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SM/84/172

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July 17, 1984

To: Members of the Executive Board

From: The Acting Secretary

Subject: Spain - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Spain. A draft decision appears on page 22.

This subject has been tentatively scheduled for discussion on Friday, August 10, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Ms. Swiderski (ext. (5)8843).

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INTERNATIONAL MONETARY FUND

SPAIN

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives
for the 1984 Article IV Consultation with Spain

Approved by L. A. Whittome and Subimal Mookerjee

July 16, 1984

I. Introduction

A staff team consisting of H. B. Junz, L. Perez, K. Swiderski (all EUR), A. Penati (RES), and B. Barrington (ADM) as secretary, visited Madrid from May 10 to 25, 1984 to conduct Article IV consultation discussions. The mission met with the Minister of Economy and Finance, Mr. M. Boyer, the Governor and the Deputy Governor of the Bank of Spain, Messrs. J. R. Alvarez Rendueles and M. Rubio, and with officials of the Ministries of Economy and Finance, Industry and Labor, and the Bank of Spain. Mr. J. L. Feito, Alternate Executive Director for Spain, attended the meetings as an observer. Spain continues to avail itself of the transitional arrangements in Section 2 of Article XIV of the Articles of Agreement.

II. Background

1. Policy problems and objectives

Since the mid-1970s, the Spanish economy has been characterized by a high rate of inflation, relative stagnation in activity, rising unemployment, and growing public sector deficits. After 1979, despite the downward trend of investment, which has a high import content, the current account of the balance of payments moved into significant deficit (Chart 1). This deficit was associated with the loss of competitiveness in the preceding years, the heavy dependence on imported oil, the deceleration in world economic growth, and higher interest rates abroad. To avoid a further deterioration of the current account that would otherwise accompany escalating labor costs, the authorities pursued an active exchange rate policy. Even so, the deteriorating terms of trade and rising labor and financial costs depressed profits, leading to sharp cuts in employment and investment. Despite expanding public sector investment, the share of fixed investment in GDP fell from 22 percent in 1976 to 18 percent in 1983, and employment in the private sector fell by 19 percent. As unemployment mounted and the private sector shrank, the public sector increasingly became both the employer of last resort and the financial supporter of declining industries (Chart 2). In the process, the public sector's financial balance (on a national accounts basis) shifted from a small surplus in the mid-1970s to a deficit equaling about 6 percent of GDP in 1983, thereby progressively depriving the private sector of access to financial resources at reasonable costs.

Against this background of structural weakness, the Government in 1982 tried to boost activity through an easing of financial policies. This attempt failed. While the rate of inflation, as measured by the CPI, remained at around 14.5 percent, unemployment rose by 2 percentage points to 17 percent of the labor force, and the overall balance of payments deficit soared to US$3.3 billion, almost five times the level of the previous two years.

The Socialist Government, that took office in December 1982, recognized that a return to higher employment levels and a sustainable growth path could not be achieved, except through a correction of the imbalances in the economy. This required, in particular, reducing the rigidities in the labor market that, year after year, had allowed real wages to rise in the face of mounting unemployment and falling demand for labor, and cutting government support of failing enterprises, while containing that of consumption (Table 1). The former would lay the basis for increases in profitability and in turn for employment, while the latter would reverse the trend toward accelerating public sector deficits so as to create room for expansion of private sector investment.

Table 1. Spain: Growth and Structure of General Government Expenditures, 1970-84

(In percent of GDP)

	General Government Expenditures					
	Own expenditures		Transfers			
	Consumption	Investment	Households 1/	Enterprises	Interest on debt 2/	Total expenditures
1970	9.9	2.8	8.5	1.9	0.6	22.1
1976	9.4	2.4	11.1	2.3	0.4	25.8
1980	11.0	1.9	15.0	3.3	0.8	32.1
1981	11.2	2.1	16.1	3.5	0.7	33.8
1982	11.8	2.9	16.3	4.6	1.0	36.6
1983	12.1	3.5	16.7	4.8	1.4	38.4
1984 3/	11.3	2.8	16.5	4.8	1.7	37.6

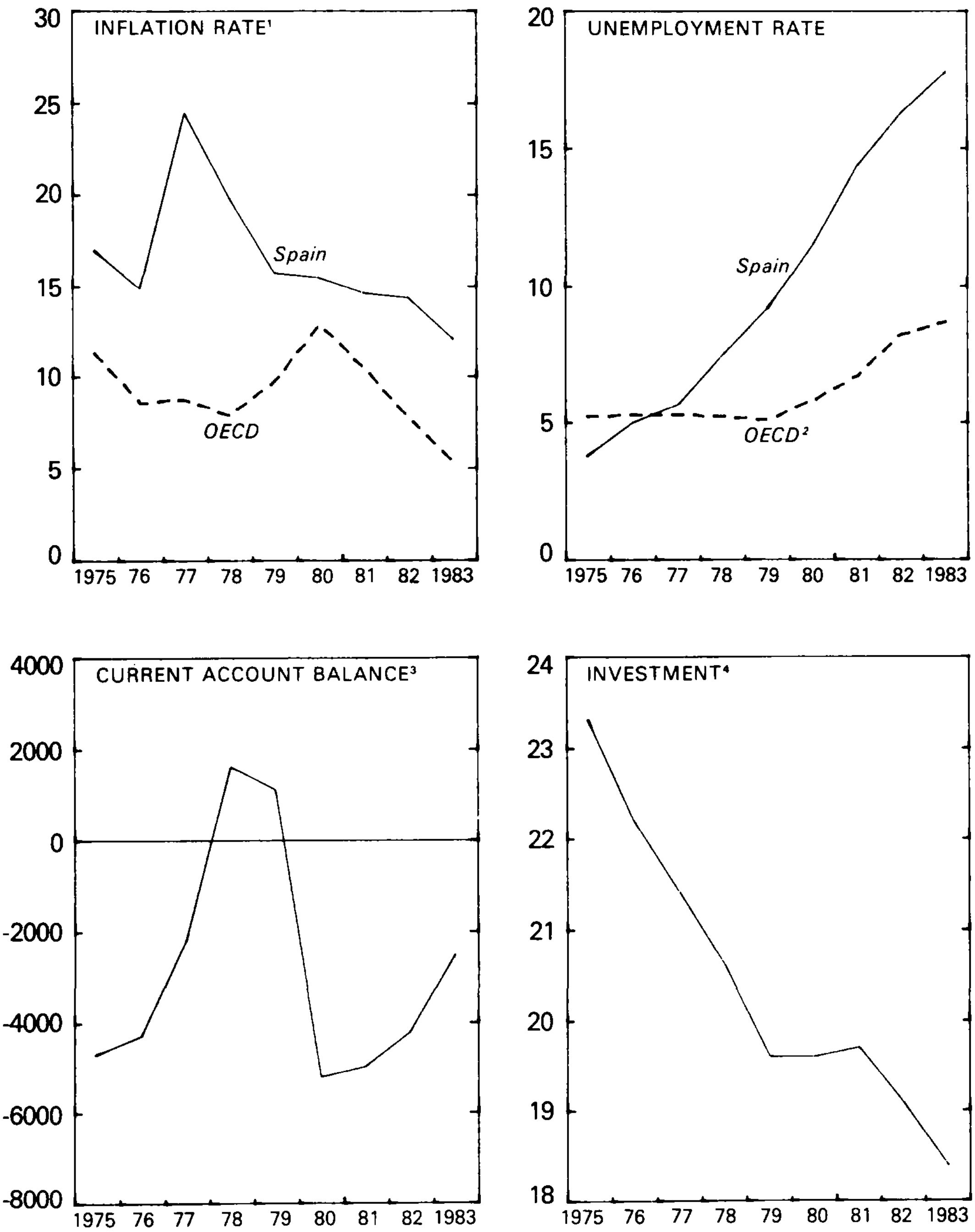
Source: Ministry of Economy and Finance.

1/ Includes "other current transfers."
2/ Does not include all the interest payments on treasury bills, which only became an important source of financing in 1983 and 1984.
3/ Official projections.

CHART 1

SPAIN

INFLATION, UNEMPLOYMENT, INVESTMENT AND THE CURRENT ACCOUNT BALANCE, 1975-83



Sources Bank of Spain, *Annual Report 1983*, forthcoming; and OECD, *Economic Outlook*, July 1984.

[1]Inflation rate measured by the consumer price index.

[2]Based on 15 OECD countries with standardized unemployment rates.

[3]In millions of U.S. dollars.

