budgeted for this Fund over the period 2000-2003. In view of the performance of the public finances, however, the actual contributions were raised to almost 11.5 billion euros so that the current balance amounts now to 15 billion euros, 2 percent of GDP.

A number of reforms implemented in the *labor market* address directly or indirectly the problem of long-term sustainability. This is the case of measures intended to raise participation and employment rates, especially among women and older workers, or to extend work life by providing incentives to postpone retirement age, by discouraging an early exit from the labor market, or by making compatible part-time contracts with partial pension benefits.

For many years, the reform of the *public pension system* has been considered in Spain an issue of the utmost political importance. Political parties agreed to keep this question out of the partisan agenda and contemplated the reform of the public pension system as a gradual, but ongoing, process that should be based on social and political consensus. This consensus was embodied in the so-called “Pacto de Toledo” (1995). The aims of this broadly-supported agreement are threefold: to guarantee the long-term financial viability of the pension system, to ensure the balance between benefits and contributions, and to enhance the transparency and efficiency of the system. A consensus on objectives is of great political significance, but of course it does not preclude problems on the ground—parties and trade—unions may still disagree on specific measures proposed by way of implementation, or on the time path of implementation.

The second and third pillars of the pension system have also been fostered by developing complementary pension schemes through both corporate and individual plans. A Pension Fund was set up in 2002 to complement the public servants’ pensions, and the first endowment is due to take place in 2004. As regards private pension plans, the basic legislation—offering attractive tax incentives—dates back to the late 80s. Over time they have grown into a significant component of the pension system. At the end of 2002, there were well over six million plan holders and private Pension Funds totaled almost 50 billion euros, around 7 percent of GDP.

Labor market: ongoing reforms will continue to improve performance

Curbing down unemployment remains a central priority. We would like to highlight a few aspects that may help place the still high unemployment rate of 11.2 percent into a broader perspective:

(i) Unemployment has been brought down significantly and persistently during the past decade. Unemployment rates were at record highs of 24.2 percent back in 1994.

(ii) Strong employment creation has helped absorb a growing labor force while reducing unemployment at the same time. Since 1997, the economy has created close to 3.5 million jobs, absorbing more than 2 million new workers. As a result, during this period, Spain has narrowed the gap with the euro area in terms of activity, employment, and unemployment rates.

(iii) Labor market weaknesses concentrate on the *female population*. Indeed, male employment and activity rates are in line with euro area averages (unemployment is almost identical), but low female activity and employment rates account for the gap with the euro area. This is nowadays an area of major concern for Spanish labor policy.

A particular feature of the Spanish labor market is the high share of fixed-term contracts, which represent 30 percent of total contracts, between 15 to 24 points higher than in other major EU economies. This higher *temporalidad* should also be understood in a wider context. First, the wide differences in the percentage of fixed-term contracts does not translate into equally large differences in the length of contracts. The percentage of workers with seniority in the job of less than one year is only moderately higher in Spain when

compared to other major EU economies. Second, fixed-term contracts introduce a certain degree of flexibility in the labor market as they provide modalities for first-time job seekers, development and outsourcing contracts, or temporary workload peaks. Third, the large majority of the employment created since 1997 are permanent jobs (more than two thirds of the 3.5 million new jobs).

In 2003, the main labor market reforms focused on indirect measures to foster female employment by raising the female participation rate, including a number of tax incentives and a higher provision of child-care facilities. A long-awaited *Ley de Empleo* was also approved last December. The law aims at improving coordination between state and regional public employment agencies, with the state agency setting out the basic principles of employment policy and regional agencies assuming responsibility for the design and implementation of ALMPs. An important step—aimed at preventing misuse of the welfare framework—is the centralization of the controls of eligibility for unemployment benefits. So far, payments had been made by a single central unit, but decentralization of controls had apparently led to somewhat loose practices.

Going forward, the authorities remain committed to further intensifying reform efforts with a view to meeting the EU's Lisbon employment objectives. The uneven evolution of female employment stays as an overriding concern. The authorities share the staff's views on the need to review the collective wage bargaining system. The wage-setting process calls for reforms that seek a stronger link between wages and productivity. An important element in this reform would be the possibility to modify at company level the agreement reached at a higher level of negotiation. This reform is high on the agenda of the authorities, but this is a matter that has found a stubborn resistance to change both from trade unions and employers' federations.

A restive housing market

The housing market is going through a remarkable boom in Spain. The staff analysis is thorough and well-balanced and the following comments are intended as a complement .

Going back to basics—demand and supply analysis—may shed some light on the process:

Demand for housing is a complex result of structural factors and policies. Spain is a country of house owners. The ratio of dwellings in ownership to the total (around 82 percent) is very high by any international standard. Over the years, governments have been all too keen to commit themselves to programs of subsidized house building as well as to maintain significant tax incentives in favor of house buyers. Even if a majority of people already own their residence, improved standards of living have raised housing to the category of a superior good, implying a strong demand elasticity to income and a shift of demand toward increased space per household (be it for roomier dwellings, or for a secondary residence). As there are now less people per household than before—shorter families, broken families, young people living on their own—both factors together, plus demand from immigrants, plus strong demand from abroad, result in a very effective push of demand.

