

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/112

10:00 a.m., July 13, 1990

R. D. Erb, Acting Chairman

Executive Directors

M. Al-Jasser
G. K. Arora
F. Cassell

Dai Q.

E. V. Feldman

R. Filosa

M. Fogelholm

G. Grosche
J. E. Ismael

J.-P. Landau

G. A. Posthumus

Alternate Executive Directors

G. C. Noonan

S. B. Creane, Temporary
J. Prader
L. B. Monyake
S.-W. Kwon
R. J. Lombardo
M. A. Fernández Ordóñez
N. Kyriazidis
A. M. Othman

O. Kabbaj

F. A. Quirós, Temporary
J.-F. Cirelli
J.-C. Obame, Temporary

S. Yoshikuni

L. Van Houtven, Secretary and Counsellor
T. S. Walter, Assistant

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Also Present

European Department: P. B. de Fontenay, Deputy Director; M. E. Galy, L. E. Molho, G. C. Pastor, E. Spitäller. Exchange and Trade Relations Department: S. Kanesa-Thasan. Legal Department: P. L. Francotte, R. Leckow. Secretary's Department: C. Brachet, Deputy Secretary; A. Tahari. Western Hemisphere Department: J. Ferrán, Deputy Director. Advisors to Executive Directors: F. E. R. Alfiler, A. Gronn, K.-H. Kleine, J.-L. Menda, A. Napky, D. Powell, A. Raza, S. P. Shrestha. Assistants to Executive Directors: C. Björklund, B. Bossone, Chen M., J. C. Demaestri, T. T. Do, B. S. Fuleihan, J. Gold, S. Gurumurthi, M. A. Hammoudi, K. Ichikawa, K. Kpetigo, R. Marino, D. Saha, J.-P. Schoder, D. Sparkes, C. M. Towe, Wang J.

1. SPAIN - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with Spain (SM/90/114, 6/12/90). They also had before them a background paper on recent economic developments in Spain (SM/90/125, 6/28/90; Sup. 1, 6/29/90; and Sup. 2, 7/5/90).

The Deputy Director from the European Department said that there had been no major developments in Spain since the completion of the staff report. The first half of 1990 could be characterized as a period of progress toward stabilization, but at too slow a pace.

Mr. Fernández Ordóñez made the following statement:

At the outset, I want to convey the appreciation of my authorities for the work done by the staff, not only in the papers presented to the Board, but also for the stimulating discussions that were held during its visit to Spain. This year, the mission team included a member from the Fiscal Affairs Department, and this allowed for an interesting and timely exchange of views during the preparatory work on tax reform.

As I think that the staff report provides an excellent description of recent developments and policy problems, and as I agree with most of its suggestions and recommendations, I will try to draw attention to only a few questions, some of which are in the center of the economic debate in Spain. The first question is whether the cooling down of the economy achieved so far has been sufficient. The authorities consider that, although domestic demand has decelerated and the deterioration in both price performance and the external deficit has been halted, the cooling of the economy has been insufficient, despite a stiffening of macroeconomic policies. Since the beginning of 1989, and especially since the adoption of the policy package in the summer of that year, monetary and fiscal policies have been tightened. The public deficit was reduced by 1 percent--to 2.1 percent of GDP--in 1989, and public savings increased by 3 percent, compared with 1.8 percent in 1988. Similarly, monetary policy has not been relaxed: in the summer of 1989, interest rates reached levels that were among the highest for industrial countries and have since been maintained at those high levels. Nevertheless, these rigorous macroeconomic policies have proved to be insufficient. Additional measures are needed.

This leads to the second question. What additional measures are needed? The authorities think that there are only two alternatives. The first one has been proposed to the trade unions and employers association under the title of "Pacto de Competitividad," or "competitiveness agreement." This alternative would not include

substantial changes in macroeconomic policies. Monetary policy would continue its present contractionary stance. Fiscal policy would be targeted to achieve a budget surplus by the end of 1992. The idea is that the main contribution should come not from macroeconomic policies, but from incomes policy and structural policies. This alternative is supported by the fact that Spain still has huge untapped labor resources, which should permit inflation to be reduced without affecting the present robust investment performance.

The other alternative would be to rely exclusively on pure stabilization policies--for instance, by advancing the date for reaching a budget surplus. In the view of the Government, this alternative will negatively and unnecessarily affect employment and investment. However, as the need to re-establish internal and external equilibria is unquestionable, the Government has made clear that it will apply this "second-best" alternative if negotiations fail.

The third question deals with the adoption of a more adequate balance between monetary and fiscal policies. The point is that stabilization efforts should be based mainly on fiscal policy. Besides other considerations, the main reason is that, at the end of 1990, credit controls and limitations on capital inflows will be lifted, and monetary policy will consequently be unable to achieve objectives other than that of exchange rate stability. Direct controls were adopted on a temporary basis. As I have said, they have been partially successful so far, but their distorting effects are now becoming more predominant while their contractionary effects are vanishing.

The fourth question is about the decision that was made one year ago to bring the peseta under the discipline of the EMs. It has been argued in certain quarters that the persistence of the inflation differential between Spain and the other EMS countries is proof that that decision has been useless in the fight against inflation. The view of my authorities is that more than one year is needed to make a sound judgment. They think that it is precisely now that the effects of discipline are becoming fully felt. Having seen clearly the loss of competitiveness of the Spanish economy during the past year, most economic agents are now recognizing the urgent necessity of making the inflation rate converge with the rates of the partners in the system of fixed exchange rates. Exchange rate discipline does not bear fruit overnight. France, which has been the most recent example of success in attaining inflation rate convergence within the EMS, did not achieve the same inflation rate as Germany in just 12 months.

The fifth question is whether it is possible to achieve an agreement on incomes policy in a situation of expansion of demand. The staff has taken the side of those who are skeptical about this possibility. Is it possible to obtain wage moderation in a situation of huge and easy profits? This is not a question of judging the desirability of a policy--in this case, incomes policy--but of the possibility of implementing that policy.