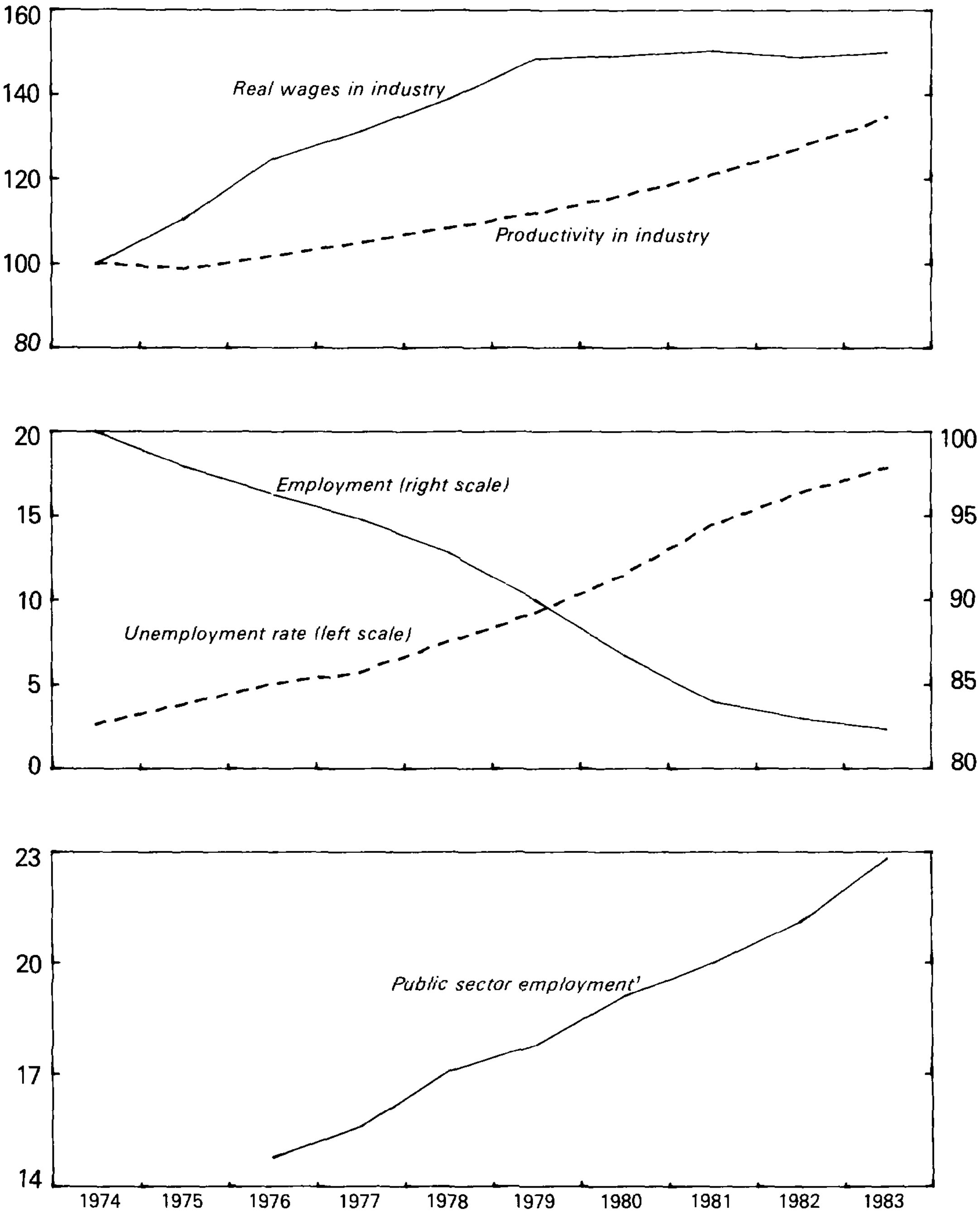
[4]Share of gross fixed investment in GDP at constant prices.

CHART 2

SPAIN

LABOR MARKET DEVELOPMENTS, 1974-83

(1974=100)



Sources: Bank of Spain *Annual Report, 1983*, forthcoming; and staff estimates.
[1]Share of public sector employment in total dependent employment.

The Government viewed 1983 as a year of transition during which the groundwork was to be laid from which basic adjustment could proceed. Accordingly, they sought first to bring inflationary pressures under control and to restore external balance. To this end, they adopted an economic program that aimed at a modest acceleration in the rate of growth of output to some 2 percent, a reduction in the rate of inflation by 2 percentage points to 12 percent by year-end, and an improvement in the current account deficit from the equivalent of 2.4 percent of GDP in 1982 to 1.5 percent in 1983. The policy strategy in support of these objectives included a reduction in the target rate of growth of broad money (M3) from 15.5 percent to 13 percent, stabilization of the public sector deficit in relation to GDP at about 6 percent, and a wage policy aimed at zero growth of real wages. An active exchange rate policy, together with the targeted moderation of wage increases, was to maintain competitiveness in world markets. Thus, the peseta was devalued by 8 percent vis-à-vis the U.S. dollar in December 1982 and allowed to depreciate further during 1983, for a 12-month change of 20 percent against the dollar and 10 1/2 percent on a trade-weighted basis, and by over 5 percent in real effective terms (Chart 3).

Against this background, Directors strongly supported the policy objectives of the Spanish authorities during the April 1983 Board discussion of the staff report for the last Article IV consultation. They noted the urgent need to contain public expenditures, particularly with respect to wages, social security benefits, and subsidies to ailing enterprises. They expressed concern, however, regarding the authorities' ability to obtain the needed wage moderation and stressed the importance of reducing the external current account deficit. They underlined the need for a flexible exchange rate policy in that process and urged implementation of a more flexible interest rate policy as well.

2. Recent economic developments

In the event, the quantitative targets of the authorities' program were broadly achieved. Partly because of favorable developments in food prices, and despite the effect of the currency depreciation on domestic prices, the CPI rose by just over 12 percent; the budget deficit, on a national accounts basis, was held to 5.9 percent of GDP, and the current account deficit declined from US$4.1 billion in 1982 to US$2.4 billion, the equivalent of about 1 1/2 percent of GDP, in 1983. At the same time, the broad money target was met and real GDP rose by 2.3 percent, actually a little more than targeted.

These successes notwithstanding, only partial progress was made toward laying the base for fundamental adjustment. In particular, wages continued to rise in real terms, albeit more slowly than earlier, and public sector expenditures, especially transfers to cover losses of public enterprises, overshot targets. These developments were reflected, to some extent, in the composition of output in 1983, which was somewhat different from what had been aimed for by the authorities. Whereas some revival of private investment demand was to have been an important aspect of the recovery, fixed investment expenditures continued to fall in real terms. This fall offset a small rise in private consumption expenditures, so that the 0.7 percentage point contribution of domestic demand to overall growth of output stemmed entirely from the public sector.

Most investment that is taking place appears to be of a labor-saving nature. This reflects both the rigidities in the labor markets, in particular the expense and time required to effect layoffs, and the fact that wage costs remain high. In 1983, labor costs, despite the priority given to their containment, still rose 1 percent in real terms. Although productivity increased by about 3 percent, the impact on profit margins was rather less to the extent that the productivity increase stemmed from plant closures, and in any event was less than consistent with the authorities' timetable for restoring adequate profitability.

As a result, the process of labor shedding, especially in small and medium-sized firms continued. By contrast, efforts to shrink the labor force in large loss-making enterprises, as part of the program to restructure industry, played only a limited role in the 2 1/2 percent decline in employment in industry in 1983. With public sector employment continuing to rise, the fall of employment in the economy as a whole was held to about 1 percent and the unemployment rate rose to 18.4 percent by year-end, with the share of long-term unemployment reaching 54 percent, compared with only 17 percent in 1975.

The continued fall in employment, together with the mounting losses of public sector enterprises, frustrated the programmed containment of the growth of public expenditures. Although the rise of the budget deficit remained within the target, this was achieved mainly by an increase in revenues, with the ratio of tax revenues to GDP rising by 1.9 percentage points. This rise stemmed from increases in indirect taxation, a reduction of tax exemptions, and some success in reducing income tax evasion.

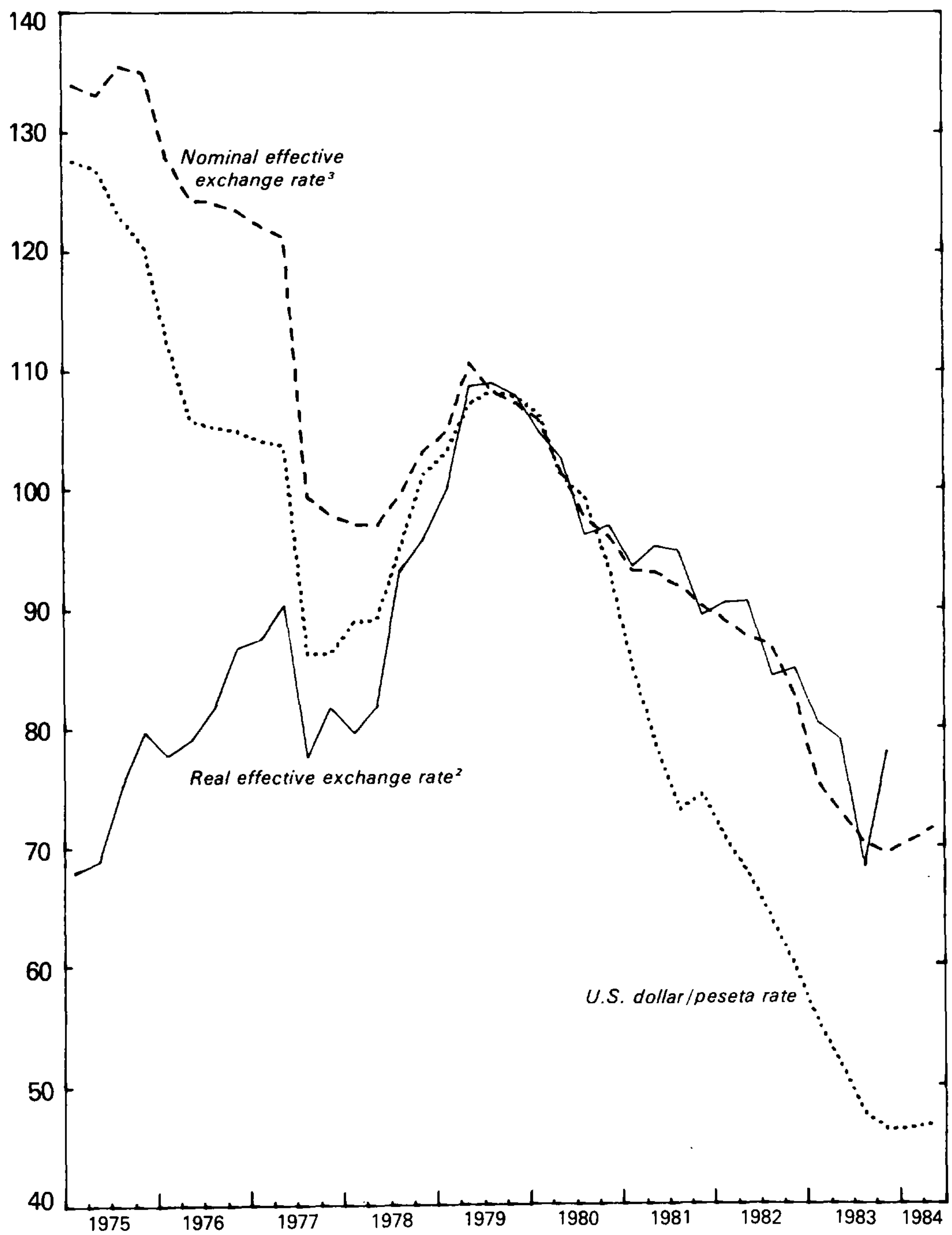
Public expenditure trends since 1982 have been difficult to discern because of the steps taken to bring past hidden deficits back into the accounting system and by the delay in the approval of the 1983 budget, which caused expenditure ceilings to be maintained at their 1982 levels until mid-1983. Abstracting from these influences, it appears that the underlying growth of expenditures outpaced GDP growth. Transfer payments to households continued to rise, although payments for unemployment compensation remained stable in relation to GDP, with new recipients being balanced by those who had exhausted their benefits. The rise reflected largely the increase of disguised unemployment in the pension schemes, with early retirement and disability pensions rising sharply. The inexorable rise of social security payments has increased the share of private consumption expenditures covered by government transfers from 14.2 percent in 1975 to 22.6 percent in 1983. This, together with the expanding public payroll, other increases in public consumption, and a drawdown of private savings, has allowed the share of consumption in GDP--at 78 percent--to remain stable between 1975 and 1983. The counterpart of this stability in the consumption share has been a fall in the

