© 2002 International Monetary Fund

March 2002
IMF Country Report No. 02/53

Spain: 2001 Article IV Consultation—Staff Report; Staff Supplement; 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 2001 Article IV consultation with Spain, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **October 22, 2001,** with the officials of Spain on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on January 10, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of **January 29, 2002** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its February 1, 2002 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.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to Publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

Price: $15.00 a copy

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

INTERNATIONAL MONETARY FUND

SPAIN

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation with Spain

Approved by Michael Deppler and G. Russell Kincaid

January 10, 2002

- Consultation discussions were held in Madrid during October 15–22, 2001
- The staff team comprised Messrs. Watson (head), Hoffmaister, and Mehrez (all EU1), and Ms. Daban (FAD). Mr. Varela (OED) participated in the meetings.
- The team met with Vice-Prime Minister and Minister of Economy Rato, Minister of Finance Montoro, Bank of Spain Governor Caruana, and other senior officials. It also met with members of the private sector—including financial institutions, the employers' association, and labor unions.
- Spain is a founder member of the euro and maintains an exchange system free of restrictions on payments and transfers for current international transactions (Appendix I).
- Spain has subscribed to the Special Data Dissemination Standard, and has accepted the obligations of Article VIII, Sections 2, 3, and 4 (Appendix II)
- The authorities have indicated their intention to publish this staff report.

Contents Page

I. Introduction 3

II. Economic Background 3

III. Report on the Discussions 7
- A. Cyclical Situation and Near-Term Fiscal Issues 7
- B. Medium- and Long-Term Fiscal Issues and the Fiscal Framework 10
- C. Labor and Product Markets 13
- D. The Financial Sector 17
- E. Other Issues 20

IV. Staff Appraisal 21

Figures
1. Spain and Euro-12: Output and Employment, 1980-2001 24
2. Aggregate Demand, 1990-2001 25
3. Consumer Prices, 1990-2001 26
4. Capacity Utilization, 1990-2001 27
5. Real Effective Exchange Rates, 1988-2001 28
6. Fiscal Indicators, 1990-2001 29
7. Inflation, Wages, and Productivity, 1997-2001 30

Tables
1. Main Economic Indicators, 1997-2002 31
2. Medium-Term Fiscal Scenario on Present Policies, 1997-2004 32
3. Authorities' Stability Plan, 2001-05 33
4. Indicators of External and Financial Vulnerability 34

Text Boxes
1. Is Spain's Inflation Too High? 5
2. Recent Labor Market Reforms 14
3. Job-Rich Growth 15
4. Exposure of the Banking System to Latin America 19

Appendices
- I. Fund Relations 35
- II. Statistical Issues 36
- III. Inflation in Spain and the Euro Area 38
- IV. The Draft Budgetary Stability Law (BSL) 42
- V. Pensions: Reform Options and Economic Outcomes 44

I. Introduction

1. **The last consultation was concluded on October 24, 2000.** Directors praised Spain's impressive macroeconomic policy management, which—together with labor and product market reforms—had led to an unprecedented combination of rapid output and employment growth, with historically low inflation. They welcomed the goal of balancing the budget by 2001, earlier than planned—especially given monetary conditions that were easy relative to Spain's cyclical position; and they advised aiming for a medium-term surplus, to complement entitlement reforms in addressing the fiscal impact of population ageing. They were concerned about the persistent inflation differential relative to the euro-area average, and about wage indexation. They urged reforms to continue stimulating employment growth, and to reduce the dispersion of regional unemployment rates.

2. **The government of Prime Minister Aznar (Partido Popular) has embarked on major initiatives to improve the fiscal framework, while continuing to move forward with other structural reforms.** A draft law on the medium-term fiscal framework is before parliament, and is flanked by new regional financing arrangements. Some further progress has been made on labor market and pension reforms—areas critical to speed income convergence and to address a serious long-run demographic shock—and further measures in these areas are on the government's agenda. Spain's EU presidency, from January 2002, will cover late-stage enlargement negotiations. In addition, the authorities' economic priorities for the presidency include continuing emphasis on structural reforms throughout the EU, including in transport and communications, and the single market in energy.

II. Economic Background

3. **The strong expansion of the late 1990s has tapered off—and unease about risks of overheating has given way to concern about the current slowdown.** The economy grew by over 4 percent annually during 1997–2000—reflecting strong consumption, competitive exports, wage moderation, and supply conditions enhanced by structural reforms. Policy credibility contributed, as interest rates declined steeply in the run-up to monetary union. Recent months, however, have seen growth projections cut—and the inflation differential with the euro-area average subsiding, in contrast with the first half of 2001 when it increased.

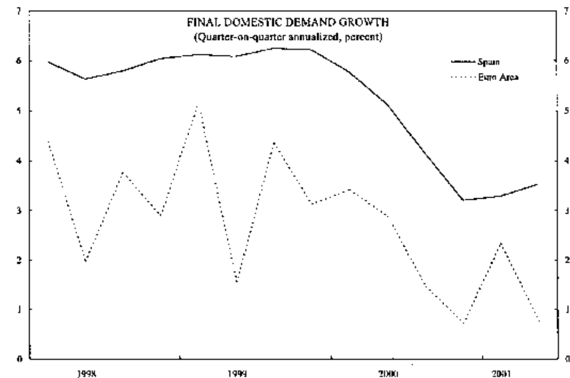
Selected Economic Indicators, 2001-02
(Growth rates in percent, unless otherwise noted)

	Spain	Euro area	Spain	Euro area
	2001		2002	
Harmonized inflation	3.6	2.7	2.1	1.6
Real GDP	2.7	1.6	2.1	1.3
Output gap 1/	0.2	-0.9	-1.1	-2.1
Real final domestic demand	2.5	1.5	2.1	1.4
Real total domestic demand	2.5	1.3	2.1	1.5
Employment	2.1	1.0	1.8	0.2

Sources: *World Economic Outlook* and Fund staff estimates in late November.

1/ In percent of potential GDP

4. **The latest high frequency indicators confirm that growth continues to slow:**



- Indicators of *final expenditure* point to a further deceleration. Growth of domestic demand slowed throughout 2000, and leveled off in 2001. Annualized real GDP growth was about 2 percent in Q3, compared to 2½ and 3 percent respectively in Q2 and Q1. Retail sales have held up reasonably well, including strong auto sales in October; but consumer confidence, hesitant since mid-2001, has turned pessimistic. Export growth has been decelerating since mid-2000, most notably to the United States and emerging markets. However, as the new economy is not strongly developed in Spain, it has not played a large role in the transmission of shocks. Capital goods imports are declining. Industrial production has been decreasing during most of 2001, and in Q3 stood ½ percent lower than a year before. And since Q2, 2001, industrial confidence indicators have shown a pessimistic balance for the first time in recent years.

- In the *labor market*, employment growth has slowed from about 5 percent in 2000 to under 2 percent (year-on-year) in Q3, 2001. Fixed-term contracts continue to play a far greater role in the labor market than in other EU economies (still accounting for some 30 percent of employment), due to very high firing costs on regular open-ended contracts. With participation slipping, unemployment has continued to decline: at just under 13 percent in Q3 it was at the lowest level since 1980, though still the highest among the advanced economies.

- In November, the 12-month headline rate of *CPI inflation* eased to under 2¾ percent, against about 4¼ percent in June. Over the past four years, its margin over the euro-area average rose from ½ to nearly 1½ percentage points (in June 2001), but has since declined to under 1 percentage point. Still, service sector inflation continues to run at about 4 percent, and core inflation—excluding food and energy—is fluctuating around 3½ percent. Some margin of cost increases over the euro-area average likely represent an equilibrium adjustment, however—and recent price trends have been within plausible bounds in this regard, as discussed in Box 1 and Appendix III.

- *Wage increases* were moderate throughout 1997–2000, but the rise in hourly earnings accelerated to 3¼ percent in Q2, 2001. Newly signed contracts show a rise of about 4 percent—½ to 1 percent above the euro-area average. In the perspective of the past five years, some real wage catch-up seems warranted, though assessment is complicated by poor productivity data. The economic slowdown appears to be encouraging continued wage moderation, with indications that settlements in 2002 may remain in low single digits.

Box 1: Is Spain's Inflation Too High?

As theory would suggest, significantly different rates of CPI inflation have emerged under EMU. In Spain, inflation has exceeded the euro-area average by some 1 percentage point over the past two years. The differential rose to 1.4 points in the first quarter of 2001, before falling to under 1 percentage point recently. Should this inflation differential be a source of concern?

In principle, the differential may reflect several factors:

- The ***Balassa-Samuelson effect***—essentially the catch-up of productivity in tradable goods, which causes appreciation of the real exchange rate. This is an equilibrating process.
- The ***convergence of nontraded goods prices as income levels converge.*** Among other factors, this could reflect the tendency for the relative demand of nontraded versus traded goods to increase as income levels rise, leading to an equilibrating real appreciation.
- The operation of ***relative price changes to dampen excessive demand in a cyclically-advanced economy under monetary union:*** when euro area monetary conditions prove relatively loose for such economies, price and wage increases in these economies will tend to be correspondingly higher, and these developments in relative prices will contribute to slowing economic growth to a more sustainable pace. This too is an equilibrating process, although overshooting of prices and wages (or asset prices) can emerge as discussed below.

With regard to the last factor, potential risks of macroeconomic disequilibria can emerge under a monetary union, if real and financial markets manifest overshooting in the form of very strong wage increases or exuberant behavior in asset markets. If left unchecked, such overshooting cycles can lead to overextended households or businesses, and/or impaired bank portfolios; and to a prolonged period of real exchange rate readjustment (issues discussed in SM/00/182). Abstracting from transmission lags and open economy leakages, fiscal tightening might dampen such a cycle. In this respect, the need for adjustment is clear when pressures arise from ***lax fiscal policy***, but less so when pressures originate from other demand sources. By contrast, ***in Spain the public finances are well under control and wage increases remain moderate*** despite its cyclically-advanced situation within the euro area. Although the available evidence requires an agnostic view on the balance of the factors underlying the inflation differential in Spain (see also Appendix III), ***the current levels of inflation do not appear to be a cause for concern requiring adjustment in aggregate demand policies.***

- *Competitiveness* still appears satisfactory—though it is hard to assess, given poor productivity data. Export profitability has certainly remained strong. However, these trends in part reflect the depreciated level of the euro, which has on average remained some 10 percent below the CGER "equilibrium" level. Spain's external current account deficit rose from 2.3 percent of GDP in 1999 to 3.4 percent in 2000—but with no particular worries in its financing, or the pattern of domestic saving-investment counterparts—and is estimated at 2.1 percent in 2001.

- In the *credit markets*, household debt has increased from 35 percent of GDP in 1997 to 50 percent in 2001. While this is about the EU average, the rise has been rapid—and consumers could pull in their horns if job creation continues to slow, dampening private consumption. Firms, too, have increased their leverage. On the supply side, commercial banks are profitable and well capitalized, though facing increased risks, especially in Latin America. Commercial bank lending has slowed of late, while savings banks have expanded their market share in the mortgage and consumer finance areas.

5. **Following the series of ECB policy rate cuts in 2001, to 3¼ percent in November, monetary conditions relative to the Spanish cyclical position have remained somewhat easier than for the euro-area average.** Real short-term interest rates are now essentially zero, and the real effective exchange rate has depreciated. Meanwhile, the output gap in 2001 was narrower than the euro-area average by approximately 1 percentage point.

6. **In 2000, the fruits of higher-than-projected growth were used to reduce the fiscal deficit, allowing the goal of balance to be advanced to 2001.** The general government deficit was cut to 0.3 percent of GDP in 2000, against a budgeted 0.8 percent. The overperformance was more than accounted for by social security and the central government. The main goal of the 2001 budget was to achieve general government balance, while increasing investment—and this appears to have been broadly on track, despite slower growth. The fiscal stance (in structural primary terms) was projected to be approximately neutral, given the anticipated growth rate. When the budget was presented, balance seemed within easy reach—but growth was then assumed to be over 3½ percent, against a likely outcome closer to 2¾ percent. Sticking to a nominal balance target with growth of only 2¾ percent is likely to have implied a contractionary impulse (at the structural primary level) of close to ½ percent of GDP. Even so, with the easing of monetary conditions, the overall stance of macroeconomic policies in 2001 appears to have been broadly neutral.[1]

7. **Forecasts for 2002 have been marked down progressively in recent months.** The economy should continue to expand at a rate significantly above the euro-area average, but the staff's projection is now for growth of only some 2.1 percent—based on a gradual and broad-based recovery of activity in the second half of 2002.[2] Investment and consumer spending are likely to pick up from Q3, as confidence recovers; and the contribution of the external sector is projected to turn positive during the course of the year. With wage growth

---

[1] Interest rates were cut by 1.5 percentage points in 2001: 0.25 percentage points on May 10 and August 30, and 0.50 percentage points on September 17 and November 8. Since interest rate cuts were mostly in the second half of the year, their impact will be larger in 2002. OEF model simulations equate a 100 b.p. fall in short-term nominal rates with a fiscal impulse of ½ percent of GDP: both lead to a first-year rise of 0.4 points in GDP growth.

[2] The December 2001 consensus growth forecast is 1.9 percent for 2002.

moderate, unemployment is likely to be broadly unchanged at just under 13 percent in 2002, while inflation is expected to fall below 2 percent by year-end.

III. Report on the Discussions

8. **The authorities considered two challenges for policy to be critical at the present time: to lock in the progress achieved in fiscal consolidation, and to move forward with structural reforms that should accelerate economic convergence—both with more advanced EU economies and within Spain.** The new Budgetary Stability Law (BSL) was designed to foster enduring fiscal stability. Product and labor market reforms were continuing to make headway. Together, these elements provide a setting for sustainable and broad-based economic growth over the medium term. Welcoming these priorities, staff emphasized the need to blend firm fiscal discipline with an avoidance of pro-cyclical policies—and, in structural reforms, the importance of changes sufficiently far-reaching as to sustain economic convergence and address fully the impact of population ageing.

A. Cyclical Situation and Near-Term Fiscal Issues

9. **Government officials expressed evolving views on the potential severity of the slowdown.** At the time of the discussions, given the exceptional uncertainty of the post-September 11 outlook, they had not yet adjusted official growth projections—which centered around 3 percent for both 2001 and 2002. There was, however, deepening awareness that Spain could be significantly affected, as the extent of the slowdown in the United States and in Europe was becoming clearer. But officials viewed as unlikely a scenario of protracted slow growth. Employment would continue to expand, sustaining household confidence and spending. Some officials and private sector participants saw particular downside risks in tourism; but others noted that the geographic mix of visitors did not appear particularly vulnerable, while a positive diversion of business away from riskier Mediterranean markets could cushion any decline in earnings. Official projections for growth in 2002 have recently been revised to 2.4 percent by the Ministry of Economy (and to 2–2.5 percent by the Bank of Spain)—as against the current staff projection of 2.1 percent.

10. **The authorities confirmed that inflation worries had diminished substantially since mid-2001.** The ongoing slowdown had lowered demand pressure in sectors where capacity constraints were tightest; and while wage indexation had become more widespread, its effect had not in practice upset the trend of wage moderation. Inflation would likely remain above the euro-area average, reflecting the gradual convergence of service sector prices toward the euro-area average—and potentially also the Balassa-Samuelson effect (Box 1 and Appendix III). Nonetheless, some officials warned of the risk that supply constraints also could contribute to keeping inflation above the euro-area average as growth reaccelerated, potentially affecting competitiveness adversely.

11. **Though not without some concerns for the future, the authorities saw competitiveness currently as broadly satisfactory.** Improvements in competitiveness in the

second half of the 1990s had been largely associated with the depreciation of the euro. At the same time, Spain's share in the imports of other euro-area members had remained roughly constant according to recent data. But any sharp appreciation of the euro could cut into currently satisfactory profit margins. Indeed, concerns about future competitiveness were expressed quite strongly by the employers' association.

12. **Even before the November 8 cut in interest rates, monetary conditions were easier than justified from a purely Spanish perspective, the authorities noted.** But given the balance of risks in the outlook, they agreed that the implications of easy monetary conditions were less troubling now than a year ago. Moreover, their expansionary effect would be partially offset by a negative fiscal impulse in 2001 and 2002. Regarding the introduction of the euro, they expected the changeover to go smoothly. Among other effects, they noted speculation that there might have been a stimulative impact in sectors such as construction as gray money returned to the system.[3] Subsequent information suggests that the euro changeover has indeed got off to a smooth start. Early indications, in the first week of January, showed euros already being used to pay for about 40 percent of retail purchases, and change being given in euros in about 70 percent of such transactions. Over 90 percent of automatic tellers were by then converted to operate in euros.

