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March 25, 1983

To: Members of the Executive Board

From: The Acting Secretary

Subject: Spain - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Spain. A draft decision appears on page 17.

This subject has been tentatively scheduled for discussion on Friday, April 22, 1983.

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INTERNATIONAL MONETARY FUND

SPAIN

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983 Article IV Consultation with Spain

Approved by L. A. Whittome and Subimal Mookerjee

March 23, 1983

I. Introduction

A staff team consisting of Mrs. T. Ter-Minassian, Messrs. D. Lachman, L. Perez, E. Croce, Ms. K. Swiderski (all EUR), and as secretary Ms. C. Nguyen (ADM) visited Madrid from January 25 to February 7, 1983 to conduct Article IV consultation discussions. The mission met with the Minister of Economy and Finances, Mr. M. Boyer, the Governor of the Bank of Spain, Mr. J.R. Alvarez Rendueles, and with officials of the Ministries of Economy and Finances, Industry and Labor and of the Bank of Spain. Mr. J.L. Feito, Alternate Executive Director for Spain, attended the meetings as observer. Spain continues to avail itself of transitional arrangements in Section 2 of Article XIV of the Articles of Agreement.

II. Report on the Discussions

1. Background

Since 1975 the Spanish economy has been characterized by a combination of near-stagnation of activity, a sharp rise in unemployment and the persistence of a relatively high rate of inflation. The current account of the balance of payments, which had improved strongly as a result of a stabilization effort in 1977-78, reverted to a sizable deficit (equivalent to 2.4 per cent of GDP) in 1980, reflecting the impact of the second oil shock as well as of the appreciation of the peseta in 1978-79.

The factors responsible for the relatively poor performance of the Spanish economy over the last few years are several and complex. Structural weaknesses ranging from a relatively high dependence on imported oil to widespread rigidities in the productive structure, in the labor market and in the financial system undoubtedly played a role. Also important were the uncertainties associated with the political transition. There is little doubt, however, that a major role was played by the sharp increase in real wages that took place between 1974 and 1981, in response to strong union pressures in a changed social environment.

Although the rate of increase in real wage rates decelerated significantly toward the end of the period, the cumulative increase (42 per cent), which took place against the background of a substantial deterioration of the terms of trade (Chart 1), exceeded by far those in other OECD countries. In the face of escalating labor costs and of the consequent pressure on profits, enterprises reacted by progressively cutting back on the expansion of output and capacity. As a result, between 1974 and 1981 the ratio of fixed investment to GDP dropped from 24.5 per cent to 19.5 per cent, while total employment declined by over 16 per cent and unemployment reached 15.5 per cent of the labor force by the end of 1981.

The stagnation of activity and sharp rise in unemployment contributed in turn to a marked deterioration of the public sector finances. From the mid-1970s to 1982 the overall balance of the General Government shifted from a small surplus to a deficit equivalent to 6 per cent of GDP (Chart 2) as a relatively sustained growth of revenues was far exceeded by the increase in expenditure, which rose by the equivalent of 12.4 percentage points of GDP. The rapid growth of public spending reflected the deepening crisis of Spanish industry which led to an escalation of social security outlays for unemployment compensation and for early retirements, and to a proliferation of subsidies and transfers to enterprises in difficulty. Superimposed on these factors was the rapid growth of other social expenditures, especially pensions, in reflection of improvements in the coverage and benefits of the social security system (see Appendix II of RED).

2. Recent economic developments

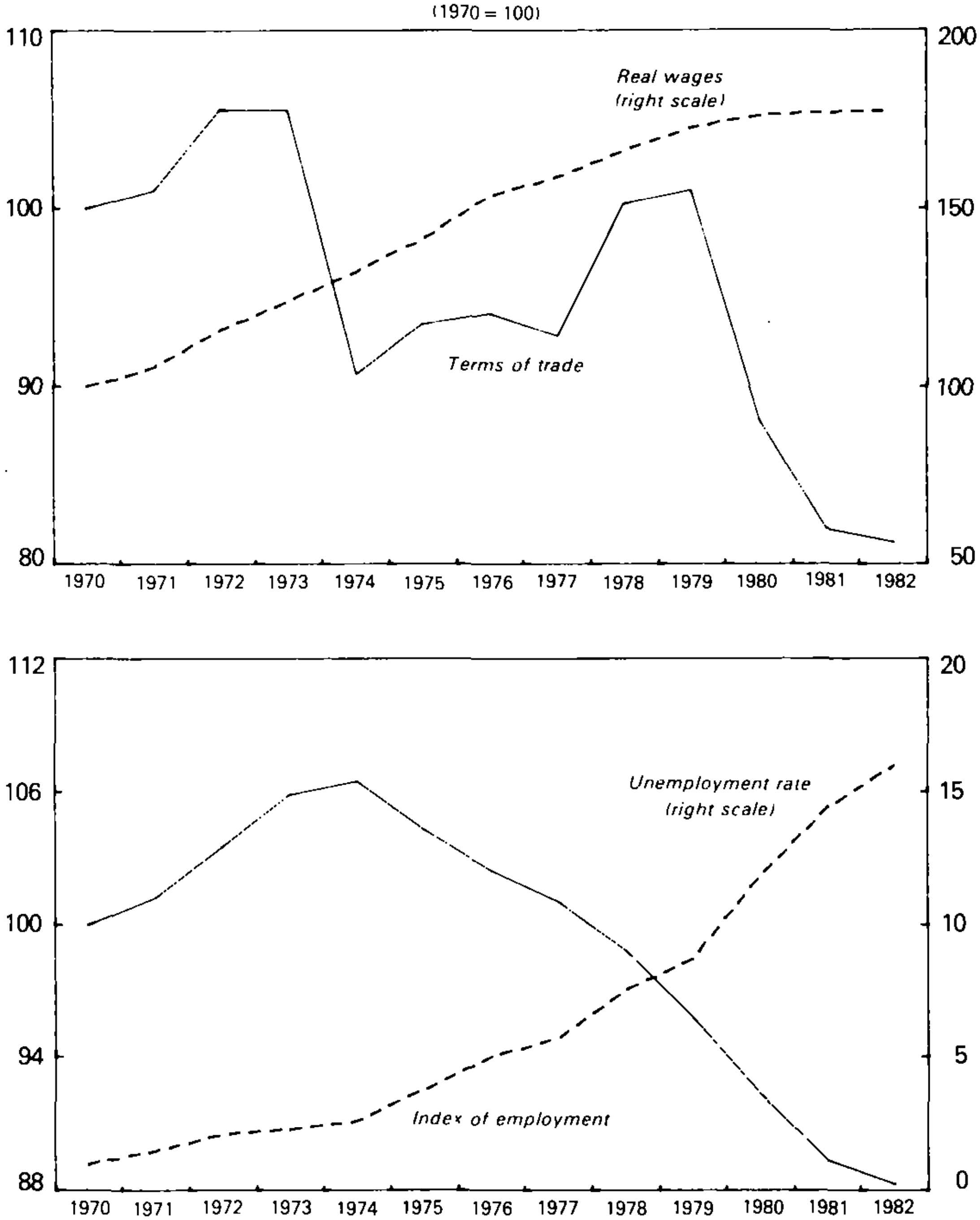
The initial stance of economic policies in 1982 was primarily shaped by the objective of curbing the unrelenting rise of unemployment. In June 1981 the authorities successfully sought the agreement of the main trade unions and of the employers' federation to a 9-11 per cent band for wage settlements which, in the light of the 12 per cent target for inflation, was expected to result in an average cut of 2 per cent in real wages. As counterpart, the Government undertook to promote employment creation through a stepped up program of public investment and through fiscal incentives to private investment. Significant improvements were also envisaged in unemployment compensation and in some specific employment promoting schemes. The attendant costs for the budget were to be compensated by efforts to moderate the growth of other items of current expenditure and by selective increases in tax rates, so as to allow a small decline of the deficit of the General Government to 3.2 per cent of GDP in 1982. In order to accommodate a positive growth of credit to the private sector in real terms, the target rate of growth of the broad money supply was set at 15.5 per cent with a 2 percentage point band on either side of the central target. This stance of economic policies was expected to be consistent with a pickup in the rate of growth of real GDP to 2-3 per cent from 0.3 per cent in 1981, some recovery of employment, and a deceleration in the rate of consumer price inflation from 14.5 per

