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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/126

10:00 a.m., August 10, 1984

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. Koné, Temporary
	H. G. Schneider
	G. E. L. Nguyen, Temporary
	J. Delgadillo, Temporary
	D. C. Templeman, Temporary
	M. Lundsager, Temporary
M. Finaish	T. Alhaimus
H. Fujino	
J. E. Ismael	
R. K. Joyce	
A. Kafka	C. Robalino
G. Laske	G. Grosche
	N. Coumbis
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	J. E. Suraisry
	E. M. Ainley, Temporary
J. J. Polak	T. de Vries
	A. J. Tregilgas, Temporary
G. Salehkhou	
	M. Camara, Temporary
	J. L. Feito
J. Tvedt	
N. Wicks	T. A. Clark
	Wang E.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

C. Blackman, Governor, Central Bank of Barbados. European Department: P. de Fontenay, Deputy Director; T. Catsambas, H. B. Junz, L. L. Pérez, K. A. Swiderski. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; G. Oliveros. IMF Institute: J. R. Gómez, Participant. Legal Department: J. K. Oh. Research Department: C.-Y. Lin, A. Penati. Treasurer's Department: B. B. Zavoico. Western Hemisphere Department: A. Cheatsey, J. Fajgenbaum, O. Gronlie, S. N. Kimaro, J. E. Zeas. Bureau of Statistics: R. Lituma. Advisors to Executive Directors: S. R. Abiad, A. A. Agah, H. A. Arias, L. K. Doe, I. R. Panday, D. I. S. Shaw, A. Steinberg, A. Vasudevan. Assistants to Executive Directors: J. Bulloch, M. B. Chatah, D. Hammann, L. Ionescu, A. K. Juusela, H. Kobayashi, S. Kolb, K. Murakami, T. Ramtoolah, J. Reddy, J. E. Rodríguez, Wang C. Y.

1. BARBADOS - 1984 ARTICLE IV CONSULTATION

Executive Directors considered the staff report for the 1984 Article IV consultation with Barbados (SM/84/176, 7/18/84). They also had before them a report on recent economic developments in Barbados (SM/84/186, 7/31/84).

Mr. C. Blackman, Governor, Central Bank of Barbados, was also present.

Mr. Joyce made the following statement:

The stand-by arrangement for Barbados approved by the Executive Board on October 1, 1982 expired on May 31, 1984. Persistence by the authorities in their adjustment efforts despite some unexpected difficulties ensured that the conditions of the stand-by arrangement were satisfactorily complied with and all purchases were made on schedule.

Greater stability now marks the progress of the economy than in the earlier years of the present decade. Real GDP after two bad years in 1981 and 1982, caused by poor sugar crops, losses of exports and a fall-off in the tourist trade, has now recovered and is expected to grow by 2.6 percent in 1984, almost 1 percentage point above earlier estimates. The deficit in the current account of the balance of payments fell to about 4 percent of GDP in 1983 and is being brought down further in 1984. The current surplus in the consolidated accounts of the Central Government and the National Insurance Fund has been doubled from a low point of about 2 1/2 percent of GDP in 1981/82 to a current figure of around 5 percent. Over the same period the authorities have reduced the overall deficit from nearly 6 1/2 percent of GDP to about a quarter of that figure. Corresponding trends are to be seen in the operations of the public sector as a whole.

The rate of increase in consumer prices is now in the range of 5 1/2 percent to 6 1/2 percent a year, having fallen from close to 14 1/2 percent in 1980/81.

The rate of pay increase has also moderated but has remained above the rate of consumer price increase in recent years. The unemployment rate has risen; it is now in the region of 15 percent and, in common with experience elsewhere, there are indications of acceptance of higher levels of unemployment as the price of higher real income for those who are employed.

In the monetary area, the authorities saw some easing of credit policy as appropriate in 1983 in view of an expected improvement in economic conditions. In the event, these expectations were not fully realized and, while credit to the private sector expanded by just over 10 percent, the banks' liabilities to the private sector increased by less than 4 1/2 percent. The failure of private sector deposits with the banking system to increase as much as might be expected was partly accounted for by an increase in the differential between domestic and foreign deposit rates, which contributed to outflows of capital. Because of these developments, the authorities have now adopted a more stringent approach to credit policy.

The general stance of policy in the management of the Barbadian economy at present must be to safeguard the broadening and diversification of the productive base that has already been achieved and to provide for the future continuation of the process. The hesitancy of the recovery in world trade, the sharp fall-off in sugar production for some years past--despite some increase in the season just ended--and the discouraging outlook in world sugar markets have all severely tested the Government's fiscal provisions and the general resilience of the economy.

The authorities are in general agreement with the staff's analysis of the current economic situation. There are, however, some differences of view with respect to the strategy required to promote adjustment at present. The authorities consider that adjustment might better be achieved by measures that differ somewhat from those proposed in the staff report. They agree that an immediate aim of policy must be to strengthen the external balance and to build up reserves. As the staff point out, the level of reserves at the end of 1983 was the equivalent of 2 1/2 months' retained imports for that year, but substantially less if allowance is made for the US$60 million of illiquid claims against the suspended Caribbean Multilateral Clearning Facility included in the official reserves' computation. If a political solution can be worked out to the problem of the suspended claims, the degree of adjustment required would of course be substantially less. However, in the circumstances they felt it prudent to take resolute actions at this time--and have acted accordingly.

In managing demand, they have cut back on the level of proposed budgetary expenditure in 1984/85 by the equivalent of some 2 percent of GDP. The cutbacks will reduce expenditure on public service wages and on new capital projects which do not require foreign financing. Meantime, the authorities are keeping capital spending under review. They stand ready to make further cuts in expenditures, if necessary, and they are also ready to introduce additional revenue measures, and especially measures that act directly on imports, if this seems called for. In the monetary area, the authorities have adopted selective credit controls which in their experience are more effective in restraining consumer spending and limiting imports in Barbados than actions of a more general kind. Banks' average interest rates and the maximum interest rate for commercial and domestic mortgages have also been raised.

Supply-side measures are being applied. Sugar exports, although lower than in the past, still account for about 10 percent of total export receipts and enjoy preferential access to the EC and U.S. markets. The authorities see continued financial support for the sugar industry as justified, even though yearly losses are at present being incurred. In this connection, they note that there is also considerable subsidization of producers in other sugar-exporting countries in the region and elsewhere. At the same time, efforts are being made to reduce production costs in Barbados through greater mechanization and more efficient operations.

Receipts from tourism have stagnated for some years past. Nonetheless, the tourism sector is picking up and is now expected to grow by 9 percent in 1984. The earlier forecast called for growth of only 1 percent. However, for the medium term, a change in the strategy of tourism development is now called for, with increasing emphasis being placed on attracting higher-income tourists. Accordingly, new promotional measures are under consideration.

The authorities agree with the staff that in the light of trading difficulties in the Caribbean Community (CARICOM) area, a reorientation of manufacturing exports to third markets is desirable. Such exports have been expanding rapidly in recent years, with growth particularly in electrical components. In their view, Barbadian producers are proving to be competitive, at home and abroad, despite the appreciation of the Barbadian dollar in some markets. In their view, the key to further growth lies in enhancing the basic attractiveness of Barbados as a manufacturing location, encouraging the production of goods and services for which world market demand is buoyant, and ensuring continued, uninterrupted access to overseas markets.

The Government of Barbados believes that the measures outlined will be sufficient to bring the economy through the present period of uncertainty with reasonable stability and without unduly endangering growth prospects. The authorities are, nevertheless, keeping developments under review, and will take further corrective action if that should be required. At this stage they are reluctant to consider changes in the exchange rate of the Barbadian dollar as an element in adjustment. They believe that such a change could upset the stability of the commercial environment and is unlikely to have offsetting advantages that cannot be gained equally well by other means.

Mr. Clark remarked that Barbados had made considerable progress under the recently completed stand-by arrangement. In particular, inflation had been reduced from about 15 percent in 1981 to about 5 percent in 1983; the current account deficit had been narrowed from 10 percent of GDP to

4 percent of GDP; and the general government deficit had been reduced from more than 6 percent to just over 1 percent in the same period. More recently, however, it appeared that the momentum of adjustment might have slackened, and he was concerned that, in a number of respects, the economy was still some way from equilibrium, especially on the external side. In the circumstances, the Barbadian authorities should continue their efforts to secure medium-term viability.

Commenting on fiscal policy, Mr. Clark joined the staff in endorsing the authorities' efforts to control the deficit, and he welcomed their moves to reduce planned budgetary expenditure so as to cut back on external borrowing. There were two specific areas in which he would have welcomed further explanation by the staff. First, he understood that a system of public health care was soon to be introduced, and he would have appreciated some elaboration on its prospective financial effects. Second, he was concerned about the financial position of the parastatals in Barbados and would have been interested in a somewhat fuller discussion of the situation of the public sector enterprises. On monetary policy, he shared the staff's doubts about the appropriateness and the efficacy of attempts to limit credit through selective controls. It would seem preferable for the authorities to aim for greater flexibility in interest rates, and he would welcome comment from Mr. Joyce on that point.

With regard to the external side of the economy, Mr. Clark considered that a key issue was clearly the link maintained between the Barbadian dollar and the U.S. dollar. The authorities were concerned that, in an open economy like that of Barbados, a devaluation could provoke a spiral of domestic cost and price pressures. However, as shown in the chart on page 8a of the staff report, Barbados's competitive position had been eroded in recent years; and, if the overvaluation were to persist in the medium term, it would likely have damaging effects on both the level and distribution of activity in the economy. On a more positive note, the authorities should be commended for providing an economic environment that was conducive to inward direct investment. Barbados had derived appreciable benefits from such investment in the past.

In general, the main problem facing the authorities in Barbados seemed to be that of restoring the exchange rate, real wages, productivity, and competitiveness to more sustainable and appropriate trends, Mr. Clark commented. It was disappointing to note that, following the progress that had been achieved in recent years in reducing nominal wage increases, there was likely to be some reacceleration of wages in 1984, despite the fact that the living standards of those who were employed had been comparatively well maintained. In the medium term, the achievement of a better balance in supply-side factors would be an indispensable counterpart to the demand restraint measures on both the fiscal and monetary side that the authorities had implemented. In conclusion, he could support the proposed decision.

Ms. Lundsager observed that, during the 20-month stand-by arrangement with Barbados ended March 1984, the economy had regained some of the ground that had earlier been lost following a period of adverse weather conditions, regional problems, and a worldwide economic recession. The implementation of the 1983/84 financial program had resulted in a substantial decline in the overall government deficit, in the rate of inflation in 1983, and in the current account deficit as a percentage of GDP projected for 1984. As a result, the external debt profile had improved.

