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IMF Executive Board Concludes 2008 Article IV Consultation with Spain

On March 11, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Spain.[1]

Background

After 15 years of impressive growth led by a housing boom, the Spanish economy has entered a sharp downturn in the wake of the global liquidity squeeze since mid-2007. With reduced funding for the large external deficit and housing boom, what started as a soft landing turned into an abrupt unwinding of imbalances. Private consumption slowed markedly reflecting weakening disposable incomes, uncertainty associated with rising unemployment, and efforts to reduce private debt (deleveraging). Housing investment has slumped as have outlays on machinery and equipment. In turn, the external current account deficit has started to narrow from a deficit of 10 percent of GDP in 2007, with a lower oil import bill and domestic demand. The general government balance has switched from moderate surpluses in 2005–07 to sizeable deficits, reflecting discretionary measures to assist the economy during the downturn and a drop in important tax bases, including housing. The debt ratio is increasing quickly from a recent low of 36.2 percent of GDP.

Banks are under strain and impaired loans are increasing, reflecting the housing market downturn and growing unemployment. Wholesale funding remains tight and competition to attract deposits is intense. While banks have weathered well the first impact of the global crisis

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

thanks to prudent regulation, sound supervision, and cautious retail-oriented business models, their operating environment is becoming very difficult with the extended deep downturn. The authorities have put in place a valuable package of assistance measures for banks. This includes extending deposit insurance and providing direct funding (Fondo para la Adquisición de Activos Financieros) and funding guarantees.

Despite the economic slowdown, wage and unit-labor costs are outpacing those in euro-partner countries and inflation remains structurally above the euro average. This reflects several factors including insufficiently contested domestic output markets, segmented labor markets, and relatively low productivity and competitiveness.

Executive Board Assessment

Executive Directors noted that, following a long period of strong growth, the Spanish economy has entered a severe downturn. While a gradual correction of the imbalances built up during the boom years had already been under way, the global financial crisis has triggered their abrupt unwinding. Directors expected the downturn in 2009 to be substantial, driven by deleveraging in the private sector and weak external conditions.

Directors commended the authorities for their timely and substantial fiscal and financial sector responses to help cushion the downturn. They emphasized that these efforts need to be complemented by reforms to bolster competitiveness and to avoid a prolonged period of slow growth and high unemployment which would make returning to fiscal sustainability more difficult. They underscored the need for sustained efforts to reduce domestic costs and increase flexibility and productivity, aimed at slowing the growth of unit labor costs.

Directors concurred that adjustment in the housing sector would likely take time. They welcomed the authorities' efforts to activate the rental market to lower vacancies, and to provide mortgage assistance to newly unemployed workers in order to limit foreclosures. Most Directors questioned the desirability of building more subsidized homes given that they could add to inventory at this time.

Directors commended Spain's early application of bold countercyclical fiscal policies, and encouraged the authorities to build on these policies to achieve growth-enhancing reforms. They felt that automatic stabilizers should continue to function freely. Given the projected increase in the public debt ratio and the possible need for assistance to banks, further fiscal stimulus measures should be considered only if warranted by a further worsening of the downturn. These measures should be well-targeted and aim at facilitating structural reforms. More generally, Directors underscored the need for fiscal policies to be anchored in a prudent, long-term sustainability framework. They encouraged the authorities to publish an inter-temporal public sector balance sheet as part of the annual budget documents, showing the debt already incurred and the consequences of present policies on future deficits. Given the high costs associated with an aging population, Directors stressed the need for pension and other long-term reforms to ensure fiscal sustainability.

Directors stressed the need for a vigorous implementation of product and labor market reforms to improve competitiveness, reduce the inflation differential with the euro area, and increase productivity. They welcomed the plans for product and service market reforms that are in line with a unified EU market for goods and services, and looked forward to the timely implementation of the relevant Directives. Directors generally called for comprehensive labor market reforms. In this regard, most Directors underscored the importance of wage moderation and differentiation by reducing wage indexation, combined with reforms to bolster labor flexibility, employment, and competitiveness.

Directors praised the timely banking assistance and strong supervisory and regulatory policies, including dynamic loan-loss provisions, which have helped banks weather the crisis well. Nevertheless, the challenge remains to assist banks through the very difficult operating environment, and to curtail the excessive reliance on wholesale funding. Directors welcomed the design of the liquidity and funding assistance to banks, with appropriate sunset clauses and pricing, and enhanced deposit insurance, as agreed with EU partners.

Directors expected that deteriorating asset quality and higher capitalization demanded by markets would continue to weigh on the outlook, and increase the likelihood of consolidation in the banking system. They welcomed the authorities' readiness to act as necessary, focusing on market-based solutions to the extent possible, complemented with the provision of capital if needed to forestall eventual systemic pressures.

Directors noted that the vulnerability of the savings banks, stemming from their dependence on local real estate activity, calls for close monitoring. They welcomed the increased acceptance of interregional mergers, and considered that greater use of participating capital shares, as conditions permit, would bolster balance sheets. Directors welcomed the continued strong resilience of Spain's two largest banks, while stressing that tight cross-border cooperation with EU, U.S., and Latin American supervisors will remain crucial in these testing times.

Spain: Selected Economic Indicators, 2004–08

	2004	2005	2006	2007	2008
Real economy (change in percent)					
Real GDP	3.3	3.6	3.9	3.7	1.2
Domestic demand	4.8	5.1	5.1	4.2	0.2
HICP (average)	3.1	3.4	3.6	2.8	4.1
Unemployment rate (in percent)	11.0	9.2	8.5	8.3	11.3
Public finance (general government; in percent of GDP)					
Overall balance	-0.3	1.0	2.0	2.2	-3.8
Primary balance	1.7	2.8	3.7	3.8	-2.3
Interest rates					
Money market rate	2.1	2.2	3.1	3.8	4.6
Government bond yield	4.1	3.4	3.8	4.4	5.3
Balance of payments (in percent of GDP)					
Trade balance	-3.8	-5.1	-6.2	-6.4	-5.6
Current account	-5.3	-7.4	-8.9	-10.1	-9.6
Fund position (as of January 31, 2009)					
Holdings of currency (in percent of quota)					86.2
Holdings of SDRs (in percent of allocation)					49.7
Quota (in millions of SDR)					3,048.9
Exchange rate					
Exchange rate regime		Euro Area Member			
Present rate (February 11, 2009)		US$ 1.2938 per euro			
Nominal effective rate (2000 = 100)	106.5	106.3	106.5	108.1	110.5
Real effective rate (2000 = 100)	115.5	119.0	120.5	124.0	129.8

Sources: INE; Bank of Spain; IFS; and IMF staff estimates.