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INFORMATION

February 23, 1982

To: Members of the Executive Board

From: The Secretary

Subject: Spain - Staff Report for the 1981 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1981 Article IV consultation with Spain. A draft decision appears on page 14.

It is proposed that this subject be brought to the agenda for discussion on Friday, March 19, 1982.

Att: (1)

Other Distribution:  
Department Heads



INTERNATIONAL MONETARY FUND

SPAIN

Staff Report for the 1981 Article IV Consultation

Prepared by the Staff Representatives for the  
1981 Article IV Consultation with Spain

Approved by Brian Rose and Subimal Mookerjee

February 22, 1982

I. Introduction

A staff team comprised of Mr. Brian Rose, Mrs. T. Ter-Minassian (both EUR), Messrs. M.S. Khan (RES), G. Kopits and E. Croce (both EUR), with Miss I. Jones (EUR) as secretary, visited Madrid from December 1 to December 15 to conduct Article IV consultation discussions. The Spanish representatives included officials from the Ministry of Economy and Commerce, the Ministry of Finance and the Bank of Spain. Members of the mission met the Vice-President for Economic Affairs of the Council of Ministers, Mr. J.A. Garcia Diez, and the Governor of the Bank of Spain, Mr. J.R. Alvarez Rendueles. Mr. A. Buira, Executive Director for Spain, attended some of the meetings as observer. Spain continues to avail itself of the transitional arrangements in Section 2 of Article XIV of the Articles of Agreement.

II. Report on the Discussions

1. Background

The Spanish economy has experienced since 1975 a combination of stagnating activity, sharply rising unemployment, and the persistence of a relatively high rate of inflation. Since 1979 the current account of the balance of payments has reverted to a deficit of significant size. The roots of these problems are complex and relate to socio-political as well as to economic conditions, as Spain has gone through a successful but not always easy political transition during this period.

At the time of the first oil shock the Spanish economy was highly dependent on imported energy; it was also relatively poor in natural resources and characterized by a weak agricultural sector and an industrial base not sufficiently diversified nor technologically advanced. The policy response to that shock was also inadequate, as domestic energy prices were not raised sufficiently to reflect fully the increases in foreign prices. At the same time that the economy was facing a massive terms of trade loss (equivalent to nearly 4 per cent of GDP in 1974),

real wage costs also accelerated sharply as trade unions exerted pressures which employers were not able or willing to check. In addition, wages rose sharply in the public sector. Between end-1973 and end-1978 real wages per man in industry rose by nearly 50 per cent, a rate almost double that of Italy, which recorded the next highest increase in OECD countries, and far above the increase in productivity. In the face of this substantial shift in relative prices, enterprises reacted by progressively cutting back on the expansion of output and capacity, as well as on employment. Fixed investment declined for five consecutive years between 1975 and 1979 and employment fell by 6.5 per cent during the same period.

As external constraints began to emerge, the authorities initiated in 1977 a stabilization effort, including a tightening of monetary policy and a marked devaluation of the peseta. These policies laid the basis for a substantial improvement of the balance of payments and a significant moderation of the rate of inflation in 1978. The rate of increase in wages declined as well, but remained relatively high by international standards. The fall in employment, however, continued at an accelerated rate and unemployment reached 12.6 per cent of the labor force in 1980. Aside from the rising social costs, the fall in activity and employment also exerted heavy pressures on the budget, which was already bearing the brunt of policies aimed at a significant redistribution of income through improvements in social benefits. The growing financing requirements of the public sector placed an increasing burden on monetary policy, thereby hindering further substantial progress in reducing inflation.

The improvement in the external position proved to be short-lived as the economy was faced with the second oil price increase superimposed on a substantial loss of competitiveness, which was largely due to a marked appreciation of the peseta during 1978 and the first half of 1979. The current account, which had shown a surplus equivalent to 1.1 per cent of GDP in 1978, deteriorated significantly in the second half of 1979 as exports weakened and imports soared despite the maintenance of a relatively flat domestic demand.

## 2. Recent developments

The deceleration of wage costs following the stabilization effort of 1977-78, and a sustained growth of productivity, which however was obtained primarily through the shedding of excess labor, led to a moderate improvement of the profit position of enterprises. This development contributed in 1980 to some recovery of private investment, which was also supported by stepped up capital expenditure by the public sector. The investment effort was especially significant in energy-related projects, spurred by a marked increase in the domestic prices of energy from 1979. The rate of growth of output accelerated to 1 1/2 per cent, compared with just over 1/2 per cent in 1979. The deceleration of the rate of increase in labor costs, along with the favorable impact of an

exceptional harvest, also contributed to keeping the rate of inflation roughly unchanged at around 15.5 per cent despite a sharp increase in import prices.

The external position was unfavorably affected in 1980 by a large loss in the terms of trade and by the delayed impact of the deterioration of the competitive position in 1978-79, leading to the emergence of a current account deficit equivalent to US\$5 billion (2.4 per cent of GDP). The pursuit of a policy of gradual depreciation of the exchange rate during 1980, along with a continued reduction in the growth of domestic costs, however, laid the foundations for an improvement in the real external balance in 1981, as the volume of exports recovered markedly in the course of the year, while that of imports fell. <sup>1/</sup> Domestic demand declined for the first time, reflecting both a fall in real disposable income of households and a reversal of the largely speculative buildup in stocks that had taken place in the previous two years. A more realistic exchange rate policy and some further tightening of monetary policy, including a significant increase in real interest rates, were the main factors behind the reduction in stocks.