CHART 3

SPAIN

EXCHANGE RATE DEVELOPMENTS, 1975-84[1]

(1980 = 100)



Sources: IMF, *International financial statistics;* and staff estimates.

[1]The weights were based on the average distribution of export and import trade with 14 industrial countries in 1980.

[2]Relative price levels (Spanish price index over partner county price index) were measured by unit labor cost indices in manufacturing.

[3]A decline in the index indicates a depreciation of the peseta.

savings rate of households--from 9 percent of national disposable income in 1975 to 5 percent in 1981, at which level it has stabilized since--and a 4 1/2 percentage point shift in the government position from a positive savings rate of 3 1/2 percent of national disposable income in 1975 to dissaving at about 1 percent in 1983.

The increasing intermediation of financial resources for consumption and investment purposes by the Government is reflected in the mounting cash deficit, which has been even more intractable than the deficit measured on a national accounts basis (Chart 4). Taking into account net lending operations (mostly net transfers to official credit institutions) and changes in the floating debt, the cash deficit increased from the equivalent of 5.3 percent of GDP in 1982 to 6.4 percent in 1983.

As in 1982, the financing requirements of the public sector posed severe constraints on the implementation of monetary policy. Although the monetary authorities were successful in meeting their targets, this was achieved at considerable cost in terms of a tightening of financial regulations and of a crowding out of the private sector from domestic credit markets. When the monetary aggregates early in the year moved well above the upper limits of their target ranges, and the peseta came under heavy downward speculative pressure, the Bank of Spain tightened its policy stance: interest and noninterest-bearing reserve requirements were raised in several steps, and increasing amounts of Certificates of Monetary Regulation (CMR) were placed by the Bank of Spain with the banking system to drain liquidity. When interest rates moved sharply higher, the already rapid growth of nondeposit liquid liabilities accelerated and the Bank, concerned about the attendant loss of control of the wider monetary aggregates, 1/ halted further growth of commercial banks' liabilities that are not subject to reserve requirements. Subsequently, the Bank negotiated an agreement with the banks under which CMRs were placed at declining interest rates, even though these rates did not fully reflect money market conditions.

As money and credit conditions tightened during 1983 and the current account balance improved, dispelling expectations of further depreciation of the peseta, capital inflows increased substantially. For the year as a whole, both public and private sector long-term borrowing abroad remained at about their 1982 levels, but the banking system increased its net foreign indebtedness and commercial credits swung from heavy outflows to a small inflow. All in all, capital inflows were sufficient to cover most of the current account deficit, so that net official reserves remained virtually unchanged in 1983, in contrast with a US$3 billion fall in 1982. The ratio of debt service payments on the nonfinancial public and private sector debt (including service payments on the foreign liabilities of the banking system lent to Spanish residents) to exports of goods and nonfactor services declined slightly from 20.9 percent in 1982 to 19.9 percent in 1983.

1/ The Bank sets targets both for M3 and total liquid liabilities (ALP) since the emergence of nondeposit liquid instruments.

2. Prospects for 1984

For 1984, the authorities aimed to reduce the rate of inflation to 8 percent for the 12 months ending December 1984 (a year-over-year increase of about 10.5 percent), to reduce the public sector deficit to the equivalent of 5 1/2 percent of GDP, and to keep the current account deficit at the equivalent of 1 1/2 percent of GDP. A tight wage policy was to play a significant role in the deceleration of the inflation rate.

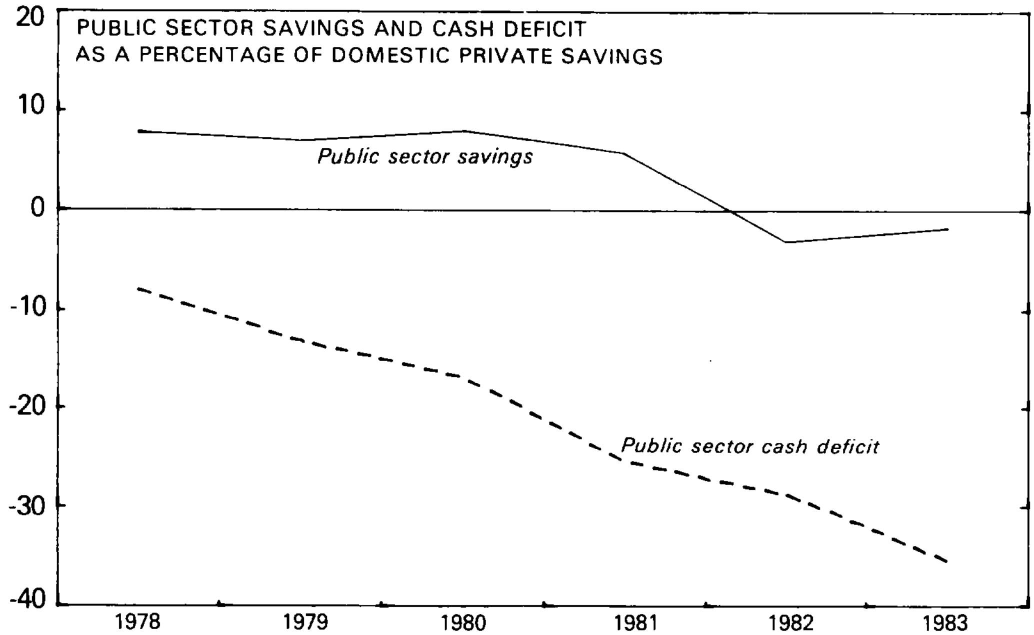
Wage increases in the public sector, at 6 1/2 percent including wage drift, are being kept within the Government's wage guidelines. However, negotiations for a nationwide wage agreement in the private sector broke down early in the year, and wage agreements have been made piecemeal. Still, the acceptance of the wage guidelines in the public sector helped keep private sector contracts to an average rate of 8 percent, well below that of last year. Including wage drift, and an estimated 10 percent increase in payroll taxes, wage costs in the economy at large may rise by about 9 percent. This increase implies a modest decline in real wages if the inflation target is achieved; the latter is even more important since efforts to eliminate the customary revision clauses, that basically index wage increases to the CPI, were only partly successful. Although about 75 percent of contracts continue to include such inflation adjustments, their effect in 1984 may be limited, because trigger dates are later in the year than customary.

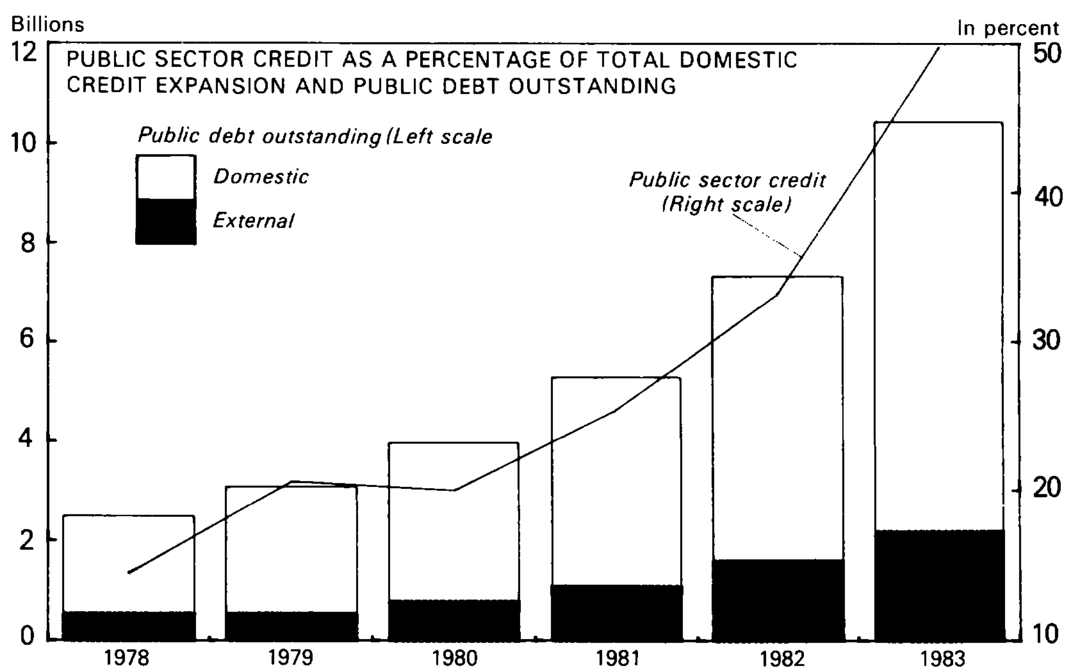
The disinflationary effort is to be supported by a continued tight monetary policy. The Bank of Spain has set its targets for the growth of M3 and ALP at 3 and 3 1/2 percentage points below their respective 1983 targets. The Government intends to achieve the target for the budget deficit by raising the rates for some indirect taxes, by constraining the growth of transfers to enterprises and households, and by reducing government investment expenditures. As in the previous year, the main impetus for the growth of output is expected to come from the external sector, with GDP targeted to grow by 2 1/2 percent in real terms. At this rate of growth, the fall in employment is to bottom out, although unemployment, because of increases in the labor force, is to continue to rise. Against this background, the government targets for industrial policy, which were to involve a significant move toward releasing resources from loss-making enterprises, have already begun to face political and social resistance.