CHART 1

SPAIN

LABOR MARKET DEVELOPMENTS, 1970-82

(1970 = 100)

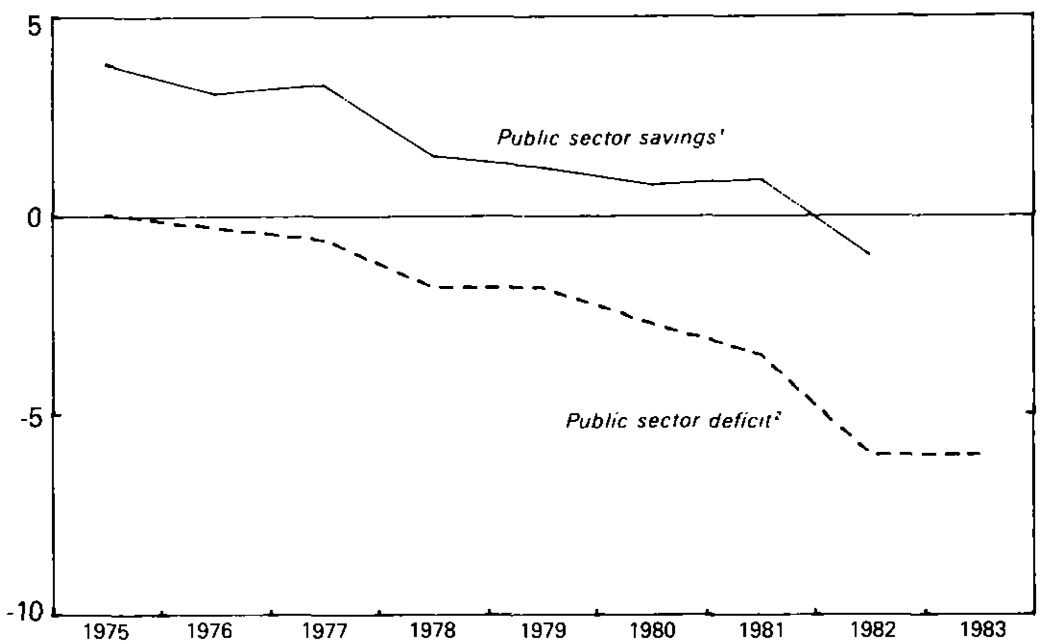


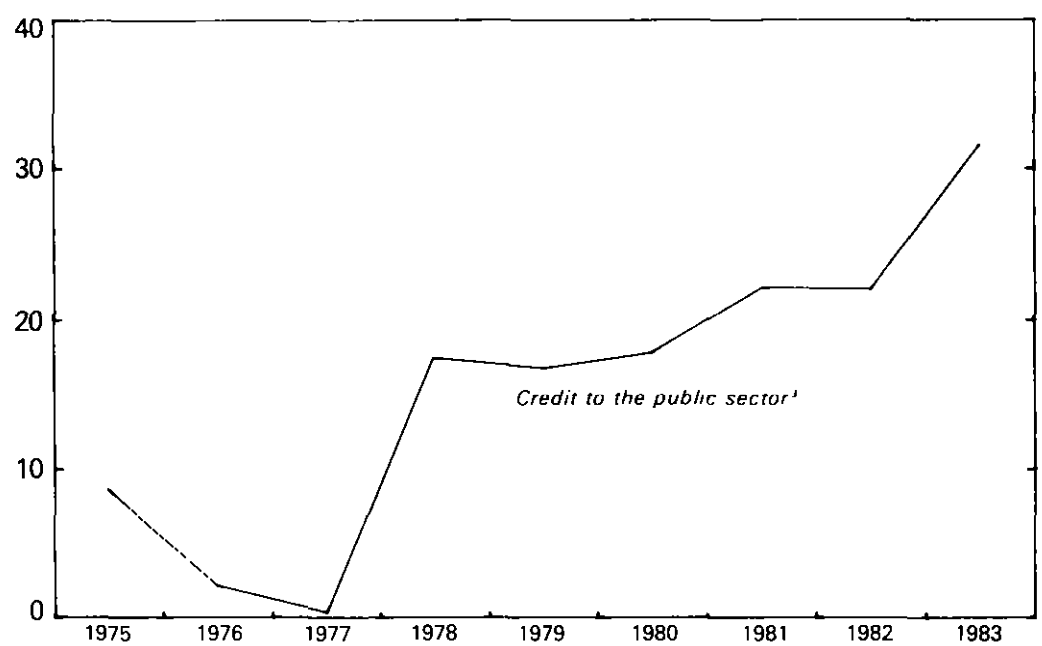
Sources: Bank of Spain, Annual Report, and staff estimates.

CHART 2

SPAIN

TRENDS IN PUBLIC FINANCES AND CREDIT TO THE PUBLIC SECTOR





Sources: Bank of Spain, *Annual Report* and data provided by the Spanish authorities.
[1]Current account of the General Government as a percentage of GDP, left scale.
[2]Overall deficit of the General Government as a percentage of GDP.
[3]Share of credit to the public sector in total domestic credit expansion.

cent to 12 per cent. The current account deficit of the balance of payments was projected to decline to US$3.5-4 billion (1.5-2 per cent of GDP).

However, significant slippages, especially marked in the budget area, occurred in 1982. Along with a less favorable than anticipated international environment, they were largely responsible for an outturn which fell well short of expectations. Wage settlements averaged an estimated 11.5 per cent after the activation in the second half of the year of a revision clause which permitted an upward adjustment of contractual wages to reflect the excess of the rate of inflation during the first half of the year over the official target. This fact, in combination with a significant wage drift, led to an increase in average wage rates in the private sector broadly in line with the rate of inflation.

The higher than expected increase in labor costs contributed to the continuation in 1982 of the process of labor shedding which has characterized the Spanish industry, especially in small and medium enterprises, over the last few years. According to preliminary estimates, employment in industry declined by about 6 per cent, while overall employment in the private sector fell by over 2 per cent. Despite a significant increase in the number of civil servants, total employment declined by over 1 per cent leading to an increase in the unemployment rate to about 17 per cent by year-end.