13. **The authorities still anticipated that the fiscal accounts would be in balance in 2001, despite slower growth in economic activity.** Revenues had been on track so far, although their composition was somewhat different than budgeted—with higher-than-anticipated personal income taxes and social security contributions offsetting lower VAT receipts. Expenditures also had been roughly in line with projections, and the substantial public investment program was being executed as budgeted.

14. **For 2002, the authorities were confident that the public finances would remain in balance—or at the worst show a very small deficit, reflecting solely growth-related revenue shortfalls.** They anticipated that private investment would benefit from the advancing of tax reforms to 2002. This package focused on promoting investment by: (i) reducing the capital gains tax from 35 to 18 percent on gains reinvested in 2002; (ii) extending the lower marginal profit tax rate for small- and medium-sized enterprises (SMEs) to a larger number of firms, by raising the SME threshold; (iii) promoting mergers and acquisitions, through a wider potential to offset gains with losses in another firm on consolidated tax returns; and (iv) increasing incentives for employer and employee

[3] The authorities anticipated no more than small effects on the price level. For the sake of illustration, however, a recent Bank of Spain study suggests that in the unlikely case that all prices were rounded up, measured inflation could increase as much as 0.4 percentage points in 2002.

contributions to collective pension funds by establishing a 10 percent tax deduction.[4] On the expenditure side, the budget placed emphasis on investment and education. Overall, and assuming that automatic stabilizers were to operate fully, a small fiscal withdrawal would emerge in 2002, in line with Spain's 2000 Stability Plan. Given very easy monetary conditions, this would imply a slightly expansionary overall stance of macroeconomic policies—fitting well with the current outlook.

15. **If growth in 2002 were slower than the 2.9 percent they anticipated at the time of the discussions, the authorities agreed—albeit with some reservations—that it would be inappropriate to introduce pro-cyclical measures.** Certainly, they did not intend to cut investment or increase rates of major taxes such as the VAT or the corporate and personal income taxes. They stressed, however, that fiscal consolidation remained the cornerstone of their economic policies, and that there must be no sense that this underlying commitment was weakening under adverse economic conditions. No officials saw a case for discretionary fiscal stimulus. Some officials, indeed, remained concerned that any emphasis on the "automaticity" of stabilizers might be misconstrued as passively allowing a loss of fiscal discipline—putting hard-won credibility at risk: in this perspective these officials did not rule out some increases in excises or duties.

16. **The staff endorsed the emphasis on strict spending control, but stressed that—to the extent growth was lower than envisaged—the resulting deficit in 2002 should be accepted.** The authorities' earlier decision not to aim for a surplus in 2002, given the deteriorating growth outlook, was welcome. Pro-cyclical actions should be avoided: past successes in consolidation had left Spain well placed to show flexibility now. But accommodating cyclical fluctuations should not open the door to a loss of discipline, staff agreed; and, absent a major change in the outlook, a discretionary stimulus was not called for, in the face of what appears to be a symmetric shock to the euro-area economy. Of course, discretionary actions to tighten policy in support of a nominal target would also be inappropriate.

17. **Actions since the consultation discussions suggest that automatic stabilizers may not be allowed to play entirely in 2002.** In November 2001, there were some modest increases in several excise taxes, although it is possible that they may do no more than offset expenditure slippages in lower levels of government. The authorities' latest Stability Plan (published in December 2001), still envisages a balanced budget in 2002, even though the projection for growth has been reduced from 2.9 percent in the budget to 2.4 percent.[5] This

[4] The authorities confirmed that they planned further tax reforms in 2003; and according to the updated Stability Plan, the impact of these is envisaged to be 0.2 and 0.1 percent of GDP, respectively in 2003 and 2004.

[5] However, in the event that growth in 2002 slips to 1.8 percent, the Stability Plan envisages a deficit of 0.3 percent of GDP in 2002 in this low-growth scenario.

appears to imply a larger fiscal withdrawal than envisaged when the 2002 budget was presented to parliament, although possibly it may not go beyond the safety margins in the budget.

B. Medium- and Long-Term Fiscal Issues and the Fiscal Framework

18. **The authorities noted that, with the general government finances essentially in line with their immediate goal of balance, issues concerning the fiscal framework had moved to center stage.** Progress in developing a new framework was at an advanced stage, with cornerstone legislation on fiscal stability approved by the lower house of parliament and under discussion in the Senate (Appendix IV). Moreover, following limited progress in the past year, the labor unions had agreed to re-open talks in 2003 on Spain's strategy to deal with longer-run demographic pressures on the public finances.

19. **The new Budgetary Stability Law, the authorities stressed, would lock in the gains achieved in fiscal consolidation, enhance fiscal discipline and transparency, and complement the recently approved regional financing agreement by fostering fiscal co-responsibility.** At the heart of the BSL was a multiyear commitment by all levels of government that—barring exceptional circumstances—budgets would be formulated, approved, and executed in balance or surplus. Any public entity failing to present or achieve balance or a surplus must submit a viable three-year adjustment plan, including the reasons behind the slippages.[6] For the regions, the law provides that the Fiscal and Financial Policies Council will be in charge of determining whether deficits are warranted—potentially including, for example, if economic growth is temporarily lower than projected. And the burden of any sanctions under the Maastricht Treaty will be borne by those levels of government responsible. A key element, the authorities added, lies in the introduction of medium-term spending ceilings for the central government—a means of ensuring a strategic approach to the management of expenditure, and enhancing policy credibility. In practice, the path of expenditures under these three-year ceilings would be set in nominal terms, in line with projected revenues that reflect the underlying macroeconomic scenario.

20. **In response to staff questions, the authorities clarified that the BSL incorporates elements of flexibility that could avoid inducing pro-cyclical policy actions.** Prudent revenue projections would doubtless continue to provide a safety margin. This would be complemented by a contingency fund of 2 percent of central government expenditures (roughly 0.5 percent of GDP) explicitly built into the budget: this could be used to cover spending associated with unexpected events such as higher interest payments, and other macroeconomic effects—but not discretionary expenditure increases. Also, the authorities reiterated that a budget deficit could be accommodated, as long as it was accompanied by a viable adjustment program to restore balance over the medium term. This could provide

[6] Public enterprises must avoid operating losses over the medium-term.

scope for automatic stabilizers to work—if it were accepted that, to this extent, no adjustment would be required to restore balance. But how far this approach is actually followed will emerge only as policy is implemented. The authorities did not foresee a danger of "base drift" in annual budgets within the medium-term expenditure framework: when setting ceilings, care would be exercised to avoid accommodating past deviations—in the spirit of the required adjustment programs for deviations from budget balance.

21. **The new permanent regional financing arrangements would also serve to enhance transparency and "co-responsibility," the authorities noted.** Regions will retain a third of personal income taxes collected in their jurisdiction, and receive 35 percent of VAT receipts—the latter adding an element of stability, as consumption varies less than income over the business cycle and among regions.[7] Closely linking a region's spending to its revenues should encourage prioritization of expenditures, or induce increases in regional taxes. It should also encourage regions to execute their budgets prudently throughout the year, to avoid being subject to the Maastricht penalties—or indeed to potential peer pressure from other regions. In the event that a region's budget turned out not to be balanced, the fact that its ability to issue bonds is subject to central government approval introduces an additional element of discipline. In view of the staff, it is important to keep under review whether this system of sanctions and penalties provides an effective mechanism to enhance fiscal discipline. The new financial arrangements have an equalization mechanism, the "asignaciones de nivelacion," that addresses existing systematic and substantial deviations between revenues and expenditures.

22. **The authorities added that, for the central government and the social security fund individually, full implementation of the BSL is subject to a 12-year transition period.** This corresponds to the period during which the central government budget would progressively assume the cost of complementary minimum pensions.[8] During this period, the balance or surplus requirement applies *jointly* to the consolidated budgets of the central government and social security. In practice the transitional period might be shorter, the authorities noted. The staff welcomed the potential to shorten the 12-year transition period: this could help allay any misplaced concerns about unduly financing the central government deficit with the social security surplus—or, more substantially, about financing expenditure more through labor taxes than other revenue sources. In response to a suggestion by the staff, the authorities expressed some interest in participating in a fiscal ROSC, seeing potential to further enhance fiscal transparency, including in the new financing arrangements with the regions.

[7] VAT revenues will be distributed according to regional private consumption. Also, regions retain electrical power and motor vehicle taxes, 40 percent of excise taxes, and all ceded taxes (on wealth, inheritances, gifts, and gambling), user fees, and stamp duties.

[8] The Pacto de Toledo requires that the complementary minimum pensions be incorporated in the central government financial accounts over a 12-year period.

23. **The BSL applies fully, from the outset, to the regional governments, but they receive certain transitional guarantees as healthcare spending is devolved to them.** The authorities explained that the earlier financing arrangements for healthcare, for those regions to which it had already been devolved, would expire at the end of 2001.[9] The new financial agreement envisaged that healthcare responsibilities would be devolved to all the regions in 2002, and transfers would be linked to the evolution of central government taxes. In this process, the Institute of Health (INSALUD) would be dismantled, and the Ministry of Health and Consumption would coordinate and establish countrywide minimum care standards. The BLS envisages a three-year transition period during which the healthcare portion of tax-linked transfers would be guaranteed as a share of GDP. Meanwhile, some progress had also been made on pharmaceutical costs, using reference prices for specific medical conditions: co-payments would be required for pharmaceuticals exceeding reference prices.

24. **The authorities went on to discuss the implications of the demographic shock in Spain, which is likely to be both deeper and later than in other EU members.** Based on existing long-term population forecasts, the shock would be severe: a drop in Spanish population of about two million by 2050. But, besides the usual uncertainties inherent in such forecasts, these projections did not reflect the current trend in immigration—which is rising much more rapidly than anticipated. The National Statistics Institute was reevaluating immigration trends and updating its forecasts. With increasing immigration, the fiscal impact of the demographic shock was likely to be somewhat less pronounced than suggested by a recent OECD/EC study (see Appendix V).[10] Higher immigration would increase activity ratios, delaying and potentially dampening the peak of the shock. The authorities confirmed that, while higher immigration would likely reduce the severity of the shock, the impact on the public finances would remain considerable. But the delay of an already late impact would allow some additional scope to develop a consultative pension strategy. In this, the social partners would face the difficulties both of determining the extent of the demographic shock and the mix of approaches to address it.

25. **The authorities confirmed that pension and labor market reforms, together with a prudent budgetary policy in the framework of the BSL, were key elements of their long-term fiscal strategy.** The implementation of reforms in the *Pacto de Toledo*, together

[9] These financial arrangements comprised transfers that were renegotiated every four years, and were guaranteed not to decline as a share of GDP. Healthcare was already devolved to 9 of the 17 regions (including the Basque Country and Navarre). So far, the devolution experience has been favorable in terms of expenditure control.

[10] This study shows Spain having the most severe demographic shock among the advanced economies surveyed, with the impact of pensions alone on public expenditure equivalent to 8 percent of GDP—though the shock occurs later than in many other economies, being felt mainly from 2025 onward.

with a rapid growth in contributors, had already allowed the social security system to generate a cash flow surplus. Those reforms had been complemented in March 2001 by new incentives for workers to stay longer in the work force. Moreover, a medium-term goal of fiscal balance or a small surplus was enshrined in Spain's EU Stability Program and the BSL. Without prejudging on-going discussions, some type of complementary pension system might also figure in the strategy—going beyond the tax incentives envisaged in 2002 for company-based pension plans. The staff agreed that stronger immigration would dampen the severity of the demographic shock, but stressed the need to ensure that reforms discourage early retirement, strengthen links between benefits and contributions, and avoid over-burdening taxpayers now or in the future. Reaching a workable and economically sound agreement with social partners over the next couple of years would help ensure wide-ranging support: but acting sufficiently early was important to allow adjustments to be gradual and politically feasible.

C. Labor and Product Markets

26. **The authorities stressed their continuing commitment to reforms in the labor and product markets.** A key priority was to accelerate economic convergence with the most advanced EU economies, and among Spain's regions—as well as to ensure that the economy responds flexibly to shocks. Their approach would remain consultative, though in some fields they had moved decisively with measures when the process of dialogue with firms and labor unions had not led to conclusions. The June 2000 decree on product market reforms, for example, met with some strong protests; and the 2001 labor market measures reflected consultation but not full agreement with the unions. Together with enhancements in infrastructure, continuing progress with structural reforms should spur the growth of productivity—which has been somewhat disappointingly slow in recent years.

Labor market

27. **The authorities discussed the labor market measures implemented in April 2001, which aimed to maintain the expansion of employment and to make more flexible the conditions of part-time contracts.** A key element was the indefinite renewal of contracts with low severance payments, introduced in 1997 to foster to open-ended work, which were set to expire this year (Box 2). The scope of these contracts was enhanced, allowing virtually all workers to qualify for them, except prime-age males unemployed for under six months. Among other modifications, the greater flexibility of part-time contracts was stressed—inter alia because these contracts have been successful elsewhere in increasing female participation. It was possible, however, that the full effects of these reforms would take time to develop.

28. **The authorities, employers, and labor unions agreed that wage moderation had contributed to robust job growth, in combination with other factors (Box 3).** There was general agreement that the moderate wage increases of recent years had contributed to greater usage of labor as economic activity had expanded. The authorities noted that, in addition, labor market reforms had introduced higher flexibility, fostering job creation; and the

Box 2. Spain: Recent Labor Market Reforms

Several further reforms were implemented in 2001. They are mainly designed to address distortions resulting from severance payments—including differential payments for fixed-term and open-ended contracts.

The main reforms are as follows:

Contracts fostering open-ended employment. These will remain in effect indefinitely, having been scheduled to expire on May 16, 2001. They were introduced in 1997 to reduce the difference in firing costs between permanent and fixed-term contracts, not only by outright cuts in firing costs but by temporarily reducing employers' social contributions.[1] They have been extended to a wider range of unemployed workers, namely those: (i) under age 30 and over 45; (ii) with six months or more searching for a job; (iii) with disabilities; (iv) women in sectors with low female employment; and (v) all fixed-term workers made open-ended by their current firm before end-2003. In sum, all workers that had experienced difficulties with labor market integration (in effect the vast majority of workers except males aged 25 to 45) are now eligible for these contracts. Even after these reforms, however, the system of contracts lacks transparency in hiring and firing costs, with the potential to distort decisions.

Fixed-term workers. Flexibility is reduced by establishing a maximum duration of one year for some specific types of fixed-term contract. The practice of continuously renewing fixed-term workers is to be addressed in sectoral labor agreements. Severance pay of eight days per year is introduced at the end of a fixed-term contract. Also, a new contract (the *contrato de inserción*) is introduced: "public administrations" can hire temporary workers for projects deemed to be in the public interest.

Part-time contracts. These are no longer subject to a limit of 77 percent of the day; and distribution of work through the day/week has been made more flexible. These changes, coupled with those made in 1998 to increase social security coverage, may make part-time contracts more attractive to employers and employees.

A policy to foster employment of specific groups. This policy consists primarily of reducing employer's social security contributions for specific groups of unemployed workers, particularly older and female workers, as long as they are hired in 2001.[2]

---

[1] These contracts cut severance payments to 33 days a year for up to 24 months, and 45 days for up to 42 months in open-ended contracts. In parallel, however, a small severance payment was introduced in 2001 for fixed-term contracts.

[2] Lower social contributions are applied to specific groups—among others, newly hired women and workers over the age of 65. These subsidies are in part geared to offset differentiation in severance payments—in effect making first-year costs of regular employment similar to those for one-year fixed-term contracts, particularly for workers over 65.

Box 3. Job-Rich Growth

The cross-country analysis presented in the background study for the consultation[1] suggests that during the 1990s, growth has been particularly employment intensive compared to previous growth episodes in France, Italy, and Spain, though less so in Germany. Unemployment rates remain high by historical standards, nonetheless. Interestingly, wage formation seems to have changed, leading to a moderation of wage increases in the 1990s, except in Germany. Labor taxes have increased, however, partially offsetting this wage moderation.