The relatively modest growth of activity (GDP is estimated to have risen by less than 1 per cent in 1981) was reflected in a continued fall of employment, and a further sharp rise in unemployment to nearly 15 per cent of the labor force by the end of the year. The conditions in the labor market contributed to a further slight moderation of labor costs and of inflation, which declined to 14 1/2 per cent despite a renewed upsurge in import prices.

The improvement in the real trade balance was offset by a continuing deterioration in the terms of trade and by the rising cost of the interest service on the external debt, leading to a further increase in the current account deficit, to nearly 3 per cent of GDP. This deficit was largely financed by long-term capital inflows, both private and public. Following substantial losses of reserves in the first few months of the year, the overall balance moved into surplus in the second half of the year, reflecting, besides seasonal factors, relatively tight domestic monetary conditions and some improvement in the current account. For the year as a whole, the reserve loss is estimated to have been below US\$1 billion. Throughout the year the authorities intervened frequently to smooth the decline of the peseta vis-à-vis the U.S. dollar. In the course of the year the effective exchange rate depreciated by over 11 per cent (4.3 per cent in real terms, (Chart 1)).

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<sup>1/</sup> The estimates for 1981 are still provisional and subject to a margin of error which is especially significant in the area of foreign trade owing to technical problems with the construction of the deflators.

### 3. Economic policy

#### a. The overall strategy for 1982

While the Spanish authorities recognize the need for adjustment of the external accounts and are also concerned to reduce the high rate of inflation, their main preoccupation is the unrelenting rise in unemployment. To intensify traditional demand management policies in an effort to reduce inflation, would exacerbate the already serious problem of unemployment. The authorities have therefore shifted the emphasis of policy, adopting a somewhat more supply-oriented strategy. In recognition of the fact that a major root of the fall in unemployment is to be found in the excessively high, although declining, rate of increase of real wages over the last several years, they have sought and obtained the social partners' consensus to a modest cut in real wages through a tripartite agreement (Acuerdo Nacional sobre el Empleo, or ANE). At the same time, the Government has also undertaken a stepped up program of public investment, reduced some of the tax burden of private enterprises, and increased the fiscal incentives for investment, particularly in the energy-related area. These various measures are expected to improve the trade-off between growth and inflation in the short run and, more importantly, to induce a higher rate of private investment in the longer term.

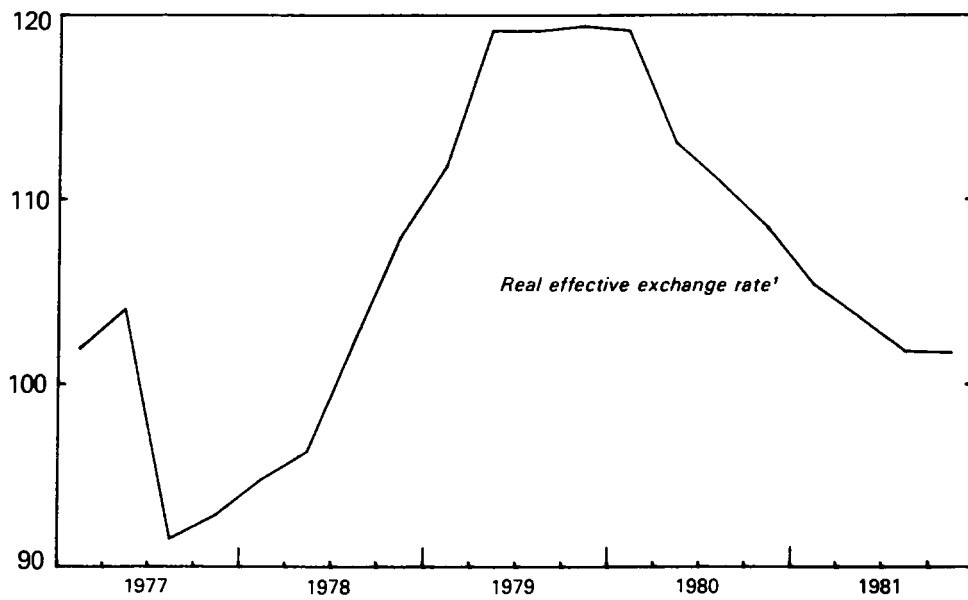
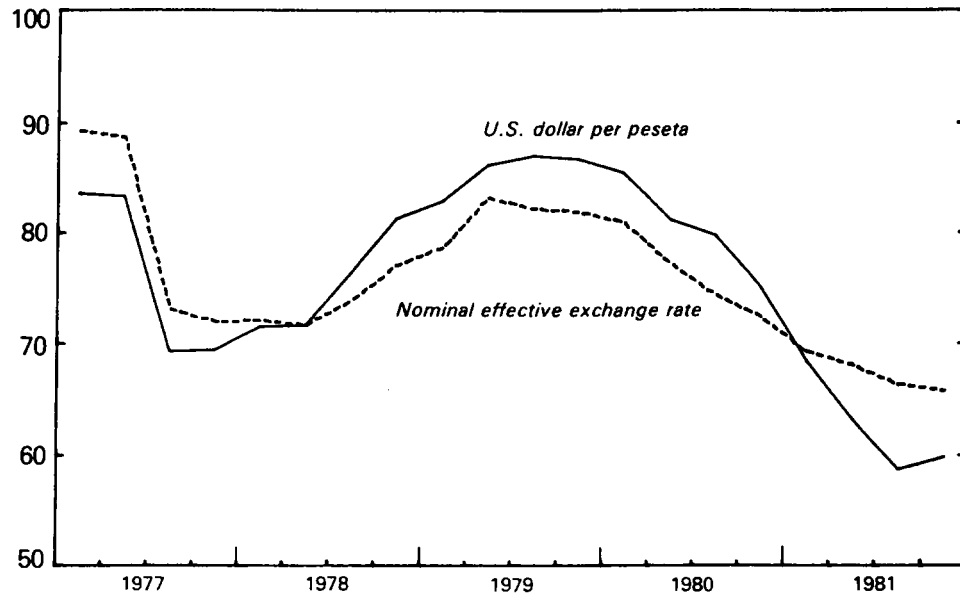
The Spanish representatives stressed that while the Government is giving priority to the fulfillment of the employment objective, progress on the inflation front still remains an important aim of economic policy. In the tripartite agreement the inflation target for 1982 is set at 12 per cent, and monetary policy is being formulated in such a way that, with the help of the expected moderation of both domestic cost increases and import prices, it should achieve this end.