Major overruns were recorded in the implementation of the 1982 budget, partly in reflection of the worsening labor market conditions and of the deepening crisis in some sectors of industry. The comparison of the 1982 outturn with previous years is made difficult by some changes in procedures for recording certain items of revenue and expenditure (see Section II of the RED paper). These factors also affect the comparison between the outturns on a national accounts and on a cash basis. Nevertheless, it is clear that the deficit of the General Government for 1982, tentatively estimated at nearly Ptas 1,200 billion (6 per cent of GDP) far exceeded the initial target of 3.2 per cent of GDP (Table 1). The overrun was mainly due to higher than budgeted expenditures, as a sizable shortfall in direct tax receipts was largely compensated by a greater than expected increase in indirect taxes and social security contributions. Overruns in expenditure were especially pronounced in social security benefits, including unemployment compensation, and in current and capital transfers to enterprises. Fixed investment also exceeded the initially budgeted amount by a sizable margin, as supplementary appropriations for public projects were voted in the course of the year to support employment in particularly depressed regions.

The higher than expected financing requirements of the public sector posed severe constraints on monetary policy in 1982. Despite a relatively successful effort to promote the placement of short-term Treasury bills with the nonbank public, the proportion of the cash deficit of the General

Government financed through resort to the Bank of Spain rose from 70 per cent in 1981 to 74 per cent in 1982. The financing of the public sector, coupled with an accommodating stance toward an increased demand for credit by the private sector, led to a monetary policy that was clearly expansionary in the first few months of the year. The private sector demand for domestic credit was boosted by developments in the covered interest rate differential with abroad. Monetary policy was, however, somewhat tightened in mid-year and interest rates were allowed to rise in response to growing pressures on the capital account of the balance of payments. For the year as a whole total domestic bank credit rose by 19.6 per cent. The growth of M_3 did not exceed significantly the 16 per cent target as a result of a sharp decline in net foreign assets of the banking system (Table 1).

The expansionary stance of financial policies, along with an unexpectedly strong increase in food prices, contributed to an acceleration of inflation in the first half of the year to an annual rate in excess of 16 per cent. Although the rate of increase in consumer prices abated significantly in the second half, the average rate of inflation at 14.4 per cent exceeded the target by over 2 percentage points. On the other hand, the easing of financial policies did not provide a sustained boost to activity. Demand and output staged a modest recovery in the early months of the year, partly on the strength of a good performance of exports, but the pace of activity slackened significantly in the course of the year in response to a downturn in exports and in investment. For 1982 as a whole the rate of growth of GDP is estimated at between 1 per cent and 1 1/2 per cent, with public consumption and the foreign balance providing the main supports (Table 2).

The current account of the balance of payments improved significantly in 1982, with the deficit declining to an estimated US$4.1 billion (2.3 per cent of GDP) from over US$5 billion in 1981. The main factors responsible for this improvement were a good performance of receipts from tourism and a sharp decline (8.5 per cent) in the volume of energy imports. A spurt in the growth of merchandise exports in the second half of 1981 was followed by a marked deceleration in the course of 1982, mainly in reflection of the downturn in external demand. Nonenergy imports rose by over 4 per cent in volume (a rate well in excess of what could have been expected on the basis of historical elasticities) partly reflecting speculative factors, as pressures on the peseta mounted during the year. On the basis of preliminary estimates, it appears that the terms of trade deteriorated slightly as exporters moderated increases in their prices to gain market shares in the face of sluggish demand (Table 3).

The capital account of the balance of payments weakened substantially in 1982 in response to relatively easy domestic credit conditions, to the maintenance of a level of real interest rates below those prevailing abroad and to growing speculation on the exchange rate. As a result, net private medium- and long-term capital inflows declined to just over US$200 million in 1982, compared with over US$3.6 billion in 1981. Also commercial banks reduced their net foreign indebtedness by about US$300 million. The current account deficit in 1982 was financed mainly by a US$1 billion net inflow of capital through the public sector and by a loss of reserves equivalent to US$3.3 billion. At the end of the year official international reserves (with gold valued at about US$250 per ounce) stood at about US$11 billion, of which US$6.9 billion (about 12 weeks of f.o.b. imports) was represented by foreign exchange. Medium- and long-term external debt at the end of September 1982 stood at the equivalent of US$27.4 billion (about 15.5 per cent of GDP). Its average maturity was about five years, having increased significantly over the last few years. Net short-term foreign liabilities of the commercial banks stood at the equivalent of about US$6 billion at the end of October 1982. The ratio of interest and amortizations of medium- and long-term debt to exports of goods and services reached 21 per cent in 1982.

In 1982 the peseta continued to depreciate both vis-à-vis the U.S. dollar and, to a lesser extent, in effective terms. During the first 11 months of the year the exchange rate depreciated by 18.5 per cent with respect to the U.S. dollar and by 6 per cent in effective terms. However, in real terms (as measured by relative consumer prices adjusted for exchange rate changes) the peseta only depreciated by 1 1/2 per cent during the same period, and in November 1982 it stood at 12 1/2 percentage points above the previous peak reached after the 20 per cent devaluation of August 1977 (Chart 3). Against the background of a significant deterioration in the export performance in the second half of 1982, of the maintenance of the current account deficit at around 2 per cent of GDP in the face of a nearly flat domestic demand, and especially of considerable pressures on the capital account of the balance of payments despite some tightening of monetary policy since mid-1982, the newly elected Government announced on December 4, 1982 an 8 per cent depreciation of the peseta. This measure was accompanied by an increase in bank reserve requirements, by the setting of the monetary target for 1983 at 13 per cent and by some increases in administered prices. From December 6, 1982 to the end of January 1983, the exchange rate depreciated by 1 1/2 per cent vis-à-vis the U.S. dollar and by over 2 per cent in effective terms.

3. Economic policies for 1983

a. The overall strategy

The situation confronting the new Spanish Government at the outset of its mandate is difficult, with unemployment nearing 17 per cent of the labor force, and inflation, albeit decelerating, remaining at a rate nearly double the average of industrial countries. The Spanish authorities are aware of the constraints that the domestic and, even more, the external environment pose on economic policy in the near term. They are particularly conscious of the dangers that, as evidenced by the experience of 1982, an expansionary stance of financial policies would create for the current and especially the capital account of the balance of payments and for inflation. Therefore, they view 1983 as a year of adjustment in which progress is to be made on inflation and the external accounts primarily through a significant tightening of the stance of monetary policy. If achieved, this progress should enable the Spanish economy to resume a sustained rate of growth once the international recovery gets firmly under way. Specifically, the authorities are targeting a modest acceleration in the rate of growth of GDP to around 2 per cent, a decline of inflation to 12 per cent by year-end and a reduction of the current account deficit to around US$3 billion (1.5 per cent of GDP). In the area of wage policy, they are seeking the maintenance of the purchasing power of wages, which they believe would be consistent with a modest increase in the profit share in national income, in the light of the expected increase in productivity.