This staff study was discussed in a seminar during the consultation. While acknowledging the value of common cross-country analysis, and agreeing in general that wage moderation played a role in the recent job-rich growth experience in Spain, participants thought that the empirical analysis, nonetheless, did not account for some key features of the Spanish job-rich growth experience. ***The seminar audience took up the following themes for Spain***:

- ***The recent job-rich growth experience is not entirely new: to some extent it also characterized growth in the second half of the1980s.*** That earlier experience reflected the dramatic increase in fixed-term jobs that followed the introduction of fixed-term contracts in 1984. What is new, however, is the creation of a larger share of open-ended versus fixed-term contracts. This change is closely linked to the introduction of labor contracts promoting open-ended jobs in 1997.

- ***The reform of labor contracts and the consequent increase in labor market flexibility were at least as important as wage moderation to the job-rich growth experience.*** Aside from potentially influencing wage determination, these contracts reduce firing costs, thereby reducing employers' natural reluctance to hire additional open-ended workers.

- ***Despite the recent experience with job-rich growth and substantial reductions in overall unemployment rates, differential unemployment rates across regions and specific cohorts have failed to decline.*** As in other countries in the study, wage moderation has come about with no explicit incomes policy but seems to have occurred more or less uniformly at the national level. In Spain this has meant that regions and cohorts with the highest unemployment rates have not experienced changes in their relative incomes. The lack of progress in reducing unemployment differentials reflects other factors also, such as the unemployment protection scheme, housing market inflexibilities, and the mismatch of skills in regions.

Regarding the technical aspects of the analysis, ***the calculation of the change in the elasticity of jobs to output growth was criticized***. In large part this was because it was computed essentially as the increased responsiveness of jobs in the period (0.5 in Spain), in other words as the "impact effect." The long-run elasticity of jobs to output growth yields a surprisingly high elasticity—greater than one—that participants found implausible.

---

[1]IMF Country Report No. 01/203, October 3, 2001.

monetary authorities noted that wage moderation had occurred in the setting of a credible national, and subsequently euro-area, monetary policy. Employers concurred that the reforms had been an important element complementing wage moderation, and singled out lower severance payments in this regard. Labor unions stressed that the most important element has been the priority given by their members to ensuring that wage increases were compatible with strong employment growth.

29. **The authorities, employers, and labor unions differed somewhat concerning the factors underlying marked regional differences in unemployment rates.** The authorities noted that deficiencies in infrastructure and disincentives to moving (associated with some specific benefits) contributed to these differences. Without prejudging the outcome of future discussions on labor market reforms, they noted that scope for decentralizing wage negotiations to allow wages to reflect more accurately differences in productivity and market conditions could help. Employers stressed also the disincentives associated with unemployment benefits as a key factor, contrasting low mobility now with the massive labor movements observed a few decades ago. In contrast, labor unions stressed a mismatch of skills as one of the most important factors. Regarding priorities for the period ahead, the authorities agreed that increased wage differentiation could contribute to reducing regional unemployment disparities.

30. **Rigidities in the housing market and supply of land were acknowledged to hinder labor mobility.** The supply of development land is controlled by municipalities and motivated by their financial incentives. Aside from transfers from higher levels of government, their revenues consist primarily of property taxes and sales of their finite land holdings. Specifically, a large share of their resources stems from property tax revenues that reflect not only tax rates, but also property values. Thus, local revenues can be increased by judiciously limiting the supply of land to boost property values to the point that they just offset the loss associated with the smaller tax base. In effect, property values and supply of land are unlikely to be optimal from a broader perspective, including that of labor mobility.

31. **Staff welcomed recent labor market reforms, as well as the intention to secure further progress on wage formation and labor mobility.** Especially welcome were the indefinite extension, and to more groups, of open-ended contracts with low firing costs, and the relaxation of restrictions on part-time work. Nonetheless, staff noted, hiring and firing costs remain complex; and reintegration policies, including unemployment benefits, need to be more efficient. Some changes were made with the objective of reducing early retirement, but it is not unchallengeably clear what impact they may have, and this needs to be kept under close review. A further scaling back of early retirement is likely needed, following a timely review of how changes introduced in 2001 in fact influenced firms and employees' behavior. Regarding wide regional imbalances, it would be crucial, staff suggested, to enhance both wage differentiation and training, thus improving labor market entry and the matching of skills. As practices in wage formation evolved, it would be critical to ensure an effective link between wages and productivity, with one aspect being freedom for variation among localities. It would be most important also to avoid a "cascading" of salary reference

levels. Improving the availability of municipal land would require a reform of local government financing that went beyond a broadening of the municipal tax base, changing the incentives for authorities.[11]

Product markets

32. **The authorities noted that progress has been made in addressing constraints on competition in telecoms, electricity, gas, pharmaceuticals, and retail sales.** The privatizations of Iberia and Aerolineas Argentinas had now been completed. And, among other reforms, a number of restrictions on competition—from textbooks to practices in the liberal professions—had been lifted in 2001. A key priority ahead remained the network industries, where a recent crucial step was the opening of the local loop in telecoms. Recent reforms had contributed to a doubling of the number of regular Internet users over the past 12 months (although this level, like broad indicators of growth in the new economy, remains quite low). Noteworthy also were a recent strengthening of the resources of the competition agency and real cuts in government subsidies to public enterprises.

33. **Welcoming recent developments, staff stressed that it would be particularly important not to slacken the pace of liberalization**. And, regarding competition, developing cooperative approaches with the territorial administrations was an important challenge: in this respect, priorities included reversing a trend toward new public enterprises at the regional and local level, and increasing competition in retail sales.

D. The Financial Sector

34. **The authorities noted that the banking sector was highly capitalized and had experienced a profitable expansion, including in international markets—but that this occurred in a setting of strict supervision to ensure adequate provision for risks**. The authorities viewed the recent slowdown in domestic bank credit growth as reflecting primarily weaker demand for credit, as economic activity slowed throughout the year in line with developments in the rest of Europe. Banks agreed that there had been a noticeable reduction in demand for credit, especially to finance new investment projects—adding however that the credit slowdown also reflected supply factors, associated with increasing uncertainties and with more cautious bank lending practices as the year progressed.

---

[11] In principle, municipalities can be thought of as maximizing the net present value of their future revenue stream. In this regard, their incentives "to supply" land are analogous to those incentives faced by a producer of a nonrenewable resource, and can be expected to act accordingly. This means, however, that the supply of land will not necessarily increase when central government transfers increase, because the marginal benefit and cost of supplying land remain unchanged.

35. **Despite a significant rise in household and corporate leverage, and increased perceptions of risk among banks, the authorities saw no likelihood of a sharp retrenchment of aggregate credit supply.** Leverage levels were only now approaching average euro-area levels. Moreover, while penetration by foreign banks is not high, the recent strong expansion in lending by savings banks would offset any slower expansion in bank credit. Savings banks confirmed that their share in credit was increasing, particularly in mortgages. In part these increases have their historical roots in the lifting of geographical limits, allowing them to compete in new markets by opening additional, more efficient, regional branch offices—with managers shared between several offices, and with far fewer employees per office than in the past. The staff agreed that any sharp deceleration in commercial bank lending—triggered, for example, by a further deterioration in the outlook for their business risks—would be offset in the household sector by savings banks, given the concentration of saving banks in household credit, but thought that this offset might perhaps be less likely for nonfinancial corporations.

36. **The authorities noted at the time of the discussions that they were continuing to pay close attention to the development of bank investments in Latin America, given economic uncertainties in that region (Box 4).** Risk assessment of these investments, they explained, had been performed using the same criteria as for on-shore banking, with both internal control and auditing from headquarters and external audits by reputable firms—in addition, of course, to local supervision. Goodwill had been amortized under an accelerated timetable—meaning that over recent years banks' earnings stream had not reflected the full profits on these investments. Supervision had been reinforced, as had communication channels with local supervisors. The authorities also noted that the Spanish banks in general, and the larger commercial banks in particular, have strong capital resources. Strict standards had been used to ensure adequate provisioning, including the introduction of an innovative forward-looking provisioning approach that smooths provisions over the business cycle.[12] Moreover, investments in Latin America had been matched by specific provisioning, in addition to the general and forward-looking provisions that are required by the Bank of Spain. Provisions were adequate for likely losses under fairly testing scenarios for individual countries, and banks' capital would not be endangered thereby. In response to further questions, the authorities confirmed that these broad assessments were robust even allowing for the fact that there was indirect exposure of the banking sector in Latin America

---

[12] Experience has been gained in a number of countries with forward-looking techniques for establishing provisions on particular categories of loans, so as to smooth their earnings impact over the business cycle; but the approach in Spain is innovative in applying this broadly to the loan portfolio, arousing interest in some other advanced economies.

Box 4. Exposure of the Banking System to Latin America

With economic and financial stresses in Argentina intensifying, the issue of Spanish banks' Latin American exposure featured in exchanges with both official and private sector participants in the consultation discussions. Some background is provided below. The assessment (here and in the main text of the staff report) is in line with the appraisal of a number of leading market commentators and rating agencies.

The direct exposure to Argentina of the two major Spanish banks, BBVA and BSCH, is modest relative to group size. The banks' direct exposure to Argentina is roughly 4 percent of group loans or 5–8 percent of profits. But for the whole of Latin America the corresponding numbers are roughly a third of net attributable profits, loans, and deposits. With capital ratios high, both major banks could meet international requirements even if fully provisioning credits to Argentina, and in addition profitability would likely not be affected to a problematic extent. In addition to direct investments, the banks have substantial exposure to Argentine risk through their specialized business lines (domestic corporate lending, and ownership of pension and investment funds, among others). In particular, Spanish industrial conglomerates have large interests in Argentina. The earnings and cash flow of these conglomerates stand to be affected by adverse financial developments in Argentina, with possible repercussions for the Spanish banks' asset quality. Fee income from mutual funds and pension management business in Argentina would likely be reduced.

The banks also have sizable investments in several other Latin American economies. While no estimate is available to staff of total direct and indirect exposure (including via domestic corporates and activities such as pension fund management), a systemic banking crisis extending to several major Latin American economies would clearly affect them much more seriously. Of course, despite their large international business, the main source of profits for the large Spanish banks continues to lie in domestic, and particularly retail, business. The banks view their stakeholdings in Latin America, however, as an integral part of their worldwide business strategy, and as long-term investments, to which they are strongly committed. They have typically taken very active management control of the subsidiaries, seconding many managers to them; and they have achieved substantial cost savings in their operations. Goodwill on acquisition was amortized rapidly (thereby reducing the upfront impact of profits on the banks' published earnings stream in recent years). The parent banks' commitments to additional funding for these subsidiaries relate, it should be added, to support for healthy and continuing business expansion, subject to considerations of commercial prudence—the subsidiaries being separately incorporated public companies. The perception in markets is that the risks inherent in the involvement of Spanish banks and enterprises in Latin America has been strongly discounted in stock price adjustments over the past year—affecting household wealth to a modest degree. While perceptions of increased risk could affect the pace at which Spanish commercial banks increase their overall credit volume, the distinct and very large presence of the savings banks in the domestic Spanish economy suggests that the likelihood of a "credit crunch" affecting a wide range of domestic borrowers is low.

through corporate clients and through their ownership of pension funds in that region.[13] The staff noted, however, that in the hypothetical event of a systemic banking crisis affecting a number of Latin American financial systems, the situation would be substantially more

[13] Given the very limited number of institutions with major exposure, the authorities could not provide their data on provisioning and exposure, because of confidentiality relating to individual institutions.

serious. Since the time of the policy discussions Argentina has devalued and suspended payments on external debt (except to IFIs) and developments have worsened substantially the outlook for the foreign-owned banks and corporations operating there. At the time of writing there has been no evidence of serious contagion to other regional markets. Further information on financial market developments will be provided to Executive Directors prior to the discussion of this staff report.

37. **The authorities confirmed that Spain's financial institutions continue to evolve in line with fast-paced changes in global and euro-area financial markets.** Asked about the savings banks, the authorities noted their role in promoting competition—especially in regional markets. On the whole savings banks had functioned well, and a few mergers had resolved some problems that had emerged in certain small institutions. The larger savings banks were among the technology leaders—and subject to some market discipline, as they had issued paper in financial markets that is priced daily. They are also, of course, subject to the same supervision as commercial banks. The authorities have fired warning shots in the case of institutions where the expansion of assets, if left unchecked, might have outrun their present managerial capacities. Some larger institutions had expressed interest in legal changes that would allow them to issue "stocks" (cuotas participativas), albeit without representation. The future development of the savings banks would doubtless continue to reflect the wide differences among them. The staff broadly shared this assessment, while remaining somewhat concerned about ownership issues and the scope, potentially at least, for links with local governments to influence lending decisions for nonmarket reasons.

38. **As the Spanish financial system continues to evolve, the authorities agreed that supervisory coordination would remain crucial.** Coordination was already well developed between banking and securities supervision. In the future, as private pensions take hold, this may well call for strengthening the institutional basis for their supervision and a deepening of domestic coordination. The staff welcomed plans for a new financial services law which, among other things, will clear the way for future EU directives—and may enhance the regulations for investment houses. The authorities acknowledged the advantages of an FSAP for a systemically important country such as Spain, though they preferred first to see the experience of the present round of participants.

E. Other Issues

39. During the discussions, the authorities stressed that efforts to combat **money laundering** and the financing of terrorism were a major domestic priority, and they have since confirmed that this would be a priority also of the Spanish EU presidency. Spain has adopted the OECD's **antibribery convention.** On **trade policy issues**, Spain remains a strong supporter of full trade liberalization vis-à-vis the least developed countries, and saw potential in a new global trade round. The authorities confirmed that Spain's **official development assistance** (ODA) in 2000 was 0.22 percent of GNP—and has fluctuated in a range of 0.22 to 0.24 percent in the past five years.

IV. STAFF APPRAISAL

40. **Of the euro-area economies, Spain ranks among the leaders in fostering strong output and employment growth.** This performance has its roots, first and foremost, in strong policies—oriented toward medium-term goals of macroeconomic stability and structural change. The main challenge now is more in structural areas than in the macroeconomic policy domain: the key challenge is to press on with reforms that will carry the economy forward to a further, extended expansion. The sources of growth over the medium term should lie both in continued job creation and in more rapid productivity growth—fostering sustained real convergence with Spain's most advanced EU partners, and among its own regions. Together with investment in human capital and infrastructure, the flexible operation of markets will be critical in ensuring sustained growth, at a time when some of the influences that boosted growth over the past five years—such as the steep fall in interest rates in the run-up to monetary union—are felt less forcefully. The authorities' continuing structural reform agenda is key.

41. **In the near term, the September 11 shock—to an already slowing euro-area economy—has caused a further weakening of demand in Spain; but even so output and employment continue to expand at a pace significantly above the euro-area average.** Growth in 2002, while well below the 4 percent average of recent years, is still set to be just over 2 percent. Consumer price inflation should fall to under 2 percent by year-end, and the unemployment rate should decline slightly further—developments that testify to labor market reforms and to the prudence of labor unions in assigning priority to the creation of new jobs, within the setting of a credible monetary framework. There are some upside possibilities. Confidence could prove more resilient; and there may be a stronger-than-anticipated impact of lower energy prices and interest rates—with monetary conditions, certainly, remaining somewhat easy for the economy. But this is not to deny downside risks: there could be a deeper or longer shock to confidence; and specific risks could affect the economy—in tourism, for example, despite likely gains from a diversion away from riskier markets.

42. **In this environment, procyclical fiscal actions should be avoided.** The government rightly shifted its goal for 2002 from surplus to balance, as growth prospects deteriorated. With activity now likely to be weaker still, the resulting purely cyclical decline in revenues should be accepted—in line with the philosophy of the EU Stability and Growth Pact. In the present uncertain setting, the 2002 budget places well-judged emphasis on investment and education spending—necessary for future growth and job creation. In addition, reforms of the corporate income tax have been advanced, and will provide some boost for investment. Absent a substantial worsening in the outlook, spending should be held to budgeted levels: indeed the strict control of spending at all levels of government must remain the bedrock of fiscal policy. Assuming stabilizers are allowed to work, the overall stance of macroeconomic policies would be slightly expansionary, and thus consistent with the current outlook.

43. **The authorities have recently taken steps to strengthen the medium-term fiscal framework.** The new Budgetary Stability Law, flanked by far-reaching changes in the financing of the regions, promises to lock-in the fiscal consolidation that has been a cornerstone of Spain's sustained expansion. Moreover, at the central government level the introduction of medium-term expenditure ceilings will enhance strategic spending restraint—helping to reconcile deficit and tax objectives and, crucially, protect public investment. The law should also help secure the potential efficiency gains of fiscal decentralization, strengthening incentives for the regions to manage their finances in ways consistent with Spain's Stability Program. To achieve these goals, the scope to ensure transparency at all levels of government needs to be fully exploited. While policy slippages must be avoided, the successes of the past in fiscal consolidation have created room to accommodate cyclical fluctuations: the new law should not be implemented in ways that trigger procyclical actions.