CHART 4

SPAIN

TRENDS IN PUBLIC FINANCES, CREDIT TO THE PUBLIC SECTOR AND PUBLIC DEBT, 1978-83





Sources: Bank of Spain, *Annual Report, 1983*, forthcoming; *Statistical Bulletin*, April 1984; and data provided by the Spanish authorities.

III. Policy Discussions

1. Overview

With the Government's 1983 targets for inflation, the current account, the budget deficit, and growth of output largely met, the focus of policy now is on reducing the public sector deficit and reversing the fall in employment. In 1984, therefore, the Government is concentrating on increasing labor market flexibility, reforming the social security system, and reducing the public sector deficit generally.

2. Labor market and industrial policies

The high and rising level of unemployment constitutes the central policy problem. Not only is overall unemployment, at a measured 19 percent of the labor force, among the highest in Europe, but the proportions of long-term unemployment and unemployment of first-time job seekers also are very high. In addition, labor reserves are even higher as participation rates have fallen from 62 percent in 1975 to 56 percent in 1982, with that for men down precipitously from 92 percent to 80 percent. Although the apparently rapid growth of the underground economy, particularly in foreign trade-related and service activities, provides some relief from the economic and social hardships associated with the high unemployment levels and the pessimistic employment outlook, it is clear that recorded employment trends will have to be reversed if the economy is to be brought back into sustainable balance.

The impediments to a sustained increase in demand for labor are well known, namely, the cost of labor and inability to manage the labor force, once hired, flexibly. The authorities recognize that continued moderation of wage developments is a sine qua non for any recovery of demand for labor, but feel there is little prospect of achieving a fall in real wages beyond the current year. In order to assure further wage moderation and to obtain support for structural labor policies, the Government has begun to initiate negotiations for a national collective agreement covering 1985 and 1986. The authorities recognize that the level of wage costs still remains high, even if their wage policy is successful. Therefore, they intend to cut wage taxes by 1 1/2 percentage points in 1984, and by a further 1 1/2 percentage points thereafter. These cuts, however, continue to be more than offset by the effects of increases in the taxable base. Thus, in 1984, increases in employers' social security contributions are estimated to raise labor costs by 1.8 percent, despite the cut in rates.

The authorities acknowledge that the time and expense involved in effecting layoffs have led firms with reason to increase employment to resort to overtime, to substitute capital for labor, or simply to keep output stable despite rising demand for their products. The cumbersome layoff procedures have resulted in a proliferation of unofficial arrangements, in which the legally stipulated severance payments of 20 days per year of employment, with a maximum allowance of one year's salary, have escalated to lump sum payments of between one to three years' salary. The authorities have taken a number of steps to ease the regulations regarding dismissals, including the introduction of short-term and part-time contracts that allow layoffs outside the normal job security procedures during the first three years of employment. Legislation is currently being presented to Parliament to remove some of the restrictive and complicated conditions governing these contracts, and to broaden their use. However, the authorities are of the opinion that, in the context of the history of labor relations in Spain, the short-run effects of institutional changes will be limited. Further steps to increase labor market flexibility can be foreseen in conjunction with entry into the European Communities, when they can be folded into an overall package of measures.

Given the rigidities in the labor market and the persistence of overmanning, particularly in large enterprises, the efforts to restructure industry and release resources from declining industries are meeting considerable difficulties. The first comprehensive effort toward industrial restructuring was launched in 1981. However, serious problems of implementation developed, both because of an underestimation of the financial requirements and the concentration of the effects of particular localities. The revised industrial reorganization plan adopted by the Government in November 1983 faces similar problems. The necessary release of labor remains the central issue. For 1984-86, redundancies in the 11 sectors under the program are estimated at over 60,000 workers, of which over 20,000 are slated to take early retirement. The remainder will be offered two choices: (1) a severance payment significantly in excess of normal redundancy payments, in addition to the usual 18 months' unemployment benefits; or (2) surrendering of the severance payment to an "employment promotion fund." In return, unemployment benefits would be extended to three years, and the Fund would finance retraining and job creation, partly by subsidizing new employers.

The Government is currently reviewing the restructuring program and is in the process of revising its expenditure estimates as well as formulating the means to finance them. Given the much higher-than-expected costs of the program, the Government has decided that, after agreement has been reached with the shipbuilding industry, the last of the 11 sectors included in the original program, no further reconversion plans will be concluded.

3. Fiscal policy

The Spanish authorities consider a steady reduction of the budget deficit to be a necessary condition for a revival of economic activity of sufficient breadth to absorb unemployment. The first step in this process was achieved with the containment of the 1983 budget deficit 1/ to the equivalent of 5.9 percent of GDP. A reduction of the budget deficit to 5.5 percent of GDP is targeted for 1984, followed by further reductions to 4 1/2-5 percent and 4 percent of GDP, respectively, in 1985 and 1986.

1/ Defined as the deficit of the General Government on a national accounts basis.

Although the fiscal problem is conceived as mainly an expenditure problem, the authorities consider that an increase in revenues is necessary if their budgetary targets are to be achieved. They believe that the level of the tax burden, including social security contributions, at 29 percent of GDP, is low, absolutely as well as by international standards. Mindful that the incidence of income taxes is very concentrated--largely on wage earners--they seek to increase tax revenues by broadening the base for the collection of income taxes and by increasing indirect taxation, in part in conjunction with the adoption of a value-added tax in 1985. For 1984, however, tax pressure is to be reduced by the equivalent of about 1 1/4 percent of GDP, because the net effects of a cut in employers' contributions to the social security system and the growth of the contributory base lags the growth of GDP. No changes, apart from a cut in tax rebates on exports, are being foreseen in the large amount of tax expenditures, which in 1983 for corporations and individuals equaled about one half and one eighth, respectively, of their expected income tax payments.

On the expenditure side, the Government has formulated a program for the reform of the social security system that will be presented to Parliament this summer. The reform focuses on three objectives: (a) reducing the burden of social security contributions on employers; (b) rationalizing the structure and size of benefits; and (c) balancing the system over the medium term. The authorities estimate that, under the impetus of demographic factors, the trend toward early retirement associated with labor shedding in declining industries, the need to extend the period of coverage of unemployment compensation with the rise in long-term unemployment, and efforts to improve the living standards of pensioners at the lower end of the scale, the deficit of the social security system by 1990 will amount to just under 2.0 percent of GDP in 1984 prices. This deficit is being reduced by perhaps one fifth through administrative measures that aim to limit abuses of the system. 1/ More fundamentally, retirement pensions are to be decreased from 90 percent of the last year's wage income to 65 percent. In addition, pensions are to be supplemented by private arrangements. Revenues are to continue to rise faster than the wage bill as the planned decrease in contribution rates of employers will be more than offset by increases in the taxable base. Although the share of social security contributions borne by employees, at 5.9 percent of covered wages compared with 31.8 percent paid by

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1/ For example, because of the difficulties associated with dismissals, increasingly fraudulent use is being made of the provisions for drawing disability pensions. From the point of view of the recipient, such pensions, which are not subject to income tax, are preferable to unemployment compensation. From the point of view of the employer, large severance payments are saved and the budget assumes the payment of salary for a period of 18 months, until full disability had been established. The large rise in the number of recipients of disability pensions, to more than one half the number of unemployed, was thus not surprising. The authorities are moving to tighten the criteria for eligibility, to prosecute fraud, and to subject disability pensions to income taxes.

employers, is low by most standards, the authorities do not intend to increase revenus by raising these contribution rates, since such increases could be translated into demands for higher wages quite quickly. Thus, the sizable deficits that still remain after the reform are to be covered by increased reliance on budgetary transfers.

The deteriorating situation of the public enterprises so far has defied policy efforts to correct it. Transfers by the State to the public enterprises under its control 1/ at 2.8 percent of GDP in 1983 constitute 13.4 percent of state expenditures. Additional financing is provided by the Bank of Spain and by local authorities. The problems of the public enterprises stem in large part from the rigidities in the labor market noted above, which led to overmanning and frequently also to wage increases well above the national average. The inability to manage the labor force flexibly has led to a deterioration of the capital/labor ratio, despite the fact that investment expenditures outstripped those in private industry. Although fixed investment expenditures have grown by more than 10 percent in volume per annum between 1977 and 1982, with some slowing of the growth rate in the latter year, the capital stock of the public enterprises is considered increasingly obsolete in most cases, adding to cost pressures. With operating losses rising tenfold between 1977 and 1983, investment has been financed by state grants and bank credit. The cost of servicing the mounting debt, coupled with low levels of capacity utilization and significant accumulation of involuntary stocks, has led to an increase in borrowing and diversion of budgetary capital grants to cover current expenditures. The borrowing requirements of these enterprises, accordingly, have risen from 13.2 percent of domestic credit expansion in 1977 to 19.6 percent in 1982, the last year for which data are available (Table 2).