The Spanish representatives underlined that the strategy for 1983 had to be viewed in a medium-term horizon. While recognizing that for this year it would be difficult to avoid a further worsening of the labor market conditions, they were hopeful that the resumption of a faster growth in the following years would allow a recovery in employment and, eventually, a decline in unemployment. In this respect they attributed importance to the Government's objective of stabilizing real wages over the next few years, so that the benefits of a faster growth rate of output would be reflected in employment. The medium-term strategy is to be articulated in detail in the four-year Plan that the Government intends to present in the autumn, in conjunction with the 1984 budget.

b. Monetary policy

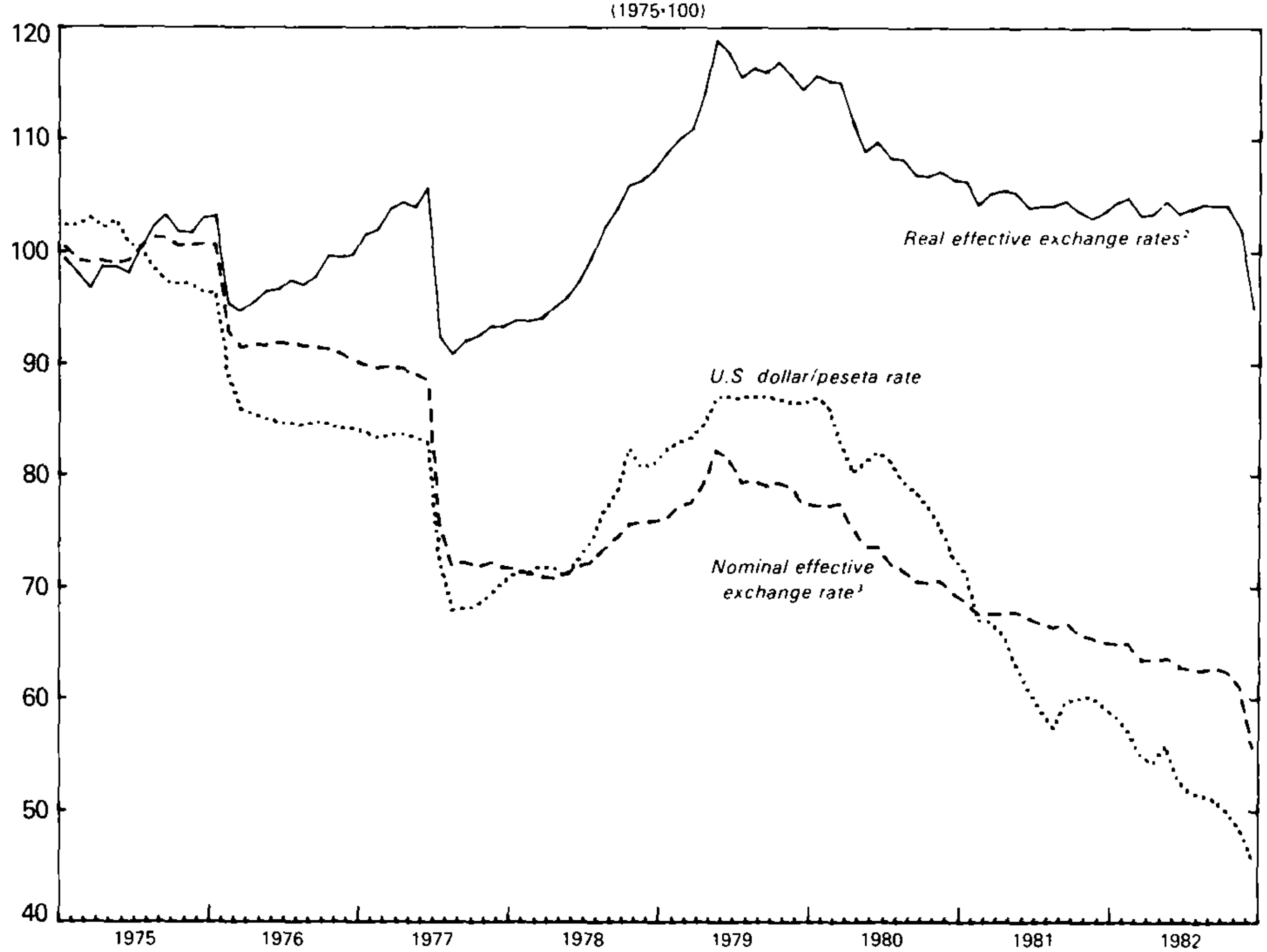
Monetary policy is to play a central role in the economic strategy for 1983. Through the setting of a target rate of growth of broad money (M_3) at 13 per cent, 3 percentage points below the rate recorded in 1982, the authorities intend to signal to economic agents at home and abroad the priority attached to a moderation of inflation and to an improvement of the external position in 1983. The monetary target which *prima facie* would appear moderately restrictive in the light of the official targets for growth and inflation, has to be seen against the background of the relative ease in liquidity conditions prevailing at the present time after the rapid expansion of the monetary aggregates in 1982. It should also be viewed against the background of the trend evident in recent years of diversification in the public's portfolio toward types of financial assets, such as Treasury bills and commercial paper, which are not included in M_3. The Spanish authorities reckon that the 13 per cent target for M_3 would be consistent with a growth of total liquid assets of the private sector of around 15 per cent. Finally, the existence of a 2 percentage point band on either side of the central target provides an element of flexibility in the management of the monetary aggregates.

CHART 3

SPAIN

EXCHANGE RATE INDICES, 1975-82[1]

(1975=100)



Sources: IMF, *International Financial Statistics*, and staff estimates.

[1] The weights were based on the average distribution of export and import trade with 14 industrialized countries in 1975.

[2] Relative price levels (Spanish price index over partner country price index) were measured by consumer price indices.

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

The degree of restraint with respect to credit to the private sector implied by the M_3 target will depend crucially on the ability of the Government to check the growth of the public sector deficit and to increase its nonmonetary financing. The initial monetary budget for 1983 envisages a cash deficit of the General Government of Ptas 1,240 billion (Ptas 1,370 billion if net lending by the Treasury to official credit institutions is included) of which about Ptas 920 billion (equivalent to a contribution of 5.6 percentage points to the growth of M_3) is expected to be financed through domestic bank credit and about Ptas 150 billion through external credit. The rate of growth of domestic bank credit to the private sector consistent with these projections (and with a loss in net foreign assets substantially smaller than in 1982) would be around 13 per cent.

The Spanish representatives recognized that the effort to diversify the financing of the public sector deficit envisaged in the initial monetary program was relatively modest, as the share of nonmonetary financing would show a small decline compared with 1982. They felt that the scope for raising medium- and long-term financing above the targeted amount was limited by the relative narrowness of capital markets and by the need to preserve adequate room for the recourse to these markets by public and private corporations. They were more optimistic about the scope for increasing the public sector financing through short-term Treasury bills. They pointed out, however, that the stepping up of efforts in this direction, which had begun in 1982 through the issue of pagares del Tesoro of up to one year maturity directly to the public, was likely to encounter opposition by the banks, concerned with the competition to deposits from these instruments.

