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Statement by Mr. Guzmán and Ms. Valle on Spain
(Preliminary)
Executive Board Meeting 09/25
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We would like to thank the staff for a thorough report on the Spanish economy. We are broadly in agreement with the assessment made.

For more than a decade, Spain experienced a period of strong growth during which the economy developed substantial imbalances; namely, the overall level of debt of households and corporate sectors (linked to a large extent to the real estate boom) and persistent large current account deficits. The correction of those imbalances started in 2006[1], albeit in a gradual manner, induced by the combination of rising interest rates and strong international demand, coupled with the country's improving supply capacity. However, the international financial crisis has triggered a credit squeeze and delivered a shock to private sector confidence that has accelerated the correction and caused a severe economic downturn. The policy stance has been revised accordingly.

The latest[2] official projections point to a -1.6 percent growth in 2009. The labor market has deteriorated significantly in 2008, with employment decreasing in the fourth quarter by -3.03 percent (y-o-y) and unemployment reaching 13.9 percent of the total labor force. CPI growth has dropped to 0.8 per cent in January, which has brought the differential vis-à-vis the EU further below the average (-0.3). Exports have shrunk sharply, but the external sector contribution to growth is increasingly positive, as imports have plummeted.

1. The adjustment

The housing market.- Transactions and prices in the residential construction sector started to decelerate in the context of a tightening cycle of monetary policy in 2006. The credit squeeze, the economic downturn, and the widespread sense of uncertainty have made matters a lot worse.

1 *See SUR/07/60 Summing Up Spain-2007 Article IV Consultation: "[…] (directors) welcomed the incipient rebalancing of the sources of growth as reflected in a slowing of housing investment and some strengthening of exports……. these developments were in line with the central scenario of a smooth deceleration of growth over the medium term".*
2 *"Spain, Stability program update 2008-2010,"* approved by the Cabinet on January 16, 2008.

My authorities are aware that a price correction is necessary, even salutary, but it is easy to overestimate the size of the adjustment. A short-term price overshooting cannot be ruled out, but the extent to which the rapid increase in property prices in Spain was due to a speculative bubble is difficult to determine. Non speculative factors (population dynamics, size reduction of households) were also behind demand dynamics that, while faltering now, may prove more re silient than envisaged by staff[3]. Once stocks are run down and financial conditions stabilize, construction activity should return to sustainable levels. In the short-term, however, the adjustment in the housing sector is having important implications on activity and employment.

The current account.- The current account deficit was mainly fueled by the buoyancy of internal demand (especially investment) and several demand factors helped explain it: lower interest rates, higher disposable income, intense job creation and well-anchored business and consumer confidence. By 2007 the current account began to adjust, although this trend was concealed by the oil prices raid at the end of 2007 and the first half of 2008. Again, the global financial turmoil has triggered an abrupt balance sheet adjustment, both of households and firms, which is rapidly reducing absorption and improving the current account. The credit squeeze and the shock to private sector confidence are arguably the channels through which the international financial crisis has most violently impacted Spain.

Once the ongoing adjustment is complete, the challenge will be to resume growth on a more balanced manner, with a competitive export sector at the cornerstone. We share Staff's assessment that the Spanish economy needs to improve its flexibility, if often underestimated, and find ways to transfer supply resources invested in housing towards more productive uses. The authorities are committed to accelerating the comprehensive reform process already underway in order to enhance competition, liberalize markets, and encourage supply diversification and greater technological content of our exports.

The financial sector.- The financial sector remains one of the relative strengths of the Spanish economy. The Spanish financial system is centered in a banking industry with a conservative retail business model, with no exposure to toxic assets, and overseen by a comparatively prudent regulatory and supervisory framework. Staff mentions the dynamic loan loss provisions introduced by the Central Bank as an example of the conservative stance of the supervisor. Rigorous regulations on the perimeter of consolidation have also been vindicated.

The drying up of the interbank markets inevitably put banks under stress, due to the reliance of their funding on European savings. The soundness of their initial balance sheet, and access to the ECB's liquidity window eased the first impact of the liquidity crisis. Authorities also reacted promptly to the situation through measures directed to solve the liquidity problem and to restore confidence.

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3 According to staff) house prices might fall by 30 percent in real terms over four years. In the 2008 April WEO, staff calculated that the house price overvaluation (i.e. not explained by fundamentals) in Spain was around 17 percent in 2007.

Looking ahead, the depth and duration of the downturn has now become the main source of concern beyond the adjustment in housing prices. The Banco de España remains vigilant and is closely monitoring developments. Precautionary balances and capital buffers built over years of efficiency gains and profits (including 2008) have so far proven instrumental to cushion the downturn. Yet, NPL ratios continue to deteriorate and there is no room for complacency.

2. The policy response

We share staff's view that, under current circumstances, the economy needs both cyclical support and structural reform, while preserving fiscal sustainability. Authorities have reacted swiftly. The response is built on three pillars: (a) strengthening confidence in the financial system and facilitating the flow of credit to households and firms; (b) cushioning the impact of the downturn; and, (c) accelerating structural reforms that contribute to growth over the long-term. The above policies shall be made compatible with our firm commitment to the long-term sustainability of public finances.