While progress had been made in several areas, there remained room for further adjustment in key sectors of the economy, Ms. Lundsager continued. Wage negotiations had resulted in higher increases than could be justified by the prevailing inflation rate; and, given that real GDP growth had been stagnant in 1983 and unemployment had reached uncomfortably high levels, wage restraint was crucial to promoting a sustained recovery in the economy. Moreover, Barbados's external financial situation remained fragile: debt service payments were still high, and reserves covered only a small portion of imports. The external current account had not improved in 1983, mainly due to stagnation in tourist earnings. Regional problems had persisted, undermining growth in traditional export markets; and, although electronic manufactured exports had improved, and other exports would benefit from the U.S. Caribbean Basin Initiative, traditional sugar exports had not yet reached a break-even level, in part because of quotas and because prices had been quoted in depreciating currencies. Also, wide differentials between foreign and domestic interest rates had emerged in late 1983 and had contributed to short-term capital outflows.

The staff was prescribing several policy actions that were clearly needed to meet the economy's weaknesses before they became more troublesome and before the consequences of adjustment became more severe, Ms. Lundsager remarked. She endorsed the authorities' commitment to curtail budgetary expenditures by an amount equivalent to 2 percent of GDP, a move that could perhaps best be accomplished through reduced transfers to the public enterprises and through a review of the wage negotiation structure aimed at restraining and even reducing real wages. The authorities had agreed to tighten credit policies, and she supported the staff view that credit controls should be avoided because they hindered the most efficient operation of the financial sector. While noting the recent increase in the ceiling on commercial bank lending rates, she would nonetheless emphasize the need to continue to increase deposit interest rate competitiveness.

With regard to the external sector, Ms. Lundsager took note of the authorities' plans to increase productivity in the sugar industry and to reorient the tourism strategy. However, the problems in the external sector could not be met by those efforts alone; the authorities should seriously consider an exchange rate change along the lines recommended by the staff. Such a change, together with wage restraint, would encourage a competitive recovery in the sugar industry and in tourism, would bring about an improved reserve position without increasing the debt service burden, and would avoid an even greater exchange rate adjustment in the future. The United States had urged a re-evaluation of the exchange rate policy of several other CARICOM members during recent Article IV consultations, and she hoped that Barbados would take the lead in following that advice. Finally, she observed that the authorities had stressed the role of private investment in promoting diversified export-led economic growth, and she hoped that the adjustment measures taken during the remainder of 1984 would successfully lead the economy toward such growth. In conclusion, she could support the proposed decision.

Mr. Ainley remarked that Barbados had an impressive record of balanced development based on outward-looking policies that had encouraged foreign investment, export diversification, and steady growth. The authorities should be commended for responding promptly to the problems that had emerged in 1981 and 1982; still, the staff paper raised a number of important questions about the prospects for the Barbadian economy and about the adequacy of present policies.

As others had noted, the stabilization program supported by the Fund had been fully and successfully implemented, Mr. Ainley continued. Output was recovering, albeit slowly, and the short-term outlook was not unfavorable. Nonetheless, medium-term prospects were uncertain. Unemployment remained high, the sugar industry was running at a loss, tourism was relatively depressed, and the scope for expansion of manufactured exports appeared limited. The balance of payments was vulnerable, particularly given the large capital outflows of recent months, and priority must therefore be given to strengthening the external position and rebuilding reserves; in that regard, while the authorities and staff were agreed on those objectives, they differed somewhat on the methods for achieving them. To some extent, the degree of adjustment required depended on whether and how soon Barbados could recover its illiquid claims--which represented a large proportion of the economy's foreign exchange reserves--against the Caribbean Multilateral Clearing Facility.

The authorities had acted prudently to reduce the fiscal deficit, and he welcomed the measures they had taken to do so, Mr. Ainley commented. In the face of criticism from some of his colleagues about the financial position of the public sector enterprises, it should be noted that marked improvement had occurred in recent years; indeed, there had been a reference in SM/84/186 to the fact that the public sector enterprises were running a current account surplus in 1983/84. That was an encouraging sign, particularly when the performance of public enterprises in Barbados was compared with the performance of those enterprises in some other countries. The staff had expressed some doubts about whether the fiscal measures adopted by the authorities were sufficient, but he found it encouraging that the authorities were ready to take further measures if the external position did not improve as planned. In that respect, he had noted that wages and salaries accounted for a large proportion of government spending, and he tended to agree with the staff and with Mr. Clark that the recent wage settlement in the public sector was on the high side. It would be helpful if the staff could explain in more detail what it had in mind in calling in its appraisal for a review of the wage determination procedures. As for monetary policy, he supported the recent tightening in the monetary stance and hoped that the authorities would work to ensure that the new credit controls did not produce distortions, and that sufficient credit was channeled to productive sectors.

With regard to exchange rate policy, Mr. Ainley observed that competitiveness had clearly declined over the past two or three years. The appreciation of the exchange rate had certainly not helped export performance; and it might have made Barbados less attractive to tourists than some other Caribbean countries that had followed a flexible exchange rate strategy. On the other hand, he could appreciate the authorities' view that a stable exchange rate was an important consideration for domestic and foreign investors. It was also possible that the benefits of a devaluation in a small, import-intensive and open economy like that of Barbados could be offset by upward pressures on wages and prices. On balance, he was open-minded on the issue of whether or not the authorities should devalue; however, if they did not, it would be particularly important to ensure that government expenditures were reduced, that monetary growth was contained, and that wage settlements were moderate. More fundamentally, the authorities might have to take other steps to promote manufactured exports, explore new markets, and attract higher-income tourists. It was therefore encouraging to hear from Mr. Joyce that they were following precisely those steps and were keeping the appropriate objectives in view. The authorities were probably adjusting sufficiently for the short run, although more forward planning would be necessary if the economy was to return to a steady growth path in the medium term.

The staff representative from the Western Hemisphere Department, remarking on the status of illiquid claims against the suspended Caribbean Multilateral Clearing Facility, observed that, in a recent summit conference of Caribbean nations, broad interest had been shown in reviving the multilateral clearing mechanism. Various general proposals had been advanced by the heads of state--including suggestions by Barbados for dealing with the problem of the illiquid claims--and the matter had been referred to Ministers for further study. At present, the staff was not in a position to say whether or when progress would be achieved.

A question had been raised regarding the staff's reference to the need for a review of wage determination procedures in Barbados, the staff representative recalled. The staff had sensed that there was a need for developing general criteria that could guide the determination of wages, together with an arbitration mechanism for handling wage disputes while ensuring that the general criteria were enforced.

Commenting on the public health services that had been discussed in connection with the 1984/85 budget, the staff representative stated that, as he understood it, the Government intended to introduce comprehensive health care over time. For the year immediately ahead, however, the intention was to establish a program that would cover only the elderly. No specific financing measures had yet been adopted; however, as full implementation of the program would in his view tax the resources of the national insurance scheme, it was to be hoped that the authorities would consider appropriate alternative ways of financing the program before it was fully implemented.

The authorities were cognizant of the need to ensure the commercial viability of the public sector enterprises and were working toward that end, the staff representative from the Western Hemisphere Department noted. Substantial progress had already been made in improving the situation of those enterprises, and budget transfers intended to cover current operations had declined as a result of specific pricing and restructuring measures. Nonetheless, a greater effort was needed to strengthen the performance of the entities in order to enable them to finance a larger part of their own investment programs; that effort would probably require further action in the areas of pricing and restructuring.

Mr. Joyce remarked that the Board seemed generally agreed that Barbados had done very well under the stabilization program and was continuing to perform well, at least in the short term. However, some concern had been expressed about those factors that would affect progress in the medium term, and he would respond to each of those factors in turn. The first factor was wages, and the authorities recognized that it was vitally important to keep increases in real wages under strict control, especially since those increases had a direct bearing on the competitiveness of the economy. However, a glance at recent history would show that the Government had been reasonably successful in holding down real wage increases. In 1982 there had been virtually no increase in public sector wages, and in 1983 the increase had been held to about 2.5 percent. The higher wage proposals for 1984 and 1985 were only a reflection of the difficulty that would always be experienced in consistently holding down wage increases. In putting forward those proposals, the Government had taken account of political and social realities, including the possibility that widespread dissatisfaction with somewhat lower proposals could easily interfere with production. On balance, he did not feel that the expected developments on the wage front were necessarily disastrous; nor did he feel that the latest proposals represented the beginning of a trend. Rather, they reflected the working out of a process in which there was a trade-off between real wage increases and unemployment, the second of the factors generating concern over the medium term.

In Barbados, as in many other countries, there appeared to be a greater willingness to accept somewhat higher levels of unemployment in return for somewhat higher levels of real wages, Mr. Joyce continued. While unemployment was by no means a positive development, it could be said that forced reductions in employment helped to make industry more efficient and effective. It had been argued by some that overemployment had long existed in the hotel industry in Barbados; however, one of the effects of wage increases in that industry had been to force hotel operators to reduce employment and to conduct their business more efficiently.

Another key issue for the Barbadian economy was overall competitiveness and what was required to maintain it, Mr. Joyce considered. The staff and some members of the Board had argued that Barbados should be considering a devaluation of its currency. The Barbadian authorities recognized that fundamental adjustments were needed through the medium term, and they had already begun to take action in that regard. However, there were many roads to adjustment, and devaluation was only one of those. Another choice was to take more effective measures on other fronts. The point was that, so long as the authorities were not attempting to avoid adjustment, the choice of which path to take toward that adjustment was their own; it was not a choice for the Fund. His Barbadian authorities were not rejecting the usefulness of a devaluation in certain circumstances. However, they were not convinced that a devaluation was the best approach in present circumstances. And that stance was adopted not only by smaller developing countries; indeed, the following statement had been made by the Governor of the Bank of Canada:

> It is because of the substantial inflationary risk involved that I have never favored depreciation where it could be avoided or at least limited. The record has not been good. Our past experience with exchange rate depreciation has been that, all too often, it has led not to a sustained improvement in our competitiveness but to an additional inflationary momentum as people attempted to protect their incomes against the loss of purchasing power. The end result has been more inflation rather than more economic activity.

It was by no means certain that a devaluation would be advantageous to industries in Barbados, Mr. Joyce remarked. Even if a 20 percent increase in earnings in the sugar industry were to be achieved through devaluation, it would probably be more than offset by the additional costs involved in modernizing the industry. The same could be said for tourism, where 60-70 percent of the costs were import costs. Besides, the hotel industry in Barbados--as was the case in other parts of the Caribbean--was in effect operating already as if the currency had been devalued; the hotel operators were discounting heavily with a view to attracting additional traffic, although their efforts had been less successful than had been hoped. If the hotel industry in Barbados was suffering, it was not so much due to the value of the currency; the Canadian tourist business to Barbados had collapsed suddenly because two of the main tour operators had filed for bankruptcy, U.S. tourists in increasing numbers were showing a preference for travel to Europe, and the tourist facilities in Barbados had perhaps not been improved as much or as rapidly as they should have been.

