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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/66

3:00 p.m., Friday, April 22, 1983

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	C. Taylor
J. de Groote	
	A. Le Lorier
A. Donoso	J. Delgadillo, Temporary
R. D. Erb	C. Dallara
	S. R. Abiad, Temporary
	Jaafar A.
	T. Yamashita
	M. Casey
	G. W. K. Pickering, Temporary
	C. Robalino
G. Laske	G. Grosche
	G. Gomel, Temporary
	A. S. Jayawardena
	E. M. Ainley, Temporary
J. J. Polak	
	K. G. Morrell
G. Salehkhou	O. Kabbaj
	M. Camara, Temporary
M. A. Senior	J. L. Feito
	A. Lindø
Zhang Z.	

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

African Department: J. Perejoan. Asian Department: S. Shah. European Department: E. Croce, D. N. Lachman, L. L. Perez, H. O. Schmitt, E. Spitaeller, K. A. Swiderski, T. M. Ter-Minassian. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; J. A. Clement, M. Guitian. Fiscal Affairs Department: C. A. Aguirre, A. L. Antonaya, G. Blöndal, A. Feltenstein. IMF Institute: J. L. de los Santos, Participant. Legal Department: S. A. Silard. Western Hemisphere Department: H. Wiesner, Director; S. T. Beza, Associate Director; H. Arbulu-Neira, C. Brachet, J. Ferrán, G. Oliveros, R. Ramaciotte. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: H. Arias, S. E. Conrado, M. A. Janjua, P. Kohnert, P. Péterfalvy. Assistants to Executive Directors: H. Alaoui-Abdallaoui, L. Barbone, R. Bernardo, J. Bulloch, L. E. J. Coene, T. A. Connors, G. Ercel, A. Halevi, M. Hull, W. Moerke, Y. Okubo, J. G. Pedersen, E. Portas, J. Reddy, J. Schuijer, H. Suzuki, P. S. Tjokronegoro, M. Toro, Zhang X.

1. URUGUAY - 1982 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors resumed from the previous meeting their consideration of the staff report for the 1982 Article IV consultation with Uruguay, and a request from Uruguay for a stand-by arrangement (EBS/83/43, 2/25/83; Cor. 1, 3/9/83, and Cor. 2, 3/31/83). They also had before them a report on recent economic developments in Uruguay (SM/83/52, 3/11/83).

The staff representative from the Western Hemisphere Department observed that the adjustment in public finances under the program did indeed appear impressive, although to put it in the proper perspective and thereby illustrate the importance of continued efforts in 1984, it should perhaps be considered from the point of view of the public sector as a whole, including the financial public sector. If the borrowing requirement of the nonfinancial public sector in 1982 was added to the borrowing requirement of the Mortgage Bank, the public sector deficit, broadly defined, had been of the order of 18 per cent of GDP in 1982, as opposed to virtual equilibrium in 1981. The comparable figures for 1983 under the program were 3 per cent of GDP for the borrowing requirement of the nonfinancial public sector, approximately 3 per cent of GDP for the Mortgage Bank, and another 2 per cent for the fiscal costs involved in the unwinding of the special assistance schemes extended late in 1982 to the private sector--for a total public sector deficit of 8 per cent of projected GDP. Those adjusted figures signaled the need for further efforts in 1984, and were the main justification for a two-year program. Expenditure cuts were clearly identified in the program, not only in absolute terms but also in terms of the monthly path foreseen for the adjustment process. It was encouraging that preliminary information indicated that the adjustment in the public finances was in line with estimates for the program during the first quarter of the year. It also was to be noted that the Central Bank was severely restraining lending to the Mortgage Bank, which had also remained in line with the program.

The justification for the emergency export taxes was that the tax on farm income (IMAGRO) was collected with a one-year lag; without a mechanism for capturing part of the gain in agricultural income resulting from the exchange rate adjustment, public sector receipts from the agricultural sector in 1983 would have been virtually nil because of the poor economic performance of that sector in 1982, the staff representative noted. The staff's understanding was that those export taxes would be dismantled at the earliest possible opportunity, because of their adverse effects on the allocation of resources and because, under the floating exchange rate regime, they tended to push the exchange rate higher than might be necessary.

The social security system had placed a growing burden on the economy over the years, the staff representative commented, and the authorities had finally taken drastic measures in October 1982, not only to modify the formula for benefits, which in the past had been indexed to the increase in wages in the previous year, but to modify the nature of the benefits, as well as the timing of the payments, and to reduce the number of beneficiaries. The figures projected for social security expenditures therefore took account of a fairly significant structural reform of the system, which, moreover, was to be carried even further in the months and years ahead.

As for the authorities' public sector pricing policies, the staff representative added, tariffs had been adjusted further at the beginning of April, by about 15 per cent for most goods and services produced by the public sector, especially fuels.

The Mortgage Bank had become a major source of disequilibrium in 1981 and 1982, the staff representative continued, not only because of the inability of the Bank to raise loanable funds on the domestic market to finance its social housing program, but also because in 1980 the Government had discontinued a special 2 per cent levy on wages, which would have brought about $80 million to the Mortgage Bank in 1982. It was because the Mortgage Bank had tended to become increasingly less of a bank as time had passed, and more of a national construction agency, that he had found it useful in his earlier remarks to include its borrowing requirements in the definition of the public sector deficit.

The imposition of reserve requirements on dollar deposits as well as on peso deposits in the banking system had been discussed at length with the authorities, the staff representative recalled, and it had been generally agreed that technically all deposits should be subject to reserve requirements. But the authorities had felt it inappropriate to subject dollar deposits to legal reserve requirements until confidence in the economy had strengthened. The problem was that when the Uruguayan peso had been floated at the end of November 1982, the press--especially in Argentina--had carried a series of articles suggesting that, given the openness of the capital account in Uruguay, the authorities would have to nationalize the banking system or convert dollar deposits into pesos. The outcome had been a run on dollar deposits, mostly those belonging to Argentine nationals, which had reduced the stock of dollar deposits by about 30 per cent from its level on the eve of the exchange rate adjustment.

On the question of interest rates, the staff representative noted that under the preannounced exchange rate system, in effect until November 1982, domestic interest rates had been the product of the announced rate of depreciation of the currency and of the international interest rate--which, it must be recalled, had been high in real terms in 1982. Moreover, the spread between nominal domestic interest rates at that point of convergence and the actual rate in the market had widened steadily in 1982 because of the growing country and corporate risk factor, which had resulted in historically high real interest rates. The greater the real appreciation of the currency, the higher the real rate and the greater the squeeze on the productive sector. Interest rates, however, varied widely, with large or multinational firms being able to borrow at rates below the average deposit rates, and others being subjected at times to spreads in excess of 30 per cent. Therefore, the interest rates mentioned in the staff reports were a statistical average, which hid a significant dispersion of lending rates. At present, the annual rate of interest in real terms was still about 40-45 per cent, although it was declining. The continued high rates of interest were probably associated in part with Uruguay's difficulties in marshaling external financial assistance, and in part with widespread doubts on the authorities' ability to carry out the program. Preliminary information suggested that performance in the first quarter of 1983 should turn expectations around gradually. The floor for interest rates was set by the rate on paper issued by the Government in open-market operations; in the past few weeks, the authorities had been testing the market to see whether or not they could lower the rate for treasury bills without adversely affecting the exchange rate. So far, that prudent approach seemed to have paid off: real interest rates were moving downward slowly without causing instability in the exchange market.

It was a matter for the authorities to decide whether or not to refer in the letter of intent to the need for Fund assistance in securing foreign financing, the staff representative from the Western Hemisphere Department stated. He noted that there were precedents, including a reference in the letter of intent from Argentina to the need for assistance from the Fund on the renegotiation of its external debt.

Provision had been made in the formulation of the balance of payments test and of the test for the net domestic assets in the Central Bank--its mirror image--for any shortfall in actual compared with projected official external financing, the staff representative added. In addition, the authorities had initiated preliminary discussions with the World Bank to determine whether or not there was any possibility of a structural adjustment loan or a "quick disbursement loan," for some $40 million to $50 million, which would be of great help not only in offsetting the deficit on capital account but also in improving the debt service profile.

The detailed cash flow projections had been included in the Fund's communication to the banks, the staff representative explained, because the banks had had difficulty distinguishing between what might be called dollar flows and balance of payments flows, owing to the importance of dollar operations with residents. Although the current account obviously was not exogenous, the staff had worked out the cash flow projection figures with the technical staff of the working committee as the best way of enabling that committee to submit appropriate remuneration to the other creditor banks in support of Uruguay's request for new financing. While the cable from management to the working committee might not have specifically included caveats as to the likelihood of the program being carried out, the staff had certainly stressed, in the meetings of the working committee in which the Uruguayan authorities had asked it to participate, that there was a margin for errors and adjustments in the future.

The level and composition of capital inflows was of great importance, as Mr. Polak had stressed, the staff representative added. On that subject, it was to be recalled that an implication of the economic policy that Uruguay had pursued until 1982 was that, if the public sector was in equilibrium and confidence was strong, private capital inflows were largely autonomous. Hence, at a given level of national savings, the greater private capital inflows, the larger the current account deficit. That was what had happened in 1979, 1980, and early 1981, and there had been no reason to show concern in those years for the large current account deficit, which merely reflected an unprecedented level of private investment. Conversely, as confidence deteriorated, or external circumstances changed, the excess of private investment over private domestic saving would narrow, and the current account deficit would be reduced accordingly.

The situation in Uruguay had changed in 1982, the staff representative recalled, because the current account deficit was reflecting entirely the deterioration in the financial position of the public sector, which had more than offset an excess of private domestic savings over private investment. Accordingly, in the first year of the program, the path of adjustment would call for a reduction in the current account deficit consonant with the improvement sought in the public finances. However, other things being equal, if for some reason confidence in the private sector strengthened rapidly, the current account deficit might be larger than programmed, without any increase in projected official capital inflows, and the overall balance of payments might record either a smaller deficit or a surplus, as it had until 1981. In countries with completely open current and capital accounts, it was thus necessary to focus on the excess or deficiency of public sector investment over public sector savings. Uruguay's public savings and investment had been roughly equal until 1980, and the high rates of growth and of fixed capital formation in the private sector until 1980/81 had reflected private capital inflows--at a time moreover when private sector savings had been increasing--that had allowed for a level of private sector investment which could not otherwise have taken place.

On the possibility of taxing the profits of exporters who had entered into export prefinancing contracts in September-October 1982, the staff representative noted, the authorities had found that such retroactive taxation was prohibited by the terms of the contracts. Moreover, they had reflected that, even if lawful, it would undermine confidence and the chances of success of the program.

As for the influence of developments in Argentina and Brazil on Uruguay's economic situation, the staff representative noted that there was both a mechanical influence--as shown in Chart 11 in SM/83/52--and a psychological influence. For instance, until 1981 Uruguay had been shielded from the significant increase in Argentina's unit labor costs, expressed in U.S. dollar terms, as a result of the real appreciation of the Argentine peso; obviously, when Argentina had begun to adjust, Uruguay's unit labor costs expressed in the same terms had soon proved unsustainable.