The financial problems of the public enterprises have proven difficult to address for the same reasons that the industrial reconversion program--under which many of them fall--has run into difficulties (see above). The authorities are well aware that little progress has been made in addressing these problems, largely because the steps implemented so far, still are dwarfed by the size of the problem. In 1984, public enterprises have been brought under the government wage guidelines, so that wage increases lag those in the rest of industry and fall well short of expected price increases. Aside from the reconversion programs, financial plans are being established for the largest loss-makers, notably the railroad company (RENFE). In addition, a three-year plan has been adopted for the official credit institutions under which financing of sectors with low rates of return is to be reduced and interest charges to be brought closer to market rates.

1/ No break between private and public enterprises is available at higher levels of aggregation.

Table 2. Spain: Financial Flows and Fixed Investment of Public Sector Enterprises, 1977-83 1/

(In billions of pesetas)

	1977	1979	1980	1981	1982	1983
Fixed investment	192.6	277.3	338.4	419.2	493.1	...
Net borrowing requirement	181.6	336.6	473.1	623.9	592.8	...
Operating losses	32.3	76.7	129.7	174.5	271.5	337.0
State transfers, total	...	...	359.5	447.0	609.3	641.5
Of which:						
Current	...	...	171.7	196.1	291.4	317.2
Capital	...	...	187.8	250.9	317.9	324.3

Source: Data provided by the Spanish authorities.

1/ Public sector enterprises under central government responsibility; data for operating losses refer to a group of enterprises representing the bulk of those under central government auspices; data on transfers are on a national accounts basis, and therefore not strictly comparable with the other data shown, which are drawn from enterprise balance sheets.

Despite these efforts, the trend toward growing operating losses appears barely to be slowing and, in most instances, restructuring also involves large, new subsidies. The authorities viewed these subsidies as money well spent, since they count on having selected investment opportunities with sufficiently high rates of return to allow future operation without subsidy. Such assessments, and progress generally, however, are hampered by the fact that inappropriate accounting methods have obscured the true financial position of a number of these enterprises. Under the circumstances, it would appear that the projected growth of government transfers for 1984, at least 12 percent, in line with the projected growth of nominal GDP, may be optimistic.

The implementation of the state budget so far this year gives cause for concern. For the first five months, the cash deficit of the State, which, in recent years, has been roughly equivalent to the cash deficit of the General Government, was 82 percent above its year-ago level and exceeded 50 percent of the targeted total for the year. Some unusual delays in revenue collections appear to have played a role as did the special factors, noted above, which appear to inflate the growth of expenditures in 1984 over 1983. Nevertheless, it also seems that expenditure on disability pensions, on transfers to public enterprises, and on goods and services have risen at a much faster pace than originally anticipated. Faced with these overruns, the Council of Ministers approved a package of corrective measures in June, which they estimate to be worth approximately 1.2 percent of GDP, and to be consistent with the original target for the budget deficit. A little under one half of the package involves revenue increases. The tax rebate on exports is being cut by 15 percent and the turnover tax base is being broadened. The remainder of the package curtails expenditures in 1984. It appears, however, that commitments still are outrunning the new expenditure levels, so that some of the expenditure cuts for 1984 are likely to be postponements of payments rather than actual cuts.

4. Monetary policy

Since 1980, anti-inflationary policies have centered on the controlled reduction of the growth rate of the monetary aggregates. Accordingly, the target for the growth of M3 has been reduced gradually from 18 percent in 1980 to 13 percent in 1983. In each of the intervening years the target has been met. However, monetary developments have deviated from their projected path from time to time, and it was the quick response of the external payment flows, such as in 1982, that brought the monetary aggregates back within their target range.

For 1984, the targets for the growth of M3 and ALP were set at 10 percent and 12 1/2 percent, respectively. These growth rates, consistent with the authorities' objectives for growth of output and for the inflation rate, were based on the assumption that the overall external payments flows would be in balance, and allowed for an expansion in domestic credit of approximately 7.5 percent and 33 percent, respectively, to the private and public sectors.

However, a basic conflict between the domestic objectives and external developments has emerged. Better-than-expected developments on the trade account, coupled with considerable borrowing abroad by the public sector and by private entities crowded out of the domestic market and no longer fearful of the depreciation of the peseta, have combined to bring about an increase in the Bank of Spain's external reserves of US$2 1/2 billion so far in 1984. The Bank of Spain can sterilize some of the reserve inflows through forward swaps with the banking system. However, the scope for these transactions is limited both in time and volume. In the absence of a reduction in the cash deficit of the budget, the remaining options that preserve the planned expansion of credit are either to engineer capital outflows by liberalizing the currently quite circumscribed ability of Spanish residents to hold foreign currency assets or to liberalize imports.

The problems for monetary policy created by the external sector clearly are not divorced from internal developments. Thus, during the first five months of the year, credit extensions to the public sector grew much faster than expected, and the unwinding of the steep rise of interest rates through mid-1983, which characterized the second half of that year, appears to have come to an end. The Government currently is negotiating a reduction in interest rates with the banks, largely because of the cost to the budget of servicing the escalating public sector debt, but partly also because of the high burden of financing costs on the enterprise sector, in the wake of sharply deteriorating equity/debt ratios of the past several years.

If the overshooting of the public sector borrowing requirement is not brought back during the rest of 1984, the attainment of the monetary targets--already in difficulty because of the capital inflows--would imply negative growth of credit to the private sector (excluding public enterprises). Although the total flow of funds is not affected by such a development, the distributional effects would be inconsistent with the objective of output growth in the range of 2-3 percent, particularly as it is based on some revival of investment demand. Alternatively, the monetary authorities could relax their policy stance. However, such a course of action would compromise the objective of bringing inflation down to 8 percent during 1984. A further buildup of inflationary pressures toward the end of the year assuredly would affect wage negotations for 1985 and threaten to interfere with the social consensus the Government is attempting to build for its labor market policies.

The difficulties encountered in accommodating the conflicting objectives of containing the borrowing costs of the Government and maintaining a tight monetary policy stance have led the authorities to increase the preassigned share of bank portfolios, thereby putting upward pressure on the cost of nonregulated funding. With treasury bills becoming the main source of budgetary financing, the Bank of Spain's CMRs have been phased out and replaced by treasury bills. In the process, the system of compulsory investment coefficients was revised with banks now having to hold treasury bills in an amount equal to 12 percent of their liabilities. With the other preallocations of bank investments remaining intact, approximately 55 percent of commercial bank assets and 68 percent of savings bank assets will be invested according to compulsory coefficients. Because most of the financial assets that satisfy these coefficients are remunerated at below-market interest rates, the coefficients imply a subsidy for the issuers of the assets, mainly the General Government and the official credit institutions. This subsidy is ultimately paid by savers, in terms of low rates on banks' deposits, and by those investors who borrow at unsubsidized interest rates. While the underlying inflation rate is approximately 10 percent, close to one half of banks' deposits are remunerated at 2 1/2 percent on average, and unsubsidized lending rates are well above 18 percent. The authorities thought that it was in the banks' own interest to keep treasury bill rates low, since that reduced pressure on deposit rates. Nevertheless, the Bank of Spain reckons that the subsidy to the Treasury implied in the new system of coefficients, at prevailing interest rates, amounts to Ptas 500 billion, or perhaps 30 percent of the projected cash deficit for 1984. 1/ The authorities did not believe that the high real interest rate on nonpreferential loans--at about 8 percent--was a major factor in

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1/ This estimate must be taken with a great deal of caution, because it is very sensitive to the assumption about the interest rate on bank loans that would prevail if banks were free of constraints. Nevertheless, it provides an idea of the relative magnitude of the subsidy.

the lagging of investment demand. They felt that cash flow, aided by rising exports and a gradual return of the labor share in value added to the levels of the early 1970s, had increased sufficiently to provide enterprises with the necessary liquidity.

The counterpart of the growing cash deficit of the Government has been the increasing proportion of domestic credit that is absorbed by the Government and recycled to the private sector 1/ in the form of transfers to enterprises and subsidized credits extended by official credit institutions. In 1983, capital and current transfers from the budget to all enterprises roughly equaled three quarters of domestic bank credit obtained by the General Government, and 35 percent of all credit extended by the banking system. During the same year, equity transfers by the Government to official credit institutions slightly exceeded total lending by the institutions to the private sector. Although these government transfers and subsidized credits have increased the effective credit share of the private sector, there clearly is a problem of efficiency in credit allocation with the Government playing such a large role in intermediation, not the least, because of the explosive growth of government debt (Table 3).

Table 3. Spain: Government Debt, 1978-1983

(In percent of GDP)

	Total	External Debt	Domestic Debt
1978	22.3	5.0	17.3
1979	23.3	4.3	19.0
1980	26.0	5.2	20.8
1981	30.5	6.4	24.1
1982	36.8	8.1	28.7
1983	45.8	9.6	36.2

Source: Bank of Spain.

The escalating debt level of the Government, of course, is adding to the financing needs of the budget for debt service purposes. In the past, because of the budget's heavy recourse to the Bank of Spain, the bulk of financing costs of the deficit has not appeared in the budgetary flows explicitly, but has been subsumed in the profits of the Bank of Spain. If proper account is taken of the cost of servicing the debt, the budget deficit in 1983 would have been 7.1 percent of GDP rather than the official 5.9 percent. With the accelerating move to treasury bill

1/ The "private sector" includes public enterprises.

financing, interest payments on the debt will become increasingly explicit in the budget and their weight in the deficit is expected to grow by 1 percent of GDP per annum in the next several years.