The banks' opposition to increases in rates on deposits is partly related to the constraints placed on their portfolio by the existence of investment coefficients which require them and the savings institutions to place a portion of their assets in securities, notably of official credit institutions, bearing relatively low rates of return (see Appendix III of RED paper). The Spanish representatives indicated that the Government would be reluctant to consider a further reduction in these coefficients, which are deemed necessary to secure the channeling of an adequate flow of medium- and long-term credit to investment and exports and to priority sectors. However, the authorities are considering the possibility of raising the returns on these securities to levels closer to market rates. More generally, the authorities agreed with the staff that considerable flexibility in the management of interest rates would be required in 1983 to ensure adherence to the announced monetary target in the light of the prospective borrowing requirements of the public sector.

c. Fiscal policy

The Spanish representatives underlined that the appearance of a significant dissaving in the general government accounts and the marked jump of the overall deficit between 1981 and 1982, from about Ptas 605 billion (3.5 per cent of GDP) to Ptas 1,194 billion (6 per cent of GDP) was in part a reflection of deficits which had been incurred by some public entities, notably by the social security system, in previous years and which had been covered by budgetary transfers in 1982. This process of clarification of the financial position of some public entitites is to continue in 1983 with the presentation to Parliament of an extraordinary budget, proposing appropriations amounting to about Ptas 500 billion to cover past expenditures or deficits of various public entities, as well as about Ptas 160 billion to finance expenditures already proposed to Parliament in the course of 1982 but not yet approved. Of the total Ptas 661 billion additional expenditures included in the extraordinary budget, only about Ptas 322 billion are expected to have an impact on liquidity, since the other Ptas 339 billion have been already financed through Treasury operations. It is the authorities' intention to spread the disbursement of the expenditures with a monetary impact over the next two years to ensure that the overall cash deficit of the General Government in 1983 remains within the official target of Ptas 1,240 billion.

The 1983 budget proper was still in preparation at the time of the consultation discussions, because of delays resulting from the change in Government. It is scheduled to be presented to Parliament at the end of March 1983. Nevertheless, the authorities had already defined the main lines of budgetary policy for 1983. The fiscal policy objective is to contain the deficit of the General Government (on a national accounts basis) to the same level in relation to GDP as in 1982. On the revenue side, the effort to secure the achievement of this target is to be articulated along the following main lines. The ratio of tax revenues to GDP is to be raised by about 1 percentage point (to about 15 per cent) through increases in the rates of selected indirect taxes, reductions in exemptions and deductions for various direct taxes, a modification of the schedule of withholdings for the personal income tax and a more vigorous enforcement effort. A small increase is expected in the ratio of social security contributions to GDP (to 12.7 per cent) as a result of modifications in the rate schedule and in the coverage of the base of such contributions, in particular those financing unemployment benefits. Finally, an additional boost to revenues is expected from the raising of various user fees (especially by local authorities) and by increases in administered prices for some public services. The Spanish representatives indicated that, in the view of the Government, there would be scope for a further moderate increase beyond 1983 in the tax ratio (including social security contributions), which at less than 27 per cent remains well below the average level (35 per cent) prevailing in major industrial countries. Over the medium term this increase would have to be achieved primarily through a reduction of evasion and a rationalization of the structure of indirect taxation, particularly through the introduction of a value-added tax currently envisaged for 1984.

The authorities recognized, however, that in the light of the possible adverse effects of a rapid growth in the tax burden, the heart of the adjustment effort in the public finances would have to lie on the expenditure side. They underlined that some of the factors responsible for the escalation of public expenditure over the last few years were rooted in institutional and structural weaknesses which could not be corrected easily in the short run. Therefore the corrective effort was going to proceed along two main lines: one consisting of steps to check the growth of spending in 1983 and the other encompassing structural reforms, notably in the areas of the social security, local finances and support to public and private enterprises.

For 1983 the authorities recognized the importance of securing a substantial moderation in wages of the public administration and the public enterprises. Negotiations had begun with the relevant unions and the objective of the Government was to secure a settlement at the lower end of the band established in the nationwide wage agreement. As concerns social benefits, pensions had been adjusted upward in a graduated fashion at the beginning of the year, with the average increase amounting to 13 per cent. Despite the fact that steps were being taken to tighten eligibility requirements for certain types of pensions, notably disability, the number of pensioners was expected to continue to increase at a significant rate. Also a relatively rapid increase was expected in unemployment benefits, in reflection of an anticipated further rise in unemployment. The Spanish representatives noted that, as a result of measures taken in 1982 to reduce the length of the period of eligibility for unemployment benefits, the coverage of the unemployment compensation scheme had declined somewhat, a fact that could give rise to significant social pressures. Additional savings in social expenditure in 1983 were expected from measures envisaged in the area of health. Over the medium term, the authorities recognized the need for a comprehensive reform of the social security system that would distinguish between a minimum level of benefits to be financed by the budget and a fully contributory system to provide additional benefits. This reform was being studied at the present time with the objective of presenting it to Parliament in mid-1984.

Transfers to enterprises in difficulty were a matter of concern. The Spanish representatives underlined that the financial position of many major public and private firms, particularly in sectors such as steel, shipbuilding, mining and automobiles, had become critical. The reasons for this deterioration ranged from inadequate pricing policies in some instances, to excessive wage increases, overmanning and inappropriate investment decisions in others. The restructuring and reconversion programs initiated over the last two years as well as special budgetary support schemes, such as that provided to the State holding company (Instituto Nacional de Industria) INI, had had limited success in securing a sustained improvement in the finances of the enterprises concerned. The authorities saw the need for integrating the budgetary support in a well defined industrial policy strategy, which would identify sectors and lines of production with growth potential and allow the necessary reductions of capacity and employment in sectors that did not have such potential. The Government also intended to establish better mechanisms for monitoring the performance of enterprises enjoying budgetary support.

A further area of difficulty regarded the finances of local and regional authorities. The ongoing process of regional decentralization carried a significant risk of leading to some duplication of functions between the central and regional levels of Government and to a consequent growth in public employment. Steps were being taken to encourage the transfer of public employees to the newly created regions. The Government was also studying ways of increasing the autonomous revenue raising capacity of regional and local authorities, and of tightening control over their recourse to domestic and external borrowing.

d. Labor market policies

During the last few years sectoral wage negotiations in Spain have been largely conducted within the framework of a national agreement between the unions and the employers' federation. The role of the Government has varied over time. In certain years the authorities have chosen not to intervene explicitly in the agreement while in others, notably in connection with the conclusion of the Acuerdo Nacional sobre el Empleo (ANE) for 1982, the Government has been a full-fledged partner to the negotiations. The Spanish representatives noted that this procedure for wage bargaining had had costs and benefits. On the one hand, the setting of a relatively narrow band for wage settlements at the sectoral level had limited the scope for differentiation of wage increases to reflect variations in productivity and in financial conditions among enterprises. On the other hand, the conclusion of national agreements had resulted in a marked decline of industrial conflicts.

The negotiations for the 1983 national agreement took place between December 1982 and January 1983 without explicit official intervention. However, the Government set as a broad objective for this year the maintenance of the purchasing power of wages. The agreement negotiated between the unions and the employers' association envisages a band for wage settlements between 9 1/2 per cent and 12 1/2 per cent, significantly higher than that contemplated in the ANE for 1982. The agreement also contains a revision clause stipulating that, if the rate of consumer price inflation beween the end of 1982 and the end of September 1983 should exceed 9 per cent, the excess would be reflected in an upward adjustment of contractual wages at the beginning of 1984.