The extensive tourism and investment in real estate in Uruguay, especially by Argentine nationals--at least until the considerable exchange rate corrections of the first half of 1981--had also had an automatic effect. Indeed, the interruption of construction activity since then was the reason for the stepped-up investment program of the Mortgage Bank. The adjustment taking place in both Argentina and Uruguay would also have an effect on the prospects for a recovery of Uruguay's exports to Argentina and, therefore, for the revival of economic activity in Uruguay during the program period. The "psychological effect" stemmed from the proximity of Argentina and Brazil, the ample coverage of developments in those countries by the Uruguayan press, and, most particularly, the similarity of the economic models adopted by Argentina until March 1981 and by Uruguay until November 1982.

The recent exchange and trade measures adopted by the Uruguayan authorities should encourage the diversification of Uruguay's exports, the staff representative commented, partly because under the system of export tax rebates that had prevailed until November 1982, certain Uruguayan exports had been barred from the markets of some industrial countries. The reduction of those rebates should reopen the door to markets in the United States and Europe.

Experience in other countries suggested, the staff representative continued, that when there were elements of a shock approach in a progam, the real income effect would be prompt and would manifest itself rapidly, if not in the overall balance of payments, at least in the trade account. It would take some time for the Uruguayan economy to adjust to the new level of relative prices, as developments in the first quarter of 1983 indicated. The recession might not therefore bottom out until the third quarter of the year, and positive rates of growth might not be resumed until the fourth quarter or until early 1984. It was difficult at the present stage to forecast the rate of growth in 1983, although, under the best of circumstances, and depending of course on the international economic situation, it should be slightly positive rather than negative.

Price developments so far bore out the expectations of the authorities for the period immediately following the exchange rate adjustment, the staff representative from the Western Hemisphere Department observed. After a corrective spiral in the rate of inflation, which on a monthly basis had been on average 12 per cent in December 1982 and January 1983, the rate of price increase had declined to less than 3 per cent in February and to hardly more than 1 per cent in March, reflecting the drastic tightening of monetary policy from January on. The trend in the wholesale price index had been similar, except that the initial price increase had been larger because of the greater weight of tradable goods in the wholesale price index. Although wage policy would of course be affected by price developments, it should be noted that wages had not been increased during the period of corrective inflation beyond the 15 per cent increase granted in January 1983. The Government was determined not to intervene in future in the determination of wages in the private sector, which would adjust its wage bill in accordance with its own financial position and conditions in the labor market. It would be advisable for the public sector to avoid giving the impression that it was relaxing its own wage policy, although actual wage developments in the public sector might have some influence on the attitude of the private sector in the longer run. However, those developments would be dictated by the speed of the economic recovery and the magnitude of productivity gains; for the time being, wages would be affected by the depressed state of the economy and the pressure of large idle capacity. Moreover, the authorities were more concerned at present with the need to reduce unemployment than with an increase in real wage levels.

The staff representative from the Exchange and Trade Relations Department responded to Mr. Laske's question about the wisdom of the authorities' statement that once the exchange rate had been allowed to find its equilibrium level, they intended to pursue a flexible exchange rate policy, either a float or a crawling peg; he said that it seemed proper for a country that decided to float its currency freely to indicate its intentions with respect to the future course of the exchange rate. In some cases, a floating exchange rate might be a way to deal with a worsening policy situation, which was not the case in Uruguay, where the free float was accompanied by a set of strong measures and was designed to lead eventually to an equilibrium level for the exchange rate. Admittedly, it was as difficult to define what that equilibrium level would be as it was to define a sustainable level for the balance of payments deficit. As he understood paragraph 12 of the authorities' letter of intent, it was an acknowledgment that they accepted responsibility for the future course of the exchange rate.

As for the effectiveness of regimes under which changes in exchange rates were preannounced, the staff representative noted that such regimes were a variation of a fixed exchange rate system, which, of course, only worked if the conditions necessary for its success were present.

Mr. Donoso noted with satisfaction that the general opinion of Executive Directors seemed to be that the program adopted by Uruguay incorporated the measures necessary to make the most important corrections to past policies to deal with the present crisis. Uruguay's policies had been ambitious in past years, and had been directed at improving the performance of the economy by means of reforms to encourage competition, both domestically and with the international economy. In spite of the country's difficult economic situation, the required corrections in policy had been made without any change in the fundamental direction of that policy: no exchange restrictions had been imposed, and the program for the liberalization of trade was being speeded up. The fiscal program that had been adopted was also an indication of the ability and willingness of the Uruguayan authorities to take difficult measures when necessary.

He did not mean to suggest that the design and implementation of the program under discussion had not posed certain difficulties, Mr. Donoso continued. It was natural for there to be pressures to change the direction of policies when production and employment decreased. With a free exchange rate, and a lack of foreign currency, those pressures tended to have a financial effect. However, in Uruguay the pressures had not been so strong as to have influenced the program. The approval of the stand-by arrangement by the Executive Board would certainly help to restore confidence in the Uruguayan economy and thereby ensure the success of the program and of the negotiations with the financial community on refinancing the country's external public debt.

Referring to the possibility of taxing the capital gains of people who had operated under the export guarantee system, Mr. Donoso noted that such a possibility would have led to uneasiness on the part of holders of dollar deposits who had also made profits because of the devaluation of the peso. Any move to tax those gains would therefore have entailed risks in present circumstances; it was not a question of the appropriateness of the export guarantee program.

On the related question of capital flight, Mr. Donoso said, part of the external financing that Uruguay needed was to compensate for private capital outflows. But he saw no direct relationship between those outflows and the dollar payments that the central bank would have to make under the export guarantee system. It was the absence of exchange restrictions that was expected to lead to some outflow of capital.

Under any exchange rate system, Mr. Donoso remarked, there would always be some degree of wage rigidity, and, in that sense, any stabilization program would have to undergo a period of some difficulty. Under the more traditional approach, attempts to restrain the growth of money led to price and cost distortions. Under a system of preannounced exchange rates, until the stabilization took place, the currency was likely to appreciate, foreign borrowing would be subsidized to some extent, and there would be problems on the current account of the balance of payments; subsequently, as the economy stabilized, the effects of recession would be felt. Under the alternative approach to the exchange rate system, the recession would be felt at the beginning of the process. It was not clear to him that one system was inherently preferable to the other.

The general subject of how to approach stabilization deserved to be analyzed in greater detail, Mr. Donoso considered. He was not raising the matter in connection with the exchange rate policy followed by Uruguay. Unfortunately, when Uruguay had had a system of preannounced exchange rate changes, external developments had suggested that the system was less appropriate, despite its many interesting features. For instance, until 1980, prices in Uruguay had been rising at a fast pace, and they had not fallen as fast subsequently, because the Argentine peso had first appreciated; when the Argentine peso had depreciated, the international price of many goods traded by Uruguay had fallen in absolute terms. Thus, Uruguay's experience with a system of preannounced exchange rate changes should not be taken as evidence of failure of that particular approach, because external developments had militated against its success.

The Chairman took note of Mr. Donoso's point that the merits of systems of preannounced exchange rate changes should be analyzed in relation to the conditions under which they had been in operation.

The Chairman then made the following summing up:

Executive Directors generally agreed with the thrust of the staff appraisal contained in the report for the 1982 Article IV consultation with Uruguay.

Directors warmly commended the authorities for the determination that they had displayed in proceeding swiftly with the needed exchange rate adjustment in November 1982 and in adopting a set of courageous supporting measures to correct relative price distortions, redress financial imbalances, and set the stage for a revival of economic activity. Directors had special praise for the authorities' adjustment program and the continued adherence to their objective of reducing trade barriers to foster efficiency in domestic industries. They also noted with satisfaction that Uruguay retained freedom of payments for current and capital transactions despite the difficult domestic and regional economic situation.

Directors were impressed by the magnitude of the contemplated adjustment in the public finances, which would facilitate accommodation of the credit demands of the private sector, and they concurred with the staff's view that the fiscal target was achievable. It was observed that a marked compression of the deficit of the nonfinancial public sector would have been, in any event, unavoidable, given the large claims on resources that had resulted from the overextension of the Mortgage Bank and the unwinding of the special assistance schemes to the private sector that had been introduced in 1982. The hope was also expressed that the emergency export taxes would be eliminated as soon as feasible.

Directors stressed the importance of a flexible and cautious monetary management--especially in the use of comprehensive legal reserve requirements and in the conduct of open-market operations--to ensure that the limits of the credit program would be observed. They urged the authorities to keep the lending program of the Mortgage Bank under close scrutiny and stand ready to contain it further if warranted by circumstances.

The authorities had been right to design incomes and demand management policies geared to a prompt deceleration of inflation after the initial spurt of corrective price adjustments, Directors said. The relatively limited one-time increase in wages and social security benefits that had followed the floating of the peso, and the decision henceforth to allow movements in remuneration to be determined by market forces should be instrumental in keeping price rises to a rate close to that abroad and in creating the conditions for the needed reduction of unemployment.

Directors emphasized that the external constraint had intensified greatly in the past two years. The recent exchange rate correction should go a long way toward improving the goods and nonfactor services account of the balance of payments, but interest payments on the external debt would keep the current account deficit high in 1983. Net official borrowing requirements would thus continue to be sizable in the first year of the adjustment, but they would drop significantly in 1984. Directors expressed satisfaction that the international financial market--in particular the commercial banks--had taken note of Uruguay's record through 1981 and the far-reaching objectives of the adjustment effort, and that they had committed themselves to accommodating Uruguay's financing needs in 1983 on a scale commensurate with the Fund's own financial assistance.

Finally, it is expected that the next Article IV consultation with Uruguay will be held on the standard 12-month cycle.

The Executive Board approved Uruguay's request for a stand-by arrangement.

The decision was:

1. The Government of Uruguay has requested a stand-by arrangement for the period April 22, 1983 to April 21, 1985 for an amount equivalent to SDR 378 million.

2. The Fund approves the stand-by arrangement set forth in EBS/83/43, Supplement 1.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7388-(83/66), adopted
April 22, 1983

2. SPAIN - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Spain, together with a proposed decision (SM/83/56, 3/25/83). They also had before them a report on recent economic developments in Spain (SM/83/59, 4/8/83).

The staff representative from the European Department made the following statement:

A limited amount of information on recent economic developments in Spain has been received by the staff since the 1983 consultation discussions in Madrid. Some of the information relates to revisions in the preliminary estimates for 1982 provided by the authorities and presented in the staff report and recent economic developments paper. Other elements of information refer to developments in the first few months of 1983.

The presentation of the budget for 1983 has been delayed, probably until local elections take place. An apparent reason for the delay is the fact that the authorities are considering additional expenditure-cutting measures to offset the possible shortfall in receipts that would result from a more modest recovery in activity than officially forecast at the beginning of the year.

Recent but still preliminary estimates for the national accounts in 1982 prepared by the National Institute of Statistics point to a 1.1 per cent rate of growth of GDP, lower than the 1.4 per cent forecast at the time of the discussions. The revision mainly affects investment, as consumption is estimated to have grown marginally faster--(0.6 per cent versus 0.4 per cent)--reflecting the boost provided to disposable income by the triggering of the wage adjustment clause in the fourth quarter.