It was unclear what the effects of a devaluation would be on exports of manufactures, Mr. Joyce said. The authorities certainly did not believe that a devaluation would increase exports to Trinidad or to the rest of the Caribbean, where the problem was mainly one of access. In fact, a devaluation was likely to exacerbate that problem. And exports elsewhere--to the United States, for example--were doing so well that import quotas or restrictions had been imposed on some products. In sum, it appeared that the problem with exports had little to do with competitiveness at the present rate of exchange and was mainly a problem of obtaining additional access to the markets where export products were competitive. On a related matter, the staff had admitted that the problems faced by Barbados with respect to reserves could be considerably attenuated if the illiquidity of some of those reserves could be overcome. As noted by the staff, discussions had been proceeding following a CARICOM summit meeting in Nassau, and the authorities believed that they were near to a solution to the problem of the illiquid claims, which arose essentially because of debts owed by Guyana. Debts owed Barbados by Jamaica had also been part of the problem, although Jamaica had already paid half the amount owed into a bilateral account.

Responding to questions on interest rates, Mr. Joyce remarked that the Barbadian authorities considered that, in present circumstances, selective controls imposed upon credit to certain key sectors--notably the purchase of consumer goods and the distribution sector--would probably be more effective than further increases in interest rates. Moreover, the authorities did not believe that interest rates in Barbados at present were much out of line with those elsewhere; even the spread between rates in Barbados and in the United States, for example, did not appear to be causing any significant amount of capital flight from Barbados. If, however, recent increases in U.S. interest rates were to be maintained at, or increased from, current levels, the Barbadian authorities would probably wish to review the situation to determine whether further action was required.

Mr. de Vries noted that, according to the Barbadian authorities, exports would not be affected very much by the exchange rate, although the internal consequences of a depreciation would be quite serious. Perhaps the authorities should consider appreciating the currency, since such an action would have beneficial domestic effects but would not create problems for exports.

Mr. Joyce replied that the authorities in Barbados would give equal consideration to all reasonable recommendations. In passing, he noted that an appreciation of the currency would not be a novel development in Barbados; in 1979, the currency had appreciated by about 10 percent, and the results had in fact been quite beneficial.

The Acting Chairman made the following summing up:

Executive Directors were generally in agreement with the thrust of the staff appraisal, and commended the authorities on the gains that had been made under the stand-by arrangement. They noted, in particular, the strong improvement in the public finances and the narrowing of the external current account deficit.

Directors encouraged the authorities to consolidate the gains already attained in adjusting the economy. It was observed that Barbados's official international reserves are low; that the economic recovery, especially in the export sector, has been slow; and that there has been a rise in unemployment. In the face of those developments, Directors felt that economic policies needed to focus on strengthening the external position and improving the prospects for both growth and employment. It was stressed that the achievement of those objectives would require prudent expenditure and revenue policies and measures to strengthen the country's competitiveness and the performance of the export sector.

Commenting on fiscal policy, Directors welcomed the authorities' decision to scale down government expenditures below the level that had been budgeted for fiscal year 1984/85. They considered that emphasis should be placed on expenditure restraint, although they indicated that additional revenue measures might also be necessary. Some Directors added that the financial position of the state enterprises was cause for concern and that budget transfers to those enterprises needed to be reduced.

There was a feeling among Directors that credit and interest rate policies should be employed to reinforce the direction of adjustment efforts in the fiscal field. They considered that there was a need to tighten credit policy, and they emphasized the importance of a more flexible interest rate policy.

Directors noted that recent wage settlements had been large, and they expressed concern that those increases could undermine financial stability. The authorities were encouraged to review the wage-setting procedures to ensure a more adequate rate of increase in wages in the future; at the same time, Directors called upon the authorities to make an effort to reverse the large wage settlements of recent years. Noting the complementarity of wage policy and exchange rate policy in relation to the need to restore international competitiveness, Directors urged the authorities to keep the exchange rate under careful review, especially in light of the real appreciation of the Barbados dollar that had occurred over the past few years.

Directors emphasized that policies of expenditure restraint needed to be supplemented by policies that would improve the cost/price structure in order to ensure that the problems of slow growth and unemployment would be addressed.

Finally, there was praise for the efforts of the authorities to maintain a liberal trade and payments system.

It is expected that the next Article IV consultation with Barbados will be held on the standard 12-month cycle.

The Executive Board then adopted the following decision:

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

2. The Fund notes with satisfaction that Barbados's exchange system is free of restrictions on payments and transfers for current international transactions.

Decision No. 7782-(84/126), adopted
August 10, 1984

2. SPAIN - 1984 ARTICLE IV CONSULTATION

Executive Directors considered the staff report for the 1984 Article IV consultation with Spain (SM/84/172, 7/17/84). They also had before them a report on recent economic developments in Spain (SM/84/183, 7/27/84).

Mr. Feito made the following statement:

My Spanish authorities broadly concur with the staff's perceptive assessment of the current economic situation.

The shorter-term aims pursued by the present Government have been controlling inflation and the balance of payments disequilibria, which were growing very rapidly when it took office at the end of 1982. The correction of domestic economic and monetary imbalances should lay the groundwork for tackling those structural factors which have fueled the real disequilibria of the public sector deficit and unemployment over the long term. The negative relation between inflationary pressures and the growth of output and employment is strongly supported by empirical evidence in Spain; from 1974 to 1982, when consumer prices in Spain were rising at an average rate more than double that of the OECD area and the traditional inflation differential against Spain widened significantly, yearly real GDP growth amounted to 1.5 percent on average, compared with 2.2 percent for the OECD area, thereby reversing the growth differential which traditionally had been favorable to Spain. In addition, over the same period the rate of unemployment, which in 1973 was about a percentage point below the average rate for the OECD, reached 17.5 percent--or twice that of the OECD--by 1983. Therefore, the need to design macroeconomic policies primarily geared to controlling inflation would seem to be beyond any question.

The authorities' commitment to the goal of monetary stability has resulted in an impressive turnaround of the external position, as well as a reversal of inflationary trends. The current account of the balance of payments has declined from US$4.1 billion, or 2.4 percent of GDP in 1982, to US$2.4 billion, or 1.5 percent of GDP in 1983, whereas the overall balance of payments deficit declined from US$3.3 billion in 1982 to US$0.3 billion in 1983. Available data for 1984 show that the current account and the net external position have strengthened further during the first half of the year. The inflation rate has been reduced to 12 percent from 14 percent in 1983, and it is expected to be brought down to the one digit zone by the end of 1984 and to approximate the OECD average in 1985.

This successful macroeconomic outturn has essentially been the result of the implementation of a determined policy of monetary restraint, together with an anti-inflationary debt management policy aimed at shifting the financing of the public sector deficit away from money toward debtcreating instruments, with other variables like the exchange rate, wages, and unemployment being either the result of those policy actions or largely beyond the control of the authorities in the short run.

I shall now offer more detailed remarks on the past and prospective stance of monetary and debt management policies and the labor market situation.

As in other countries applying techniques of money supply targeting, the implementation of monetary policy in Spain has had to weather the storm of financial innovation. The relationship between M-3, the traditional money supply target of the Bank of Spain, and nominal income, have gradually become less stable and reliable as a result of several factors. Prominent among these factors have been the shift from money to debt financing of the budgetary deficit, a more competitive climate brought about by the increased activity of foreign banks operating in Spain as well as by high international interest rates, and the very techniques of money supply targeting, which in seeking to control a given monetary aggregate induce the placement of wealth in financial instruments not included in that aggregate. The high and variable inflation rates that have prevailed over past years, as well as the differential fiscal treatment in favor of earnings on financial assets relative to other incomes, have encouraged those processes of financial innovation.

The appearance and rapid growth of monetary assets competing with those included in M-3 has led the Bank of Spain to downgrade the latter aggregate, at least for the time being, in favor of a broader target that encompasses all financial assets usable as means of payment at very short notice. The demand for this broad aggregate relative to nominal income has exhibited a notable stability so that its control has made possible the achievement of the price and balance of payments objectives assigned to the monetary authorities.

That despite all the turbulences affecting the working of the financial system, the Bank of Spain has been able to keep the growth of nominal income and prices within the targeted path, bears witness to the overwhelming importance the authorities attach to price stability. Incidentally, it also shows that the effect of monetary policy does not basically depend on the targeting techniques employed but rather on whether or not it is accomplished in a way designed to overcome the inflationary forces in the economy. The adherence of the Bank of Spain to its stability stance in the face of disequilibrating forces threatening that strategy has strengthened the credibility of market participants in the Government's commitment to the disinflationary process. As a result, contractual wage increases negotiated in the first four months of 1984 have been limited to about 8 percent, including wage drift, a figure about 3.5 percentage points below that of a year earlier, which augurs well for the attainment of the inflation objectives of the Government this year.

For the first time in several years, the growth of the budget deficit in 1983 has been contained and that of its borrowing requirement significantly decelerated. More importantly the share accounted for by direct monetization of the deficit through resort to the Bank of Spain has been considerably decreased from 51 percent in 1982 to 6 percent in 1983, the proportion of treasury bills growing from 5 percent to 58 percent in corresponding years. While the sizable financial borrowing requirements of the public sector have many distortive effects which can only be prevented by the narrowing of the deficit, that improvement in the financing of the budgetary imbalance is a second-best option with some positive consequences not to be lightly underestimated.

For a country with a small and relatively unsophisticated capital market, the formation of a market for public securities is a major step toward deepening and improving the functioning of financial mechanisms in the economy. Although many of these benefits are of a long-term nature and are obscured by the current deteriorated economic environment, they should be given proper consideration in any analysis of the economy. For instance, the growth of a treasury bill market, by offering wealth holders maximum safety on a part of their funds, may encourage them to take risks with the remainder, thereby promoting enterprise and new investment. It may also stimulate savings of middle-income earners by affording them the possibility of earning real interest rates on relatively small placement of wealth, a possibility previously absent owing to the imperfections and oligopolistic structure of the banking system. In addition, the emergence of the public sector as an important borrower in the financial markets tends to foster competition and erode oligopolistic pricing in those markets. Moreover, the shift from the inflationary tax to debt financing makes more explicit the costs of fiscal imbalances, thereby helps to raise public consciousness of the need for corrective measures. In this respect, although the shift to debt financing of the budgetary deficit has been accompanied by an increase of the coefficients regulating the amount of public securities to be held by financial institutions, and the interest on those securities has fallen slightly below market rates, it should be noted that a large share of these public securities were already voluntarily owned by those institutions prior to the imposition of increased coefficients.

These considerations in no way intend to deny or question the need to reduce the public sector deficit. Quite the contrary, if the borrowing needs of the public sector are not compressed, the disadvantages associated with the growth of the public debt may rapidly outweigh whatever conveniences it may provide--all the more so, if account is taken of the fact that those public obligations have been contracted to a large extent to finance relatively low productive undertakings. Under these circumstances, the mounting public debt tends toward wealth concentration and, while mortgaging future revenues, engenders a growing conflict between the interests of major bond holders and those of other income groups that shoulder the greater proportion of the tax burden. In addition, both theoretical considerations and historical experience show that in a small open economy excessive government borrowing sooner or later requires high real interest rates as well as a high real exchange rate in order to maintain price stability and external balance. Therefore, the further accumulation of public deficit may jeopardize the success of the disinflationary process and reduce the relative size of the sectors producing tradable goods whose productivity is normally higher than that of other sectors of the economy.