I would add that the same skeptical judgment could be extended to the possibility of making substantial progress in the area of structural policies before the economy has cooled down. For instance, in the case of labor rigidities, trade unions want to reduce the impact of the flexibility introduced four years ago. At first glance, their arguments appear brilliant. For example, in the past four years, Spain has gone from having the lowest ratio of fixed-term contracts to total contracts in the EEC to having the highest. Nevertheless, the Government says that old contracts continue to be more rigid than those in other European countries and that, consequently, the liberal thrust of the 1984 labor laws should not be altered. In this debate, the Fund's asking for additional liberalization of the labor markets has been very helpful. Unfortunately, most of the remaining rigidities--for example, lack of regional mobility--are embodied in collective agreements; that is why it is highly desirable to obtain the consensus of the trade unions and employers.

This question of structural policies leads me to my final point. As I have just said, in conditions of excessive domestic demand and swollen external deficits, pressures develop on governments to make the economy less open and to protect the sectors affected. Experience shows that most countries confronting these macroeconomic disequilibria have resorted to protectionist measures. This has not been the case in Spain; just the opposite, in fact, has been true.

Shortly after joining the EEC, Spain had the dubious achievement of registering the third largest trade deficit in the world and continues to be listed on that "honor roll." Despite these external disequilibria, however, Spain has not modified its program of progressive trade liberalization and, since 1986, has been reducing its trade barriers, suppressing quotas, and reducing tariffs year by year. To this effort--which is one of the commitments of the Treaty of Accession to the EEC and which will continue during the next few years--should be added the implementation of single market directives. All the directives that are being implemented in Europe to achieve an economic and monetary union go in the direction of opening the economy, not only to EEC countries, but also to the rest of the world. My authorities consider that

this policy, to which they are firmly committed, is in the interests of not only the world economy, but also the Spanish economy in the long run.

However, nobody can deny that the rigidity provided by the multilateral agreement--in this case, the regional multilateral agreement--has been very helpful in maintaining that commitment. I wish to emphasize that the fact that these liberal policies are embodied in multilateral agreements gives them a stamp of irreversibility, a permanence that goes beyond the desires of national governments to change them and the opportunities available for that purpose. In this way, the loss of sovereignty that is accepted in multilateral agreements through the imposition of restrictions on national policymakers may be one of the best contributions a country can provide to the world economy.

Mr. Grosche made the following statement:

The excellent staff report before us today addresses quite adequately the main policy problems. As the staff report shows, the Spanish economy has benefited greatly from membership in the EC. Among the many good decisions that the Spanish authorities have taken in the past, joining the Community was a crucial one that demonstrates their excellent management of economic policies. Foreign investors seem to share that view. The stock market is bullish, Spain has no difficulty in attracting long-term capital inflows, and the balance of payments has basically remained in a comfortable surplus position.

Like Mr. Fernández Ordóñez, I can endorse the staff analysis and its recommendations. With respect to the first question that Mr. Fernández Ordóñez put forward in his opening statement--whether the cooling down of the economy achieved so far has been sufficient--the supplement to the background paper indicates that much more needs to be done to reduce excess demand. Mr. Fernández Ordóñez agrees.

On the second issue raised by Mr. Fernández Ordóñez--the question of what additional measures should be taken--he advances two solutions as alternatives. One is to establish a more favorable climate for industrial relations, so as to moderate wage increases. Indeed, a pact with the social partners could help to improve the control of cost developments, and I wish the authorities success in their attempt to negotiate an agreement that would restore centralized wage bargaining and improve competitiveness. The other approach is to further strengthen the stabilization efforts. Unfortunately, this is considered only a second-best alternative by the Government. I, for one, however, believe that these

approaches should not be considered to be alternatives, but to be complementary to each other. Financial discipline, in particular, will help to control wage developments. For example, subsidies, transfers, and capital injections into public and private enterprises have been reduced much less in recent years than could have been expected after four years of a booming economy. The availability and provision of budgetary funds encourage financial laxity and retard necessary structural adjustments. Thus, tighter policies vis-à-vis loss-making enterprises are needed to strengthen public finances, and more ambitious programs of privatization could help to reach a budget surplus earlier than presently planned.

On Mr. Fernández Ordóñez's third question, it is obvious that, with the upcoming elimination of credit controls, fiscal policy has to play a major role in the adjustment process. I am concerned about the effects of an excessive reliance on interest rates to curb credit growth. With the staff, I believe that controlling the economy with interest rates alone carries the danger of offsetting capital inflows, with unfavorable consequences for investment and growth. There is a long way to go in giving fiscal policy the larger role it needs to play, particularly on the expenditure side. On taxes, reforms should be revenue neutral, at the least. Given, on the one hand, the relatively high taxes on employment and labor income, and, on the other, the internationally low overall tax burden, measures to widen the tax base and to combat tax evasion should be intensified. This will require changing taxpaying habits and tax collecting methods. The public should be made aware of the need for spreading the overall tax burden more evenly between wage and nonwage incomes.

I have nothing much to add to Mr. Fernández Ordóñez's remarks with respect to his fourth question. Like him, I am confident that exchange rate discipline leading to a proper mix of financial policies will eventually result in a narrowing of the inflation differential between Spain and the EMS countries.

On the fifth question raised by Mr. Fernández Ordóñez, here, again, I find myself in broad agreement with him. Suffice it to say that, in the real world, it is not always easy to implement a policy that, although desirable from a macroeconomic viewpoint, meets strong resistance from the labor unions. However, as I indicated above, stronger action on the fiscal side, particularly with regard to unspecific and broadly spread subsidies to enterprises, should help to install better financial discipline on the enterprise level--as well as in the budget--and should help to negotiate wage resettlements that are better in line with the needs of the economy.

In conclusion, I share the staff's view that the Spanish authorities will successfully deal with the challenges ahead, thus preserving Spanish competitiveness and maintaining a favorable climate for investment activity.