As regards the external sector, preliminary data on trade developments in the fourth quarter indicate a marked pickup in both exports and imports from the depressed levels of the middle quarters of the year but little change in the trade balance. These data suggest a significant upward revision in the rates of growth of exports and imports in value terms on a customs basis for the year as a whole, to about 19.6 per cent and 16.7 per cent, respectively. The trade deficit (imports c.i.f./exports f.o.b.) is estimated at Ptas 1,208 billion. Recent estimates by the Bank of Spain indicate that the current account deficit for 1982, at $3.9 billion, was smaller than the $4.1 billion previously forecast, mainly because net interest payments abroad, at $2.4 billion, was lower than the expected $2.75 billion. A larger net inflow of medium-term and long-term capital--$1.77 billion versus $1.32 billion--is also estimated to have occurred. The overall balance is estimated at $3.35 billion.

On the fiscal side, the revisions are relatively small. The deficit of the state budget on a cash basis, excluding net lending, is estimated at Ptas 1,130 billion and that of the General Government at Ptas 1,155 billion, or 5.9 per cent of GDP.

The few available conjunctural indicators for the first months of 1983 point to a continued weakness of activity and a relatively depressed business outlook. A pickup in the demand for durable consumer goods, especially automobiles, appears to have been met largely by running down inventories. The rate of inflation in consumer prices has decelerated from 14 per cent at the end of 1982 to 13.1 per cent by February 1983, mainly reflecting a seasonal moderation in food prices. Preliminary and partial indications on sectoral wage settlements so far point to rates of increase of the order of 11-11.5 per cent within the 9.5-12.5 per cent band agreed at the national level.

On the external side, no information is available on trade developments to date in 1983. There are, however, indications that, following a substantial reflow of foreign exchange into Spain after the devaluation of the peseta in December 1982, the exchange rate has come under renewed pressure in the first quarter of this year, necessitating sizable intervention by the Bank of Spain. The latest published data on foreign exchange reserves relate to January 1983, when they stood at $7.06 billion, or about 12 weeks' imports. Between the end of 1982 and mid-April 1983, the peseta depreciated by about 7 per cent vis-à-vis the U.S. dollar and by about 4 per cent in effective terms. The forward discount on the peseta rose from 6 per cent to about 10 per cent in the same period.

In the face of the pressure in the exchange markets, the authorities have gradually tightened the stance of monetary policy. The 12-month rate of growth of M-3, which had accelerated from 16.2 per cent in December 1982 to 17.9 per cent in January 1983, declined to just under 14 per cent by March. Although, due to a change in the series, precise information is not available on developments in bank credit beyond the end of 1982, there are indications that it is decelerating as well. In mid-April, the authorities announced a 1 percentage point increase in the coefficient of remunerated reserve requirements, which is expected to drain about Ptas 150 billion of bank liquidity. Short-term interest rates in the money market, which had declined slightly in the first months of the year, have picked up again in recent weeks and currently stand at about 17 per cent.

The staff had been informed that day that the budget had been presented to Parliament within the past few hours, the staff representative from the European Department added.

Mr. Feito made the following statement:

On behalf of my Spanish authorities, I would like to thank the staff for the excellent set of papers. The perceptive insights regarding the economic problems and policy dilemmas faced by the new Spanish Government indeed give an accurate picture of the current environment. My authorities are in general agreement with the staff appraisal.

Economic developments in Spain over the past few years can be best described as a slow deceleration of nominal income growth, some features of which are worth reviewing to highlight the constraints limiting the application of macroeconomic policy instruments. In so doing, I will refer to those economic developments in 1982 on which I would like to supplement or emphasize the information contained in the staff papers.

Average Rates of Change

	1979	1980	1981	1982
Real GDP	0.4	1.5	0.3	1.4
GDP deflator	16.7	13.7	13.0	13.7
M-3	19.6	17.1	15.2	16.5
Unemployment rate	8.7	11.8	14.4	16.5

One of the main inferences that could be drawn from the impressionistic picture provided by the above data is that monetary disinflation in Spain had a relatively small impact on prices but a disappointingly large effect on output and employment. In this regard, it would seem quite clear that the behavior of wages has been one of the major causes behind the unfavorable breakdown of nominal demand between prices and output. Other supply shocks--like the second round of oil price increases and the recently marked appreciation of the dollar--have certainly also played a major role in the relative response of quantities and prices to lower rates of monetary growth. On balance, however, it is the sustained growth of real wages and labor costs throughout the period--the cumulative increase over the last eight years, as pointed out by the staff, is 42 per cent--that must be held most responsible for the negative split of nominal spending waves into output and price components. Thus, an understanding of the process of labor services pricing and, in particular, of the reasons underlying the downward inflexibility of the rate of growth of nominal wages, would seem to be essential for the appropriate evaluation of economic policy. Unfortunately, economic theory does not provide clear, let alone conclusive, propositions on the process of nominal wage determination. Nevertheless, in the specific context of the Spanish economy, the following observations on the evolution of nominal wages and unemployment seem to be borne out by available empirical evidence.

The mechanics of the bargaining process within which wages are determined for many sectors of the economy has been highly influenced by political considerations. In some phases--particularly during the transformation of the old regime into a democracy--trade unions pursued rather aggressive policies, competing with one another to gain increasing shares of employed workers and to strengthen their role in the political process, their degree of success being measured by the level of wages that they were able to attain. Entrepreneurs, in turn, in general seemed willing to trade off increases in nominal wages that were greater than productivity gains, for improvements in the climate of industrial relations. Incidentally, bearing in mind the major political and economic reforms launched over the period, it is indeed encouraging to note in this respect the extremely low number of conflicts that arose in the labor market.

The path followed by money wages was also affected by the expectation, based on experience over the period, of countercyclical reversals of monetary and fiscal policy. Employers consented to nominal wage demands because they expected the authorities somehow to undo the harm by lowering the value of money and, thereby, the real equivalent of the agreed money wages.

Another factor to be explained is the very low sensitivity of real wages to the rise in unemployment up to 1979 and, to a lesser extent, thereafter; wages have certainly been impervious to market forces. There are many institutional rigidities regulating the working of the labor market in Spain that have a bearing on this relationship. Prominent among them may have been that, until recently, dismissal of workers was allowed only in case of bankruptcy or near-bankruptcy, so that the increase in the excess supply of labor had little influence on wage determination. This rigidity, together with the high level of real wages, led many enterprises to deal with vacancies through attempts to increase the productivity of their stock of workers. This trend was reinforced by declining flows of fixed investment over the period. In the absence of significant additions to the stock of fixed capital, the bulk of productivity increases had to come from increases in unemployment brought about by the closing down of plants and the reduction of capacity, or by postponing the filling of vacancies. Thus, though productivity gains achieved in this manner over the past two years have been significant, absolute levels of productivity remain relatively low, and it will require a significant upturn in investment activity to increase them sizably.

The foregoing considerations must be taken into account in judging the economic events in 1982, which, as can be seen from the above table, were a turning point in the process of deceleration of nominal income growth.

During 1982, an increase in the labor force added to some of the above-mentioned factors to intensify the disequilibrium in the labor market. With unemployment reaching 16.5 per cent and still rising, this problem is without a doubt the gravest one in the economy and the source of most other maladjustments, particularly, the deterioration of public finances. As well described on pages 33-34 of SM/83/59, the public sector deficits for 1981 and 1982 are not strictly comparable because of the accounting regularization undertaken by the new Government, the coverage of the 1981 figure being lower than that of 1982. However, the increase in the public sector deficit as a percentage of GDP from 3.5 in 1981 to 6.0 in 1982 still gives an idea of the two major forces operating behind fiscal policy during 1982. On the one hand, the low levels of activity and the further deterioration in unemployment accounted for the major share in the increase of the public sector deficit, although there were also some budgetary overruns that could have been avoided. Therefore, fiscal policy followed a more expansionary stance than initially sought, particularly when it was perceived that general elections were going to be held in the course of the year.

Moreover, the reversal of the path of monetary deceleration which took place in 1982 led to a revival of inflationary expectations that have undoubtedly been embedded in the wage agreements recently concluded. It is interesting to note that the reversal in the process of nominal demand disinflation that took place last year did not have significant effects on either output or employment but was channeled rather to prices and to the balance of payments. Thus, after five years of sustained decline, the average growth of the GDP deflator increased in 1982 to 13.7 per cent from 13 per cent in 1981. The deficit of the current account of the balance of payments as a percentage of GDP, however, fell from 2.7 to about 2.3. This figure, although it reflects the beneficial effects of the reforms in the energy field undertaken during the period, is still relatively high when seen against the background of the low levels of activity and investment prevailing in the economy. It was the capital account of the balance of payments that reflected the major impact of the shift in the stance of monetary policy so that gross official reserves (with gold valued at $42 per ounce) fell from $11.5 billion to $8 billion by the end of 1982. There are two important corollaries to be drawn from the process of nominal demand deceleration followed until 1981 and its reversal during 1982. In the first place, the stickiness of wages and other costs establishes a discouraging asymmetry on the monetary movements of the economy. An expansionary monetary policy vis-à-vis the international stance, channels the inflated nominal demand to prices and balance of payments without significantly permanent effects on output and unemployment. On the other hand, a drastic monetary deceleration leads to employment and output losses without major effects on prices. Additionally, the current level of unemployment imposes severe limits to the degrees of monetary restraint that can be implemented. A second inference is that economic behavior and, in particular, nominal wages depend quite heavily upon expectations about policy. It would seem that the only control that can be exerted on money wages is to strengthen the credibility of government disinflationary policies; this, in turn, takes time if the previous record has been disappointing. Developments regarding the tripartite agreement of 1981 and 1982 among wage earners, entrepreneurs, and the Administration seem to indicate that wages are not controllable by the authorities in the short run and their rate of growth can be brought into line with prices and productivity developments only by cautious and persistent policies.

The situation of the Spanish economy at the end of 1982, joined to the persistently grim international environment, has considerably narrowed the room for maneuver for the new Government that took office last December. Given the nature of current economic problems, in particular the high unemployment, the authorities are seeking a careful balancing of priorities in their design of economic policy. The medium-term objective of the Government is to restore activity and employment. Drawing from experience gained by failures of policy over the past year, however, it has become clear that the attainment of that objective on a permanent rather than temporary basis requires first the abatement of inflationary expectations and the achievement of external balance. Therefore, in the shorter run the authorities have attached priority to bringing the growth of nominal demand to rates closer to those of aggregate supply. This should secure an improvement in the competitiveness of the economy in order to allow the recovery of output and employment as the international economy ameliorates. Monetary policy, the main instrument of short-run macroeconomic management, has thus been formulated to achieve the desired deceleration of the rate of growth of nominal demand. Immediately after taking office, the new Government made an upward adjustment in the cash reserve requirement coefficient of the banking sector (from 5.75 to 6.75). It also announced a target range for M-3 growth during 1983 centered around 13 per cent (the M-3 average rate of growth during 1981 was about 16.5 per cent). On the basis of expected developments in interest rates abroad and velocity estimates, the targeted rate of growth for M-3 is consistent with an intended 2 percentage point reduction in inflation and a 1 percentage point reduction in the ratio of the current account of the balance of payments to GDP by the end of 1983. My authorities are aware that this policy stance will be subject to severe pressures if the growth of aggregate nominal wages evolves around the upper limit recently agreed and a significant wage drift takes place. Recent wage negotiations, as I mentioned above, have been influenced by the reversals of policy and accompanying inflationary effects of last year. The Government feels that only strict adherence to monetary targets will break these inflated expectations and pave the way for lower rates of wage growth and recovery of employment next year.