The rising trend in the volume of exports in 1981 as well as the stabilization, or even improvement, in the terms of trade expected in 1982 provides, in the view of the Spanish authorities, welcome scope for a moderate increase of domestic demand without the risk of running into external constraints. The authorities are however conscious that, in order to be sustainable over the longer term, the recovery should be based on rising productive investment and be supported by a continued growth of exports. In this respect, they are aware of the importance of reversing the deteriorating trend in public sector savings and of ensuring a significant shift in the composition of public spending toward productive investment.

#### b. Wage and employment policies

The main feature of the tripartite agreement between the Government, trade unions and employers' federation (the first to be signed by both the socialist and communist unions) is a commitment by the social partners to keep contractual wage increases in 1982 within a range of 9-11 per cent, except for enterprises in difficulty which are authorized to grant smaller increases. This agreement is predicated on the achievement of a

CHART 1  
SPAIN  
EXCHANGE RATE DEVELOPMENTS  
(1975=100)



Source: International Monetary Fund, *International Financial Statistics*.  
¹Relative consumer price adjusted for exchange rate changes.





rate of inflation of 12 per cent and contains an automatic wage adjustment clause for increases in prices in excess of the target. The main counterpart for this cut in real wage rates is the commitment by the Government to promote the creation of 350,000 new jobs, which, given the expected losses of jobs in some sectors, is considered necessary to allow dependent employment to return by end-1982 to the level of June 1981.

The fulfillment of this goal is to be fostered by, first of all, an increase in the rate of public investment, estimated to rise by over 5 per cent in real terms in 1982. It is envisaged that priority will be given to projects with a relatively high employment-creating potential. In order to stimulate the creation of employment in the private sector, the agreement contemplates the takeover by the budget of 90 per cent of social security contributions for firms hiring previously unemployed workers, and a surcharge on contributions for overtime work, intended to discourage use of the latter. The agreement also envisages some improvements in unemployment compensation benefits.

The Spanish representatives stressed that the tripartite agreement was expected to have an important favorable impact on industrial relations and the outlook for profits and inflation in 1982. Although some of the measures contemplated in the agreement involved a sizable direct cost for the public sector budget, such a cost could ultimately be offset by the beneficial impact on the budget itself of an upturn in activity and the containment of unemployment. Their optimism with regard to the employment target, however, was tempered by the recognition that since the conclusion of the agreement in June 1981, the number of unemployed workers has increased by about 100,000.

In a longer-term perspective, the Spanish representatives pointed to the fact that the costs of hiring and firing workers remained high, despite a liberalization of labor legislation in recent years. The long-term prospects for employment would certainly be improved by actions that would effectively promote a greater labor mobility from some traditional industries which require a reduction in capacity (such as steel, ship-building, textiles, etc.) to those with greater potential for development.

#### c. Fiscal policy

Since the mid-1970s there has been a steady deterioration of the public finances. Tax revenues (including social security contributions) were relatively buoyant, the tax ratio to GDP increasing by over 5 percentage points over the period to over 26 per cent by 1981, partly reflecting the favorable impact of a tax reform in 1978, which involved the replacement of schedular taxes with a unified personal income tax and which was coupled with significant improvements in tax administration and collection. The growth of expenditures, especially current expenditures, however, far outpaced that of revenues. The main factors behind the rapid growth of public spending were the pursuit of income redistribution aims through increases in, and expansion of the coverage of, social

benefits, the escalating budgetary cost of unemployment compensation and policies to support employment in both the public and the private sectors. As a result of these developments, the overall deficit of the General Government rose from a negligible level in the mid-1970s to an estimated 4.3 per cent of GDP on a national accounts basis, or 4.7 per cent of GDP on a cash basis in 1981, nearly double the initially targeted amount.