These are some of the reasons why the Government attaches absolute priority to correcting the public sector deficit whose growth would entail undesirable distributive and allocative consequences. The strategy and the obstacles faced by the Government in this area are very well described in the staff papers. Suffice it to say that there is a high degree of concordance between the Government and the staff in pointing to the reform of the social security system and the financial restructuring of deficit-making public enterprises, most of which are included in the industrial reconversion program, as absolute preconditions for balancing the budget in the medium term. Indeed, a deceleration in the rate of growth of transfers to enterprises, social security benefits, and public consumption, is planned to bring down the ratio of public expenditure to GDP this year, which, together with some slight increase in revenues, should further reduce the budget deficit to about 5.5 percent of GDP.

The situation in the labor market continues to be a source of major concern. There seems to be widespread, though not universal, agreement that the growth of real labor costs and the institutional rigidities hindering the functioning of the labor market are the main factors behind the growth of unemployment. Thus, whereas in 1975 the unemployment rate in Spain, of the order of 3.7 percent, was almost two percentage points below the OECD average rate, by 1983 it had reached 17.5 percent, more than twice the OECD average rate for that year. Over this period, hourly real wages in manufacturing increased by 32 percent, well in excess of increases in other OECD countries, while payroll taxes paid by entrepreneurs have ranked among the highest in the OECD area. As can be inferred from these impressionistic data, the stock of capital has not grown in Spain so as to warrant those rapidly accelerating levels of real labor costs without sizable accretions to unemployment. On the contrary, there seems to have been a vicious circle at work in which inappropriate real wage levels have reduced investment which in turn called for lower real wages to clear the labor market and prevent unemployment from increasing. Thus, unremitting unemployment growth has resulted from the conflict between the fall in flows of capital formation, which indeed called for a corresponding moderation of real labor costs to at least keep unemployment from growing, and from the increasing real wage rates imposed from the supply side of the labor market. The situation has been compounded by the institutional rigidities regulating the labor market, which prevent unemployment levels from exerting significant dampening effects on real wages, thereby blocking a way out of that vicious circle. Prominent among these rigidities was the inability until recently, to dismiss workers--except in case of bankruptcy or proven near bankruptcy--so that the increased excess labor supply did not have much influence on wage determination.

The gravity of the unemployment situation is not only the result of inappropriate average wage rates but also the inappropriate distribution of wage rates. The viscosity of the wage pattern induced by the mechanics of the collective bargaining process has made sectoral and regional adjustments in employment more difficult, thereby causing unemployment to increase in response to shifts in demand among sectors and lengthening the average duration of unemployment. Consequently, an acceleration in the growth of nominal demand not only might fail to increase employment, but indeed might add to unemployment because the difficulties and high costs involved in effecting layoffs could lead profitable sectors to increase wages and prices rather than output and employment in response to a rising demand for their products. On the other hand, given the rigidity of the wage structure, less profitable or more labor-intensive sectors have to pay wage rates very close to those agreed by more efficient ones, which ultimately leads to reducing capacity and closing down plants with the ensuing reductions of employment. That appears to have happened in 1982 when an expansion of nominal international demand channeled the inflated nominal income to prices and the balance of payments without any significant impact on output and employment levels.

My authorities are aware that growth of demand will fail to exert significant and lasting positive effects on employment unless the barriers to entry into employment, such as layoff regulations and the downward rigidity of real wages, are progressively dismantled. Measures have therefore been enacted to increase the flexibility of the labor market, while strict adherence to monetary targets seems to be having a beneficial influence on the wage negotiations presently underway for the coming year. However, adjustment in the labor market will probably be a slow process: it will take time to reverse the growth pattern shaped over the past decade on the basis of disequilibrium in wage rates and characterized by labor-saving investment in conjunction with faster relative growth of those branches of production with rather low labor requirements.

Mr. Laske remarked that, over the past 12-18 months Spain had made some progress toward reducing the large internal and external imbalances that had gradually evolved over the decade. That progress was reflected in a slightly reduced inflation rate, some improvement in the external accounts, and a higher growth rate than originally anticipated. But the improvements had not been accompanied by adaptations in the rather rigid structure of the Spanish economy; the economy remained hampered by serious structural deficiencies in the labor market, inflexible fiscal policies, unsatisfactory financial performance by the public enterprises, and proliferating expenses in the social security system. The rigidities in the capital and financial markets and the relatively high degree of protectionism were additional causes of concern. Without tackling those more deep-seated structural problems, the scope for an ongoing recovery of economic activity and for a lasting abatement of the internal and external imbalances seemed limited. The Government had recognized the problems and was prepared to deal with them, and he believed that the overall policy approach chosen by the authorities was appropriate. However, they should persevere in their efforts to strengthen policy; only a high degree of determination and commitment would help them to meet the political concerns about the potential social consequences of the necessary reform measures.

The disconcerting developments in the fiscal area had been strikingly outlined in Table 17 of SM/84/183, which showed the intensification of the fiscal imbalance since the end of the 1970s and the strong growth of the government sector as well, Mr. Laske continued. While the share of government expediture in GNP had grown by almost 14 percentage points in eight years, the overall deficit as a share of GNP had increased nearly sixfold. Both those factors helped to explain Spain's current economic problems; in the circumstances, the effort to contain government expenditures should be a matter of the highest priority. Measures to increase revenues might also need to be considered, although they should be designed to spread the tax burden over a wider range of the population and thus improve the level and structure of incentives.

The objectives of the containment of expenditures and the creation of adequate incentives could best be met if the social security system were thoroughly reviewed, Mr. Laske considered. In recent years, transfers had accounted for an overwhelming part of the increase in expenditures, and he was thus pleased that the Government intended to limit abuses of the system and to establish greater equity between the various kinds of benefits, such as those for disability and for unemployment. It was somewhat baffling that disability pensions had thus far not been taxable and had been much easier to obtain and much more advantageous to the respective employer than unemployment benefits. Without appropriate corrections to the system, a further rise in disability pension expenditures might be unavoidable and might increase overall government expenditures considerably, which would seriously strain the financial viability of the social security system.

Another cause for concern was the progressive deterioration in the financial position of the public sector enterprises, whose precipitously rising operating deficit had claimed an ever growing share of domestic credit expansion over the past six to seven years, Mr. Laske commented. Hence, he welcomed the authorities' intention to "reprivatize" certain enterprises and to extend to them the government guidelines on wages and salaries. A more global approach to dealing with the multifaceted difficulties of the public sector enterprises should be developed to provide for more decentralized decision making, better management, and more exposure to market forces and competition. Without such changes, the public enterprises would continue to impose a heavy burden on the fiscal situation and on the Spanish economy more generally.

Appendix I of SM/84/183 revealed that, within the OECD area, Spain's labor market was characterized by particularly poor performance, Mr. Laske observed. The overall unemployment rate in Spain was the highest among OECD countries, the proportion of the long-term unemployed was the second highest, and youth unemployment was at a particularly high level. The unsatisfactory labor situation was highlighted by the drastic decline in the total participation rate, which had occurred since the end of the 1970s. The rapid deterioration in employment was closely correlated with the continuous growth in the government sector. Depressed private sector activity together with rising labor costs impaired private sector profitability and eroded Spain's international competitiveness. The rising unemployment level had not had much effect on the development of the unit labor cost, which had increased at a rate of more than 7 percent in 1983. It should be noted, however, that the 1983 rate of increase in unit labor costs had been somewhat lower than in the immediately preceding years.

The disappointing performance in the labor market and the limited response of wages to that performance were obviously related to the high degree of structural rigidity and to the high costs of layoffs, Mr. Laske remarked. According to the staff paper, those costs could total 20-25 percent of actual labor costs; it was not surprising that such costs had had a deterrent effect on the filling of existing vacancies and the creation of new jobs. He welcomed the various measures adopted for increasing labor mobility and reducing the inherent risks involved for the individual enterprise in expanding employment. However, if layoff costs were not also reduced, the beneficial impact of the measures might never be felt.

Commenting on monetary policy, Mr. Laske agreed with the staff that there were dangers inherent in an uncontained public sector deficit. The strong growth of the Government's credit demand implied a contraction of credits to the private sector, if the monetary targets were to be achieved; that would have negative effects on private investment demand and on the creation of badly needed new employment opportunities. Facing rapidly expanding public sector borrowing requirements, the authorities had regrettably made recourse once again to regulating for the financial markets. Under the approach adopted, the entire banking system--including the Central Bank--would channel financial resources from the private sector to the government sector. As a result, deposit rates would become negative in real terms, while lending rates for private borrowers would be high.

He strongly urged the Government to disentangle fiscal from monetary policy, Mr. Laske said. The high degree of monetary financing of the budget should be decisively curtailed, and the Government should make stronger recourse to the capital markets and nonbank lenders. Experience showed that such an approach had significant advantages in terms of the transparency of government activity, the conduct of monetary policy, the mobilization of savings, and the allocative efficiency of the financial markets in general. Finally, he encouraged the Spanish authorities gradually to reduce the high degree of protectionism. Over the longer run, a more liberal attitude toward foreign trade could enhance competitiveness, contain wage pressures, and prepare the economy for Spain's membership in the European Communities.

Mr. Templeman observed that the Spanish case presented an extreme version of those problems, common to many industrial countries, caused by the attempt of a society to achieve complete job and income security, thereby creating rigidities and distortions which could jeopardize future economic growth, employment, and financial stability. The effort to ensure job security in particular had led to placing severe limits on layoffs, resistance to the elimination of redundancies in public enterprises and elsewhere, and a tendency to turn to the government as the employer of last resort.

The extent to which serious distortions had been created in the labor, fiscal, and monetary areas of the Spanish economy could be seen in a number of remarkable statistics presented in the report on recent economic developments, Mr. Templeman continued. Private sector employment had declined 19 percent between 1976 and 1983, and the drop in employment in Spain had been greater than in any OECD country listed in Table 64. Overall unemployment at 17.4 percent in 1983 and youth unemployment at 38.9 percent had also been higher in Spain than in any of the countries shown in Tables 58 and 60, respectively. Moreover, lump sum severance payments in Spain could amount to 1-3 years' salary; and pensioners could receive 90 percent of their former salaries. Other data revealed that public enterprise losses had risen tenfold between 1977 and 1983; total government transfers to public enterprises in 1983 had amounted to about one half of the cash deficit; that the commercial banks' compulsory investment coefficient had amounted to 55 percent of their assets to 68 percent of savings banks' assets; that more than 60 percent of all bank deposits were subject to legal limits on interest rates, with average yields on such savings and time deposits ranging between only 3.75 percent and 7.5 percent; and that the intermediation role of the Government had reached a point where government transfers to business equaled about three fourths of the Government's borrowing. Having cited those startling figures, he hastened to add that progress had been made in a number of areas, especially with respect to inflation and the balance of payments, and the authorities were to be commended for that progress. Also, he was aware of the difficulties and political sensitivities involved in the authorities' efforts to deal with a wide variety of fundamental issues. It was clear that their efforts to resolve the problems of the economy would need to be comprehensive and persistent and that development of a political consensus would be crucial to their success.