Mr. Cassell made the following statement:

Following a period of impressive growth, Spain is now trying to moderate demand to a more sustainable rate, in order to reduce inflationary pressures. Despite early difficulties with the application of monetary policy, there are signs that high interest rates are starting to work. But, as some other countries have found, a prolonged period of buoyant domestic demand fueled by high consumer confidence, easier access to credit, higher asset prices, and rising real incomes can be very difficult to slow down. The GDP deflator, which, although probably the best measure of Spain's domestic price pressures, may nevertheless give too little weight to inflation in the service sector, is sticking stubbornly at about 7 percent. Therefore, the obvious question posed by the staff papers is whether the measures already taken by the authorities are sufficient to cool down the economy; the characteristically forthright answer given by Mr. Fernández Ordóñez in his opening statement is that they are not.

As the staff report notes, Spain's membership in the ERM is likely to place a heavier burden on the role of fiscal and structural policies in the adjustment process. As far as tightening fiscal policy is concerned, the authorities have already made considerable progress. The budget deficit has been reduced from 7 percent of GDP five years ago to 2 percent today, although the staff has doubts, which I share, about the way in which it is being financed. The authorities wish to avoid a further rise in the tax burden and feel that the scope for cutting priority public spending is limited. But, given the constraints on monetary policy and the fact that structural reforms take some time to work, one feels that fiscal policy needs to be even tighter in the present circumstances, and certainly at this stage of the cycle. I welcome, therefore, the authorities' commitment to the elimination of the deficit by 1992. I am unsure, however, how this will be done, especially if economic growth slows significantly; reducing tax evasion is unlikely on its own to be sufficient.

This brings me to the area of structural policies, where Mr. Fernández Ordóñez puts considerable weight. It is clear from the staff report that the Achilles' heel of the Spanish economy, and the main obstacle to a so-called soft landing, is the rigidity of the labor market. This is not, of course, a problem unique to Spain, but that does not make it any less urgent. It is striking

that, after five years of very strong output growth, Spain still has one of the highest rates of unemployment--over 16 percent--despite the very low female participation rate. While the authorities are right to emphasize increased vocational training and reforms in education as a means of tackling chronic long-term unemployment, the most worrying feature of the Spanish labor market is not skill shortages, but the de facto system of wage indexation. Removing this labor market rigidity will require a long process of education and sensitive handling. The weighted average of wage increases negotiated in settlements is currently over 8 percent, contributing to the rebound of consumer demand in the second quarter of this year. The authorities should spell out quite clearly in their discussions with the unions the consequences for competitiveness--and, hence, for employment and living standards--of letting wage rises outstrip productivity growth. I would be interested to know whether the authorities have prepared the ground for any measure of trade union reform, and also the extent to which privatization could play a part in decentralizing wage bargaining. The authorities could themselves take the lead in introducing more flexible pay structures in the public sector and encouraging initiatives such as profit-related pay.

As long as these labor market rigidities persist, and until the full discipline of ERM membership is felt by management and the labor force, the authorities will have to rely on less satisfactory, second-best measures to ensure that continued growth is consistent with low inflation. To the extent that monetary and fiscal policies have to be tighter than they otherwise would be, the Spanish economy will grow more slowly, unemployment will be higher, and investment will be smaller. Since Spain joined the ERM, the authorities have bolstered monetary policy by credit and capital controls, and these have succeeded in slowing down credit growth for the time being. But, as the authorities are aware, controls of this sort lose their effectiveness with time; if kept in place for long, they would undermine Spain's rapid progress toward an open and efficient financial sector. They are only a temporary expedient that buys time while the fundamental causes of excess demand growth are tackled. When lending controls are lifted at the end of this year, the authorities will have to return to more orthodox techniques of monetary control.

Interest rate policy faces dilemmas in a fixed exchange rate regime. The authorities' weak influence over the banks' lending and deposit rates has received a good deal of attention in the background paper, and it clearly undermined counterinflationary strategy in 1988 and 1989. I would be grateful for the staff's assessment of whether the transmission mechanism has since been sufficiently strengthened to enable it to bear the full weight of monetary policy.

The authorities attach great importance to the use of wage policies to defeat inflation. While such policies can have a role in puncturing inflationary expectations, past experience in Spain and in other countries has shown the perils of relying too heavily on them, especially when demand is growing strongly. These policies can rarely be sufficiently flexible to allow individual companies to adjust wages to recruit and retain labor in their particular sectors. In addition, wage policies tend to reinforce centralized, unionized wage bargaining, whereas the authorities should be trying to move in the opposite direction.

I also have some reservations about the authorities' efforts, partly with the aim of encouraging savings, to reform the tax system. The tax system certainly has an important place on the agenda of structural reform, but I share the staff's skepticism about the wisdom of providing selective tax relief to individual types of saving. This might affect the pattern of private saving, but I am not aware of any evidence that it would lead to an increase in the total volume of saving. Moreover, over time, selective reliefs can cause distortion and are difficult to withdraw when they outlive their usefulness. The staff's suggestion for a global deduction for net savings is therefore sensible, but, if this is impractical, the authorities might consider a shift from direct to indirect taxation: Spain's VAT rate is below the EC average. I was less convinced by the staff's recommendation for lower employers' social security contributions as a means of encouraging employment. If, as seems likely, the effective incidence of these contributions is on employees, a cut in the contribution rate would be reflected in higher wages rather than higher employment. Perhaps the staff could comment on this.

I endorse the thrust of the staff report. I wish the Spanish authorities well in their further efforts to cool down the economy and hope that they can win support for the further crucial structural changes that will be necessary if Spain is to reap the full benefits of ERM membership and successfully meet the challenge of the single European market.

Mr. Prader made the following statement:

In such key areas as output and employment growth and economic restructuring, the performance of the Spanish economy continues to exceed that of other European countries. However, Spain still suffers from an extremely high unemployment rate and a number of other serious problems. Spain's relatively high rate of demand growth has produced a higher inflation rate than the average for European comparator countries and has caused its current account to

worsen. Moreover, there are signs of tension over the distribution of growth, which could slow the continuation of growth-oriented economic policies. However, Spain cannot afford to accept significantly lower economic growth if the basic problem of reducing unemployment is to be solved, and the rapid modernization of the economy and its integration into the European market are to be achieved.