The authorities are fully aware of the dangers inherent in the large intermediation of funds through the budget, and remain committed, in principle, to the deregulation of financial markets. However, in the absence of a capital market, and with a money market lacking in depth, reduction of the investment coefficients is not considered to be possible. In fact, the needs of the budget dictate an increase. The second-best option, thus, is to allow lending rates for the preferred sectors to approximate market rates as much as possible. In that respect, the authorities feel that the level of lending rates is too high under current circumstances, rather than that deposit rates are too low. Thus, spreads and bank profits should be reduced from the asset rather than from the liability side. Furthermore, bank lending to priority sectors, of its nature, should be remunerated less than unregulated lending, since the former carries a government guarantee.

5. External policies

The Spanish authorities are conscious that some of the gains in competitiveness registered in 1983 have begun to be eroded. In real effective terms, measured by relative consumer prices, there has been a 2-3 percent loss during the first quarter of 1984. On the export side, profitability has been further squeezed by the reduction in rebates of indirect taxation decided upon in June. However, in the official view, the overall competitive position remains consistent with the continuation of the strong export performance, which, together with the strengthening of world demand, will help reduce the current account deficit to US$1 billion or less. While recognizing that there may be an inconsistency between the monetary targets and the avoidance of a further real appreciation of the exchange rate, the authorities intend to continue to manage the exchange rate flexibly so as to ensure the broad maintenance of the overall competitive position. The authorities noted that the growth of the outstanding external debt has decelerated since 1981, and that Spain has not met with any resistance in international capital markets. Although borrowing terms in 1983 were slightly less favorable than earlier, they clearly remained quite favorable in comparison with most other sovereign loans. In 1984, current plans envision an increase in the public sector's external debt by the equivalent of US$850 million.

During the 1985-86 period, the Spanish representatives expect the current account to continue to strengthen, and the debt service ratio to average 20.6 percent, even after allowing for some greater recourse by the private sector to international markets because of relatively tight domestic credit market conditions. Scenario A, Table 4, is based on the authorities' views through 1986 and extends these trends to 1990, however, assuming a small current account deficit for the remainder of the decade. On that assumption, the debt service ratio for 1987-1990 rises modestly to 22 percent on average. Scenario B of the same table shows the effect of allowing the current account deficit to rise from 0.6 percent of GDP

Table 4. Spain: Illustrative Medium-Term External Debt Projections, 1984-90

	1983	1984	1985	1986	1987	1988	1989	1990
Scenario A								
Scenario assumptions								
Current account balance (in billions of U.S. dollars)	-3.4	-1.0	0.5	1.1	-1.0	-1.0	-1.2	-1.2
(in percent of GDP)	(-2.2)	(-0.6)	(0.3)	(0.6)	(-0.5)	(-0.5)	(-0.5)	(-0.5)
Increase in net official reserves (in billions of U.S. dollars)	-0.3	2.5	1.0	0.5	--	--	--	--
Main results								
Debt service ratio, in percent of exports of goods and services	19.9	20.3	18.7	22.8	23.8	21.2	20.6	22.2
Amortization rates	10.3	10.9	9.5	16.5	18.0	16.5	16.3	18.2
Interest payments ratio	9.6	9.3	9.2	6.3	5.7	4.7	4.3	4.0
Outstanding debt, in percent of GDP	18.6	19.1	17.3	14.4	13.7	12.6	11.6	10.9
Interest payments, in percent of GDP	2.0	2.0	2.0	1.3	1.2	1.0	0.9	0.8
Foreign exchange reserves, in percent of GDP	4.4	6.3	6.5	6.5	6.5	6.5	6.6	6.8
Scenario B								
Scenario assumptions								
Current account balance	-3.4	-1.0	-1.0	-1.9	-1.2	-1.1	-1.2	-1.2
(in percent of GDP)	(-2.2)	(-0.6)	(-0.6)	(-1.0)	(-0.5)	(-0.5)	(-0.5)	(-0.5)
Increase in net official reserves	-0.3	2.5	1.0	0.5	--	--	--	--
Main results								
Debt service ratio, in percent of goods and services	19.9	20.3	18.9	23.4	25.9	25.3	24.9	26.2
Amortization rates	10.3	10.9	9.5	16.5	19.2	19.9	19.9	21.6
Interest payments ratio	9.6	9.4	9.4	6.9	6.6	5.4	5.0	4.7
Outstanding debt, in percent of GDP	18.6	19.2	18.2	17.4	15.9	14.7	13.5	12.8
Interest payments, in percent of GDP	2.0	2.0	2.0	1.4	1.4	1.1	1.0	1.0
Foreign exchange reserves, in percent of GDP	4.4	6.3	6.5	6.5	6.5	6.5	6.6	6.8
Scenario C								
Scenario assumptions								
Current account balance	-3.4	-1.0	0.5	1.1	-1.0	-1.1	-1.2	-1.2
(in percent of GDP)	(-2.2)	(-0.6)	(0.3)	(0.6)	(-0.5)	(-0.5)	(-0.5)	(-0.5)
Increase in net official reserves	-0.3	2.5	--	--	--	--	--	--
Main results								
Debt service ratio, in percent of goods and services	19.9	20.3	18.7	22.6	22.7	19.8	19.1	21.0
Amortization rates	10.3	10.9	9.5	16.5	17.2	15.4	15.0	17.3
Interest payment ratio	9.6	9.4	9.2	6.1	5.4	4.4	4.1	3.8
Outstanding debt, in percent of GDP	18.6	19.2	16.8	14.2	13.0	11.9	10.9	10.2
Interest payments, in percent of GDP	2.0	1.9	2.0	1.3	1.1	0.9	0.8	0.8
Foreign exchange reserves, in percent of GDP	4.4	6.3	6.5	6.5	6.5	6.5	6.6	6.8

Sources: Bank of Spain; and staff estimates.

1/ Covers all medium- and long-term borrowing, including the borrowing done through resident banks.
Note: For the three scenarios other main assumptions were: (a) the targets for real GDP growth of the medium-term plan are assumed for the 1984-86 period (2.5, 3.1, and 3.5), 3.0 percent for 1987 and 2.5 percent for the 1988-1990 period; (b) nominal value of exports of goods grow by 12.2 percent in 1984, by 8 percent in 1985 and by 7 percent the rest of the years; (c) net direct investment grows by 8 percent annually in nominal terms; (d) short-term capital flows are assumed to be equal to zero on a net basis; (e) amortization payments on new debt are based on the assumption of a two-year grace period and three equal payments the following three years; and (f) effective Eurodollar borrowing rates: 11.3 percent for 1984 and 1985, 8.5 percent for 1986 and 1987, and 7.5 percent for 1988-90.

in 1984 and 1985 to 1.0 percent in 1986, the rest of the decade being the same as under Scenario A. Under these assumptions, the debt service ratio rises on average to about 26 percent during 1987-90. Scenario C shows that, if there are no increases in net official reserves as a result of borrowing abroad, and the current account objectives of the authorities are achieved, the debt service stays at 20.5 percent during the rest of the decade and the ratio of outstanding debt to GDP declines to 10.2 percent by 1990. These variants illustrate how sensitive the debt service ratios are to relative small changes in the underlying assumptions for either the current account or reserve management policies.

The tariff protection Spain accords its industrial sector is higher than in other industrial countries; in addition, Spain maintains a system of quotas on imports of foodstuffs, textiles and clothing, machinery, television sets, and transportation equipment, which effectively limits foreign competition in these sectors. The quotas have become tighter over the years, as their peseta value has increased annually by about 10 percent, thus lagging inflation rates. Variable levies are imposed on some agricultural imports to equalize import prices with the level of domestic support prices. Because Spain's tariffs are, on average, higher than the EC's external tariffs, the Spanish representatives feel that the net effect of joining the EC would be a liberalizing one. As regards the exchange system, the authorities noted that, in practice, the system is free of restrictions on payments and transfers for current international transactions. However, payments above certain maximum levels require declarations to be filed with the Ministry of Economy and Commerce. The authorities do not feel that unreasonable delays result from the centralization of the filing of such declarations.

Spain extends official development assistance (ODA) mainly to former territories and to countries in Latin America. The ODA takes the form of bilateral loans, contributions to multilateral aid institutions, technical assistance, and food aid. As a percentage of GDP, the ODA doubled from 0.07 percent of GDP in 1980 to 0.13 percent of GDP in 1981 and 1982. It appears that in 1983 the ratio of ODA to GDP declined somewhat.

IV. Staff Appraisal

The performance of the Spanish economy in 1983 and, so far in 1984, appears to show significantly better results than in the previous three years, as, on the face of it, a number of the basic targets are broadly being met. In 1983, the inflation rate fell by more than 2 percentage points, despite the effect of the depreciation of the peseta on domestic prices; the current account deficit was reduced by over US$1 1/2 billion to US$2 1/2 billion, or about 1.5 percent of GDP; GDP rose by a little over 2 percent; the budget deficit, on a national accounts basis, stopped rising; and the expansion of broad money was within its target range. For 1984, it appears that, for the first time in several years, wage moderation could be significant; the current account deficit is likely to fall by at least another US$1 1/2 billion to well below the medium-term target of about 1.5 percent of GDP; and inflation should decelerate further.

Nevertheless, only partial progress is being made toward reducing the fundamental disequilibria in the economy. As a result, the success implied by the broad achievement of the economic targets in 1983 could well be short-lived. The fragility of the progress achieved so far stems from the clear incompatibility that has begun to emerge between the targets for the rate and structure of real economic growth and the monetary program. At the heart of the problem is the virtual intractability of the budget deficit. Whereas in 1983 the previous explosive growth of the budget deficit, when measured on a national accounts basis, appeared to have been contained, the cash deficit and the borrowing requirement continued to rise, and the expected outcome for 1984 is not likely to be much better.

