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March 9, 2009

Statement by Mr. Majoro on Spain
(Preliminary)
Executive Board Meeting 09/25
March 11, 2009

1. The Spanish economy has been severely impacted by the global liquidity squeeze and economic downturn over the last few months, with the drying up of funding for the housing sector, a large external deficit, ballooning fiscal deficit, and a surging unemployment. The spike in food and energy inflation, though subsiding, remains above the Euro average. With construction activity collapsing, banks under pressure, foreign demand faltering, and competitiveness weak, we note that staff and authorities converge on the economy's pressing needs for both cyclical support and deep structural reforms.

2. We concur with the staff assessment on the seriousness of the country's macroeconomic challenges, especially on the possibility that the country could get stuck in a low-growth extended adjustment. We note that banks have weathered well the first impact of tighter funding conditions and weaker asset quality owing to strong prudential cushions. Going forward, we welcome the authorities' commitment to provide a sizable stimulus package to address the critical downside risks. However, we note the several challenges they face in pursuing these objectives, including the ability to provide adequate cyclical support, and capacity to implement deep structural reform that draws support from their' social partners. We concur with the broad thrust of the staff assessment and the reassurances of Mr. Guzman and Ms Valle in their buff statement and we focus our observations for emphasis on the risks to the housing and banking sectors, and fiscal policy.

Risks to the housing sector

3. We note Spain's impressive housing sector development of the recent past. However, we are concerned over the significant divergences between the authorities and staff assessment of recent developments in the sector especially on the new housing starts and price developments. Nonetheless, we concur with staff assessment over the gravity of the adverse effects of the bust in the housing market, especially on the rising unemployment, pressure on banks and their fiscal implications.

4. The authorities' response with a stimulus package to assist the construction sector to create jobs – especially through public infrastructure –, facilitating mortgage refinancing, limiting foreclosures, promoting the rental market, and expanding subsidized housing are steps in the right direction. We concur with staff recommendations for further improvement of the housing rental market that could improve labor mobility and absorb vacant housing stock. In this regard, and while we see some merit in the authorities' optimism over the country's potential for housing sector rebound on account of the country's attractiveness as a residential destination for many Europeans, we encourage them to persevere with the stimulus effort and, additionally, to implement staff recommendations.

Risks to the banking sector

5. We are encouraged by the banking sector's capacity to weather the initial impact of the global crisis, supported by prudent regulation that reduced incentives for off-balance-sheet vehicles, sound supervision, and the cautious retail-oriented business models that enabled banks avoid investing in opaque structured products. Nevertheless, balance sheet restructuring which includes, inter alia, banks' recourse to the ECB and government funding assistance, disposal of industrial participation, and tightened credit standards, was contributing to the slowdown in the lending growth rate. We note the potential feed back effects of the exposure of Spain's large banks to Latin America that may worsen domestic credit conditions. These risks are paralleled by the increasing bankruptcies among large real-estate developers and a recent surge in impaired loans (NPLs) that are eroding prudential cushions.

6. We commend the authorities for taking bold steps to address the vulnerability of the banking sector on the funding side, and for adopting legal provisions for potential capital support. We note with encouragement the Bank of Spain's scaled-up surveillance and its readiness to act as needed to forestall systemic disruptions.

Fiscal policy

7. With the sharp downturn in the large tax-yielding housing sector, the fiscal accounts have weakened commensurably. The fiscal stimulus measures of 4 percent of GDP taken by the authorities constitute an appropriate response to the noted sharp downturn in the macroeconomic framework. Despite the divergence between staff and the authorities in the assessment of the impact of the stimulus on the structural deficit, the fiscal balance has moved from a surplus in 2007 to a significant deficit in 2009, exceeding the SGP limits.

8. We commend the authorities for adopting an exist strategy that entails dropping out of spending once the recession fades. We concur with the authorities' approach to first give the approved measures (current stimulus) a chance to generate their full impact, and, if more measures were required, to consider transfers to the poor and liquidity-constrained families with high spending propensities (extending unemployment support, welfare) and labor-intensive infrastructure spending to protect employment. We concur with staff recommendation that in the latter case further fiscal support should combine with long-run

fiscal and product market reforms.

9. We note that the authorities are mindful that current economic policies do not secure long-run fiscal sustainability due to Spain's high aging costs – that ranks highest among advanced countries. Such structural costs may limit the expansion of the country's fiscal space, unless the authorities persevere with structural reforms in the key cost centers. We therefore encourage the authorities to implement, inter alia, pension and health reforms, and limit benefit indexation for the wealthiest, a combination of progressive income tax increases and expenditure cuts in the non-aging related budgets, including phasing out the mortgage interest deductions with the view to fostering the public balance sheet and long-run fiscal sustainability.

10. With these remarks, we wish the authorities success in meeting their challenges.