44. **Longer-run fiscal challenges still need to be fully addressed, and in this regard continuing progress in reforming the pension system remains important.** Spain's demographic strategy needs to draw on a range of elements. One, already falling into place, is a modest surplus in the social security fund. But this is only part of the solution—which also requires reforms to the pension system, such as the proposal to allow pensioners to work, and the evolving plans to develop a viable second pillar. In the public pension system itself, there remains a need to align contributions and benefits more closely: the opportunity to do this has been deferred to 2003, but should not slip further. While long-run projections are intrinsically uncertain—and changing immigration trends make them more so—there is no question that improvements in the efficiency of the pension system are also of value in their own right: they can play an important role in strengthening incentives to work.

45. **Recent labor market reforms promise further progress in fostering job creation, but major challenges remain if unemployment—throughout Spain, and across social groups—is to be reduced to more acceptable levels.** Especially welcome is the recent extension of open-ended contracts with low firing costs—indefinitely, and to more groups; the relaxation of restrictions on part-time work; and cuts in social contributions to promote the hiring of women. Reintegration policies and benefit design remain in need of reforms to foster their efficiency. And a further scaling back of early retirement is needed, followed by a timely review of how reforms introduced in early 2001 influence firms' and employees' behavior. Inefficiencies in housing markets also need to be addressed, to help foster mobility and relieve bottlenecks as growth reaccelerates; and there is a need to enhance both wage differentiation and training to improve the matching of skills. As practices in wage formation evolve, it will be critical to avoid cascading increases from one level to another, and to ensure an effective link between wages and productivity—including across regions and localities.

46. **Tax reform also can play a role in stimulating employment growth.** Recent years have seen a major modernization—reducing compliance costs; improving neutrality; enhancing incentives for work, saving, risk-taking, and investment; and lifting obstacles to international activity. The next round of personal income tax reform needs to give priority to incentives for work, including through a cut in rates on labor income. An increase in the

earned income allowance is desirable. And it is important, in the structure of taxes over the medium term, that there not be undue reliance on social contributions, which fall directly on labor.

47. **In the product markets, progress has continued.** Bold steps have been taken to attack competition constraints in telecoms, electricity, gas, pharmaceuticals, and retail sales. The privatizations of Iberia and Aerolineas Argentinas have been completed, a number of restrictions on competition lifted, and the competition agency's resources strengthened. In the network industries, much progress has been made and it is important to keep up the pace. Also, the further real reduction in central government subsidies to public enterprises in the 2002 budget needs to be extended in the future. There are regional and local priorities also: reversing a trend to create new public enterprises, and increasing retail competition. Indeed, as in fiscal policy and the labor market, so in product markets: the regional dimension is becoming more important. With structural and fiscal policies interacting increasingly as tax bases become more decentralized, the regions have a deeper stake than ever in the success of structural reforms.

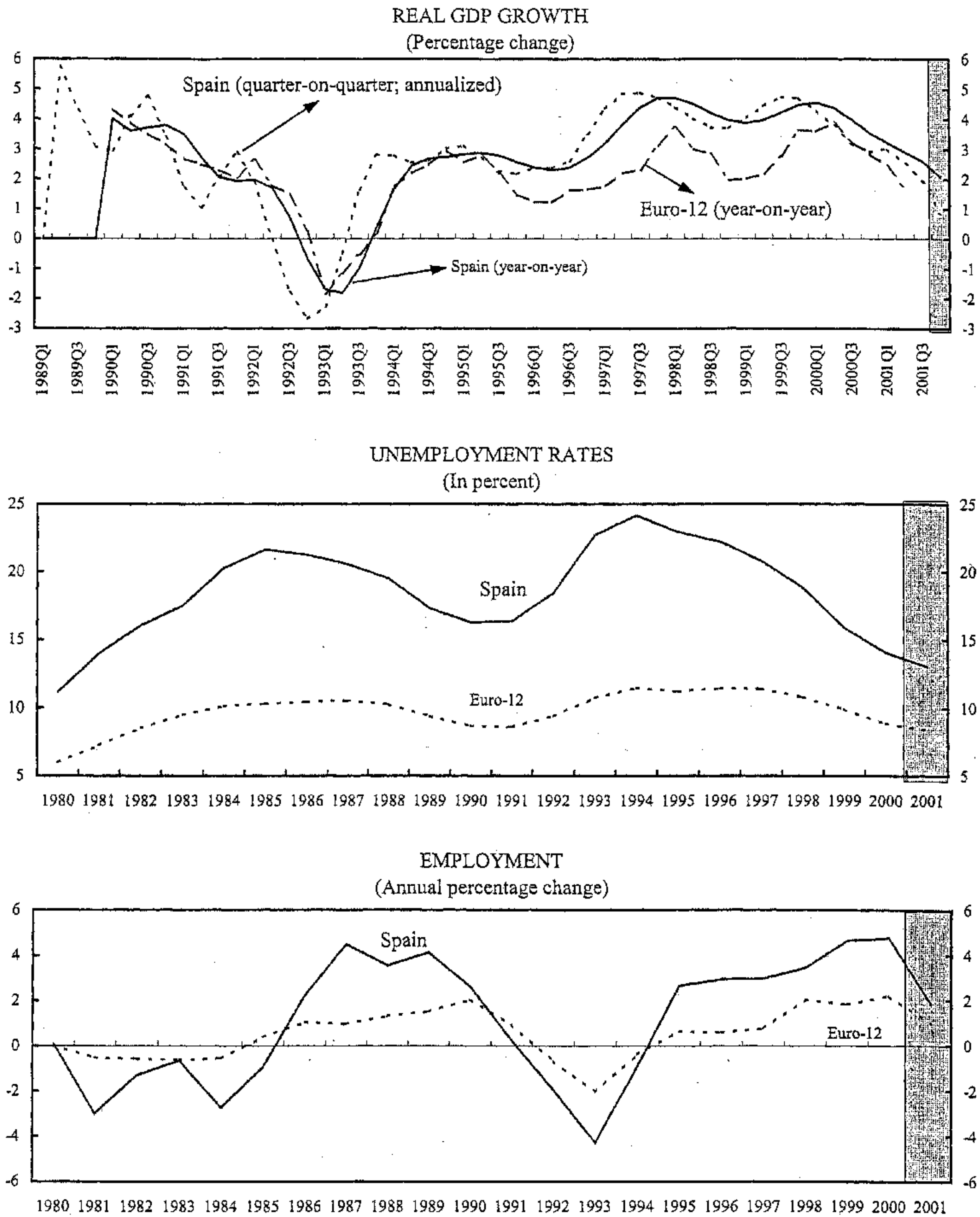
48. **The financial sector has undergone profitable expansion, in international as well as domestic markets—but the case for supervisory vigilance remains particularly strong given the international involvement of Spanish banks.** With savings and commercial banks playing a dynamic role, the system remains competitive and broad-based, and serious credit constraints do not appear likely. Supervisors have introduced an innovative and forward-looking approach to loan provisioning over the business cycle. And levels of capital are high. But the system is evolving: all categories of institution need to continue adapting to market changes—a setting in which supervisory coordination (including increasingly in pensions) will remain crucial. And both banks and supervisors are right to pay heightened attention to the risks associated with investments in Latin America. Supervisors have wisely ensured a conservative accounting treatment of these investments, forged working links with their overseas counterparts, and strengthened their own capacity for monitoring risk. It is recommended that Spain participate in the FSAP program.

49. Spain is encouraged to increase its **ODA** and raise it toward the international benchmark of 0.7 percent of GNP.

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

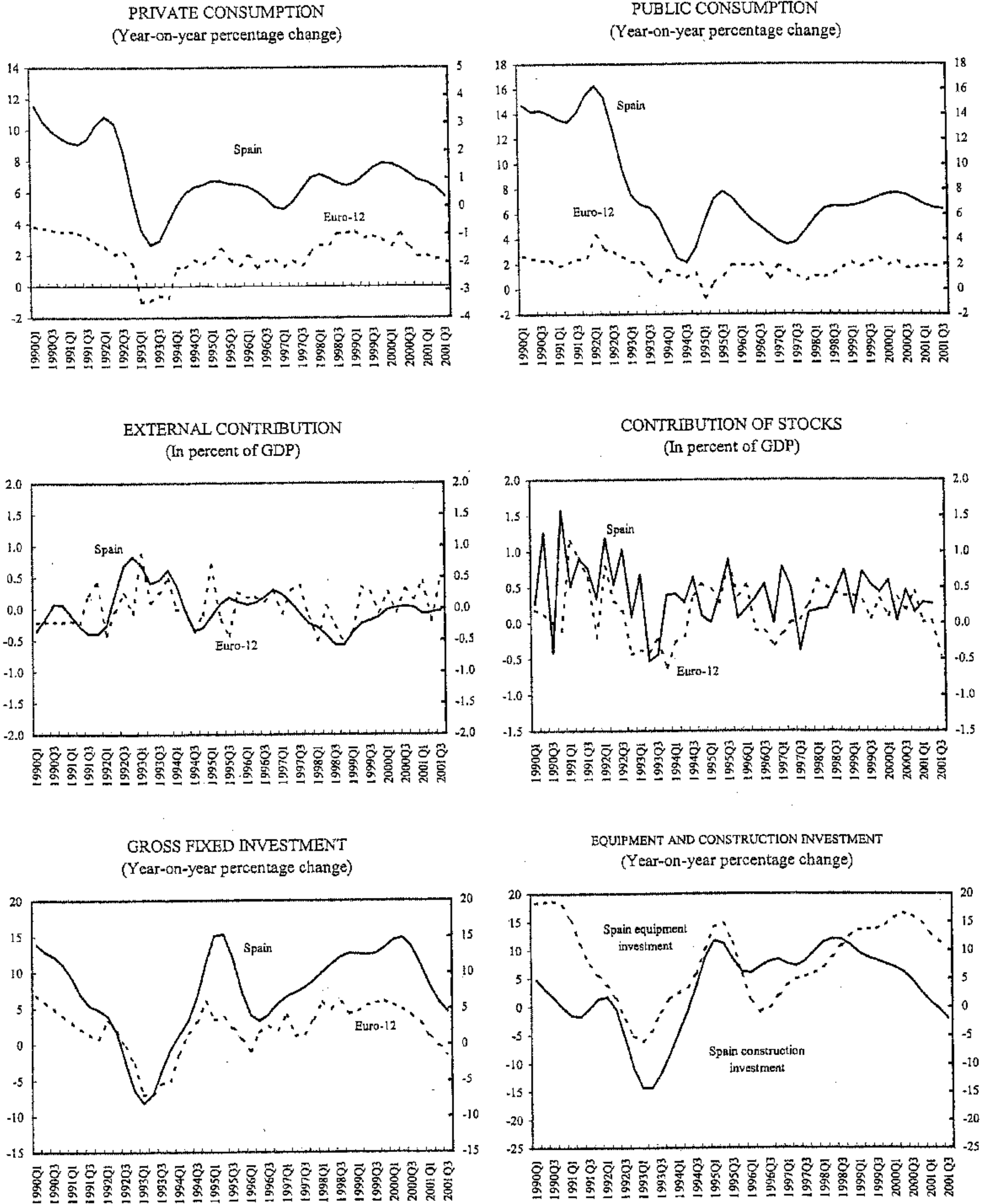
51. It is recommended the **next consultation** take place on the standard 12-month cycle.

Figure 1. Spain and Euro-12: Output and Employment, 1980-2001



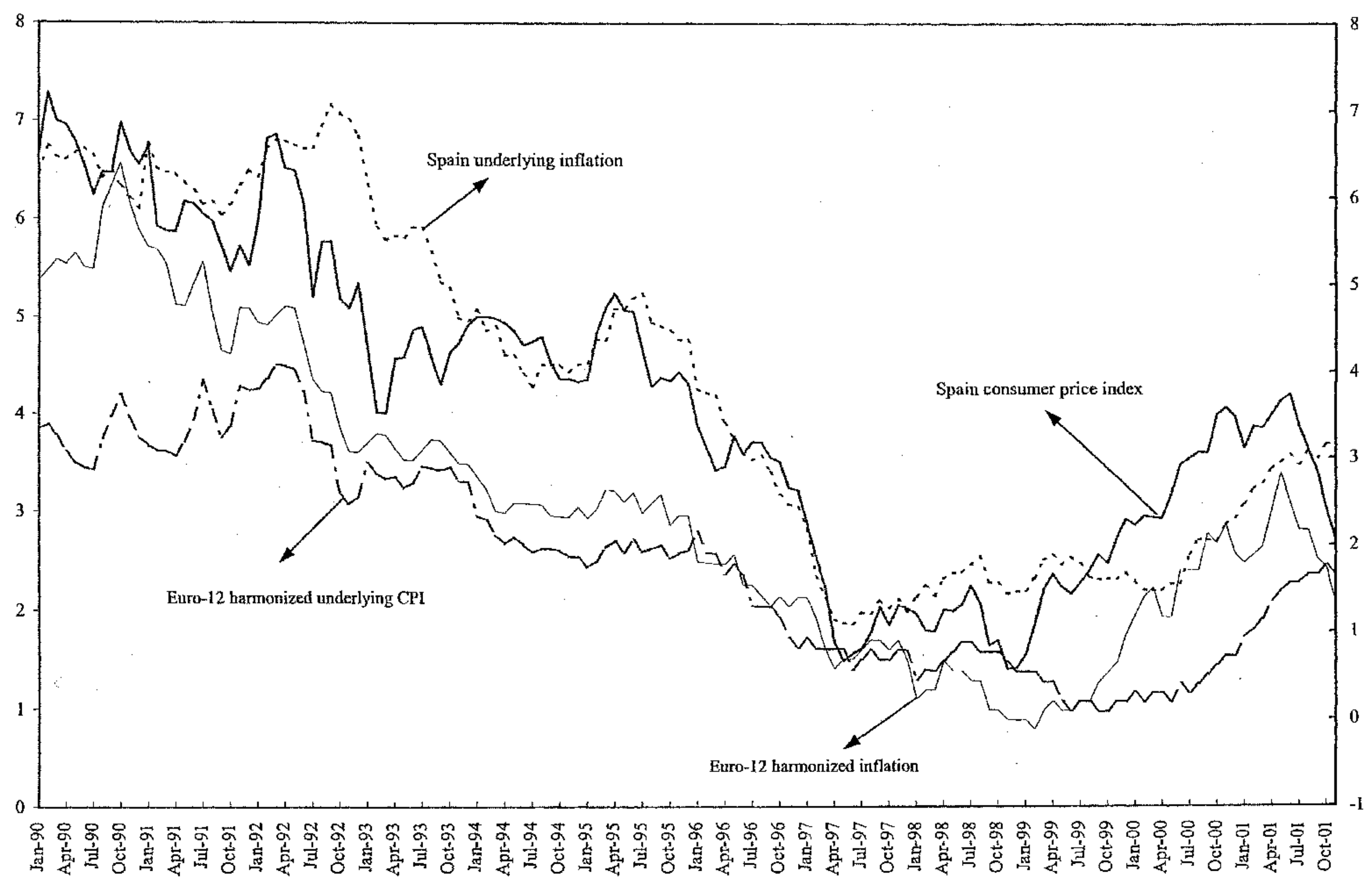
Sources: Bank of Spain; Bloomberg; and Fund staff projections.

Figure 2. Spain: Aggregate Demand, 1990-2001



Sources: Bank of Spain; and Eurostat.