The initial 1982 budget is shaped by the goal of reducing the deficit as a percentage of GDP, while ensuring the support to employment to which the Government has committed itself in the ANE. For this purpose the increase in wage rates of public employees was limited to 9 per cent and an effort is to be made to moderate the increase in the number of civil servants. In addition, the rates of some indirect taxes were raised, the increase in pensions was set at 10 per cent and entitlement to certain social benefits tightened. Besides the measures contemplated in the ANE, support to employment is to be provided through aid to industries in the process of restructuring, including a takeover by the state budget of past debt of the major public holding company (INI).

On the whole, the general government deficit for 1982 is projected in the initial budget at around Pta 626 billion (3.2 per cent of GDP) on a national accounts basis. The Spanish representatives recognized that there existed significant risks of overruns in some items of expenditure, as well as of shortfalls in some tax receipts. They stressed that both the revenue estimates and the projections for unemployment benefits were predicated on the attainment of the employment target of ANE. There was also the likelihood that supplementary budgetary appropriations may be required to finance additional aid to ailing industries, partly in fulfillment of commitments for industrial restructuring approved in the middle of 1981. The authorities thought that, in all, these overruns could add at least the equivalent of half a percentage point of GDP to the budgeted deficit.

The Spanish representatives pointed to the ongoing process of regional and local decentralization and to the prospects for the social security system as areas of concern for the public finances over the medium term. It would be important to ensure that the shift of financial responsibilities to the new regional autonomies did not result in a duplication of functions and excessive growth of public employment. As for social security, the Spanish representatives indicated that the Government had recently appointed a commission, with the participation of the social partners, to make recommendations for a comprehensive reform of the system which is widely recognized to contain inefficiencies and waste. Although no decisions had been taken yet, it seemed likely that to ensure the longer-term viability of the system it would be necessary to limit the role of the public sector in the social security area to the provision of a socially agreed minimum level of services, allowing for a greater role of the private sector in the provision of additional services. The reform would also have to be linked to changes in the methods of financing the system so as to reduce the burden of social charges on labor costs, which, despite recent reductions, remains quite

high by international standards. In this respect, the introduction of the value-added tax, presently scheduled for 1984, could provide the scope for further reductions in social security contributions, as well as represent a more efficient and income-elastic form of taxation than the existing turnover tax.

d. Monetary policy

For several years, the Spanish authorities have conducted monetary policy within the framework of a quantitative annual target for the growth rate of broad money (M3), consistent with the expected behavior of real output, inflation and income velocity. A band of 2 per cent on either side of the target has been used to provide a degree of flexibility. This target growth of M3 has been pursued primarily through the control of the monetary base, specifically bank reserves. The actual policy instruments utilized by the Bank of Spain have been changes in short-term credits to the banking system, sales and purchases of Treasury bills and of certificates of deposits, and on occasion, changes in reserve requirements. Since 1977 the choice of the target value has been geared toward a gradual reduction of inflation which has been reduced steadily in each year, from 24.5 per cent in 1977 to 14.5 per cent in 1981. The Spanish representatives indicated that gradualism had been dictated primarily by the concern that, with relatively inflexible real wages, a tighter stance of monetary policy would lead to an unacceptable increase in unemployment. A further constraint to a faster deceleration of the growth of the money supply has been posed by the escalating public sector deficit which, owing to the various rigidities in the financial system, has in the main been financed via the banking system.

Monetary policy which, following the stabilization effort of 1977-78, had been considerably eased in 1979, was gradually tightened again in the course of 1980 as the authorities were faced with a rapid deterioration of the external current account and with large capital outflows in the first half of the year, in reflection of an adverse interest differential and of speculation on the exchange rate. M3 grew by 16.7 per cent during the year, as against an initial target of 17.8 per cent.

The target for 1981 was set at 16.5 per cent, on the basis of an expected range for inflation of 13-15 per cent and a growth of output of 1-2 per cent. Credit to the public sector, which represented about 10 per cent of total credit at end-1980, was targeted to increase by 28 per cent and that to the private sector by 17 per cent. During the first part of the year, the authorities, threatened with substantial losses of reserves, were forced to allow interest rates to rise significantly, following the international trend. In the second half of the year, although external pressures abated considerably, interest rates remained relatively high in reflection of the need to mop up liquidity injected into the system by the financing of a budget deficit nearly double the originally projected amount. Preliminary estimates for the

year as a whole suggest that the growth of M3 remained about 1-1 1/2 percentage points below the target, primarily reflecting a larger than expected loss of reserves as well as a weaker than projected demand for credit by the private sector.

The Spanish representatives said that events in 1981 gave an idea of what was in store for 1982. The size of the fiscal deficit was expected to be a continuing problem for monetary management. This was especially so as the nonbank public had shown limited interest in medium-term and long-term government securities in which there is a limited secondary market, and the authorities faced strong opposition from the banking system to direct sales to the public of short-term securities with market-related yields, which the banks regarded as serious competition for deposits. Although the authorities intended to press ahead with the issue of about Pta 150 billion short-term securities, it was unclear how much of this amount would be absorbed by the nonbank public. Therefore, it appeared likely that the Bank of Spain would once again have to finance a large part (perhaps as high as 75 per cent) of the cash deficit of the public sector in 1982 as had been the case in 1981.