The Spanish representatives recognized that in the light of the nationwide agreement and of the likelihood of some wage drift, which in recent years has averaged 2-3 percentage points a year, there was a significant danger of some acceleration of wage costs in 1983 compared with 1982. This danger is heightened by the proposed legislation to set a ceiling of 1,820 on the number of hours worked per year. A precise quantification of the impact of this measure on labor costs is made difficult by the fact that the number of hours actually worked per year varies greatly among sectors and enterprises of different size. The Spanish officials estimate that the reduction in the workweek will raise labor costs on average by around 1 1/2 per cent in 1983 and by a further 1 1/2 per cent in 1984, since the measure is not expected to come into effect until the middle of this year.

The Spanish representatives recognized that, in the light of the experience of other countries, little beneficial impact on employment could be expected from the reduction of the number of hours worked per employee. They thought that measures, such as the introduction of temporary or part-time contracts, taken over the last couple of years to reduce rigidities in the labor market might be more promising in this respect. The process of reduction in the work force, that has taken place over the last few years, appears to have strengthened the position of parts of Spanish industry, especially small and medium enterprises. However, a sizable degree of overmanning remains in large enterprises, especially in sectors in difficulty. Therefore the Spanish authorities saw little scope for a sustained recovery of employment until a pickup in the international cycle would allow a stronger expansion of domestic demand and output. They also stressed that, in this respect, an important role should be played by industrial and public investment policies concentrating financial support by the public sector on those lines of industry that offer greater promise for sustained employment generation over the medium term.

e. External policies

The Spanish authorities noted that the depreciation of December 1982 has restored the overall competitive position to a level which, albeit significantly below its previous peak, is, in their view, sustainable and consistent with the objective of securing a further significant improvement in the current account position in 1983. They indicated the intention to continue to manage the exchange rate flexibly so as to ensure the broad maintenance of the overall competitive position at that level. They were hopeful that such a management of the exchange rate would be consistent with a further improvement of competitiveness vis-à-vis major European currencies.

The continued weakness of the current account over the last three years has been reflected in a sizable increase in the external debt. The Spanish representatives agreed with staff projections suggesting that, even on relatively optimistic assumptions about the trend of foreign real interest rates and of export receipts, the current account deficit over the next few years should not exceed on average 1-1 1/2 per cent of GDP if the debt service ratio is to be gradually reduced from the current

21 per cent to around 15 per cent by the end of the eighties. They noted that medium- and long-term external borrowing was closely monitored and controlled by the monetary authorities and by a special interministerial committee, with a view to ensuring an orderly access of Spanish borrowers, particularly public entities, to foreign capital markets. The terms obtained by Spanish borrowers have generally compared favorably with those of countries of similar size and level of development. For 1983, the authorities intend to pursue a policy of currency diversification in their foreign borrowing operations. The public sector, including the major public enterprises, is expected to increase its net foreign indebtedness by the equivalent of over US$2 billion.

Spain disburses official development assistance mainly to former territories and to countries in Latin America. It is not a member of the Development Assistance Committee. Spain's ODA has averaged slightly over 0.1 per cent of GDP over the last few years. It is the authorities' objective to raise gradually this percentage to levels closer to those of other industrial countries.

As regards trade policy, the Spanish representatives indicated that little change has taken place since the liberalization measures introduced in 1979. While recognizing that the degree of effective protection of Spanish industry remains significantly higher than in most other industrial countries, the Spanish representatives noted that further progress in the liberalization of the trade regime is largely linked to the process of accession to the EC. Discussions with the EC to date have led to agreement on a number of questions but some crucial issues such as the length of the transition period for various sectors, remain unsettled (see RED, Appendix IV). The Spanish Government has set the objective of signing the accession treaty before the end of its mandate in 1986.

4. Prospects

The staff forecast for 1983 presented in Table 2 is predicated on the maintenance during the year of the initially announced stance of financial policies. Under that assumption the growth of domestic demand is expected to remain modest, although a pickup may be expected in the course of the year. The staff forecast is somewhat more pessimistic than the official forecast regarding fixed investment, which is likely to be adversely affected by continued uncertainty about the strength of the recovery of external demand, by the tightening of monetary policy and by the existence of wide margins of unutilized capacity. The foreign balance is expected to continue to provide a significant stimulus to GDP growth. The volume of exports should show a recovery from the depressed level of the second half of 1982, in reflection of some pickup in external demand and of the improvement in competitiveness following the depreciation at the end of 1982. Energy imports are expected to continue to decline, albeit at a much slower rate than in 1982, as a result of the ongoing effort to diversify energy sources and to contain consumption through the raising of domestic energy prices (see Section IV of the RED). A deceleration is projected in nonenergy imports, in reflection of the tightening of monetary policy and the abatement of speculation on the exchange rate. On the whole, GDP is projected to rise at broadly the same rate as in 1982 (1 1/2 per cent). Employment is expected to show a further significant decline, leading to a renewed increase in the rate of unemployment, to around 18.5 per cent.

The staff projections are also more pessimistic than the official forecast with respect to costs and prices (Table 2). Unit labor costs in industry are expected to accelerate compared with 1982, as a result of the maintenance of a relatively high rate of wage increases and of a decline in the rate of growth of productivity. Import prices in domestic currency are likely to be boosted by the effects of the depreciation of the peseta of December 1982. The adverse impact of these developments on consumer prices should, however, be partly offset by an expected moderation of food prices and by the tightening of the stance of financial policies.

The current account should show a considerable improvement in 1983, with the deficit declining to an estimated US$2.2 billion (1.3 per cent of GDP) (Table 3) due largely to an expected 10 per cent decline in oil prices and a 4.5 percentage points reduction, on average, in foreign interest rates. The first should contribute about US$900 million and the second about US$350 million to the reduction in the current account deficit. The non-oil terms of trade are expected to show a small deterioration on the assumption that Spanish exporters try to maintain some of the competitive advantage gained through the depreciation of the peseta. Finally, receipts from tourism are projected to show a small increase from the record level of 1982. On the assumption of the maintenance of a relatively restrictive stance of domestic credit policy and of a realistic exchange rate policy, the projected current account deficit should be financed mainly through capital inflows, with a limited loss of reserves.

III. Staff Appraisal

The room for maneuver for the Spanish authorities in 1983 is severely constrained not only by the persistence of an unfavorable international environment but also by the fact that, despite a high rate of unemployment, Spain continues to lag behind most other industrial countries in adjusting to the second oil shock. The rate of inflation, at 14 per cent, remains double the average of major industrial countries and the current account deficit of the balance of payments is, in relation to GDP, among the highest for industrial countries. The staff shares the authorities' view that the only viable economic strategy for 1983 is one aimed at securing a significant reduction in inflation and improvement in the external accounts. Such a course of policy, if pursued with determination, should lay the foundation for a sustained recovery of output and employment as the international environment improves.

