

Spain: 2010 Article IV Consultation—Staff Statement; Staff Supplement; Staff Report; Statement by the Executive Director for Spain; and Public Information Notice on the Executive Board Discussion

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 2010 Article IV consultation with Spain, the following documents have been released and are included in this package in reverse chronological order to reflect the significant policy developments and the resulting update in staff appraisal after the Staff Report was originally issued to the Board:

- A staff statement of July 13, 2010
- A staff supplement of June 29, 2010
- The staff report, prepared by a staff team of the IMF, following discussions that ended on May 24, 2010 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 June 29, 2010. 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 statement by the Executive Director for Spain.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 14, 2010 discussion of the staff report that concluded the Article IV consultation.

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

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**International Monetary Fund
Washington, D.C.**

**Statement by the IMF Staff Representative on Spain
July 14, 2010**

1. **This statement updates the staff report (SM/10/148) and supplement for the decree-law reforming the legal and regulatory regime for saving banks approved by the government on July 9.** The decree-law goes in the direction advocated by staff and does not change the thrust of the report.

2. **The main elements of the reform are:**

- Allowing “*cuotas participativas*” (equity-like instruments issued by savings banks) to have voting rights and removing the five percent limit on an individual investor’s holding.
- Giving savings banks the option to: (1) maintain their existing structure; (2) operate through a bank; (3) become part of a formal group of savings banks (*Sistema Institucional de Protección, “SIP”*) with a commercial bank as the central entity; or (4) change their legal nature and become a foundation and a (potentially minority) shareholder of the bank to which it transfers its business.
- Altering corporate governance structures, including: (1) reducing the maximum voting rights for public entities’ from 50 percent to 40 percent; (2) prohibiting elected officials to be members of governing bodies; and (3) strengthening reputation and experience criteria.

3. **Staff’s preliminary assessment of the reform is positive, although further enhancement of some aspects would be beneficial.** The assessment is preliminary as it is based on the summary of the decree-law (as the full text had not been published by 12 July). In terms of the objectives outlined by staff, the decree-law enhances the ability of savings banks to raise external capital, offers an opportunity to transform into a stock-holding company, and reduces political influence. However, some elements remain that could limit the attractiveness of savings banks to potential investors: the 50 percent limit on the total amount of *cuotas participativas* a saving bank can issue is maintained, and, similarly, the capital participation of saving banks in a SIP cannot fall below 50 percent, although the possibility envisaged in the decree-law for savings banks to transform into foundations and transfer their banking activity to a bank would effectively allow these limits to be exceeded. Also, systemically important savings banks are not required to transform into joint-stock companies.

INTERNATIONAL MONETARY FUND

SPAIN

Staff Report for the Article IV Consultation—Supplementary Information

Prepared by the European Department
(In Consultation with Other Departments)

Approved by Ajai Chopra and Martin Mühleisen

June 29, 2010

1. **Significant policy developments have occurred since the Staff Report was issued.** While they go in the direction advocated by staff and do not change the thrust of the report, they do affect staff's appraisal of the relevant policy areas.

Labor market reform

2. **On June 16, the government approved a decree-law reforming the labor market.** The decree was approved by parliament and entered into force on June 22. It will undergo a review process to be converted into law. The main elements of the reform are:

- the reduction of severance pay to 33 days per year of tenure for unfair dismissal (previously 45 days was the norm) for almost all new permanent contracts;
- financing 8 days of all severance payments via a fund paid for by firms;
- easing the criteria for “fair” dismissal (which would entail 20 days severance payment); and,
- broadening the conditions under which firms can opt-out of collective wage agreements.

Other reforms include: tightening conditions for temporary contracts; increasing internal flexibility of firms (e.g., working hours); and, opening labor intermediation more broadly to private firms.

3. **Although the reform has many positive aspects that will improve the working of the labor market, there is scope for further strengthening.** Notably, severance pay remains above EU average levels and it is not clear whether the easing of criteria for fair dismissal and procedures for opt-outs is sufficient to have a substantial impact – much depends on how the courts interpret the new provisions. More generally, effective decentralization of wage setting to firms will likely require a change in the collective bargaining process, which is currently under review by the social partners. The government should thus take every opportunity to deliver the required radical overhaul, including during the passage of the decree-law through parliament and the review of the wage bargaining system.

Banking sector stress tests and consolidation

4. **Governor Ordóñez announced on June 16 the Bank of Spain's intention to publish bank-by-bank results of stress tests.** Staff welcomes this intention, which should enhance transparency and underpin market confidence. It will be important that the stress tests are based on sufficiently conservative assumptions and accompanied by a clear strategy to recapitalize and restructure those institutions with capital shortfalls identified by the stress tests.

5. **The process of consolidating savings banks has accelerated as staff had recommended.** As of mid-June, 2010, 12 merger/integrations were underway, involving 38 savings banks, comprising 92 percent of the assets of the savings bank sector, thus covering almost the entire system. Staff welcomes this development, and it will be important to ensure that the process reduces overcapacity and enhances cost efficiency as envisaged.

INTERNATIONAL MONETARY FUND

SPAIN

Staff Report for the 2010 Article IV Consultation

Prepared by Staff Representatives for the 2010 Consultation with Spain
(in consultation with other departments)

Approved by Ajai Chopra and Martin Mühleisen

June 29, 2010

EXECUTIVE SUMMARY 1/

Context: The necessary adjustment is underway and output has stabilized. Imbalances accumulated during the long boom have begun to unwind, though unemployment has soared. The recovery is likely to be weak and fragile, with significant downside risks.

Challenges: Spain's economy needs far-reaching and comprehensive reforms. The challenges are severe: a dysfunctional labor market, the deflating property bubble, a large fiscal deficit, heavy private sector and external indebtedness, anemic productivity growth, weak competitiveness, a banking sector with pockets of weakness, and difficult financial market conditions.

Policies and staff views: Ambitious fiscal consolidation is underway. But it is based on potentially optimistic macroeconomic projections and the achievement of the targets should be made more credible. A bold pension reform, along the lines originally proposed by the government, should be quickly adopted. This needs to be complemented with growth-enhancing structural reforms, especially overhauling the labor market. Consolidation and reform of the banking system needs to be accelerated. Such a comprehensive strategy, especially with broad political and social support, would underpin investor confidence, and time is of the essence.

Authorities' views: The recovery is likely to be stronger than staff envisage, boosted by rebounding private consumption and buoyant exports. Fiscal policy is on track to achieve the ambitious targets and any slippage would be promptly met with additional measures. Significant labor market reform is likely in the coming weeks, and pension reform is underway. Savings bank consolidation, which should also be complete in the coming weeks, will substantially reduce banking sector pressures.

1/ Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached [Staff Statement](#) and [Staff Supplement](#).

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I. SPAIN AND THE GLOBAL FINANCIAL CRISIS

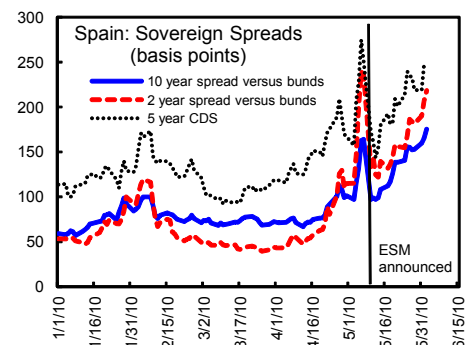
A. Spain's Challenges

1. **Spain's economy faces severe challenges.** Spain's economic cycle was already turning and its long-standing imbalances beginning to unwind when the global crisis hit, turning the soft landing hard (Figures 1 and 2):

- *The crisis has taken a heavy toll on the labor market.* Despite a similar output fall as elsewhere in the euro area, unemployment soared to 20 percent, double the euro area average. Beyond the heavy social toll, this puts pressure on the fiscal accounts and the banks, and erodes human capital.
- *The deflating property bubble compounds the effects of the global financial crisis.* Because the real estate boom involved a large volume increase (unlike in the UK) and housing price adjustment has been slow, construction output and employment have contracted sharply.
- *Spain has exhausted its fiscal space.* The combination of a large stimulus and evaporating cyclical and one-off revenues yielded one of the largest deficit increases in the euro area.
- *The economy is highly indebted.* During the boom, households and corporations borrowed heavily, resulting in Spain incurring one of the most negative International Investment Positions among advanced countries.
- *Productivity growth and competitiveness are weak.* Anemic productivity growth, despite high investment ratios, and rapid wage increases led to substantial rises in unit labor costs and contributed to large current account deficits.
- *Part of the banking sector is fragile.* The banking system relied heavily on wholesale borrowing to fund domestic lending to the real estate sector and witnessed a rapid growth of “cajas” – unlisted mutual savings banks without formal owners and share capital and particularly exposed to local property markets – which generated overcapacity in the system.

2. **Financial market tensions also increased sharply in the wake of the Greek crisis.**

Following the Greek crisis, financial market conditions became increasingly difficult for many peripheral euro area countries, including Spain. Sovereign spreads over Germany 10-year bunds rose to a post euro peak of about 164 bps in early May, 5-year CDS spreads for the largest Spanish banks widened to about 250 bps, and market access tightened further. The pressure was only eased



Sources: Thomson Financial/DataStream; and Bloomberg.

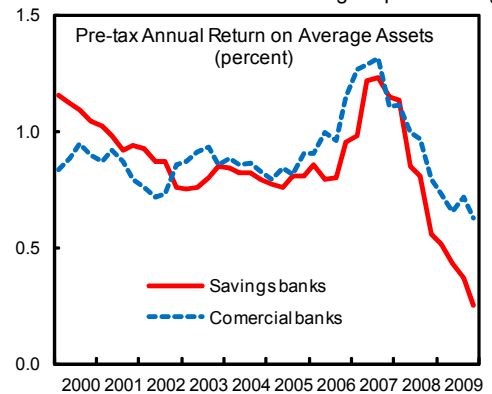
after the announcement of the European Financial Stabilization Mechanism and the ECB's Securities Market program to reduce excessive volatility in sovereign debt markets. However, conditions have since then trended negatively and many measures of sovereign risk are back at levels prevailing just before the announcement of the Stabilization Mechanism. This is also reflected in restricted access for Spanish banks to wholesale funding markets. Given Spain's systemic importance, this underscores that tackling Spain's economic challenges and strengthening market confidence is critical first and foremost for Spain but also for Europe and the global economy.

3. **The combination of these challenges makes Spain's recovery from the crisis particularly difficult, though mitigated by some pre-existing strengths.** Some of these challenges were masked by the previous boom and the abundant global liquidity. Others are mitigated by strong policy settings and initially healthy starting points, such as the history of fiscal surpluses, relatively low public debt, strong policy credibility, the investment-grade government debt rating, the prudent financial supervision framework, and banks' high capital and provision buffers. But the underlying structural weaknesses left Spain poorly placed to face the global crisis and now hinder the adjustment process and undermine growth prospects.

B. Global Financial Crisis Impact: Large, Despite a Pro-active Policy Response

4. **Despite its retail-oriented business model, the banking system came under pressure.** With wholesale funding drying up, Spanish banks scaled up their use of ECB refinancing facilities (now broadly in line with Euro-area average), competed more fiercely for domestic deposits (some banks are offering up to 4 percent), and tightened lending standards (Figure 3 and Table 2). The bursting of the real estate bubble and the sharp downturn in activity further worsened banks' operating environment (Table 3). Banks increased their holdings of government securities (though exposure to other Southern euro area sovereigns is minor), credit growth collapsed, NPLs soared, and the high pre-crisis provision coverage ratio swiftly declined to that of European peers. Banks managed distressed or potentially problematic exposures actively, including through debt-for-property swaps and debt restructuring, to mitigate the buildup of delinquencies. Banking sector profits contracted markedly and turned negative in the last quarter of 2009 before recovering in the first quarter of 2010. Nonetheless, leading Spanish banks, including the largest savings banks, have expanded overseas into UK, US and Asian markets and through their local subsidiaries were able to support credit in Latin America during the peak of the global financial crisis.

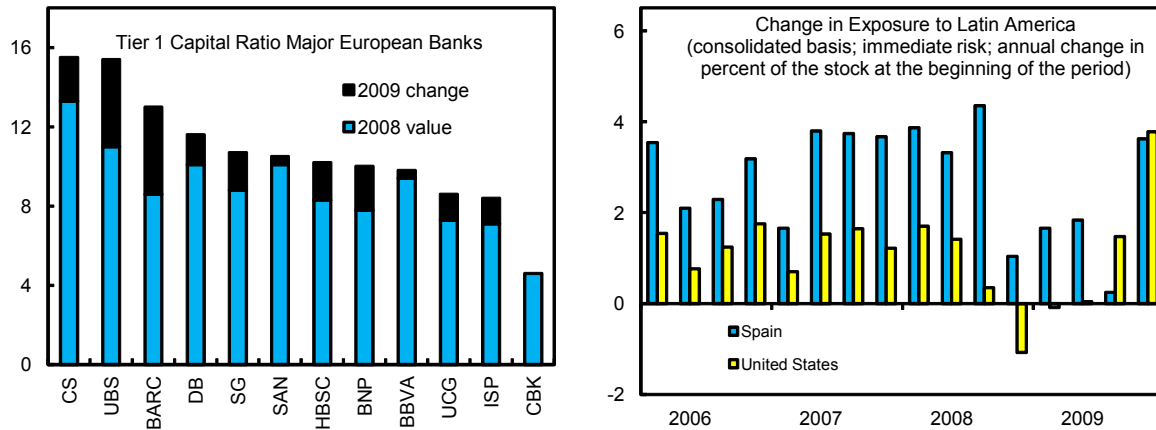
Savings banks' profits contracted more markedly than commercial banks due to higher provisioning.



Sources: Banco de España; and IMF staff estimates.

5. The impact of the crisis differed greatly among banks:

- The two largest banks, Santander and BBVA, preserved reasonable operating profitability, owing to their international diversification, and were able to strengthen the level and quality of their capital. However, the share price recovery of 2009 had partly corrected by early 2010 and CDS spreads have lately trended upward partially reflecting increasing sovereign risk (Figure 4).



Sources: J.P. Morgan; Bank for International Settlements; and IMF staff estimates.

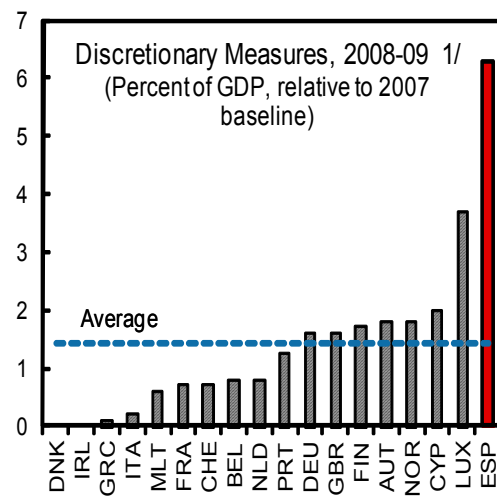
- Small commercial banks posted still positive profits mainly reflecting an increase in net interest margins. However, the negative economic environment and the expected pressure on margins are weighing on their outlook.
- Savings banks have suffered the most given their real estate exposure, although the sector is marked by substantial heterogeneity. Two small savings banks, comprising a total of 1½ percent of total assets of the banking sector, were intervened by Banco de España (BdE) in March 2009 and in May 2010. Some savings banks have also relied heavily on official liquidity support and government guarantees. Although at different stages of finalization, 11 mergers/integrations, comprising 34 institutions and accounting for more than a third of the banking sector, are underway.

6. **The authorities pursued a two-stage approach to ease financial sector stress.** At the start of the crisis, the focus was on securing funding. The government established a fund to purchase high-quality securities issued by credit institutions (*Fondo de Adquisición de Activos Financieros*—FAAF) and provided guarantees for credit institutions' new debt issues. As the deteriorating operating environment and the collapse of the property market increased pressure on domestic banks' capital, the emphasis shifted to consolidation and recapitalization and the government created the Fund for Orderly Bank Restructuring (*Fondo de Reestructuración Ordenada Bancaria*—FROB), to provide temporary capital assistance to merging credit institutions. While fine-tuning conservative provisioning rules to take into account collateral (with haircuts), the BdE tightened allowances on repossessed assets to prompt their rapid dismissal. Further revisions, including a unified and accelerated provisioning schedule, were published for consultation on May 26, 2010.

7. **The fiscal accounts deteriorated sharply, reflecting the large stimulus.** With the crisis, the incipient deterioration in the fiscal accounts accelerated as revenue-rich real estate collapsed, automatic stabilizers kicked in, and the large stimulus package took effect. The general government deficit swung from a surplus of 2 percent of GDP in 2007 to a deficit of 11.2 percent of GDP in 2009, sparking widening spreads and ratings downgrades (Figures 5 and 6, and Table 4). Stimulus measures amounted to some 7 percent of GDP over 2008–09, well above other euro area countries. Expenditure measures focused mostly on temporary measures, including broadening social protection and increasing public investment. On the revenue side, tax reductions largely did not have an expiry date, though many were later reversed. In addition, the government has taken measures to support credit lines to firms, especially SMEs, and housing, notably through a facility to refinance mortgages of unemployed or households with financial difficulties.

Impact of Fiscal Measures 2008–09 (Percent of GDP)			
	2008	2009	Total
Revenue (- stimulus)	-1.7	-0.9	-2.5
€400 PIT deduction	-0.4	-0.2	-0.6
Reduction withholding for mortgage payers		-0.2	-0.2
Change in VAT returns and payment 1/	-0.4	-0.5	-0.9
Child support (<i>cheque bebe</i>)	-0.1		-0.1
2007 PIT reform	-0.3		-0.3
2007 CIT reform	-0.5	-0.1	-0.6
Elimination wealth tax		-0.2	-0.2
Increase fuel, tobacco tax and other		0.2	0.2
Expenditure (- stimulus)	-1.2	-3.4	-4.6
Local Investment Fund (Plan E)		-0.7	-0.7
Other stimulus		-0.3	-0.3
ALMPs and unemployment support	0.0	-0.2	-0.2
Public works	-0.2		-0.2
Primary current expenditure pressure	-1.0	-2.1	-3.1
Total (- stimulus)	-2.9	-4.3	-7.2

Sources: SGP Budget, European Commission; and IMF staff estimates.
1/ One-off measure.

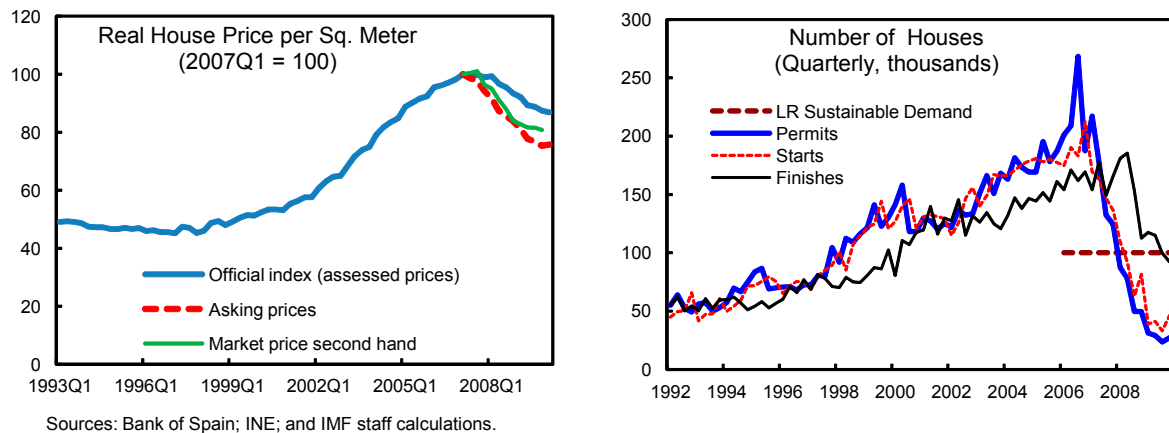


Sources: IMF REO, 2009; and IMF staff estimates.
1/ Excluding one-off and temporary measures.

8. **The recession has been sharp and longer than elsewhere.** Cushioned from the full extent of the global financial crisis, the property bust and private sector deleveraging by the strength of the banking sector and the large fiscal response, output fell somewhat less than the euro area average (Figure 7, Table 1). Yet the output decline was still very substantial, and was driven by sharp declines in investment, exports, and private consumption, with weaker imports and rising government demand providing some offset. Imbalances have been correcting, with domestic demand contracting much more sharply than in the euro area, and net exports improving substantially. The hardest hit sectors were industry and construction/real estate (Box 1). The recession ended in the first quarter, when output grew by 0.1 percent, quarter-on-quarter (Figure 8).

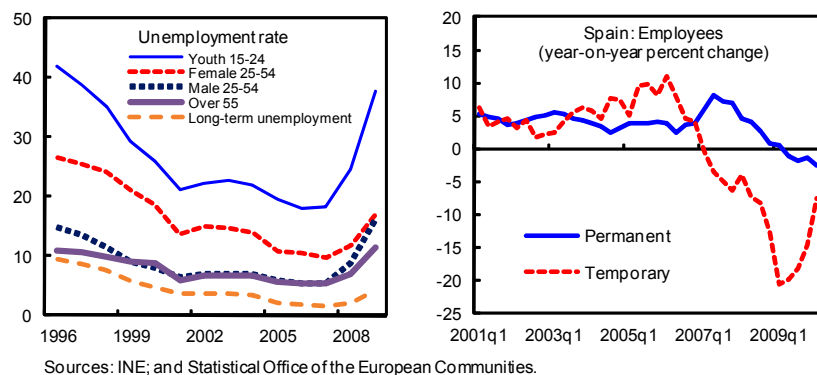
Box 1. How Much Further Has The Property Bubble to Deflate?

EMU and euro adoption led to a large property boom, both in prices and supply. At their peak in 2007, prices were some 20–30 percent above their long-run equilibrium. Unlike some other countries with sharp increases in property prices (e.g. the United Kingdom), supply also responded sharply, with construction comprising about 9½ percent of GDP in 2007 compared to a euro area average of 5½ percent. The ensuing correction in prices has been somewhat less rapid than in other countries that had a similar boom, with “official” real prices only down about 13 percent since the peak, suggesting at least another 10 percent still to fall. However, other price series (asking prices, prices of second hand properties) suggest that the “true” market price may have fallen by more, as transactions have been few, banks have been taking over property rather than selling it, and the official index is based on assessments by private appraisal companies, which may be overestimated. Recent stabilization may also be driven by temporary factors, such as the increase in the VAT rate from July and the removal of mortgage interest relief for most taxpayers from next year. There is also considerable variation in price declines, with coastal areas more heavily affected. The new supply of property is however adjusting strongly, with the annual housing finishes running at about 425,000 units and new housing permits at 111,000 units compared to 650,000 units for both finishes and permits in 2007. An “overhang” of property at some 700,000 units and an equilibrium demand for property of 400,000 units, would imply another two to three years before supply conditions normalize.



9. The labor market has been adjusting in quantities, with unemployment soaring.

With the application of previously contracted substantial wage increases, labor costs continued to grow strongly (Figure 9). Wage and working hours rigidities combined with the large share of temporary workers and the real estate bust have led unemployment to soar to

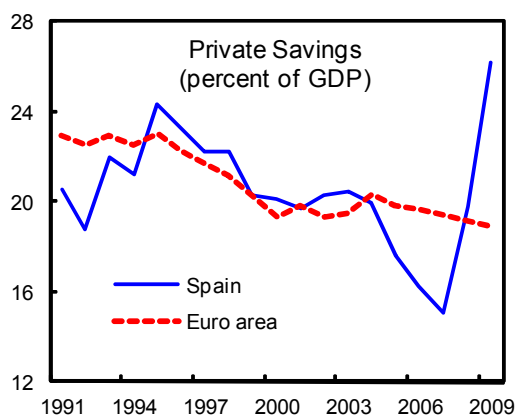
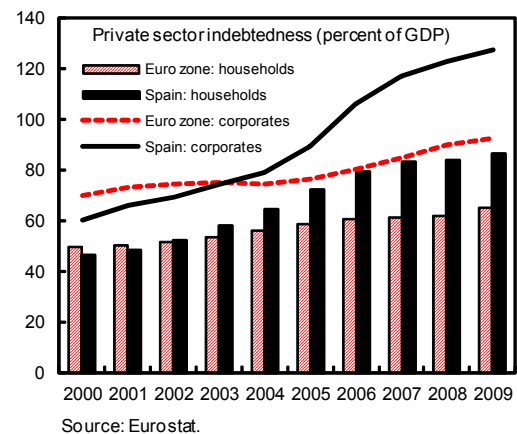


20 percent, affecting mostly temporary workers and youth. Labor force participation started falling. Spain has the highest sensitivity of unemployment to output growth among advanced economies – partly related to the large share of temporary workers. The flip side, however, is that unlike in other euro area countries which have lower employment losses, productivity improved and helped narrow the gap in unit labor costs. Wages have started moderating recently with the conclusion of a three-year wage agreement between social partners.

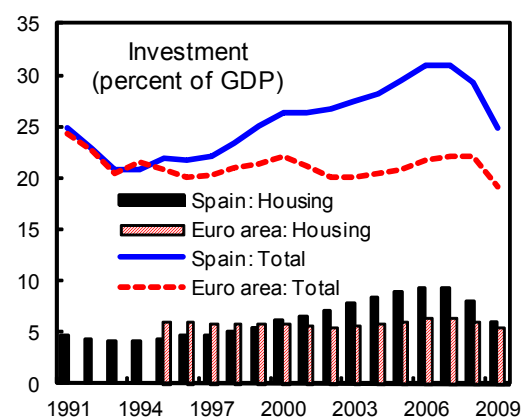
10. **The product market, in contrast, has been adjusting in prices.** Inflation dropped quickly into negative territory and below the euro area average, reflecting the sharp drop in oil prices, Spain's high energy intensity, and collapsing demand (Figure 10). Although headline inflation has since risen back in line with the euro area, for the first time in many years, core inflation is persistently below the euro area average, even for services. The higher price flexibility may well reflect the strong deregulation of product markets of recent years. With rising labor costs and declining prices however, profit margins have been squeezed and bankruptcies have surged.

11. **Private sector imbalances have begun to correct, though debt levels remain high.**

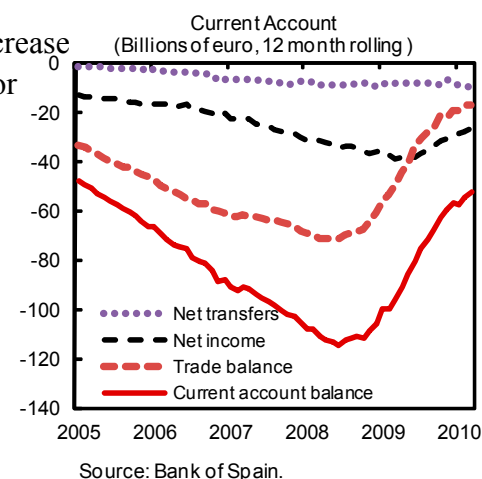
Over the last decade, Spanish household and corporate indebtedness grew at one of the fastest rates in the EU. Household and corporate indebtedness reached about 210 percent of GDP in 2009, significantly higher than the euro area average of around 160 percent. A sharp correction has started, as households became net lenders and companies substantially reduced their net borrowing (see Annex). The private saving rate jumped to 25 percent of GDP, well above the euro area average, and private investment fell markedly (Figure 11). Corporate deleveraging has been most intense in construction and real-estate companies, but overall debt levels remain high compared to the euro area.



Source: WEO.



12. **External imbalances narrowed sharply.** As the increase in private sector net savings outweighed weaker public sector savings, the current account improved sharply. This was reflected in the trade balance improving significantly, largely through declining imports and falling oil prices (Tables 5 and 6). The adjustment in the current account is likely to be largely structural, reflecting the unwinding of the housing boom and a return of private saving rates to more sustainable levels (in addition to a strong precautionary component). More recently, however, the current account balance has begun to stabilize, as import growth picked up.



II. THE OUTLOOK: A WEAK AND FRAGILE RECOVERY

13. **Staff projects the recovery to be weak and fragile.** The particular challenges facing Spain will likely make the recovery slower and more fragile than in the euro area. Not only does each factor pose a challenge by itself, but, together, they may create a vicious cycle of negative feedback. The central scenario is one of a long and gradual adjustment of the various imbalances in the economy. Growth remains slightly negative in 2010 and weakly positive thereafter, rising gradually to a range of 1½ to 2 percent over the medium term.

Spain: Real GDP Growth
(Percent)

	2010	2011	2012	2013
IMF	-0.4	0.6	1.7	1.9
MoF	-0.3	1.3	2.5	2.7
Bank of Spain 1/	-0.4	0.8	...	...
EC 1/	-0.4	0.8	...	...
OECD	-0.2	0.9	...	...
Consensus 1/	-0.4	1.0	...	...

1/ Do not include the effect of the fiscal package announced in May.

Spain: Staff Medium Term Outlook--Baseline Scenario 1/

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Real GDP	3.6	0.9	-3.6	-0.4	0.6	1.7	1.9	1.9	1.8
Total domestic demand	4.2	-0.5	-6.0	-1.5	-0.4	1.1	1.5	1.8	1.8
Private consumption	3.6	-0.6	-4.9	0.4	0.8	1.4	1.4	1.3	1.4
Public consumption	5.5	5.4	3.8	0.6	-1.1	-1.3	-1.3	1.0	1.3
Fixed investment	4.6	-4.4	-15.3	-8.0	-2.9	2.8	4.4	3.5	3.3
Net exports 2/	-0.9	1.4	2.8	1.1	0.9	0.5	0.4	0.2	0.1
Exports	6.6	-1.0	-11.5	7.0	4.3	4.6	4.8	4.9	5.1
Imports	8.0	-4.9	-17.9	2.1	0.6	2.6	3.5	4.3	4.9
CPI inflation, pa	2.8	4.1	-0.3	1.4	1.3	1.2	1.4	1.6	1.8
Unemployment rate, pa	8.3	11.3	18.0	19.3	18.7	18.0	17.3	16.6	16.0
Potential growth	2.7	2.4	1.3	0.3	0.3	0.5	0.8	1.1	1.4
Output gap	3.9	2.3	-2.7	-3.5	-3.2	-2.1	-1.1	-0.4	0.0
Current account balance	-10.0	-9.7	-5.4	-4.9	-4.3	-3.9	-3.6	-3.5	-3.5

Source: IMF staff calculations.

1/ Percent.

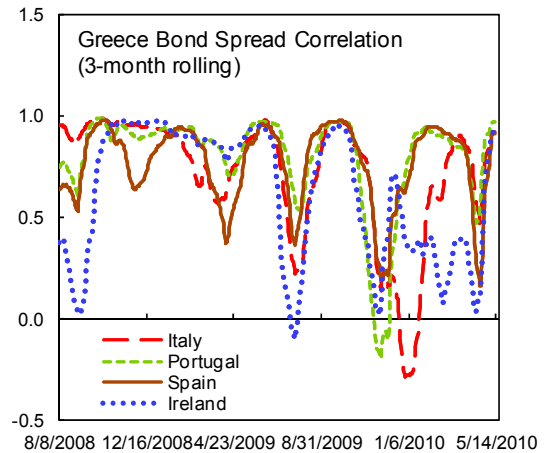
2/ Contribution to growth.

Domestic demand recovers only slowly, with private demand weighed down by continued uncertainty, high unemployment, and the need to reduce indebtedness, and public demand by

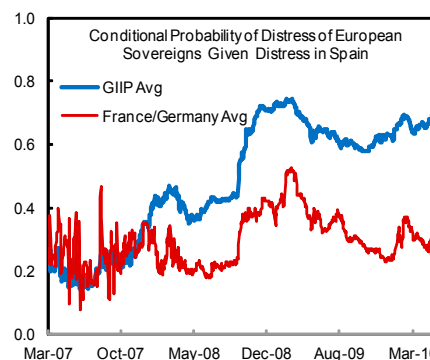
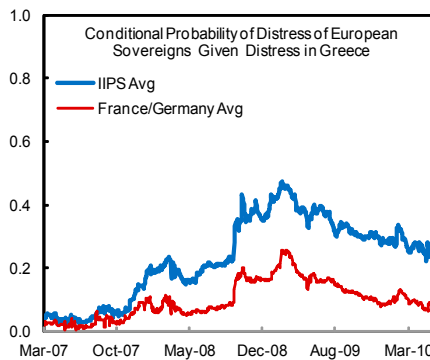
large-scale consolidation. Despite an energy-driven rebound and the VAT increase, inflation remains subdued, helping regain competitiveness. Unemployment stays high, reflecting the sluggish output growth and persisting structural rigidities. Slowing population growth, reduced immigration, high unemployment, and moderate investment levels, all weigh on potential growth, despite some (likely cyclical) rebound in productivity.

14. **The outlook is particularly uncertain.** On the upside, household consumption could grow more rapidly, reflecting rising confidence, and stronger growth in partner countries and the weaker euro may induce faster export growth. On the downside, two key risks threaten:

- The economy may essentially stagnate. Regaining competitiveness and private sector deleveraging may take many years to work through. And negative feedback loops between deleveraging, fiscal consolidation, and confidence may be stronger than envisaged.
- A domestic failure to implement fiscal consolidation or external shock such as an intensification in the recent market stress for peripheral euro area countries. If distress were to spread to Spain, given its systemic importance, the impact on the rest of Europe, and indeed globally, could be substantial. Notably, the average conditional probabilities of distress in European sovereign debt markets, given distress in Spanish government debt, are higher than those under Greek distress.



Source: Bloomberg and staff estimates.



Sources: Bloomberg; and IMF staff estimates.

Note: IIPS Countries: Italy, Ireland, Portugal, & Spain; GIIP Countries: Greece, Italy, Ireland, & Portugal

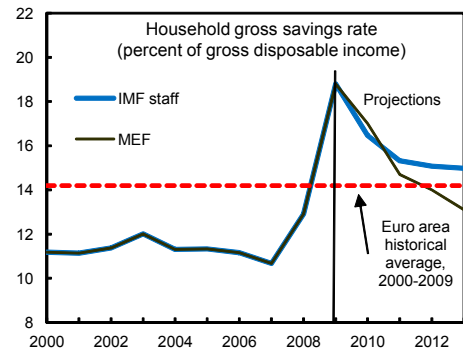
The estimation of conditional probabilities of distress uses a methodology developed by Miguel Segoviano. For a description of the methodology, see Segoviano (2006) "The Conditional Probability of Default Methodology," Financial Markets Group, London School of Economics (LSE), Discussion Paper No. 558; Segoviano (2006) "The Consistent Information Multivariate Density Optimizing Methodology," Financial Markets Group, LSE, Discussion Paper 557; Segoviano and Goodhart (2009) "Banking Stability Measures," IMF WP/09/4; and Segoviano (2008) "The CIMDO-Copula. Robust Estimation of Default Dependence Under Data Restrictions," Financial Markets Group, LSE, forthcoming Discussion Paper.