Figure 3. Spain: Consumer Prices, 1990-2001
(Year-on-year percentage change)

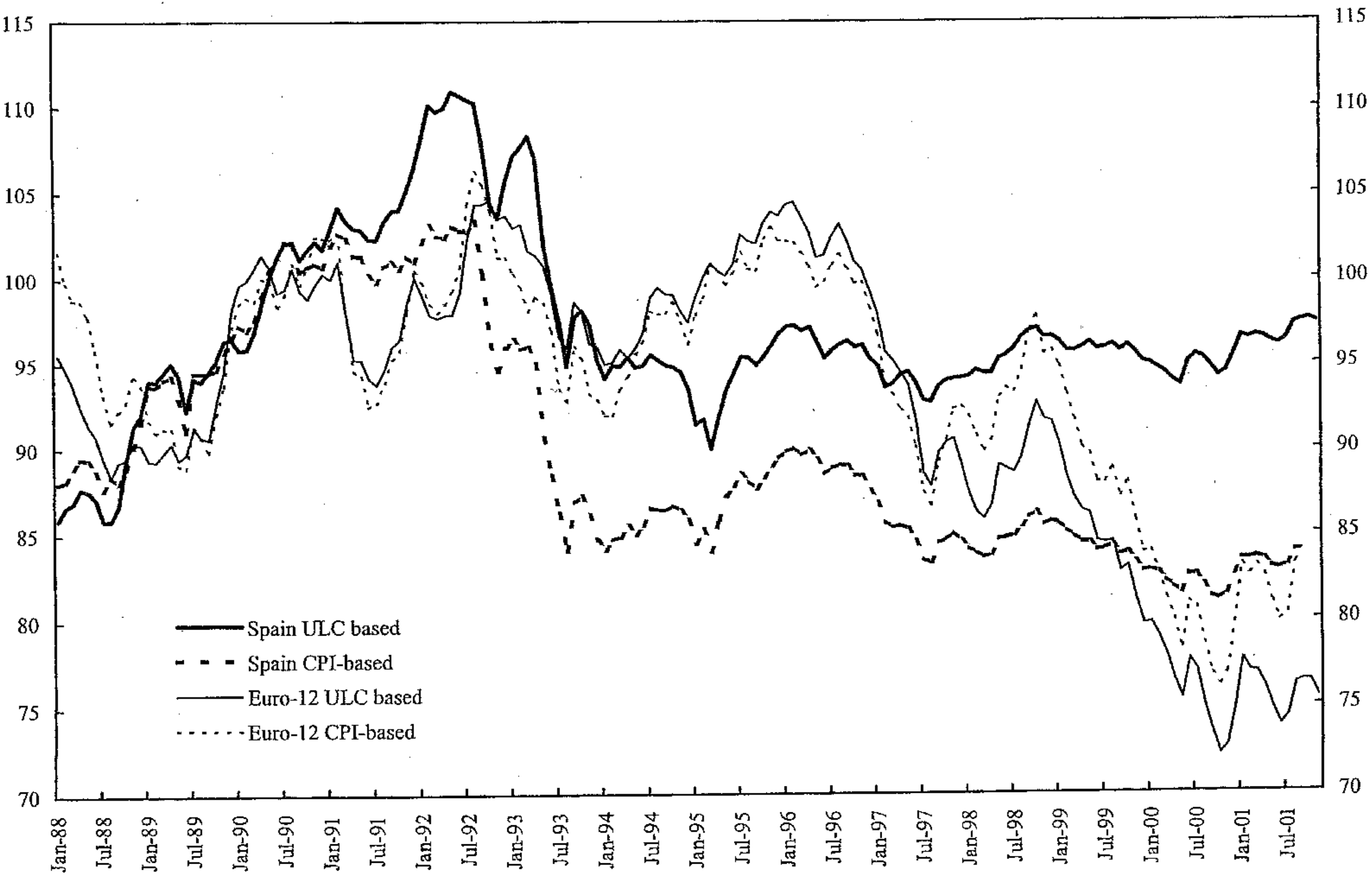


Sources: Bank of Spain; and Eurostat.

Figure 4. Spain: Capacity Utilization, 1990-2001

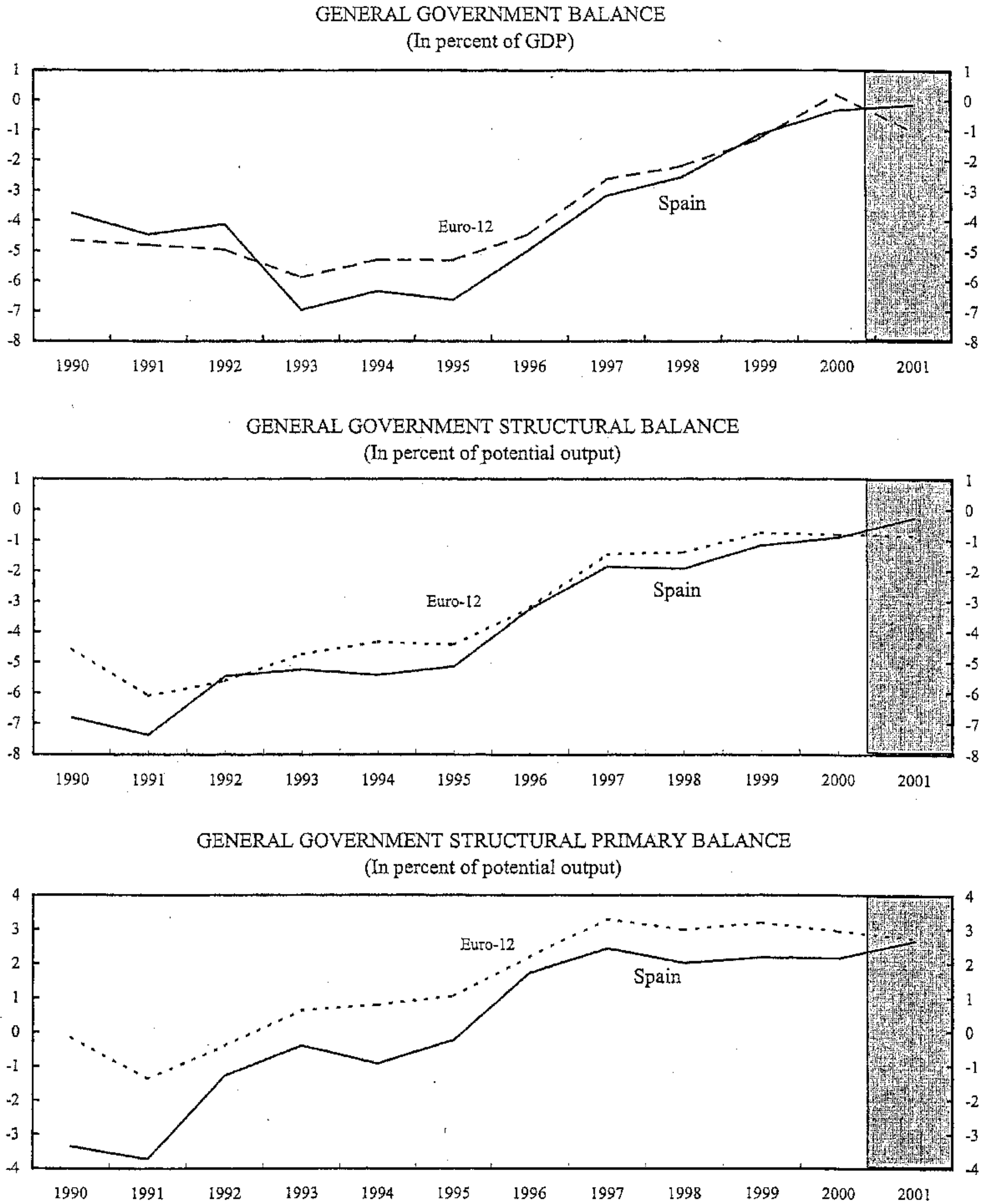
Sources: Bank of Spain; and WEFA.

Figure 5. Spain: Real Effective Exchange Rates, 1988-2001
(Index 1990=100)



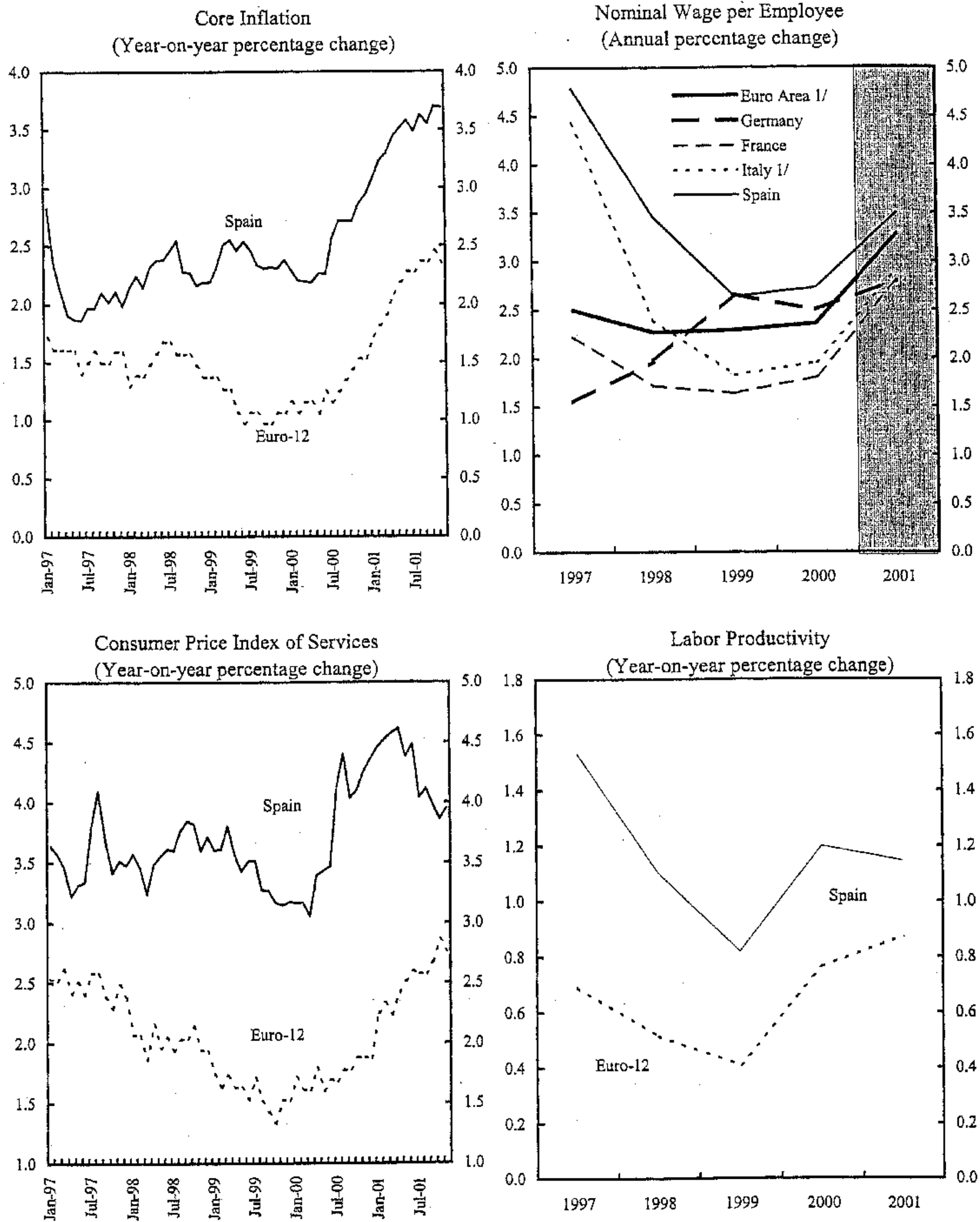
Sources: Bank of Spain; and IMF, *Information Notice System.*

Figure 6. Spain: Fiscal Indicators, 1990-2001



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

Figure 7. Spain: Inflation, Wages, and Productivity, 1997-2001



Sources: European Commission; IMF, *World Economic Outlook*; Bank of Spain; Eurostat; and Fund staff calculations.

1/ 1998 data adjusted for tax reform in Italy.

Table 1. Spain: Main Economic Indicators, 1997-2002 1/

	1997	1998	1999	2000	Proj. 2001	Proj. 2002
Real economy (change in percent)						
Real GDP	4.0	4.3	4.1	4.1	2.7	2.1
Output gap (percent of potential)	-1.8	-0.7	0.1	0.9	0.2	-1.1
Domestic demand	3.5	5.7	5.6	4.2	2.7	2.1
Private consumption	3.2	5.7	5.6	4.2	2.7	2.1
Gross fixed capital formation	5.0	9.7	8.8	5.7	2.5	2.1
Exports of goods and services	15.3	8.2	7.6	9.6	3.7	3.8
Imports of goods and services	13.2	13.3	12.8	9.8	3.8	3.6
CPI (average)	2.0	1.8	2.3	3.4	3.5	2.1
Private savings (percent of GDP)	23.1	22.5	21.1	20.6	21.3	21.7
Household savings (percent of GDP)	13.4	12.7	12.0	11.4	11.3	...
Unemployment rate (in percent)	20.8	18.8	15.9	14.1	13.0	12.8
Gross national saving (percent of GDP)	23.1	23.3	23.2	23.4	23.9	24.1
Gross domestic investment (percent of GDP)	22.7	23.8	25.5	26.8	26.0	26.0
Public finance (percent of GDP)						
General government balance	-3.2	-2.6	-1.2	-0.3	-0.1	-0.5
Primary balance	1.2	1.4	2.2	2.8	2.8	2.3
Structural balance	-1.9	-1.9	-1.2	-0.9	-0.3	0.0
Structural primary balance	2.4	2.0	2.2	2.2	2.6	2.9
General government debt	68.1	64.4	63.4	60.7	58.9	56.6
Money and credit (end of year, percentage change)						
Credit to households and firms	12.0	16.7	19.5	18.9	...	...
Broad money (ALP)	2.4	1.7	5.7	7.4	...	...
Interest rates (percent)						
Money market rate	5.4	4.2	2.7	4.0	4.2	...
Government bond yield	6.4	4.8	4.7	5.6	4.7	...
Balance of payments (percent of GDP)						
Trade balance	-2.4	-3.5	5.1	-5.9	-5.8	-5.7
Current account balance	0.5	-0.5	-2.3	-3.4	-2.1	-1.9
Official reserves excl. gold (US$ billions)	69.1	56.2	33.9	31.8	33.5	35.3
Reserve cover (months of imports)	5.8	4.2	2.7	...	...	...
Exchange rate						
Exchange rate regime			Member of EMU			
Euros per U.S. Dollar (monthly average)	0.9	0.9	0.9	1.1	1.1 2/	...
Nominal effective rate (1990=100)	76.6	76.2	74.7	71.9	72.3 3/	...
Real effective rate (1990=100)	84.9	84.9	84.2	82.1	83.5 3/	...
Unit labor cost (average)	1.6	1.4	1.7	1.8	2.5 4/	...
Memorandum items:						
Euro area output gap (percent of potential)	-1.9	-1.3	-1.1	-0.1	-0.9	-2.1
Euro area cpi	1.7	1.3	1.2	2.4	2.7	1.6

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

1/ Figures for 2001-02 are Fund staff projections.
2/ As of December 2001.
3/ As of October 2001.

Table 2. Spain: Fiscal Accounts, 1997-2002 1/
(In percent of GDP)

	1997	1998	1999	2000	Proj. 2001	Proj. 2002
Current Revenues	38.0	38.0	38.1	38.2	38.5	38.5
Indirect taxes	10.5	11.1	11.6	11.6	11.7	11.8
Direct taxes	10.5	10.2	10.2	10.5	10.7	10.6
Social security contributions	13.1	13.0	13.1	13.3	13.4	13.4
Other current revenues	4.0	3.7	3.2	2.8	2.8	2.7
Current expenditures	37.6	36.8	35.3	34.8	34.4	34.5
Public consumption	17.5	17.5	17.3	17.1	16.9	17.1
Current transfers	13.3	12.8	12.4	12.3	12.3	12.3
Interest payments	4.8	4.3	3.6	3.3	3.1	3.1
Other current expenditures	1.1	1.2	0.9	1.0	0.9	0.9
Current balance	0.4	1.2	2.8	3.4	4.1	4.0
Gross fixed capital formation	3.2	3.3	3.4	3.3	3.4	3.6
Capital transfers and other	1.8	1.8	1.9	1.7	1.9	1.9
Primary balance	1.2	1.4	2.2	2.8	2.8	2.3
Overall balance	-3.2	-2.6	-1.2	-0.3	-0.1	-0.5
Government debt	66.5	64.4	63.4	60.7	58.9	56.6
Memorandum items:						
Structural primary balance 2/	2.4	2.0	2.2	2.2	2.6	2.9
Structural balance 2/	-1.9	-1.9	-1.2	-0.9	-0.3	0.0
Structural expenditure	41.4	41.4	40.6	40.1	39.9	39.5
Structural revenue	39.5	39.5	39.4	39.3	39.6	39.6

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

1/ Based on staff projections and changes in the overall balance in 2002 and 2003 identical to those in the Stability Program.
2/ Potential output and output gap are staff estimates for 2000, excludes 0.1 percent of GDP received from the auction of mobile telephone licenses.