The 1984 monetary program posits a 7.5 percent increase in credit to the private sector, which is estimated to be compatible with the objective of financing both the working capital needs of an economy that grows at a 2.5 percent rate in real terms and a leveling off of the fall in private fixed investment. At the same time, the inflation rate, aided as in 1983 by low food prices, is expected to moderate to between 8-9 percent through the year. This moderation in the inflation rate, in turn, is crucial to keep wage agreements at a level that allows further recovery of profit shares. However, a realistic assessment of the borrowing requirements of the government sector implies that the posited availability of credit to private enterprises cannot materialize under the specified inflation target. If the authorities hold to their monetary targets, growth of credit extensions to the private sector would have to be reduced, perhaps to 2-3 percent. The growth in credit available for productive uses is likely to be smaller yet, because a considerable share of "private sector" credit goes to finance the losses of public and quasi-public enterprises.

This incompatibility is being compounded by the better-than-expected performance of the export sector, which, together with capital inflows triggered by stringent credit conditions, is likely to lead to an increase in foreign exchange reserves of at least US$3 billion, in contrast to the assumption of zero reserve accumulation that underlay the authorities' monetary program. The monetary authorities will be forced to sterilize an increasing amount of these capital inflows if their inflation target is to be met. This, in turn, will set monetary and exchange rate policies on a collision course. If the monetary targets are to be achieved, interest rates will come under increasing upward pressure, triggering further capital inflows. The latter would bring about an appreciation of the exchange value of the peseta, which would reduce some of the recently regained competitiveness in world markets. If, as appears more likely, the authorities allow the monetary targets to be overshot, the policy of wage moderation would be compromised.

The continued growth of the credit needs of the public sector is clearly at odds with the basic policy goal of promoting employment opportunities through private investment in fixed assets. Whereas the cash flow of enterprises has improved, mainly as a consequence of the upsurge of export activity and some moderation of the growth of labor costs, past cost pressures produced a significant deterioration of enterprises' balance sheets, which it will take some time to restore. The financial situation, together with the low overall rate of capacity utilization, and the uncertainties regarding the economic outlook in general, and policy prospects in particular, raises doubts about an early revival of investment activity.

For this reason, progress toward better balance in the economy and reabsorption of unemployed labor presupposes both firmness of action and clarity of purpose in dealing with the reduction of the budget deficit. Efforts to broaden the tax base and, in particular, to reduce tax evasion, are clearly both helpful and necessary. But their success cannot be assured and a policy that aims to maintain government expenditures at their current level of GDP, while relying on revenue increases to narrow the deficit, may be precariously based. Thus, the core of the budget problem remains on the expenditure side, concentrated in the areas of social security and public enterprises.

In the area of social security, the measures taken recently to limit expenditures and to broaden the revenue base are crucial. Nevertheless, despite the major efforts to rationalize expenditures, the medium-term projections still visualize a large widening of the gap between the growth of expenditures and revenues and look to additional budgetary transfers. The measures adopted to contain abuses, particularly in the area of disability benefits, should generate significant savings. But these savings are likely to be offset, in large part, by the need to increase the coverage of benefits, in particular to alleviate the social and financial pressures of long-term unemployment. The demographic trends appear to indicate that, even under optimistic assumptions regarding the growth of employment, the ratio of contributors to recipients in the social security system will decline gradually below 2 to 1 during the next eight years. Early adjustment to the medium-term benefit and contribution trends seems inescapable, if recourse to the budget is to be kept within reasonable bounds.

The authorities, quite rightly, see a need to reduce employers' contributions to the social security system, since their high level--at 18 percent of the wage bill--discourages the growth of employment. With the reduction of social security rates paid by employers, the relative contribution of employees is rising. Nevertheless, the latter is at a very low absolute level. Thus, it might be advisable to tax potential beneficiaries of the social security system directly through an increase in their contributions, rather than indirectly through the cost of increasing the financing needs of the State. In addition, an increase in employees' contributions would help raise public consciousness of the need for forceful measures to eliminate fraud and to scale down benefits to a level that the economy can afford.

The need to deal with the mounting losses of the public enterprises clearly is fundamental and urgent. The financial resources absorbed by loss-making public enterprises have more than doubled over the past few years, and are continuing to mount. The cost of the industrial reconversion program is acknowledged to be high, and there is a question whether its full extent is being recognized in the anticipated budgetary flows. As it is, in 1983 capital and current transfers from the state budget to public enterprises equaled just about half the cash deficit.

The high degree of financial intermediation through the budget has led to an increase in the banks' investment coefficients and cash reserve requirements, and has brought moves toward liberalization of financial markets to a halt, if not actually reversed them. The process of financial innovation, which had provided borrowers and savers with the variety of instruments and maturities suited to their needs, has been slowed in an effort related to the orderly financing of the budget deficit. Thus, the deficit is interfering with the much-needed reduction of rigidities in a banking sector that, for too long, has enjoyed excessively high spreads, stemming from oligopolistic practices. The legal limits that govern the rates paid on about 50 percent of bank deposits both appear in conflict with the policy objective of increasing savings in the form of financial assets and of increasing competition in the banking sector. To some extent, a better functioning treasury bill market could meet the policy objectives in both respects.

The second major area of inflexibility in the economy that materially interferes with and retards the adjustment process relates to the well-known rigidities in the labor market. The measures instituted to increase labor mobility and to reduce the inherent risks in taking on labor could be very helpful in that respect. However, despite the great social and political difficulties involved in broadening these efforts, these measures constitute only first steps toward increasing the flexibility in the labor market sufficiently to help reduce unemployment substantially. With layoff costs as high as they are, the discounted value of these costs, based on an average tenure of eight years, can add up to 20-25 percent to actual labor costs. In an environment where real wages need to decline, the deterrent effect on employment of such a surcharge is clear. To avoid further destruction of job opportunities, layoff costs need to be reduced and efforts to ease the rules and regulations governing layoffs and to allow more flexible use of the labor force are needed. This in turn would also help reduce the problems of loss-making enterprises.

The adjustment process of the Spanish economy would also be furthered by the liberalization of a trade system that is characterized by a relatively high degree of effective protection and by reliance on quantitative restrictions for particularly sensitive imports. The Spanish authorities are of the opinion that additional trade liberalization measures should be implemented in conjunction with other policy changes when Spain joins the EC, which it hopes to do in 1986. While this is an understandable position from a negotiating perspective, the adjustment costs of entry appear heavy. Thus, entry into the EC should proceed from as balanced an economic position as possible and any trade liberalization measures implemented before accession would be supportive of the needed structural changes, particularly in the industrial sector. The authorities also feel that obligations under Article VIII should await entry into the EC, although such acceptance would only formalize current conditions. The staff sees no particular reason for linking these two events in time.

Finally, a major area of concern, at a time when assessing the success or otherwise of policy measures is crucial, is the apparent deficiency of the economic information base. Data gaps, or the poor quality of data, prevent the tracking of developments in the economy in an adequate and timely fashion. And this apparent lack of information involves, in particular, those policy issues that form the core of the economic policy program, such as industrial investment activity, wage developments, and public enterprise accounts. These data gaps, therefore, may interfere directly with the efficiency of policy implementation.

It is recommended that the next Article IV consultation with Spain be held on the standard 12-month cycle.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Spain, in light of the 1984 Article IV consultation with Spain conducted under Decision No. 5392-(77/63) adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Spain continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

Fund Relations with Spain

(As at end-June 1984; in millions of SDRs)

I. Membership status

Spain became a member of the Fund in 1958. Spain continues to avail itself of the transitional arrangements in Section 2 of Article XIV of the Articles of Agreement.

A. Financial Relations

II. General department

(a) Quota: SDR 1,286 million.

(b) Total Fund holdings of pesetas: SDR 966.4 million (75.1 percent of quota).

(c) Fund credit: none.

(d) Reserve tranche position: SDR 319.6 million.

(e) Current operational budget: the Spanish peseta is being used in the current budget in the amount of SDR 10.9 million, of which SDR 9.0 million is presently available.

(f) Lending to the Fund (in millions of SDRs): Spain is not a participant.

III. Stand-by or extended arrangements and special facilities

A one-year stand-by arrangement in the enlarged first credit tranche, equivalent to SDR 143.2 million, was approved in February 1978, but was not drawn upon. In February 1978, Spain purchased its whole entitlement (SDR 572.1 million) under the oil facility, and a further SDR 98.8 million under the compensatory financing facility.

IV. SDR department

(a) Net cumulative allocation: SDR 298.8 million.

(b) Holdings: SDR 63.1 million, or 21.1 percent of net cumulative allocation.

(c) Current designation plan: the peseta is included in the current plan.

V. Administered accounts

Not applicable.

VI. Overdue obligations to the Fund

None.

B. Nonfinancial Relations

VIII. Exchange rate arrangements

Spain has maintained a managed float of the peseta since 1974. The exchange rate has weakened since the second half of 1979, as the external position deteriorated. Between the second quarter of 1979 and the third quarter of 1982 the peseta depreciated by 40.7 percent with respect to the U.S. dollar and by 21.4 percent in nominal effective terms, but only by 13.4 percent in real terms. On December 6, 1982 the peseta was devalued by 8 percent with respect to the dollar in response to intense speculative pressures. In real effective terms, the exchange rate is estimated to have depreciated by about 3.8 percent during the fourth quarter of 1982 and by 11.1 percent through 1983. During the first quarter of 1984, the exchange rate is estimated to have appreciated by 3.2 percent.