Financial sector.- Confronted with the worldwide seizure in capital markets Spanish banks experienced liquidity pressures, despite their solvency. Among the measures adopted by authorities, described in Box 2 of the staff report, the FAAF is a mechanism established to deal with this transitory funding shortage and is, by no means, a toxic asset rescue program. So far, it has injected 19.3 billion Euros (of a maximum of 50 billion) in medium-term finance, through the acquisition of top quality assets from credit institutions. The FAAF is specifically designed to help activate the flow of credit to companies and individuals: up to 25 percent of the funds are awarded in the so-called non-competitive tranche of the auctions, rewarding banks according to their contribution to credit growth.

Some banks have also used government guaranties to issue new debt, for a total of 5.5 billion Euros. The initial amount approved for this line of support (100 billion Euros) will probably not be fully utilized in 2009. Finally, the report duly remarks that the Spanish authorities stand ready to provide capital support to banks in case it were required. However, while some consolidation might help smaller weaker entities weather the storm, no public interventions to address solvency issues are considered necessary so far.

The Banco de España on its part has doubled its efforts in monitoring the situation. The scrutiny of liquidity and solvency positions takes place on a continuous basis and the Bank's supervision is keeping banks under tight control (provisioning and dividend policy).

Fiscal Policy.- As a result of previous years of fiscal prudence Spain confronted the crisis from a relatively comfortable position. Year 2007 ended with a general government surplus of 2.2 percent of GDP and a debt-to-GDP ratio of 36.2 percent. This budgetary margin has enabled the Spanish economy to contribute to the European Economic Recovery Plan adopted by the European Council in December 2008.

The set of temporary measures with a direct fiscal impact in 2009 is expected to amount to 1 percent of GDP. These, coupled with other permanent measures—involving lower tax rates and changes in the tax prepayment system to enhance the liquidity of companies and households—will bring the total fiscal stimulus for 2009 to 2.3 percent of GDP. The measures adopted and the operation of the stabilizers will bring the general government deficit to a -5.8 percent of GDP in 2009. The stimulus is consistent with EU criteria and with IMF recommendations:

- The measures are, to the extent possible, both temporary and targeted. They were selected on their short-term effect on growth and employment, but also on account of their longer-term impact. The government remains firmly committed to the long-term sustainability of public finances.

- The Spanish stability program (EU commitment) update envisages an ambitious fiscal adjustment from 2010 onwards, to 3.9 percent of GDP in 2011. This includes improvements in the structural balance amounting to over 1 percent of GDP.

The available fiscal space has probably been exhausted and there is no intention to implement further stimulus measures at this point. But circumstances call for caution and for a close monitoring of the situation. Authorities are prepared to react as events unfold over the coming months/years.

Monetary conditions.- It is worth noting that monetary policy is reinforcing the effects of the fiscal stimulus. The sharp decline in the interest rates of the main refinancing operations by the ECB (275 bp since last September to the current 1.5 percent) substantially eases the burden of Spanish borrowers. In particular, most debt held by households is linked to short-term market rates (Euribor). This should help limit the rise in NPLs of banks, and should also help consumption or, alternatively, it will accelerate the needed balance sheet adjustment.

Structural reforms.- Substantial progress has been achieved in this front over the years. The latest update of the OECD product and service indicators places Spain within the group of above-average reformers. Nevertheless, my authorities agree on the importance of accelerating structural reforms to increase growth potential and to facilitate the reallocation of resources from the housing industry. We estimate that the transposition of the Services Directive underway could increase potential GDP by 1.2 percent and we expect qualitatively similar effects from other planned measures, such as the reform of professional services and the increase in competition in transport and energy.

With regard to the reform of the labor market, my authorities are urging social partners to strengthen their dialogue. This dialogue is the framework in which an in-depth and constructive discussion on the functioning of the labor market should address the need for changes in the regulation, that might contribute to smoothing the downturn and facilitating the recovery.

Concluding Remarks

Spain's demand-driven growth during the past decade was based on easy financing conditions that caused the accumulation of imbalances. Under normal circumstances, the adjustment would have required maintaining a restrictive fiscal stance, limiting expenditure and debt, and promoting supply side measures to regain lost competitiveness. The international financial crisis has caused a steep correction of expenditure and debt levels and placed our adjustment process in an extremely adverse scenario, making it more intense and a lot more difficult.

The Euro has shielded us from stronger winds but, without the recourse to currency devaluation, overcoming the crisis still requires a rebalancing of our growth model through a reduction of costs, prices and margins vis-à-vis the rest of the world. As recovery takes place, fiscal policy will, to the extent possible, support growth. Meanwhile, we will strive to preserve the stability of the financial sector. Ultimately, a lot depends on the depth of the recession and on the speed of recovery elsewhere. My authorities will cooperate in the relevant fora to contribute to global solutions.