15. **The political context may also prove challenging.** Although general elections are not due until 2012, local elections are due in 2011 and the governing socialist party does not have a majority. Indeed the May fiscal package was only passed with a margin of one vote. Many of the regions, which are especially autonomous in Spain, are controlled by the opposition.

Authorities' views

16. **The government sees a significant recovery, especially in outer years.** Growth is seen as rebounding more strongly from 2011 onward, reaching 2.7 percent by 2013 with the output gap closing by 2014. This rebound is driven chiefly by:

- Stronger export growth, reflecting continued dynamism of Spanish exports, including in expanding to markets outside the euro area.
- Stronger household consumption, as the savings ratio falls back more quickly (though remaining above historical averages) and supported by strengthening household financial wealth.



Sources: Eurostat; Ministry of Economy and Finance; and

The BdE's forecast for growth in 2011 is more in line with that of staff, with lower private consumption and export growth than the Ministry of Economy and Finance.

III. THE POLICY AGENDA: REBALANCING THE ECONOMY AND BOOSTING CONFIDENCE¹

17. **Policy should focus on fostering the smooth rebalancing of the economy.** This calls for quick and decisive action on:

- fiscal consolidation and pension reform to put public finances on a sustainable footing;
- making the labor market more flexible to promote employment and its reallocation across sectors; and
- banking sector consolidation and reform to cement the soundness and confidence in the financial system.

18. **Such broad reforms in many sectors simultaneously would produce synergies.** For example, labor market reform coupled with further liberalization of product and service markets would boost investment and employment and reduce prices, making fiscal

¹ Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached [Staff Statement](#) and [Staff Supplement](#).

consolidation easier and strengthening banks. Such reforms would also support Spain's long-term convergence with higher-income peers.

19. **The heightened risks Spain faces, and the heavy costs for Spain and others should they materialize, make these reforms especially urgent.** In such conditions, it is imperative to “get ahead” of markets with a pro-active, comprehensive, and credible strategy. Failure to do would result in a much worse outcome eventually and pressure to continuously react to market developments in the meantime. The particularly high cost of policy delay in these circumstances, and not just for Spain, underscores the need for Spain to do its utmost to secure market confidence. This would be greatly helped by broad political and social support for such a far-reaching strategy.

20. **Other countries have overcome similar challenges from very difficult starting positions with comprehensive policy packages.** Canada, Australia, United Kingdom, New Zealand, Ireland, and the Netherlands all have undertaken path-breaking fiscal and structural reforms in the 1980s and 1990s. Indeed, Spain itself has reduced real wages in its pre-euro past, substantially reformed its economy and public finances in the run up to EU and euro entry. Empirical evidence also suggests that recoveries from economic crises often serve as an opportunity for reform and that it is best to undertake them with broad-based support. Again, examples from other countries can help, such as independent commissions to set the agenda (France's Attali Commission and Australia's Productivity Commission) or monitor public finances (Sweden's Fiscal Policy Council), and pacts with social partners (the Netherlands' Wassenaar agreements).

A. Fiscal Policy: Making the Consolidation More Credible

Near and medium-term outlook

21. **Spain has started ambitious fiscal consolidation to reach the 3 percent of GDP deficit target by 2013.** In addition to measures envisaged in the 2010 Budget and Stability Program, which included increases in VAT rates and personal income tax, greatly restricted hiring, cuts in selected transfers and subsidies, and reduced public investment, a new fiscal package was adopted in May (shortly after the European Stabilization Mechanism was announced). This new package significantly strengthened the envisaged

The Government Fiscal Targets 2010-13
(Percent of GDP)

	Targets				
	2009	2010	2011	2012	2013
Budget 2010	-9.5	-8.1	-5.2	-3.0	...
SGP 2010-13	-11.4	-9.8	-7.5	-5.3	-3.0
SGP 2010-13 with new measures	-11.2	-9.3	-6.0	-4.4	-3.0

Source: Ministry of Finance and Economy.

adjustment and enhanced credibility by taking concrete and emblematic measures, such as cutting public sector wages (which should also have a signaling effect on the private sector). The new deficit path is also appropriately front-loaded, with nearly two-thirds of the required adjustment achieved by 2011.

The Government's Fiscal Plan 2010–13 (Percent of GDP)		Measures 2010–13 (Percent of GDP)	
Total	8.2	Total	6.0
Measures	6.0	Revenue measures	1.3
Revenue	1.3	Suspension of 400 euro PIT deduction	0.4
Expenditure	4.7	Increases in VAT rates and excise tax	0.8
Reversal of stimulus program	2.5	Expenditure measures	4.7
Local Investment Fund	0.8	Budget 2010 - current spending cuts	0.8
Stimulus Fund for Economy and Employment	0.3	2010 Immediate Action Plan	0.5
Extension of €420 unemployment benefit	0.1	2011-13 Expenditure Review Plan	1.9
Lower CIT-SMEs	0.1	May 20, 2010 measures	1.5
Others (extraordinary deferrals, etc)	1.2	5 percent wage cut	0.4
Cyclical factors	1.2	No pension adjustment	0.1
Increase in interest payments	-1.4	Elimination baby-check	0.1
		Investment cuts	0.4
		Others (ODA, Farm. expenses, Regions)	0.5

Sources: Stability Report; and IMF staff estimates.

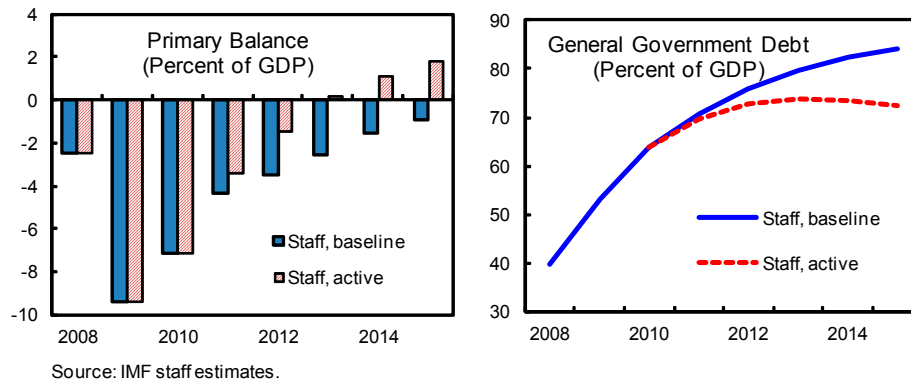
Sources: Stability Report; and IMF staff estimates.

SGP and IMF Staff Fiscal Projections 2009–13

	2009	2010	2011	2012	2013
	(Billions of euros)				
Revised SGP 2010-13 projections (estimates)					
Revenue	365.0	376.0	396.4	422.9	453.0
Primary expenditure	463.8	451.0	433.4	439.9	451.1
Interest	18.9	23.0	27.7	32.7	36.9
Overall balance	-117.6	-97.9	-64.7	-49.7	-35.0
Staff projections					
Revenue	365.0	376.0	387.5	404.1	423.7
Primary expenditure	463.8	450.9	433.6	442.3	452.3
Interest	18.9	23.0	27.8	33.7	38.2
Overall balance	-117.6	-97.9	-73.9	-71.9	-66.8
	(Percent of GDP)				
Revised SGP 2010-13 projections (estimates)					
Revenue	34.7	35.8	36.8	37.5	38.3
Primary expenditure	44.1	42.9	40.2	39.0	38.1
Interest	1.8	2.2	2.6	2.9	3.1
Overall balance	-11.2	-9.3	-6.0	-4.4	-3.0
General government debt	53.2	63.5	68.5	70.4	70.5
Staff projections					
Revenue	34.7	35.9	36.6	37.1	37.7
Primary expenditure	44.1	43.0	41.0	40.6	40.2
Interest	1.8	2.2	2.6	3.1	3.4
Overall balance	-11.2	-9.3	-7.0	-6.6	-5.9
General government debt	53.2	63.7	70.6	75.8	79.8
<i>Memorandum items</i>					
Nominal GDP (billion of euros)					
SGP	1051	1051	1079	1128	1182
Staff	1051	1048	1059	1089	1125

Sources: SGP 2010–13; and IMF staff projections.

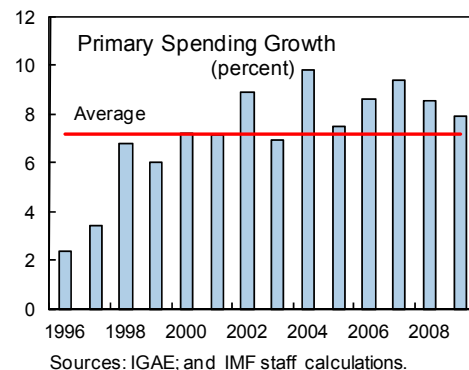
22. **But the envisaged adjustment is based on potentially optimistic macroeconomic projections.** On announced policies, staff projects the fiscal deficit to decline to 9.3 percent of GDP in 2010, in line with the target, but only to 7 percent of GDP in 2011, 1 percent of GDP above the target. The gap widens further over the medium-term to around 2½ -3 percent of GDP in 2013. The differences arise from staff’s less buoyant macroeconomic projections (especially on nominal GDP growth), which are also subject to significant downside risk.



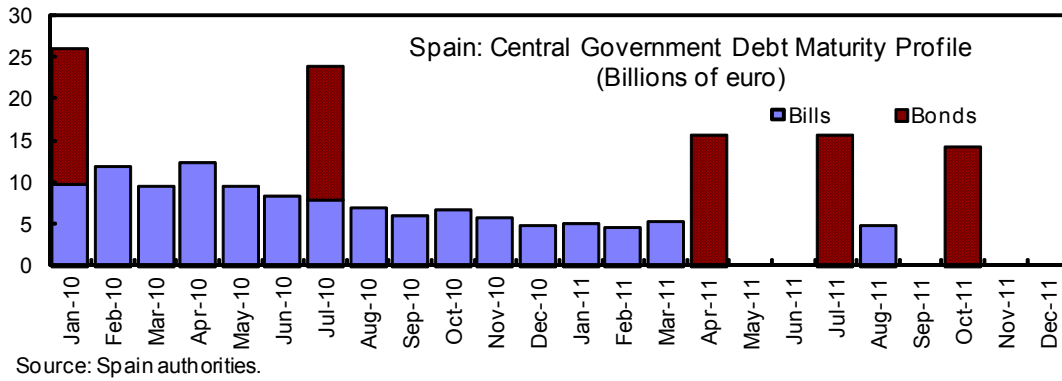
23. **Staff projects the debt ratio to continue to rise to about 85 percent GDP by 2015.** Staff’s “baseline” scenario implies the debt ratio continuing to grow strongly (though still below the projected euro area average) over the medium term. Even under staff’s “active” scenario where the government’s deficit targets are met, the debt ratio still increases slightly in 2013 and further consolidation in 2014 of about ½ percent of GDP would be required to start reducing the ratio. The required adjustment would of course be even larger if yields were to rise significantly.

24. **There are a number of additional risks to the planned medium-term fiscal consolidation:**

- *The tax base could recover more slowly than assumed.* Household savings may remain higher, and consumption weaker, given their high indebtedness and expected increases in interest rates. Without reforms in the labor market, recovery in employment may be more protracted affecting the labor tax base.
- *Achieving the necessary sustained spending restraint will be challenging.* The government program envisages de facto freeze on primary expenditure between 2009–13. However, since 1996, primary spending has risen at an average pace of about 7.2 percent a year.
- *The needed consolidation will not be possible without the regions doing their part.* Beyond 2011, the lion’s share of consolidation is expected at the level of sub-national governments, where the bulk of the spending occurs (see Annex).



- Spain's financing requirements are large and, retaining market confidence will be critical. The central government's gross financing needs for 2010 are some €219 billion (21 percent of GDP); roughly half of this is needed for deficit financing and the rest for amortization (with a peak in July). For 2011, the gross financing need is about €226 billion (also roughly 21 percent of GDP).

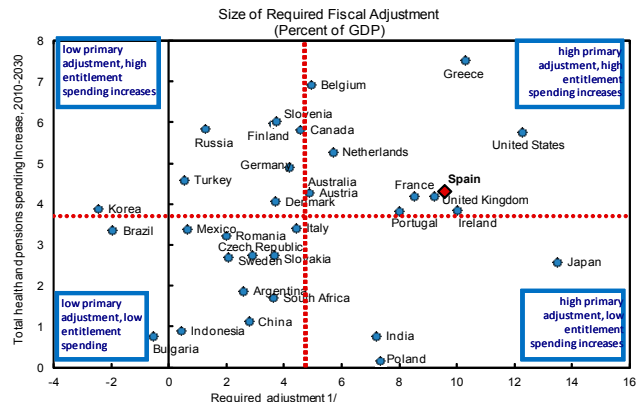


25. **The government should thus make the achievement of their targets more credible and aggressively pre-empt any slippage.** Macroeconomic projections should be made more prudent and additional measures prepared to ensure the targets are attained. Such measures should protect the most vulnerable segments of society and could include further reduction in current spending (which has increased sharply over the last decade) and investment (high by EU standards), reducing tax benefits, and further raising still relatively low VAT and excise rates. Such measures should be supported by structural reforms to support growth.

	Standard		Reduced	
	Standard	Reduced	Standard	Reduced
DNK	25.0			
SWE	25.0	12.0	6.0	
FIN	22.0	17.0	8.0	
IRL	21.5	13.5	4.8	
BEL	21.0	12.0	6.0	
AUT	20.0	12.0	10.0	
ITA	20.0	10.0	4.0	
PRT	20.0	12.0	5.0	
FRA	19.6	5.5	2.5	
DEU	19.0	7.0		
GRC	19.0	9.0	4.5	
NLD	19.0	6.0		
ESP 1/	18.0	8.0	4.0	
UK	17.5	5.0		

Source: OECD.
1/ Effective July 2010

26. **Stronger fiscal frameworks could also support achieving the difficult consolidation task.** In particular, adopting more cautious macroeconomic projections would minimize the risk of over-transferring to regions, which would provide more incentive at the local level to use their revenue-raising powers or improve efficiency. Institutionalizing spending review processes could also help improve the quality and durability of spending reductions. Options such as establishing an independent fiscal council (like Sweden's or Belgium's) to provide objective analysis of fiscal developments and long-term sustainability issues could be useful to bolster the credibility of fiscal policy.



Source: IMF staff calculations.
1/ Required adjustment in the structural primary balance between 2010 and 2020 to reach 60 percent of GDP debt ratio by 2030.

Longer-term outlook

27. **Spain faces strong spending pressures due to aging and slowing population growth.** Costs associated with aging are projected to rise by 9 percent of GDP through 2060 (above the EU average), largely reflecting a relatively high increase in pension expenditure. Combining a long-run projection of future fiscal primary deficits on current policies that include these aging costs (in NPV terms) with other assets and liabilities already on the Spanish public sector balance sheet results in a deeply negative public sector net worth of some 200 percent of GDP in 2010, a large deterioration from minus 40 percent of GDP in 2007 (Table 7). Eliminating this gap would require an upfront permanent improvement in the primary balance of close to 5 percentage points of GDP, in addition to the projected turnaround in the primary balance by 2013. The European Commission also classifies Spain as high risk regarding long-term sustainability, in light of its expected aging costs and the large recent budgetary deterioration. In addition, the financial implications of supporting the banking sector may be significant.

28. **Spain needs a bold pension reform.** Major adjustments including raising the retirement age, increasing incentives to work in old age, and adding an explicit link between benefits/retirement age and changes in life expectancy would help bolster sustainability. The government had proposed in its Stability Program presented in January 2010 a plan to reform the pension system, whose key measure is to gradually increase the retirement age from 65 to 67 years. Other proposed changes under discussion include extending the period of earnings history used to calculate pension benefits and limiting the use of early retirements. These measures should be accompanied by a mechanism automatically linking key parameters of the pension system, to life expectancy, in line with European peers that have already reformed their pension systems. As such reforms would boost fiscal sustainability without undermining growth, they should be quickly adopted.

Authorities' views

29. **The authorities emphasized their commitment to achieving their deficit targets.** They saw staff's macroeconomic scenario as overly pessimistic, especially given their structural reform agenda, and the government's good forecasting track record. They stressed the measures adopted were sufficient to achieve the targets but that they stand ready to take whatever additional actions are required, as the May 2010 fiscal package demonstrated. Were additional measures to be required, the authorities thought there was sufficient scope on both revenue and expenditure sides if needed. A pension reform had been initiated and the necessary cross-party political support would require some months to coalesce.

30. **The authorities considered the existing fiscal frameworks to be sufficient to achieve their objectives.** The authorities were not convinced that an independent fiscal council could play a useful role in Spain, and stressed the importance of accountability and credibility of existing institutions and the role played by international organizations. They agreed increased coordination with the sub-national governments is key to achieving

consolidation but stressed that existing arrangements, and the newly enhanced mechanism to monitor and control their borrowing should be sufficient.

B. Real Sector: Fostering the Adjustment²

Competitiveness

31. **Indicators point to a significant, but declining, competitiveness gap.** The growth model of the boom years, driven by excessive domestic demand and a real estate boom, left competitiveness damaged. While substantial adjustment has taken place in the last year or so, in part automatically via the housing correction, the current account deficit remains above the 3 percent level that would stabilize Spain's international investment position at its highly negative 2008 level. The competitiveness gap, measured as the adjustment in the real effective exchange rate needed to bring the current account to the level that would stabilize the international investment position, is around 14 percent. Real effective exchange rate measures through 2009 based on relative consumer prices and unit labor costs also indicate an appreciation of about 20 percent since euro adoption in 1999 (Figure 13). About half the real appreciation reflected relative price developments, with the rest driven by appreciation of the nominal effective exchange rate (though this has reversed somewhat recently). While export market share has been maintained, the export-to-GDP ratio is low for the size of the economy and import penetration is relatively high. Labor and product market reform are essential to restore competitiveness, in addition to boosting employment and growth.

Spain: Real Exchange Rate Developments, 1999-2009
(Percent Change)

	Real Effective Exchange Rate	Nominal Effective Exchange Rate	Relative Price Index
Against 36 partners, using 1/			
HICP Deflator	16	10	6
GDP Deflator	21	10	11
Export Price Deflator	18	10	8
Nominal Unit Labor Cost of Total Economy	17	10	7
Nominal Unit Wage Cost of Manufacturing	28	10	18
External sustainability norm 2/	14	...	...

Source: European Commission and IMF Staff Calculations.

1/ Based on the Price and Cost Competitiveness database of the European Commission.

2/ Change in the real effective exchange rate needed to bring the current account to the level that would stabilize the net foreign assets-to-GDP ratio at its 2008 level.

² Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached [Staff Statement](#) and [Staff Supplement](#).

Labor and product markets

32. **The labor market is not working.** Employment and the unemployment rate are highly cyclical, much more so than in other advanced economies³, causing large social and productive costs (Attachment III and Figure 12). The underlying “structural” unemployment rate is very high (about 14 percent), and the labor market is highly dual, with about a third of the labor force in fixed-term contracts. The wage bargaining system, which hamstrings wage and firms’ flexibility, is ill-suited to membership of a currency union. Unions represent mostly permanent workers, who benefit from high employment protection, fostering wage demands that do not fully internalize the employment implications, especially for the easily dismissible temporary workers. Wage agreements are negotiated at the industry and province levels and are automatically extended to the entire province or industry, without much scope to opt-out for individual firms or workers. This problem is compounded by a high degree of wage indexation, much more widespread than in other countries, causing a high wage drift and reducing the sensitivity of real wages to labor market conditions.

Spain: Severance Payments for Fair and Unfair Dismissals 1/2/
(Months of salary)

	Fair Dismissals			Unfair Dismissals
	9 months tenure	4 years tenure	20 years tenure	20 year tenure
Austria	0	0	0	6
Belgium	0	0	0	14
Denmark	0	0	1.5	9
Finland	0	0	0	14
France	0	0.8	6.7	16
Germany	0.2	1	5	18
Greece	0.3	1	6	6
Ireland	0	0.4	1.9	24
Italy	0	0	0	15
Luxembourg	0	0	6	5
The Netherlands	0	3	9	7
Portugal	3	4	20	15
Spain	0.5	2.7	12	22
Sweden	0	0	0	32
The United Kingdom	0	0.5	2.3	8.0
EU15	0.3	0.9	4.7	14.1

Source: OECD.

1/ The large majority of dismissals are treated as unfair in Spain.

2/ Average over all types of workers.

Spain: Extent of Wage Indexation
(percent of affected workers)

	Spain	Euro area	France	Italy	Belgium
Automatic link to past inflation	38	16	8	1	98
Automatic link to expected inflation	16	4	2	0.5	0
Indirect relation with past inflation	10	9	21	3	0
Indirect relation with expected inflation	5	5	8	2	0
No link to inflation	29	64	59	94	2

Source: Bank of Spain.

³ A recent study suggests that the increase in Spain’s unemployment rate would have been halved had it adopted France’s employment protection institutions before the recession.

33. **A radical overhaul of the labor market is urgent.** The reform will need to be ambitious and comprehensive if it is to significantly change labor market dynamics and to avoid missing an historic opportunity. In particular:

- reducing duality and encouraging permanent hires requires lowering severance payments to at least EU average levels, having a more gradual increase in such severance payments in the early years of tenure, and preventing excessive use of unfair dismissals;
- boosting wage flexibility and employment requires coupling this reduced protection of permanent contracts with decentralizing wage setting (for example by moving to an “opt-in” rather than “opt-out” system for collective bargaining) and eliminating indexation.

34. **The prospective agreement by social partners may need to be significantly strengthened.** The government proposed some guidelines for labor market reform, focusing on encouraging permanent hires, making working hours more flexible, improving labor intermediation, and fostering youth employment, to be agreed by social partners. On the critical issue of employment protection, the proposal being discussed is a generalization of the 33 days (per year of service) severance pay for unfair dismissals (instead of 45 days) and making the 20 day cost for fair dismissal more widespread. While these reforms are positive, they fall short of the necessary “regime change” and, crucially, do not address the wage bargaining system. Care should also be taken that any reform not increase the fiscal cost of the system nor make temporary employment more difficult in the near term. The government should thus follow up on its commitment to take action itself and introduce a more fundamental reform, including of the wage bargaining system.

35. **Commendable progress on product and service market reform needs to continue.** Much progress has been achieved in recent years, especially in reducing the state’s involvement in business operations and administrative burdens, and in reforming railways, roads, and retail (Figure 14). The authorities have also transposed the EU Services Directive into law (though implementation will be critical) and have submitted a Sustainable Economy draft bill that will, among other reforms, partially eliminate incentives for buying houses and promote the rental market. Given the pressing need to boost growth and competitiveness, however, Spain should aim to be among the top performers in terms of product and service market liberalization. The priority should be to further reduce restrictions on retail trade, professional services, and the rental market. Reviewing the insolvency framework may also be warranted.

Authorities’ views

36. **The authorities agreed with the need for growth-enhancing structural reforms.** The authorities recognized that Spain has a competitiveness gap, but did not think it was as substantial as staff’s estimates, pointing to a range of factors, especially the robustness of Spanish export market shares, the expected continued improvement in the current account

following the natural unwinding of the housing boom, and the recent improvement in productivity and moderation in wages. On the labor market, the authorities agreed with much of the diagnostic, but the government stressed the importance of including the social partners in the reform although they were ready to act in the absence of agreement. The views of the BdE, however, were closer to staff on the labor market and saw the need for a more rapid and fundamental reform.

C. Financial Sector: Prompting Restructuring and Loss Recognition⁴

37. **The financial sector outlook remains difficult and vulnerabilities elevated.** In aggregate, Spanish banks report solid capital and provision buffers. However, risks remain elevated and unevenly distributed across institutions. In an adverse scenario, in which unemployment climbs to 24½ percent by 2011 and house prices fall another 15 percent, NPLs are projected to peak at 7–8 percent in 2011. Taking into account repossessed assets, securities investments and prudent loss-given-defaults, and assuming that pre-provision income more than halves over the 2010–12 period, the gross drain on capital could reach €5 billion and €17 billion respectively for commercial and savings banks (some 2 percent of GDP and 5 and 22 percent of Tier 1 capital respectively and substantially less than the €99 billion maximum potentially available under the FROB).⁵ The situation is further complicated in that much of banks' repossessed real assets is land, which is particularly difficult to value.

38. **Despite the unprecedented measures announced by the European Union and the ECB to stabilize markets, funding and profitability pressures loom.** Although funding is generally of medium-term maturity, market conditions remain difficult and access limited, especially for smaller banks and for term funding. As of end-2009, the system has sufficient liquid assets, including ECB eligible collateral, to broadly cover debt maturing at least during 2010. Further strains may arise from the unwinding of the exceptional liquidity measures by the ECB, the ending of the funding guarantee scheme, and from the intense competition for deposits. These funding difficulties, including declining private sector deposits, coupled with lower earnings due to weak credit growth, higher provisioning for troubled assets and the system's overcapacity, will likely lead to pressure on profitability.

39. **Consolidation needs to accelerate to reduce overcapacity and produce more robust institutions.** Progress, under the aegis of the FROB, has been too slow, though the recent agreement between the two main political parties in this regard and the announcement of additional mergers is encouraging. Much more progress needs to happen before the FROB deadline of end-June 2010, and thereafter the mergers/integrations need to deliver the envisaged gains, such as cost reduction to strengthen profitability and capital buffers. The

⁴ Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached [Staff Statement](#) and [Staff Supplement](#).

⁵ See Annex 1.3 of the GFSR (2010).

BdE should be prepared to intervene promptly if pockets of weakness remain. To this end and to enhance investor confidence, a comprehensive and transparent bank-by-bank “diagnostic” based on conservative assumptions on asset valuation and prospects could help. In this context, a brief extension of the “capital support” window of the FROB might be warranted.

40. **At the same time, the legal framework of savings banks should be updated for the new economic context (see Annex and Box 2).** Performance among savings banks is highly diverse and the sector has an important role to play, but the current legal structure is not well suited to Spain’s needs going forward. Under the current framework, cross-region mergers still need to be approved by regional governments, the sector remains closed to external investors, and savings banks’ capacity to raise external capital remains limited, putting public funds at risk. The legislative and policy priority should be to: (1) reduce political influence in savings banks; (2) enhance their ability to raise external capital, and (3) offer an opportunity to transform into stock-holding companies, and, indeed, requiring this for systemically important savings banks. This reform should be implemented promptly to strengthen the consolidation process and to provide savings banks with the full range of options to raise capital as soon as possible.

Authorities’ views

41. **The authorities broadly shared staff’s views.** They considered that solvency and funding weaknesses in the banking sector were limited to a handful of small/medium institutions, mainly savings banks, and they are manageable and did not represent a threat to credit flowing to the economy. They also agreed with staff that the consolidation and reform of savings banks needs to be accelerated. While merits were seen in a UK/US style diagnostic, the BdE pointed to the already high degree of transparency and strong rule-based regulatory/supervisory framework. In addition, the part of the FROB law that allows direct intervention to facilitate the restructuring of ailing credit institutions does not have a fixed deadline. The BdE reaffirmed their readiness to swiftly address any remaining weaknesses in the system to support market confidence. As for the reform of the savings banks, there is political consensus to put forward a legal reform by the end of July.

IV. STAFF APPRAISAL

42. **The necessary adjustment is underway and output has stabilized.** Imbalances accumulated during the long boom have begun to unwind, with the current account deficit halving as private savings surged and housing investment fell. Competitiveness has begun to improve as productivity rose and the core inflation differential turned negative. The large fiscal deficit is beginning to fall. Output rose slightly in the first quarter, ending the long and deep recession. But unemployment has soared as firms adjusted employment rather than wages or working hours.

43. **The recovery is likely to be weak and fragile.** Growth is projected to rise gradually to 1½–2 percent in the medium term, with domestic demand weighed down by continued

Box 2. The Reform of Savings Banks: the Experience of Italy and Norway

Both Italy and Norway significantly reformed their savings banks in recent years. In Italy, the reform was the first step towards their privatization whereas in Norway, the reform preserved the savings banks' structure.

Italy—The process of reforming the banking sector started in the 1980s and reached its turning point with the *Amato law* of 1990. This transformed the legal structure of savings banks into joint-stock companies, the capital of which was conferred on (publicly owned) foundations. The purpose was twofold: (i) to legally separate the banking business from public-oriented activities (to strengthen the separation between management and ownership of the credit institution); and (ii) to allow savings banks to issue common equity securities. In principle, the foundation was supposed to behave as a disinterested investor, but in practice, the foundation (and hence the political) influence over the banking activity remained unchanged as the foundation (as major shareholder), retained the right to appoint the bank management. Thus the subsequent legal interventions aimed directly at privatizing the banks. The *Dini law* of 1994 repealed the obligation for the foundations to keep control of their credit institutions and introduced tax advantages for those foundations willing to dispose of their bank shares within a four-year period. The *Ciampi law* of 1998 set a mandatory four-year time limit for the divestment by the foundation of their controlling interests in credit institutions; lack of compliance would have triggered the intervention of the supervisory authority.

Norway— The process of deregulation, which started in mid-1980s, fostered consolidation of the Norwegian banking industry, particularly in the savings bank sector. In 1987, the Savings Banks Act was amended to enable savings banks to tap capital markets to strengthen their equity capital by issuing primary capital certificates, termed equity certificates (EC) as from July 1, 2009, which count as Tier 1 capital. The ECs are traded securities conferring property rights over the capital and profits of the savings bank. The key principle is that the equity certificate holders' capital (equity capital) and the institution's other capital (ownerless capital) are subject to the same rules upon allocation to, respectively, dividends and charitable funds, and upon allocation to reserves. EC's representation in the general assembly is not proportional to their share capital but it ranges between 20 and 40 percent, while the remaining voting rights are allocated among the other stakeholders (depositors, employees, and municipal council). An EC-bank is then a hybrid between a commercial bank and a nonprofit savings bank. In 2002 savings banks were given the option of converting into limited companies. In this case, the original capital must be converted into a foundation, which needs to own more than 10 percent of the bank's share capital to enable the converted entity to retain the qualification of "savings bank."

uncertainty, high unemployment, deleveraging and fiscal consolidation. Inflation will likely remain subdued, helping regain competitiveness. The uncertainty around this outlook is large. On the upside, household consumption could grow more rapidly as confidence firms, and the global recovery and the weaker euro may induce faster export growth. On the downside, the economy may stagnate as the weakness in private demand and fiscal consolidation interact,

and financial market conditions may also deteriorate further.

44. **Policy should focus on fostering the smooth rebalancing of the economy and securing market confidence.** This calls for quick and decisive action on: (1) fiscal consolidation to put public finances on a sustainable footing; (2) making the labor market more flexible to promote employment and its reallocation across sectors; and (3) banking sector consolidation and reform to cement the soundness and efficiency of the system. The heightened risks faced by Spain, and the heavy costs for Spain and others should they materialize, makes these reforms especially urgent. Such a far-reaching strategy would be helped by broad political and social support.

45. **Ambitious fiscal consolidation is underway, but achievement of the targets needs to be made more credible and complemented by bold pension reform.** To achieve the implied 10 percent of GDP improvement in the primary balance from 2009 to 2013, the government has taken a wide range of concrete and bold measures. The envisaged deficit path, which implies cutting the deficit by more than five percentage points of GDP in 2010 and 2011, is also appropriately front-loaded. But to make attaining the targets more credible, the macroeconomic projections should be made more prudent and additional measures prepared. These should be supported by a bold pension reform, along the lines proposed by the government in its Stability Program.

46. **Stronger fiscal frameworks could help.** Robust mechanisms, in particular, aimed at enhancing the incentives (both political and economic) for compliance, are required to ensure regions deliver the needed adjustment. Institutionalizing spending review processes could also help improve the quality and durability of spending reductions. An independent fiscal council might also help bolster the credibility of fiscal policy.

47. **A radical overhaul of the dysfunctional labor market is urgent.**⁶ The reform will need to be ambitious and comprehensive if it is to significantly change labor market dynamics and to avoid missing an historic opportunity. In particular:

⁶ Significant labor market policy developments occurred after this Staff Report had been issued to the Board. A labor market reform (adopted in June 2010) has reduced severance pay for unfair dismissal, facilitated the financing of a part of severance payments, eased the criteria for fair dismissal, and broadened the conditions for firms to opt-out of collective wage agreements. The [Staff Supplement](#) attached to this report provides the staff's appraisal of these developments, reproduced here for convenience. *“Although the reform has many positive aspects that will improve the working of the labor market, there is scope for further strengthening. Notably, severance pay remains above EU average levels and it is not clear whether the easing of criteria for fair dismissal and procedures for opt-outs is sufficient to have a substantial impact – much depends on how the courts interpret the new provisions. More generally, effective decentralization of wage setting to firms will likely require a change in the collective bargaining process, which is currently under review by the social partners. The government should thus take every opportunity to deliver the required radical overhaul, including during the passage of the decree-law through parliament and the review of the wage bargaining system.”*

- reducing duality and encouraging permanent hires requires lowering severance payments to at least EU average levels, having a more gradual increase in such severance payments in the early years of tenure, and preventing excessive use of unfair dismissals;
- boosting wage flexibility and employment requires coupling this reduced protection of permanent contracts with decentralizing wage setting and eliminating indexation.

Care should be taken that any reform does not increase the fiscal cost of the system or make temporary employment more difficult in the near term. Ideally the social partners will quickly deliver such an overhaul, but if not, the government will need to follow through on its commitment to take action itself, including on collective bargaining.

48. **Commendable progress in recent years on product and service market reform needs to continue.** Many important measures have been taken recently, especially in transposing the EU Services Directive (though implementation will be critical). The priority going forward should be to further reduce restrictions on retail trade, professional services, and the rental market.

49. **The banking sector remains sound but under pressure.** Although impaired assets have increased with the downturn, Spanish banks overall report robust capital and provision buffers, supported by a strong supervisory framework. But the risks remain elevated and unevenly distributed across institutions, focused mainly on the savings banks. On the liquidity side, although funding is generally of good duration, market conditions remain difficult. Further strains may arise from the unwinding of the exceptional liquidity measures by the ECB, the ending of the funding guarantee scheme, and from the intense competition for deposits. These funding difficulties, coupled with lower earnings due to weak credit growth, provisioning for troubled assets and the system's overcapacity, will likely lead to pressure on profitability.