Although no decisions had been made at the time of the discussions on a target rate of growth for M3, the monetary authorities were leaning toward a rate around 15 per cent, which would be slightly below the projected outturn for 1981, in order to continue the policy geared to dampening inflationary expectations. The Spanish representatives recognized that, given the expected improvement of the current account, the likely resort to external borrowing by public entities, and the size of the financing requirements of the General Government, adherence to such a target might require some restriction of credit to the private sector. There was a danger that this could in turn lead to inflows of capital from abroad on a scale that could put unwanted upward pressure on the exchange rate. The Spanish representatives felt however that, notwithstanding the possibility of a conflict between domestic monetary stability and external adjustment, it was essential to adhere to a policy of gradually reducing the permissible growth of monetary aggregates.

A notable development in the financial field in 1981 was a substantial liberalization of the financial system. This involved the freeing of most lending rates and of rates on deposits with longer-term maturities over six months. Steps were also taken to ensure greater transparency in the system of bank charges and commissions. The rate of reduction of some mandatory investment ratios (which require financial institutions to hold a certain percentage of their assets in specified low interest loans to so-called priority sectors) was accelerated, although the levels of the eventual minimums were not changed. Finally, the system of convertible peseta accounts was liberalized and commercial banks were allowed to offer forward cover to nonresidents on those accounts. The Spanish representatives saw these as important steps in the ongoing process of modernizing the financial system and introducing greater competition into it, to promote efficiency and prepare it for the inevitable changes that would be required by EC membership in the medium term.

e. External policies

The sharp appreciation of the peseta in 1978 and in the first half of 1979 (Chart 1) led to a marked loss of competitiveness which unfavorably affected the real trade balance in 1979-80. Since mid-1979 the authorities have allowed the exchange rate to depreciate gradually in effective terms. Between the peak level of May 1979 and December 1981 the effective rate declined by 20 per cent and the depreciation was especially steep in 1980. In 1981, as the U.S. dollar strengthened vis-à-vis the EC currencies, and the authorities attempted to moderate the decline of the peseta against the dollar, the exchange rate appreciated marginally vis-à-vis the average of the EC. By December, however, it had returned to the level at the beginning of the year.

The real exchange rate, as measured by relative consumer prices adjusted for exchange rate changes, has also depreciated by 11 per cent since mid-1979 (Chart 1), but remains about 12 percentage points above the level reached after the 1977 devaluation, which the authorities regard as having been an overshoot. The Spanish representatives said that the improvement in the competitive position in the last two years, especially vis-à-vis the U.S. dollar area, had contributed to the strong performance of exports in recent months and also to a noticeable geographic redirection of trade from the EC particularly toward Latin American countries and OPEC. They recognized, however, that with Spain due to enter the EC it was important to improve competitiveness vis-à-vis the Community.

The Spanish representatives agreed that the persistence of a significant current account deficit against the background of a relatively flat domestic demand, underscored the need to maintain and preferably to improve the overall competitive position. This need is further emphasized by the fact that the still high degree of effective protection in the Spanish economy has to be reduced over time as Spain enters the EC. In the view of the Spanish representatives, however, a lasting improvement of competitiveness would best be achieved through firm financial and other economic policies that secured a steady deceleration of domestic costs and prices. While stressing that any substantial depreciation of the exchange rate would undermine the progress made so far on the inflation front, the Spanish representatives indicated that the authorities were not committed to the maintenance of any particular exchange rate, either against the dollar or in effective terms. For the near term, their concern was mainly with avoiding possible upward pressure on the exchange rate, stemming from the need to keep a relatively tight monetary policy in the face of large public sector borrowing requirements.

Spain disburses official development assistance (ODA) mainly to former territories and to countries in Latin America. It is not a member of the Development Assistance Committee (DAC). According to official Spanish sources, ODA has averaged less than 0.1 of GDP over the period 1977-80.

f. Energy policy

The adjustment of the Spanish economy to the massive increase in oil prices in 1973-74 remained quite modest until 1979. The "apparent" income elasticity of demand for energy during that period was not significantly different from that prevailing during the period 1965-73. This was largely a reflection of the failure to pass on the full increase in imported oil prices to domestic prices. Indeed, the real domestic prices of oil products, after rising significantly in the years immediately following the first oil shock, declined thereafter (see Appendix I to Recent Economic Developments).

The policy response was markedly different following the renewed upsurge of oil prices in 1979. Between July 1979 and July 1981 domestic prices of various petroleum products were raised on six occasions. The price of fuel oil was increased on the whole by over 170 per cent, that of gasoline by 56 per cent and that of diesel by 116 per cent. A comparison with other European countries shows that, for all major oil products, domestic prices in Spain are now at or above the average of these countries.