The objective assigned to fiscal policy is to freeze the public sector deficit as a proportion of GDP at the 6 per cent figure of last year. My authorities know that the attainment of this objective will not be easy and will require strong efforts and determination in the current conditions of the economy. It will certainly be difficult to arrest the rate of growth of the public sector deficit in the face of high and rising unemployment. Under these circumstances, there are many inertias and rigidities which cannot be easily controlled in the short run. The Government, however, is firmly committed to achieving fiscal discipline and to this end is developing the necessary instruments. Thus, an administrative reform is being launched in order to improve tax collection, which, as in most countries, has been made increasingly difficult by the deteriorating economic situation. This reform also contemplates a greater coordination between spending and taxing units all over the Spanish territory and inside the public administration. In the shorter run, some taxes penalizing consumption will be raised and subsidies reduced, and, above all, some transfers, primarily those to local entities and enterprises, will be reduced. The budget embodying these actions, whose preparation has been delayed because of the recent change in government, will be presented to Parliament after the holding of local elections in May.

Any evaluation of the mix between fiscal and monetary policy must certainly tackle the question of its impact on the balance between the public and private sectors. To ascertain with some degree of accuracy the extent to which a given stance of fiscal policy would crowd out or stimulate private productive activity, it would be necessary to know the determinants of private investment. In this respect, it must be pointed out that protracted underutilization of capacity has severely damaged the marginal efficiency of capital in Spain. It seems that private investment is deterred by the belief that high unemployment and low economic growth are the long-term norm rather than a transitory phase in the evolution of the economy. Under these circumstances, the evaluation and judgments on fiscal policy should be carefully balanced.

In any event, the authorities are firmly determined to prevent fiscal developments from endangering the overall strategy or economic policy. In this respect, it is important to note that the new Government has a much greater degree of parliamentary strength than the previous Government. This allows for the adoption of monetary and fiscal actions needed to achieve the final objectives of policy in the face of unexpected domestic or international developments. As a concluding note in this regard, last week the Government made an additional 1 percentage point upward adjustment in the remunerated reserve requirement of the banking system.

Mr. Feito informed Executive Directors that the budget submitted to Parliament within the past few hours was more restrictive than the one described in the staff report. The initial idea had been to maintain the public sector deficit at 6 per cent of GDP, whereas in the revised budget, the target was a deficit of 5 per cent of GDP. Certain projects had been postponed, spending priorities had been changed, and, in addition, tax revenues had been recalculated following the devaluation of the peseta.

Mr. Dallara said that he was in general agreement with the staff's analysis and appraisal, and supported the proposed decision. The Spanish economy appeared to be in need of substantial adjustment: inflation and unemployment were both high, and the balance of payments position was relatively weak. He shared the staff's view that the public sector deficit was too large relative to GDP. In that connection, he welcomed the indication by Mr. Feito that the revised budget pointed toward a deficit on the order of 5 per cent rather than of 6 per cent of GDP, and would welcome a further indication of the areas in which expenditure reductions were being made.

It was clear from the interesting appendix on real wage developments (SM/83/59) that real wages had grown too rapidly and were in part responsible for the high rate of unemployment, Mr. Dallara noted. He agreed with the staff that it was important to achieve a moderation of wage settlements. The indications given by the staff representative of sectoral wage increases of up to 11-11.5 per cent for 1983 did not seem consistent with a significant reduction in the rate of unemployment or the maintenance of Spain's competitive position in international markets.

While the authorities were fine-tuning monetary policy in 1983, Mr. Dallara continued, the planned rate of growth of the monetary aggregates was still apparently compatible with a relatively high inflation rate. Therefore, he hoped at a minimum that the monetary target would be attained and that the upper band above the target would not be reached. The Spanish financial system, as described in Appendix III to the report on recent economic developments, was highly regulated. Interest rates seemed quite low relative to inflationary expectations. It would be helpful if the authorities could make further progress in deregulating the financial system in the near future. Even in a regulated environment, there appeared to be substantial room for adjusting deposit and loan rates upward.

Referring to external policies, Mr. Dallara said that he too placed emphasis on reducing the current account deficit, which was surprisingly large, given the low level of economic activity in Spain. The tightening of financial policies in conjunction with the recent exchange rate move should help to lower the deficit and improve the external debt position over the medium term. It was important for the authorities to give confidence to market participants; recent reserve movements might in fact indicate some continued unease in the markets about the thrust of policies. If that was the case, the authorities should take it as a signal that credible, comprehensive, and early moves toward adjustment could not be delayed.

Mr. Salehkhou said that the unfavorable international environment only partly explained the generally weak performance of the Spanish economy in the past few years. The unsatisfactory developments seemed to be more the result of difficulty in adjusting the economy to the important political and social changes of the mid-1970s, which had ended a long period of stable economic conditions. The political transition had been accompanied by a significant strengthening of union pressures and a sharp increase in real wages, resulting in relatively high rates of inflation and seriously affecting the competitiveness of Spanish industries. On the other hand, while the expansion of the economy before the mid-1970s had been remarkable, it had been achieved at the cost of financial and structural rigidities that no longer encouraged an efficient allocation of resources, and it had thus also been largely responsible for the difficulties that had accumulated in recent years.

The newly elected Spanish Government had inherited a difficult situation, Mr. Salehkhou observed, characterized by significantly high inflation and unemployment, a low rate of real growth, and an unsustainable deficit on the current account of the balance of payments. He therefore greatly welcomed the inclusion in the Government's priorities of efforts to reduce inflation and the current account deficit, despite the projected adverse impact on unemployment, at least in the short run, and the legitimate expectations of the electorate in that respect. Indeed, those efforts should pave the way for a resumption of economic growth in 1984.

He agreed with the thrust of the staff's analysis of the appropriateness of the authorities' strategy for 1983, based on the limited objectives described in the staff report and appraisal, Mr. Salehkhou said, but wished to comment on the main elements, starting with the primary objective of achieving a significant tightening of the monetary stance. Like the staff, he believed that attainment of the monetary targets would depend to a large extent on a flexible interest rate policy and on the successful implementation of the fiscal program. While the imposition of investment coefficients on the portfolios of commercial banks could undoubtedly be justified by the need to promote official credit institutions and to secure an adequate flow of credit to priority sectors, adverse effects on the structure of interest rates should be avoided. In that connection, the authorities were apparently considering the possibility of raising the return on securities subject to such coefficients to rates closer to market levels. It would then be possible for the commercial banks to increase interest rates on deposits.

Fiscal policy needed to be particularly cautious, Mr. Salehkhou considered, because the necessary adjustment of the finances of the Government and of public entities had been delayed for a long time, and because substantial expenditure overruns had occurred in recent years. The overall budgetary deficit had almost doubled in 1982 to 6 per cent of GDP. He had been pleased to note the recognition by the new Spanish Government of the structural and institutional weaknesses of fiscal policy, and the assessment being made of ways to alleviate the burden on the budget of large transfers to cover the deficits incurred by some public entities. It was also welcome that, although the heart of the adjustment effort was seen to lie on the expenditure side, the authorities envisaged important revenue measures, including increases in selected indirect taxes, the reduction of exemptions from various direct taxes, and a more vigorous enforcement effort. On the expenditure side, the projected structural reforms in the areas of local finances, social security, and support for public and private enterprises in difficulties should be carried out as a matter of urgency.

It was also necessary for the public administration and public enterprises to take the lead in securing a substantial moderation of wages, Mr. Salehkhou continued. National wage agreements had markedly reduced the number of industrial conflicts. However, a more active and explicit role by the Government in negotiations between the unions and employers' federations might help to achieve a greater differentiation of wage increases to better reflect variations in productivity among enterprises. At any rate, the authorities' labor policy should aim at preventing a renewed acceleration of wage costs, which had plagued investment and growth in the past few years and which might resume as a result of legislation to reduce the number of hours worked per year.

With respect to external policies, welcome efforts were being made to restore the overall competitive position of the Spanish economy, Mr. Salehkhou noted. If successful, those efforts would help to reduce the current account deficit of the balance of payments to a level that was more sustainable and more consistent with the objective of bringing down the external debt service ratio. However, the Spanish authorities continued to rely excessively on exchange rate policy to maintain competitiveness and achieve external adjustment, leaving the impression in a few instances that they were seeking unfair competitive advantages. The use of a broader set of policy instruments would be desirable from the point of view of medium-term adjustment. Spain's potential for economic growth was considerable, given its natural and human resources, but its fulfillment was dependent on the restoration of a stable international economic environment.

Mr. Robalino observed that the Spanish authorities, to meet their economic objectives, had set planning targets aimed at reversing the growing rate of unemployment, limiting wage increases to 9-11 per cent, reducing the public sector deficit to 3.2 per cent of GDP, bringing the rate of inflation down to 12 per cent and, finally, achieving a $4 billion deficit on the current account of the balance of payments. However, most of those targets had proved optimistic and had been far from accomplished during the year covered by the staff report, when conditions unfavorable to steady economic growth had developed, with negative consequences for developing economies in general.

The departures from planning targets had led to certain maladjustments in Spanish economic policy, Mr. Robalino went on. The development of wages had been inconsistent with the targets, and had caused an increase in the unemployment level. Demand management policies had been inadequate, and the deficit of the public sector, which had been deteriorating for some years, had shown an unexpected worsening. It would be particularly important to control the fiscal deficit by means of reductions in government expenditures. In that respect, spending in such sectors as social security should be carefully reviewed. It would also be necessary to avoid further nominal wage increases, beyond those justified by increases in productivity, and to tighten financial and monetary policy to restrain aggregate demand to a level consistent with a sustainable balance of payments position. He welcomed Mr. Feito's additional remarks about the revised budget.

Among the noteworthy achievements of the Spanish economy, Mr. Robalino noted in particular the decline in the current account deficit, due to a significant reduction in the volume of energy imports and the maintenance of a flexible exchange rate policy promoting export competitiveness. He welcomed the policy of reducing energy imports by controlling domestic demand, as well as the exchange rate depreciation in December 1982 and the authorities' commitment to a flexible exchange rate policy, which should permit a further improvement in the current account deficit.

Mr. Ainley said that he was in general agreement with the staff appraisal. As others had observed, Spain continued to face difficult economic problems, and its room for maneuver was limited by sizable deficits on both the fiscal and the external accounts. In the circumstances, priority had to be given in the short run to bringing down both inflation and inflationary expectations, and to strengthening the balance of payments.

The authorities had already started to move in the right direction, Mr. Ainley considered. The recent tightening of the monetary stance was an important first step, but, to be effective, it would have to be supported by firm action, in the immediate future and over the medium term, to limit the fiscal deficit and control the rise in labor costs. On the fiscal side, he welcomed the intention to reduce the public sector deficit to 5 per cent of GDP in 1983. The recent and proposed improvements in the administration and enforcement of tax collection procedures were clearly appropriate. Nonetheless, the focus had to be on reducing current expenditures, where there had been major overruns in the past. The rapid increase in social benefits and transfers to ailing industries had imposed a severe burden on the budget and on the resources available for investment.