Turning to more specific elements of the economy, Mr. Templeman noted that there had apparently been a deceleration in the decline in employment in the agricultural sector and, perhaps, in construction and industry. He wondered whether secular shedding of labor in the agricultural sector might be ending and whether some upturn in employment in construction and industry could be foreseen. On the matter of labor costs, he was encouraged that wages in the public sector in 1984 were to be held within a 6.5 percent guideline and that recent private sector settlements had been averaging a fairly moderate 8 percent. He also hoped that the authorities would succeed in obtaining continued wage moderation as a result of the current efforts to reach a national collective agreement for 1985 and 1986. The introduction of short-term and part-time contracts might be helpful in overcoming the strict limits on dismissals, and the options offered to redundant workers under the Industrial Reorganization Plan might help in reducing the number of excess workers, although there appeared to be some question about the balance between the likely costs and benefits of such a plan.

On the fiscal situation, Mr. Templeman indicated his support for the emphasis given by the staff to needed expenditure cuts, especially in the social security and public enterprise areas. The goals of social security reform, consisting of a cut in the burden on employers, a rationalizing of benefits levels, and the re-establishment of financial balance over the medium term, seemed reasonable and even crucial to fiscal stabilization. The elimination of fraudulent access to disability benefits, some reduction in the pension level, an increase in employee contributions to the pension plan, and possible taxation of high-income beneficiaries were all ideas worth pursuing. He also agreed with the staff that cutting the losses of public enterprises was fundamental and urgent. A positive step would be achieved if the public sector enterprises could bring their employees within wage guidelines and if a financial plan could be established for the largest loss makers, such as the railroad company. Also helpful would be the adoption of the proposed three-year plan for official credit institutions aimed at reducing lending to loss makers and raising their interest rates closer to market rates. While cost cutting by the public enterprises might be more important, he wondered about the adequacy of their pricing policies.

On the revenue side, Mr. Templeman said that he shared the staff's skepticism about depending on any further increase in the tax burden, even if that burden was at present relatively low by European standards. On the other hand, some broadening of the tax base, the introduction of a value-added tax, and further cuts in tax expenditures--such as a reduction in export rebates--offered some limited prospects for reducing the deficit.

In the monetary field, Mr. Templeman expressed concern about the immediate problem of achieving the 1984 monetary targets, given the unexpected buildup of foreign reserves and the larger than expected expansion in credit to the public sector early in 1984. As noted by the staff, those developments could impinge upon the availability of credit to the private sector, which was necessary for a revival of business investment. More important were considerations involving structural and institutional developments in financial markets. Despite assurances that the Spanish authorities were committed to deregulation, a number of developments seemed to suggest that they were moving in the opposite direction. For example, the negotiation for a reduction in interest rates paid by the Government on loans from the banks seemed inconsistent with the goal of deregulation and would shift the financial cost to savers--who would be less able to obtain attractive deposit rates--and to nongovernment borrowers, who would have to pay correspondingly higher interest rates. Moreover, nonmarket factors in the form of portfolio investment requirements limited the ability of banks to make credit decisions based on market-related considerations, and the large intermediation role assumed by the Government was tending to thwart the development of broader-based innovative financial markets. In sum, the task of economic adjustment and reform facing the Spanish authorities was a daunting one. However, the alternative was to accept the evolution of the economy in a direction that would leave Spain on the margin of modern and efficient industrial economies. The Spanish authorities seemed to be fully aware of that danger and were determined to avoid it; he wished them well in their endeavor.

Mr. Kafka considered that the Spanish economy had substantially readjusted in macroeconomic terms and had met almost every quantitative target of the 1983 program. In particular, inflation had been reduced by 2 percentage points, to 12.2 percent, and the current account deficit had been brought down from 2.4 percent of GDP in 1982 to 1.5 percent in 1983, with further progress planned for 1984. Also, remaining structural problems were to be addressed by the authorities, whose commitment to that end was deserving of support.

On the other hand, Mr. Kafka continued, nominal wages had grown at an average annual rate of 13.5 percent, which exceeded the suggested wage band of 9.5-12.5 percent. Added to earlier wage increases, that growth had no doubt been the main cause of the rise in the unemployment rate, which had reached almost 18 percent in 1983. He understood that the area of labor and wage management was a sensitive one that needed to be handled with great care; nonetheless, as the authorities were aware, decisive and concrete measures would need to be taken soon.

The authorities' intention to continue reducing the public sector deficit through both income and expenditure adjustments was to be commended, Mr. Kafka remarked; success in carrying out that intention was crucial to the program. On the income side, he welcomed the commitment of the authorities to broaden the tax base, increase indirect taxation, and improve tax collection. Also to be welcomed was their intention to reform the social security system, inter alia, by reducing the burden of social security contributions on employers and by rationalizing the structure and size of benefits. Priority should be given to the implementation of those reforms in order to improve the public sector finances. Moreover, determined efforts should be made to reduce income losses of the public enterprises. The railroad company alone had accounted for 53 percent of total losses, and it would be interesting to hear details about how the authorities planned to deal with the situation of that company.

On monetary policy, Mr. Kafka observed that the target rate of growth for M-3 had been set at 13 percent in 1983, consistent with a reduction in the rate of inflation and with the targeted ratio of the current account of the balance of payments to GDP. All three targets had been met, and the authorities must be given credit for having successfully implemented a restrictive monetary policy. He encouraged them to maintain the policy selected for 1984, which foresaw a further reduction in the growth of monetary aggregates, even in the face of pressure for credit expansion by the public and private sectors and the pressure for reserve accumulation that accompanied credit stringency. Reducing the public sector pressures on the banking system would of course be far more preferable than heroic efforts to accommodate them through portfolio prescriptions.

Exchange rate management had thus far been adequate, Mr. Kafka considered. Obviously, progress toward reducing the public sector deficit was important to ensure that the course of the exchange rate would not be affected in a way that could interfere with the international competitiveness of the Spanish economy. Finally, he could support the proposed decision.

Mr. Schneider remarked that it was clear from the staff paper where improvements in the Spanish economy had taken hold and where weaknesses remained that might hinder further progress. The overall improvement of the economy during 1983 had been reflected in a rise in GDP, a reduction in the current account deficit, a drop in the inflation rate, and the containment of the budget deficit. Those developments had been accompanied by a successful observance of the broad monetary targets. In general, the improved performance could be attributed to a stronger than expected surge in foreign demand as well as to the successful implementation of the economic program adopted by the authorities. Most of the quantitative objectives of that program had been met; on the other hand, the scope of the program had been relatively modest, with the limited aim of laying the groundwork for further structural adjustment. In the circumstances, it was not surprising that fundamental weaknesses in the economy persisted. The most important structural imbalance to be tackled by the authorities had its origins in the numerous deficiencies of the public sector.

The budget deficit remained high at 5.9 percent of GDP, and he agreed with the staff that the main problem with that deficit concerned expenditures rather than revenues, although there was scope for an increase in the latter, Mr. Schneider continued. Two categories of expenditure needed urgently to be reviewed: the social security system and the public enterprises. The growth of public transfers was largely due to the high and still increasing unemployment rate, a problem that could be solved only through structural changes, including supply-side measures. And the system of unemployment benefits was subject to abuse and accounted for approximately 20 percent of the social security deficit. In addition, the structure and size of unemployment benefits required adjustment. Much relief would certainly be provided by the shift in burden-sharing from the employers to the beneficiaries of the system; and additional relief could be achieved through the planned decrease in pensions from 90 percent to 65 percent of the last year's income. While he was fully aware of the political sensitivities surrounding the issues in question, he urged the authorities to implement the program they had outlined to the staff.

Another major category of fiscal expenditure requiring review was related to the transfers from the Government to the public enterprises, Mr. Schneider observed. He had been surprised to learn that the losses incurred by the public sector enterprises had quadrupled between 1979 and 1983. Also, the Government's burden was not confined to financing those losses: the failure of the public enterprises to generate their own resources made it necessary for the Government to finance their investments as well. In addition, the capital stocks of the public enterprises seemed by and large to be obsolescent. And rigidities imposed by existing labor regulations and the past practice of granting above average wage increases to the public enterprise labor force had added to the difficulty of dealing with those imbalances.

One aspect of the problems of the public enterprise sector had not been addressed by the staff, namely, the question of management efficiency, Mr. Schneider said. Experience showed that ridigities at the management level were often an important element in the overall problems of public enterprises. He would appreciate staff comment on that point as well as an indication of the prospects for returning at least some of the public enterprises to private ownership.

Developments in the labor market had generally been negative, Mr. Schneider noted with concern. The unemployment rate had reached a critical level in 1983, rising to 20 percent, and the staff and Mr. Feito had indicated that the link between the high level of real wages and reduced investment activity had led in turn to further decreases in labor demand. However, the most important aggravating factor was the institutional rigidity inherent in the labor market regulations. Social considerations had led to a system of labor protection that left no room for maneuver, even under the most severe conditions. It was thus not surprising that the high unemployment rate did not exert much effect on the increases in real wages. In addition, the obstacles to the layoff of workers made him wonder whether hidden unemployment might not be quite high. In brief, it was crucial to find a social consensus that would remove the impediments to an increase in the demand for labor. To that end, layoff procedures should be liberalized, and real wages should be contained or reduced where they were out of line with an appropriate distribution. The negotiations on those matters initiated by the Government were important if mobility in the labor market was to be regained.

A striking feature of monetary policy was the effort of the authorities to remedy the long-standing precarious financial situation of the public sector and its enterprises through the establishment of so-called compulsory investment coefficients for banks, Mr. Schneider commented. The remedial effort had resulted in a large disequilibrium of interest rates; moreover, excessive credit demand stemming from the cash deficit of the Government had had a crowding out effect on the private sector and had led to large capital inflows. Those disequilibria and the allocation of financial resources, which had resulted from well-intentioned but inadequate policy choices, might further aggravate the structural problems facing the Spanish economy.

Another area in which corrective action was required was trade policy, Mr. Schneider considered. Protective barriers should be eliminated in order to liberalize trade flows; had such a move been made earlier, some of the problems stemming from the massive capital inflows that had occurred during 1983 would have been far less harmful. He agreed with the staff on the need to further liberalize trade policy in order to facilitate Spain's entry into the European Communities. Measures to that end should be taken prior to, rather than at the moment of, entry so as to avoid an adjustment shock that could hurt the Spanish economy further. In sum, most of the variables of the Spanish economy had showed some improvement in the recent past, but the fundamental problems of structural adjustment remained to be attacked with vigor. It was vital that the distortions of market mechanisms produced by the present configuration of public policy choices were eliminated.