It should perhaps be noted in passing that Spain's problems must be viewed from a wider perspective than would be applicable for most other cases of macroeconomic stabilization and structural adjustment. It is no accident that several East European countries have been attentive to the successful example set by Spain's political and economic transformation, and it is by comparison with the problems of these countries, which are emerging from equally authoritarian economic and political regimes, that we can appreciate and measure the Spanish case.

Comparisons aside, however, the Spanish authorities will continue to face a daunting task in attaining the conflicting goals of their economic policies in the present business situation. On the one hand, they must maintain a strong economic growth rate and reduce unemployment, while, on the other hand, they must restrain demand, in order to reduce Spain's inflation differential with other European countries and check the deterioration in the balance of payments.

The authorities have shown their readiness to discard all ideological inhibitions and to adopt all the instruments of economic policy available to them, including tough restructuring and incomes policies. Since mid-1989, they have significantly tightened monetary policy, not shrinking from the use of credit ceilings and capital controls. On the occasion of the 1989 consultation with Spain, this chair supported the temporary use of such administrative measures, if they were directed at slowing the growth of domestic credit and alleviating pressure on the exchange rate. Although we could endorse the continued use of such instruments--despite their obvious distorting effects--until sufficient progress has been made in terms of lower inflation and slower domestic demand growth, we have taken note of the monetary authorities' intention to abolish these controls by the end of 1990.

Monetary tightening alone, however, will not do the job: it will need to be reinforced by fiscal restraint. Apparently, some of the tightening and other difficulties of monetary policy could have been avoided if fiscal policy had taken a more restrictive course in 1989. It is not clear whether fiscal policy in 1990 has been sufficiently adjusted to provide clear signals about the authorities' commitment to the objective of inflation convergence

and their intentions with respect to the peseta's position in the Exchange Rate Mechanism (ERM) of the EMS--and in particular the transition of the currency to the narrow ERM band by 1992. The lack of fiscal restraint is even more surprising if measured against the ambitious target of balancing the budget in 1992. It would appear that, if the Government is serious about realizing these targets, it will have to move more decisively, and do so soon, particularly with respect to the announced dismantling of credit and capital controls.

On the other hand, the goal of balancing the budget in 1992 does not seem consistent with Spain's economic modernization objectives, which require the country to continue growing faster than other European countries. As a result, the typical conflicts between longer-term goals and short-term stabilization needs--of which overheating, current account deficits, and inflation are manifestations--take on a quasi-natural appearance. However, as long as investment activity and foreign capital inflows remain as strong as they have been in the past, the maintenance of growth and the financing of the current account deficit should be relatively easy.

In recent years, Spain has benefited more from foreign investment inflows than perhaps any other European country. The low cost of labor has been one of the main inducements for foreign investment. Over time--which is to say, once the industrial restructuring and modernization of the economy is complete--the Government's policies should strive to attract foreign investments other than those which are primarily interested in low wage costs. Because those kinds of businesses hinder rather than help a country's development, the Government's investment policy should instead be directed at attracting investments that require qualified and well-paid workers.

Meanwhile, however, the present favorable investment trend could be threatened by wage movements, which, despite high unemployment, has managed to rise to levels that seem far beyond those consistent with price stability and the maintenance of external competitiveness. The Government's approach--seeking the support of the trade unions for its economic strategy of dampening inflationary pressures through incomes policy while maintaining high economic growth--seems to be a possible and even a necessary policy option.

In the eyes of countries that have ample experience with incomes policy, however, it appears that certain of the institutional conditions existing in Spain, such as the highly politicized trade unions and their low degree of centralization, do not favor

the successful implementation of such policies. Some institutional reformation of the trade unions might therefore be required to make an incomes policy work on a longer-term basis.

I trust, however, in the ingenuity of Spanish economic policy-makers to find a solution to Spain's persistent inflation problem. The history of inflation in Spain is indeed a long one. The French historian Pierre Vilar writes that there are more memoranda about money in Spanish archives from the 17th century than currently exist in the archives and offices of the International Monetary Fund. Moreover, in a picaresque novel by Velez de Guevara, an "expert" becomes so excited by his fight against rising inflation that he sticks a pen into his eye and goes on writing without noticing what he has done.

Mr. Feldman made the following statement:

As in recent years, the Spanish economy performed successfully in 1989, as growth remained strong, fueled once again by an impressive expansion of investment. The growth was accompanied by a rapid increase in employment, while the Government was able to sustain the pace of fiscal consolidation.

In 1989, however, the divergence between the growth rates of domestic demand and GDP was further exaggerated. This overheating of the economy has run counter to the objective of a deceleration in the rate of inflation, which, after six years of continued reduction, increased during 1989. Furthermore, the current account of the balance of payments deteriorated, and the peseta continued to appreciate.

That having been said, I broadly agree with the staff appraisal. I would merely like to offer some comments on the main policies and on their relationship to what I believe are the two key issues of the Spanish economy, namely, overheating and the external imbalance. There seems to be a consensus that the cooling down of the economy has not been enough. On the subject of the proper policy mix, I would broadly agree with Mr. Fernández Ordóñez that the main contribution to solving the problem of overheating should come from the competitiveness agreement and from structural policies, although I feel that the role of fiscal policy is still central. I feel more positively about this than does Mr. Fernández Ordóñez, although I recognize that the risk of falling into the British pattern might exist.

As I share the authorities' concern about the detrimental effect on employment and investment of a hasty and perhaps excessive withdrawal of fiscal stimulus, it is to be hoped that these

additional fiscal measures, if implemented, would operate as a deterrent that would introduce the element of moderation into the process of negotiating an incomes policy.

In this context, we believe that the competitiveness agreement could be an efficient instrument for maintaining and improving the external competitiveness of the Spanish economy. It could also allow for an orderly process of increases in real wages, hand in hand with increases in labor productivity. In this respect, I wonder whether the agreement would also include "catch-up" clauses or, rather, be based solely on productivity and the expected rate of inflation.

However, I would like to stress--and I fully share the staff's view--that, given the strength of demand pressures, incomes and structural policies will not succeed on their own, and that the current financial policy will need to be continued steadfastly. In light of the restrictions on monetary policy stemming from the participation of the peseta in the EMS, fiscal policy will have to continue carrying most of the financial policy burden in the adjustment process.