In July 1979 a National Energy Plan covering the period to 1987 was approved. Its basic objectives are the promotion of energy conservation in both domestic and industrial uses through appropriate pricing and other policies, and a reduction in the share of oil in the structure of energy consumption from just under 70 per cent in 1979 to 45 per cent by the end of the 1980s. This is to be achieved primarily through the substitution of heavy fuel oils by coal and nuclear power in electricity generation, targeted to be virtually completed by 1985. The effort toward oil substitution has already involved a substantial amount of investment (estimated at some Pta 660 billion in 1979-80) and will continue to do so over the next few years. This investment, consisting of construction of several new coal-fired and nuclear power plants and of infrastructures to import, store and transport natural gas and coal, and modifications to existing industrial plants and equipment to shift from oil to coal, has been encouraged through fiscal incentives and the provision of low cost financing from the official credit institutions.

Although the fruits of these policies are to be expected mainly in the medium term, some results have already begun to appear. Primary energy consumption declined by over 1 per cent in 1980 and is estimated to have shown a further small decrease in 1981. The authorities are projecting that in 1982 total energy imports will decline by at least 5 per cent, despite a moderate recovery of activity, as new coal-fired and nuclear power plants come on stream.

4. Prospects for 1982

The Spanish representatives were confident that the adjustments undertaken by the economy in recent years, as well as the conclusion of the social pact on employment and wages, have laid the foundation for a

moderate but sustained recovery of activity in 1982. Although private consumption is expected to stagnate, reflecting the decline in real wages and the targeted moderation of social transfers, investment is in their view likely to show a significant growth of over 3 per cent. The main factors behind this recovery are expected to be the stimulus provided by public investment, an improvement in profits and the prospect of a continued relatively strong performance of exports. The authorities recognize, however, the risk that, in the event of a substantial excess of the budget deficit over the initial forecast, private investment may be unfavorably affected by the need to keep relatively high interest rates. Projections for the growth of GDP range between 2 per cent and 3 per cent, provided primarily that the growth in the volume of exports envisioned by the authorities materializes.

The Spanish representatives were also optimistic about the outlook for inflation, as both domestic and external cost pressures were expected to remain moderate. They expressed, however, some concern about possible effects of the adverse weather conditions in the last quarter of 1981 on food prices in 1982. They also emphasized that the inflation forecast of around 12 per cent was predicated on the assumption of no further weakening of the peseta with respect to the U.S. dollar.

The current account is expected to improve significantly in 1982. Exports are projected to increase by about 8 per cent in real terms, thereby recording a significant gain in market shares in line with the pattern of 1981. Although nonenergy imports will probably rise by over 5 per cent, the overall growth of imports is expected to remain modest as a result of the decline in energy imports referred to above. A small improvement is projected for the terms of trade, on the assumption that oil prices will not rise through the end of the year. The services account is expected to show a modest improvement, the strength of non-factor services (especially tourism) outweighing the increasing burden of the external debt service. Estimates for the current deficit range between US\$3.5 and US\$4 billion (1.5 per cent to 2.0 per cent of GDP).

### III. Staff Appraisal

The Spanish economy has made significant progress in the recent past in adjusting to the consequences of the sharp increase in the relative prices of energy and labor that occurred in the second half of the 1970s. The adjustment is, however, far from complete in a number of respects. The growth of output and productive investment remains less than satisfactory. Employment has declined for several years in a row and the unemployment rate has risen to nearly 15 per cent--a level which is high for Spain and in comparison to other OECD countries. The rate of inflation remains at around 14 per cent which, though a substantial improvement on the performance of a few years ago, is still relatively high, especially when seen against the background of a continued weakness of demand. A deficit has emerged in the current account of the balance

of payments, which albeit still modest in relation to GDP, gives cause for concern in a medium-term perspective as it is not the counterpart of a strong investment performance but rather of a deterioration of domestic savings, especially of the public sector.

There needs to be a delicate balancing of priorities in addressing these problems. The desirability of increasing employment--or at least, in the short run, arresting its fall--must rank high, but it would be a mistake to try to achieve this either by increasing subsidies to inefficient industries or through public investment programs of a "make-work" character, as such measures would actually lower the rate of growth in the medium term by retarding the needed reallocation of resources. Equally, an expansionary monetary policy, while possibly raising the growth of output in the short run, would likely rekindle inflationary expectations that would produce damaging effects later on. In the view of the staff, pressures for strong reflation should be resisted as such a policy could at best be expected to produce only a temporary improvement in the situation.

The monetary authorities should be commended for their efforts over the past few years to bring about a gradual reduction in the rate of inflation through a steady deceleration in the growth of monetary aggregates. However, firm monetary control is increasingly being hindered by the sharp rise in the deficit of the public sector in recent years, which threatens to continue in 1982. Financing a deficit significantly higher than targeted in the budget, largely through the Bank of Spain, would lead to an excessive increase in the monetary aggregates unless the authorities were prepared to reduce the flow of domestic credit to the private sector. Such a reduction could lead to sizable capital inflows and perhaps to an appreciation of the exchange rate which would be clearly undesirable from the viewpoint of external adjustment.

While the balance of payments does not appear to pose an immediate constraint, a continued deficit of the present size could over the longer run produce a burdensome increase in the foreign debt. To secure a reduction of the deficit in the face of an upturn in domestic demand, a strong export performance will be essential. This in turn requires coherent policies aimed at enhancing the competitive strength of the foreign sector.