Mr. Finaish considered that the 1983 economic program, which had been adopted by the Spanish authorities with a view to laying the groundwork for further and more basic adjustments, had produced some significant results. The rate of price increases had decelerated, the budget deficit--on a national accounts basis--had been in line with the targeted level, and the targets for the external current account deficit and for broad money had been met. Moreover, at 2.3 percent, the real rate of GDP growth had been the highest in six years and had surpassed the program's target; at the same time, there had been some slowdown in the rate of increase in unit labor costs in industry, accompanied by improved productivity. Those results had been achieved against the backdrop of persistent weaknesses in several areas, and the factors contributing to the continued sizable fiscal deficit, the high and rising unemployment rate, and the slower than desired progress in the structural adjustment program had been analyzed in detail in the staff papers. The staff report had also usefully highlighted the policy areas in which determined efforts would be particularly important, both for the attainment of the 1984 objectives and for the effective correction of domestic and external imbalances.

Monetary policy in recent years had been aimed at higher output growth and inflation control through a gradual deceleration of monetary expansion, Mr. Finaish noted. However, the effective management of monetary policy had been constrained in 1982 and 1983 by the financing requirements of the public sector, which had imposed an additional tightening of financial regulations entailing a reported crowding out of the private sector from domestic credit markets. That development in conjunction with high real interest rates on nonpreferential loans and high labor costs were believed to have been the major factors behind the lag in domestic private investment. In that connection, the decline of fixed capital formation for the second consecutive year seemed to reflect what some might be tempted to call a lack of confidence. At the same time, however, Table 50 of SM/84/183 indicated that, in 1983, the value of foreign direct investment in Spanish enterprises, despite the completion of certain industrial projects, had been double the level recorded in 1981. He would welcome staff comment on that phenomenon. Generally speaking, the pursuit of a continued tight monetary policy throughout the current year seemed to be consistent with the inflation and external objectives. However, as noted by others, such a tight stance would have to be supported by firm action in both the short and medium term to limit the fiscal deficit. A realization of the authorities' intention to reduce the public sector deficit to about 5.5 percent of GDP in 1984 would be an important step in the right direction, although much would remain to be done. Evidently, the attainment of that objective would depend not only on the achievement of the contemplated increase in revenues but also, to a great extent, on the containment of current expenditures.

There were two areas where major expenditure overruns had occurred in recent years, Mr. Finaish continued. It was clear from the staff papers that the weak financial situation of the public sector enterprises, which had been draining public resources, stemmed from deep-rooted structural problems that the authorities had been attempting to address in the context of industrial restructuring. Considering the nature of the problems involved and the current level of unemployment, a successful approach to the structural problems would require determined short-term measures on the supply side that would contribute to improving the allocative efficiency of existing capacity and would facilitate an appropriate reorientation of the supply of labor.

The other area of the economy contributing to budgetary weakness was the social security system, Mr. Finaish remarked. The difficulties with the system clearly reflected the unemployment situation and the underlying labor market rigidities as well as the structure of the social security system itself. In that regard, he had noted the staff's reference to the rapid growth of the underground economy and wondered about the extent to which that growth had contributed to the rise in recorded unemployment and the financial imbalance of the system. While labor market rigidities in Spain were clearly a problem that needed to be addressed, it was questionable whether employment stability should inevitably lead to rigidity if certain trade-offs were mutually accepted by the social partners. It would be interesting to know, for example, whether the Japanese experience in respect of lifetime employment in exchange for wage and benefits moderation could offer lessons for the Spanish authorities or whether the alignment of the Spanish system to that prevailing in member countries in the European Communities was necessarily more appropriate to Spain's circumstances. In any event, the proposed reform of the social security system, if fully implemented, could help to improve public finances and moderate the increase in effective wage costs, thus slowing the growth of unemployment. One noteworthy aspect of the proposed reform was the objective of balancing the system over the medium term, which seemed to be a realistic approach, in view of the unpredictability of the system's operation over a short span and of the experience of other countries in that regard.

Mr. Nimatallah stated that he was in general agreement with the staff appraisal and could support the proposed decision. The Spanish authorities had made some progress toward stabilizing the economy in recent months: monetary growth had been restrained, wage settlements had been moderate, and the exchange rate had been flexibly managed. As a result, output had risen, inflation had fallen, and the external position had improved. On the other hand, very little had been done to deal with the deep-rooted structural imbalances in the economy, particularly in the industrial sector. Long-standing rigidities persisted in the public sector finances, in the labor market, and in the financial system. It would be difficult for the authorities to translate their recent achievements into more permanent gains if those imbalances were not reduced. In the short run, there was no alternative to demand restraint, and the authorities recognized that a steady reduction in the budget deficit was necessary to sustain activities and employment in the private sector. Hence, he welcomed the measures that had been adopted to broaden the tax base and reduce tax evasion--measures that could be implemented even more strongly if government spending were brought under control.

The rapid increase in social security benefits had imposed a severe burden on the budget, and the proposed reform of the social security system would be a step in the right direction, Mr. Nimatallah continued. And he encouraged the authorities to press forward with plans to restructure the public sector enterprises, the performance of which had deteriorated in recent years; far-reaching measures were required to deal with the problems of overmanning, excess wage increases, and inappropriate investment decisions.

There were signs that fiscal policy was currently on the right course, which was important if monetary policy was to continue to operate effectively, Mr. Nimatallah considered. Without appropriate fiscal and monetary policies, the result would be either a crowding out of private investment with no new job creation or a relaxation of monetary policy leading to a resumption of inflationary pressures. That dilemma could be eased if the public sector deficit was steadily reduced over time. In that regard, continued wage restraint was vital. The authorities had set a good example thus far with public sector wage settlements, which had influenced negotiations in the private sector. Given the financial problems that many companies faced, there was clearly a need to link future wage increases more closely to productivity gains. It would be helpful if Mr. Feito or the staff could provide any further information on the discussions between the Government and the social partners for a national wage agreement in 1985/86.

Looking further ahead, Mr. Nimatallah remarked that demand restraint should be accompanied by comprehensive supply-side measures to facilitate structural change. He supported the authorities' efforts to restructure the industrial sector; it was in the longer-term interest of Spain, and of other industrial countries, to shift resources to areas where a comparative advantage existed. It was also important that Spanish industry should be in a position to benefit fully from membership in the European Communities. He thus welcomed the moves to encourage labor mobility and ease the regulations governing layoffs of workers. It was to be hoped that the authorities would also continue to promote competition and to improve efficiency in the financial sector. The present system of regulations and compulsory investment coefficients could help certain sectors on a temporary basis, but the approach should not be taken too far. Otherwise, it could turn out to be counterproductive by reducing incentives for private savings and, hence, limiting credit availability for productive use.

On a more positive note, Mr. Nimatallah welcomed the recent broadening of the treasury bill market and other innovations described by Mr. Feito. He wondered whether there was also scope for developing the capital market in a way that could help the authorities to meet more of the financing requirements of the public sector in a noninflationary manner. Finally, he agreed with the staff that the process of structural adjustment could be enhanced through a liberalization of the trade system. Action to dismantle trade barriers could promote competition and greater efficiency in resource allocation.

Mr. Clark observed that, in a number of respects, Spain's economic performance had shown marked improvement in the past two years. Still, as the staff had made clear, some substantial imbalances remained, including the persistence of a large fiscal deficit and various structural problems contributing to that deficit or resulting from it.

The borrowing requirement of the public sector needed to be tackled both urgently and systematically, Mr. Clark considered. He welcomed the steps the authorities were taking to increase fiscal revenues, particularly the measures aimed at broadening the tax base and reducing tax evasion. The authorities should also consider the staff's recommendation that employees' social security contributions should be raised from their present low levels. Revenue measures alone, however, were unlikely to provide a solution to the problem. More rigorous efforts to reduce expenditures would be needed; in particular, there was a clear need to contain the mounting burden of the loss-making public sector enterprises. The staff's observation that inappropriate accounting methods had obscured the financial position of some enterprises was disquieting and prompted him to raise two points. First, if the staff believed that the Government's projection of a 12 percent increase in transfers to the public enterprises in 1984 was optimistic, could it suggest a more realistic figure? Second, he would be interested in hearing more about any plans for privatization of public enterprises covered by The National Institute of Industry.

Still on fiscal policy, Mr. Clark welcomed the authorities' reaction to the anticipated overruns in the 1984 budget. Again, however, much of the package seemed to rely on revenue measures, and he shared the fear expressed by the staff that the proposed expenditure measures might be more in the nature of postponements than of actual reductions. On a related matter, the staff had indicated that a program for the reform of the social security system would soon be presented to parliament; he would be interested in hearing when the reform was likely to come into effect. In view of the escalation of expenditure by the regional governments in 1983, the next Article IV consultation report should pay particular attention to the evolution of the new method of revenue sharing between the Central Government and the regions. It would be important to avoid any widening of the general government deficit as a result of the devolution of financial responsibility.

The authorities were facing an unenviable dilemma with respect to monetary policy, Mr. Clark observed. On the one hand, there was a risk of crowding out through higher interest rates and an appreciating exchange rate and, on the other, the risk of excessive monetary growth and upward pressure on inflation. He would be interested in hearing how the authorities proposed to tackle that problem. On the institutional aspects of the financial situation, it was disappointing that the credit demands of the public sector had inhibited the process of liberalizing the financial system. That development raised questions about the competitive position of Spanish banks in the face of Spain's accession to the European Communities.

He welcomed the authorities' attempts to introduce greater flexibility into the labor market as a necessary counterpart to the labor shedding that would be involved in the industrial reorganization plan, Mr. Clark continued. However, he agreed with the staff that more needed to be done if employment prospects were to improve over the longer term. It had recently been reported that the authorities planned special expenditures of Ptas 100 billion on public works in 1985 to relieve unemployment. He would be grateful for any further information on that idea, with particular emphasis on how it would fit in with the overall strategy of fiscal restraint.

The flexible exchange rate policy pursued over the past two years had apparently made a substantial contribution to the improvement in both the trade and current accounts, Mr. Clark remarked. That improvement had led to a deceleration in the growth of Spain's medium- and long-term debt, and the country was continuing to meet with a favorable reception in international capital markets. Nevertheless, the medium-term scenarios provided by the staff--which, in his view, had been based on rather optimistic assumptions--served to indicate that debt service pressures were likely to persist for the remainder of the decade, which seemed to argue for keeping the current account deficit within the range of figures assumed by the staff. Finally, he shared the staff's view that early trade liberalization was desirable in its own right. The closer the authorities could move toward such liberalization in advance of their membership in the European Communities, the easier the transition would prove.

Mr. Coumbis stated that he was in agreement with the thrust of the staff's appraisal and could endorse the proposed decision. There was no doubt that the performance of the Spanish economy in 1983 had been substantially better than in previous years. All quantitative targets and most of the short-term objectives--especially those relating to the rate of inflation and the current account of the balance of payments--had been met. However, those developments had been overshadowed by the increase in the unemployment rate, which had risen to 17.9 percent in 1983--among the highest in Europe--and was expected to increase further in 1984 to 19.8 percent. That increase revealed the basic structural weaknesses and fundamental disequilibria in the Spanish economy, mainly in the labor market and in the public sector. If those problems were not confronted effectively, the achievements of economic policy in 1983 would not be sustained.