50. **Savings bank consolidation needs to accelerate.**⁷ Progress, under the aegis of the FROB, has been too slow, though has accelerated recently. The Bank of Spain should be

⁷ Significant financial sector policy developments occurred after this Staff Report had been issued to the Board. The [Staff Statement](#) and [Staff Supplement](#) attached to this report provide the staff's appraisal of these developments, reproduced here for convenience. On the intention to publish bank-by-bank stress test results: "Staff welcomes this intention, which should enhance transparency and underpin market confidence. It will be important that the stress tests are based on sufficiently conservative assumptions and accompanied by a clear strategy to recapitalize and restructure those institutions with capital shortfalls identified by the stress tests." On the accelerated savings bank consolidation process: "Staff welcomes this development, and it will be important to ensure that the process reduces overcapacity and enhances cost efficiency as envisaged." On the reform of the legal and regulatory framework for savings banks: "Staff's preliminary assessment of the reform is positive, although further enhancement of some aspects would be beneficial. The assessment is preliminary as it is based on the summary of the decree-law (as the full text had not been published by 12 July). In terms of the objectives outlined by staff, the decree-law enhances the ability of savings banks to raise external capital, offers an opportunity to transform into a stock-holding company, and reduces political influence. However, some

(continued)

prepared to intervene promptly if pockets of weakness remain. To this end and to enhance investor confidence, a comprehensive and transparent bank-by-bank “diagnostic” based on conservative assumptions on asset valuation and prospects could play a useful role.

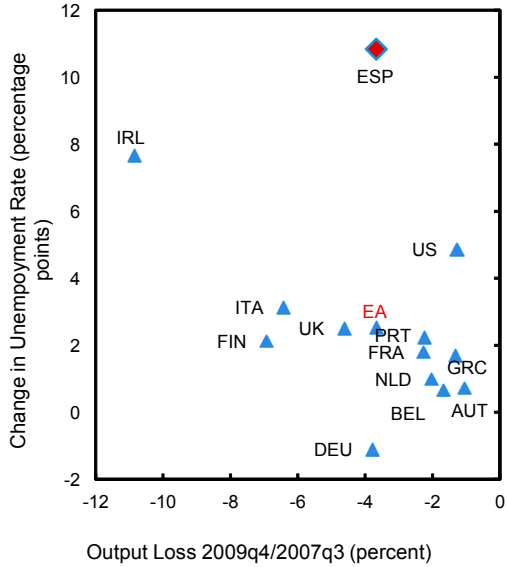
51. **The legal framework of savings banks should be updated for the new economic context.**⁷ Performance among savings banks is highly diverse and the sector has an important role to play, but the current legal structure is not well suited to Spain’s needs going forward. The legislative and policy priority should be to: (1) reduce political influence in savings banks; (2) enhance their ability to raise external capital, and (3) offer an opportunity to transform into stock-holding companies, and, indeed, requiring this for systemically important savings banks. This reform should be implemented promptly so savings banks can have the full range of options to raise capital as soon as possible.

52. **It is proposed to hold the next Article IV consultation on the regular 12-month cycle.**

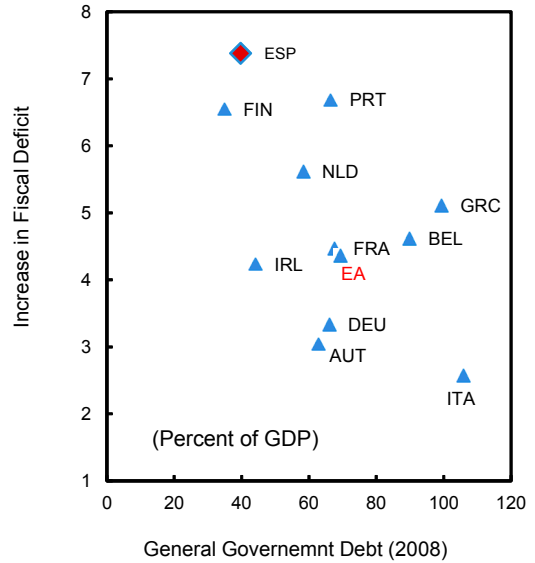
elements remain that could limit the attractiveness of savings banks to potential investors: the 50 percent limit on the total amount of cuotas participativas a saving bank can issue is maintained, and, similarly, the capital participation of saving banks in a SIP cannot fall below 50 percent, although the possibility envisaged in the decree-law for savings banks to transform into foundations and transfer their banking activity to a bank would effectively allow these limits to be exceeded. Also, systemically important savings banks are not required to transform into joint-stock companies.”

Figure 1. Spain and the Global Financial Crisis

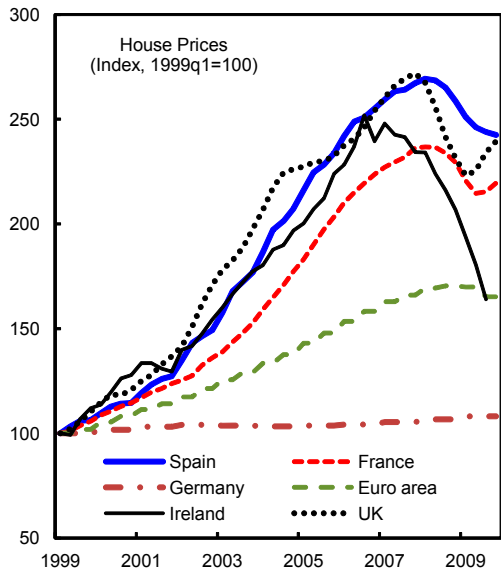
Unemployment soared despite an average output fall.



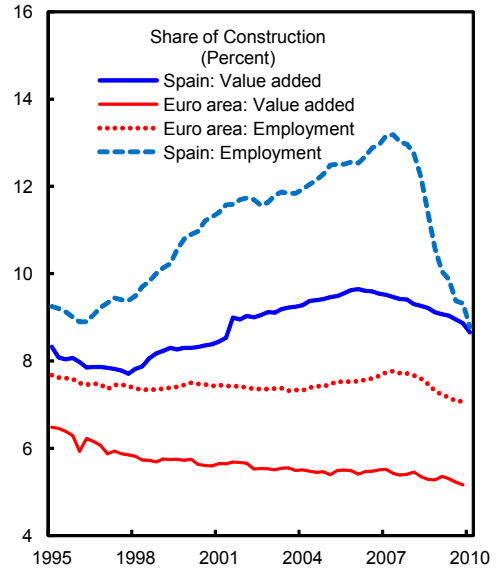
Spain experienced the largest deficit increase in the euro area.



Housing price adjustment has been slow...



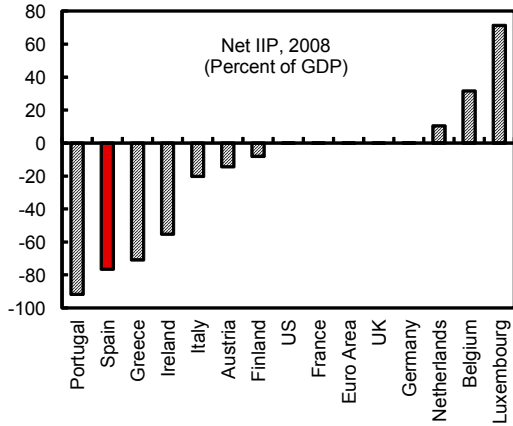
...while construction output and employment contracted sharply.



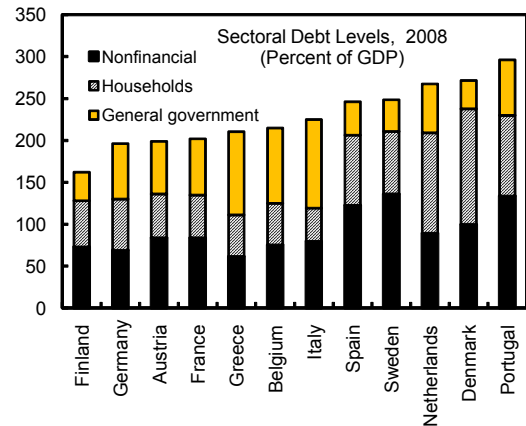
Sources: Eurostat; and WEO.

Figure 2. Spain's underlying weaknesses

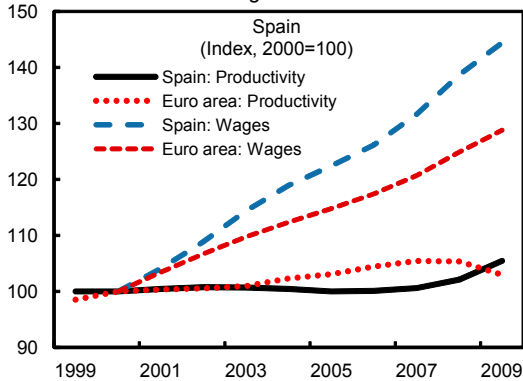
Spain accumulated one of the most negative IIPs among advanced economies.



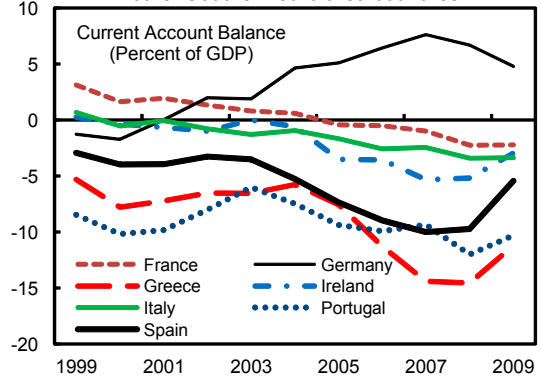
Households and corporations are highly indebted.



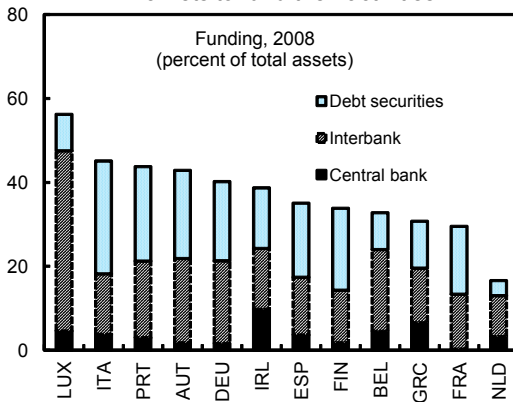
Wage increases were high despite very low productivity growth...



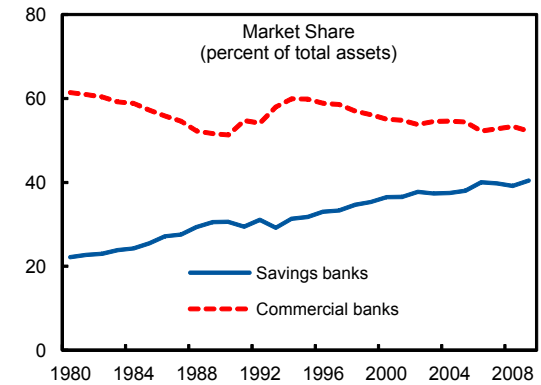
...leading to sustained large current account deficits, like in other Southern euro area countries.



Banks have relied significantly on wholesale credit markets to fund their activities.



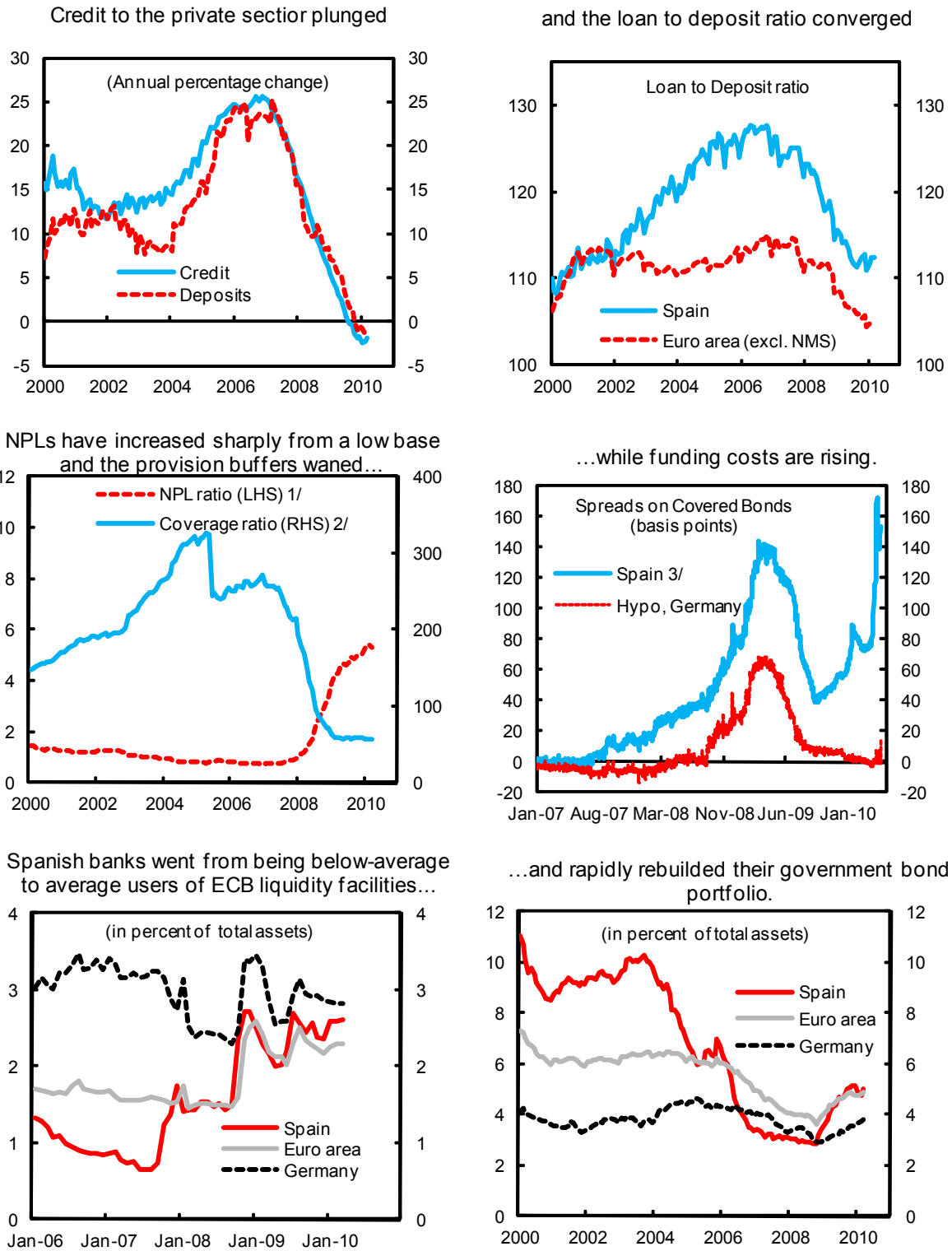
Savings banks have become more prominent.



Sources: Eurostat; Bank of Spain; European Central Bank; and IMF staff estimates.

1/ Monetary financial institutions. Market funding comprises money market funds/shares and debt securities issued. Twelve month change over the stock of total assets at the beginning of the period.

Figure 3. Spain--Financial Sector Indicators (I)
(Year-on-year percent change, unless otherwise indicated)



Sources: Bank of Spain; ECB; and data provided by the authorities.

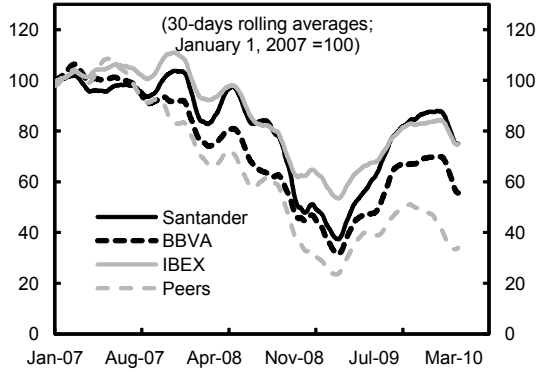
1/ NPL ratio = nonperforming loans in percent of total loans.

2/ Coverage ratio = provisions in percent of nonperforming loans.

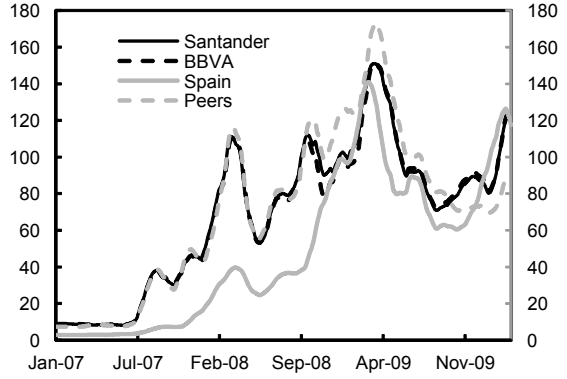
3/ Simple average of asset swap spreads on covered bonds by Santander, BBVA, Caja Madrid, and Caixa Barcelona.

Figure 4. Spain: Financial Sector Indicators (II)

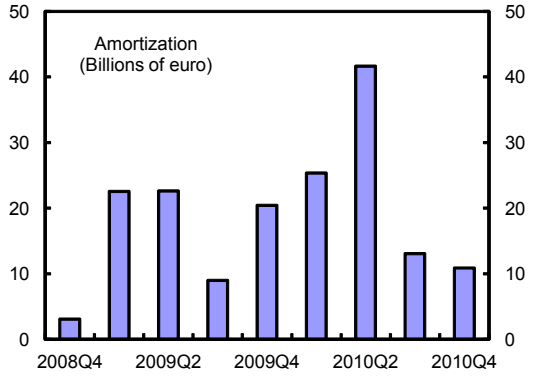
Santander and BBVA stock prices outperformed peers ...



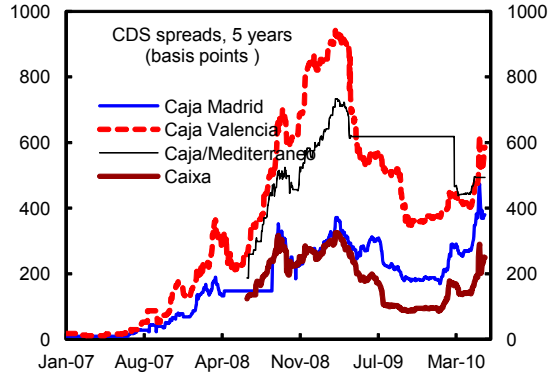
... but their CDS recently increased, reflecting also higher sovereign risk.



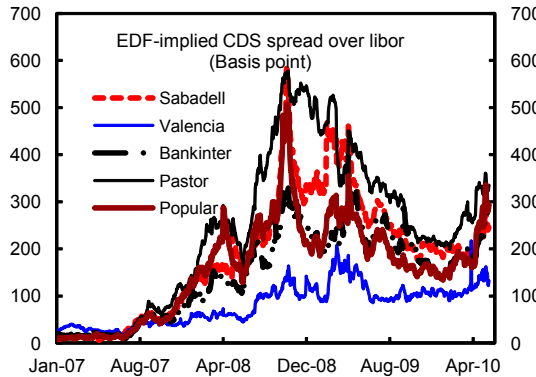
The banks have large amortizations falling due.



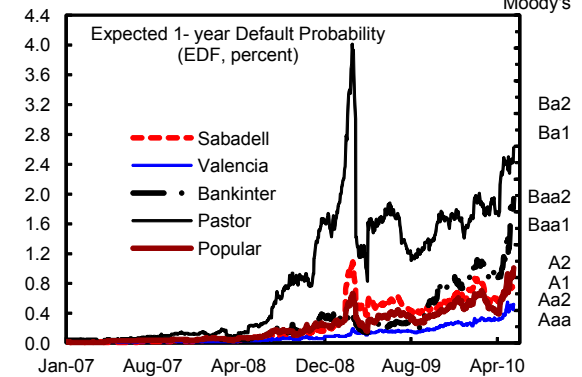
Some cajas show troubling CDS spreads...



...as do some private banks...

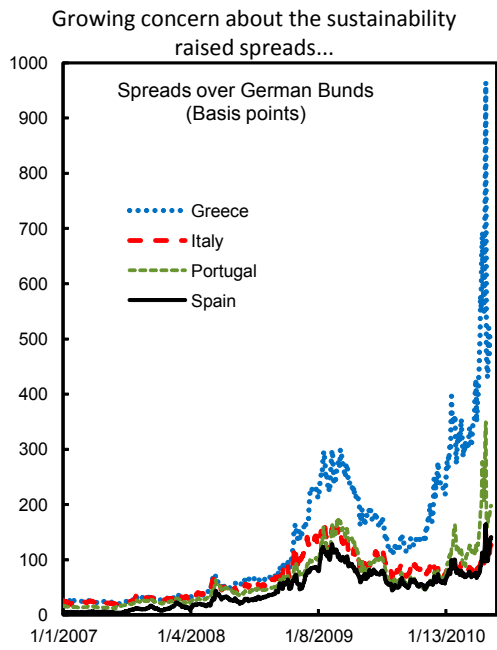
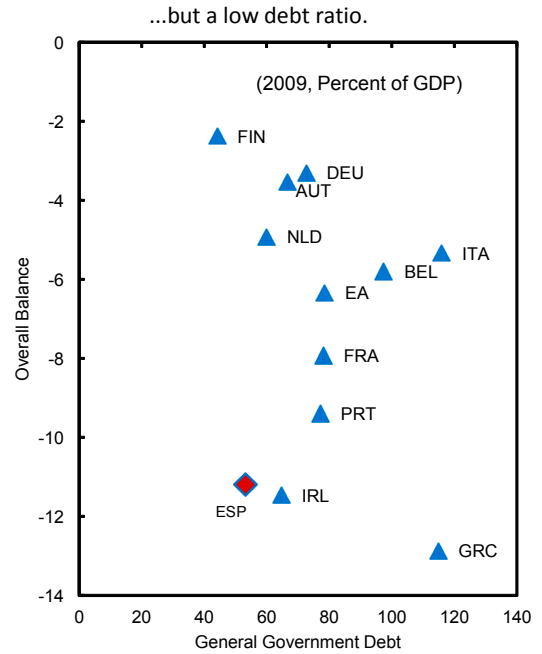
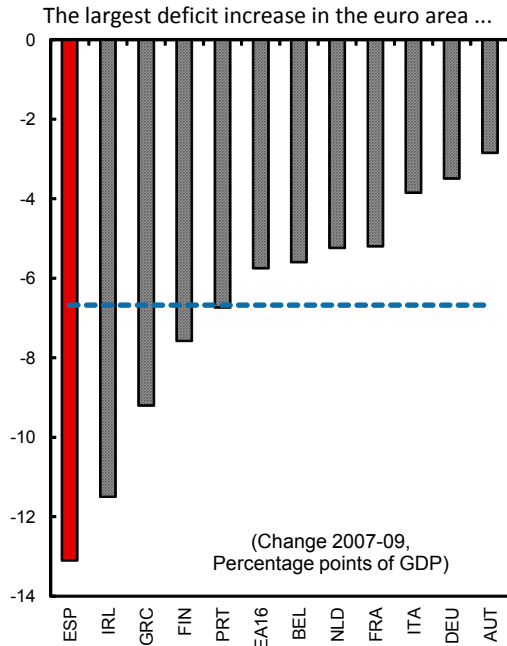


...and their probabilities of default have increased.

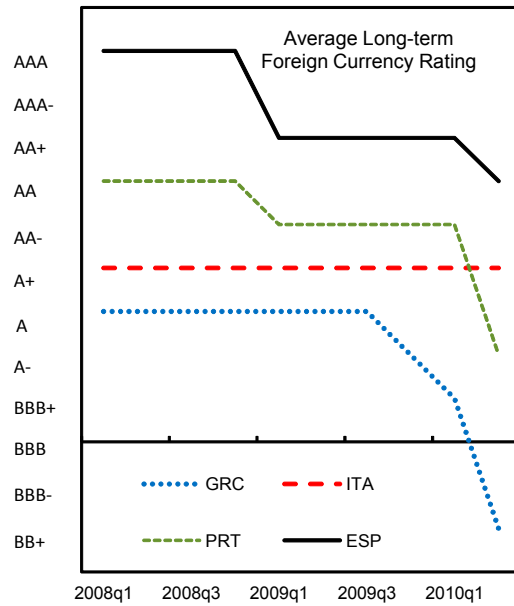


Sources: Data provided by the authorities; Bank of Spain; ECB; and Bloomberg.

Figure 5. Spain: Fiscal Developments and International Comparison

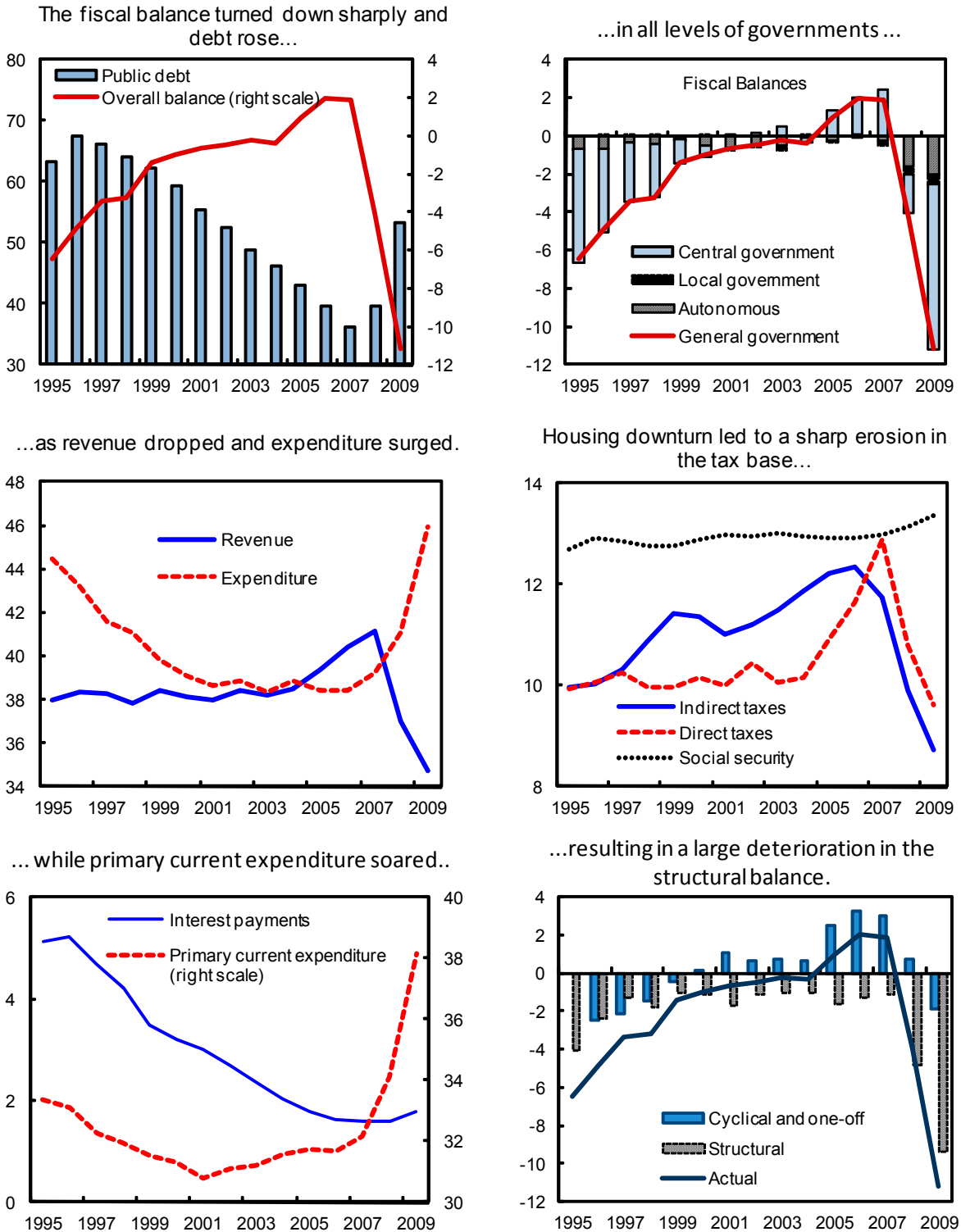


...and resulted in downgrading by rating agencies.



Sources: Bloomberg; and WEO.

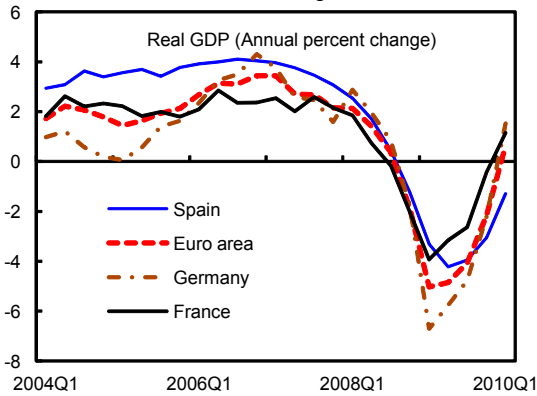
Figure 6. Spain: Fiscal Developments 1995–2009
(Percent of GDP)



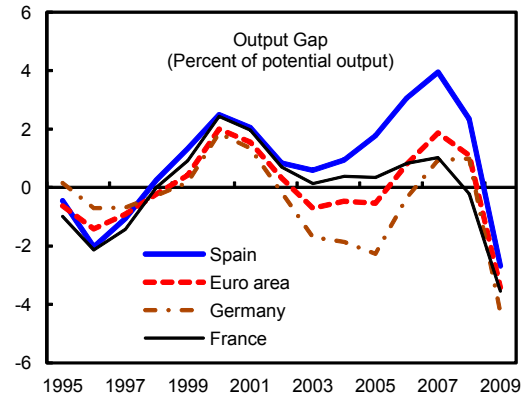
Sources: Ministry of Finance; Eurostat; and IMF staff estimates.

Figure 7. Spain: National Accounts

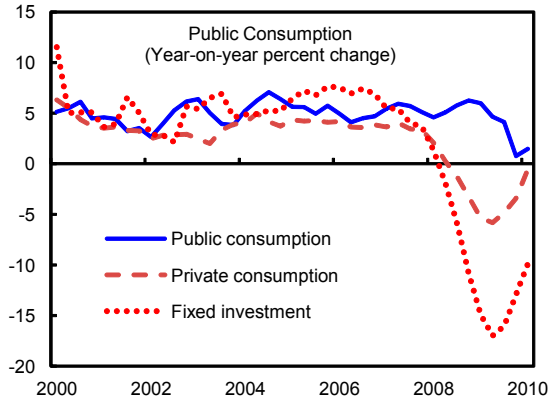
Output fell strongly, though a bit less than the euro area average...



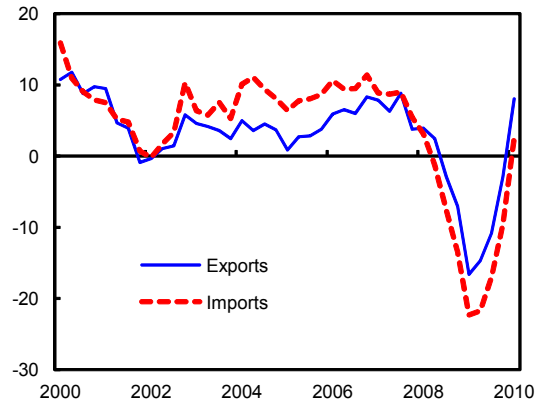
...leading to a large reversal of the output gap.



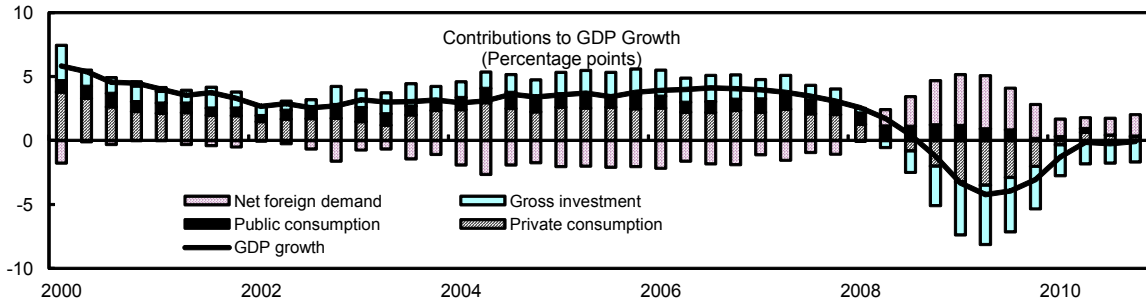
Domestic demand contracted sharply...



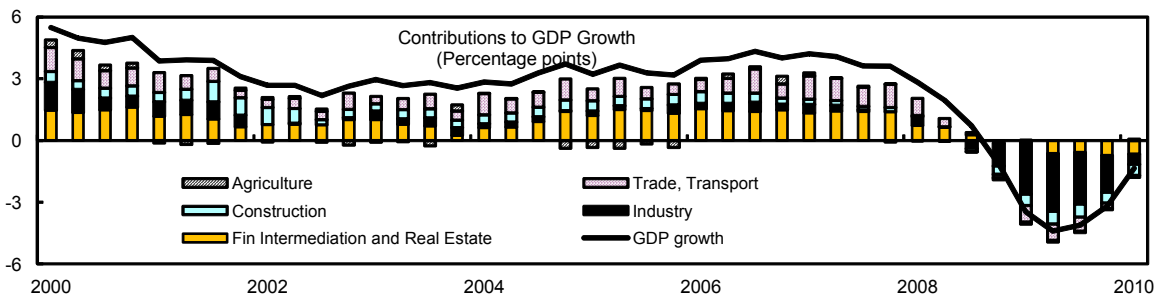
...leading imports to fall more than exports.



And the contribution of net exports became strongly positive, providing some offset.



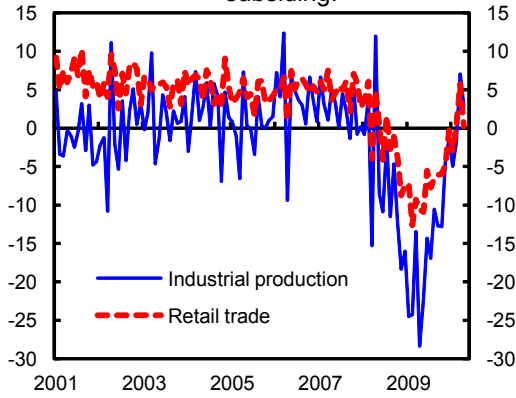
Industry and real estate were hardest hit by the crisis.



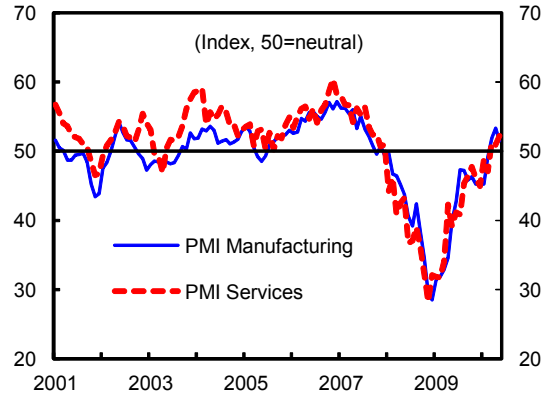
Sources: WEO; Bank of Spain; Eurostat; and IMF staff calculations.