Faced with these problems, the authorities have begun to implement a strategy to ensure the maintenance of an adequate level of competitiveness in a number of areas. The first element of policy, all the more important because it also has a strong bearing on the prospects for increasing employment and reducing inflation, is the question of real labor costs. Over the last several years these increased considerably faster than productivity, though the picture has improved significantly in the last couple of years. The resulting pressure on profits contributed to the fall in employment and also diminished the ability of Spanish industry to compete on world markets. The tripartite agreement between employers, workers, and the Government provides for an increase in contractual money wages in 1982 below the expected rate of inflation,



and every effort needs to be made to keep to the objectives of this agreement. A second element in the strategy of maintaining competitiveness is exchange rate policy. The depreciation of the peseta in effective terms in 1980 and 1981 has made a considerable contribution to the improvement of the competitive position and the staff welcomes the flexible response of the Spanish authorities to exchange market developments after the unfortunate appreciation of the peseta in 1978/79, and hopes that the float of the peseta will continue to be managed in such a way as to give full weight to the need for a strong competitive position.

A further element in the area of the competitiveness and efficiency of the economy is more diffuse but no less important, i.e., the numerous structural rigidities that characterize both the financial system and the real economy as a whole. Over the last few years considerable progress has been made in the difficult task of liberalizing the financial system. Further action in this area deserves priority. Consideration should be given, for example, to further liberalization of interest rates; to the issue of a wider spectrum of securities of a short-term maturity; and to a relaxation of regulations governing the operations of foreign banks. A financial system more responsive to market forces would contribute to a more efficient allocation of resources. On the fiscal side, the efforts to contain the public deficit should also be supplemented by measures aimed at improving the quality of public expenditure by redirecting it from the support of consumption to that of productive investment. There is a real need to moderate the growth of both subsidies to ailing industries and social transfers. In this respect the authorities' intention to enact in the near future a comprehensive reform of the social security system is to be welcomed. On the tax side, a greater effort is required to strengthen tax administration and enforcement, in order to distribute the tax burden more evenly and to further modernize the tax system through an early introduction of the value-added tax. The latter will also permit the intended reduction of the social security tax burden on labor costs. Finally, attention ought to be given to a further liberalization of the fairly restrictive import regime. For a modern industrial economy, soon to become a member of the European Community, the degree of effective protection in Spain (especially if one takes into account quotas and other nontariff barriers) remains relatively high and tends to perpetuate the existence of industries which are no longer able to provide badly needed opportunities to expand employment.

#### IV. Proposed Decision

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

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

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

Fund Relations with Spain

(As at end-January 1982)

Quota: SDR 835.5 million.

Fund holdings of pesetas: SDR 771.6 million or 92.35 per cent of quota, including net purchases under the oil and compensatory financing facilities, equivalent to 16.95 per cent of quota.

SDR Department: SDR 318.58 million or 106.62 per cent of net cumulative allocation.

Gold distribution: 338,053 fine ounces.

Lending to the Fund: Associated with lending arrangement between the BIS and the Fund.

Exchange rate: Spain has maintained a managed floating of the peseta since 1974. The exchange rate, which after the 1977 devaluation had appreciated sharply in 1978 and in the first half of 1979, reflecting a strong current account position and tight credit conditions, began to weaken in the second half of 1979 as the external position deteriorated. During 1980 the peseta depreciated by 19.8 per cent with respect to the U.S. dollar and by 10.2 per cent in effective terms. From December 1980 to December 1981, the peseta depreciated by 6.4 per cent in effective terms and by 18.5 per cent with respect to the U.S. dollar, and devaluated in effective terms by 1.5 per cent with respect to EC currencies.

Previous relations: Spain purchased its whole entitlement (SDR 572.1 million) under the oil facility and a further SDR 98.8 million (25 per cent of quota) under the compensatory financing facility in February 1978. A one-year stand-by arrangement in the enlarged first credit tranche, equivalent to SDR 143.2 million, was approved in February 1978 but was not drawn upon.

Last consultation: The previous Article IV consultation took place in December 1979 and the report was discussed by the Executive Board on March 5, 1980 (SM/80/28, 1/28/80; SM/80/32, 2/1/80 and Supplement 1). On that occasion the following decision was adopted by the Executive Board:

"1. The Fund takes this decision in concluding the 1979 Article XIV consultation with Spain, in the light of the 1979 Article IV consultation with Spain conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The bilateral payments agreement with Equatorial Guinea has expired and the bilateral payments agreement with Colombia has been replaced by a reciprocal credit arrangement. The Fund notes with satisfaction that Spain no longer maintains a bilateral payments agreement with any member."

In December 1980, a staff team visited Spain for informal discussions with the Spanish authorities on current economic policies and prospects.