The proposed reform of the social security system, outlined in the interesting appendix to SM/83/59, seemed sensible and could make a great contribution toward improving the Government's financial position.

He shared the staff's concern over the likely acceleration in unit labor costs in 1983, which seemed to be confirmed by recent data, Mr. Ainley remarked. As the staff had commented, the Government should set an example of wage moderation. It would be useful to learn of any developments in that respect, and to know what the staff had in mind in referring in its appraisal to a possible need for further action to limit wage increases. Perhaps the staff was thinking of a formal incomes policy, although Mr. Feito had suggested that wages were not controllable by the authorities in the short run.

He commended the authorities for their decision to devalue the peseta in December 1982, and welcomed their intention to pursue a flexible exchange rate policy, Mr. Ainley continued. Those moves should help to restore competitiveness and improve the debt service position, provided that they were supported by firm domestic policies. It was encouraging that the authorities were reviewing their industrial restructuring programs with a view to making their assistance more selective and more effective. The problems mentioned by the staff--inadequate pricing policies, excessive wage increases, overmanning, and inappropriate investment decisions--all deserved high priority in the medium-term plan under preparation.

The problem of wages deserved special attention, Mr. Ainley went on. The sharp increase in labor costs over the past decade had clearly damaged Spain's competitiveness and had been a major factor behind the relatively poor performance of the economy. But he had noted from Mr. Feito's statement that wages seemed to be impervious to market forces. The authorities needed to follow credible and persistent anti-inflationary policies, and to take every opportunity to explain the consequences of excessive wage settlements to the public.

He hoped that the medium-term plan would also examine ways of promoting competition and improving efficiency in the financial system, Mr. Ainley commented. It would be interesting to know what scope there was, perhaps involving new legislation, for broadening the money and the capital markets, and how such a development in Spain could meet the objective of financing the public sector deficit in a less inflationary manner.

Finally, Mr. Ainley observed that the staff's assessment of the consequences of Spain's membership in the European Community in Appendix IV to SM/83/59 had emphasized the transitional problems and the heavy short-term costs, particularly for Spanish industry. In theory, enlargement of the European Community or of any similar economic grouping should lead to greater specialization and further economies of scale in the longer run. It would be useful if the staff could say more about the potential benefits, both for Spain and for the European Community, in the medium term.

Miss Le Lorier remarked that among the difficulties continuing to face the Spanish authorities was a rate of unemployment reaching 17 per cent of the labor force, despite some good achievements on the export side, in an international environment which had so far constrained the potential for growth. A number of positive results had already been recorded on the external front. Exchange rate management had successfully restored an adequate competitive position. No less important had been the pursuit of a determined effort that had resulted in 1982 in a marked decline in energy imports for the second consecutive year. As a result, the current account of the balance of payments had improved significantly in 1982, and the deficit was expected to decline further in 1983.

On the domestic side, however, the outcome in 1982 had fallen short of expectations, Miss Le Lorier continued, with slippages in the budget area and a higher than expected increase in labor costs. On fiscal policy, a positive step had been taken toward halting, by means of procedural changes, the practice of unrecorded deficits that had amounted to 18 per cent of the overall deficit in general government operations in the past year. A process of clarifying the financial position of public entities would be pursued in 1983, and the overall cash deficit of the Government would be contained, as indicated by Mr. Feito, below the 1982 level. But it was more than a question of the level of the deficit per se. As the staff had stated in its appraisal, close attention had to be paid to the need to arrest the proliferation of subsidies to enterprises in difficult circumstances, concentrating budgetary support on those sectors with growth potential; to check the growth in social benefits while undertaking an active study of the reform of the social security system; and finally, to pursue a modernized tax structure.

As for the higher than expected increase in labor costs, Miss Le Lorier remarked, the results of wage negotiations so far in 1983 seemed likely to continue, as in the past, to result in a further deterioration in the employment situation. Perhaps Mr. Feito could indicate further actions that might be feasible if labor costs rose significantly above expectations. For instance, would a further shift from payroll taxes to contributions by wage earners to the social security system be considered? She would like to conclude from Appendix I of SM/83/59 on that incomes policy was of key importance. However, circumstances suggested that the basis for such a policy would have to be established first. Her view, which might not be the widespread opinion of the Executive Board, was that the Spanish Government had rightly assigned the central role in its strategy to a wise monetary approach, and for two main reasons. First, the outcome of wage settlements, not only in 1983 but over the medium term, would appear to be strongly influenced by the confidence of the economic partners in the maintenance of a gradually restrictive stance of financial policies. Second, domestic credit expansion in 1982 had induced an unprecedented rise in nonenergy imports, and the capital account appeared to be the weak part of the balance of payments. For those reasons, a moderate--namely, a sustainable--restrictive monetary stance would have the advantage of permitting the fullest impact on cost and price expectations.

There was every indication that gradualist approach to reducing the growth of the monetary aggregates was appropriate, along the lines being followed by the Bank of Spain, Miss Le Lorier stated. There seemed to be a slight disagreement between the staff and the authorities over the definition of the term "gradual" and the aggregates to be monitored. However, the steps taken to liberalize the financial system, and the flexibility demonstrated by the Bank of Spain in its management of interest rates, should be duly acknowledged. She was confident that, if it proved necessary, further action would be taken in the course of the current year.

To conclude, Miss Le Lorier reiterated the wish expressed by her chair in 1982 that further liberalization of the trade system should be given high priority among the structural reforms undertaken by the Government.

Mr. Grosche noted that the several factors responsible for the poor performance of the Spanish economy over the past few years had been well explained in the staff report, with which he was in broad agreement. But it might be worth mentioning that the situation in 1982 had not been entirely bleak; some positive developments could be discerned, particularly the abatement in the rate of increase of consumer prices in the second half of the year and the significant improvement in the external current account. Nevertheless, the large imbalances that still existed in the economy, and the need to prepare the country for entry into the European Community, called for determined policy actions.

It was evident that the authorities were confronted with conflicting priorities, Mr. Grosche commented. The unemployment rate, approaching 17 per cent, was far too high and had to be reduced. Yet a further significant lessening of inflationary pressures was needed, for domestic and external reasons. He believed that the authorities were right to regard 1983 as a year of adjustment in which progress should be made on inflation and on the balance of payments, so as to lay the foundation for sustained recovery in Spain when the international environment improved.

The central role of monetary policy in the adjustment strategy for 1983 gave rise to some doubts, Mr. Grosche considered. First, as Mr. Feito had mentioned, monetary disinflation seemed to have had a relatively small impact on prices, but a disappointingly large effect on output and employment. Second, the public sector deficit had been a severe constraint on monetary policy. Therefore, he wondered whether more weight should have been given in the overall strategy to fiscal policy. Even with the revised budget, in 1983 the deficit would still be high relative to GDP; in combination with a significant decline in total domestic credit expansion, the private sector might risk being crowded out. He welcomed Mr. Feito's comments on the issue, but still believed that fiscal developments might endanger the authorities' overall strategy.

Capital markets remained relatively narrow in Spain, Mr. Grosche observed, and it would be interesting to know whether or not the authorities had plans to promote their development. A better financial system might bring forth the additional domestic savings needed to overcome the structural weaknesses of the economy. In that respect, he generally agreed with the staff view that real interest rates should be increased. However, considering the detrimental effect that a sharp reduction of interest subsidies could have on the financial position of a number of enterprises, the authorities should move cautiously.

On fiscal policy, Mr. Grosche said, he had nothing to add to what the staff had said in its appraisal. He would only underline that the fiscal problems being faced by the authorities were to a large extent structural. Comprehensive reforms of the tax and social security systems were called for, and the substantial time lags with which they would be carried out argued for their prompt implementation.

On labor market policy, Mr. Grosche mentioned his strong doubt that the Government's policy of trying to maintain the purchasing power of wages while setting a ceiling on the number of hours worked per year was conducive to improving labor market conditions. The additional cost push would impair the competitive position of Spain, thereby diminishing the chances of reducing unemployment. In Spain, as in many other countries, the view still seemed to predominate that the state could be held responsible for determining the level of real wages. Experience had shown, however, that different forms of state intervention in the setting of wages had almost always resulted in added inflationary pressures, unemployment, and a reduction in investment.

Finally, Mr. Grosche expressed his full agreement with the staff's assessment that the estimated decline in the current account deficit in 1983 seemed optimistic, unless wages rose less than forecast. Furthermore, receipts from tourism in Spain might be affected by exchange restrictions recently introduced in France.

Mr. Gomel declared that the economic outcome in Spain had not been favorable recently. The yardstick against which policy successes and failures were to be measured was a collection of adverse factors that had long operated in the Spanish economy: stagnant output, higher and rising unemployment rates, persistent inflation, and sluggish investment. Compounded by an uncertain external environment, the problems facing the policy makers looked almost intractable. He could therefore endorse the staff's twofold conclusion that the room for maneuver was severely constrained by a delayed adjustment to the second oil shock, and that the only viable strategy for 1983 was one aimed at securing a significant reduction in inflation and in the external deficit.

The policy measures envisaged by the authorities, and largely supported by the staff, were the standard ones, Mr. Gomel continued. On a few points warranting more specific comments, he referred first to the downward trend in the savings ratio that had been quite marked in recent years, but that seemed to have been stemmed and reversed in 1981 and 1982. According to the report on recent economic developments, a strong increase in private savings had been recorded in the past year. It would be helpful if the staff could highlight the main underlying factors: had the institutional changes in domestic financial markets affected savers by making available a larger variety of assets, or had savings responded to higher deposit rates offered by the banking system? Perhaps the staff could also give its assessment of the progress made in deregulating financial markets, and the prospects for a larger nonmonetary financing of the public sector deficit.

The marked jump in the budget deficit in 1982 seemed to have been due largely to the working of automatic stabilizers, Mr. Gomel said. Tax revenues, including social security contributions, declined in 1982, falling short of 27 per cent of GDP; a cyclical upturn would obviously bolster them. As for measures intended to increase the ratio of taxes to GDP, the cautious posture taken by the authorities seemed sensible, given the depressed levels of activity. Capital spending by the public sector had continued its upward trend in 1982, giving a welcome impetus to domestic investment, which had been stagnant or declining for a prolonged period. Current revenues had fallen short of current expenditures in the past year, but the budget deficit appeared to be largely accounted for by capital expenditures, a more encouraging feature. Nevertheless, action to contain current spending was needed. Wages and transfers to enterprises seemed to be the two critical domains calling for restraint.

The target for the current account of the balance of payments, and the projections underpinning it, seemed reasonable, Mr. Gomel remarked. Spain's competitive position had improved in 1981 and 1982, and export performance should benefit well into 1983. The continued stagnation in domestic spending, and the somewhat stronger growth of exports expected for the current year, should give more impetus to the export sector. The likely outlook for imports was less certain. The staff had predicted constant imports in terms of volume, too low a projection after two years of decline, in his view, and given the small but positive growth of output so far.