Figure 8. Spain: High Frequency Indicators
(Year-on-year percent change, unless otherwise indicated)

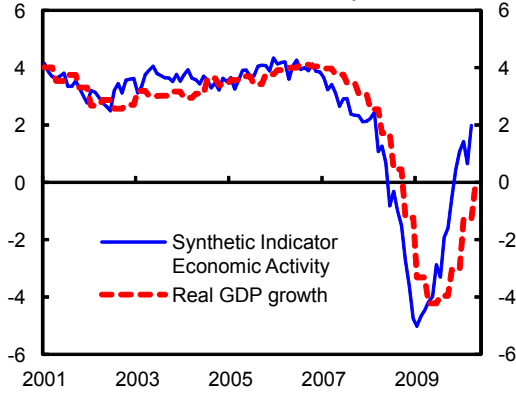
The fall in industrial production and retail trade is subsiding.



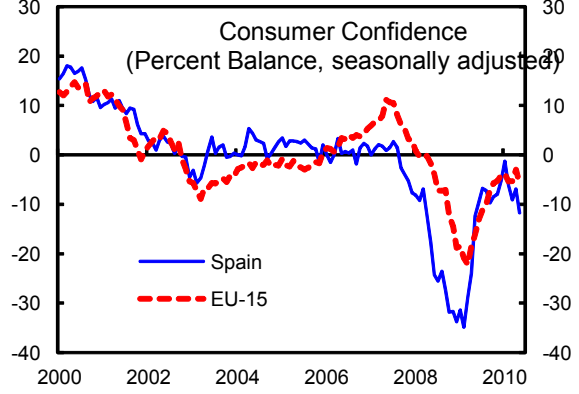
PMI's point to stabilization.....



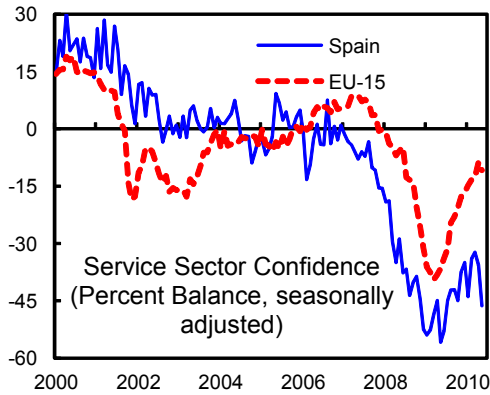
...and so does the synthetic indicator of economic activity.



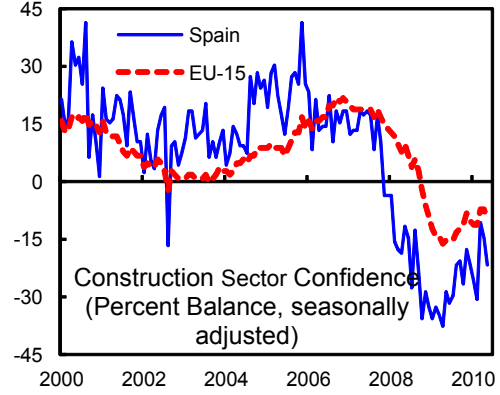
Consumer confidence is recovering.



However, it remains low in services...

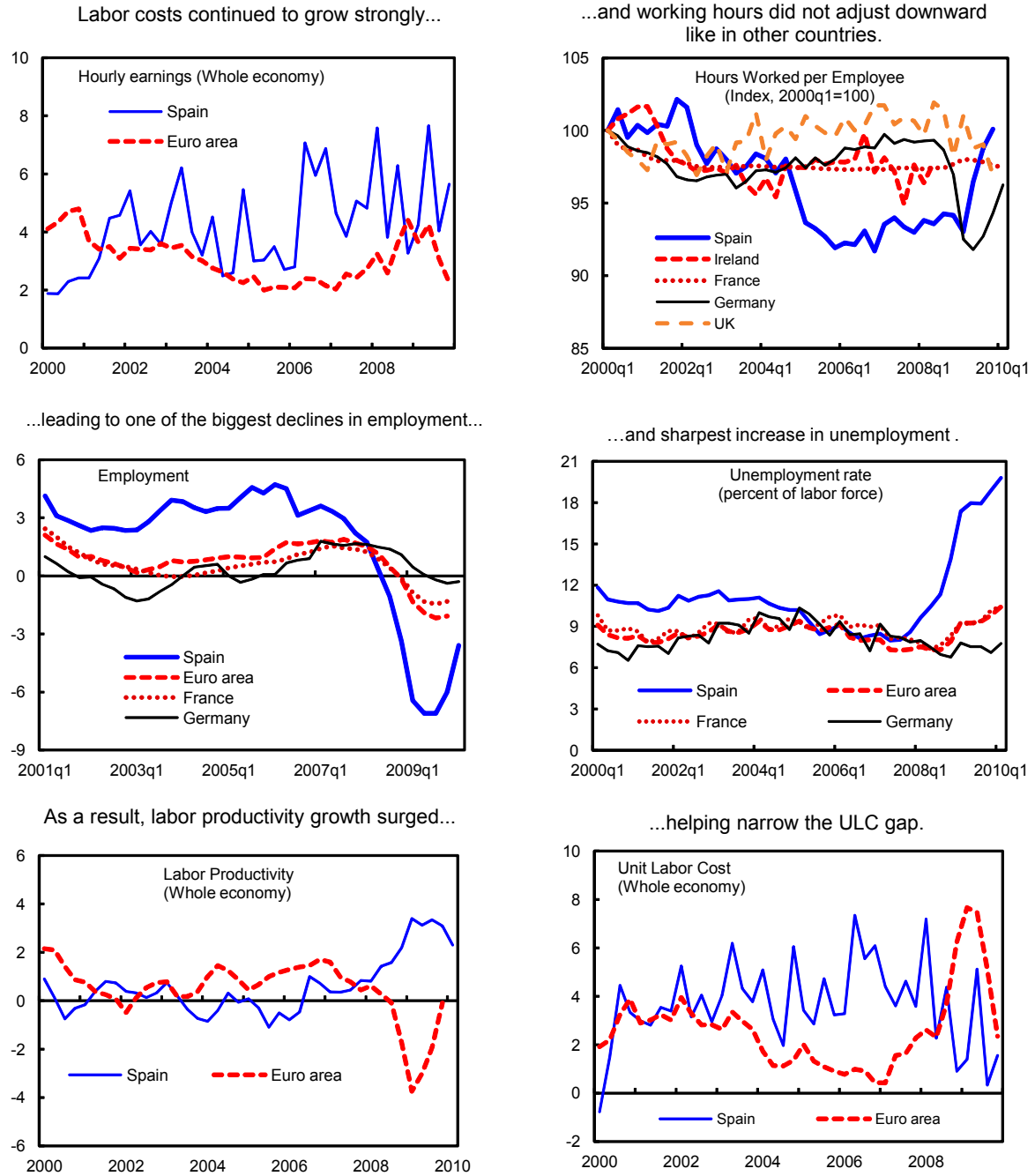


...and in construction.



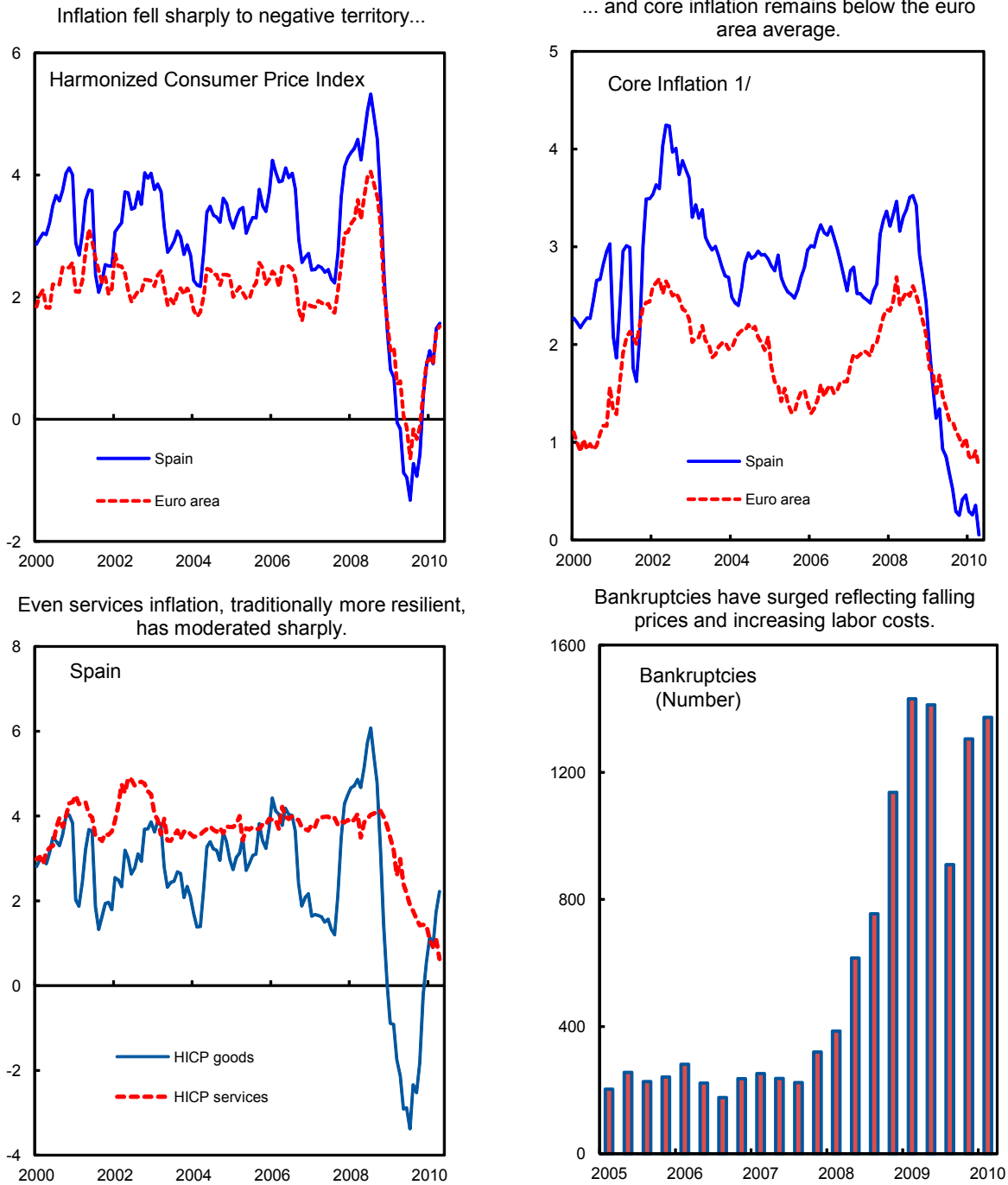
Sources: IEurostat; and MF staff calculations based on data provided by the authorities.

Figure 9. Spain: Labor market indicators
(year-on-year percent change, unless otherwise indicated)



Sources: Eurostat; IMF staff projections based on data provided by the authorities; and WEO.

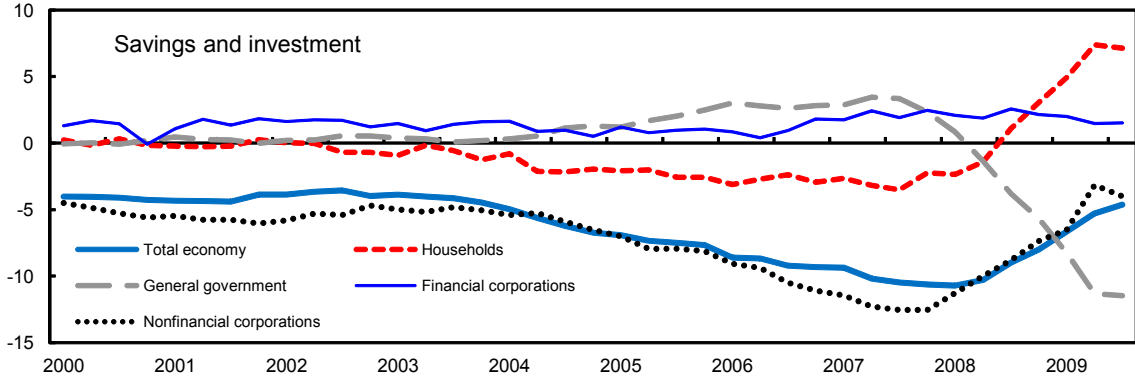
Figure 10. Spain: Inflation
(year-on-year percent change, unless otherwise indicated)



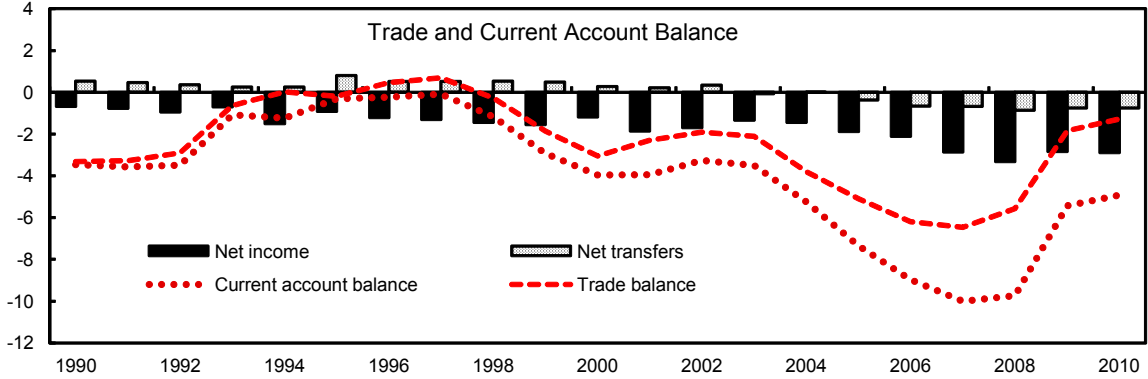
Sources: Eurostat; IMF staff projections based on data provided by the authorities; and WEO.
1/ Excludes nonprocessed foods and energy products.

Figure 11. Spain: Balance of Payments
(Percent of GDP)

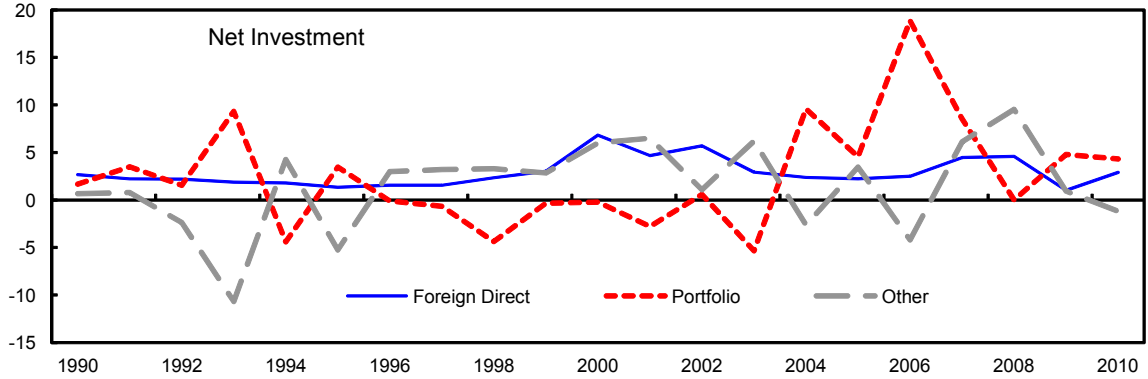
The current account has narrowed substantially as households and corporations have improved their net savings...



...yielding a strong improvement of the trade balance...

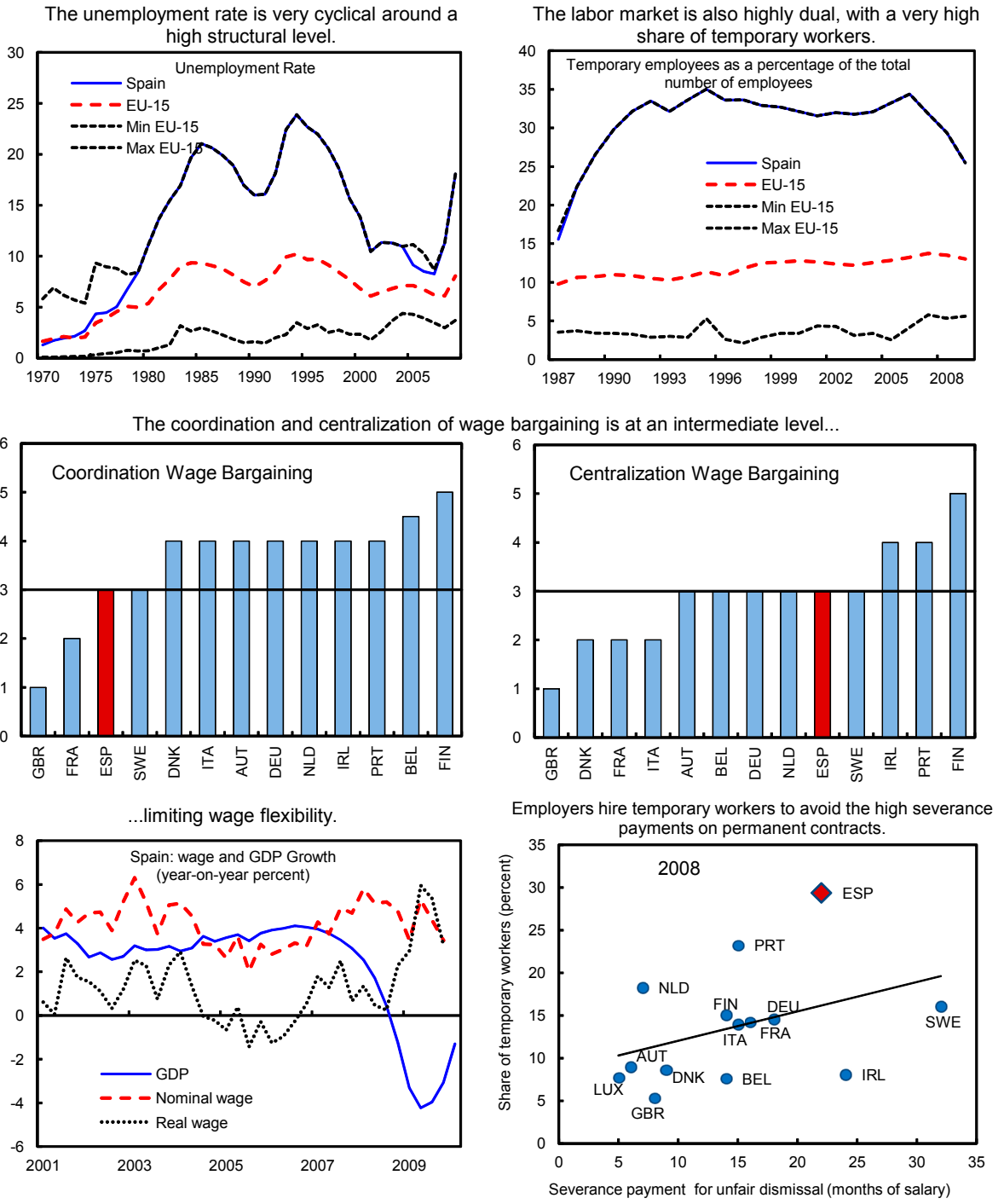


... and adjusting to reduced external financing.



Sources: Eurostat; Bank of Spain.

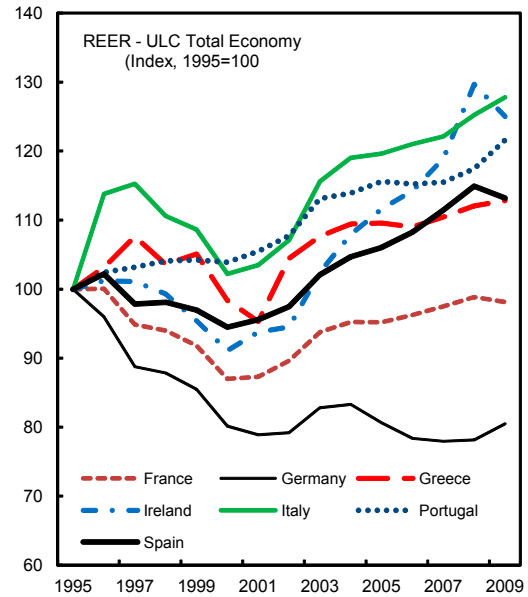
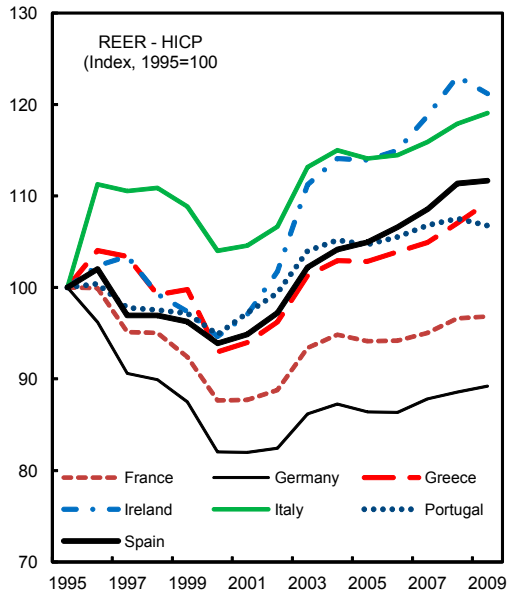
Figure 12. Spain: Structural Labor Market



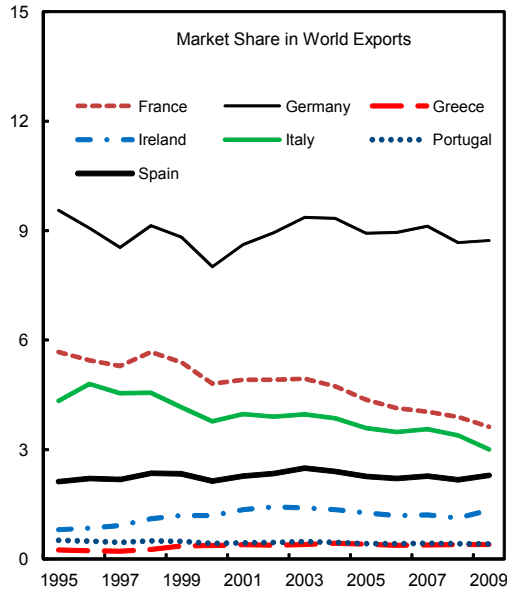
Sources: OECD; Eurostat; European Commission; Instituto Nacional de Estadística; WEO.

Figure 13. Spain: Competitiveness

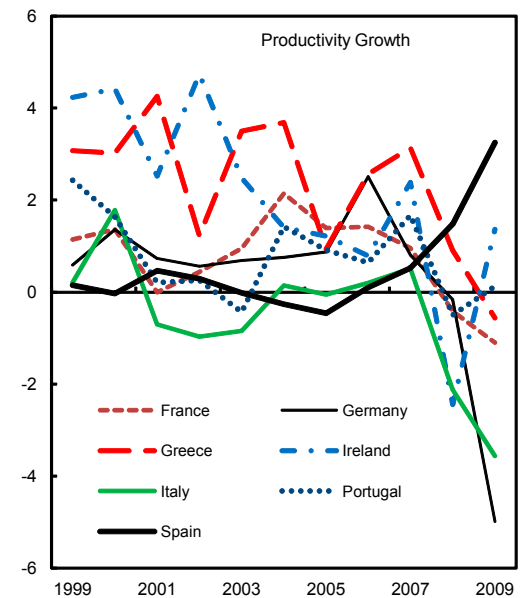
Real effective exchange rates show a strong appreciation since euro adoption.



The export market share has held up...

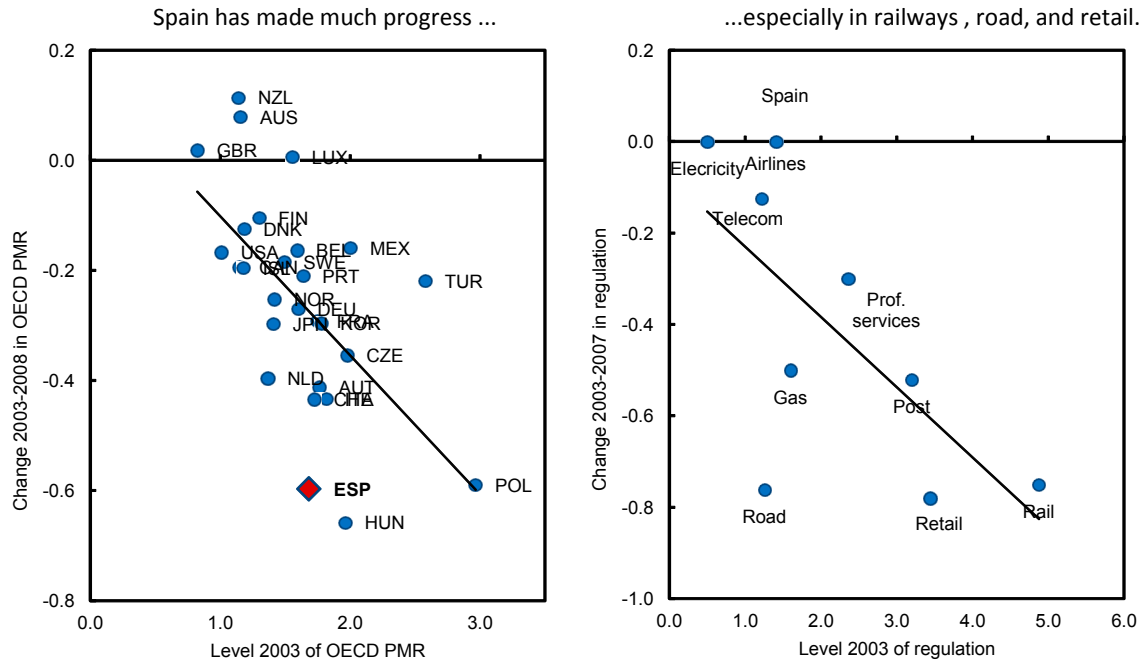


...but trend productivity growth has been weak.

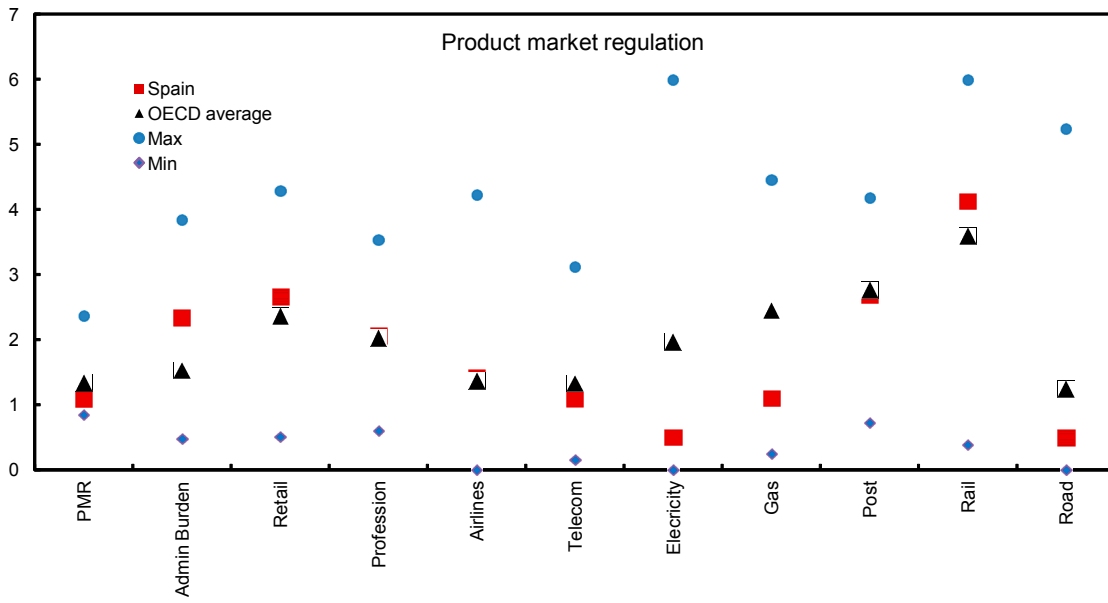


Source: Direction of Trade; Eurostat ; and WEO.

Figure 14. Spain: Product Market Reform



Administrative burdens remain heavy while regulation is still high in rail, post, retail, and professional services.



Source: OECD.

Table 1. Spain: Main Economic Indicators
(Percent change unless otherwise indicated)

	2005	2006	2007	2008	2009	Projections	
						2010	2011
Demand and supply in constant prices							
Gross domestic product	3.6	4.0	3.6	0.9	-3.6	-0.4	0.6
Private consumption	4.2	3.8	3.6	-0.6	-4.9	0.4	0.8
Public consumption	5.5	4.6	5.5	5.4	3.8	0.6	-1.1
Gross fixed investment	7.0	7.2	4.6	-4.4	-15.3	-8.0	-2.9
Construction investment	6.1	6.0	3.2	-5.5	-11.2	-11.2	-7.5
Other	8.4	9.0	7.1	-2.6	-21.2	-2.7	2.9
Stockbuilding (contribution to growth)	-0.1	0.3	-0.1	0.1	0.0	0.0	0.0
Total domestic demand	5.1	5.2	4.2	-0.5	-6.0	-1.5	-0.4
Net exports (contribution to growth)	-1.7	-1.4	-0.9	1.4	2.8	1.1	0.9
Exports of goods and services	2.5	6.7	6.6	-1.0	-11.5	7.0	4.3
Imports of goods and services	7.7	10.2	8.0	-4.9	-17.9	2.1	0.6
Potential output growth (long run HP-filter)	2.8	2.7	2.7	2.4	1.3	0.3	0.3
Output gap (percent of potential)	1.8	3.0	3.9	2.3	-2.7	-3.5	-3.2
Non-financial private sector borrowing 1/	21.2	24.2	15.5	6.4	-0.7	-1.0	...
Household savings (percent of disposable income)	11.3	11.2	10.7	12.9	18.8	16.5	15.3
Prices							
GDP deflator	4.3	4.1	3.3	2.5	0.2	0.1	0.5
HICP (average)	3.4	3.6	2.8	4.1	-0.3	1.4	1.3
HICP (end of period)	3.7	2.7	4.3	1.5	0.9	1.6	1.1
Differential with euro area average	1.2	1.4	0.7	0.8	-0.5	0.3	0.0
Employment and wages							
Unemployment rate (in percent)	9.2	8.5	8.3	11.3	18.0	19.3	18.7
Unit labor cost in manufacturing	2.5	2.8	3.4	5.8	6.7	-1.5	0.4
Labor cost in manufacturing	4.3	4.1	3.7	4.8	5.0	1.1	1.4
Employment growth	4.1	3.9	3.0	-0.6	-6.7	-2.0	0.0
Labor force growth (in percent) 2/	2.0	3.2	2.7	2.8	0.9	-0.4	-0.7
Balance of payments (percent of GDP)							
Trade balance (goods)	-7.5	-8.5	-8.7	-8.0	-4.3	-4.2	-3.8
Current account balance 3/	-7.4	-9.0	-10.0	-9.7	-5.4	-4.9	-4.3
Official reserves excl. gold (US\$ billions)	9.7	10.8	11.5	12.4	18.2	...	...
Nominal effective rate (2000=100) 4/	105.9	107.4	109.8	110.6	111.1	109.7	...
Real effective rate (2000=100, CPI-based) 4/	100.3	102.5	105.9	106.9	107.3	105.5	...
Public finance (percent of GDP)							
General government balance	1.0	2.0	1.9	-4.1	-11.2	-9.3	-7.0
Primary balance	2.8	3.7	3.5	-2.5	-9.4	-7.1	-4.3
Structural balance	-1.6	-1.2	-1.1	-4.8	-9.3	-7.8	-5.6
General government debt	43.0	39.6	36.1	39.7	53.2	63.7	70.6

Sources: IMF, *World Economic Outlook*; data provided by the authorities; and IMF staff estimates.

1/ Data for 2010 refer to March 2010.

2/ Based on national definition (i.e., the labor force is defined as people older than 16 and younger than 65).

3/ Capital account not included.

4/ Based on data from IMF, *International Financial Statistics*. Data for 2010 refer to March 2010.

Table 2. Spain: Selected Financial Soundness Indicators
(Percent or otherwise indicated)

	2005	2006	2007	2008	2009
Solvency					
Own funds to risk-weighted assets 1/	11.0	11.2	10.6	11.3	12.2
Tier 1 capital to risk-weighted assets 1/	7.9	7.2	7.6	8.5	9.7
Own funds to total assets 1/	6.8	7.2	6.7	6.4	6.8
Returns on average assets 1/	0.9	1.0	1.1	0.7	0.5
Profitability					
Returns on average equity 1/	16.6	19.7	20.0	12.6	9.3
Net interest income to gross income 1/	55.7	53.2	54.7	60.0	65.3
Operating expenses to gross income 1/	52.1	47.0	44.4	45.7	43.1
Asset quality					
Non performing loans (EUR bn)	9.6	10.9	16.3	63.1	93.3
Non-performing to total loans	0.8	0.7	0.9	3.4	5.1
Provisions to non-performing loans	255.5	272.2	214.6	70.8	58.7
Exposure to construction sector (EUR bn) 2/ of which: Non-performing	262.8 0.5	378.4 0.3	457.0 0.6	469.9 5.7	453.7 9.6
Liquidity					
Liquid to total assets 3/	15.9	11.1	11.4	...	...
Use of ECB refinancing (EUR bn) 4/ in percent of total ECB refin. operations	30.3 7.7	21.2 4.9	52.3 11.6	92.8 11.6	81.4 12.1
in percent of total assets of Spanish MFI	1.4	0.8	1.4	2.7	2.4
Loan-to-deposit ratio	129.7	131.9	133.1	130.6	129.5
Macroeconomic indicators					
Real GDP (percent growth)	3.6	4.0	3.6	0.9	-3.6
HICP (average; percent growth)	3.4	3.6	2.8	4.1	-0.3
Unemployment rate	9.2	8.5	8.3	11.3	18.0
Current account (in percent of GDP)	-7.4	-9.0	-10.0	-9.7	-5.4
Credit to the private sector (percent growth)	27.2	25.4	16.7	6.2	-1.8
Corporate debt (in percent of GDP)	87.8	104.1	115.4	120.0	123.9
Households					
Total debt (in percent of disposable income)	110.0	122.7	129.6	127.3	125.0
Mortgage debt (in percent of disposable income)	80.6	90.7	96.4	94.8	93.9
Market indicators (end-period)					
Stock market (percent changes)					
IBEX 35	18.2	31.8	7.3	-39.4	29.8
Santander	22.1	26.8	4.6	-51.0	73.0
BBVA	15.6	21.0	-8.1	-48.3	49.4
Popular	6.2	33.3	-14.8	-48.0	-13.9
CDS (spread in basis points) 5/					
Spain	3.1	2.7	12.7	90.8	103.8
Santander	9.3	8.7	45.4	103.5	81.7
BBVA	9.1	8.8	40.8	98.3	83.8

Sources: Bank of Spain; ECB; WEO; Bloomberg; and IMF staff estimates.