Demand is buoyed by two significant developments. First, the mortgage market is highly developed and the practice of mortgage refinancing has become widespread (the so-called “equity withdrawal” is however unusual in Spain), without prejudice to the legal protection of the rights of mortgage lenders which remains particularly strong. Second, the dramatic fall in interest rates in the eurozone has opened up unexpected possibilities for mortgage refinancing on cheaper terms. Spanish households (or businesses, for that matter), after chafing many years at the bit because of high nominal (and real) interest rates, have been quick to substitute cheap euro financing at variable rates for the traditional two-digit, fixed rate of mortgages. Given the current inflation rate and the terms offered by the banking system to customers, the actual burden in real terms is extremely low.

Finally, investing in housing seems the sensible thing to do when other alternatives offer lower yields. The yield of ten-year, risk-free bonds is negative when we discount the CPI and taxes. If past experience is a guide, a house or an apartment is bound to gain in value over time, the buyer-occupier will save on the opportunity cost of a lease, and taxation on capital gains, in case of resale, is relatively light.

So much for demand. The response of *supply* to housing demand has been forceful. In spite of frequent rigidities in the availability of development land, house starts have topped the figure of 500,000 *in each of* the past five years, a remarkably high figure by any standard. In spite of this, prices have gone up by around 60 percent in the course of the period. Part of the increase can be put down to higher input prices—occasional bottlenecks are unavoidable when supply is expanding at a fast clip—part to lagging supply of land, and part to the fact that construction, even at that rate, just cannot keep pace with the pressure of demand. Supply is not sufficient to clear the market, and prices take the brunt of adjustment.

Households’ wealth—and debts

The flipside of this boom—of any asset boom—are the *financial risks* run by the economic agents, in particular the ability of households to keep current in servicing the banks’ loans. It is worth looking at the estimates of annual debt burden over the paying capacity of households (proxied by their gross disposable income (GDI)), rather than at ratios based on price indexes or total debt stock. The ratio of interest payments over GDI is currently 4 percent (2003), and it goes up to little above 12% if we take into account interest plus debt repayments. These ratios are reassuring. It would not seem that households are right now under any unbearable constraint. Households would still be saving net (or not earmarked) over 2 percent of GDI, when we deduct the estimate of the debt burden from their gross saving.

Like every boom, this one will taper off—or will it rather end with a bang? Records show that a sudden market collapse has seldom happened in Spain. Previous housing booms ended with nominal prices stabilizing around a high level and staying there for some years.

The really worst-case scenario would be marked by a *sudden and abrupt reversal* of interest rates in the eurozone. This is the scenario of a vigorous European pickup at such a fast rate that the ECB would be led to fear an imminent risk of overheating and rush to anticipate

inflationary pressures by a pre-emptive tightening of monetary policy. Problems would be compounded if the move choked off recovery and led to a spate of layoffs, widening output gap and slower or no growth. Households would then have to face a higher debt burden from a much weaker position in terms of current income. But we can wonder whether these developments conform a likely scenario for the eurozone in the near future.

An alternative scenario assumes that price rises will eventually run out of steam while GDP and private consumption keep strong, and investment and export demand from the eurozone take over from construction as the main drivers of the economy. Although experience shows that there is no quick fix here, the authorities are trying to smooth the process by curtailing current housing demand and increasing its supply. Fiscal incentives to ownership have stayed frozen in nominal terms for some time now, and a favorable fiscal framework was put in place late in 2003 to breathe some life into the undeveloped Spanish rental market. Land supply is probably less of a constraint than formerly, but there is a lot to be done yet in this area. On the other hand, there is some sign of change in that banks are starting to harden somewhat the terms for mortgage loans. To sum up, interest rates can be expected to edge up again at some stage, but if the movement is orderly and the economy keeps growing, there is reason to expect that higher household incomes will keep up with higher mortgage payments.

Improving infrastructures: accounting for the future

The availability of infrastructures in Spain—especially growth-related infrastructures in the area of transport—is not up to EU averages. In recent years, the authorities have made a huge effort to increase investment in ports and airports, as well as on the expansion or upgrading of the road and railroad network. The current budgetary framework did not ensure sufficient funding to carry out all these programs, prompting the authorities to set up special corporate vehicles in the case of income-generating, self-financing projects, or to look around in the EU for the experience of other countries in calling in private sector investment to participate in partnerships with the public sector.

The authorities are conscious that these innovative modalities require close monitoring, a strict accounting methodology and full public transparency. This is a matter of special concern if governments let in the private sector to finance-build-operate projects, but still assume some of the attendant risks, because—as the staff rightly points out—this could well distort the true condition of today's budget by obscuring now contingent commitments that might turn into actual liabilities at a later date. In the EU, its Statistical Bureau, Eurostat, has special responsibilities in setting common standards for the accounting treatment of these partnerships, as a correct understanding of fiscal policy in each member country requires homogeneous rules of measurement across the area. Like every other member of the EU, Spain sticks to these standards (which by the way have recently been clarified and toughened up) and submits to the supervision performed by the bureau. Spain has also requested a ROSC for fiscal transparency which will no doubt give an opportunity to further discuss this issue with the Fund.