Concerning external debt and its servicing, Mr. Gomel went on, medium-term and long-term external borrowing was, he understood, being closely monitored by the authorities. For purposes of surveillance, as reiterated in the recent discussion in the Executive Board, short-term debt to foreign lenders was to be monitored as well. Had the staff taken up the issue with the Spanish authorities?

Finally, Mr. Gomel noted that the degree of protection of Spanish industry remained appreciably higher than in most of the country's trading partners. He shared the staff's view that an improved competitive position should make room for more liberal trade policies and encouraged the authorities to speed up their efforts in that direction.

Mr. Taylor welcomed the establishment of an annual cycle of Article IV consultations with Spain because of its importance as an industrial country whose economy seemed to suffer from a number of major imbalances and deep-rooted structural problems that were seriously constraining growth.

Those rigidities, and the fairly extensive restrictions in the economy on trade and capital, suggested to him that the staff might have given further emphasis to the need for strong adjustment in the short term, and more thought to the necessary adaptation of the economy in the slightly longer term to membership in the European Community.

It would not be easy to reduce the government budget deficit to about 5 per cent of GDP instead of the 1982 figure of 6 per cent, the latest move by the Spanish authorities, about which he had been glad to learn from Mr. Feito, Mr. Taylor considered. For one thing, the effort would have to be particularly strong, four months into the fiscal year, and would need to center on steps to curb public spending and improve expenditure controls. The staff had convincingly demonstrated the importance of avoiding a repetition of past budget overruns, but had possibly understated the economic difficulties confronting public sector enterprises. Spain had considerable overcapacity in a number of heavy industries and had not moved as fast as some other industrial countries to reduce it in line with falling world demand. The state holding company--the National Institute of Industry, INI--needed to step up the pace of its restructuring program even at the cost of increasing its social security expenditures. The staff in its appraisal had also made a telling point in emphasizing the importance of securing moderate wage settlements throughout the public sector. More rigorous tax enforcement should help to realize larger revenues, and the Government would have to reform the administration and structure of the tax system so as to increase the tax base. The general goal should be to enable fiscal policy to become a more influential instrument of demand management.

The exclusion of certain types of assets from the definition of M-3, and the 2 per cent band allowed on either side of the central monetary target, led him to join those Directors who felt that there was a considerable risk of monetary policy being too accommodating and thereby not giving enough support to the Government's objectives on inflation and the fiscal deficit, Mr. Taylor said. He endorsed the statement in the staff appraisal that a more flexible interest rate policy would contribute to the gradual liberalization of the financial system, and therefore welcomed the greater emphasis on financing the public sector deficit by the sale of treasury bills to the nonbank sector. He asked whether the banks' apparent unhappiness with that development was associated with the rather unremunerative rates on the reserve assets that they were required to hold.

As Mr. Feito had stated, there was indeed relatively limited scope in Spain for more restrictive demand management, Mr. Taylor commented. Despite the latest fiscal developments, presumably efforts to reduce inflation would have to rely heavily on the control of wages through incomes policy and similar devices. In that respect, he wondered how helpful the 1983 national agreement would be. The top end of the agreed wage band was 12.5 per cent; allowing for the possibility of some wage drift, and for the operation of the indexation clause if consumer price inflation exceeded 9 per cent by the end of September 1983, there was little provision for much of a slowdown in inflationary momentum. The possibility of virtually complete indexation, with Spain's rate of inflation nearly double the OECD average, combined with limitations on the authorities' room for maneuver on the exchange rate, did not augur well for progress toward either internal or external balance.

Unless the current account of the balance of payments improved significantly in 1982, Mr. Taylor continued, Spain would be faced with difficult external financing prospects. The debt service ratio had risen to over 20 per cent in 1982. Admittedly, the depreciation of the peseta at the end of that year, and the expected modest growth in world trade, should help Spain to increase the volume of its exports by about 3 per cent. However, he too had asked himself why the staff had projected no growth in imports at a time when domestic spending was actually increasing.

Continued exchange rate flexibility would be desirable, Mr. Taylor commented, but he would advise the authorities to consider placing primary emphasis on their domestic adjustment policies and wage policy in their search for an adequate level of external competitiveness. He had noticed the judicious wording of the last sentence of the staff appraisal, which referred to the need for the authorities to preserve the competitiveness of the paseta against other European Community currencies. Certainly, it was right for the Fund not to appear to be encouraging an exchange rate adjustment that would go beyond maintaining Spain's competitiveness in the period immediately prior to entering the European Community.

In conclusion, Mr. Taylor mentioned his support for the proposed decision, especially the recognition that Spain continued to maintain an exchange system that was free of restrictions on payments and transfers for current international transactions. That good record led him to ask whether Spain was any nearer to adopting Article VIII status. The move might be largely symbolic but could be an important signal of the member's cooperative relationship with the Fund, and an appropriate gesture at a time when integration of the Spanish economy into the European Community was coming closer into sight.

Mr. de Vries drew attention to a particular fundamental maladjustment in the Spanish economy, namely, the one resulting from the high rise in real wages, which had increased by about 42 per cent over the past eight years. Clearly, that development was at the origin of many of Spain's present difficulties; it created high unemployment, and a deficit on the current account of the balance of payments. As the staff had pointed out in its appraisal, that deficit was among the highest, in relation to GDP, of any industrial country, but it would probably be even higher if it were calculated on the basis of full employment. It was hard to find out from the staff report how the efforts being made by the Spanish authorities would tackle that fundamental problem, of which they were no doubt well aware. The Fund of course was not in a position to find the solution; if Spain was to become part of the modern industrialized European region and to achieve a more flexible economy, it would have to find the way, even though a solution would take quite a while to work out. In that light, he could support most of the valuable albeit marginal comments made by the staff.

A flexible exchange rate policy was useful, but would not in and of itself deal with the large disequilibrium in real wage levels, Mr. de Vries stated. Similarly, the authorities' attempts to control monetary expansion to make sure that the public sector deficit did not rise were important, but were again basically directed at managing the present situation of fundamental disequilibrium. That disequilibrium, he reiterated, was the result of a level of real wages that was comparable to European levels alongside productivity that did not stand comparison with that of surrounding countries.

Mr. Abiad said that he too was in broad agreement with the general thrust of the staff appraisal. It was clear from the reports that the pursuit of policies to promote economic recovery and reduce the external imbalance was made extremely onerous in an unfavorable international setting. The difficulties had been heightened by the dilemma faced by the Spanish authorities in trying to meet the equally important priorities of arresting the undesirable increase of unemployment and containing the fiscal imbalance.

Nevertheless, Mr. Abiad remarked, Spain had achieved greater success in reaching some of its desired objectives than might have been expected in the circumstances. As Mr. Grosche had noted, the rate of increase in prices and in unit labor costs, although higher than initially projected, was on a slight downward trend, reflecting in part some gains in productivity. Real GDP had recorded some growth in spite of stagnant demand, and the current account deficit had decreased appreciably. Yet the authorities were still confronted with major problems. Of the two main but unrelated ones, the weak fiscal performance called for particular attention. As indicated in the staff reports, a main factor contributing to budgetary overruns and to the increase in the budget deficit in 1982 had been the deterioration in labor market conditions, coupled with large unbudgeted transfers to enterprises, reflecting growing difficulties in the restructuring of the industrial apparatus. Consequently, the public sector deficit remained high in relation to GDP. The authorities seemed to be aware of the other problems associated with the weak fiscal position, including the impact on monetary policy, and the cost of dealing with structural rigidities.

A large part of Spain's problem therefore needed to be tackled from a long-term perspective, Mr. Abiad stated. From that point of view, the authorities' strategy was appropriate, aimed as it was at containing the growth of expenditures in the short run--as was apparently being done already under the revised budget--while focusing on the need to avoid overruns in the longer term.

The second serious problem facing the authorities, which was having a significant effect on fiscal performance, was unemployment, Mr. Abiad noted. According to the staff report, the most significant factors contributing to the continued increase in unemployment included the increase in the labor force, the slow pace of economic activity, the restructuring and modernization of certain industries, and rigidities in wage and price formation. The authorities seemed to have a good understanding of the importance of alleviating some of those rigidities to ensure the success of their efforts to contain inflation, maintain competitiveness, and arrest the growth of unemployment. However, it should again be noted that the structural dimensions of the problem called for a gradual approach. In that connection, Mr. Feito had been candid in stating that the rate of growth of wages, in Spain's circumstances, could only be brought in line with the development of prices and of productivity by means of cautious and persistent policies.

The pragmatic exchange rate policy pursued by the Spanish authorities should contribute to the country's external competitiveness, Mr. Abiad considered. Apparently, receipts from tourism were estimated to increase slightly in 1983 from the record figure of the previous year. It would be useful to know whether those projections were likely to be affected by the measures recently introduced by France, given the traditionally substantial flow of tourists between the two countries.

Mr. Delgadillo said that he was in agreement with the staff's assessment that the authorities' objectives regarding growth, inflation, and the external accounts would constitute an important part of the adjustment process over the medium term. The overall strategy of the Spanish Government in the face of severe constraints emerging from the domestic as well as from the external sectors reflected a good deal of courage and determination. The four-year Plan to be presented later in the year and its subsequent successful implementation would play a critical role in triggering the resumption of a faster rate of growth and in bringing about an eventual decline in unemployment.

The downward trend of the rate of household saving in the latter part of the 1970s had been due not only to the effects of income redistribution, but also, to a larger extent, to the maintenance of negative interest rates on financial assets, Mr. Delgadillo continued. The more realistic credit policies followed had reversed the fall in Spain's domestic savings ratios, and thus contributed to reducting inflationary pressures and improving the balance of payments position. Since 1979, the authorities had moved steadily toward the adoption of flexible interest rate policies, which, together with the falling rate of inflation, had accounted for a marked decrease in the income velocity of broad money during 1978-82. The authorities were to be commended for that positive development and should be encouraged to push on even further into deregulating financial markets.

In 1982, public sector financing, coupled with a flexible stance on the private sector's increased demand for credit, had led to a monetary policy that had clearly been expansionary in the first few months of the year, Mr. Delgadillo remarked. That expansion had contributed to an acceleration in the rate of inflation in the first half of 1982 and to a weakening in the capital account of the balance of payments, owing to the existence of an adverse interest rate differential. Against that background, the newly elected Government had announced in December 1982, a depreciation of the peseta accompanied by a tighter monetary policy and the maintenance of constant real wages for 1983. He welcomed that prudent approach to credit policy and urged the authorities to maintain the realistic interest rate policies that had rendered such positive results in the past. There might still be some more room for upward adjustment in the rates on savings and short-term deposits. The ratio of household saving to disposable income had increased dramatically in 1982--by as much as 20 per cent--compared with the two preceding years. That significant improvement in domestic private savings, despite the emergence of dissaving in the public sector, had resulted in a reduction in the current account deficit for 1982. Realistic interest rate levels were therefore essential to prevent a deterioration of the household savings rate and to support the capital account of the balance of payments.