1/ Consolidated groups of credit institutions.

2/ Including developers.

3/ Liquid assets include cash and holdings of securities different from equity shares and participations.

4/ Sum of main and long-term refinancing operations; end of period.

5/ Senior 5 years in euro.

Table 3. Spain: Financial Soundness Indicators of the Non-banking Sectors

	2002	2003	2004	2005	2006	2007	2008	2009
Insurance sector								
Solvency ratio 1/	...	...	...	2.8	2.7	2.6	2.6	2.7
Profitability (return on average equity)	9.36	19.7	18.2	21.7	22.1	26.4	14.7	14.2
Corporate sector								
Total debt as a percentage of GDP 2/	68.4	73.2	77.7	88.0	104.3	115.6	120.1	125.0
Total debt as a percentage of equity 3/	143.5	149.5	144.5	151.4	163.0	170.5	175.7	...
Profitability (Ordinary net profit over equity) 3/	13.6	14.0	14.2	13.8	13.8	13.5	11.3	...
Debt service (interest only) coverage 3,4/	6.0	7.4	7.8	7.2	6.1	4.7	3.9	...
Number of applications for protection from creditors 5/	1,021	996	915	927	916	1,033	2,894	5,057
Household sector								
Debt as a percentage of GDP	52.0	57.5	64.3	71.8	79.2	83.2	83.8	86.0
Debt as a percentage of disposable income	79.2	88.2	98.8	110.3	122.9	129.8	127.5	125.1
Debt service burden to total disposable income	12.4	12.5	13.3	14.2	15.6	17.4	18.2	16.9
Interest burden as a percentage of total disposable income	4.1	4.0	4.0	4.1	4.9	6.5	7.5	6.2
Financial savings ratio as a percentage of GDP	0.8	0.1	-0.6	-1.3	-1.7	-1.9	0.2	5.4
Real estate sector								
House price inflation 6/	15.7	17.6	17.4	13.9	10.4	5.8	0.7	-7.4
Mortgage loans as percent of total credit to the resident non-monetary private sector 7/	52.2	55.7	58.1	60.1	59.6	59.2	58.4	60.4
o/w Domestic households	30.5	30.8	31.3	33.6	33.8	33.7	33.9	34.2
o/w real estate	21.6	24.9	26.8	26.5	25.9	25.5	24.5	26.3

Sources : Data received from the authorities and the IMF Corporate Vulnerability Utility.

1/ Available solvency margin over required solvency margin.

2/ Debt includes securities other than shares and loans (excluding inter-company loans). Calculated with information obtained from Financial Accounts of the Spanish Economy and National Accounts.

3/ Calculated using the information in the CBA and CBB databases (derived from the Balance Sheet Data Office's annual survey and balance sheet information deposited in the Spanish Mercantile Registries).

4/ Earnings before interest and tax over interest expenses.

5/ Since 2004, Bankruptcy Proceedings Statistics replace the Suspensions of Payments and Bankruptcy Declarations Statistic.

6/ Assessed housing prices per square meter in the free housing market as published by the Ministry of Housing. Average year-on-year growth.

7/ Including de-recognised loans.

Table 4. Spain: General Government Operations 2007–15

	2007	2008	2009	SGP 2010-13 with May Package 1/				Staff Projections					
				2010	2011	2012	2013	2010	2011	2012	2013	2014	2015
(Billions of euros)													
Revenue	432.8	402.7	365.0	376.0	396.4	422.9	453.0	376.0	387.5	404.1	423.7	441.8	459.9
Current	427.9	400.4	365.8					371.3	382.6	398.9	418.3	435.6	453.4
Indirect taxes	123.5	107.6	91.8					100.4	105.8	109.9	114.6	118.7	123.3
Direct taxes	135.8	117.5	101.0					104.5	106.8	111.7	118.0	124.1	130.0
Personal (PIT)	81.3	80.2	72.1					75.7	77.3	80.1	83.8	87.7	91.7
Corporate (CIT)	54.5	37.3	28.9					28.7	29.5	31.6	34.2	36.4	38.2
Social security contributions	136.8	143.0	140.4					138.6	141.3	146.0	152.1	158.0	164.1
Other	31.8	32.2	32.7					27.8	28.7	31.4	33.6	34.8	36.1
Capital	4.9	2.3	-0.8					4.7	5.0	5.2	5.4	6.2	6.4
Primary expenditure	395.8	429.7	463.8	451.0	433.4	439.9	451.1	450.9	433.6	442.3	452.3	460.1	471.0
Current	338.6	371.5	401.3					399.4	391.1	395.9	404.4	411.2	420.3
Wages and salaries	107.8	117.6	124.3	122.6	118.9	117.3	115.1	122.6	118.9	117.3	115.1	119.2	123.6
Goods and services	55.4	59.8	61.1	61.4	60.7	59.6	59.8	61.4	60.7	59.6	59.8	61.9	64.2
Social transfers	148.4	163.6	183.5	192.2	193.9	198.8	205.5	192.7	194.1	201.2	206.7	208.5	211.6
Subsidies	11.3	11.7	11.6	7.5	6.3	6.3	6.8	7.5	6.3	6.3	6.8	6.5	6.8
Other 2/	15.7	18.7	20.9	26.6	22.0	22.7	27.6	15.3	11.1	11.5	16.0	15.0	14.0
Capital	57.2	58.2	62.5					51.5	42.5	46.4	47.9	48.9	50.7
Gross fixed capital formation	42.6	41.6	46.0	40.7	31.6	35.2	36.3	40.7	31.6	35.2	36.3	37.6	39.0
Capital transfers and other	14.6	16.6	16.5					10.8	10.9	11.2	11.6	11.3	11.7
Primary balance	37.0	-27.0	-98.8	-74.9	-37.0	-17.0	1.9	-74.9	-46.0	-38.2	-28.5	-18.3	-11.2
Interest	16.9	17.2	18.9	23.0	27.7	32.7	36.9	23.0	27.8	33.7	38.2	43.2	47.8
Overall balance	20.1	-44.3	-117.6	-97.9	-64.7	-49.7	-35.0	-97.9	-73.9	-71.9	-66.8	-61.5	-59.0
(Percent of GDP)													
Revenue	41.1	37.0	34.7	35.8	36.8	37.5	38.3	35.9	36.6	37.1	37.7	37.9	38.1
Current	40.6	36.8	34.8					35.4	36.1	36.6	37.2	37.4	37.5
Indirect taxes	11.7	9.9	8.7					9.6	10.0	10.1	10.2	10.2	10.2
Direct taxes	12.9	10.8	9.6					10.0	10.1	10.3	10.5	10.7	10.8
Personal (PIT)	7.7	7.4	6.9					7.2	7.3	7.4	7.5	7.5	7.6
Corporate (CIT)	5.2	3.4	2.7					2.7	2.8	2.9	3.0	3.1	3.2
Social security contributions	13.0	13.1	13.4					13.2	13.3	13.4	13.5	13.6	13.6
Other	3.0	3.0	3.1					2.7	2.7	2.9	3.0	3.0	3.0
Capital	0.5	0.2	-0.1					0.4	0.5	0.5	0.5	0.5	0.5
Primary expenditure	37.6	39.5	44.1	42.9	40.2	39.0	38.1	43.0	41.0	40.6	40.2	39.5	39.0
Current	32.2	34.1	38.2					38.1	36.9	36.4	36.0	35.3	34.8
Wages and salaries	10.2	10.8	11.8	11.7	11.0	10.4	9.7	11.7	11.2	10.8	10.2	10.2	10.2
Goods and services	5.3	5.5	5.8	5.8	5.6	5.3	5.1	5.9	5.7	5.5	5.3	5.3	5.3
Social transfers	14.1	15.0	17.5	18.3	18.0	17.6	17.4	18.4	18.3	18.5	18.4	17.9	17.5
Subsidies	1.1	1.1	1.1	0.7	0.6	0.6	0.6	0.7	0.6	0.6	0.6	0.6	0.6
Other 2/	1.5	1.7	2.0	2.5	2.0	2.0	2.3	1.5	1.0	1.1	1.4	1.3	1.2
Capital	5.4	5.3	5.9					4.9	4.0	4.3	4.3	4.2	4.2
Gross fixed capital formation	4.0	3.8	4.4	3.9	2.9	3.1	3.1	3.9	3.0	3.2	3.2	3.2	3.2
Capital transfers and other	1.4	1.5	1.6					1.0	1.0	1.0	1.0	1.0	1.0
Primary balance	3.5	-2.5	-9.4	-7.1	-3.4	-1.5	0.2	-7.1	-4.3	-3.5	-2.5	-1.6	-0.9
Interest	1.6	1.6	1.8	2.2	2.6	2.9	3.1	2.2	2.6	3.1	3.4	3.7	4.0
Overall balance	1.9	-4.1	-11.2	-9.3	-6.0	-4.4	-3.0	-9.3	-7.0	-6.6	-5.9	-5.3	-4.9
Central government	1.1	-2.8	-9.4	-5.9	-2.3	-3.2	-2.1	-5.9	-2.0	-3.2	-3.2	-2.9	-2.8
Territorial government	-0.5	-2.0	-2.5	-3.7	-4.1	-1.6	-1.3	-3.7	-5.2	-3.6	-3.0	-2.6	-2.3
Autonomous Communities	-0.2	-1.6	-2.0	-3.1	-3.3	-1.3	-1.1	-3.1	-4.2	-3.1	-2.6	-2.4	-2.2
Local Corporations	-0.3	-0.5	-0.5	-0.6	-0.8	-0.3	-0.2	-0.6	-1.0	-0.5	-0.4	-0.2	-0.1
Social Security	1.3	0.8	0.8	0.2	0.4	0.4	0.4	0.2	0.2	0.2	0.2	0.2	0.2
Government debt	36.1	39.7	53.2	63.5	68.5	70.4	70.5	63.7	70.6	75.8	79.8	82.3	84.3
<i>Memorandum items:</i>													
Structural balance	-1.1	-4.8	-9.3	...	...	...	...	-7.8	-5.6	-5.7	-5.4	-5.1	-4.9
Impulse (+ stimulus)	-0.1	3.7	4.5	...	...	...	...	-1.5	-2.3	0.1	-0.2	-0.3	-0.2
Public consumption (percent of GDP)	18.4	19.4	21.1	21.3	20.5	19.6	18.7	21.4	20.9	20.3	19.7	19.5	19.4
Public consumption growth (percent)	9.0	9.1	5.2	0.9	-1.3	-0.1	0.1	0.9	-1.3	-0.1	0.1	2.7	3.2
Real GDP growth	3.6	0.9	-3.6	-0.3	1.3	2.6	2.8	-0.4	0.6	1.7	1.9	1.9	1.8
Nominal GDP	1052.7	1088.5	1051.2	1051.1	1078.6	1127.7	1182.5	1047.6	1058.7	1088.8	1124.5	1164.7	1208.0
Output gap	3.9	2.3	-2.7	...	...	...	...	-3.5	-3.2	-2.1	-1.1	-0.4	0.0
Real primary current expenditure (increase)	5.2	7.0	7.8	...	...	...	...	-0.6	-2.6	0.1	0.7	0.1	0.4

Sources: *Cuentas Financieras*, IGAE; Bank of Spain; and IMF staff projections.

1/ Staff estimates.

2/ SGP figures for other current expenditure includes capital transfers and other.

Table 5. Spain: Balance of Payments

	2007	2008	2009	Projections					
				2010	2011	2012	2013	2014	2015
	(Billions of euros)								
Current Account	-105.3	-106.0	-57.2	-51.5	-45.2	-42.0	-40.2	-40.6	-42.1
Trade Balance of goods and services	-68.1	-60.6	-19.3	-13.3	-6.1	-1.2	2.5	4.2	5.0
Exports of goods and services	286.0	290.2	248.6	270.4	286.7	304.6	324.4	346.4	371.3
Exports of goods	192.7	192.7	160.5	177.0	188.0	199.9	213.0	227.5	243.9
Exports of services	93.3	97.4	88.1	93.5	98.7	104.7	111.4	118.9	127.4
Imports of goods and services	-354.1	-350.8	-267.9	-283.8	-292.8	-305.8	-322.0	-342.1	-366.3
Imports of goods	-283.8	-279.5	-205.5	-220.8	-228.7	-239.0	-251.7	-267.6	-286.5
Imports of services	-70.3	-71.3	-62.4	-62.9	-64.1	-66.8	-70.2	-74.6	-79.8
Balance of factor income	-30.1	-36.0	-29.8	-30.3	-31.1	-32.5	-34.2	-36.0	-37.9
Balance of current transfers	-7.1	-9.4	-8.0	-7.9	-8.0	-8.3	-8.5	-8.8	-9.2
Capital Account	4.6	5.5	4.1	4.1	4.1	4.2	4.4	4.5	4.7
Financial Account	100.7	100.5	53.1	47.5	41.1	37.7	35.9	36.1	37.4
Foreign Direct Investment	-53.2	-1.1	-0.9	14.7	8.5	7.6	5.6	5.8	6.0
Portfolio Investment	89.9	0.0	50.4	45.3	42.8	31.9	27.4	27.6	28.6
Other Investment	64.4	103.7	9.7	-12.5	-10.2	-1.8	2.8	2.6	2.7
Reserves In(+)/Outflows(-)	-0.2	-0.6	-1.6	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omissions	-0.3	-1.5	-4.5	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent of GDP)								
Current Account	-10.0	-9.7	-5.4	-4.9	-4.3	-3.9	-3.6	-3.5	-3.5
Trade Balance of goods and services	-6.5	-5.6	-1.8	-1.3	-0.6	-0.1	0.2	0.4	0.4
Exports of goods and services	27.2	26.7	23.6	25.8	27.1	28.0	28.9	29.7	30.7
Exports of goods	18.3	17.7	15.3	16.9	17.8	18.4	18.9	19.5	20.2
Exports of services	8.9	9.0	8.4	8.9	9.3	9.6	9.9	10.2	10.5
Imports of goods and services	-33.6	-32.2	-25.5	-27.1	-27.7	-28.1	-28.6	-29.4	-30.3
Imports of goods	-27.0	-25.7	-19.6	-21.1	-21.6	-21.9	-22.4	-23.0	-23.7
Imports of services	-6.7	-6.5	-5.9	-6.0	-6.1	-6.1	-6.2	-6.4	-6.6
Balance of factor income	-2.9	-3.3	-2.8	-2.9	-2.9	-3.0	-3.0	-3.1	-3.1
Balance of current transfers	-0.7	-0.9	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Capital Account	0.4	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Financial Account	9.6	9.2	5.1	4.5	3.9	3.5	3.2	3.1	3.1
Foreign Direct Investment	-5.1	-0.1	-0.1	1.4	0.8	0.7	0.5	0.5	0.5
Portfolio Investment	8.5	0.0	4.8	4.3	4.0	2.9	2.4	2.4	2.4
Other Investment	6.1	9.5	0.9	-1.2	-1.0	-0.2	0.3	0.2	0.2
Reserves In(+)/Outflows(-)	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omissions	0.0	-0.1	-0.4	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Bank of Spain; and IMF staff projections.

Table 6. Spain: International Investment Position, 2003–09

	2003	2004	2005	2006	2007	2008	2009
	(Billions of euros)						
International Investment Position	-354.3	-436.4	-505.5	-648.2	-816.8	-881.3	-983.4
Direct Investment	-93.9	-91.9	-67.1	-19.3	1.6	-19.3	-17.1
Assets	175.0	207.2	258.9	331.1	398.9	428.5	448.4
Liabilities	268.9	299.1	326.0	350.4	397.3	447.8	465.5
Portfolio Investment	-102.3	-203.2	-273.6	-508.9	-646.7	-603.1	-683.8
Assets	319.8	359.3	454.7	455.7	440.2	355.5	385.4
Liabilities	422.0	562.5	728.4	964.6	1086.9	958.6	1069.2
Financial Derivatives	0.0	0.0	0.0	-9.6	-18.8	-6.4	-1.0
Other Investment	-214.2	-209.4	-236.5	-206.1	-231.8	-303.4	-325.7
Assets	204.0	222.2	268.2	324.9	379.5	386.5	369.8
Liabilities	418.1	431.6	504.7	530.9	611.3	690.0	695.5
Bank of Spain	56.1	68.1	71.7	95.7	78.9	50.9	44.1
o/w Reserve Assets	21.2	14.5	14.6	14.7	12.9	14.5	19.6
	(Percent of GDP)						
International Investment Position	-45.2	-51.9	-55.6	-65.9	-77.6	-81.0	-93.6
Direct Investment	-12.0	-10.9	-7.4	-2.0	0.2	-1.8	-1.6
Assets	22.4	24.6	28.5	33.6	37.9	39.4	42.7
Liabilities	34.3	35.6	35.9	35.6	37.7	41.1	44.3
Portfolio Investment	-13.1	-24.2	-30.1	-51.7	-61.4	-55.4	-65.1
Assets	40.8	42.7	50.0	46.3	41.8	32.7	36.7
Liabilities	53.9	66.9	80.1	98.0	103.2	88.1	101.7
Financial Derivatives	0.0	0.0	0.0	-1.0	-1.8	-0.6	-0.1
Other Investment	-27.4	-24.9	-26.0	-20.9	-22.0	-27.9	-31.0
Assets	26.1	26.4	29.5	33.0	36.0	35.5	35.2
Liabilities	53.4	51.3	55.5	53.9	58.1	63.4	66.2
Bank of Spain	7.2	8.1	7.9	9.7	7.5	4.7	4.2
o/w Reserve Assets	2.7	1.7	1.6	1.5	1.2	1.3	1.9
Memorandum Item:							
Nominal GDP (Euro billions)	782.9	841.0	908.8	984.3	1052.7	1088.5	1051.2

Source: Bank of Spain.

Table 7. Spain: Public Sector Balance Sheet
(Percent of GDP, otherwise indicated)

	2000	2005	2006	2007	2008	2009	2010
Financial assets	27	26	28	29	31	35	35
Currency and deposits	9	8	9	10	9	11	11
Securities other than shares	0	3	4	5	7	7	7
Loans	4	4	4	4	4	4	4
Shares and other equity	9	8	8	8	8	9	9
Other accounts receivable	4	3	3	3	3	3	3
Financial liabilities	71	57	52	48	54	70	79
Currency and deposits	0	0	0	0	0	0	0
Securities other than shares	53	42	37	33	38	52	62
Loans	12	9	8	8	8	10	10
Other accounts payable	6	5	6	7	7	8	8
Financial Net worth	-44	-30	-24	-19	-23	-35	-44
Nonfinancial fixed assets (net)	48	48	48	48	48	48	48
Current net worth	4	18	24	29	25	13	4
NPV of future primary balances 1/	-12	-43	-49	-68	-160	-174	-194
Intertemporal net worth	-8	-25	-25	-39	-135	-160	-190
Intertemporal financial net worth 2/	-56	-73	-73	-87	-183	-208	-238
<i>Memorandum items:</i>							
Government debt	59	43	40	36	40	53	64
Nominal GDP	630	909	984	1053	1089	1051	1048

Sources: Bank of Spain; and IMF staff estimates.

1/ Net present value of 50-year future primary balance projections in the baseline scenario of unchanged policies. The discount rate is equal to the average interest rate on the public debt.

2/ Excludes fixed assets as these may not be marketable.

ATTACHMENT I. SPAIN'S PRIVATE SECTOR BALANCE SHEETS¹

A. Introduction

1. **The deleveraging of the non-financial private sector poses significant risks for the economic outlook.** Household and corporate indebtedness reached about 210 percent of GDP, significantly higher than the euro area average of 160 percent and a two-fold increase since the inception of the EMU. This dynamic was to a large extent driven by excessive housing investment and the associated expansion in the construction and real-estate sectors. An abrupt adjustment has taken place, with households dramatically adjusting their savings and companies sharply reducing their net borrowing. However, the correction of these imbalances to more sustainable levels has further to go and the necessary deleveraging constitutes a source of vulnerability for the macro-economic outlook.

B. Households

2. **Spanish households have become heavily indebted, in particular to finance house purchases.** The pace of the increase in indebtedness was one of the fastest in the EU. From a lower than average debt to gross disposable income ratio compared to the euro area at the beginning of the decade (of close to 60 percent), Spanish households become some of the most indebted (at over 125 percent in 2009). The growing financing need, even in the context of fast income growth during the boom years, stemmed from the rapid expansion in household residential investment, coupled with a relatively low savings rate. More than three quarters of the increase in liabilities was used to finance mortgage purchases, the overwhelming majority of which are floating rate. This has been linked to various factors, among which tax incentives and the high propensity of Spanish households to invest in real-estate, reflected by the high rate of owner-occupied residences (at 86 percent, the highest in the euro area). Variable-rate loans represent over 90 percent of mortgages - compared to an average of 44 percent in the euro area² - which is indicative of the vulnerability of households to monetary tightening and risk-premia shocks. Due to increased indebtedness and the monetary policy cycle, the interest burden has more than doubled from the start of the decade, to over 7.5 percent of gross disposable income in 2008, before falling back to around 6.2 percent in 2009.

¹ Prepared by Adina Popescu (EUR), with contributions from Nikki Sodsriwiboon (MCM). Comments from Dale Gray (MCM), Roberto Blanco and Juan Ayuso (both Bank of Spain) gratefully acknowledged.

² ECB (2009): *Housing finance in the euro area*, by Task Force of the Monetary Policy Committee of the European System of Central Banks, March 2009.

3. **While a number of factors mitigate the vulnerabilities arising from high indebtedness, risks are high and skewed towards the poorer households.** About 75 percent of the debt of Spanish households consists of housing, the majority of which are primary residences, implying lower default risks than for consumer credit. In addition, residential mortgages in Spain have been predominantly of the traditional type, while riskier products, such as home equity loans and buy-to-let mortgages have been negligible. The share of mortgages with a loan-to-value ratio exceeding 80 percent has been limited - Spain has largely avoided the problems stemming from “subprime” mortgages. While debt service has increased over time (until declining recently), it has so far remained on average manageable, with principal plus interest payments currently totaling about 18 percent of gross disposable income. However, the distribution of household debt, income and wealth is quite skewed. Households in the lower percentiles of the income distribution are significantly more indebted than in other large economies with highly leveraged households³ (such as the UK and the US). While the indebtedness ratio increased by 30 percent between 2002 and 2005 for the median indebted household, the figures are greater for low income and medium-high income group – at around 40 and 50 percent respectively. For the poorest indebted households, debt payment increased from 30 percent of gross disposable income in 2002 to 38 percent in 2005 and for about a quarter of these households, debt to gross household wealth exceeds 75 percent. However, relatively few low income households have debt (19 percent in Spain, compared with 53 percent in the US⁴) and households have used borrowing largely to purchase housing, implying a reduction in rent payments. Even taken into account these factors, the financial burden ratio of low income households is high and likely to have increased compared to the latest available survey from 2005. Taking also into account the adverse macroeconomic developments, such as the high unemployment and the tightening of financial conditions, imply that low income households may come under considerable financial strain.

4. **While the asset side of the balance sheet is dominated by non-financial assets (housing), net financial worth has been declining until recently.** Even with the recent decline in real-estate prices, at around 800 percent of disposable income, the housing wealth of Spanish households is the highest among the large OECD countries. On the other hand, financial assets expanded at a lower rate than liabilities prior to the crisis. Household financial net worth declined from close to 200 percent of gross disposable income in 2000 to about 110 percent at the end of 2009, which is lower than the euro area average of around 190 percent. The relatively low level of financial assets of Spanish households is also a

³ Bank of Spain (2005): *Survey of Household Finances (EFF): description, methods, and preliminary results*, Economic Bulletin, January and Bank of Spain (2008): *Survey of Household Finances (EFF) 2005: methods, results and changes between 2002 and 2005*, Economic Bulletin, January.

⁴ Figures refer to 2005 for Spain and 2004 in for the US. Sources: Spanish Survey on Household Finances (EFF) and US Survey of Consumer Finances (SCF).

source of vulnerability, since it reduces the amount that can be used to pay off debt in the event of adverse shocks. The financial asset allocations of Spanish households are broadly similar to other European countries, dominated by deposits and equity (including mutual funds) – each about 100 percent of gross disposable income - and investments in insurance and technical reserves – at about 35 percent of gross disposable income (partly linked to the fact that life insurance is required by credit institutions for house purchase loans). Large valuation swings have affected both financial and the non-financial assets, partly as a correction the overvaluations from the boom years.

5. **Significant adjustment in household balance sheets is taking place.** Gross disposable income, which grew faster than the euro area average until the crisis – at 7 percent per annum compared to less than 4 percent – decelerated sharply after the second half of 2008, including a quarter of outright contraction in 2009:Q3 (and 1 percent increase for the year). This dynamic has been driven by a sharp fall in the two main sources of income: employee compensation and proprietors’ income, with automatic stabilizers - the increase in net social transfers received and declining income taxes –only partly mitigating these effects. The shock to current incomes, wealth losses on financial and non-financial assets, coupled with the increased uncertainty, in particular regarding labor market prospects, have led to a dramatic increase in the savings rate. From 11 percent on average over the last decade (compared to 14 percent for the euro area as a whole), the savings rate spiked to 18.8 percent in 2009 – the largest increase in the EU. As a consequence, from a net borrower position of 3.8 percent of gross disposable income just before the crisis, households’ reverted to being net lenders to the economy - to the extent of 10.3 percent of disposable income in 2009. During the crisis, the composition of household financial assets has shifted towards less risky and more liquid instruments, in particular deposits, as well as recent increases in mutual funds and insurance technical reserves, while there has been a reduction in liabilities by somewhat less than 1 percent in 2009. However, while the debt-to-income ratio has declined to 125 percent in 2009, the debt-to-GDP ratio has continued to increase (to 86 percent at the end of 2009), as overall economic activity displayed a stronger cyclical decline than household income.

6. **Going forward, maintaining a high savings rate is critical to reducing household debt ratios to more sustainable levels.** According to staff’s baseline projections, given continued high uncertainty, which increases the precautionary behavior of households, the savings rate is likely to remain elevated for the medium-term, gradually declining to a level close to the euro area average (14-15 percent). As housing investment continues to contract in 2010-11, households’ net lending capacity remains substantial, though gradually declining. Households will use this additional financial capacity partly to build financial assets and partly to reduce debt. In particular, the composition of household portfolios would shift towards more liquid and safer investments (e.g. currency, deposits, government securities and insurance technical reserves). New credit to households would remain negative in 2010 as lending conditions continue to be tighter than in the euro area and would revert to positive

territory afterwards, however at weak growth rates. Households' net financial assets would improve and debt ratios gradually decline, as growth recovers. However, this scenario is subject to risks. On the upside, a faster recovery and increased confidence would lead to a lower savings rate. Under the scenario in which households revert to their pre-crisis savings rate of around 11 percent, the debt ratios would likely continue to increase (though this could be compensated by households allocating more of their available resources to debt reduction). Under a more adverse macroeconomic scenario, which may include financial market shocks, financial asset price declines and a sharper adjustment of the property market, the savings rate would remain even higher and deleveraging could be significantly more abrupt.

C. Non-financial Corporations

7. **Corporate leverage and indebtedness grew fast, especially in the construction and real-estate sectors.** The total corporate debt in 2009 at about 125 percent of GDP and over 700 percent of gross operating surplus was among the highest in the euro area. While indebtedness increased in all sectors, it was most excessive in the construction and real-estate sectors, due to their inherent high credit intensity - for example, the debt to gross operating profit was over 1800 percent in this sector in 2008. The pre-crisis increase in net borrowing was mainly financed by loans and to a lesser extent by issuing new stock, while bond finance has remained limited. Bank corporate credit amounted to about 90 percent of GDP in 2009 for the entire economy, out of which approximately half was concentrated in construction and real-estate (compared to the average for Germany, France, Italy and UK of 42 and respectively 15 percent⁵). The debt service burden of non-financial corporations also increased prior to the crisis, to almost 30 percent of income in 2008, but has moderated significantly afterwards. Construction and real estate face higher debt repayments than the rest of the economy – a ratio of interest to gross operation profit of 69 percent in 2008, which is about double than for the other sectors. Leverage ratios such as debt to equity and debt to assets percent have also been among the highest in the euro area, both on aggregate and in most sectors. During the current crisis, the total corporate debt to equity ratio peaked at over 100 percent in 2009 and the debt to asset ratio at over 70 percent – 10 percent higher than in the euro area in both cases. As debt increased much faster than financial assets, the (negative) net financial worth of the corporate sector gradually deteriorated, to about 150 percent of GDP at the end of 2009, from about 100 percent at the start of the decade - also the current euro area average.

8. **High leverage was used to finance an investment boom.** Spain's average investment rate over the last decade of 32 percent of gross value added exceeded by about 10 percentage points that of the euro area. At the peak in 2007, the Spanish investment rate reached a level above 30 percent of GDP, roughly equally split between equipment and construction. In particular, given the strong and growing contribution of residential

⁵ BBVA (2010): *The Adjustments of the Spanish Economy: Risks and Strengths*, May 19.

construction to Spain's economic activity during the last decade, housing investment accounted at the maximum for 9½ percent of GDP. Abstracting from the dynamics of the real-estate and construction sectors, the high investment rates were likely part of a normal process of catching up with the more capital intensive core European economies. A result has been the emergence of clusters of diversified and strong companies, in particular the export-oriented, technology intensive sectors (IT, aeronautics, energy, chemicals). The profitability of large listed corporations, as measured by accounting ratios (such as the return on equity and on assets) has been quite high by euro area standards.

9. **The corporate sector has started adjusting sharply.** Following almost a decade of high economic growth – aggregate net value added average growth rate of 7 percent, 3 percent higher than the euro - productive activity contracted severely in 2009, by close to 9 percent, compared to only around 4 percent in the euro area. As revenue fell, both employee compensation (the main expense) and net entrepreneurial income (akin to pre-tax profits in business accounting) declined significantly, while property income receivable (which includes dividends and retained earnings from foreign investment) had some mitigating effect. The collapse in the investment growth rate has also been much sharper than in the rest of the euro area, mostly driven by residential investment which has halved to about 4 percent of GDP, while equipment investment has declined towards its historical average of around 10 percent of GDP. While in the boom years, the net borrowing of the Spanish corporate sector deteriorated sharply to over 30 percent of net value added right before the crisis (11 percent of GDP), it has sharply adjusted during the recession to 6 percent of net value added (2.2 percent of GDP). Credit to corporations contracted sharply. Loans to non-financial corporations, which were rising at annual rates of up to 30 percent by 2007, declined abruptly, causing a reduction in the debt stock in the second half of 2009 (by close to 3 percent). In order to mitigate the scarcity of bank and market funding, companies drew down on their relatively large stocks of liquid assets (cash and deposits) accumulated during the boom years.

10. **Corporate vulnerability has increased economy-wide, while being particularly high in the construction and real estate sectors.** Using a contingent claim approach (CCA) analysis⁶, the risk of corporate defaults for all listed corporations has increased substantially during the crisis economy-wide, but remains lower than in other Western European countries. Based on theoretical BSM⁷ default probabilities, in a cross-country comparison, Spain ranked slightly above the euro area in 2008. On the other hand, using Moody's KMV, the default risk of Spanish listed corporations are relatively low compared to their Western European

⁶ The data come from the IMF Corporate Vulnerability Utility, based Gapen, M., Gray, D. F., Lim, C. H. and Xiao, Y. (2005): *Measuring and Analyzing Sovereign Risk with Contingent Claims*, IMF Working Paper Vol., pp. 1-50, August and Moody's KMV provided by Creditedge. Many thanks to Kalin Tintchev (MCM) for help with this data.

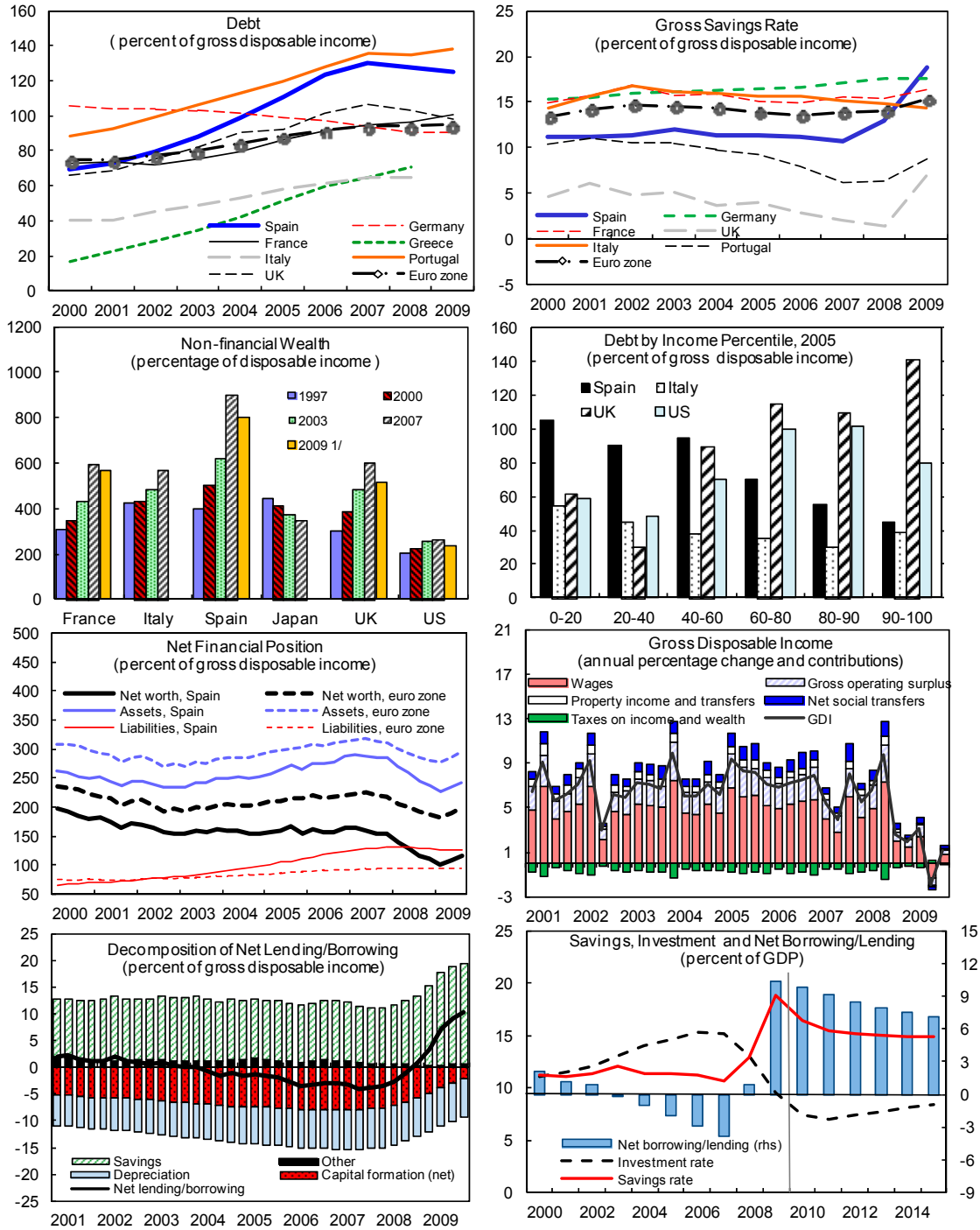
⁷ The BSM (Black-Sholes-Merton) expected default probabilities and distance to default measures are derived under the risk-neutrality assumption and generally overstate the actual probability of default. Moody's KMV approach is based on mapping risk-neutral expected default frequencies (EDFs) into "actual" EDFs – i.e. based on historical default and bankruptcy frequencies of Spanish corporations.

peers. Financial distress has been most acute in the construction and real-estate sectors. The average one year-ahead BSM default risk in the construction sector has exceeded 50 percent in 2008, surpassing the over 30 percent implied default probability in the financial, insurance and real-estate sector. Moody's KMV data also show above average expected default probabilities for the construction, real-estate development, tourism and consumer non-durables sectors. Actual corporate defaults have also increased: the number of insolvencies in the real estate sector in 2009 was about 9.5 times that registered in 2005, compared with 4.3 times in the non-real estate-related corporate sector⁸.