In Spain's labor market, real wages had not yet fallen, despite the expectation of a sharp increase in the rate of unemployment, Mr. Coumbis continued. According to a recent OECD report, a rise in real wages in countries of the OECD area had stopped when employment had reached a much lower level than that in Spain. Hence, wage formation in Spain must be improved, which meant that the labor market must be made more flexible. The efforts of the authorities to restructure the industry, release redundant workers, and ease the regulations regarding dismissals were welcome, as was the provision for short-term and part-time contracts that allowed layoffs during the first three years of employment.

In the fiscal area, the authorities and staff were agreed that a revival of economic activity and a subsequent reduction in the unemployment rate could not be fulfilled if the budget deficit was not reduced to lower levels, Mr. Coumbis noted. The deficit had been stabilized in 1983 at about 5.9 percent of GDP, and it was planned to cut the deficit to 5.5 percent of GDP in 1984 and to 3.5 percent of GDP by 1987. To reduce the current account deficit in 1983, the fiscal authorities had relied solely on new taxes; indeed, expenditures had actually increased from 31.7 percent of GDP in 1982 to 32.8 percent in 1983. For 1984, there had been both an increase in indirect taxes and a reduction in expenditures, although the latter had been concentrated mainly in fixed investments.

While a broadening of the tax base would be welcomed, more emphasis should be placed on restraining expenditures in the medium term, Mr. Coumbis said; and that should be done by overhauling the social security system and public enterprises. The program formulated by the Government to reform the social security system, the industrial reconversion program, and the special financial plans for the largest loss-maker among the public enterprises were all to be welcomed. The authorities were clearly aware of the fact that little progress had been made thus far in addressing the problems in the social security system and the public enterprises, and there was no doubt that improvements in those areas would require both time and great effort.

While remarkable improvement had been registered in the public sector finances on a national accounts basis, no similar progress had been observed in the public sector finances on a cash basis, Mr. Coumbis remarked. In fact, after taking into account net lending operations of the Government, the cash deficit in 1983 had been estimated at 6.4 percent of GDP, against a deficit of 5.3 percent of GDP in 1982. There were also indications that the implementation of the state budget on a cash basis in 1984 was not satisfactory. Indeed, the cash deficit of the state budget in the first five months of 1984 had exceeded by 50 percent the targets for the year, and by 82 percent the level registered in the previous year. The authorities had approved a package of corrective measures in June, but there were some doubts whether the budget deficit on a cash basis would improve. If it did not, a crowding out problem would occur in the private sector in 1984. As noted on page 13 of the staff report, "if the overshooting of the public sector borrowing requirement is not brought back during the rest of 1984, the attainment of the monetary targets...would imply negative growth of credit to the private sector...[and] 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."

The problems facing the authorities would require delicate handling, since the public reaction to the choice of policies would no doubt be strong, and the unions would probably fight against the required changes, Mr. Coumbis commented. Hence, the authorities should proceed with caution, and only after a serious study of all possible consequences. Structural changes, if they were to be successful, should be implemented on the basis of a broad consensus among those who would be affected by such changes.

Mr. Nguyen remarked that the Spanish situation gave rise to both optimism and concern. It was clear that the courageous adjustment efforts were bearing fruit, especially in the areas of inflation, the current account, and economic growth; some worrying problems remained, particularly those relating to the structural weaknesses of the economy. In general, he was in agreement with the staff appraisal and with the view that policies should focus on the budget deficit and the labor market, the two main underlying imbalances in the economy.

The most troubling problem in the Spanish economy concerned the budget, Mr. Nguyen continued. Of course, the fiscal deficit needed to be reduced, but he was less concerned about the size of the deficit itself than with certain of its components. In his view, the authorities had rightly designated the three main areas where corrective efforts should be concentrated: modernization of the tax structure; reform of the social security system; and reduction of subsidies and transfers to public enterprises. He shared Mr. Clark's concern about the slippages in the execution of the budget, but he remained confident that the authorities were prepared to take corrective action if necessary.

On monetary policy, Mr. Nguyen said that he had no major worry about the authorities' ability to control the growth rate of the monetary aggregates and his only question was related to the banks' compulsory investment coefficient; he wondered how long the measures adopted in January 1984 were expected to last and what effects they were likely to have on bank profitability. On the external side, he had no difficulty with Spain's management of the exchange rate, since Spanish products seemed to remain competitive, as evidenced by the growth in exports.

Commenting on structural problems in the economy, Mr. Nguyen considered that the main difficulty faced by the authorities at present was the current rate of unemployment, which was among the highest of all OECD countries and affected one fifth of the active population in Spain. He agreed with the staff that more flexibility should be introduced to ease the rigidities in the labor market. In particular, the restrictive laws on layoffs should be relaxed to create greater mobility, both geographically and among specific enterprises. In that regard, he would be interested in more information on the staff's allusion to the existence of an underground economy in Spain.

It was particularly important that the profitability of enterprises should be restored, Mr. Nguyen remarked. It was thus crucial to maintain wage moderation so as to reduce production costs and preserve the competitiveness of enterprises. He welcomed the apparent deceleration in contractual wage increases from the rate of the previous year; however, there appeared to be some difference of view between the staff and the authorities on whether or not wage drift had been taken into account. On another matter, he agreed with the staff that the reduction in employers' social security contributions could be counterbalanced by an increase in employees' participation. That measure and others he had mentioned were prerequisites for a more favorable economic environment, although they could not by themselves induce a rapid improvement in employment, a development that could occur only after a restructuring of industry.

The authorities had already undertaken to improve industrial policy and to focus on a restructuring of industry, Mr. Nguyen continued. Their efforts should also be aimed at halting the deterioration in the financial situation of the public enterprises and at reorganizing the banking and financial sectors. In addition, he would appreciate some elaboration from Mr. Feito on the policy of the authorities concerning the question of the financing of public enterprises--especially in light of the growing recourse to foreign credits--and on the subject of foreign investment.

In sum, Mr. Nguyen considered that 1984 would witness some easing of pressures. The real economy was likely to begin to grow once again, thanks to a good crop year and greater industrial production. Those positive developments should in turn induce a reduction in the current account deficit and a further deceleration in the rate of inflation. However, fundamental imbalances would have to be reduced if the gains made thus far were not to be eroded. The task of the authorities was by no means easy, especially given the heritage of the past. However, the positive results achieved thus far proved clearly that the right issues were being addressed. Finally, he hoped that the negotiations concerning Spain's entry into the European Communities would soon be brought to a satisfactory conclusion.

Mr. de Vries noted from the staff papers and from Mr. Feito's statement that the authorities had taken a number of important measures that showed their awareness of the problems facing the Spanish economy. While the measures they had taken were welcome, more needed to be done, especially in reducing the rigidities that had for centuries characterized the economy and its institutions. With Spain's entry into the European Communities in prospect, it was important for the authorities to overcome those rigidities and to adopt modern ways of managing the economy.

Improvements in the public finances, and particularly the reduction of the public sector deficit, were crucial, Mr. de Vries continued. By comparison with national income or with deficits in other European countries, the Spanish deficit might appear small. However, those comparisons could be misleading, since deficits were greatly influenced by what was by definition included in or excluded from the public sector. In addition, the allowable or acceptable level of the deficit was very much influenced by the propensity to save in the private sector. It turned out that savings in the so-called private sector in Spain were quite low because public and semipublic enterprises were included in that sector, and those enterprises were at the moment incurring quite large losses. Hence, very little in savings remained to finance the government deficit; and recourse to borrowing to finance the deficit increased the danger of crowding out of the private sector--a development that the Spanish authorities would not wish to see occur.

The public sector enterprises in Spain had received a great deal of attention, Mr. de Vries commented. It was important for them to cut their losses and to improve managerial efficiency, especially since they would soon be facing the rigors of competition from enterprises in other Common Market countries.

Another element of the Spanish economy that had attracted attention was the social security system, Mr. de Vries noted. He agreed with the staff that it would be desirable to increase direct contributions by participants in the social security system in order to make the necessity of equilibrating that system more apparent. It might also be necessary to scale down some of the benefits presently being granted; on the other hand, a case could also be made for widening some of the coverage. If the figures in the staff paper were indicative, total social security expenditures amounted to about 15 percent of national income; while the percentage was not particularly high, neither was the distribution very efficient.

Other structural problems existed in the labor market, Mr. de Vries observed. For example, the costs of severance were high, which discouraged employment. Indeed, the staff had calculated that employers might be wise to add 20-25 percent to labor costs as a discounted value of the severance costs that they might have to pay out. Another element requiring improvement was the relatively high level of real wages. It seemed probable that the high rate of unemployment--at about 20 percent--and the relatively disappointing record in adding to employment opportunities were clearly related to an excessive level of real wages, a problem that would increase upon Spain's entry into the Common Market. Of course, the wage rigidities might have historical roots. Labor unions had for decades been forced to fight for their political survival; with the political dangers no longer present, there might still be economic dangers to which the unions were not yet fully attuned. And if Spain was to make progress, the labor unions must establish wage and economic policies designed to fill the need for increasing employment and meeting the competition in the European Communities. On a related matter, once negotiations for Spain's entry into the European Communities were completed, it might be helpful for Spain to reduce its rather effective, but by no means beneficial, protectionism.

In passing, Mr. de Vries noted that monetary policy had been hampered greatly by the needs of the public sector for financing. Some innovative efforts to resolve the problem had been made, but it seemed necessary for the authorities first to tackle the government and public sector financial problems before any practical changes could be effected in the field of monetary policy. In sum, while he was impressed by the efforts of the new Government to address the problems of the Spanish economy, he was equally impressed by the magnitude of the problems that remained to be solved.

Mr. Joyce considered that Spain's recent macroeconomic performance had been characterized by a number of welcome developments. The new Government in Spain had clearly viewed 1983 as a year of transition, during which the groundwork was to have been laid for economic adjustment and for a return to higher employment and growth; and the Government had achieved most, if not all, of its targets for the year. However, there remained a number of imbalances that could obstruct longer-term economic progress. Continued labor market rigidities would make reductions in the unemployment rate difficult to achieve; and, notwithstanding the anticipated moderation in wages, labor costs were likely to remain far too high. Moreover, continued difficulties were being encountered in containing the fiscal deficit, which raised the threat of a crowding out of the private sector in domestic financial markets. Those financial imbalances, taken together, could jeopardize the attainment of the Government's economic targets over the short term and could give rise to strains that might threaten the longer-term international competitiveness of Spanish industry. With the prospective entry of Spain into the European Communities, it was essential that adjustment measures be pursued early and in a determined way in order to achieve greater flexibility in the industrial sector.