The policy objective of containing the fiscal deficit in the current year to the same proportion of GDP as in 1982 was appropriate, Mr. Delgadillo observed. As the increase in public spending during past years had been primarily due to institutional and structural weaknesses, the task of reducing the fiscal imbalance would have to be carried out largely on the expenditure side in the short run. In the future, major reforms were needed to improve the revenue performance, especially in such specific areas as social security, local finances, and support for public and private enterprises. The authorities' expressed intentions to strengthen the present mechanisms for monitoring entities financially supported by the state, and to improve the revenue raising capacity of regional and local authorities were promising in that respect.

Labor market conditions were indeed a serious cause for concern, Mr. Delgadillo commented. There was a risk of some acceleration of wage costs during 1983 because of a reduction in the number of hours worked per year, which would apparently not have a significantly favorable impact on employment. Thus, emphasis should be placed on investment policies directed at encouraging employment-generating activities in the medium term.

As for external sector policies, Mr. Delgadillo said that he supported the authorities' intention to manage the exchange rate flexibly so as to sustain an overall competitive position that was consistent with further improvements in the current account. Such improvements would depend critically on labor market developments as well as on the chosen exchange rate policy. It was therefore of great importance that the growth of the nominal wage bill not exceed the expected rate of currency depreciation, if the overall competitive position was to be secured. The Spanish authorities were of course well aware of that fact, and he hoped that social and political conditions in the country would permit wage negotiations to be conducted in a climate of general moderation.

In short, Mr. Delgadillo concluded, the Spanish authorities seemed to be highly committed to implementing fiscal discipline, reducing the level of inflation and the external imbalance. Despite the risks involved, he was confident that they would carry out a successful program.

Mr. de Groote noted that one of the interesting topics that had arisen during the Executive Board's recent discussion of the functioning of the European Monetary System was the role of the EMS in harmonizing the economic policies of the participants. Many Executive Directors had recognized that countries operating under a commonly agreed framework should aim at a convergence of economic policies. From that point of view, it was clear to him that the current efforts of the Spanish Government were in harmony with the general policy trends prevailing among the partners in the European Community, although paradoxically, there were greater policy divergences among those partners than between the overall situation of the European Community and nonmembers.

The Spanish Government had not however made sufficient sacrifices to consolidate or to speed up the adjustment process, Mr. de Groote said, and continued to lag behind in adjusting to the second oil shock, as the staff had reported. The characteristic indicators--the rate of inflation, the deterioration of public finances, and the evolution of monetary aggregates--all differed greatly from those in the countries of the European Community. That disappointing trend was probably increasing the gap between the performance of the Spanish economy and that of its prospective partners. Moreover, recently adopted measures, as well as other measures mentioned in the press as being likely to take effect in the near future, might set back even further the possibilities of smoothly integrating Spain into the European Community. The period of transition might be more difficult than envisaged by the staff, which was pessimistic on the point.

He was especially worried by the relative cost position of Spanish industry, Mr. de Groote continued. The general political climate in Spain, based on the more comfortable mandate that the new authorities enjoyed, might indicate the possibility of further measures of restraint. The most important of such measures would be those designed to curtail the high rate of inflation of 12 per cent. To that end, more determined steps were required to restrain wages, both in the private and public sectors, especially as the number of public civil servants had continued to increase. As the staff had observed, nonselective and overall wage increases augmented the labor costs of small and medium-sized industries as well, leading to labor shedding and an increase in unemployment.

Fiscal policies had been drastically changed, especially on the expenditure side, Mr. de Groote observed. But the tendency of the Spanish authorities to stress the revenue side might be counterproductive in the long run, because it would probably have the effect of diminishing the role of the private sector and of entailing a further reduction of savings. In that connection, he failed to see that there had been an upward trend in the rate of savings. According to the statement made by the staff representative, the most recent statistics showed that consumption had grown faster than envisaged, a development that in his own view was due to the boost given to disposable income by the triggering of the wage adjustment clause in the fourth quarter of 1982. Thus, the prospects for saving and investing out of domestic resources were worsening. Fiscal reform should therefore be given priority. Obviously, in its current stage of economic development, Spain could no longer afford such a wide-ranging and highly developed social security and welfare system. The comprehensive reform that the authorities envisaged undertaking should therefore be implemented quickly, and not simply be announced as a medium-term program. At the same time, more imaginative solutions would have to be found for dealing with the increases in budget transfers to finance the losses of state enterprises. Unless the public sector deficit were brought under control, the Government's monetary policy could not be successful. However, some progress could perhaps be made if interest rate policy were applied in a more selective way to benefit the export sector in general.

In concluding, Mr. de Groote said that the Spanish authorities deserved recognition for having taken measures to preserve their competitive position in an unfavorable economic environment, although it still seemed imperative for Spain to speed up its adjustment effort. Otherwise, it would not be able to join a community of developed countries as an equal member.

The staff representative from the European Department remarked that the target set by the authorities for significantly decelerating the rate of growth of the monetary aggregates from the relatively high level of 1982 might perhaps need to be reduced further, although she would not describe the announced stance of monetary policy as being too accommodating. The fiscal deficit was significantly lower, as a percentage of GDP, in the new budget than had been foreseen at the time of the Article IV consultation discussions, and the staff hoped that the authorities would take the opportunity to reconsider the monetary program accordingly. Experience during the first quarter of 1983 in the exchange market suggested that there was still considerable pressure on reserves, indicating that liquidity in the economy continued to be ample and to flow abroad. She understood that consideration was being given to lowering the operating target by which the Bank of Spain controlled liquidity of the banks. Certainly, the recent action to raise by 1 per cent the coefficient on remunerated reserves had gone in the right direction.

Of course, to tighten the monetary target, a flexible interest rate policy would become even more necessary; in that respect again, the recent indications given in the staff's opening statement suggested that progress was being made in the right direction, the staff representative went on. There had been some inching up of interest rates in the short-term money market and on the certificates issued by the Bank of Spain in conducting its open-market operations. Flexibility in interest rates seemed essential not only to control liquidity in the short term, but also to establish the conditions for a more flexible and less regulated financial market. The Spanish financial system, despite progress in recent years, remained relatively regulated, and further progress would be desirable.

The reason why the banks objected to an aggressive policy of nonmonetary financing of the budget deficit, the staff representative explained, was that if treasury bills were sold to the public at attractive rates, they would provide strong competition for deposits, so that deposit rates, which remained negative in real terms, would tend to rise. The profit position of the banks was being squeezed because they were required, by means of the investment coefficient, to hold certain securities of the special credit institutions, which in turn provided subsidized credit for various activities, such as exports and investment. The Government intended gradually to raise the rates of interest on those securities, although the staff would prefer a gradual reduction of the investment coefficient, as initially proposed; there was still some margin for reducing and in fact eventually eliminating it, particularly for the savings banks. The Spanish authorities considered that if interest rates on the securities that the banks were required to hold were raised in due course to match market rates, the need for the investment coefficients would disappear because the banks would willingly hold the securities.

The effect of the increase in interest rates on the behavior of savings in the private and the household sectors as a result of the deregulation that had taken place was likely to be marginal, the staff representative considered. It should be emphasized that the figures on the savings ratio in the staff reports were very preliminary; national accounts in Spain were prepared with long delays, and the projections for 1982 were still tentative. In fact, the upward revision of the estimates of consumption, based on the latest information from the Institute of Statistics, suggested that the savings ratio would be correspondingly lower. In general, the savings ratio in the household sector was quite low, probably for structural reasons, in particular owing to the negative interest rates on financial assets over a long period.

There had been a cyclical component in the increase in the budget deficit in 1982, although it had probably not been the major one, the staff representative stated. The increase in subsidies to ailing enterprises seemed to have structural rather than a purely cyclical origin. The new Government had been in place only about two months at the time of the Article IV consultation discussions, and consideration was about to be given to structural problems. Certainly, both the Ministry of Industry and the Ministry of Finance and Economy were keenly aware of the need to review once more overall policy on subsidies to enterprises in difficulty, particularly to state enterprises. They were also aware of the need to tackle the problem with more wide-ranging measures than subsidies, which could not bring about a lasting improvement in the situation. It had been clearly recognized that it would be essential to reduce capacity in some sectors, like steel and shipbuilding, if the Spanish economy was to be successfully integrated into the European Community.

There was also a clear need for a comprehensive reform of the social security system, the staff representative continued. The Government was determined to make major improvements in the administration of social security benefits. Already in 1982, the requirements for determining eligibility for unemployment benefits had been tightened. Over the medium term, the task would be one of reforming the entire system, essentially by limiting the benefits for which everyone was eligible, and by distinguishing between different levels of benefits, some of which would be funded fully by contributions. However, the authorities attached considerable importance to improving the financing of the system, by placing greater reliance on tax revenue and less on contributions, which added to labor costs. The introduction of the value-added tax might provide some room for maneuver over the medium term. As indicated in Appendix II to SM/83/59, social security contributions, as a proportion of labor costs, were relatively high in Spain, in comparison with rates in most other industrial countries.

There was scope for a firmer wages and incomes policy in the public sector, the staff representative considered. Negotiations with the unions had just begun at the time of the Article IV consultation discussions, and they had probably not yet been concluded. The Government had not announced any increase in wages for civil servants, unless a decision had been reached in connection with the budget. If the rate of growth of wages in 1983 appeared to be too high, two possible courses of action might be to postpone the reduction of the work week to moderate the increase in labor costs, and to seek agreement among the social partners that the wage revision clause should not be activated. Of course, the impact would be felt only in 1984, when the additional boost to labor costs from the reduction of the work week would be felt. The Minister of Economy and Finances currently felt that it would have been difficult politically for such a new Government to introduce an incomes policy. Such a policy might be more feasible in 1984 in the context of a medium-term plan that would offer the unions a framework in which wage concessions could be traded for action to improve employment over the medium term.

If the balance of payments forecasts presented in the staff reports were being prepared at present, rather than in March, the staff representative observed, the projections would probably show an increase in the estimated balance of payments deficit. The staff had projected that energy imports would decline by about 1-1.5 per cent and that nonenergy imports would increase by about the same amount. The projections had seemed consistent with the projected rate of growth of domestic spending, because they had been predicated on the assumption that, under the announced policy stance, there would be no increase in real wages and a tight adherence to the monetary targets. Furthermore, the data available to the staff on imports and exports up to the third quarter of 1982 suggested a depressed level of economic activity that would be translated into a reduced average rate of growth in 1983. However, exports and imports seemed to have rebounded in the fourth quarter of 1982. Therefore, revised projections would probably show a more significant growth in import volume. A less favorable performance might be forecast however with respect to receipts from tourism. Not only had the estimates of receipts for 1982 been revised downward, but the possible impact of the restrictions imposed by France on spending by tourists, and the continued depreciation of the peseta against the U.S. dollar, were likely to have a negative impact.

The staff did not believe that Spain had placed excessive reliance on the exchange rate, the staff representative observed. Before the December devaluation, the real exchange rate, measured by admittedly imperfect indicators, had been 13 per cent above the 1977 peak, and even at present, according to the staff calculations, was about 3-4 per cent above that peak. It could be argued that the 1977 peak did not represent an equilibrium rate, because of the sharp appreciation that had subsequently taken place. Nonetheless, in the medium term, a competitive exchange rate was necessary, because Spain was facing the prospect of accession to the European Community and a sizable reduction in tariff and nontariff trade barriers, which remained at a high level.