As to how to proceed with fiscal consolidation, we see more merit--in the Spanish economy's present circumstances--in putting more emphasis on the revenue side than in reducing or postponing public expenditures. As pointed out by the staff, there is room for strengthening tax compliance and administration in order to reduce evasion and fraud. Furthermore, we believe that there is some room for increasing corporate taxation and reducing or, at a minimum, maintaining the fiscal burden of noncorporate economic agents. It is true that, from the point of view of resource allocation, an increase in consumption taxes would have been called for; however, in all likelihood, this would have conspired against the objective of a lower inflation rate--although the effects might have been felt on prices rather than on the rate of inflation. Because profitability has been very strong in the corporate sector, it seems to us that an increase in corporate taxation could be absorbed by firms without significantly affecting investment decisions. Again, this is more of a question than an assertion.

On the public expenditure side, we do not see the advantages in delaying the implementation of projects related to public investment, unless there are clear indications that an increase in private investment could substitute for this decrease in public investment.

Although the public sector has easy access to external and domestic borrowing, interest payments are imposing an increasing burden on public expenditures. Therefore, we see the advantages

in trying to reduce interest expenditures. However, changes in the financing procedures introduced in the 1990 budget appear to run counter to the objective of reducing interest payments. Although we understand that the ceiling on public sector borrowing from the central bank would increase transparency regarding the cost of financing and would contribute to fiscal discipline, we believe that this ceiling could become either redundant or extremely rigorous. On the one hand, owing to the availability of intra-annual financing from the Bank of Spain, the new restriction can work effectively only either at the beginning or at the end of the year. On the other hand, if the ceiling were designed to operate without interruption, it would be extremely rigid and rigorous. In other words, a yearlong nominal flow of zero public sector financing from the central bank could impose too much rigidity on financial policies. In these circumstances, I wonder whether it would not be technically better to limit the rate of increase of the stock of public sector debt to the Bank of Spain to, for instance, the rate of growth of real GDP.

On monetary policy, I have a question related to the introduction of the system of credit ceilings. From the background paper, it appears that the growth rate of credit to the private sector was less than the ceiling. If the ceiling is nonbinding, I wonder whether there is any reason to maintain that restriction. Is it perhaps, although nonbinding on an aggregate level, effectively restricting some banks more than others? In that case, is the system generating any kind of distributional effect on the lending capacity of the respective banks? If distortions are starting to build up, this would be a further reason to reassess the usefulness of the instrument.

Finally, with respect to the external imbalance of Spain, I would like to comment on the decision to bring the peseta under the discipline of the EMS in 1989. I had not planned to address this issue, as our position regarding the risks associated with import liberalization in the context of an appreciation of the peseta had been expressed during the previous Article IV consultation with Spain. On that occasion, we wondered whether a once-and-for-all realignment of the peseta before 1992 could not have been called for. This year, the staff report clearly expresses the view of the staff and the Spanish authorities on devaluation, namely, that such a measure would be futile for either improving competitiveness or strengthening the Government's credibility. However, because Mr. Fernández Ordóñez has himself drawn attention to that decision of the authorities, I would argue that the persistence of the inflation differential between Spain and the EMS countries' average is an indication that Spain's decision to bring the peseta under the discipline of the EMS could have been untimely. Of course, I share Mr. Fernández Ordóñez's view that a period of one year is

perhaps not enough to achieve price convergence; clearly, the existence of lags is a factor, and exchange rate discipline does not bring advantages overnight. However, we believe that the eventual cost of the untimely entrance into the EMS should also be assessed and made explicit. Part of the cost relates to being on the "honor roll," as Mr. Fernández Ordóñez has mentioned, with the third largest trade deficit in the world. It has to be recognized that the rest of the world has shown strong willingness to finance Spain's current account deficit; however, there are other related costs stemming from a long period of very high real interest rates, potential inefficiencies in resource allocation, and the long-run external competitiveness situation. With Mr. Fernández Ordóñez, we fully share the authorities' clear commitment to trade liberalization and multilateralism. However, it is precisely for the adequate fulfillment of these objectives--and for the maintenance of the long-term efficiency of the economy--that the exchange rate should be kept as competitive as possible.

Mr. Quirós said that the Spanish economy had continued to perform well during 1989. The rate of growth over the past four years had been one of the highest in the OECD. This was indeed a good performance that could certainly be maintained in the future.

The transformation of Spain's economy in recent years was due to several factors, Mr. Quirós continued, including, inter alia, the large inflows of investment-oriented foreign capital during the first four years of Spain's EEC membership; the gradual dismantling of barriers to trade and capital flows; and the implementation of appropriate policies to deal with the fiscal situation and the exchange rate.

From the figures presented by the staff, and in the light of domestic and external imbalances, GDP should increase at a rate of 4 percent in 1990, Mr. Quirós noted. That would represent a lower growth rate than any recorded during the first four years of EEC membership. Inflationary pressures had intensified, and consumer prices had increased by close to 7 percent during 1989. That situation would also require care, given the projected growth rate.

It had always been recognized that the most promising approach to the unemployment problem was to provide for sustained growth in the economy, Mr. Quirós remarked, while maintaining wage moderation, developing workers' skills through education, and ameliorating some of the rigidities in the labor market. The authorities recognized that that was a difficult and important problem and were making great efforts along those lines. According to the staff, the authorities had strived to create a competitiveness agreement, as they believed that a more active incomes policy could have a positive implication for the avoidance of wage overruns. If an agreement of that nature could ultimately be worked out, it would help to reduce

simultaneously inflationary pressures and current account imbalances. Most important, it would create the appropriate environment for further efforts at implementing the additional structural reforms that were required for Spain to face the difficult but promising new decade of the 1990s.

Mr. Noonan made the following statement:

The excellent performance of the Spanish economy in recent years, which supported the creation of over 1 million new jobs, showed signs of faltering in 1989, as the authorities sought to control mounting inflationary pressures by tightening financial policies. Nevertheless, domestic demand continues to outpace GDP growth, and further corrective action is needed.