11. **Going forward, corporate deleveraging to more sustainable levels will require difficult trade-offs.** Under staff's baseline scenario for the medium-term, in an environment with sluggish growth, weak corporate income and mounting financial debt expenses, the corporate sector as a whole would face significant trade-offs between expanding activity and rebalancing its financial structure. Deleveraging will continue, in particular in the construction and real-estate sectors, which will substantially shrink their balance sheets, as their contribution to economic growth going forward is going to be modest. The corporate debt to GDP ratio and other measures of leverage would gradually decline, as the sharp improvement in corporate net borrowing continues and growth starts to gain traction. However, this scenario is subject to risks. On the positive side, higher demand may boost activity faster, as there is substantial spare capacity, the construction and real-estate sectors have significantly deleveraged and a weak euro is boosting international competitiveness. On the downside, risk-premia shocks may increase the interest burden and may constrain the supply of credit. Under this scenario, firms will be forced to deleverage faster, restructure their debts and shed assets, while investment would remain very weak in the medium term.

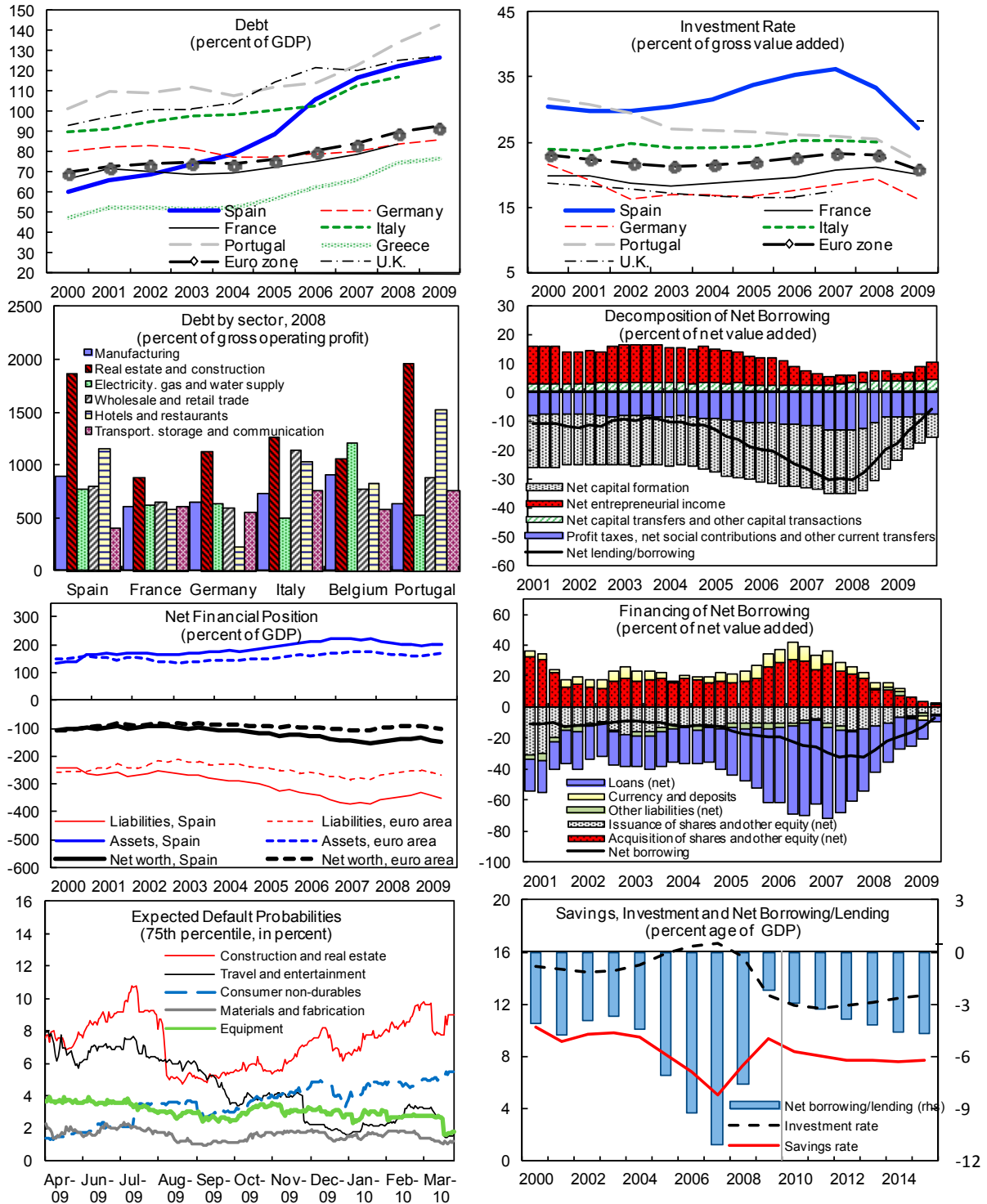
⁸ Standard & Poor's (2010): *Banking Industry Country Risk Assessment: Spain*, RatingsDirect on the Global Credit Portal, March 15.

Figure 1. Evolutions in households' balance sheets



Sources: Eurostat; Bank of Spain; OECD; and IMF staff projections.
 1/ Data refer to 2008 for France, UK and the US.

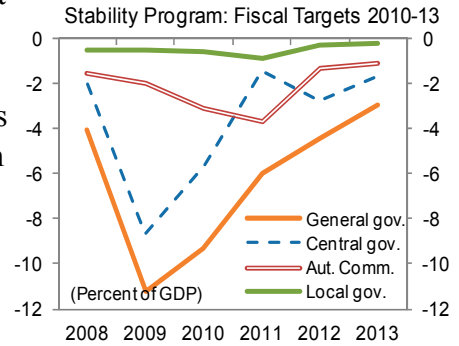
Figure 2. Evolutions in non-financial corporations' balance sheets



Sources: Eurostat; BACH; Moody's KMV; and IMF staff projections.

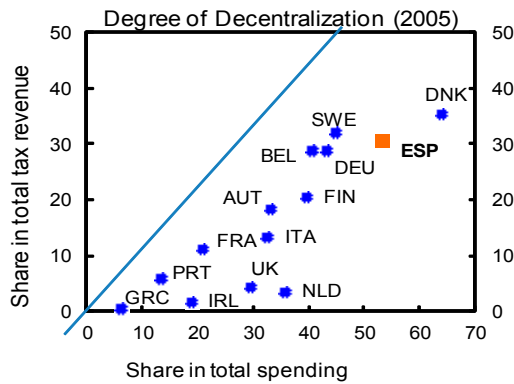
ATTACHMENT II. FISCAL CONSOLIDATION AND FISCAL FEDERALISM IN SPAIN¹

1. **The government aims to achieve a 3 percent of GDP budget deficit in 2013.** With the general government deficit amounting to 11.2 percent of GDP in 2009, the required fiscal adjustment is substantial. In the context of Spain’s high degree of decentralization, achieving the envisaged consolidation is particularly challenging as it requires strong coordination among the different levels of governments. In fact, beyond 2011, the lion’s share of consolidation is expected at the level of subnational governments, the Autonomous Communities (ACs) and the Local governments (LGs).

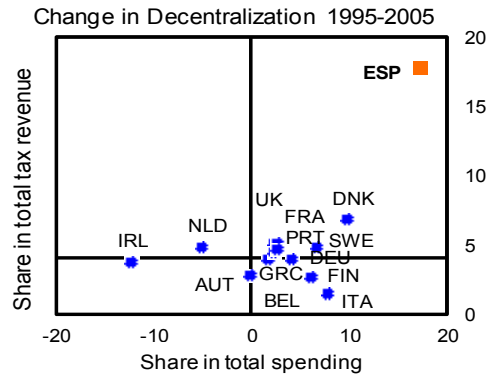


Background

2. **Over the last 30 years Spain has become one of the most decentralized industrialized countries.**² Subnational government spending increased significantly over the period 1979-2005, accounting for about a half of total public spending in 2008 and nearly 80 percent of public consumption. The number of employees has also increased from 6 percent of public sector employment in 1983 to 54 percent in 2009. In particular, employment at the ACs surged following the full devolution of health expenditure in 2002. The ACs are primarily responsible for education and healthcare, while local governments are responsible for other services including water and sewerage, waste management, parks, and street lighting.



Sources: OECD and Eurostat.

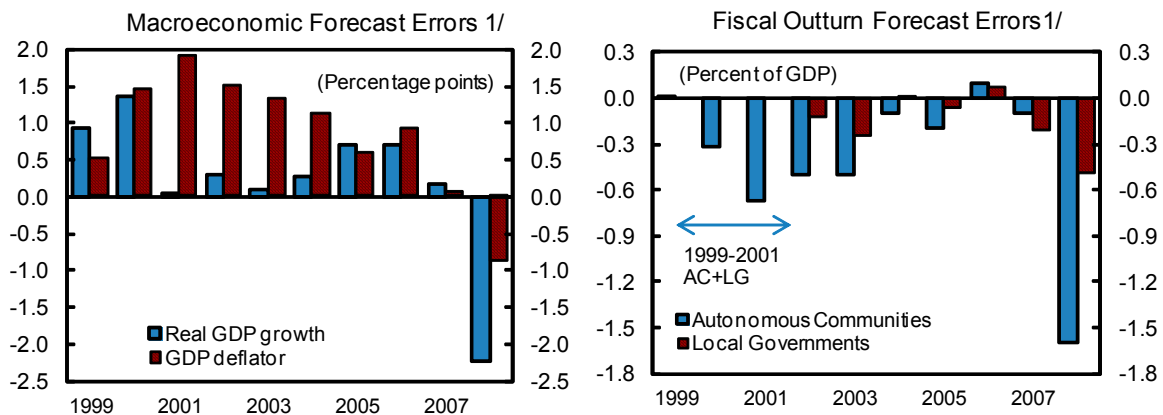


Sources: OECD and Eurostat.

¹ Prepared by Keiko Honjo.

² The current structure of general government includes the central government (incl. social security), 17 Autonomous Communities (ACs, regional governments) at the intermediate level, and the local levels of government (50 provinces and 8,112 municipalities, including 2 Autonomous Cities). While the ACs have some regulatory powers over the local governments, the fiscal structure is not hierarchical—the central government deals directly with the intermediate and local level of governments.

3. **Significant decentralization has been accompanied by fiscal consolidation, though the subnational governments have consistently underperformed.** Until 2008 Spain enjoyed favorable surprises in macroeconomic assumptions. During 1999-2007, real GDP growth exceeded the budget forecast by about ½ percentage point on average. Despite the favorable surprises, the general government fiscal outturn was only slightly better than budgeted, by 0.1 percent of GDP on average. The key contributing factor was the underperformance by the subnational governments, especially the ACs whose fiscal outturn was on average 0.3 percent of GDP weaker than budgeted. In part this reflected a widening gap between their spending responsibilities, especially on healthcare, and revenue raising powers. With the global financial crisis, the extent of the subnational underperformance widened to about 2 percent of GDP in 2009.



1/ Positive value indicates actual was greater than projected.

Financing system of the subnational governments

4. **The rapid decentralization and the associated increase in spending pressures by the ACs led to a gradual reform in the financing system.** The reform aimed at higher revenue autonomy by the ACs to secure greater efficiency and accountability. The initial funding system was predominantly on the basis of a general purposes grant, which was gradually changed to a system funded by ACs ceded taxes, revenue sharing in central government taxes, and a general equalization transfer. A new financing system approved in December 2009 under the common regime³ shifted further resources to the regions. The new financing system increased the share of ceded and shared taxes in total revenue to roughly 90 percent allowing annual adjustment to reflect any significant demographic changes. Moreover, it transferred more regulatory powers to the ACs to expand their capacity to decide on the composition and volume of their revenues.⁴ Recent changes have brought the

³ Two different financing systems coexist: the Basque Country and Navarre have almost full fiscal autonomy, while the other ACs have more limited fiscal autonomy under the “common” regime.

⁴ 75 percent of the tax revenue and about €7.4 billion of the additional resources from the state will fund the

(continued)

regions' revenue-raising powers more in line with their responsibilities. VAT and excises tax revenue are allocated across the regions on the basis of an index of consumption, while others are allocated on the basis of several indexes and criteria.

ACs Revenue Assignments under the Common Regime (2009)

	Tax	Sharing %	Admin. (AC/CG)	Discretion
Ceded taxes	Electricity tax	100	CG	No
	Inheritance and gift tax	100	AC	Tax schedule, threshold, and tax credits
	Capital transfer tax	100	AC	Tax rates and tax credits
	Tax on gambling	100	AC	Tax rates, tax base, allowances.
	Vehicles registration	100	AC	Tax rates
	Hydrocarbons retail sales	100	AC	Tax rates
Tax sharing	VAT	50	CG	No
	Excise taxes	58	CG	No
	PIT 1/	50	CG	Tax schedule, tax credits

Source: Ministry of Economy and Finance.

1/ ACs can set the rate schedule provided the schedule is progressive. Currently, 4 ACs have applied a different rate schedule.

Local governments enjoy a higher level of autonomy in setting tax rates or credits, funding roughly 60 percent of their revenue on municipal taxes, and user fees and charges, and the remainder in transfers/grants. However, the assessment of property values for the property tax, the main tax, is managed by the central government.

Local Governments: Tax Assignments

	Tax	Admin.	Discretion
Owned tax	Vehicle tax	LG	Tax rates and tax credits
	Property tax	LG	Tax rates and tax credits
	Economic activities tax	LG	Tax rates and tax credits
	Tax on constructions, installations and works	LG	Tax rates and tax credits
	Tax on capital gains in urban areas	LG	Tax rates and tax credits

Source: Ministry of Economy and Finance.

Fiscal Rule

5. **In the context of EU membership, to ensure meeting the Maastricht criteria a stronger level of coordination in fiscal policy became necessary among all levels of governments.** The Budget Stability Law was approved in 2001, which has provided the means to distribute the general government deficit target between different levels of

Fund to Guarantee Public Services or Guarantee Fund (GF) which will be shared among ACs according to adjusted population. Each ACs will retain the remaining 25 percent of the tax revenue. The GF ensures that ACs meet their funding needs with the resources assigned under the new model. ACs will also receive funds from the two Regional Convergence Funds. The Competitive Fund aims at reinforcing fairness and efficiency in funding needs and the Cooperation Fund seeks to harmonize regional development by fostering the convergence of per capita income between regions. The new funding system will be fully in place in 2011.

government. The law was amended in 2006 to deal with procyclical nature of the rule and was revised to target a fiscal balance *over the cycle* for the general government, excluding the social security system. To avoid the complexities of defining the cyclical position, the law establishes targets depending on the real growth rate: a fiscal balance for normal growth between 2 and 3 percent, a small deficit for low growth; and a surplus (of underdetermined size) for high growth. For the social security system, it envisages a separate target, set to ensure its financial sustainability. Targets for each region are determined by bilateral negotiations; in the event of non-compliance, a 3-year financial recovery plan needs to be submitted and approved by the Fiscal and Financial Policy Council (CPFF)⁵. In case of non-compliance, authorization from the central government is required to obtain credit operations abroad or issue public debt. To further strengthen the control of the regions, additional conditions were introduced to obtain debt authorization and increase transparency by providing the information in a more timely manner.

Real GDP growth	Level of Gov.	Target	Capital exp. 1/	Fiscal Balance
Low growth < 2 percent	Total	-1.00	0.50	-1.50
	Central	0.20	0.20	0.40
	Regional	-0.75	0.25	-1.00
	Local	-0.05	0.05	-0.10
Normal growth 2 < growth < 3	Total Balance	0.50	-0.50	
	Central Balance	0.20	-0.20	
	Regional Balance	0.25	-0.25	
	Local Balance	0.05	-0.05	
High growth > 3 percent	Total Surplus	0.50	Surplus-0.5	
	Central Surplus	0.20	Surplus-0.2	
	Regional Surplus	0.25	Surplus-0.25	
	Local Surplus	0.05	Surplus-0.05	

1/ excluded from the target.

Challenges ahead

6. The current system of fiscal federalism will likely face some challenges in delivering the needed fiscal consolidation.

- *Mismatch between revenue and spending growth outlook:* the new financing scheme has increased the subnational share of the tax revenue, but the revenue outlook is particularly uncertain, reflecting a significant erosion in the tax base (housing market) and higher unemployment. In contrast, ACs expenditure is basically structural (health and education), which has rapidly increased in recent years and pressure may continue to arise from aging, especially on healthcare.
- *Optimistic projections:* In staff's view, the macroeconomic projections underpinning the government's medium-term fiscal consolidation plans may prove optimistic, especially in outer years when the subnational governments are expected to play a larger role in the consolidation. The recovery in the two main taxes, PIT and VAT, may only pick up slowly, reflecting permanent erosion in the tax base. Transfers and grants from the State, linked to the state's revenue, are also projected to fall.

⁵ The CPFF is a consultative body that links the central and regional governments, composed by the Ministries of the central government and representatives of the ACs.

- *Need for coordination:* The general government budget objectives are set by the central government, while the objectives for the subnational governments need to be coordinated in the CPFF of the Autonomous Communities and the National Commission of Local Administrations. Setting the individual objectives for each subsector in turn involves negotiation among the sectors, though the central government has half of the votes of the CPFF.

7. **Countries have adopted different approaches to ensure fiscal discipline at subnational levels** (Table 1). Common rule-based approaches focus on budget balances, debt ceilings or capacity to service debt, and expenditure ceilings. Alternatively, many countries use sanctions to foster compliance of subnational governments with rules. These include financial sanctions or administrative constraints which involve authorization of the subnational governments' borrowing operations by the central government. However, studies suggest effective implementation of these rules requires key conditions including a robust legal basis, a clear definition of institutional responsibilities, timely and transparent reporting, and credible enforcement of rules and sanctions.

Recommendations

8. **A range of measures could be considered to strengthen the compliance with, and credibility, of the subnational fiscal consolidation plans.** While longer-term issues of the fiscal federalism framework should be revisited (such as the growth rates underpinning the fiscal rule), the most pressing need is to strengthen the likelihood that subnational consolidation plans will be adhered to and are credible. A range of options might help, mainly focused on increasing the costs (both political and economic of non-compliance).

- **Introduce credible penalties/enforcement mechanisms for non-compliance:** without any penalty for not fulfilling the 3-year financial recovery plan, regions can continue to present new plans every year, postponing adjustment. This has been exacerbated by the lack of timely information on the ACs' budget execution which hindered implementing the necessary recovery plan. The recent decision to tighten the criteria for debt authorization should help but there may be additional channels for borrowing through the ownership and control of local enterprises and banks that are difficult to monitor. Withholding transfers could be an alternative option in case of non-compliance.
- **Link non-compliance with regional tax rates.** The ACs have not much used their greater regional tax autonomy. In particular, the ACs have only marginally used their discretionary powers for the personal income tax which accounts for the bulk of their own tax revenues. To enhance regional accountability, non-compliance with targets could trigger an automatic increase in regional tax rates.

- **Introduce binding multi-year spending ceilings:** At present specific constraints exist such as on personnel—the central government imposes a limit on the increases in the number of permanent employees, and sets basic salaries and their annual adjustments for civil servants. But this has been partly circumvented by hiring on temporary contracts.
- **Adopt more cautious macroeconomic projections.** More prudent macroeconomic projections minimize the risk of excessive transfer to the regions and thus for a “refund” (the difference between the projected and realized taxes) at the *settlement* after two years.⁶ This would also give more incentive for regions to use their revenue-raising powers to cover their required resources or improve efficiency. An independent fiscal council to set the projections might be helpful in this regard.
- **Change the timing of transfers and settlement** – there seems to be a case for changing the revenue sharing to be directly linked to actual revenue, rather than linking to budget projections for adjustment in two years. Alternatively, in line with the recent decision to allow repayment to the central government (negative transfer due to weaker revenue outturn than budgeted) to be distributed in 60 months, any positive transfers should be also conducted in installments, which could also prevent fiscal policy being procyclical.
- **Broadening the coverage of the existing rule** - the Golden rule could be extended to include larger municipalities.

⁶ The excess of taxes allocated to ACs in 2008 amounts to about €6 billion. Instead of fully paying back in 2010, the ACs will repay in 60 monthly payments from January 2011.

Table 1. Fiscal Rules in the Subnational Governments in Selected OECD Countries

Country	Budget balance		Debt rule			Expenditure		Sanctions		Monitoring	Enforcement		
	% Nominal GDP	Golden ceiling rule	% Nominal GDP	Debt ceiling	New service loans	Nominal growth	Nominal ceiling	Financial	Administrative				
Austria	RG/LG								Fine proportional to the shortfall.	Committee with RG, LG and CG representatives	Committee with RG, LG and CG representatives		
Belgium		LG							Limits on borrowing	Independent (High Council of Finance)	Cooperative		
Canada		RG/LG 1/							Wage cuts (some provinces)	RG, LG, and CG			
Czech republic									Propose corrective measures (possible sanctions)	Ministry of Finance	Ministry of Finance		
Estonia									Propose corrective measures (possible reduction in transfers)	Ministry of Finance	Ministry of Finance		
Finland		LG							Propose corrective measures. Possible personal admonitions	Independent body and Ministry of Interior	Independent body Ministry of Interior		
France		LG LG							Propose corrective measures.	Independent body	Prefect		
Germany		RG/LG RG						RG	For LG, possibly refusal to authorise the budget; impose consolidation programs; take over the administration	Financial Planning Council and Communal Supervisory Agencies of the Länder	Financial Planning Council and Communal Supervisory Agencies of the Länder		
Hungary													
Ireland		LG							Limits on borrowing	Ministry of Finance	Ministry of Finance		
Italy		RG						RG/LG RG 2/	RG charged for 30% of the excess, AIFA of 70% 2/	Limits on the purchase of goods and services; prohibition to hire new staff and to contract debt to finance investment.	Ministry of Finance, AIFA, and Board of Performance Assessors	AIFA and independent committee of auditors	
Latvia									LG		Independent body	Ministry of Finance	
Lithania		LG								Possibility (claim to the Court)	Council of Municipalities	Government, Parliament	
New Zealand		LG											
Portugal		LG							LG LG RG/LG		Ministry of Finance	Ministry of Finance	
Romania		LG							LG 3/ LG	Propose corrective measures.	Ministry of Finance	Ministry of Finance	
Slovak Republic									RG/LG 3/ RG/LG		Supreme Audit Office and Ministry of Finance		
Slovenia									LG LG		Court of Auditors and MoF	Ministry of Finance	
Spain		RG/LG RG							RG/LG 3/ 4/ RG 4/ LG		Submit a 3-year plan for correction	Ministry of Finance, and Autonomous Communities	MoF, Council of Ministers and Autonomous Communities
Sweden		LG								Propose corrective measures.	Court of Auditors		

Sources: European Commission and Sutherland et al. (2005).

1/ Details differ by regions/local governments.

2/ For pharmaceutical products: 16.4 percent (14 percent territorial, 2.4 percent hospital) of the financing level for the National Health Service contributed by the State.

3/ Ceilings in terms of percentage of revenues (Est), previous year's current revenues (ESP, SVK), current revenues (LTV)

4/ For Autonomous Communities, short-term financing is restricted to covering transitory liquidity needs while longer-term financing should be exclusively for investment. The total debt service payments (interest and principle) must not exceed 25 percent of current revenue. For those ACs that do not comply with the principle of budgetary stability, authorization from the State is required to obtain credit operations abroad or issue public debt.

5/ For Local governments, short-term financing is restricted to transitory liquidity needs and cannot exceed 30 percent of last year's current revenue. Authorization is required for any long-term borrowing and total debt cannot exceed 110 percent of current revenues and must register positive savings.

ATTACHMENT III. THE SPANISH LABOR MARKET IN A CROSS-COUNTRY PERSPECTIVE¹²

This annex places the Spanish labor market in a cross-country perspective and examines the factors behind the Spanish labor market problems. Specifically, it attempts to shed light on two related questions: (1) What labor market institutions and policies explain the high underlying unemployment rate and share of temporary workers? (2) What reforms could cut both the unemployment rate and the share of temporary workers?

A. A Highly Dysfunctional Labor

1. Problems include:

- **A high structural unemployment rate.** Spain has had the highest unemployment rate among the EU15 for most of the period since 1980. Even during the recent boom years, its unemployment rate remained relatively high and with the recent crisis it has returned to 20 percent, double the EU15 average and the highest in the EU15. It affects especially young and temporary workers.
- **High cyclical employment and unemployment.** Output elasticities of employment are larger than for other EU15 countries. When faced with a strong negative demand shock, firms adjust by dismissing workers or going out of business rather than reducing wages or working time. In contrast, when output picks up, employment rebounds substantially.
- **High share of temporary contracts, but few part-time contracts.**³ About 30 percent of the labor force is in temporary contracts, the highest level in the EU15 (since the mid-1980s) and about double the EU15 average. The incidence of temporary contracts is highest for youth and women. In contrast, the share of part-time contracts (another type of flexible contract) has remained very low in Spain.
- **High degree of wage rigidity.** Wages and labor costs have been growing faster than in most other EU15 countries, but also much faster than labor productivity growth, leading to widening unit labor cost differentials. Moreover, real wages have not responded much to the conditions of the labor market and have even behaved counter-cyclically, amplifying employment fluctuations.

¹ Prepared by Florence Jaumotte.

² Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached [Staff Statement](#) and [Staff Supplement](#).

³ Temporary contracts (or workers) refer to both fixed term contracts (workers) and temporary agency work contracts (workers).

B. The Roots of the Problems

2. **The literature has identified a number of institutions and policies as important determinants of labor market outcomes.**⁴ Among these, Spain stands out in its system of collective bargaining and the employment protection of permanent workers.

- *Spain is among the few countries with an intermediate level of coordination of wage bargaining.* The coordination of wage bargaining takes place primarily at the province and industry level, instead of the national or company level. This system is less employment-friendly than either a highly coordinated system where externalities of excessive wage agreements can be better internalized or a completely decentralized system where wage agreements can be better tailored to the individual company. The wage bargaining system is made worse by: (i) national guidelines for wage increases are further increased at the industry/provincial level, and sometimes at the company level; (ii) unions represent mostly permanent workers (union density is very low), yet wage agreements are automatically extended to the entire province or industry, creating a large insider-outsider problem; (iii) "opt-out" clauses (clauses that allow firms to opt-out from the agreements if economic conditions become difficult) can only be used under very restrictive conditions that give some control to competitors.
- *Wage agreements also stand out by their high degree of indexation to inflation.* Wages are typically highly indexed on past inflation and corrected when inflation turns out higher than expected (but not vice versa), increasing real wage rigidity.
- *Dismissing permanent workers is very costly in Spain.*⁵ While Spain scores well on the length of notice periods and on procedures, it has among the highest severance payments and a very restrictive interpretation of fair dismissals. Due to the latter, about 90 percent of lay-offs of permanent workers are treated as unfair. Severance payments in case of unfair dismissals vary between 33 and 45 days per year of service with a maximum of 24 and 42 months respectively. For a worker with 20 years of tenure, this implies a severance payment of 22 months of salary, compared with an average 14 months in the EU15.⁶ Severance payments for fair

⁴ These include the level and duration of unemployment benefits, the tax wedge, employment protection legislation, union density, the degree of centralization/coordination of collective bargaining, active labor market policies, and the extent of product market regulation.

⁵ Spain scores average on the OECD overall indicator of employment protection for permanent workers. The OECD indicator suggests that the strictness of regulation on temporary contracts is above EU15, but this seems at odds with the high share of temporary workers in Spain.

⁶ The difference is even greater if one compares with the conditions for fair dismissals in EU15, since many unfair dismissals in Spain would actually be considered fair in other countries.

dismissals are also much higher in Spain than the EU15 average, for all tenures. In contrast, severance payments for temporary workers are only 8 days per year of service. Finally, the trial period, i.e., the initial employment period during which an employer can dismiss a new employee without severance payment, is much shorter than in other countries. The effect of employment protection on the unemployment rate is unclear a priori: it reduces hirings but also firings. However, it has been argued that it increases the share of temporary workers, as employers use temporary contracts to avoid the inflexibility created by the high protection of permanent workers.

- *Spending on active labor market policies remains low and relatively focused on employment subsidies instead of training and public employment services.* Although active policies do contribute to reduce the unemployment rate, there is much controversy about the size of their impact.

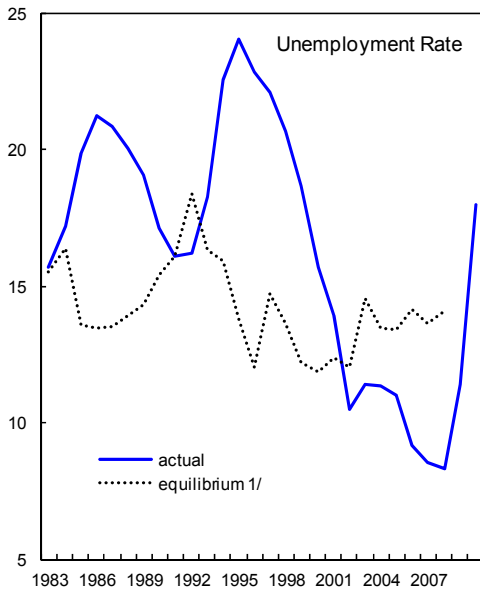
3. **Spain's differences with EU15 are less marked on other policies.** Unemployment benefit net replacement rates are broadly in line with the EU15 average at 50 percent (average over first five years), but with a steeper profile which seems broadly adequate to strengthen incentives to return to the labor market, while providing high initial protection. The tax wedge is also broadly in line with the EU15 average at 32 percent, although the composition varies somewhat, with higher employers' social security contributions and lower employees' social security contributions and personal income tax (and cash benefits). Product market regulation is somewhat below the EU15 average.

C. Determinants of the Unemployment Rate

4. **A quantitative analysis finds that unemployment increases with intermediate bargaining, high unemployment benefits, a high tax wedge, and strict product market regulation, but is little affected by employment protection legislation.**⁷ The estimated model tracks closely the behavior of the unemployment rate in Spain from 1982 to 2007 (the last year for which all data are available), and these findings are broadly in line with those of the literature.

5. **The model suggests that the Spanish equilibrium unemployment rate has not changed much from its high level over the last 25 years.** The equilibrium unemployment

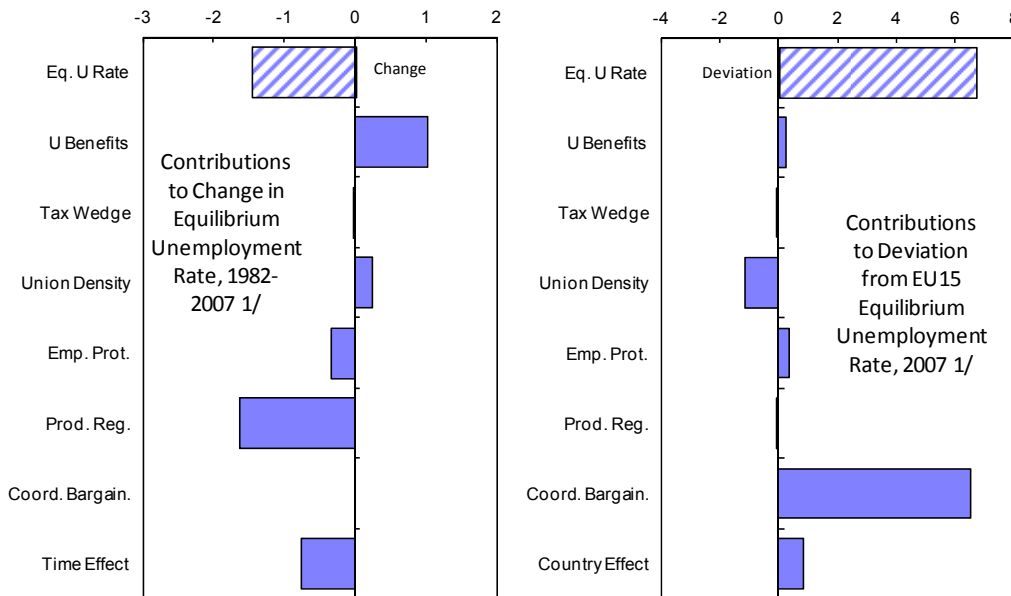
⁷ The estimated equation relates the unemployment rate to the degree of coordination of wage bargaining (and its square, to allow for non-linearity), union density, the degree of employment protection legislation, the average gross replacement rate of unemployment benefits, the tax wedge, the degree of product market regulation, the lagged unemployment rate (to allow for autocorrelation), the output gap, and country and time fixed effects. The model is estimated on a sample of 20 OECD countries during the period 1982-2007. See forthcoming working paper for details.



rate, i.e. the unemployment rate implied by the evolution of policies and institutions once all adjustment has taken place, is around 14 percent and has only slightly declined by 1.5 percentage point since 1982. Over this period, there was little change in the system of wage bargaining and the tax wedge. And while the deregulation of product markets boosted employment creation, this was largely offset by a sharp increase in unemployment benefits.