Table 3. Spain: Authorities' Stability Plan, 2001–05
(In percent of GDP)

	Plan				
	2001	2002	2003	2004	2005
General government 1/					
Revenue	39.3	39.4	39.2	39.1	39.2
Expenditure	39.3	39.4	39.2	39.1	38.9
Current expenditure	34.3	34.3	33.9	33.7	33.4
Of which : interest payments	3.1	3.0	2.9	2.8	2.7
Capital expenditure	5.0	5.2	5.2	5.4	5.5
Of which: gross fixed capital formation	3.4	3.5	3.6	3.7	3.8
Balance	0.0	0.0	0.0	0.1	0.2
State	-0.5	-0.5	-0.5	-0.4	-0.3
Social security	0.5	0.5	0.5	0.5	0.5
Territorial governments	0.0	0.0	0.0	0.0	0.0
Gross debt	57.5	55.7	53.8	51.9	50.0
Primary balance	3.1	2.9	2.9	2.8	2.9
Macroeconomic scenario					
Real GDP	3.0	2.4	3.0	3.0	3.0
Private consumption	2.8	2.2	2.8	2.8	2.8
Public consumption	1.9	2.0	2.0	2.0	2.0
Gross fixed capital formation	4.0	3.4	4.7	4.7	4.7
Domestic demand	3.0	2.4	3.1	3.1	3.1
Exports	5.3	4.5	7.6	7.6	7.6
Imports	5.1	4.6	7.7	7.7	7.7
Other variables					
GDP deflator	3.8	2.8	2.4	2.4	2.4
Private consumption deflator	3.6	2.6	2.0	2.0	2.0
Employment	2.1	1.1	1.8	1.8	1.8
Authorities' low-growth scenario					
Real GDP growth	3.0	1.8	2.6	2.6	2.6
General government balance	0.0	-0.3	0.0	0.0	0.0
Gross debt	57.5	56.3	54.7	53.1	51.5

Source: Spanish authorities; presented in late 2001.

1/ On an ESA95 basis.

Table 4. Spain: Indicators of External and Financial Vulnerability 1/
(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	
					Latest observation	Date of observation
External indicators 1/						
Exports (annual percent change, in U.S. dollars)	6.0	7.4	2.9	1.6	3.6	September
Imports (annual percent change, in U.S. dollars)	4.4	11.3	8.4	3.3	0.5	September
Terms of trade (annual percent change)	-1.6	3.8	1.7	-1.5	...	...
Current account balance (settlements basis)	0.5	-3.4	-2.1	-1.9	-2.5	September
Capital and financial account balance	0.6	1.1	3.1	4.4	3.8	September
Of which : Inward portfolio investment (debt securities etc.)	1.7	2.4	6.6	12.0	1.6	September
Inward foreign direct investment	0.9	1.6	2.3	7.6	0.4	September
Other investment liabilities (net)	2.6	3.1	2.5	7.2	1.6	September
Official reserves (in U.S. dollars, billions, end-of-period) 2/	69.1	31.8	33.5	35.3	31.2	October
Broad money to reserves	7.7	9.5	10.1	...	...	...
Central Bank foreign liabilities (in U.S. dollars, billions) 2/	62.0	69.8	77.4	74.5	66.8	October
Foreign assets of the financial sector (in U.S. dollars, billions)	181.1	206.4	254.9	313.3	318.1	October
Foreign liabilities of the financial sector (in U.S. dollars, billions)	270.3	347.2	423.1	506.7	521.7	October
Official reserves in months of imports 2/	4.7	2.5	2.2	2.2	2.1	September
Total external debt	23.1	24.5	30.6	31.7	30.6	June
Of which : General government debt	15.7	16.2	18.2	...	...	...
Total external debt to exports (ratio)	1.2	1.3	1.7	0.8	0.8	June
Exchange rate (per U.S. dollars, period average)	146.4	180.1	186.4	184.9	188.8	December
Financial market indicators						
Public sector debt (Maastricht definition)	68.1	60.7	58.9	56.6	...	...
3-month T-bill yield	5.0	3.8	3.0	4.6	3.1	November
3-month T-bill yield (real)	3.1	2.0	0.8	1.2	0.4	November
Stock market index	195.0	286.1	309.1	330.0	278.4	November
Share prices of financial institutions	207.2	336.3	355.1	413.8	381.9	November
Spread of 3-month T-bills with Germany (percentage points, end-of-period)	1.7	0.4	0.1	0.3	0.1	November
Financial sector risk indicators						
Share of foreign exchange loans in total lending (percent)	10.4	7.2	6.7	7.1	...	...
Share of foreign deposits in total deposits (percent)	6.1	7.7	22.9	25.1	...	...
Share of real estate sector in private credit	27.4	27.8	28.7	...	...	...
Share of nonperforming loans in total loans	2.9	2.0	1.5	1.2	1.2	September
Share of nonperforming loans in total assets	1.2	0.9	0.7	0.6	0.6	September
Risk-based capital asset ratio (national definition) 3/	12.2	11.5	11.1	10.5	...	...

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

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

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

3/ Comparable data for June 2001 is not available, but not accounting for accrued profits the ratio is 10.0.

Spain: Fund Relations

(As of November 30, 2001)

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

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	3,048.90	100.00
Fund holdings of currency	2,168.11	71.1
Reserve tranche position	880.80	28.9

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	298.81	100.0
Holdings	279.19	93.4

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

V. **Financial Arrangements**:

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

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

VII. **Exchange Rate Arrangement**:

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

VIII. **Article IV Consultations**:

The last Article IV consultation was concluded on October 20, 2000. Spain is on the standard 12-month consultation cycle.

Spain: Statistical Issues

Spain's economic data on the core variables needed for surveillance are at acceptable standards of quality, coverage, and timeliness. The authorities are fully cooperative in providing data to the Fund, and do so regularly. The Bank of Spain and the Ministry of Economy transmit data electronically to the Fund on a monthly basis, and a wide variety of data and documents are available from Internet sites maintained by the National Statistics Institute, the Bank of Spain, the Ministry of Economy, and other official agencies. Spain has subscribed to the Special Data Dissemination Standards.

Data on the budgetary balance of the general government on both a cash and accruals basis are available, but greater information about the calculations involved in reconciling the two deficit measures would increase the transparency of government accounts. In addition, data on budgets and fiscal outturns for regional governments are available only on an aggregate basis. Two different measures of unemployment are reported by the authorities (so-called "registered" and "survey" unemployment), which vary substantially. A wider dissemination of the methodological differences in calculating these numbers would aid in their interpretation. Data on employment growth are distorted by the flow of workers from the informal to the formal labor force, which complicates the calculation of productivity growth and hence unit labor costs. The very large growth in receipts from the value added tax in 1999 may indicate that consumption and output growth are being underreported in the national accounts data. National accounts and fiscal data through 1995 have been revised in line with the 1995 version of the European System of Accounts, but pre-1995 data have yet to be revised.

Spain: Core Statistical Indicators
(As of December 15, 2001)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 1/	GDP/GNP	External Debt 2/
Date of Latest Observation	12/15/01	11/30/01	10/31/01	10/31/01	12/15/01	11/2001	9/2001	9/2001	2000	Q2/2001	Q1/2001
Date Received	12/15/01	12/15/01	12/14/01	11/30/01	12/15/01	12/14/01	12/14/01	12/14/01	3/16/01	10/19/01	7/31/01
Frequency of Data	Daily	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annual	Quarterly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annual	Quarterly	Quarterly
Source of Update	Reuters; Central Bank	Central bank; Reuters	Central bank	Central bank; Reuters	Central bank; Reuters	National Institute of Statistics; Reuters	Central bank; Reuters	Central bank; Reuters	Ministry of Finance	National Institute of Statistics; Reuters	Central bank
Mode of Reporting	Electronic	Electronic, tape and publication	Electronic, tape and publication	Electronic, tape and publication	Electronic, tape and publication	Electronic and publication	Electronic, tape and publication	Electronic, tape and publication	Tape and publication	Electronic, tape and publication	Electronic, tape and publication
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annual	Quarterly	Quarterly

1/ Central government balance is released to the press monthly, about three weeks after the end of the month, and published by the Ministry of Finance.
2/ Spanish government debt held by nonresidents is released to the press weekly by the central bank and drawn by staff from Reuters

Inflation in Spain and the Euro Area

With the establishment of a broad monetary union in Europe, the question of how to interpret the differential inflation rate among member countries has become important. For example, inflation in Spain and Ireland has exceeded average inflation in the euro area by about 1 percentage point in the last couple of years. In Spain, the differential increased to about 1.4 percentage points in the Q1, 2001, although recently it has dropped below 1.0. This presents an important policy issue: should Spain's inflation (or differential) matter from a macroeconomic policy point of view given that it shares a common monetary policy with other euro-area countries? Should the inflation differential be treated, and largely ignored, as it is within states or provinces of a nation state? Not surprisingly, the answer depends on the factors underlying the differential.

In principle, the inflation differential can reflect three distinct factors:[1]

- First, the inflation differential can reflect the **Balassa-Samuelson** effect—that is, the catch-up of productivity in the tradable goods sector. To the extent that higher wages in the tradable goods sector push economy-wide wages and prices in the nontraded goods sector, the inflation differential can lead to an equilibrating real appreciation.

- Second, the inflation differential can reflect the **convergence of nontraded goods** prices as income levels converge. As income levels rise, relative demand for nontraded goods increases, pushing up their relative price and total inflation. Convergence can reflect changes in the relative demand of nontraded goods as income levels converge, that is, nonhomothetic preferences associated with expansion paths that curve toward nontraded goods. As income increases, the relative demand of nontraded goods rises, leading to an equilibrating real appreciation achieved via a positive CPI differential.

- Third, the inflation differential can reflect underlying **macroeconomic pressures,** that is, excess demand. As often the case with demand pressures, it is important to identify the source of the excess demand in determining whether or not there is cause

[1] A technical issue regarding the measurement of the inflation differential can also be important in the discussion of inflation differentials. The inflation differential is estimated using the "harmonized index of price to consumers, HIPC." This index harmonizes the list of goods across countries so that the index reflects the same bundle of goods; however, the weights of these goods are not the same across countries. To the extent that individual prices increase at different rates, the differing weights will give rise to a composition effect in the measurement of the inflation differential. Recently, these compositional effects tend to narrow the measured HIPC inflation differential between Spain and the euro average because two high inflation items—energy prices and services—have a lower weight in Spain's HIPC.

for concern. Starting from full employment and external equilibrium, an increase in *domestic demand* will translate into a weaker external position, and the inflation differential will lead to a real appreciation reestablishing internal equilibrium albeit with a worse external position. Under similar circumstances, an increase in *external demand* will translate into a better external position, and the inflation differential will help restore both internal and external equilibrium.

Thus, an adjustment of macroeconomic policies might be required when the inflation differential reflects macroeconomic pressures associated with domestic demand. Leaving aside issues relating to the effectiveness and lags of fiscal policy in open economy, a fiscal tightening could offset these pressures avoiding the loss of external competitiveness and the crowding out net exports.[2] But, this is not always required.

Consider the individual components of domestic demand. If the pressures are associated with *investment* that essentially reflects private incentives—higher return on investment vis-à-vis trading partners—and does not pose undue risks for the financial sector, inflation can be an equilibrating adjustment. A similar argument can be made when pressures are associated with an increase in *private consumption*, although with a bit more caution. The increase may reflect a stock adjustment following a financial reform and the lifting of liquidity constraints, or greater consumer confidence as the outlook in labor markets improve. However, the increase may reflect wealth effects associated with increases in asset prices, notably equity and housing prices. This could be of concern, particularly in a monetary union where monetary policy could be too loose for cyclically advanced countries. There is a risk that an asset price "bubble" could burst as monetary policy is tightened when other countries enter the boom phase of their output cycle. An adjustment to macroeconomic policies may be needed to avoid a substantial credit expansion that could impair bank loans, or an over-leveraged private sector. Clearly, if the source of the demand pressures can be traced back to lax *fiscal* policy, then putting fiscal policy back on track would be the appropriate policy response to avoid the loss of international competitiveness.

[2] Of course, within a monetary union the nature of concerns about a current account imbalance are different; they may relate to potential fragility in external financing (that is not the case in Spain): more substantially and typically the concerns are of cycles that can develop as real wages move out of equilibrium, or domestic balance sheets stresses build up. The costs of external disequilibrium are no longer an exchange rate crisis and reserve loss: they lie in a protracted and painful domestic adjustment as underlying disequilibria are corrected.

In practice, it is difficult to establish precisely the origins of the inflation differential in Spain, and the available evidence does not clearly point to the origin:

- ***The Balassa-Samuelson effect.*** Three recent studies attempt to measure the inflation differential that could be attributed to the Balassa-Samuelson phenomenon in Spain. Alberola-Illa and Tyrvainen, 1998, based on a cointegration framework, suggest that an inflation differential of as much as 1.5 percentage points can be attributed to Balassa-Samuelson on average from 1985 to the mid-1990s. This is based on labor productivity, not total factor productivity as suggested by the underlying conceptual framework. Perhaps the most satisfactory approach to measurement to date is contained in Swagel, 2001, which improves upon the setup in Alberola-Illa and Tyrvainen by measuring productivity in terms of total factor productivity in both traded and nontraded sectors. Although this study does not directly provide a measurement for Spain, it does suggest orders of magnitude for other European countries in particular, Greece and Italy, that are roughly in line with the results reported above (roughly 1.7 and 1.4 percentage points).[3]

- ***Convergence of nontraded good prices.*** Empirical evidence on this phenomenon is scarce. Most work on nonhomothetic preferences has focused on analyzing the role of demand factors in determining trade—typified by Markusen, 1986, Helpman, 1981, and Ethier, 1982—and not on the impact it may have on the real exchange rate. The scant empirical evidence on nonhomothetic preferences (Markusen and Hunter, 1989, and Hunter, 1991) does suggest, however, that increases in real income would be associated with a real appreciation. Specifically, these estimates suggest that as income increases, the income share of nontraded goods (medical services and recreation) increase, and that of traded goods (food, clothing, and fuel) decrease. To the best of staff's knowledge, however, these factors have not been used to quantify the magnitude of the inflation differential that may be attributed to them.

- ***Macroeconomic pressures.*** A recent study by the CEPR concludes that inflation in Spain, in contrast to Ireland, is worrisome. This is because the sources of demand pressures in Spain are alleged to have translated into an increasing current account deficit that does not reflect an investment boom as it does in Ireland. Moreover, the available evidence suggests that productivity growth is weak. The authors note that this evidence does not make a strong case for higher current account deficits in Spain. And although financing the current account deficit does not seem problematic now, it does imply a worse net international investment position and increased future

---

[3] The European Commission, 1999, based on simulations using a macroeconomic model, estimates that if the Spanish economy were to reach 90 percent of the average income of the European Union over the next 10 years, the average inflation differential would also be in the order of 1.5 percentage points.

investment income payments. Their policy advice for Spain is to run a fiscal surplus leading to a reduction in inflationary pressures stemming from a consumption boom.

As is generally the case, the empirical evidence is not devoid of problems. Regarding the evidence on Balassa-Samuelson, measured total factor productivity in the traded and nontraded sectors imply unlikely behavior of the nontraded sector's total factor productivity in Spain (negative productivity growth in the service sector), which is why empirical studies have either dropped Spain from the sample (Swagel, 2001) or relied on labor productivity as a proxy (Alberola-Illa and Tyrvainen, 1998). Perhaps more damaging is that recent studies do not control for demand factors in measuring the Balassa-Samuelson phenomenon. To the extent that increases in output and productivity occur contemporaneously with demand factors, the econometric techniques could not isolate the relative contributions of the supply and demand factors. An earlier study, Giovannini, de Gregorio, and Wolf, 1994, controls for demand factors in their measurements although the classification of traded goods sector is problematic, as it includes agricultural goods that are heavily subsidized in the EU, and whose prices are to a large extent determined administratively. Moreover, and abstracting from these difficulties, the available studies do not provide an indication of the uncertainties that are associated with the estimates that are provided, that is no standard errors are reported.

Regarding the evidence on macroeconomic pressures, while not disputing the desirability of running a larger fiscal surplus in Spain in the medium term, it is not clear that this can be predicated on the basis of inflationary worries. The macroeconomic data does not show a "consumption boom" in Spain especially relative to Ireland. Excluding the CEPR's projections for 2001, which far exceed more recent projections, consumption has increased by less than domestic demand by a larger margin in Spain than in Ireland. Granted investment growth has been impressive in Ireland, and has exceeded that in Spain; but in both countries investment increases have exceeded domestic demand during 1998–2000.