An unfortunate, but unavoidable, consequence of corrective action has been some slowdown in output growth, but it is still relatively strong. We agree with the staff that this relatively strong growth is desirable, both to enable Spain to move closer to the average EC living standard and to reduce its high level of unemployment. It would therefore be regrettable if the further measures that are needed continue to be deferred, or otherwise take a form that unduly depresses growth and employment prospects. In either event, the outcome would be reflected in the Spanish economy performing below its potential. An inadequate response would limit the extent to which the economy could support the authorities' apparent aspirations to strengthen Spain's traditional links with Latin America. Stronger links, on the other hand, could help to reinforce mutually beneficial linkages between the EC and Latin America--and, perhaps, in due course, provide Mr. Fernández Ordóñez with another example of the benefits of multilateralism.

In reviewing Spain's 1989 experience, we accept that the authorities were faced with a perplexing policy dilemma: how to tighten their overall policy stance and dampen aggregate demand growth while minimizing the adverse impact of those corrective measures on the achievement of their targets for the monetary aggregates. The apparent inability of the authorities to satisfactorily resolve that dilemma without recourse to direct exchange and credit controls suggests a weakness in their capacity to effectively implement macroeconomic policy using market-oriented instruments.

We are puzzled that the authorities were unable to conduct monetary policy without resorting to direct administrative controls. The authorities have argued that the slow or incomplete pass-through to credit markets of the recent adjustments to the intervention rate required a reversion to nonmarket policy instruments. Nonetheless, between September 1988 and June 1989, the authorities were able to raise the one to three-year loan rate by

160 basis points to 16.3 percent, or about 9 1/2 percent in real terms. Moreover, while the authorities stated that their monetary targets were being imperiled by foreign exchange inflows, the staff has noted in Appendix II of the supplement to the background paper that the authorities have been successful in sterilizing such inflows in the past. Consequently, notwithstanding the arguments advanced, we still have difficulty in understanding why recourse to such controls should have been necessary in 1989. I should add that we are pleased to note Mr. Fernández Ordóñez's statement that direct controls are being lifted at the end of 1990.

We wonder whether some of the difficulties that face the authorities may have been caused by the delay in raising interest rates, which may have resulted in a sharper increase in short-term interest rates than otherwise would have been needed, thereby exacerbating the capital inflows that complicate the authorities' monetary management. Moreover, we wonder whether the authorities' room to maneuver during the first half of 1989 was restricted by the liquidity injection arising from the shortfalls in fiscal revenues related to the legal challenges to the income tax liability of married filers. I would appreciate the staff's comments on these possibilities.

As regards the external accounts, we note the very large value of the errors and omissions category in the balance of payments statement for 1989. That suggests that the current account deficit may have been understated by over 1 percent of GDP. The background paper provides some indication that the massive increase in the volume of imports over recent years has been related in part to imports of capital equipment. To the extent that the deficit was financed by associated long-term capital inflows, it could be viewed as relatively benign; however, we also note that, in 1989, unlike the previous two years, over 50 percent of capital inflows were related to public sector borrowing and portfolio investment, rather than direct investment. Therefore, we would urge the authorities to work toward a more sustainable external position and to avoid a further erosion in competitiveness. Perhaps the staff could elaborate on the composition of capital inflows during the first five months of 1990.

As regards further corrective action that is needed, I agree with other speakers that the authorities take too negative a view of fiscal policy measures. The deflationary impact that they fear has been more conspicuous by its absence when fiscal policy has been tightened elsewhere. The staff's analysis shows that the basic imbalances fueling excess demand include a long-term downward trend in the personal savings ratio that is not offset by a growth in public savings. If this analysis is accepted, it is difficult to understand why the authorities should be reluctant to achieve

greater growth in public savings in order to help correct those basic imbalances. There is scope for achieving those savings, as the staff points out, both by curtailing public sector expenditures, including wages, and by enhancing revenues.

While I hope that the authorities will be successful in their negotiations with the trade unions and employees, I share the skepticism that has been expressed about relying on a negotiated pact. Normally, I would be supportive of a collective pay settlement based on a consensus on the type and size of settlement required. However, I do not see that such a consensus has been reached in Spain.

I would also like to express some reservations as regards the authorities' view, as set out in Mr. Fernández Ordóñez's opening statement, "that there are only two alternatives." The fact that wages have followed rather than preceded inflation, that food and service prices have increased disproportionately, and that, to quote Mr. Fernández Ordóñez, there is "a situation of huge and easy profits" and a "lack of regional mobility," all point to the need for more than an incomes and wages policy.

These facts also point to the need for more effective action on structural policies and, especially, for more competition among existing enterprises, particularly in the tertiary sector. They also perhaps suggest that a rapid growth in farm incomes may have contributed to inflationary pressures. Without knowing the extent to which these issues would be addressed in the proposed competitiveness agreement, I suspect that, in practice, the agreement would be concerned mainly with pay rates, taxation, and social security. Irrespective of which alternative is adopted, I would urge the authorities to forcefully address the structural impediments to effective competition, the absence of which is evidenced by very high profit margins, particularly in the tertiary sector. Effective competition is a potent means of controlling inflationary tendencies.

Mr. Fogelholm made the following statement:

Spain has experienced impressively high economic growth since the mid-1980s, helped, of course, by a favorable external environment, but also as a result of growth-promoting economic policies. However, it became clear in 1989 that the economy had entered an overheated phase, leading to widened external imbalances and renewed inflationary pressures. The most worrisome aspect of the present overheating is the growing wage pressures that--if not restrained--will adversely affect future price developments, and, subsequently, economic stability.