6. The high level of the Spanish equilibrium unemployment rate reflects to a large extent the intermediate coordination of bargaining. The Spanish equilibrium unemployment rate is about double the level of the EU15, which is estimated at 7 percent. With the tax wedge, unemployment

benefits, and product market regulation broadly at the EU15 average, the bulk of the difference in equilibrium unemployment rates between Spain and the EU15 seems to reflect the higher degree of coordination of wage bargaining in other EU15 countries. However, the magnitude of this effect should be taken with caution, due to the small number of observations that are available to estimate the impact of such a policy change.



7. Reforms to reduce the unemployment rate should focus on moving towards more flexibility of wage bargaining and/or a combination of reducing unemployment benefits and the tax wedge. Policy simulations using the estimated model suggest that moving from an intermediate level of bargaining to either a fully coordinated bargaining

system or a completely decentralized bargaining structure would reduce the equilibrium unemployment rate by a substantial amount (estimated between 7 to 10 percentage points, though the magnitude should be taken with caution). Given the relatively large size of the Spanish economy (implying a diversified productive structure) and the current need for sectoral reallocation from nontradables to tradables, moving towards flexibilization rather than centralization of wage bargaining would seem preferable. Reductions in the unemployment benefit replacement rate and the tax wedge would also help reduce the unemployment rate. Although it would take large changes in each of these two policies to reduce substantially the unemployment rate, a combination of moderate changes in both could deliver a substantial reduction in the unemployment rate while minimizing the budgetary impact (see Table). Finally, the literature suggests that spending on active labor market policies would gain in efficiency by refocusing on training away from employment subsidies.

Spain: Policy Simulations for the Unemployment Rate 1/
(Change in the Unemployment Rate, percent)

	Long-Run Effects		
	Average EU15	Minimum EU15	Policy Change2/
Unemployment Benefit Replacement Rate	-0.2	-3.0	-1.3
Tax Wedge	0.0	-4.4	-1.4
Union Density	1.1	-0.3	-0.5
Employment Protection Legislation	-0.3	-0.9	-0.4
Product Market Regulation	0.1	-0.3	-0.5
Coordination of Wage Bargaining	-6.5	-6.9	-9.8

Source: IMF staff calculations.

1/ Using the benchmark regression in Table 5.

2/ Policy change is defined as a 10 percentage point reduction for the unemployment benefit replacement rate, the tax wedge and union density, and a one unit reduction for employment protection legislation and product market regulation.

For the coordination of wage bargaining, the alternative policy scenario considered is a complete centralization.

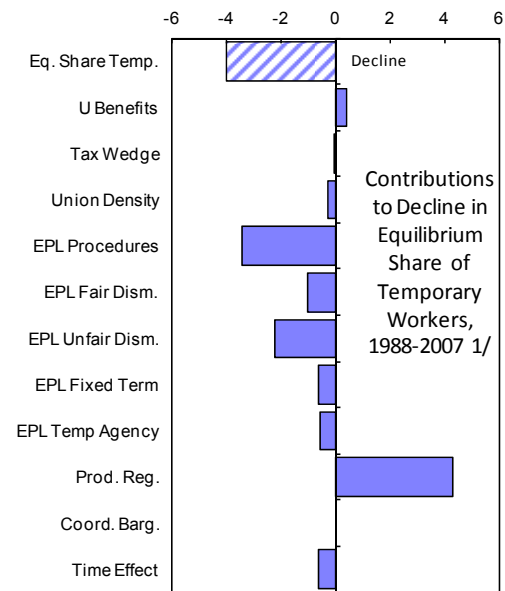
8. The experience of other countries suggests that the equilibrium unemployment rate can be reduced substantially by a mix of policy and institutional reform. Four EU15 countries have succeeded in reducing substantially their actual and equilibrium unemployment rate and bringing it to one of the lowest pre-crisis levels (Annett, 2007). These are Ireland, the United Kingdom, the Netherlands, and Denmark. Ireland took some sweeping steps: it sharply reduced the tax wedge and union density, and transformed collective bargaining from decentralization to complete coordination. The other three countries used a mix of more moderate policy changes, including decreases in unemployment benefits, tax wedges (UK and Denmark) and union density, and product market deregulation.

D. Determinants of the Share of Temporary Workers

9. **An empirical examination finds that the share of temporary workers is boosted by high employment protection of permanent workers, high unemployment benefits, a high tax wedge, and low product market regulation.**⁸ The model used explains pretty well the share of temporary workers over time in Spain.⁹ While employment protection for permanent workers increases strongly the share of temporary workers – especially the provisions relating to unfair dismissals, the impact of the strictness of regulation of temporary work is insignificant and not robust. This is also confirmed by simple correlations. The effect of high unemployment benefits and a high tax wedge presumably operate by reducing labor demand, making it easier for employers to impose flexible contracts which fit their needs. Finally,

lower product market regulation could increase the share of temporary workers for several reasons: (i) lower product market regulation increases competition and the need for firms to be able to adjust quickly, making it more tempting to hire temporary workers; (ii) lower product market regulation tends to favor the expansion of services sector, where temporary work is more frequent; (iii) the lower rents induced by lower product market regulation may prompt firms to reduce labor costs by hiring temporary workers (with lower wages and dismissal costs).

10. **Reforms to reduce the share of temporary workers should focus on reducing the employment protection of permanent contracts and/or a combination of reductions in the tax wedge and unemployment benefits.** The estimations suggest that the reforms enacted by Spain since the 1990s to reduce the employment protection of permanent



⁸ The estimated equation is similar to the one for the unemployment rate. The main difference is that it allows different subcomponents of the employment protection legislation index to have different impacts on the share of temporary workers. Indeed, while high employment protection of permanent workers would tend to increase the share of temporary workers, strict regulation of temporary work should reduce it. The model is estimated on a sample of 20 OECD countries during the period 1985-2007 (or maximum years available). See forthcoming working paper for details.

⁹ We are aware of only one macroeconomic study that looks at the determinants of the share of temporary workers (Nunziata and Staffolani, 2007). They also find a negative impact of EPL for permanent workers on the share of temporary workers using a panel of European countries over the period 1983-1999.

workers contributed to reduce the equilibrium share of temporary workers; however this was to a large extent offset by product market deregulation. Policy simulations using the estimated model imply that bringing the three components of employment protection of permanent workers to the minimum level observed in the EU15 would reduce the share of temporary workers by respectively 1, 3.5, and 9 percentage points, or a total of 13.5 percentage points (see Table). Reducing the tax wedge and the replacement rate of unemployment benefits would also help to lower substantially the share of temporary workers.

Spain: Policy Simulations for the Share of Temporary Workers 1/
(Change in the Share, percent)

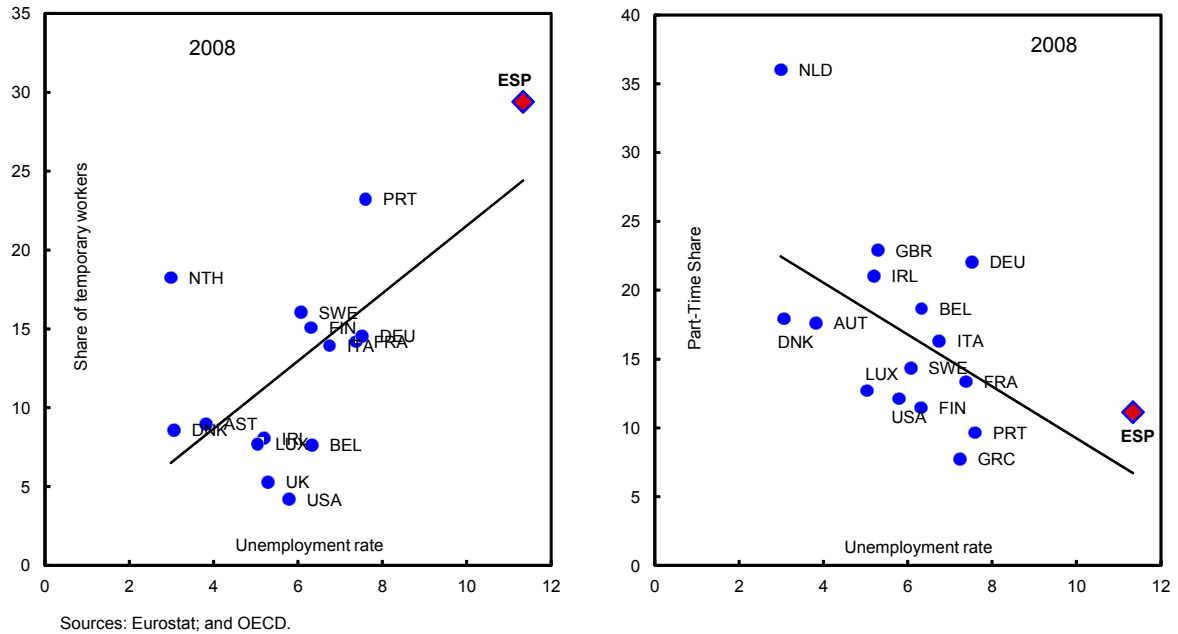
	Long-Run Effects		
	Average EU15	Minimum EU15	Policy Change ^{2/}
Unemployment Benefit Replacement Rate	-0.4	-5.0	-2.1
Tax Wedge	0.0	-6.9	-2.2
Union Density	-1.9	0.6	0.9
Product Market Regulation	-0.2	0.9	1.3
Subcomponents of EPL			
EPL Regular Contracts			
Procedural Inconvenience	0.4	-1.2	-1.2
Notice and Severance Pay for Fair Dismissal	-1.3	-3.5	-1.7
Difficulty of Dismissal	-1.8	-8.9	-4.5
EPL Temporary Contracts			
Fixed Term Contracts	0.7	1.7	0.6
Temporary Work Agency Employment	-0.8	-1.3	-0.4

Source: IMF staff calculations.

1/ Using the benchmark regression in Table 8, but estimated with the corrected employment protection for permanent workers for Spain.

2/ Policy change is defined as a 10 percentage point reduction for the unemployment benefit replacement rate, the tax wedge and union density, and a one unit reduction for employment protection legislation and product market regulation.

11. The unemployment rate and the share of temporary workers are positively correlated, suggesting the two could be reduced simultaneously. Countries with higher shares of temporary workers also have higher unemployment rates. The results from the regressions confirm these conclusions: most reforms of labor market institutions and policies either yield changes in the unemployment rate and the share of temporary workers that go in the same direction (e.g. unemployment benefits and the tax wedge) or affect one without affecting the other (e.g. EPL and the degree of coordination of collective bargaining). The main exception is product market reform that seems to reduce the unemployment rate but increase the share of temporary workers, suggesting that product market reform should be accompanied by labor market reform (especially lowering of the protection of permanent workers).



12. **Interestingly, a higher share of part-time contracts is associated with a lower unemployment rate.** This is in sharp contrast to the share of temporary workers, which is positively correlated with the unemployment rate. While both types of contracts provide additional flexibility, most part-time contracts are voluntary, hence they do not reflect adverse labor demand, but rather seem to be “imposed” from the supply side. They encourage the participation and employment in the labor market of groups that would otherwise not work, e.g. women especially with children, youth, and older workers. This may be an avenue worth pursuing for Spain, which has a very low share of part-time contracts.

E. Conclusions

13. **Reforming labor market institutions and policies can have substantial effects on the unemployment rate and the share of temporary workers.** Different policy mixes can achieve a similar result. A fundamental reform of the collective bargaining system towards flexibilization of wage bargaining would go a long way toward bringing the unemployment rate closer to the EU15 average. But a combination of more moderate policy changes, involving reduced unemployment benefits, lower tax wedges, and further product market deregulation would also deliver a significant improvement in the unemployment rate. Turning to the objective of reducing the share of temporary workers, one key reform needed is the reduction of employment protection on permanent workers, though reducing unemployment benefits and the tax wedge would also help. Interestingly, some reforms – especially those of unemployment benefits and tax wedges – seem to improve simultaneously the unemployment rate and the share of temporary workers. In contrast, product market deregulation reduces the unemployment rate but at the cost of an increase in temporary employment. Hence, it suggests that product market reform should be

accompanied by labor market reform, especially by a lowering of the employment protection of permanent workers.

14. **One aspect not examined in this paper is the role of interactions between policies and/or institutions.** One interaction that would seem particularly important in the Spanish context is between decentralization of collective bargaining and the reduction of employment protection on permanent workers. If the employment protection on permanent workers is not reduced substantially, the decentralization of collective bargaining may not lead to the expected flexibility in wages, as unions' representatives would keep defending the interest of their firm's permanent workers at the cost of the firm's temporary workers. Hence, it appears that these two reforms would have to be implemented hand-in-hand to be effective.

ATTACHMENT IV. REFORMING THE SPANISH SAVINGS BANKS^{1 2}**A. Overview**

1. **One of the main features of the Spanish banking sector is the major role played by savings banks.** The Spanish savings banks (cajas) are financial institutions organized as private foundations with no formal owner and pursuing a wide array of competing goals: from promoting savings, to enhancing competition and to contributing to regional development. Given the lack of ownership, the law identifies five groups of stakeholders—depositors, local and regional governments, founders, employees, and other (private or public) institutions—to whom it provides representation in the institution’s governing bodies, although relative voting powers vary depending on the specific regional law. The savings banks do not have any share capital and their equity consists mainly of reserves generated through retained earnings.
2. **Savings banks have gradually reduced their regional specificity, expanded their range of activities, and become solid competitors to commercial banks.** With the deregulation of Spanish financial markets in mid-1970s, savings banks were allowed to carry out universal banking activities; compulsory direct lending coefficients were gradually lifted and abolished in 1992; branch barriers were removed in steps until they were completely eliminated in 1988. Nowadays, savings banks offer a wide range of financial products and activities like regular commercial banks: from bank-assurance to asset management and private banking. Over time many savings banks strengthened their national presence, as illustrated by the increasing trend in the number of employees and branches, which resulted in some overcapacity in the system (Figure 1). This expansion went hand in hand with growing lending to construction companies, real estate developers, and to households for mortgages. Although deposits have continued to fund a large share of the activities, savings banks have increasingly relied upon wholesale credit markets.
3. **The universe of savings banks remains, nonetheless, heterogeneous.** The sector comprises two large players (La Caixa and Caja Madrid), which compete nation-wide and on international markets; a few medium-sized institutions (Bancaja, Caja del Mediterráneo, Caixa Catalunya), which have a market share, measured in terms of credit institutions’ total assets, of at least 2 percent; and 40 small and very small institutions (Figure 2).
4. **The allocation of responsibilities in the regulation and supervision of cajas is grounded on a delicate balance between central and local powers.** In broad terms, Banco

¹ Prepared by Alessandro Giustiniani.

² Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached [Staff Statement](#) and [Staff Supplement](#).

de España (BdE), as banking supervisor, has powers over financial stability aspects, related to the solvency and liquidity of such institutions, while the competence of autonomous communities (ACs) falls more within corporate governance and consumer protection issues. Cross-regional mergers among savings banks need to be approved by the respective ACs. The central government maintains responsibilities in the issuance of sanctions such as revocations of licenses, performed in cooperation with BdE.

B. The Impact of the Global Financial Crisis

5. **Despite the traditional retail-oriented business model and forward-looking prudential regulation, the Spanish banking sector came under pressure with the unfolding of the crisis.** At the start of the crisis, the authorities implemented policies aimed at shoring up market confidence and banks' liquidity conditions (Table 1). As the deteriorating operating environment and the collapse of the property market increased pressure on domestic banks' capital, the emphasis shifted to consolidation and recapitalization.

6. **Savings banks, albeit with different intensity, suffered the most and the outlook is challenging.** A number of factors, which in part apply to commercial banks as well, contribute:

- *Reported NPLs may underestimate the actual quality deterioration of the loan portfolio.* Like commercial banks, savings banks have actively managed their exposure to the ailing real estate and construction sectors through debt-for-property swaps. Staff estimates that repossessed or acquired real estate assets by savings banks amount to around €31 billion, equivalent to 38 percent of Tier 1 capital. If these problematic assets were included in measuring the quality of loan portfolios, the NPL ratio for savings banks would increase from 5.3 to 8.6 percent and the coverage ratio would drop from 56 to 34 percent.
- *Asset valuation might be overstated.* The picture is complicated by the fact that about 45 percent of repossessed assets is land, the true value of which is particularly uncertain. However, the BdE has introduced changes in order to promote adjustment in the housing sector: the *provisioning* applied to real estate assets held into financial institutions' balance sheets has been increased from 10 to 20 percent if these assets are held longer than one year; a proposal to rise the provision to 30 percent after two years (unless an updated appraisal proved it not to be necessary) has been issued for public consultation on May 26, 2010.
- *Profitability is under pressure.* Despite a temporary improvement in net interest income due to the different re-pricing of assets and liabilities, savings banks have witnessed a marked contraction of their profitability owing to provisioning. Going forward, pressure on the cost of funding together with lower credit volume and still high loan loss provisioning would weigh on savings banks' capital generation capacity.

- *Savings banks have relied heavily on official liquidity support and government guarantees.* Savings banks hold the lion share of bonds issued with the Spanish government guarantee; almost three-quarters of the total for an amount of € 32.5 billion (see below). As for refinancing operations with the ECB, the use by savings banks is estimated to range between 40 and 70 percent of total refinancing operation carried out by the Spanish credit institutions.

7. While the authorities' policy measures have contributed to mitigate the impact of the liquidity squeeze, the process of bank restructuring and consolidation has fallen short of expectations, though has accelerated recently.

- Caja Castilla La Mancha (CCM) was intervened by BdE in March 2009 and taken over by Cajastur in November 2009 through a competitive tender procedure in line with the statutory requirements of the Deposit Guarantee Scheme for Saving Banks. Nonetheless, the operation raised market criticisms regarding the cost and transparency of the transaction, which preserved a role for the stakeholders of CCM in the new institution.
- In June 2009, the BdE approved the merger between Unicaja and the ailing Cajasur but after almost a year of negotiations Cajasur rejected the merger and the BdE decided to intervene it (May 2010).
- Only recently a handful of institutions requested financial support from the FROB, subject to EU Commission approval (Table 2).
- Another group of cajas (Navarra, Burgos, and Canarias) has launched the first *Sistema Institucional de Protección* (Institutional Protection Scheme—SIP) by creating the banking group Banca Cívica.³ Another four mergers and three SIPs have recently been announced.

8. The launch of the FROB has not prompted significant changes in the legal framework of the savings bank sector, except in the case of direct intervention (Box 1).

- *Cross-border mergers still need to be approved by local authorities.* The few attempts have been frustrated by political difficulties.

³ SIPs were originated in the cooperative sector. SIPs could be defined as a contractual agreement aimed at protecting and improving the liquidity and solvency of participating institutions, which remain separate legal entities. SIPs are regulated by the BdE, which recently strengthened the conditions for establishing such an arrangement, including: (i) the constitution of a central entity (either a savings or a commercial bank) which is responsible for determining business plan and activities, risk management and internal control for the group as a whole as well as the fulfillment of the regulatory consolidated reporting requirements; and (ii) a binding contract of mutual support among the participating institutions equivalent to at least 40 percent of each institution's equity.

- *Due to their legal nature, savings banks remains closed to external investors. Preventing private sector involvement increases the risk for tax-payer money. Furthermore, savings banks' capacity to raise external capital remains limited.*

C. Elements of a Far-reaching Reform

9. **The current situation calls for a more fundamental restructuring of the savings bank sector.** While the crisis presents challenges for the banking system, it also offers an opportunity to restructure it to become more resilient to future crises. The reform process should be guided by three fundamental objectives:

- Strengthening the oversight and intervention powers of BdE;
- Enhancing the ability of savings banks to raise external equity; and
- Opening savings banks to more dynamic structures of ownership and governance.

Strengthening the BdE's oversight and intervention powers

10. **Although savings banks are subject to the same prudential regulation as commercial banks, the opaqueness of their ownership and the relevant political involvement complicate the playing field.**

- Market mechanisms to ensure prudent management do not fully apply. Although the majority of savings banks are rated by international agencies, given their legal status and the lack of traded equity capital, potential takeovers do not represent a possible threat and hence a disciplinary device.
- The fact that mergers and acquisitions between savings banks need to be approved by ACs adds a political dimension, which further complicates the picture. Negotiations have proved to be lengthy because ACs need to agree on the distribution of the public sector representatives in the governing bodies of the new institutions. The difficulties in this political bargaining do not seem to lessen even in cases where one of the merging institutions has significant solvency issues. This can prevent mergers when they might be economically advantageous.
- The dual legal framework governing savings banks poses the risk of potential conflicts in the exercise of supervisory and sanctioning authority. Although the cooperation between the BdE and ACs has worked smoothly, and there are circumstances where – due to legal ambiguity – overlapping national and regional legal frameworks may cause conflicts, particularly in the application of supervisory authority on prudential issues.⁴

⁴ The BdE has full powers on prudential issues. Each AC operates under its own legal framework, which generally provides for licensing, supervisory and sanctioning authority to oversee the activities of saving banks

- In case of weak institutions, typical corrective actions that affect shareholders—such as call for cash (equity) injection, or suspension of particular or all shareholders rights—cannot be applied since the control exercised by savings banks' stakeholders is not coupled by legal ownership of the institution and the capacity of savings banks to raise equity capital is limited.
- Although the BdE has the powers to intervene ailing savings banks, this does not necessarily imply that the stakeholders of the intervened institution lose control, although the decisions of the board of directors have to be validated by the special administrator appointed by the BdE.

11. **The attribution of responsibilities between the BdE and ACs needs to be reformed to strengthen the BdE's oversight powers over savings banks.** The trend towards a consolidation of the savings banks sector may increase their systemic relevance. Against this background, it is of paramount importance to avoid any potential fragmentation of regulatory and supervisory powers thus bringing the supervisory framework for savings banks closer to that established for commercial banks. In particular, the legal regime should empower the BdE with the sole responsibility of approving mergers of savings banks, while taking into account the national competition authority's opinion.

Enhancing the savings banks' ability to raise external capital

12. **The savings banks' limitations in raising equity capital have several implications:** (i) they may reduce the scope of these institutions to expand if a particular operation (e.g., a purchase of another institution) requires more capital than what the *caja* has; (ii) they seriously limit the capacity to replenish capital if an institution suffers major losses; and (iii) they deprive savings banks of an instrument (the value of a share) to assess the market's view on an institution's performance on a continuous basis.

13. **Although savings banks can issue capital instruments, market appetite is limited or their loss-absorption capacity is doubtful.** Besides issuing subordinated debt (Tier 2 capital), the capital instruments available to savings banks are:

- the *cuotas participativas* (Tier 1 capital) – equity-like variable income instrument that grants no voting rights to its holder; there are limits on individual investor's holding (5 percent) and on the total amount that an institution can issue (50 percent of capital). In seven years since the legislation was passed, *Caja de Ahorro del Mediterraneo* has been the only savings bank to have issued *cuotas participativas*.⁵

headquartered in their respective jurisdictions, particularly with regards to corporate governance, consumer protection, transparency and dividend policies supporting social contributions (*obra social*).

⁵ The issued *cuotas participativas* represent 7.5 percent of the equity of Caja del Mediterraneo.

- the *participaciones preferentes* (Tier 1 capital in the case of qualifying preferred participations and Tier 2 capital in the case of non-qualifying preferred participations) – a subordinated debt instrument that grants the holder the right to receive a fixed dividend when the issuer (a caja) obtains profits, and no right to dividends when the institution suffers losses. Two recent events, however, raise doubts about the real loss-absorption capacity on a going-concern basis of *participaciones preferentes*: the securities issued by CCM were bought back at par after the institution was intervened; and Cajasur paid the March 2010 €1.5 million coupon on its €150 million outstanding hybrid capital.

14. **Savings banks have to adapt to the forthcoming new more demanding capital requirements.** The forthcoming new Basel agreement is likely to raise the quality, consistency, transparency, as well as the minimum level of bank capital. Savings banks may find the new regulatory environment more challenging than commercial banks owing to their limited ability to raise external equity capital.

15. **Against this background, savings banks' loss-absorbing capital instruments should be improved.** The first option would be to remove the quantitative limits *to cuotas participativas* and grant representation and voting rights to investors; this would be almost equivalent to issue equity shares. In this case, however, the question arises as to how such form of capital, and its remuneration, fits with the overall design of *cajas* as not profit-distributing organization. Another possibility would be to allow the issuance of contingent capital notes (like Radobank in the Netherlands), which will probably require the definition of the proper legal framework.

Strengthening ownership structure and governance

16. **The influence of local governments over savings banks has become a macro-financial risk.** In principle, public ownership does not entail, per se, less prudent management than private ownership if appropriate arms-length arrangements that safeguard bank management's commercial autonomy from political powers are established. However, as recent events have shown, political difficulties have delayed the consolidation process and even the appointment of top managers at certain systemically important savings banks.

17. **Strengthening the separation between management and savings banks' stakeholders would be crucial.** To this end, reducing the number of political representatives in the governing bodies of savings banks can be a first step. However, it should be taken into account that there are many ways in which political interference can be exercised over business decision making processes, and representation in governing bodies is but one.

18. **To break the above mentioned link and to achieve a sound management of savings banks the first line of defense is to have effective legislation setting out proper and fit criteria.** The legislation needs to ensure, also at a local level, that the management

has the appropriate authority and autonomy to perform its functions, and that a dividing line is drawn between the business, day-to-day decisions and the political control. Further, the exercise of a strong, independent, supervisory function will be necessary to ensure compliance with such fit and proper standards. Empirical evidence suggests that not always have chairs of savings banks had sufficient experience in managing and operating a credit institutions and this contributes to explain the heterogeneity in savings banks' performance.⁶

19. **Spain's economic and financial development has much reduced the rationale for the legal distinction between savings and commercial banks.** Paraphrasing the famous "duck" test, one could argue that since savings banks behave like commercial banks, offer the same financial services like commercial banks, can be systemically important like commercial banks, then they should probably be commercial banks in all aspects including the legal structure. From a political economy point of view, savings banks, at least the largest ones, no longer address specific market failures, such as limited access to financial services of some social groups.

20. **Such a change in the legal structure has a number of advantages.** It would clarify the ownership structure of these institutions. It would help these institutions to tap capital markets to raise equity capital. It would open the consolidation process to "outside" investors (Spanish or foreign institutions) and, hence, it would reduce the threat to the public finances. In this new environment, the take-over threat and the potential additional layer of external shareholders would be a strong disciplinary device on managers' behavior.

21. **The change in the legal structure can be either voluntary or mandatory.** Norway chose the first approach; Italy opted for the second one across the board. A possible third approach could be to make the change in the legal structure mandatory if a savings bank's market share exceeds a determined threshold. Empirical evidence, in fact, indicates that when savings banks increase in size, the economic goals (profit maximization) gains in importance over the social-oriented ones.⁷

22. **The resources of the FROB could be used to incentivize this structural change.** The resources of the FROB could be dedicated to those savings banks (individual or potential merger) that decide to opt for the stock-holding company option but need additional capital to clean their balance sheet from doubtful real estate exposure. As in the current framework, the FROB would become a shareholder of these "transformed" institutions with the opportunity to sell its participations directly to the market.

⁶ , Vicente and Luis Garaciano (2009) "Did Good Cajas Extend Bad Loans? The Role of Governance and Human Capital in Cajas' Portfolio Decisions," FEDEA Monograph, "The Crisis of the Spanish Economy", November.

⁷ García-Cestona, Miguel A. and Jordi Surroca (2008) "Multiple Goals and Ownership Structure: Effects on the Performance of Spanish Banks," European Journal of Operational Research, 187(2), pp. 582-599.

Box 1. The *Fondo de Reestructuración Ordenada Bancaria* (FROB)

The objective of the FROB is to assist and foster the reorganization of the Spanish banking industry (Royal Decree Law 9/900). The initial capital of the FROB amounts to €9 billion, of which €2.25 billion were contributed by the Deposit Guarantee Funds (*Fondos de Garantía de Depósitos*, FGDs) and the rest by the state (unused resources from the FAAF). The FROB can issue securities guaranteed by the state and/or it can seek other funding, but it can leverage up to 10 times (i.e. €99 billion).^{1/} The law envisages two courses of actions: the integration and the restructuring process. The capital-support window for the former process will expire on June 30, 2010.

The *integration process* is for fundamentally sound institutions that need a temporary capital injection to support their merger or takeover plans, which have to be approved by the BdE. The beneficiaries are deemed to be fundamentally sound when according to BdE do not present weaknesses that can affect their viability and have a core capital (capital, reserves, generic provision) ratio of at least 6 percent.

The capital injection by the FROB, which takes the form of convertible preference shares, cannot exceed 2 percent of risk-weighted assets, except in exceptional circumstances.^{2/} In any event, the subscription of securities by the FROB is capped as a maximum to the amount necessary to reach a core capital ratio of 8 percent taking into account the potential economic losses in a two-year horizon.

The FROB securities are part of the non-core Tier 1 of the beneficiary institution and will carry an annual yield equal to the minimum between 7.75 percent and the 5-year Treasury bonds plus 500 bp. The rate is increased by 15 bp each year. However, the interest is not cumulative and it is paid whenever and to the extent that the beneficiary institution has distributable profits. The issuer is committed to repurchase the preference shares within 5 years.^{3/} If the time period expires and the issuer has not repurchased the preference shares, or if the BdE at any time consider the buy-back to be unlikely, the FROB will convert the securities into ordinary shares (or its equivalent for the other credit institutions) and the restructuring process will apply (see below).

The FROB support is subject to behavioral safeguards; in particular (i) refrain from non-organic growth (or downsize in case of FROB subscription exceeds the envisaged threshold or the institution is not fundamentally sound); (ii) align managers' remuneration to the Commission recommendations;^{4/} (iii) enhance cost efficiency; and (iv) cap (or refrain from) dividend distribution. Should these safeguards be breached, the rate of FROB securities will be increased by 200 bp.

The *restructuring process* is aimed at those institutions affected by significant weaknesses (i.e., asset quality, capital adequacy and capacity to generate recurrent revenues), which could jeopardize their viability in the medium to long term. Should a market-oriented solution fail, the BdE would directly intervene the weak institution and appoint a FROB representative as its administrator (as it happened in the case of Cajasur). The FROB will devise a restructuring plan, to be approved by the Bank of Spain, which would outline the steps necessary to overcome the distressed situation. This could result in a merger with other institutions with a high degree of solvency, or the sale or transfer of its assets and liabilities through an auction process, among others. Support during the restructuring period could come in the form of guarantees, loans at favorable rates, subordinated debt, the acquisition of assets or capital injections.

To allow the operability of the FROB in the case of savings banks, the Law governing those institutions has been amended to remove current limits on individual holding of *cuotas participativas* (5 percent) and total amount of *cuotas* that can be issued (50 percent of capital), and to grant voting power to the *cuotas* issued in favor of the FROB. Furthermore,

Furthermore, specific transactions to merge credit institutions (including savings banks) under the restructuring process approved by the BdE will not require any additional administrative authorization other than those required by the competition law.

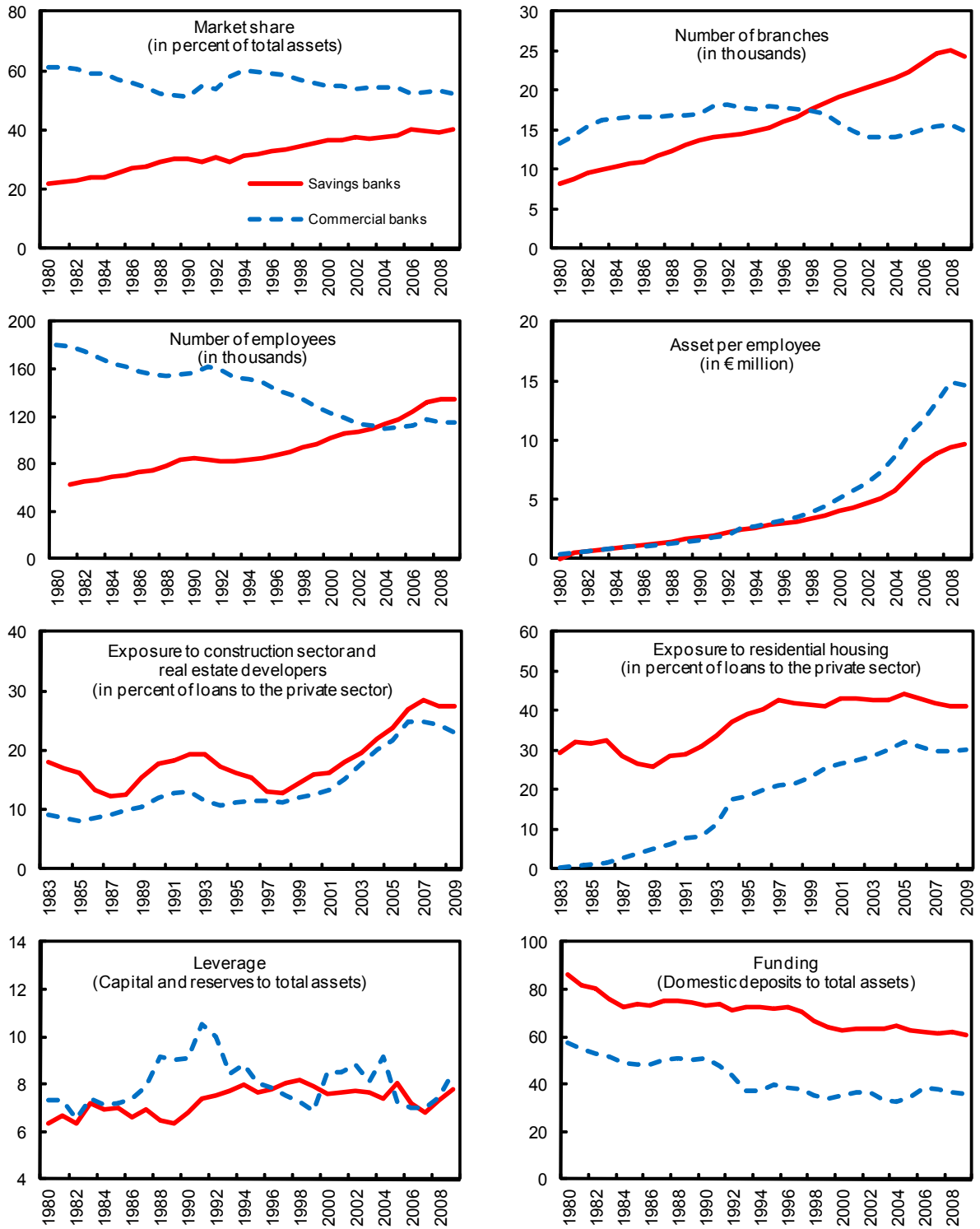
^{1/} On November 19, 2009, the FROB issued its first bond for €3 billion with a five year bullet maturity and a 3 percent coupon paid annually. The issue was rated triple-A given the irrevocable and unconditional guarantee by the state.