The Government's objectives with regard to growth, inflation, and the external accounts, if achieved, would constitute a first step in the necessary medium-term adjustment of the Spanish economy to bring it more in line with those of its main trading partners. The objective of securing further convergence in future years should rank high in the strategy of the medium-term plan which the Government intends to prepare over the next few months. The attainment of the official economic targets for 1983 will require a carefully balanced and determined use of various economic policy instruments. The staff shares the authorities' view that a significant deceleration in the growth of the monetary aggregates is necessary to secure the targeted moderation of inflation and improvement in the external accounts. This tightening of monetary policy must, however, be supported by strong efforts to contain the public sector deficit and the growth of labor costs, if adverse effects on growth and employment are to be minimized.

The challenge facing the Spanish authorities in reversing the deteriorating trend of the public finances is clearly a difficult one. The objectives of satisfying valid social needs and of promoting the growth of productive investments through the budget will have to be sought at the expense of established interests that have come to rely on various forms of budgetary support in the past. The effort to improve the public finances will undoubtedly have to be pursued over several years as some aspects of it will take time to be effectively implemented and to produce results in terms of budgetary savings. This is true of the steps envisaged by the authorities to modernize the structure of indirect taxes through the introduction of a value-added tax, to substantially improve tax administration and enforcement, and to reform the public administration, the social security system and the local finances. Nevertheless, the very fact that these reforms operate with considerable lags adds urgency to their introduction.

The prospects for the public sector finances in 1983 give cause for concern. The targeted level of the deficit of the General Government at the equivalent of 6 per cent of GDP is likely to generate serious pressures on the control of liquidity. It is, therefore, all the more essential that the overruns that have characterized the implementation of past budgets be avoided. This will require in particular a very substantial effort to contain expenditure. In this respect, it is especially important to secure moderate wage settlements in the public administration and in the public enterprises and to confine budgetary support to those, among enterprises in difficulty, which are economically viable in the medium term.

In the light of the prospective financing requirements of the public sector, it is important that flexibility be maintained in interest rate policy. An increase in real interest rates on financial assets, including bank deposits, which currently stand significantly below the levels prevailing in the main industrial countries, may be required in the course of this year. The impact of such an increase on the non-subsidized lending rates could be mitigated by reducing the subsidy element in the privileged circuits of credit, thus continuing the process of gradual liberalization of the financial system that has taken place over the last few years.

The experience of the last several years in Spain clearly indicates that enterprises react to relatively high increases in labor costs by severely cutting back on employment. In this respect, the wage band of 9 1/2-12 1/2 per cent, recently agreed upon by the trade unions and the employers' federation, also gives cause for concern. This agreement, which is somewhat higher than that of 1982, could well lead to an acceleration of unit labor costs compared with last year, particularly when account is taken of the inevitable wage drift and of the fact that the proposed reduction of the workweek will have, on average, a significant impact on labor costs. Of additional concern is the inclusion in the agreement of a revision clause which could result in a significant further boost to wage costs at the beginning of 1984. The staff hopes that the Government will promote, primarily through the wage negotiations in the public sector, moderation within the band in actual wage settlements at the sectoral level. If, as it is to be feared, labor costs rise by more than is officially anticipated, further action will need to be taken to ensure their moderation.

In the external area, the staff shares the authorities' view that a reduction of the current account deficit of the balance of payments to below 1 1/2 per cent of GDP should rank high among the priorities of economic policy in 1983. If this is achieved, Spain's external financing requirements could be expected to be met without undue difficulties, provided that the capital account of the balance of payments is safeguarded through the tightening of financial policies. A significant contribution to the reduction of the current account deficit in 1982 was made by the decline in volume of energy imports, in reflection of a more realistic domestic pricing policy for oil products and of a strong investment effort in the energy field. It is to be hoped that these policies will be continued in the next few years within the framework of the revised National Energy Plan.

The need to secure a continued improvement in the current account balance and a moderation of the external debt service burden, while allowing some recovery of domestic demand and output, underlines the importance of maintaining a favorable competitive position for the Spanish industry over the next few years. The recent depreciation of the peseta appears to have restored Spain's competitiveness to a level which, albeit below the previous peak in 1977, should allow the preservation and possibly some gain of market shares. The staff would encourage the authorities to pursue a flexible exchange rate policy to allow the broad maintenance of the competitive position at that level. This should permit a resumption of the gradual process of liberalization of the trade system, which, despite the steps taken in 1979, remains characterized by a relatively high degree of effective protection. The preservation of competitiveness with respect to EC currencies would appear of particular importance in view of Spain's medium-term prospects for accession to the EC.

IV. Proposed Decision

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

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Spain, in light of the 1983 Article IV consultation with Spain conducted under Decision No. 5392-(77/63) adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

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

Table 1. Spain: Selected Financial Indicators, 1979-83

	1979	1980	1981	1982 1/	1983 2/
	(As a percentage of GDP)				
Fiscal indicators					
General Government					
Revenues	28.4	29.8	30.7	29.9	...
Of which:					
Direct and indirect taxes	12.2	13.4	14.7	14.0	15.0
Social security contributions	13.0	13.2	12.9	12.6	12.7
Expenditures	30.2	32.5	34.2	35.9	...
Current expenditures	27.2	29.0	29.8	31.1	...
Capital expenditures	3.0	3.5	4.4	4.8	...
Current balance	1.2	0.8	0.9	-1.0	...
Overall balance	-1.8	-2.7	-3.5	-6.0	-6.0
Overall cash balance	-2.5	-3.1	-4.7	-5.2	-6.1
	(End of period; percentage change except as otherwise indicated)				
Monetary variables					
M_3	18.0	16.7	15.8	16.1	13.0
Total domestic credit expansion	17.2	20.3	20.2	19.6	15.9
Credit to the private sector	13.7	15.6	18.4	17.3	13.0
Credit to the public sector	35.2	38.2	40.9	35.5	33.0
Share of credit to the public sector in total domestic credit	9.5	10.9	12.8	14.6	16.8
	(In per cent; period changes)				
Interest rates					
Three-month interbank rate	15.6	16.5	16.2	16.3	...
Average lending rate 3/	15.8	16.9	17.4	17.5 4/	...
Average deposit rate 5/	11.1	11.8	12.4	12.9 4/	...

Sources: Bank of Spain, Annual Report and Statistical Bulletin; data provided by the Spanish authorities; and staff estimates.

1/ Provisional estimates.
2/ Official targets.
3/ Rates on commercial bank loans of one to three years.
4/ Average of first 11 months of the year.
5/ Deposits of one to two years.