Thus, the strengthening of financial policy in 1989 was most welcome and, indeed, necessary. This has led to a dampening of domestic demand and a decrease in price pressures. However, the current account has continued to deteriorate, although at a decelerated pace. Despite this progress, the present policy stance is hardly sufficient to reduce the inflation rate to the level of Spain's main trading partners. To achieve this goal and to reach a sustainable external position, a further tightening of present policies is needed, if one looks at the staff's medium-term scenarios. I am pleased to note from Mr. Fernández Ordóñez's opening statement that the authorities hold the same view. Nevertheless, I doubt that their preferred policy option, namely, reliance on income and structural policies, will lead to the desired outcome. Instead, and in line with previous speakers, I believe that the authorities should be advised to supplement these policies with a slightly tighter fiscal policy stance than envisaged, as I share the staff's and, if I read correctly between the lines, Mr. Fernández Ordóñez's own skepticism regarding the feasibility of attaining wage moderation under the present demand conditions and amid the prevailing rigidities in the labor markets.

One way to achieve this tightening could be to succumb to the pressures to decrease marginal and capital income taxes and, as proposed by the staff, increase indirect taxation, so that the total effect would be slightly contractionary. This would not only have the benefit of changing the tax structure more toward the European, but would also, I believe, not have any negative effect on employment; on the contrary, a marginal tax cut could perhaps encourage labor mobility between professions.

Continuing on the topic of fiscal policy, I welcome the change in financing procedures--beginning in 1990--that prevents the level of central bank financing of the budget deficit from increasing. In light of this, I am somewhat disturbed by the size of the monetary financing so far this year, which has been attributed to delayed increases in interest rates on government paper. I urge the authorities to be more responsive to market conditions in setting these interest rates, in order to secure market financing of the deficit. This will both discipline fiscal policy and counter inflationary pressures.

Although I agree in principle that, now that Spain is participating in the ERM--which in itself is providing a welcome disciplinary action for economic policies--its monetary policy will be restrained by exchange rate management, I believe that the staff overemphasizes somewhat the limitations on the use of monetary policy, as such limitations clearly have a time dimension. Room for maneuver could well develop in the not-too-distant future, if

the current overheating with accompanying loss of competitiveness leads to a lessening of market confidence in the present rate of the peseta. In such a situation, tightening of the monetary policy stance could be possible and, indeed, necessary to defend the rate of the peseta in the ERM.

I am pleased to note that the recent reintroduction of credit controls will be reversed soon, and hope that this will happen before they have a negative effect on resource allocation. Here, I note from the staff's supplement to the background paper that the money supply actually has grown faster than targeted, when one takes into account the large shifts out of the traditional monetary aggregate--something that is already an indication of circumvention of credit controls.

Although I do not believe that income and structural policies are sufficient in the present situation, I, of course, fully support all planned actions in these areas. Further liberalization of the labor markets would seem to be particularly important. The persistently high, although declining, unemployment rates, together with the already emerging bottlenecks, are certainly evidence of existing labor market rigidities. Proposed measures, which include increased vocational training for the unemployed and an improved supply of rental housing to increase labor mobility, definitely seem well founded.

Moreover, the Government's determination not to give in to the demands of trade unions to reduce the flexibility of present labor contracts deserves our full support. As the agreement between the Government and the social partners will be comprehensive, in that it covers not only wages but also social services, some aspects of taxation, and in particular enterprise reinvestment policies, the Government should also ensure that microeconomic efficiency is not endangered by this agreement.

In conclusion, like the staff, I have full confidence in the ability and determination of the authorities to surmount the challenges ahead. There is an additional and special reason for this confidence: the return home of Mr. Fernández Ordóñez, which will clearly be the Board's loss but Spain's gain, to use an old but appropriate cliché.

Mr. Al-Jasser made the following statement:

Since the middle of the previous decade, the Spanish economy has undergone a major economic revival, characterized by rapid output and employment growth. This expansion has, in part, reflected the implementation of far-reaching structural reforms

that merit strong commendation. Unfortunately, in the past two years, the economy has exhibited signs of overheating, leading the authorities to tighten their financial policies. As indicated in Mr. Fernández Ordóñez's opening statement, the authorities recognize that the immediate challenge confronting them is to bring about a soft landing of the economy.

The fascinating feature of the Spanish economy is that the same policy choices that have led to dramatic expansion have also created the fundamental imbalances that currently plague it. Indeed, the authorities' efforts to integrate the economy into the rest of the EC, and the resulting opening of the economy and liberalization of the financial system, have led to a massive inflow of foreign capital and to a drastic increase in domestic investment. This, coupled with optimistic expectations, has led to a continuously appreciating exchange rate and a deteriorating current account balance.

In my view, however, this current account deficit could be characterized as benign. First, the deficit has not created a financing problem, since it has been more than compensated for by foreign investment and other long-term capital flows. In other words, it can be argued that the current account deficit is a mirror image of the resource inflow. Second, a substantial portion of the current account deficit is reflected in the rapid accumulation of capital, which, if productively allocated, need not cause concern. Finally, the downward trend in private sector saving, which has also contributed to the current account deficit, may be partly due to financial liberalization. Indeed, the removal of credit constraints allows agents to make optimal intertemporal consumption decisions that are likely to decrease current private savings. This can be considered a consequence of a policy that we have continuously advocated. I would hasten to add that financial liberalization, in and of itself, need not lead to a permanent reduction in the rate of savings.

The authorities have responded to these developments by imposing credit ceilings, tightening the fiscal stance, and, most significantly, breaking the expectations cycle by joining the wide band of the ERM. Regarding the last-named action, I agree with the authorities and the staff on the importance of maintaining the current parity for the anti-inflationary strategy, particularly since a nominal devaluation to improve the real effective exchange rate would be futile. Therefore, greater reliance on fiscal policy as a major anti-inflationary tool is essential, particularly since the credit ceilings are to be rescinded soon.

In this regard, it is important to note that the authorities seem to be approaching their objectives with an overburdened policy

package. Given that monetary policy is dedicated to maintaining the external objectives, fiscal and incomes policies must address the domestic objective. However, both of these policy tools appear to be constrained by social and political considerations. Naturally, if incomes policy is not sufficiently tight, external competitiveness will suffer, thereby rendering private sector investments inefficient. This, in turn, could transform the benign current account deficit into a malign one. Regarding incomes policy, I share the staff's concern about the spread of implicit and explicit indexation of wages and pensions, which could reintroduce serious rigidities to the labor market. Moreover, inadequate public expenditure on social and physical infrastructure could also adversely affect competitiveness. The immediate solution to this dilemma lies in the implementation of structural measures to improve the flexibility of the economy. While I endorse fully the staff recommendations in this regard, it must be recognized that this is easier said than done.