Short-term debt should be controlled more tightly, the staff representative commented. At present, debt statistics did not cover short-term trade credit. The staff had had ongoing discussions with the Spanish authorities to identify the portion of trade or short-term credit channeled through the banking system, as recorded in both the monetary and external debt statistics. A clear definition of the way in which such credit was treated had not yet been arrived at, but, by the time of the 1984 Article IV consultation, the staff hoped to have a clearer view of the position. The authorities themselves were aware of the need to improve the monitoring of statistics on short-term debt. While they were not particularly concerned with the growth of the net foreign liabilities of the banking system, which had not increased greatly in recent years, they were watching carefully the matching of maturities on the assets and liabilities side of the banking system, and were tightening to some extent control over the acquisition of foreign assets by Spanish banks.

Finally, referring to Spain's prospective entry into the European Community, the staff representative remarked that it was indeed essential for there to be greater convergence of Spanish economic policy with that of its prospective partners. She believed that the Spanish authorities intended to rank that goal high among the priorities of the medium-term plan. Clearly, there would also be a need for specific action in sectors in which Spain, and the rest of the European Community, had been plagued by excess capacity. Shipbuilding, steel, and textiles were among the sectors of concern.

As for the medium-term advantages of entry into the European Community, the staff representative from the European Department added, aside from the obvious political advantages, it seemed to the staff that the Spanish economy, which was so regulated and had been so protected in many ways for such a long time, would benefit, once the difficult transitional period was over, from more competition and also from the widening of markets that would permit greater economies of scale. The process would unquestionably be difficult, and the authorities were aware of the complex set of changes in the economy that would be entailed.

Mr. Feito commented that monetary policy was perhaps the Government's principal instrument of macroeconomic policy in the short term; he would, therefore, concentrate on that topic. Three general criticisms of that policy had been made during the discussion. First, it had been said that monetary policy might be too accommodating, because of the development of other financial assets in the system. The rate of growth of 13 per cent that was projected for M-3 allowed for part of the demand for liquidity throughout 1983 to be met by the development of those other assets. It should be noted that a similar development of financial assets had taken place in 1982. Monetary growth, therefore, was fully consistent with the intended reduction in the rate of inflation. The rate of monetary expansion was also consistent with both the estimated rate of growth in real terms and the balance of payments situation. In that respect, it should not be overlooked that the Government had used variables other than M-3 in conducting monetary policy. For instance, reserve requirements had been adjusted twice in the past three or four months.

The second question that had been raised concerned the possible incompatibility of monetary policy with fiscal policy, Mr. Feito continued, the need for financing the Government's borrowing requirements being seen as likely to slow down the impact of monetary policy. In that connection, an analysis of Table 1 of SM/83/56 might be clarifying. The assumption in that table was that the public sector deficit as a proportion of GDP would be about 6 per cent, whereas the borrowing requirements of the public sector--namely, the rate of expansion of domestic credit to that sector--would be about 33 per cent. Given the share of credit to the public sector in total domestic credit, the rate of growth of domestic credit to the private sector would be 13 per cent as of the end of 1983, and should reach about 14 per cent on average during the year. In real terms, depending upon the price deflator used, private credit would grow by 1.5-2.5 per cent, a figure fully consistent with projections for the real sector of the economy.

Moreover, the development of other financial assets that were not included in the definition of monetary variables covered in Table 1 was largely benefiting the private sector, so that the overall rate of growth of credit to that sector in nominal terms would be closer to 15 per cent, or 3 per cent in real terms, Mr. Feito said. Credit flows to the private sector in real terms in any of the amounts that he had mentioned would be entirely compatible with the Government's projections for the real sector of the economy, and with the objectives for prices and the balance of payments. Thus, monetary policy should also be fully compatible with a fiscal policy associated with a public sector deficit of 6 per cent of GDP. The recent review of government policy had led to a reduction of 1 per cent in the projected fiscal deficit, to about 5 per cent of GDP, making it possible to make the two short-term instruments of macroeconomic policy even more compatible.

The third issue raised in connection with monetary policy, Mr. Feito remarked, was how the Government would respond, in terms of monetary policy, if the rate of growth of wages exceeded the range agreed upon between employees and employers under the national agreement. The authorities believed that the rate of growth of wages should remain in the central area of the agreed band. It was unlikely that that band would be exceeded, for two reasons. First, the negotiations between the main representatives of the trade unions and the employers' federation to determine wages in various sectors of the economy would have to take account of a higher rate of unemployment than in previous years. Second, high unemployment could exert some downward pressure on wages during 1983, because labor markets would be affected by the availability of additional opportunities for employers to dismiss workers and engage in temporary contracts for labor services. Considerable use had begun to be made of the more flexible regulations relating to the termination of employment, and their use would be intensified in the coming year.

Furthermore, Mr. Feito remarked, the announcement by the Government of its budget, and of its firm decision to carry out its monetary policy, as demonstrated by the reserve requirements being applied to the banking system over the past week, was helping to increase its credibility with the market and would have a favorable impact on wage developments. If, however, the rate of growth of wages did exceed the agreed band, the Spanish Government would fulfill its monetary objectives and ensure the necessary degree of adjustment in the economy; the stabilization of wages in real terms was a matter of high priority if there was to be a satisfactory economic recovery in the medium term.

He did not yet know whether a decision had been reached, as part of the new budget, on wages in the public sector, Mr. Feito commented. It should be noted, however, that the Government had already reduced the salaries of civil servants, in comparison with wages in the private sector, by increasing the effective working week in the public sector at the beginning of 1983, whereas the working week for the private sector had been reduced. He believed that the increase was a firm signal of the Government's intention not to allow wages in the public sector to increase excessively; on the contrary, it was an indication that remuneration in the public sector was not to exceed the recently agreed wage spread.

In sum, the monetary policy of the Government had been drawn up in a consistent fashion, Mr. Feito stated. Basically, the objective was to increase Spain's competitiveness, bringing it up to the level necessary to permit the international economic recovery to be reflected in the Spanish economy.

Although it might be true that the Spanish economy was subjected to more regulation than were the economies of the members of the European Economic Community, Mr. Feito commented, it should not be overlooked that Spain had carried out a number of important reforms at great speed. There were always conflicts between the short-term costs and long-term benefits of reforms, and the costs could become unbearable if too many changes continued to be made at the same time.

There had been a considerable liberalization of interest rates, since 1981 in particular, Mr. Feito remarked. As a result, savings as a percentage of GDP had increased markedly over the past three years, if not in absolute terms. The thoroughgoing reform of the financial system had also had considerable costs; many financial entities had ceased to operate, at a much higher social cost than in other sectors of the economy because of the potential impact on confidence. Every effort would have to be made to avoid the possibility of an adverse effect on overall confidence in the economy. Many financial institutions had had to improve their efficiency and productive capacity. A more rapid liberalization of the financial system would have been difficult and probably counterproductive.

The process of trade liberalization had been intensive between 1977 and 1979, Mr. Feito recalled, but had been carried out much more slowly since that time. The fundamental reason had been the realization that Spain's entry into the European Community might be further in the future than had been expected. At the end of the 1970s, a number of phases of the negotiation had been delayed, and the Spanish authorities had begun to feel that measures of trade liberalization should be more closely linked with the progress being made in negotiations with the authorities of the European Community, if only because of the increased protectionist measures taken by the EC against Spanish exports.

The external debt situation of commercial banks was more than adequately controlled by the authorities, Mr. Feito remarked, for the simple reason that, in moving to liberalize the financial system, they had loosened their previously complete control of access to external markets only when it was certain that the information was available to monitor developments at all times. For instance, commercial banks were subject to a regulation requiring them to cover 70 per cent of the liabilities acquired over a given period of time by assets of the same maturity. The Spanish authorities were therefore ensuring, under their system of capital controls, that the net liability position of commercial banks would be monitored as part of the indispensable adjustment of the Spanish economy. On the whole, the adjustment of the structure of the Spanish economy was a delicate process that had to take account of the optimal pace of adjustment and to be guided by the need to move toward convergence with the economies of the European Community. As for short-run considerations, the social costs of a rate of unemployment of 16.5 per cent posed great risks for Spanish policy. Whether fiscal and monetary policies should be more severe or weaker was open to debate, but the basic orientation of economic policy was not. As the Interim Committee had stated in its February communiqué, only through the control and reduction of inflation would the foundations be laid for a better growth rate of GDP in real terms.

The Chairman then made the following summing up:

> Executive Directors strongly supported the Spanish authorities' view that a priority objective of economic policy in 1983 should be securing a reduction of inflation and a strengthening

of the external position. Substantial adjustment was needed, they said, and the introduction of effective measures toward that end had become urgent.

The successful implementation of the authorities' program for 1983 would, in the view of many Directors, constitute an important first step in the medium-term adjustment necessary to bring the Spanish economy more into line with those of other industrial countries, particularly those in the European Community. It would also lay the foundation for a sustained recovery of output and employment in subsequent years, in line with the expected recovery in world demand.

Directors noted that the attainment of the Government's objectives for 1983 would require a well-coordinated and determined use of various policy instruments. They welcomed the authorities' intention to tighten the stance of monetary policy, and, in that respect, the view was expressed by some Directors that the target for M-3 might be too accommodating. Directors also stressed the need to support the tighter monetary policy with a determined effort to contain the growth of the public sector deficit and labor costs. The rapid growth of the public deficit in recent years was noted by Directors with concern, particularly in the light of the impact of the deficit on liquidity reation. Directors therefore welcomed the intended reduction in the public sector deficit to the equivalent of 5 per cent of GNP, as envisaged in the 1983 budget. They stressed the importance of avoiding overruns and the need for a substantial effort to contain public expenditures, particularly wages in the government sector and in public enterprises, social security benefits, and subsidies to ailing industries.

Directors welcomed the authorities' efforts to increase the nonmonetary financing of the deficit. Observing that interest rates on deposits remained negative, they underlined the importance of a more flexible interest rate policy and noted that there was still large scope for a further liberalization of the financial system.

Directors also expressed serious concern at the possibility of an acceleration of the growth of labor costs in 1983 in the light of the negotiated wage band and of the proposed reduction of the work week, which was likely to have a detrimental impact on labor costs. They urged the authorities to secure wage moderation in the public sector and to prepare for further action if wage increases in the private sector should threaten to exceed the targeted range. Wage moderation was seen by Directors as an essential element in the effort to improve employment prospects over the medium term.

Directors stressed the importance of securing a significant reduction in the current account deficit of the balance of payments in order to moderate the debt service burden, which is relatively high. They also urged the authorities to strengthen the mechanisms for control of the external debt, especially short-term debt.

The importance of maintaining a competitive exchange rate in the external adjustment effort was underlined, and, in that respect, Directors noted the recent depreciation of the peseta and stressed the importance of continuing with flexible management of the exchange rate to prevent any sustained real effective appreciation. They expressed the hope that such an approach would permit an early resumption of the liberalization of the trade system.

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

The Executive Board then took the following decision:

Decision concluding 1983 Article XIV Consultation

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.

Decision No. 7389-(83/66), adopted
April 22, 1983

APPROVED: September 27, 1983

LEO VAN HOUTVEN
Secretary