^{2/} In these circumstances, the prudential limit of 30 percent of Tier 1 to the total issuance of convertible preference shares is waived.

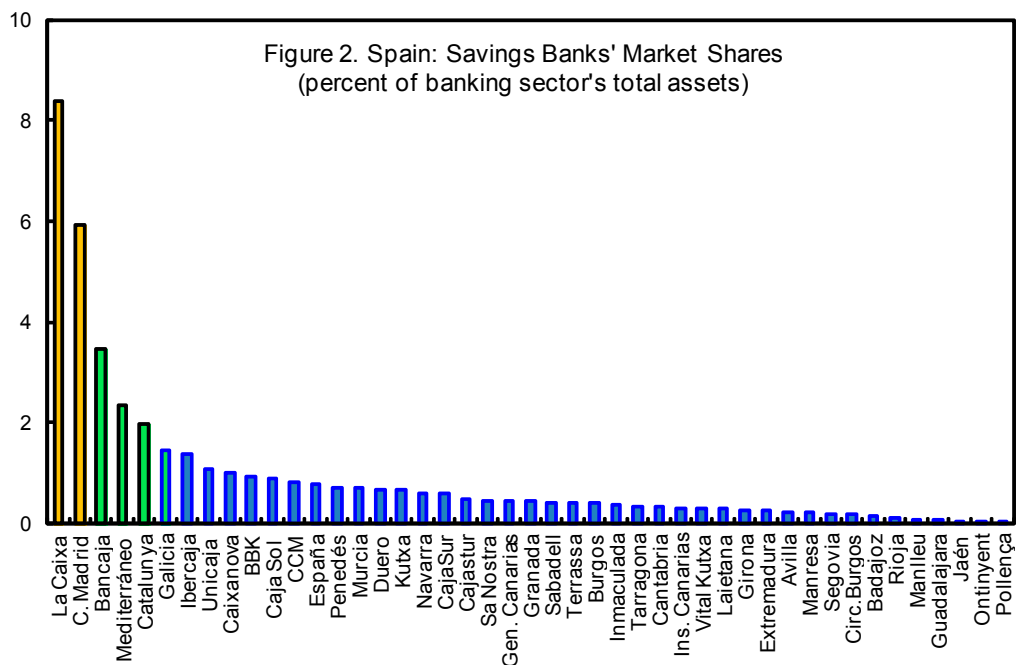
^{3/} Exceptionally, the buy-back period can be extended for two more years at a penalty surcharge of 100 bp per year.

^{4/} Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector, Official Journal of the European Union, 15.5.2009.

Figure 1. Spain: Savings Banks vis-a-vis Commercial Banks, 1980-2009



Sources: Banco de España; and IMF staff estimates.



Source: Bank of Spain.

Table 1. Spain: Financial System Support Measures

Program	Amount (€ bilion)	Operations	Actual use (as of end-April 2010)
Deposit insurance	N/A	In October 2008, the deposit insurance limit was increased to €100,000.	0.0
Guarantee	200	In October 2008, the government approved plans to guarantee up to €100 billion of bank debt for 2009. Another €100 can be extended if needed.	45.7
Other liquidity-support measures	50	In October 2008, the government established the FAAF with an endowment of up to €50 billion to buy non-toxic assets from banks and other financial institutions.	19.3
Capital support	99	In June 2009, the government created the FROB with an initial capital of €9 billion that could be raised by an additional €90 billion by issuing government-guaranteed debt securities. ^{1/}	2.2 2/

1/ The state contribution (€6.75 billion) comes from the unused portion of the FAAF; the remaining €2.25 billion is paid in by the different Deposit Guarantee Funds (banks, savings banks and credit cooperatives). On November 19, 2009, the FROB issued its first bond for €3 billion with a five year bullet maturity and a 3 percent coupon paid annually. The issue was rated triple-A given the irrevocable and unconditional guarantee by the state.

2/ Based on the three mergers approved by end-April (see, Table 2).

Table 2. Spain: Mergers and FROB Support

Merging institutions	Amount of the support (Millions of euro)
Caja Manlleu, Caja Sabadell, Caja Terrassa (Cataluña)	380
Caja Catalunya, Caja Tarragona, Caja Manresa (Cataluña)	1,250 (*)
Caja Duero, Caja España (Castilla y León)	525

(*) FROB support in excess of 2 percent of total risk-weighted assets of the three institutions.

ATTACHMENT V. EXTERNAL AND FISCAL SUSTAINABILITY

Spain has large domestic and external funding needs for the next few years. The government's funding pressure arises largely from amortization payments. On a year-to-date basis, the central government has raised roughly 37 percent of its total funding needs for 2010, in line with its pattern from 2009. Relative to its European peers on a debt-to-GDP basis, the public sector is not exceptionally indebted. And, debt rollover is a small portion of total government debt – the average maturity has lengthened in recent years to 6.8 years. Still, market scrutiny of its ability to meet its financing needs has increased recently and interest costs on newly-issued debt have risen. Spain's external funding needs arise largely from bank debt.

Baseline Scenarios

In the *baseline scenario* for the fiscal sustainability assessment, the underlying fiscal position is projected to improve slightly over the medium-term, with the gross financing need-to-GDP ratio peaking in 2011, at 22 percent, before falling gradually thereafter. Still, though improving, relative to history, gross government financing need is expected to remain large.

By contrast, and despite the narrowing current account deficit, the underlying gross external financing need is expected to extend its recent trend and rise gradually, reflecting primarily banks' reliance on wholesale funding.

Alternative Scenarios for Fiscal Sustainability

- **Interest rate.** Real interest rates in the baseline scenario are assumed to average 3.1 percent over the projection period. The impact of an increase in interest rate is not expected to have a significant effect on interest expenditure. Should real interest rates increase above the historical average of 1.3 percent (the historical average is depressed in large part by relatively high GDP deflators in the mid 2000s) and reach 3.7 percent (representing a ½ standard deviation shock), debt would increase to 97 percent of GDP by 2014/15, a little over 2 percentage points of GDP above the baseline. The modest impact on interest payment reflects the long average life of central government debt, whose average maturity has risen from 5.5 years in 2000 to 6.8 years in 2009. As a result, debt rollover over the forecasting period is expected to be modest.
- **Growth.** Relative to interest rates, Spain's public debt profile is more sensitive to shocks to growth. Should growth fall by a little over 1 percentage point over the forecasting period, the debt-to-GDP ratio could reach 108 percent by 2014/15, 13 percentage points higher relative to the baseline.

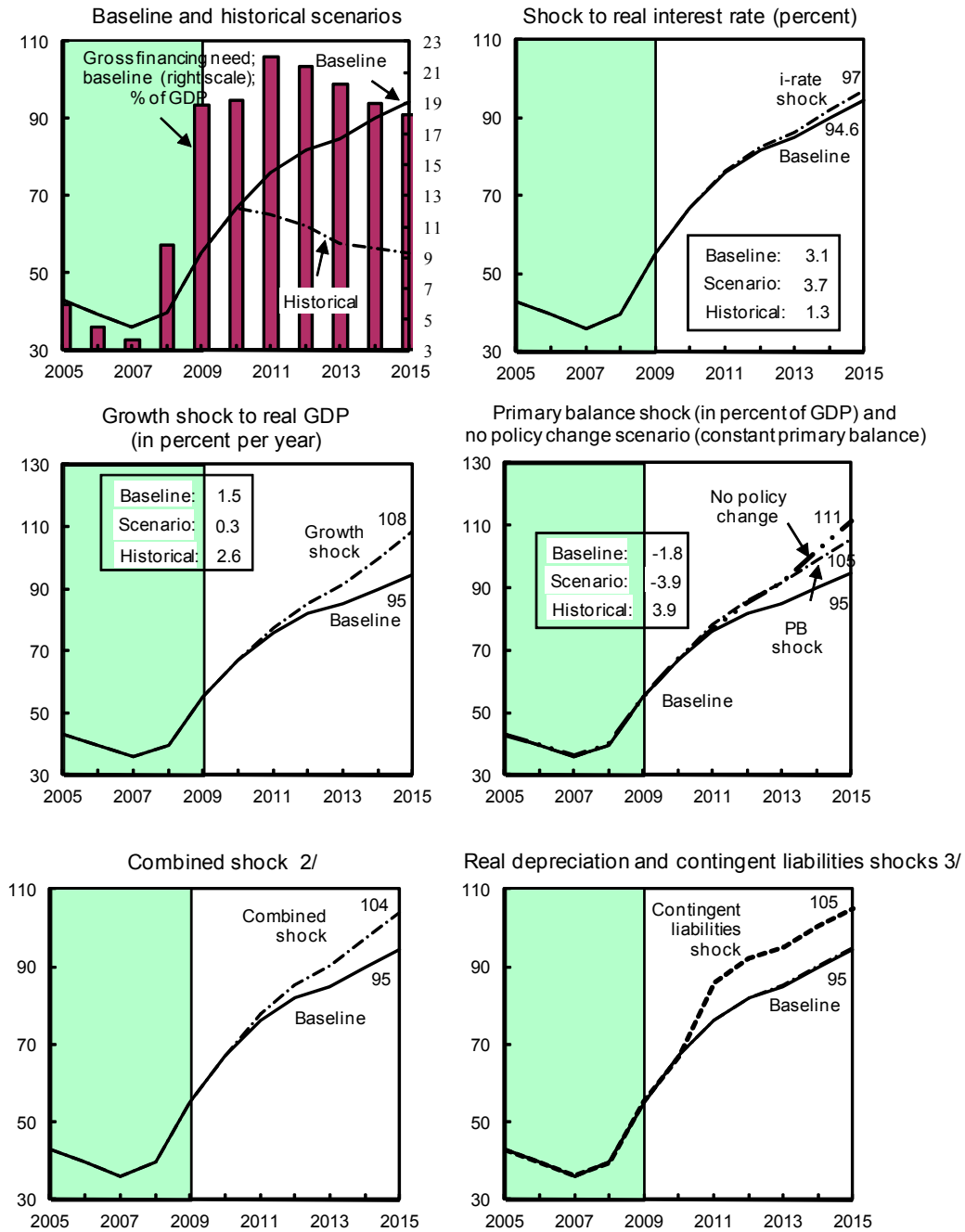
- **Euro depreciation and contingent liabilities.** In the case of a 30 percent nominal depreciation of the euro, after adjusting for domestic inflation, and a contingent liability shock of 10 percent of GDP, the debt-to-GDP trajectory is expected to increase to 105 percent. It is notable that the portion of the government's liabilities denominated in foreign currencies is small, at less than 2 percent. Thus, all else being equal, the impact of a sudden depreciation in the euro exchange rate on the debt profile would be modest.

Alternative Scenarios for External Sustainability

Despite the large external financing need, growth and current account shocks are expected to have modest impacts on the debt profile, while the impact of higher interest rate is projected to be small. And, largely as a result of the modest amount of debt denominated in foreign currency – at roughly 5 percent, a sharp depreciation of the currency poses limited risk to the baseline scenario.

- **Interest Rate.** The impact of a permanent $\frac{1}{2}$ standard-deviation shock to the interest rate for all outstanding debt — a 0.6 percentage point increase from the baseline — would increase debt by roughly 4 percentage points to 116 percent of GDP in 2015.
- **Exchange rate.** A one-time 30 percent depreciation in the euro in 2010 would increase debt by about 5 percentage points to 112 percent of GDP.
- **Combined shock.** A permanent $\frac{1}{4}$ standard deviation shock applied to the real interest rate, growth and the current account balance would increase external debt to 121 percent of GDP by 2015 (9 percentage points more than the baseline).

Figure 1. Spain: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

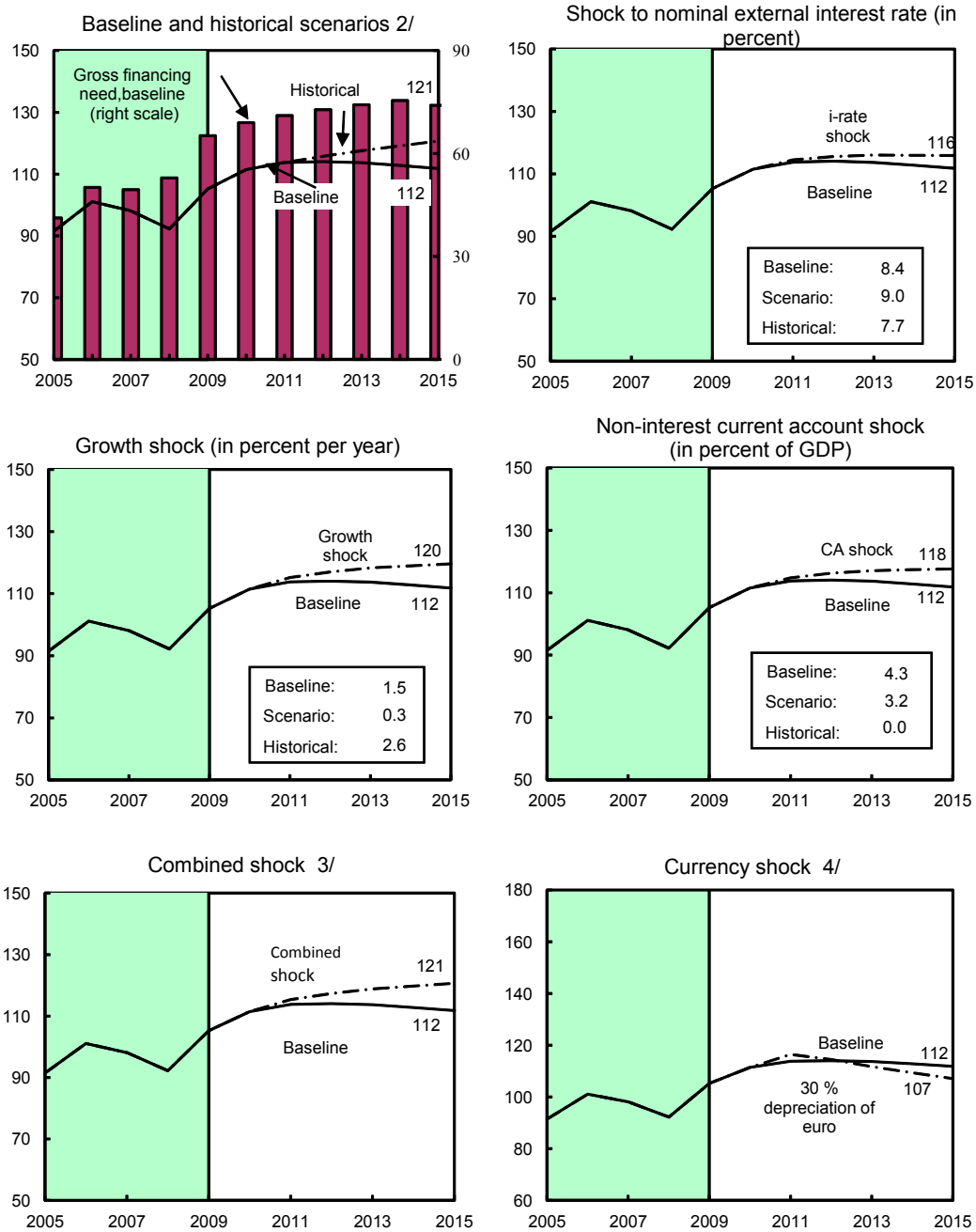
1/ Shaded areas represent actual data. In individual shocks are permanent one-half standard deviation shocks.

Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 2. Spain: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
 1/ External debt is derived as total external debt minus FDI and central bank holdings; calculations are based on Banco de Espana data.
 Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
 2/ Gross financing need is defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
 3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
 4/ One-time real depreciation of 30 percent occurs in 2010, real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

INTERNATIONAL MONETARY FUND

SPAIN

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by the European Department

June 30, 2010

	Contents	Page
Appendix		
I.	Fund Relations	2

Appendix I. Spain: FUND RELATIONS

(As of April 30, 2010)

- I. **Membership Status:** Joined September 15, 1958.
- II. **General Resources Account:**
- | | SDR Million | Percent of Quota |
|---------------------------|-------------|------------------|
| Quota | 3,048.90 | 100.00 |
| Fund holdings of currency | 2,482.13 | 81.41 |
| Reserve position in Fund | 566.78 | 18.59 |
- III. **SDR Department:**
- | | SDR Million | Percent of Allocation |
|---------------------------|-------------|-----------------------|
| Net cumulative allocation | 2827.56 | 100.00 |
| Holdings | 2951.89 | 104.4 |
- IV. **Projected Payments to Fund (SDR Million):**

	Forthcoming				
2010	2011	2012	2013	2014	
Charges/Interest	0.02	0.02	0.02	0.02	0.02
Total	0.02	0.02	0.02	0.02	0.02

- V. **2010 Article IV Consultation:** A staff team comprising J. Daniel (Head), K. Honjo, F. Jaumotte, M. Moreno-Badia, A. Popescu (all EUR), S. Chen (SPR), and A. Giustiniani (MCM) visited Madrid on May 13–May 24, 2010 to conduct the 2010 Article IV Consultation discussions. Mr. Guzman, Ms. Balsa, and Mr. De Las Casas from the Spanish Executive Director’s office, joined the discussions. For outreach, the mission met with parliamentarians, trade unions, employers’ organizations, bankers, and independent analysts. The concluding statement was published and the staff report is expected to be published as well. The Consultation includes annexes on (1) Spain’s Private Sector Balance Sheets; (2) Fiscal Consolidation and Fiscal Federalism in Spain; (3) The Spanish Labor Market in a Cross-Country Perspective; and (4) Reforming the Spanish Savings Banks. Spain is on a standard 12-month cycle. The last Article IV consultation discussions were concluded on March 11, 2009.
- VI. **Exchange Rate Arrangements and Restrictions:** Spain’s currency is the euro, which floats freely and independently against other currencies. Spain has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange rate system free of restrictions on payments and transfers for current international transactions, other than restrictions notified to the Fund under Decision No. 144 (52/51).

Statement by Mr. Ramon Guzmán, Executive Director for Spain
July 14, 2010

We thank the staff for the work put into the Report. While we broadly share the staff's analysis, most of the policy recommendations have somehow been overtaken by the response of my authorities to the crisis, with bold and ambitious measures that had been under preparation for months and were adopted within weeks of the consultations. These measures aim at returning to a sound fiscal position and at unlocking potential growth through structural measures in both the factor and product markets. Financial sector restructuring and the labor market reform are crucial steps already adopted, but also products and services markets have been under thorough reform. We would call the attention of the Board towards the Update Supplement and to Section 2 below.

1. Background

For more than a decade, Spain experienced a period of strong growth during which the economy developed substantial imbalances; namely, the overall level of debt of households and corporate sectors (linked to a large extent to the real estate boom) and persistent large current account deficits. Euro adoption in 1999 eliminated the currency risk and brought unprecedented low levels of real interest rates. European savings joined domestic savings to finance a buoyant private demand, also fueled by higher disposable income, intense job creation and consumer and business confidence.

It is relevant to underline that the increase in the indebtedness of the Spanish economy was essentially a private sector phenomenon. Spain adhered strictly to the European (SGP) public deficit and debt limits. By 2007 public debt was 36.1% GDP (well below EU average) and Spain presented a 2.2% GDP surplus.

Banks tapped European savings to finance credit growth through the securities markets. However, a sound regulatory framework kept risks at bay; provisions—including a countercyclical generic buffer—were roughly four times higher than in other EU banking systems; off-balance sheet vehicles were banned out of the banking landscape and lending standards did not universally relax (NPL in mortgages are still today below 3 percent).

The correction of the imbalances started in 2006–07, albeit in a gradual manner, induced by the combination of rising interest rates and stronger European demand. When the central scenario was that of a soft landing, the international financial crisis triggered a credit squeeze and delivered a shock to private sector confidence that accelerated the correction and caused a severe economic downturn. The economy adjusted mainly in quantities. Construction sector activity plummeted. The inefficiency of the Spanish labor market produced unemployment at the same speed as it produced employment during the boom. The downturn hit especially those under fixed-term contracts and those involved in the construction industry. Consumption and investment also adjusted severely. However, inflation also turned negative for a brief period, for the first time in decades.

Banks resisted the first impact of the crisis without government support (with the exception of some liquidity and funding facilities put in place during the first stages of the turmoil) although uncertainty about the length and depth of the downturn compelled the Government to initiate the restructuring of the sector. Some weaknesses gradually appeared, mainly linked to the Cajas. The Spanish savings banks suffered from a relatively high exposure to Real Estate and, given its legal nature, a more limited access to capital markets.

The sound initial fiscal position also helped the economy weather the initial phase of the crisis. However, the fall in tax receipts and the increase in transfers via unemployment benefits took the deficit to unexpectedly high levels (11.2 percent of GDP at end 2009). Part of the deficit originated in the stimulus measures adopted to mitigate the impact of the crisis as part of the EU/G20 coordinated response.

The management of the Greek crisis failed to prevent contagion to other European countries. In January 2010, Spain announced fiscal measures redoubling efforts to consolidate, already within the restrictive envelope of the 2010 Budget. Also, in January, the Government launched the pension reform debate and challenged unions and business federations to reach agreement on a reform of the labor market in six months. Tensions in financial markets continued to increase. Ultimately, in the weeks immediately after the European Council Decisions of May 9th (creation of the EFSF in the wake of the approval of the Greek package) my authorities multiplied their efforts to stabilize market perceptions and to support the incipient recovery.

2. Recent Policy Measures

Fiscal measures. The first priority was to reassure markets on the commitment of the Government to fiscal sustainability. On May 20th Parliament approved a package of fiscal measures to guarantee the accomplishment of the 3 percent deficit target by 2013. The measures reverse the stimulus package put in place during 2009 and deliver further structural adjustment, altogether adding 1.5 cumulative percentage points in 2010 and 2011, to the initial consolidation plan. The measures are bold; they imply significant cuts in wages (applicable to all levels of Government), pensions, public investment and other current expenditures. The deficit is projected to fall from 11.2 percent to 9.3 percent of GDP by end 2010, and to 6 percent of GDP by end 2011. The package effectively frontloads 60 percent of the total adjustment in the first two years of the consolidation period (2010-2013).

On June 15th the Fiscal and Financial Policy Council—that coordinates fiscal matters with the regions—unanimously agreed on the fiscal targets for the regional governments for the period 2010-2013. Moreover, the agreement with the Regions contemplates a significant tightening of the budgetary discipline framework, with bi-annual evaluations linked to the adoption of additional measures and/or to debt authorizations. An explicit prohibition to municipalities to raise debt in 2011 has also been introduced. Finally, on June 16th the Government approved the expenditure ceilings for 2011 (with a 7 percent reduction on preceding budget ceilings).

The fiscal policy is designed around its deficit targets and is independent of the macro scenario. Monitoring will detect slippages due to lower growth and additional measures are

prepared and will be implemented if the 6 percent or the 3 percent targets were at risk. Any excess receipts will not be used to increase expenditure.

Last but not least, a comprehensive pension reform is underway in the context of a special parliamentary Commission. The Government has tabled a proposal based on a gradual increase of the retirement age (to 67 years), on strengthening the relationship between contributions and benefits, and possibly including an adjustment of other parameters of the current system. This reform will be finalized in the next few months and will constitute a decisive step to guarantee the sustainability of the pension system and a significant improvement of the long-term fiscal outlook.

Labor market reform. The second challenge was to reform the labor market in order to unlock growth potential. Again, the staff report and update describe the main issues. Let me emphasize that the two key objectives are a) to foster the flexibility of firms, both in terms of wages (effectively allowing for the opt out clauses to function) and working conditions and, b) to reduce the duality in the labor market by generalizing the use of an indefinite contract with 33 days wages per year of service as termination payment (currently 45) and by providing legal certainty and a less burdensome process for the firing of workers on economic grounds.

The measures approved represent a significant break with years of inaction and point in the right direction as staff highlights. As with any structural change, its effects will be felt only over a period of time, but my authorities are confident that the newly awarded flexibility will serve the companies well in adjusting to competition, ultimately facilitating the shift of resources towards the tradable sector from less productive activities.

Financial sector. Finally, the consolidation process of the financial sector under the FROB (Fund for the Orderly Restructuring of the Banking sector, launched in June 2009) was finalized. The FROB avoided a widespread recapitalization and addressed the problems of banks individually and minimizing costs for the taxpayer. The process has ended with 92 percent of the Cajas sector assets (39 out of 45 Cajas) involved in merger operations. This process will imply a 15 percent reduction in personnel and a 25 percent reduction in terms of branches, significantly reducing capacity and triggering synergies that will help get credit flowing back into the economy.

As the consolidation process went on, lingering doubts about the health of the sector centered on bank's exposure to Commercial Real Estate (CRE). In April 2010, GFSR and BoS stress tests took into account this exposure and concluded that, even in the most severe scenarios, losses would be contained and FROB resources would comfortably cover them. My authorities have since promoted the publication of stress tests, on a bank by bank basis, in order to restore the credibility of the robustness of our financial system. Pending details on common assumptions and methodologies, the BoS has already committed to this publication in the context of the European wide stress tests, probably on July 23rd.

Looking beyond the short term, the Government approved the Reform of the regulatory regime of Cajas, on July 9th. Basically, this reform aims at facilitating the transformation of Cajas into banks (by delinking the banking business from the consolidated and merged Cajas) with total independence from the former governing bodies, professional management and

subject to capital markets discipline. A number of small, vocationally local, Cajas might be allowed to retain their legal statute, but the regulatory burden will be tailored to carefully balance their capitalization capabilities and business models.

3. Outlook

While we agree on the thrust of Report, our analysis is more optimistic on the pace of the recovery. Differences of view merely qualify the challenges facing the economy and impact on the speed and specific shape of the adjustment looking forward, but do not imply differences on the broad diagnosis, neither on the policy mix necessary to facilitate recovery:

Real Estate Sector downsizing. The necessary price correction in housing might be overestimated. Demand for housing services or for housing as a store of value has proven a consistently sound investment; NPLs in mortgages are below 3 percent which hints at non-speculative factors behind demand (population dynamics, size reduction of households). However, supply outgrew demand in 2006 and 2007 and the stock of unsold houses, estimated at 700,000, will start to shrink in 2010, but still limits residential investment that will remain negative in 2010 and 2011. The length and speed of this adjustment is crucial for the economy; my authorities estimate that within two years trend demand will absorb the accumulated inventory.

Speed of deleveraging. A close up picture of the Spanish private sector's indebtedness reveals important facts concealed beneath the averages. In the corporate sector, leverage is essentially a problem linked to the Real Estate boom. Credit to Gross Value Added for the Construction and Real Estate sector reached 439 percent in 2009, while it is a mere 62 percent for the rest of the non-financial corporations, not far away from the 53 percent average in the Euro Area. All in all, gross savings rates and net borrowing to GDP rates of non-financial corporations prove that the deleveraging process of Spanish firms is well underway.

Also household deleveraging might prove faster than what staff anticipates. Households financed their housing investment with bank debt and in doing so increased their real wealth and reduced their housing expenses. If residential rent payments are taken into account, debt service relative to income is moderate, while interest rates remain at historically low levels (96 percent of mortgages at variable rates). Moreover, as the staff points out, households' savings ratio has jumped to unprecedented levels making deleveraging compatible with moderate consumption growth [especially non-durables and services].

Competitiveness of the Spanish economy. Over half of the investment that took place in the run-up to the crisis did not go into construction, or into real estate. "Asian" rates of investment helped modernize the capital stock and the infrastructures of the economy. Price competitiveness indicators tend to overestimate cost and inflation factors as the engines behind our current account deficit, and conceal the well-known dual inflation problem in the Spanish economy (export prices do not rise as those of non tradable). If it is probably true that the ongoing reduction of costs vis-à-vis the rest of the world would contribute to the rebalancing of our growth model, it is easy to exaggerate the degree to which it is necessary in

the overall adjustment of the economy. My authorities do not foresee a drastic deflationary process looking forward.

To sum up, my authorities have embarked in an ambitious package of measures to put in place the necessary conditions to facilitate the rebalancing of our growth and to trigger the recovery. However, progress will not be possible unless financial market conditions stabilize. While the measures adopted, per se, should have a positive impact on consumer and investor confidence, and increase aggregate demand, we are also fully aware of the importance of the recovery within the EMU and the EU more broadly, and of the importance of fiscal consolidation and banking sector recovery at the European level.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 10/106
FOR IMMEDIATE RELEASE
July 30, 2010

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

IMF Executive Board Concludes 2010 Article IV Consultation with Spain

On July 14, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Spain.¹

Background

After 15 years of strong growth led by a housing boom, the Spanish economy has entered a sharp downturn in the wake of the global financial crisis since mid-2007. Output fell sharply, driven by sharp declines in investment, exports, and private consumption, while weaker imports and rising government demand provided some offset. Imbalances accumulated during the long boom have begun to unwind, with the current account deficit halving as private savings surged and housing investment fell. Competitiveness has begun to improve as productivity rose and the core inflation differential with the euro area turned negative. However, the crisis has taken a heavy toll on the labor market, with the unemployment soaring to 20 percent, reflecting wage and working hour rigidities, the large share of temporary workers and the real estate bust. A labor market reform was adopted in June 2010.

The general government deficit swung from a surplus of 2 percent of GDP in 2007 to a deficit of 11.2 percent of GDP in 2009, due to the large stimulus and evaporating cyclical and one-off revenues. The debt ratio increased significantly – though from a low level. Fiscal consolidation is underway, including with a range of measures taken in

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. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

2010, aimed at achieving the government's deficit target of 3 percent of GDP by 2013 (which has also been agreed with sub-national governments).

Spanish banks overall report robust capital and provision buffers, supported by a strong supervisory framework. However, risks remain substantial and unevenly distributed across institutions. The authorities have put in place a range of measures to support banks, including the Fund for Orderly Bank Restructuring (Fondo de Reestructuración Ordenada Bancaria—FROB) that supports the consolidation and recapitalization of the sector by providing temporary capital assistance to merging credit institutions. The process of consolidating savings banks has accelerated – as of end-June 2010, 12 merger/integrations were underway, comprising 92 percent of the assets of the savings bank sector. Governor Ordóñez also announced in mid-June the Bank of Spain's intention to publish bank-by-bank results of stress tests. A decree reforming the regulatory framework of savings banks was approved by the government on July 9, 2010.

Executive Board Assessment

Executive Directors noted that the necessary adjustment of the economy is underway as imbalances accumulated during the long boom years have begun to unwind, and that output has stabilized. The growth outlook, however, remains uncertain owing to unstable financial market conditions and weak domestic demand.

Directors welcomed the authorities' decisive policy response to the financial market turbulence and recent reform measures to secure market confidence and foster the smooth rebalancing of the economy. They noted that the Spanish authorities have undertaken significant corrective measures since the staff report was issued. They stressed that continued action will be needed on several policy fronts, including: (i) moving ahead with fiscal consolidation and pension reform, to put public finances on a sustainable footing; (ii) strengthening the recent labor market reform, to promote employment and its reallocation across sectors; and (iii) and following through on banking sector reform, to cement the soundness and efficiency of the system. Directors emphasized that these actions will help to contain the heightened risks faced by Spain, and to avoid the heavy costs for Spain and other countries should these risks materialize. Directors agreed that the successful implementation of such a far-reaching reform strategy will require broad political and social support.

Directors endorsed the ambitious fiscal consolidation underway. They welcomed the wide range of concrete and bold measures adopted and considered the envisaged deficit path to be appropriately front-loaded. Directors stressed that, owing to the considerable uncertainty associated with the macroeconomic projections, additional measures should be prepared if needed to make attaining the targets more credible. Directors underscored the need for a bold pension reform to complement fiscal consolidation and recommended strengthening compliance mechanisms.

Directors welcomed the recent labor market reform and encouraged further efforts to make the labor market more flexible and competitive. They broadly agreed that severance payments should be reduced to at least EU average levels and that this

should be complemented by further clarifying the conditions for fair dismissals, decentralizing the wage setting process, and eliminating wage indexation.

Directors noted that the banking sector remains sound, but faces elevated and unevenly distributed risks. They welcomed recent consolidation of savings banks and the reform of their regulatory regime. They also welcomed the authorities' announcement of their intention to publish bank-by-bank stress tests results, noting that it will be important for these tests to be based on realistic assumptions and accompanied by a clear strategy for addressing capital shortfalls faced by any institutions.

Directors commended the considerable progress achieved in recent years on product and service market reform. They agreed that, going forward, the main priorities should be to further reduce restrictions on retail trade, professional services, and the rental market.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The [staff report](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2010 Article IV Consultation with Spain is also available.

Spain: Selected Economic Indicators, 2005–10

	2005	2006	2007	2008	2009	2010 1/
Real economy (change in percent)						
Real GDP	3.6	4.0	3.6	0.9	-3.6	-0.4
Domestic demand	5.1	5.2	4.2	-0.5	-6.0	-1.5
Harmonized index of consumer prices (HICP)	3.4	3.6	2.8	4.1	-0.3	1.4
Unemployment rate (in percent)	9.2	8.5	8.3	11.3	18.0	19.3
Public Finance (in percent of GDP)						
General government balance	1.0	2.0	1.9	-4.1	-11.2	-9.3
General government structural balance	-1.6	-1.2	-1.1	-4.8	-9.3	-7.8
Primary balance	2.8	3.7	3.5	-2.5	-9.4	-7.1
General government debt	43.0	39.6	36.1	39.7	53.2	63.7
Interest rates (in percent)						
Money market rate	2.2	3.1	4.3	4.6	1.2	0.8
Government bond yield	3.4	3.8	4.3	4.4	4.0	4.0
Balance of payments (in percent of GDP, unless otherwise noted)						
Trade balance (goods and services)	-5.1	-6.2	-6.5	-5.6	-1.8	-1.3
Current account balance	-7.4	-9.0	-10.0	-9.7	-5.4	-4.9
Fund position (April 30, 2010)						
Holdings of currency (percent of quota)						81.4
Holdings of SDRs (percent of allocation)						104.4
Quota (millions of SDRs)						3,048.9
Exchange rate						
Exchange rate regime						Euro Area Member
Euro per U.S. dollar (July 14, 2010)						0.79
Nominal effective rate (2000=100) 2/ 3/	106.3	106.5	108.1	110.5	110.7	108.7
Real effective rate (2000=100) 2/	119.1	122.4	126.4	134.7	135.2	133.4

Sources: Bank of Spain; National Institute of Statistics (INE); Eurostat; and IMF staff estimates.

1/ Staff projections, unless otherwise noted.

2/ Data from IMF, *International Financial Statistics*.

3/ Corresponding to the ULC-based real effective rate.