In sum, neither macroeconomic demand pressures nor productivity improvements (telling a clear a Balassa-Samuelson story) are evident. Recent empirical estimates by the Bank of Spain suggest that total factor productivity in manufactured goods has exceeded those in services (excluding communications) by about 1 percent in the past 20 years, but overall total factor productivity growth has been declining since the late 1980s. It is not clear why, if Spain is further away from the average euro-area income and technology than other counties, its measured productivity gains are smaller. Overall, the price convergence of nontraded goods appears to be an interesting avenue for further analysis.

The Draft Budgetary Stability Law (BSL)

The government's initiative to introduce a new fiscal law reflects the view that a more rules-based fiscal framework, covering all levels of government, would enhance policy formulation and execution in Spain. Budgetary procedures can be improved—for reasons related to the general issues relevant to most EU economies discussed in the cross-country background paper on fiscal rules.[1] In particular, while fiscal consolidation in Spain has been very successful there are some concerns that it may have been achieved by squeezing out public investment. Also, the regions have experienced slippages in their contribution to the consolidated public budget, and the principles concerning their deficits and debt need greater transparency and accountability. Moreover, there is the need to squarely address the medium- and long-run issues associated with an ageing population. The BSL should be viewed in this context, as well as the potential to improve the efficiency of public expenditure.

Goals of the draft BSL: (i) to consolidate gains and achieve medium-term sustainability; (ii) to create a permanent framework for coordination between central and lower levels of government; and (iii) to strengthen budgeting, accounting, and reporting at all levels.

Institutional coverage: extends to the central government, lower levels of government (an essential element in Spain's decentralized system), and public enterprises.

Multiyear framework: Public entities must formulate their budget in a multi-year macro-budget framework. The cabinet would set fiscal targets for each level of government and impose limits on central administration (*Estado*) expenditures for a three-year period.

Fiscal rules: All public entities must formulate, approve, and execute budgets in balance or surplus.[2] The central government surplus is used to pay down public debt, while social security surpluses are used to create a pension fund. Public enterprises are required to be in "financial equilibrium"—understood as avoiding operational losses in the medium term. A Contingent Liabilities Fund (CLF)—of 2 percent of central government expenditures—is set up to cover unexpected, nondiscretionary spending; the unused portion of the CLF does not carry over to the next year. If under exceptional circumstances any entity approves or executes a budget in deficit, it is required to formulate a three-year corrective program. A special framework covers the Basque Country and Navarre.

---

[1] IMF Country Report No. 01/203, October 3, 2001.

[2] The version of the BSL approved by Congress, and currently in the Senate, includes a 12 year transition period for the central government and the social security fund. During this period, the balance or surplus applies jointly to the consolidated budgets of the central government and social security, corresponding to the period during which the central government budget would progressively assume the cost of the noncontributory pensions.

Monitoring and transparency: All government levels will be under National Accounts Office (IGAE) surveillance. The government presents the fiscal targets together with a multiyear macroeconomic framework, included in the Stability Program, to parliament for discussion and approval. All actions by public entities must include an ex ante analysis of their budgetary impact. The European Accounting Standard (ESA 95) is used throughout.

Enforcement and sanctions: Sanctions under the Maastricht Treaty will be allocated among the different levels of government according to their responsibility.

Pensions: Reform Options and Economic Outcomes

Old-Age Pension Spending
(In percent of GDP)

	2000 (1)	2035 (2)	2050 (3)	Change (3)-(1)
France	12.1	16.4	16.3	4.2
Germany	9.7	15.1	15.5	5.8
Italy	14.4	16.3	14.3	-0.1
Spain	9.4	14.5	17.4	**8.0**
OECD average	8.1	11.3	11.2	**3.1**

Note. The spending projection for France in column (3) refers to 2040.

Source: Fiscal Implications of Ageing, OECD, 2001.

A recent study by the OECD/EU suggests that spending on old-age pensions in advanced economies is likely to increase by 3 to 4 percentage points of GDP over the next 50 years, primarily due to an increase in dependency ratios—the number of individuals older and younger than the group aged 20 to 64. The rise in spending is projected to be significantly larger in Spain—amounting to roughly 8 percentage points of GDP—mainly because the baby boom arrived somewhat later than in other industrial countries.[1] This confirms earlier studies by Herce and Meseguer, 2000, and the Fund staff, with regard to age-related spending in Spain. Although long-term projections are inherently uncertain and sensitive to key assumptions (population projections, fertility rates, life expectancy, net immigration, and unemployment), these projections, nonetheless highlight the special features of the demographic shock in Spain: it is unusually deep, but arrives unusually late.[2] The following paragraphs take this finding as given, and go on to consider the economics of alternative reform strategies.

Without reforms, the projected impact in Spain challenges the pay-as-you-go system: contributions would need to increase significantly and/or additional government transfers to the system would require higher taxation. This would have major macroeconomic effects on per capita GDP, resulting from increased distortionary taxes. Simulations performed in the context of a general equilibrium model of overlapping generations suggest that increases in contribution rates of about 10 percentage points—bringing total contributions to more than 35 percent of wages—would be required to maintain current pension benefits. Aside from questions of feasibility, the macroeconomic impact would be to reduce per capita output between 5 and 11 percent compared with a scenario in which benefits would decline between 20 and 35 percent as the dependency ratio increases (see Montoya, 2000, and Arjona, 2000). Higher taxes likely would also fall to a significant degree on labor, and would have analogous, if perhaps slightly lesser, effects.

From a welfare standpoint, it is thus very attractive to implement at an early stage reforms that would reduce the level of benefit payments by tying them more closely to contributions,

[1] These increases do not include health care-related expenditures that by analogy to other countries could accentuate significantly the change in age-related spending.

[2] Currently the National Statistical Institute is revising its long-term population projections to reflect recent higher trends in immigration. Relaxing the immigration assumptions underlying the projections is likely to move later increases in dependency ratios, but does not eliminate the demographic shock.

and extending the period of the latter. Interestingly, an indirect approach of increasing the effective age of retirement by some five years would have a powerful impact, without cutting benefit rates. This could be accomplished by stronger incentives to forego early retirement, increasing the statutory retirement age, and increasing the link between contributions and benefits. Finally, bearing in mind the widening gap that will open up between incomes and pensions that are indexed solely to the CPI, it would appear strongly desirable to introduce incentives for private pensions: in the absence of this, the political sustainability of the indexing system may be questionable as the population ages.

INTERNATIONAL MONETARY FUND

SPAIN

Staff Report for the 2001 Article IV Consultation
Supplementary Information

Prepared by the European I and
Policy Development and Review Departments

Approved by Michael Deppler and G. Russell Kincaid

January 29, 2002

1. This supplement reports on economic and financial developments since the issuance of the Staff Report (SM/02/15). The information does not alter the thrust of the staff appraisal.

2. **Industrial production** remained weak in Q4 2001, and November data suggest that it stood about one percent lower than at the beginning of the year. The downward trend of headline CPI **inflation** was interrupted in December when the price index increased by 0.4 percent resulting in a 12-month inflation of 2.7 percent. This was largely due to one-off factors associated with hotel services—but its margin over the euro-area average remains less than one percent. Moreover, pay agreements reached late last year bode well for continued wage moderation, and are consistent with the outlook for inflation discussed in the Staff Report.

3. The most recent data on the execution of the **2001 budget** suggest a favorable level of revenues and expenditure, with a small surplus emerging through November. Official sources suggest that, while December data have not yet been finalized, developments are consistent with achieving balance in 2001—pointing toward a marginally smaller deficit than that foreseen in the Staff Report. Meanwhile, parliament passed into law in late December the **Budgetary Stability Law.** It came into effect on January 1, 2002, and will be effective for budgets at all levels of government from January 2003. The authorities consider that the final text of the law is consistent with the portrayal in the Staff Report.

4. In the area of structural reforms, there have been several further developments. In **labor markets,** the recent framework wage agreement has introduced a degree of flexibility to adjust pay increases to the firm-specific circumstances, including labor productivity. This is a step in the right direction, although the authorities acknowledge that a more general reform to the wage bargaining process is still needed, and note the worrying further spread of price indexation clauses. The authorities are planning also to move forward on a further reform of the unemployment benefit, in consultation with the social partners—including the income tax treatment of workers taking jobs before their unemployment benefits expire. In **product markets,** legislation was approved by parliament in late 2001, establishing the Competition

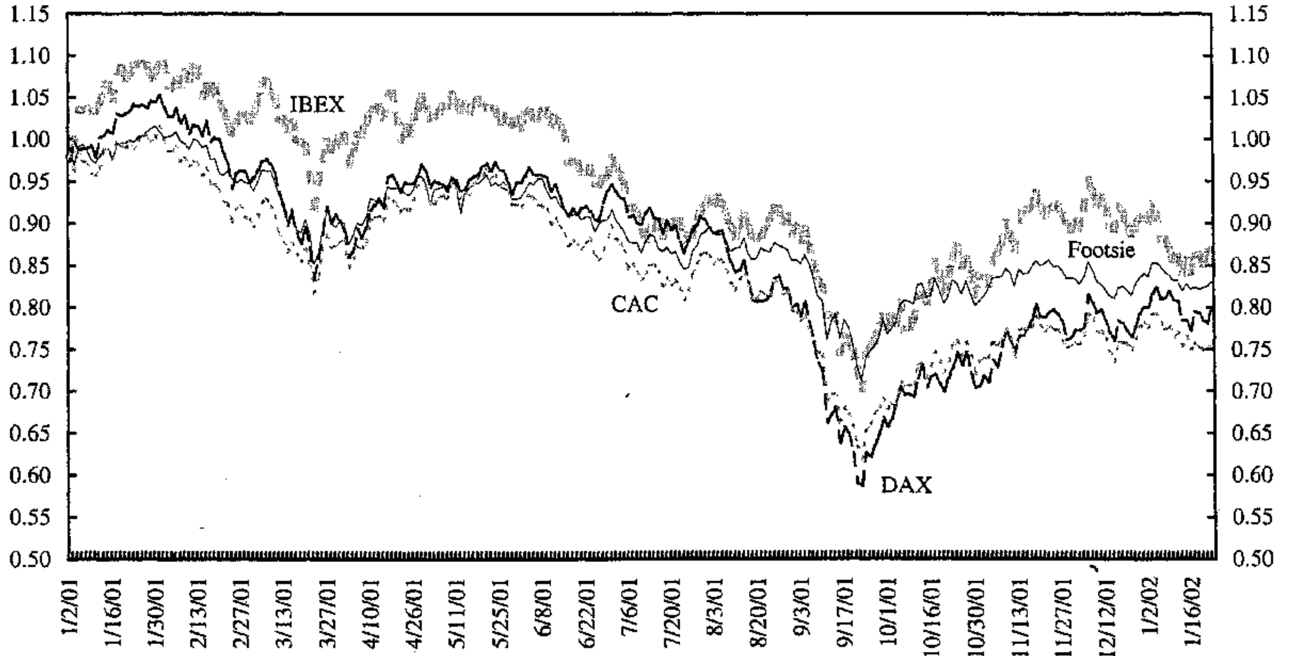
Protection Court as an independent agency (although it remains functionally assigned to the Ministry of Economy). Also, steps have been taken to increase competition in specific product markets, including the pricing of inter-city land transportation.

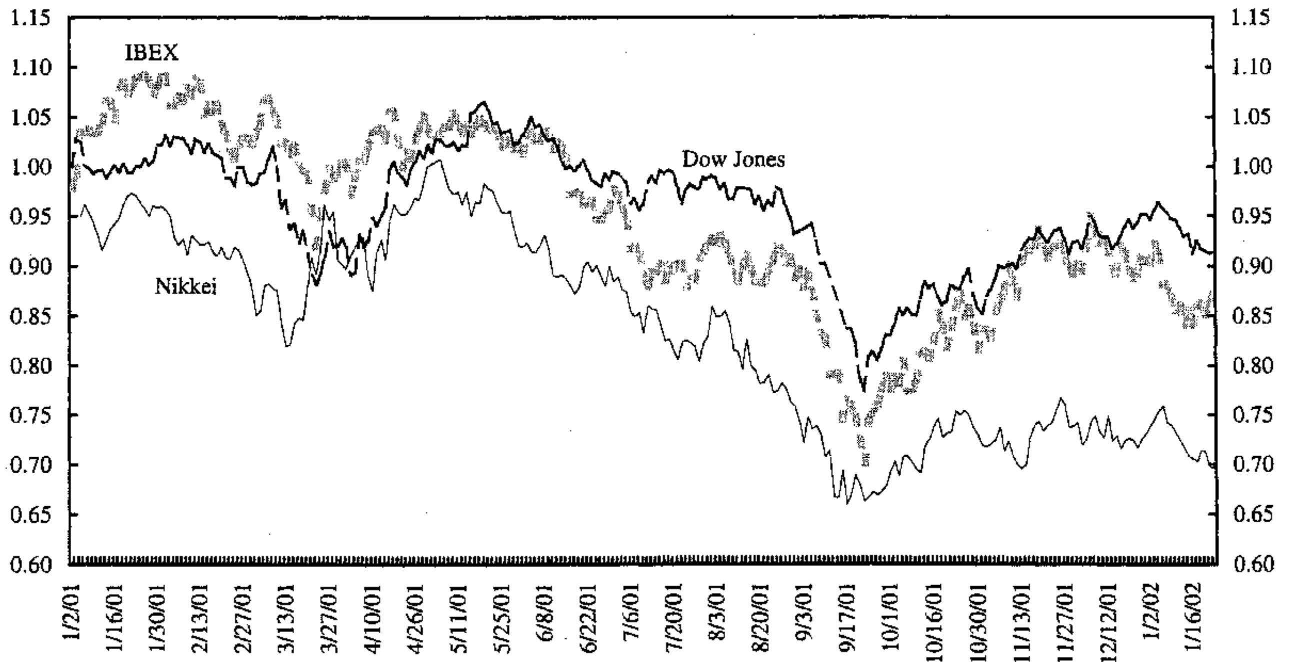
5. In the **financial sector**, stock prices in Spain have fallen throughout 2001. The trend of prices has been broadly consistent with those in other major equity markets (Figure 1). In the closing months of 2001, stock prices of major banks and large firms that operate in Latin American, and specifically in Argentina, have increasingly reflected markets' reassessment of those firms' profitability given the unfolding events in Argentina (Figure 2). These price declines appear to have reflected a measured reassessment of projected earnings for 2002. At the time of writing, of course, notable uncertainties remain in Argentina. The National Accounting and Auditing Institute has recommended a conservative treatment of the exchange rate for investments in Argentina, indicating that recent developments in that country are to be duly taken in consideration as firms close their financial accounts for 2001.

6. The authorities do not expect the financial crisis in Argentina to exercise a significant negative effect on the domestic Spanish economy be it through the banking system or Spanish firms with overseas interests. In particular, they note that any adjustment of domestic investment plans of firms with a presence in Argentina would have very small overall effect on domestic investment, as these firms account for less than two percent of total investment. And the authorities pointed out that bulk of the decline in financial wealth associated with stock price adjustments had already occurred in 2001—with imperceptible effects on consumption. Even under stress-testing scenarios, they note that further deterioration in bank portfolios is envisaged to be small in comparison with that already experienced; the potential for supply-side constraints on aggregate credit growth is limited; and trade linkages are very small. Also, the authorities confirm that their assessment of the robustness of the banking system remains consistent with that reported in SM/02/15—specifically, paragraph 36 and Box 4. However, they agree with the staff's assessment that it is not possible to rule out entirely a more substantial effect on confidence in the event of a systemic banking crisis affecting a number of Latin American financial systems--a scenario that remains, however, remote on current trends. The authorities have provided an update of banks' solvency ratio as reported in the attached revision of Table 4. They note that their strict definition of eligible funds—that exclude both statistical and general provisions—used to compute these ratios translate into numbers about two percentage points lower than comparable BIS ratios.

7. Regarding **euro conversion**, the authorities expect that the bulk of this major changeover will be completed by the end of January. They indicate that all automatic teller machines were converted in the first week of January, and that over 95 percent of all transactions in the economy were transacted in euros by late January.