IX. The last Article IV consultation was concluded at EBM/83/66 (4/22/83), at which time the following decision was taken:

> 1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Spain, in light of the 1983 Article IV consultation with Spain conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).
>
> 2. The Fund notes with satisfaction that Spain continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

Spain is on a 12-month consultation cycle.

Basic Data

Area	504,800 square kilometers
Population (mid-1982)	37.83 million
Labor force (September 1982)	13.04 million
GDP per capita (1983)	Ptas 602,117 (SDR 3,927)

Use and supply of resources (1983)	In billions of pesetas	In per cent
Private consumption	15,720.1	69.0
Public consumption	2,808.3	12.4
Fixed investment	4,310.5	18.9
Stockbuilding	72.9	0.3
Total domestic demand	22,911.8	100.6
Exports of goods and services	4,654.0	20.4
Imports of goods and services	-4,787.7	21.0
Gross domestic product	22,778.1	100.0

Selected economic indicators (annual percentage change)	1981	1982	1983
GDP (at constant prices)	0.2	1.2	2.3
Private consumption (at constant prices)	-0.9	0.6	0.7
Gross fixed investment (at constant prices)	1.0	-1.8	-1.5
Industrial output	0.5	-0.6	3.0
Exports of goods (in pesetas)	31.6	20.5	28.0
Imports of goods (in pesetas)	24.0	16.9	20.5
Unit labor costs in industry	10.6	7.8	7.1
Consumer prices	14.6	14.4	12.2
GDP deflator (at market prices)	13.8	13.4	12.0

Balance of payments (in millions of SDRs)	1981	1982	1983
Exports of goods, f.o.b.	17,785	19,322	19,488
Imports of goods, f.o.b.	26,363	27,638	26,412
Net services and transfers	4,354	4,496	4,554
Balance of goods, services, and transfers	-4,224	-3,820	-2,370
Net capital movements	3,625	799	2,070
Overall balance	-599	-3,021	-300
Foreign exchange reserves (end of year)	8,759	6,548	6,683

Source: Data provided by the Spanish authorities.

Table 5. Spain: Selected Financial Indicators, 1980-84

	1980	1981	1982 1/	1983 1/	1984 2/
			(As a percent of GDP)		
Fiscal indicators					
General Government					
Revenues	30.2	31.0	31.1	32.4	31.1
Of which:					
Direct and indirect taxes	13.7	14.5	14.2	16.1	16.4
Social security contributions	13.1	13.2	13.3	13.2	12.0
Expenditures	32.2	34.0	36.7	38.4	36.4
Current expenditures	28.8	30.0	31.7	32.8	31.5
Capital expenditures	3.4	4.0	5.0	5.6	4.9
Current balance	1.4	1.0	-0.6	-0.3	-0.4
Overall balance	-2.0	-3.0	-5.6	-5.9	-5.3
Overall cash balance	-2.9	-4.4	-5.3	-6.4	...
			(End of period; percentage change except as otherwise indicated)		
Monetary variables					
M_3	16.5	16.0	15.4	12.9	10.0
ALP	16.9	17.0	17.9	16.0	12.5
Total domestic credit expansion	19.2	19.1	19.5	15.2	13.1
Credit to the private sector	17.3	16.3	15.2	9.2	7.6
Credit to the public sector	35.1	38.9	44.5	43.1	32.5
Share of credit to the public sector in total domestic credit	20.0	25.3	33.1	49.8	...
			(In percent)		
Interest rates					
Three-month interbank rate	16.5	16.2	16.2	20.0	16.2 3/
Unregulated lending rate 4/	16.8	17.4	17.5	17.6	18.2 3/
Unregulated deposit rate 5/	11.8	12.4	12.9	12.7	12.8 3/

Sources: Ministry of Economics and Finance; Bank of Spain; and staff estimates.

1/ Provisional estimates.
2/ Official targets.
3/ April.
4/ Rates on commercial bank loans of one to three years.
5/ Deposits of one to two years.

Table 6. Spain: Main Economic Variables, 1980-84

(Percentage changes)

	1980	1981	1982	1983 1/	1984 2/
Demand and output					
Private consumption	1.3	-0.9	0.6	0.7	0.5
Public consumption	4.4	1.5	6.2	4.1	3.5
Fixed investment	1.3	1.0	-1.8	-1.5	-0.7
Stockbuilding 3/	0.6	-1.3	--	--	0.3
Total domestic expenditure	2.1	-1.5	0.7	0.6	0.9
Exports of goods and services	0.6	6.9	7.1	7.6	9.0
Imports of goods and services	3.8	-2.8	4.5	-0.6	2.0
Foreign balance 3/	-0.6	1.8	0.6	1.7	1.6
GDP	1.5	0.2	1.2	2.3	2.5
Industrial production	1.2	-1.0	-1.1	2.6	2.0
Wages, costs, and prices					
Wages per man (industry) 4/	16.0	15.4	13.5	13.0	9.0
Productivity (industry)	3.7	4.3	5.3	5.5	3.5
Unit labor costs (industry)	11.9	10.6	7.8	7.1	5.3
Consumer prices	15.5	14.6	14.4	12.2	10.8
GDP deflator (at factor cost)	13.9	13.6	13.3	11.3	11.0
Employment	-3.2	-3.1	-1.2	-0.9	-0.5
Unemployment rate (average levels)	12.2	15.0	16.9	17.9	19.8
Disposable income of households	14.6	14.2	15.2	13.0	10.4
Savings ratio (levels)	7.7	6.9	7.1	7.0	6.6

Source: Spanish authorities.

1/ Provisional estimates.
2/ Staff forecast.
3/ Changes in stockbuilding and the foreign balance are expressed as a percentage of GDP in the previous year.
4/ Including social security contributions

Table 7. Spain: External Developments, 1980-84

	1980	1981	1982	1983 1/	1984 2/
	(Percentage changes)				
Trade developments					
Imports, c.i.f. 3/					
Unit value	38.1	31.2	13.2	21.0	9.1
Volume	4.1	-7.6	3.1	-0.4	2.0
Exports, f.o.b. 3/					
Unit value	20.0	19.0	12.5	18.3	10.3
Volume	1.9	6.2	6.3	6.5	10.0
Market growth	7.9	3.1	--	-0.6	6.3
	(In billions of U.S. dollars)				
Balance of payments summary					
Trade balance, f.o.b.-f.o.b.	-11,725	-10,115	-9,181	-7,402	-5,713
Services	4,489	3,443	3,383	3,698	4,010
Of which:					
Tourism	5,720	5,709	6,122	5,942	6,260
Investment income	-1,548	-2,410	-2,422	-2,354	-2,350
Transfers	2,048	1,692	1,581	1,171	-1,000
Current balance	-5,188	-4,981	-4,217	-2,533	-703
(As a percent of GDP)	(-2.4)	(-2.6)	(-2.4)	(-1.5)	(-0.4)
Capital balance	4,538	4,274	882	2,214	
Of which:					
Changes in net foreign position of banks	732	638	53	463	...
Long-term capital	4,195	4,294	1,827	3,089	...
Overall balance	-650	-706	-3,335	-319	...
Memorandum items:					
Gross official reserves 4/	12,480	11,422	8,272	8,019	
In months of imports 5/	5.6	4.4	3.5	3.3	
Spanish pesetas per U.S. dollar (period average)	71.7	92.3	109.9	143.4	
Nominal effective exchange rate (percent change) 6/	-7.6	-8.1	-5.9	-17.0	
Real effective exchange rate (percent change) 6/7/	-6.4	-6.5	-4.2	-12.9	
Medium- and long-term external debt 8/	23,719	27,205	28,772	29,462	
Debt service ratio	17.3	21.5	20.9	19.9	

Sources: Data provided by the Spanish authorities; IMF, International Financial Statistics; and staff estimates.

1/ Provisional estimates.
2/ Staff forecast.
3/ Customs basis, in pesetas.
4/ End of period, in millions of U.S. dollars with gold valued at US$42 per ounce.
5/ Imports of goods during the following 12-month period.
6/ The weights are based on the average distribution of export and import trade with 14 industrialized countries in 1980.
7/ As measured by relative consumer prices adjusted for exchange rate changes.
8/ End of period, in millions of U.S. dollars.

Spain - Statistical Issues

1. Coverage, currentness, and reporting of data in IFS

		Latest Data in July 1984 IFS
Real sector	- National accounts	1983
	- Prices	April 1984
	- Production	December 1983
	- Wages	January 1984
Government finance	- Deficit/surplus	January 1984
	- Financing	January 1984
	- Debt	1981
Monetary accounts	- Central bank	February 1984
	- Deposit money banks	February 1984
	- Other financial institutions	February 1984
External sector	- Merchandise trade: values	April 1984
	- Merchandise trade: prices	1979
	- Balance of payments	Q4 1983
	- International reserves	April 1984
	- Exchange rates	May 1984

During the past year, the reporting of data for inclusion in the IFS has been timely.

2. Outstanding statistical issues

a. Monetary accounts

Revisions to the data, based on the new system of accounts and bank returns recently implemented by the Bank of Spain, are being incorporated in the Data Fund. It is also planned to publish in IFS an expanded and comprehensive coverage of Spain's financial system, including data on certain institutions not previously available, such as cooperative banks and the money market intermediaries. A financial survey section is also planned.

The Bureau of Statistics is also in correspondence with the Bank of Spain regarding the establishment of a system of data exchange by tape.

b. Merchandise trade--prices

The data on trade indices are very uncurrent, but it is understood that the Spanish authorities are in the process of restructuring the indices.

c. Balance of payments

There was a technical assistance mission on balance of payments statistics in March 1984. The report containing several recommendations for improving the compilation procedures was sent to the authorities on June 20, 1984.

d. International liquidity statistics

Spain is not as yet a participant in the Fund's confidential quarterly survey on the currency composition of foreign exchange reserves.