Unemployment in Spain was among the highest in any industrial country and was projected to increase further to 20 percent in 1984, Mr. Joyce continued. Such a rate could hardly be sustainable without serious social problems; yet, there seemed little indication that the situation could be quickly changed. Economic growth was somewhat unbalanced, and most investment was concentrated in labor-saving areas, which eroded the effectiveness of efforts to contain fiscal expenditures. He welcomed the measures being undertaken to improve labor mobility and to monitor labor costs. However, the staff had correctly noted that those measures could only be regarded as first steps. Of course, there were political constraints to making such adjustments, and he was concerned about the implications--especially in smaller communities--of labor shedding in small and medium-sized firms. Nonetheless, it must be a matter of high priority for the authorities to introduce measures that would increase the attractiveness of more labor-intensive economic expansion. Central to any such effort must be the removal of regulations that added to the cost of laying off workers. Such adjustments would greatly help efforts to reduce unemployment by increasing the direct costs of excessive wage demands and by encouraging increased employment in growth sectors of the economy.

The authorities' determined efforts to reduce inflationary pressures were encourging, Mr. Joyce remarked. However, they were being jeoparized, along with efforts to develop the domestic financial market, by the current stance of fiscal policy. While the budget deficit had been contained and the borrowing requirements had been significantly cut back, the demands of the public sector remained too high. Given the determination of the authorities to reduce inflation, the continuing large borrowing requirements of the public sector prompted a justifiable concern that they would hinder the private sector's access to domestic financial markets. The authorities had been placed in the unenviable position of either offsetting the market pressure arising from the current fiscal policy--thus putting at risk the attainment of economic growth targets--or of being too accommodating, thus risking increased inflation. He was also concerned that the Government's efforts to facilitate the financing of the deficit might have resulted in a slowing of financial market liberalization. In particular, the retention of limits on interest rates paid on various types of bank deposits was regrettable. He did of course welcome the formation of a market for public securities and commended the steps taken by the authorities to increase revenue-raising efforts, particularly the increase in indirect taxes. Further broadening and diversification of the tax base could be helpful in improving Spain's fiscal position; however, it would be a mistake for the authorities to concentrate solely on revenue-generating measures, particularly if those were to increase operating costs in the industrial sector.

He shared the staff's view that the root of the fiscal problem lay in excessive growth in expenditures, Mr. Joyce said. Social security expenditures were clearly a matter of concern, and further efforts should be taken to contain them. However, in view of the high level of unemployment, it was debatable how quickly a realistic adjustment in that area could be made. A major element in the expenditure overrun had been a faster than expected increase in transfers to public enterprises. Indeed, in 1983, capital and current transfers from the budget to the public enterprises had been equivalent to three fourths of bank credit to the Government, or 35 percent of all bank credit. Reducing the losses incurred by public enterprises must therefore be given high priority. As the staff had noted, those losses had more than doubled in recent years and were continuing to grow.

Spain's external accounts were generally sound, at least for the present, Mr. Joyce considered. Nonetheless, as the authorities themselves had recognized, some of the gains in competitiveness registered in 1983 had already been eroded. He was worried about the level of trade barriers being used to protect domestic industry. The authorities had noted that trade liberalization would accompany Spain's admission into the European Communities and that early progress in liberalizing international trade was desirable. However, such a development would result in increased competition for Spanish industry and would call for major structural adjustments. For those adjustments to proceed with a minimum of disruption, the authorities must act quickly to identify and ease structural rigidities of the sort he had already mentioned.

Finally, Mr. Joyce commended the Spanish authorities for the steps they were taking to correct fiscal and monetary imbalances. It was clear from Mr. Feito's statement that the authorities were aware of the seriousness of the underlying structural problems of the economy and were determined to deal with them as quickly as possible. It was to be hoped that they would succeed in their endeavors and that Spain would be able in the near future to take up a position as a viable and prosperous member of the European Communities.

Mr. Delgadillo said that he was pleased to note that, in 1983, virtually all the policy objectives of the Spanish authorities had been met and that the success in implementing the macroeconomic policies geared toward monetary stability had gone well beyond the simple achievement of quantitative targets. The persistent inflationary trend of the past several years had been reversed, with a reduction in the rate of growth of the consumer price index from 14 percent in 1982 to 12 percent in 1983. Moreover, significant improvement had been recorded in the external sector, with a decline in the current account deficit from 2.4 percent of GDP in 1982 to 1.5 percent of GDP in 1983. The fiscal deficit had also been contained at 5.9 percent of GDP.

Monetary developments in Spain were likely to be heavily influenced by the performance of the fiscal sector in future, Mr. Delgadillo continued. Even though restrained monetary growth thus far had helped to produce a moderation in prices, the growing financing requirements of the public sector could jeopardize the real sector targets by depriving the private sector of needed funds for investment. An increase in capital inflows could place additional pressure on exchange and interest rates and, in order to avoid conflicting policies, a permanent and careful assessment of the situation was called for, together with a more flexible use of monetary and exchange rate policy instruments when necessary. In his view, the most important task facing the Spanish authorities in the years ahead was to take additional steps to reduce the fiscal deficit so as to obtain a durable revival of economic activity. The rationalization and reform of social security contributions would certainly aid in the improvement of the public finances. On the revenue side, moreover, it would be important to proceed with a broadening of the tax base, an expansion of indirect taxation, and the adoption of a value-added tax system in 1985. In addition, the adoption of recovery plans for some of the most financially troubled public entities would add to the fiscal improvement. The June package of corrective fiscal measures was an encouraging sign of the authorities' determination to correct present imbalances.

The gradual reduction of rigidities in the labor market would greatly contribute to the adjustment effort, Mr. Delgadillo considered. Several measures had already been adopted in that area, including action to increase labor mobility. As indicated by Mr. Feito, the Spanish authorities were well aware of the fact that, unless several barriers in the labor market were lifted or dismantled, there would not be a meaningful and lasting solution to the unemployment problem. Still, he agreed with the authorities that the resolution of the problem would require some time. In sum, considerable progress had been made since the previous Article IV consultation, and the authorities should be encouraged to persist in the effort further to improve Spain's financial and economic situation.

The staff representative from the European Department said that it was difficult to assess whether the apparent deceleration in labor shedding in the agricultural sector was of a permanent nature. Job opportunities were nonexistent in the cities and, given the family structure in Spain, there was probably at present a greater amount of hidden unemployment in the agricultural sector than there might have been earlier, as people returned from the cities to their rural roots. As to whether or to what extent an increase in employment in industry could be expected, there were grounds for hoping that employment would not rise too rapidly, given the need to reduce overmanning in the public sector enterprises and the great difficulty that had been experienced in accomplishing that goal. For the time being, the focus should be on imparting greater flexibility to the labor market, thereby creating employment opportunities and offsetting the required reduction in overmanning in large enterprises, both public and private. It was difficult to forecast the speed at which employment could begin to grow again, although there were indications at present that the decline in employment was beginning to flatten out.

As to the extent to which the pricing policies of the public sector enterprises had contributed to the losses those enterprises had experienced, the staff representative noted that, according to the authorities, pricing policies were the least important part of the problem. Prices, even in the monopolies such as the electricity and railroad companies, were being adjusted upward in line with what normal profitability in those activities should be. The basic problem with the public sector enterprises lay in overmanning and/or in the inability of enterprises to shift quickly to other lines of production. As to whether or not the losses could be curtailed by reselling some of the enterprises to the private sector, it should be remembered that a large part of the problem had arisen because the public sector had taken on the loss makers from the private sector through nationalization. It would at present be difficult to find buyers in the private sector, particularly if it was clear that they would have to take over the existing labor force and would have to deal with inflexibility in production schedules of the sort that had been brought about by management deficiencies in the existing public enterprises. The authorities were aware of those deficiencies and were developing guidelines for improving management. However, over the years, managers had been operating with a woefully inadequate accounting system; hence, it was a difficult matter simply to separate those lines of production that were profitable from those that should be phased out.

In response to Mr. Clark's request for a more realistic estimate of transfers to enterprises in 1984, the staff representative explained that it was difficult to say what was "realistic" in the circumstances, in part because so much depended on when the Government would make payment on some of the enterprises' losses it had assumed. There were time lags that made estimates of the transfers quite difficult. All that could be said was that, in the staff's view, the projections and estimates provided by the Government were optimistic.

Regarding the so-called underground economy, the staff representative remarked that, precisely because it was an underground economy, it was difficult to tell what effect it had on unemployment figures. The authorities themselves had not undertaken the sort of study that could have indicated the size of the underground economy, although it was their view that its effects were significant. It was difficult to be precise about the extent to which overall unemployment had been underestimated. It was clear that a large number of those earlier listed as unemployed were again fully employed, in part because they were no longer collecting unemployment benefits. On the other hand, the fall in labor force participation rates certainly must indicate some employment in the underground that was not being recorded in any of the statistics.

As she understood it, wage increases in the 1984 agreements included wage drift for the public sector but not for the private sector, the staff representative continued. As for 1985/86, the Government was in the process of negotiating contracts with unions and with business, but no agreement had yet been reached.

Commenting on the effects on bank profitability of the measures adopted in early 1984 and of the changes in the investment coefficient, the staff representative remarked that bank profitability was not a major concern with regard to the regulatory system. The spreads were quite large, mainly because deposit rates were low and because lending rates on unregulated credits were quite high. Those spreads were being protected by the oligopolistic nature of the banking sector in Spain. The staff doubted that the changes in early 1984 had been detrimental to bank profitability, since the reserve requirements were being remunerated at a higher rate as of January 1984.

The staff was supportive of all that had been said by Directors regarding the need to develop a broader and deeper capital market, the staff representative commented. The effort to sell government debt directly to the public was a helpful sign, although the appropriate institutions clearly needed to be developed and, as had been noted by the authorities on several occasions, difficulties arose in developing a proper network, largely because it was not always in the interest of the banking community to aid that effort.

It had been asked why foreign direct investment had doubled between 1981 and 1983 while, at the same time, investment activity in Spain had been generally depressed, the staff representative from the European Department recalled. Foreign direct investment represented only a small proportion--about 4.5 percent--of total nongovernment investment. Still, the fact that it had doubled had been due in part to the lumpiness of such investment. For example, a General Motors plant, which had opened in 1984, represented the majority of recorded investment in 1982 and 1983. Part of the attractiveness of Spain to foreign investors was related to that country's prospective entry into the European Communities; furthermore, considerable incentives were being provided to foreign investors that were not available to domestic or resident investors. Moreover, foreign investment was highly capital-intensive and did not provide the extent of job opportunites that might have been hoped for. That fact was not unrelated to the rigidities in the labor market that, despite an enormous labor reserve, continued to dictate that capital-intensive investment was less risky than labor-intensive investment.

The Executive Directors agreed to continue their discussion in the afternoon.

3. EXECUTIVE DIRECTOR

The Acting Chairman bade farewell to Mr. Laske at the conclusion of his service as Executive Director for Germany.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/125 (8/8/84) and EBM/84/126 (8/10/84).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/27 and 84/28 are approved. (EBD/84/211, 8/3/84)

Adopted August 9, 1984

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/167 (8/7/84) is approved.

APPROVED: May 23, 1985

LEO VAN HOUTVEN
Secretary