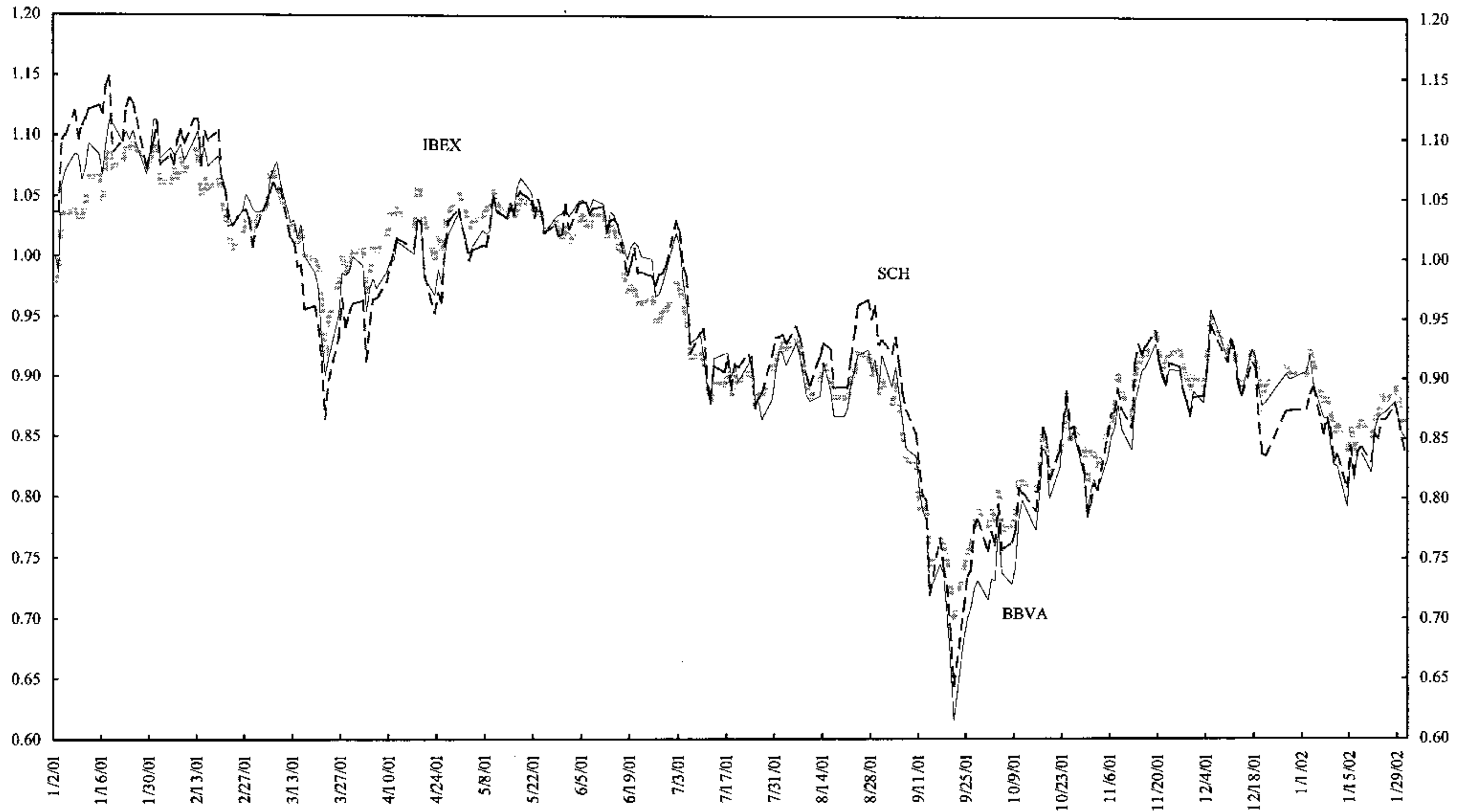
Figure 1. Spain: Stock Market Indices of Major Financial Centers, 2001-02
(December 2000 = 100)





Source: Bloomberg.
Note: Data are daily observations through January 25, 2001.

Figure 2. Spain: IBEX and Stock Price Indices of Major Spanish Banks with Investments in Argentina, 2001-02
(December 2000 = 100)



Source: Bloomberg.
Note: Data are daily observations through January 31, 2001.

Table 4. Spain: Indicators of External and Financial Vulnerability 1/
(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	
					Latest observation	Date of observation
External indicators 1/						
Exports (annual percent change, in U.S. dollars)	6.0	7.4	2.9	1.6	3.6	September
Imports (annual percent change, in U.S. dollars)	4.4	11.3	8.4	3.3	0.5	September
Terms of trade (annual percent change)	-1.6	3.8	1.7	-1.5	...	...
Current account balance (settlements basis)	0.5	-3.1	-2.1	-1.9	-2.5	September
Capital and financial account balance	0.6	1.1	3.1	4.4	3.8	September
Of which : Inward portfolio investment (debt securities etc.)	1.7	2.4	6.6	12.0	1.6	September
Inward foreign direct investment	0.9	1.6	2.3	7.6	0.4	September
Other investment liabilities (net)	2.6	3.1	2.5	7.2	1.6	September
Official reserves (in U.S. dollars, billions, end-of-period) 2/	69.1	31.8	33.5	35.3	31.2	October
Broad money to reserves	7.7	9.5	10.1	...	...	...
Central Bank foreign liabilities (in U.S. dollars, billions) 2/	62.0	69.8	77.4	74.5	66.8	October
Foreign assets of the financial sector (in U.S. dollars, billions)	181.1	206.4	254.9	313.3	318.1	October
Foreign liabilities of the financial sector (in U.S. dollars, billions)	270.3	347.2	423.1	506.7	521.7	October
Official reserves in months of imports 2/	4.7	2.5	2.2	2.2	2.1	September
Total external debt	23.1	24.5	30.6	31.7	30.6	June
Of which : General government debt	15.7	16.2	18.2	...	...	...
Total external debt to exports (ratio)	1.2	1.3	1.7	0.8	0.8	June
Exchange rate (per U.S. dollars, period average)	146.4	180.1	186.4	184.9	188.8	December
Financial market indicators						
Public sector debt (Maastricht definition)	68.1	60.7	58.9	56.6	...	...
3-month T-bill yield	5.0	3.8	3.0	4.6	3.1	November
3-month T-bill yield (real)	3.1	2.0	0.8	1.2	0.4	November
Stock market index	195.0	286.1	309.1	330.0	278.4	November
Share prices of financial institutions	207.2	336.3	355.1	413.8	381.9	November
Spread of 3-month T-bills with Germany (percentage points, end-of-period)	1.7	0.4	0.1	0.3	0.1	November
Financial sector risk indicators						
Share of foreign exchange loans in total lending (percent)	10.4	7.2	6.7	7.1	...	...
Share of foreign deposits in total deposits (percent)	6.1	7.7	22.9	25.1	...	...
Share of real estate sector in private credit	27.4	27.8	28.7	...	...	...
Share of nonperforming loans in total loans	2.9	2.0	1.5	1.2	1.2	September
Share of nonperforming loans in total assets	1.2	0.9	0.7	0.6	0.6	September
Risk-based capital asset ratio (national definition) 3/	12.2	11.5	11.1	10.5	...	...

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

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

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

3/ Comparable data for June 2001 is not available, but not accounting for accrued profits the ratio is 10.0.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 02/18
FOR IMMEDIATE RELEASE
February 28, 2002

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

IMF Concludes 2001 Article IV Consultation with Spain

On February 1, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Spain.[1]

Background

The strong expansion of the late 1990s has tapered off—and unease about risks of overheating has given way to concern about the current slowdown. The economy grew by over 4 percent annually during 1997–2000—reflecting strong consumption, competitive exports, wage moderation, and supply conditions enhanced by structural reforms. Policy credibility contributed, as interest rates declined steeply in the run-up to monetary union. Recent months, however, have seen growth projections cut—and the inflation differential with the euro average subsiding, in contrast with the first half of 2001 when the differential increased.

Recent indicators confirm that growth continues to slow:

Annualized real GDP growth was about 2 percent in the third quarter of 2001, compared to 2.5 and 3 percent respectively in the second and first quarters. Industrial production has been decreasing during most of 2001, and in November stood about 1 percent lower than a year before. And since the second quarter of 2001, consumer and industrial confidence indicators have shown a pessimistic balance for the first time in recent years.

---

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the February 1, 2002 Executive Board discussion based on the staff report.

The annual growth of employment has slowed to under 2 percent in the third quarter of 2001 from about 5 percent in 2000. With participation slipping, unemployment has continued to decline: at just over 13 percent in the third quarter it was at the lowest level since 1980, though still the highest among the advanced economies.

In December, the 12-month headline rate of CPI inflation was 2.7 percent less than 1 percentage point above euro-area average, compared with inflation of about 4.3 percent in June nearly 1.5 percentage points over euro-area average. Still, service sector inflation continues to run at about 4 percent, and core inflation—excluding food and energy—is fluctuating around 3.5 percent.

Household debt has increased from 35 percent of GDP in 1997 to 50 percent in 2001. While this is about the EU average, the rise has been rapid. Firms, too, have increased their leverage. On the supply side, banks are profitable and well capitalized, though facing increased risks, especially in Latin America. Bank lending has slowed of late, while savings banks have expanded their market share in the mortgage and consumer finance areas.

The main goal of the 2001 budget was to achieve general government balance, while increasing investment—and this appears to be broadly on track, despite slower growth. When the budget was presented, real GDP growth was assumed to be over 3.5 percent, against a likely outcome closer to 2.7 percent. Sticking to a balance target would imply a contractionary impulse (at the structural primary level) of close to 0.5 percent of GDP. With the easing of monetary conditions, however, the overall stance of macroeconomic policies in 2001 appears to have been broadly neutral.

Forecasts for 2002 have been marked down progressively in recent months. The economy should continue to expand at a rate significantly above the euro-area average, but the staff's projection is now for growth of only some 2.1 percent—based on a gradual and broad-based recovery of activity in the second half of 2002. Investment and consumer spending are likely to pick up from the third quarter, as confidence recovers; and the contribution of the external sector is projected to turn positive during the course of the year. With wage growth moderate, unemployment is likely to be broadly unchanged at just under 13 percent, while inflation is expected to fall to under 2 percent by year-end.

Executive Board Assessment

The Executive Directors commended Spain's sustained implementation of sound macroeconomic policies and structural reforms. Oriented firmly toward medium-term goals, these policies have fostered rapid economic growth, while reducing inflation to relatively low levels. Directors considered that, in view of this exemplary performance, Spain is well-placed to ride out the current weakness in the world economy, and to achieve sustained growth and convergence with its most advanced EU partners over the medium term. This will require using the scope that is available to respond flexibly to the fiscal impact of slower growth, while keeping up the pace in labor and product market reforms that are crucial for continued job creation, productivity growth, and reducing regional disparities.

Directors noted that growth in 2002 will likely be well below the 4 percent average of recent years, although still at a margin above the euro-area average. Earlier inflation worries have abated due to receding demand pressures. Vigilance will nevertheless continue to be required, since a renewed rise in the inflation differential vis-à-vis other euro-area economies, or an appreciation of the euro, could weaken Spain's competitive position. In this regard, Directors welcomed indications of continued wage moderation, which is testimony to the prudence of labor unions in fostering conditions to sustain the rapid job creation of recent years. They considered, however, that the widespread use of wage indexation should be monitored closely, and a number of them favored its scaling back. Directors also highlighted the importance of perseverance with structural reforms, which should help ensure that competition dampens any potential tendencies toward unwarranted price increases, particularly in the services sector.

Directors welcomed the authorities' decision no longer to aim for a fiscal surplus for 2002 in the face of the deterioration in the outlook for economic growth. It will remain important to avoid pro-cyclical policies at the present juncture. Directors considered that the commendable gains by Spain in achieving fiscal discipline and credibility have positioned the authorities well to allow a full play of automatic stabilizers while maintaining strict expenditure control at all levels of government. Combined with monetary conditions in the euro area, which are relatively easy in terms of Spain's cyclical position, this should help ensure an overall moderately expansionary policy stance, which Directors considered to be appropriate for the current economic outlook.

Directors commended the decisive steps taken in 2001 to strengthen Spain's medium-term fiscal framework, in particular the approval of the Budgetary Stability Law and the signing of regional financing arrangements between the central government and the autonomous communities. They agreed that the medium-term central government spending ceilings set under the Budgetary Stability Law, together with the balanced budget rule, should help protect spending on investment and education while safeguarding medium-term fiscal discipline. Directors urged the authorities to use the flexibility available under the BSL to take appropriate account of cyclical developments. They welcomed the importance attached to fiscal responsibility and transparency at all levels of government in the new fiscal framework, while noting that more timely regional fiscal data will be key for monitoring developments under the framework. Directors also welcomed the authorities' plan to move ahead with the reform of the corporate income tax.

Directors underscored the importance for long-term fiscal sustainability of comprehensive action to address the challenge of an aging population. The surplus in the social security fund is part of the solution, but should be complemented by entitlement reforms that discourage early retirement and align contributions and benefits more closely. While current immigration trends might well delay the demographic shock, its impact on the public finances will remain considerable. Accordingly, Directors encouraged the authorities to step up efforts to mobilize political and social support for early agreement on reforms that would allow adjustments to pension entitlements to be phased in gradually, and improve the incentives to remain in the labor market, building on some promising reforms that have recently been adopted to promote later retirement.

Directors welcomed the recent labor market reforms aimed at fostering more rapid job creation, especially the extension of open-ended contracts with low firing costs to a wider range of workers, and the relaxation of restrictions on part-time contracts. While Spain's unemployment rate has substantially declined in the past years, it remains nevertheless the highest among the advanced economies and subject to wide regional dispersion, and Directors therefore urged the authorities to continue their efforts to streamline reintegration policies, rationalize unemployment benefits, and lower labor income taxation. They also considered that improvements in wage differentiation, and steps to promote training and worker mobility, in particular by addressing rigidities in the housing market, will be helpful in addressing the mis-match in the labor market.

Directors commended the authorities' efforts to strengthen competition in product markets, including actions to increase the competition agency's resources and ensure its independence. They encouraged further action to foster competition and liberalization, including in the network industries, as progress in these areas will be key to enhancing productivity growth and EU convergence. Some Directors cautioned against the trend toward creating new regional public sector enterprises, and suggested that regional regulations should not impede the nation-wide trend toward greater competition in product markets.

Directors noted that the financial sector has undergone a profitable expansion, and that banks enjoy strong capital ratios. They welcomed the supervisors' increased vigilance over banks' overseas investments in light of the crystallization of international risks due to developments in Argentina, and emphasized the need to continue a conservative accounting treatment of such assets. However, while recommending continued close monitoring, Directors saw no grounds to expect any significant impact from these developments on economic growth or credit availability in Spain. They noted that, as the financial system continues to evolve, supervisory coordination will remain key, including in the growth area of private pensions. Directors welcomed Spain's efforts to combat money laundering and the financing of terrorism. They encouraged the authorities to consider participation in the Financial Sector Assessment Program in a timely manner.

Directors encouraged Spain to increase its funding for official development assistance towards the UN target of 0.7 percent of GNP.

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

Spain: Selected Economic Indicators 1/

	1997	1998	1999	2000	2001	2002
Real economy (change in percent)						
Real GDP	4.0	4.3	4.1	4.1	2.7	2.1
Domestic demand	3.5	5.7	5.6	4.2	2.7	2.1
CPI (average)	2.0	1.8	2.3	3.4	3.5	2.1
Unemployment rate (in percent)	20.8	18.8	15.9	14.1	13.0	12.8
Public finances (general government; in percent of GDP) 2/						
Overall balance	-3.2	-2.6	-1.2	-0.3	-0.1	-0.5
Primary balance	1.2	1.4	2.2	2.8	2.8	2.3
Gross debt	68.1	64.4	63.4	60.7	58.9	56.6
Interest rates (year average)						
Money market rate	5.4	4.2	2.7	4.0	4.2	...
Government bond yield	6.4	4.8	4.7	5.6	4.7	...
Balance of payments (in percent of GDP)						
Trade balance	-2.4	-3.5	-5.1	-5.9	-5.8	-5.7
Current account	0.5	-0.5	-2.3	-3.4	-2.1	-1.9
Fund position (as of November 30, 2001)						
Holdings of currency (in percent of quota)					71.1	
Holdings of SDRs (in percent of allocation)					93.44	
Quota (in millions of SDR)					3,048.9	
Exchange rate						
Exchange rate regime					euro area member	
Present rate (January 8, 2002)					US$0.8909 per euro	
Nominal effective exchange rate (1990=100)	84.9	84.9	84.2	82.1	83.5 3/	...
Real effective exchange rate (change in percent)	1.6	1.4	1.7	1.8	2.5 3/	...

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

1/ Figures for 2001 and 2002 are Fund staff estimates and projections, respectively.
2/ Maastricht basis.
3/ As of October 2001.