Basic Domestic Data

APPENDIX II

Population (December 1980)  
Labor force (September 1981)  
GDP per capita (1980)

37,412,000  
12,860,000  
Pta 402,970 (SDR 4,318)

	1980		1978	1979	1980	1981 <sup>1/</sup>	1982 <sup>2/</sup>
	In billions of pesetas	In per cent	Percentage changes				
<u>Demand and output</u>							
Private consumption	10,632	70.5	1.5	0.9	1.2	-0.8	0.2
Public consumption	1,704	11.3	5.5	3.8	3.2	2.4	2.6
Fixed investment	2,887	19.1	-1.1	-2.0	0.5	1.0	3.1
Stockbuilding <sup>3/</sup>	236	1.6	-0.5	0.3	0.3	-0.6	--
Total domestic demand	15,459	102.5	0.8	0.9	1.6	-0.7	1.0
Foreign balance <sup>3/</sup>	-383	-2.5	1.9	-0.3	-0.4	1.4	0.9
GDP	15,076	100.0	2.7	0.6	1.5	0.7	2.0
Industrial production	...	...	...	0.1	1.4	1.0	...
<u>Wages, costs, and prices (nonagricultural sector)</u>							
Wage rate per man	...	...	25.4	22.5	16.9	15.0	13.0
Unit labor costs	...	...	20.5	19.5	13.2	10.5	8.8
CPI	...	...	19.8	15.7	15.5	14.5	12.0
GDP deflator	...	...	20.3	15.4	12.9	12.7	12.4
<u>Labor market</u>							
Employment	...	...	-1.9	-2.4	-3.2	-3.0 <sup>4/</sup>	-1.5
Unemployment rate (levels)	...	...	7.7	9.6	12.6	14.6 <sup>4/</sup>	...
Participation rate (levels)	...	...	49.6	49.3	48.5	48.2	...
Disposable income of households	...	...	23.0	15.7	15.6	13.6	12.2
Savings ratio (levels)	...	...	10.0	8.6	7.3	7.2	7.2
<u>Main financial aggregates</u>			(As per cent of GDP)				
General government sector							
Tax receipts	...	...	24.2	25.3	26.0	26.6	26.9 <sup>5/</sup>
Current expenditure	...	...	25.5	26.9	28.7	30.0	28.9 <sup>5/</sup>
Current balance	...	...	1.5	1.2	0.1	-0.4	1.0 <sup>5/</sup>
Overall balance	...	...	-1.8	-1.9	-3.4	-4.3	-3.2 <sup>5/</sup>
Overall cash balance	...	...	-2.4	-2.5	-3.0	-4.7	...
	Dec. 1980		1978	1979	1980	1981 <sup>6/</sup>	
	In billions of pesetas						
Money and quasi-money (M3)	12,243.4	19.9	18.0	16.7	15.0		
Total domestic credit	12,917.7	15.5	17.2	20.3	19.2		
Credit to the private sector	11,513.5	13.7	15.6	18.4	16.3		

Basic External Data

	1978	1979	1980	1981 <sup>1/</sup>	1982 <sup>2/</sup>
Balance of payments (in millions of U.S. dollars)					
Exports, f.o.b.	13,480	18,352	20,928	20,426	23,082
Imports, f.o.b.	17,505	24,022	32,389	31,288	33,040
Trade balance	-4,025	-5,670	-11,461	-10,862	-9,958

Basic External Data (continued)

	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u> <sup>1/</sup>	<u>1982</u> <sup>2/</sup>
Balance of payments (in millions of U.S. dollars)					
Services (net)	4,001	5,014	4,424	3,837	4,291
Transfers (net)	<u>1,656</u>	<u>1,782</u>	<u>2,048</u>	<u>1,732</u>	<u>1,839</u>
Current balance	1,632	1,126	-4,989	-5,293	-3,828
As percentage of GDP	1.1	0.6	2.4	2.8	1.9
Net long-term capital inflow	2,017	3,220	4,201	4,662	
Of which:					
Investment	1,114	1,349	1,277	1,465	
Borrowing	1,299	1,498	2,750	2,653	
Public	-396	373	174	544	
Net short-term capital inflow <sup>7/</sup>	<u>171</u>	<u>-2,243</u>	<u>-757</u>	<u>-5</u>	
Overall balance	3,820	2,103	-1,545	636	
Change in net foreign position of commercial banks	139	1,335	829	30	
Change in foreign reserves	-3,959	-3,438	716	606	
External in long-term debt outstanding <sup>8/</sup>	17,158	19,461	23,695	26,242 <sup>4/</sup>	
Net official reserves <sup>9/</sup>	10,015	13,117	12,358	11,879 <sup>10/</sup>	
Exchange rate (peseta/U.S. dollar)	76.7	67.1	71.7	92.3	
Change in U.S. dollar/peseta	-0.9	14.3	-6.4	-22.3	
Change in effective exchange rate	-8.7	10.6	-6.3	-11.7	

Sources: Data provided by the Spanish authorities; and staff estimates and projections.

<sup>1/</sup> Estimate.

<sup>2/</sup> Forecast.

<sup>3/</sup> As percentage of previous year GDP.

<sup>4/</sup> September 1981.

<sup>5/</sup> Initial budget.

<sup>6/</sup> Twelve months ending October 1981.

<sup>7/</sup> Including errors and omissions.

<sup>8/</sup> Valued at market exchange rate (end of period).

<sup>9/</sup> With gold valued at SDR 35 per ounce (end of period).

<sup>10/</sup> November 1981.