Table 2. Spain: Main Economic Variables, 1979-83

(Per cent changes)

	1979	1980	1981	1982 1/	1983 2/
Demand and output					
Private consumption	1.0	1.0	-1.5	0.4	0.8
Public consumption	4.2	4.4	2.0	3.3	4.5
Fixed investment	-4.5	0.3	1.0	-0.5	-1.0
Stockbuilding 3/	0.7	0.6	-1.3	--	--
Gross domestic expenditure	0.9	1.8	-1.9	0.5	0.8
Exports of goods and services	7.1	1.3	7.9	3.5	3.5
Imports of goods and services	11.6	2.6	-4.3	-1.0	--
Foreign balance 3/	-0.6	-0.2	2.3	0.9	0.7
GDP	0.2	1.5	0.3	1.4	1.5
Industrial production	0.8	1.2	-2.4	-0.9	-1.0
Wages, costs, and prices					
Wages per man (industry)	...	16.1	15.5	16.0	15.5
Productivity (industry)	2.9	4.1	5.2	6.0	4.1
Unit labor costs (industry)	...	11.7	9.8	9.5	11.0
Consumer prices	15.7	15.5	14.6	14.4	13.5
GDP deflator	16.7	13.7	13.0	13.7	14.0
Employment	-2.1	-3.2	-3.1	-1.1	-1.3
Unemployment rate (average levels)	8.7	11.8	14.4	16.0	18.5
Participation rate (levels, end of period)	49.3	48.5	48.3	48.2	...
Disposable income of households	16.8	15.4	13.4	16.9	14.0
Savings ratio (levels)	9.1	7.7	8.0	9.6	9.3

Source: Spanish authorities.

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

Table 3. Spain: External Developments, 1979-83

	1979	1980	1981	1982 1/	1983 2/
			(Percentage changes)		
Trade developments					
Imports, c.i.f. 3/					
Unit value	5.9	37.5	30.6	14.2	16.8
Volume	13.0	2.8	-6.0	-1.3	0.2
Exports, f.o.b. 3/					
Unit value	5.4	19.7	19.0	13.0	19.5
Volume	14.2	3.3	7.6	2.5	3.0
Market growth	7.2	4.6	2.9	1.6	2.6
			(In billions of U.S. dollars)		
Balance of payments summary					
Trade balance, f.o.b.-f.o.b.	-5,688	-11,725	-10,115	-9,049	-7,938
Services	5,014	4,489	3,382	3,355	4,100
Of which:					
Tourism	5,558	5,720	5,709	6,250	6,440
Capital income	-1,088	-1,548	-2,471	-2,750	-2,400
Transfers	1,782	2,048	1,692	1,600	1,600
Current balance	1,108	-5,188	-5,041	-4,094	-2,238
(As a per cent of GDP)	(0.6)	(-2.4)	(-2.7)	(-2.3)	(-1.3)
Capital balance	2,408	4,547	4,358	768	1,600
Of which:					
Changes in net foreign position of banks	1,335	829	544	-300	100
Long-term capital	3,216	4,252	4,277	1,315	2,200
Overall balance	3,516	-641	-683	-3,326	-638
Memorandum items:					
Gross official reserves 4/	12,925	12,275	11,499	8,015	7,400
In months of imports 5/	4.8	4.8	4.7	3.3	3.1
Spanish pesetas per U.S. dollar (period average)	67.1	71.7	92.3	109.9	130.0
Nominal effective exchange rate (per cent change) 6/	8.2	-7.2	-8.6	-6.7	...
Real effective exchange rate (per cent change) 6/7/	15.1	-3.9	-5.1	-1.4	...
Medium- and long-term external debt 8/	19,497	23,719	27,205	27,800	...
Debt service ratio	15.1	15.2	19.5	21.1	...

Sources: Bank of Spain, Annual Report; Ministry of Economy and Commerce, Balanza de Pagos de Espana; IMF, International Financial Statistics; data provided by the Spanish authorities; and staff estimates.

1/ Provisional estimates.
2/ Staff forecast.
3/ Customs basis, in pesetas.
4/ End of period, in millions of U.S. dollars with gold valued at US$42 per ounce.
5/ Imports of goods during the following 12-month period.
6/ The weights were based on the average distribution of export and import trade with 14 industrialized countries in 1975.
7/ As measured by relative consumer prices adjusted for exchange rate changes.
8/ End of period, in millions of U.S. dollars.

Fund Relations with Spain

(As at end-January 1983)

Quota:	SDR 835.5 million
Fund holdings of pesetas:	SDR 634.7 million (76.0 per cent of quota) including net purchases under the oil facility, equivalent to 0.6 per cent of quota.
SDR department:	SDR 185.8 million or 62.2 per cent of net cumulative allocation.
Gold distribution:	338,053 fine ounces.
Lending to the Fund:	Associated with lending arrangement between the BIS and the Fund.
Exchange rate:	Spain has maintained a managed float of the peseta since 1974. The exchange rate, which after the 1977 devaluation had appreciated sharply in 1978 and in the first half of 1979, reflecting a strong current account position and tight credit conditions, began to weaken in the second half of 1979 as the external position deteriorated. Between the second quarter of 1979 and the third quarter of 1982 the peseta depreciated by 40.7 per cent with respect to the U.S. dollar and by 22.7 per cent in effective terms, but only by 11 per cent in real terms. On December 6, 1982 the peseta was devalued by 8 per cent with respect to the dollar in response to intense speculative pressures. In effective terms the exchange rate is estimated to have depreciated by about 5 per cent during the fourth quarter of 1982.
Previous relations:	Spain purchased its whole entitlement (SDR 572.1 million) under the oil facility and a further SDR 98.8 million under the compensatory financing facility in February 1978. A one-year stand-by arrangement in the enlarged first credit tranche, equivalent to SDR 143.2 million, was approved in February 1978 but was not drawn upon.
Last consultation:	The previous Article IV consultation took place in December 1981 and the report was discussed by the Executive Board on March 9, 1982

(SM/82/43, 2/23/82; SM/82/45, 3/3/82). On that occasion the following decision was adopted by the Executive Board:

"1. The Fund takes this decision in concluding the 1981 Article XIV consultation with Spain, in the light of the 1981 Article IV consultation with Spain, conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

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

Basic Data

Area	504,800 square kilometers
Population (mid-1981)	37.55 million
Labor force (September 1982)	13.01 million
GDP per capita (1981)	Ptas 455,638 (SDR 4,017)

Use and supply of resources (1981)	In billions of pesetas	In per cent
Private consumption	11,997	69.8
Public consumption	2,025	11.8
Fixed investment	3,452	20.1
Stockbuilding	58	0.3
Gross domestic expenditure	17,532	102.1
Exports of goods and services	3,004	17.5
Imports of goods and services	-3,359	-19.6
Gross domestic product	17,177	100.0

Selected economic indicators (annual percentage change)	1980	1981	1982
GDP (at constant prices)	1.5	0.3	1.4
Private consumption (at constant prices)	1.0	-1.5	0.4
Gross fixed investment (at constant prices)	0.3	1.0	-0.5
Industrial output	1.2	-2.4	-0.9
Exports of goods (in pesetas)	23.7	28.0	15.8
Imports of goods (in pesetas)	41.4	22.8	12.7
Unit labor costs in industry	11.7	9.8	9.5
Consumer prices	15.5	14.6	14.4
GDP deflator	13.7	13.0	13.7

Balance of payments (in millions of SDRs)	1980	1981	1982
Exports of goods, f.o.b.	15,813	17,458	18,162
Imports of goods, f.o.b.	24,821	26,036	26,358
Net services and transfers	5,023	4,303	4,488
Balance of goods, services, and transfers	-3,985	-4,275	-3,708
Net capital movements	3,494	3,696	696
Overall balance	-491	-579	-3,012
Gross official reserves (excluding gold; end of year)	9,140	9,349	6,707

Source: Data provided by the Spanish authorities.