It is by now obvious that greater economic integration within the EC and membership in the ERM does not only imply a harmonization of monetary policies, but also the adoption of compatible fiscal, structural, and social policies. Therefore, Spain is faced with the difficult task of generating the necessary domestic consensus to adopt a tight incomes policy, reduce nonproductive public expenditures, harmonize its tax system with that of the EC, and reform its labor market.

It is noteworthy to recall the experience of Belgium, which, by joining the ERM, was constrained to adopt the necessary fiscal, structural, and incomes policies. Indeed, as Mr. de Groote put it, adherence to the discipline of anchors was the key to Belgium's 1982 program from the start, helping to forge the necessary social consensus to correct the remaining imbalances, which enabled the dynamics of unification to fully unfold. I hope that the Spanish experience will prove equally rewarding and successful.

Finally, while welcoming the increase in Spain's official development assistance, I urge the authorities to bring its level closer to the UN target.

Mr. Posthumus said that Mr. Fernández Ordóñez's opening statement had highlighted some of the main policy issues facing Spain while avoiding a repetition of the staff's analysis of the excellently managed economy. As Mr. Fernández Ordóñez had noted, the rigorous macroeconomic policies had proved to be insufficient--at least for the time being. The authorities thought that only two additional sets of measures were possible: incomes and structural policies, including, in particular, labor market and tax reform; and a more restrictive fiscal policy.

The possibility of implementing an effective incomes policy was doubtful, Mr. Posthumus considered, but, as Mr. Grosche had said, the attempt was worth a try, assuming that it did not involve substantial budget costs. Such centralized policies could also impede flexibility in the labor market. Furthermore, structural policies had the disadvantage of being concerned with structures, which could not always be changed or abolished in a short time.

Fiscal policy had been characterized by Mr. Fernández Ordóñez as having a purely stabilizing effect, which would negatively and unnecessarily influence unemployment and investment, Mr. Posthumus remarked. However, as Mr. Noonan had noted, although that might be true to some extent in the short term, fiscal policy would not have those effects in the medium term. In the current overheated situation, a faster pace in moving toward the intended budget surplus went in the right direction; such a policy should therefore be given serious consideration. Presumably, that was also what was meant by the reference in the staff appraisal to the major role that fiscal policy would have to play in the adjustment process.

More generally, liberalization meant less control, Mr. Posthumus continued. In a more liberalized economy, the braking time needed for restrictive and stimulative policies to have effect inevitably became longer. That had to be accepted as the price for a more efficient market economy.

In fact, Mr. Fernández Ordóñez had made the same observation when commenting on the time that it took for the EMS discipline to make itself fully felt, Mr. Posthumus noted. That consideration led to a second observation, in the context of the question raised in the staff appraisal as to whether the tightening of financial policies had been sufficient to reduce inflation to the EC level by 1992. The target should not be the average inflation rate for EC countries--4.9 percent over the most recent 12-month period--but the inflation rate for currencies in the narrow EMS band--3.3 percent over the same period.

The points just made served to further emphasize the issue, depicted in the medium-term scenarios, of a possible trade-off between growth and inflation, Mr. Posthumus commented. It would be appreciated if the staff could comment on the possibility that, even during a period of restructuring, Spain's long-term growth prospects could be stronger in an environment of higher inflation than in one of lower inflation.

Despite the macroeconomic disequilibria, he joined Mr. Fernández Ordóñez in supporting the commitment to continue steadfastly the implementation, in the context of regional multilateral agreements, of the trade liberalization process and, to the extent possible, the capital liberalization process, Mr. Posthumus said. He supported the recommendation that the next Article IV consultation with Spain should be held on the standard 12-month cycle.

Ms. Creane made the following statement:

Despite slippage in some areas in 1989, steady financial policies over the past five years have produced significant progress in stimulating growth, cutting inflation, and bringing down the unemployment rate in Spain. Spain has one of the best fiscal positions in the EC or the OECD, and has moved forward with most of the trade and capital market liberalization that has been required by the EC.

From another point of view, Spanish economic performance does not appear to be quite as positive. Although at a reduced rate, domestic demand continues to exceed economic growth, with the result of continued upward pressure on prices and on the current account. While we commend Spain for its success in reducing the rate of inflation through May of 1990, its inflation differential with major trading partners remains stubbornly fixed at about 2 1/2 percent. The deterioration of the current account has slowed, but, as a proportion of GDP, the deficit is still approaching the 4 percent range. While the large investment goods component of imports and large capital inflows provides consolation, we are concerned about the risks involved with a current account deficit of that magnitude. Finally, while the unemployment rate has come down from earlier peaks, it is still very high, at 15.9 percent in May 1990.

The persistence of these negative characteristics points to the existence of entrenched structural rigidities in the Spanish economy. Thus, we agree with the staff that, if Spain is to continue with its impressive economic record and successfully face the challenges of the EC single market in 1992, some fundamental imbalances in the economy must be addressed.

Perhaps the most important structural imbalances remain in the labor market. We are concerned that a wage-price spiral would have a negative impact on foreign direct investment inflows and the potential for sustained growth. Along these lines, we regret the decision to allow public sector employees the right to bargain collectively, and hope that, in practice, it will work otherwise than planned. If not, the risk would be increased that the agreed wages would be too high to cover lower-productivity geographical areas. These types of rigidities contribute to Spain's high rate of unemployment. Although 1989 saw the most improvement in unemployment in five years, most of this came from the public sector, and not from an easing of long-term bottlenecks in the labor market. We encourage the Spanish authorities to maintain a hard line against the reintroduction of other rigidities in the labor market and to push for greater flexibility in the wage system.

We agree with the staff that the "problem of the continued higher rate of inflation in sheltered and tourism sectors than in the tradable goods sector deserves greater attention." The supplement to the background paper points out that this trend continued into the first half of 1990. We would recommend that the Spanish authorities follow the staff's advice on implementing reforms by improving the supply of rental housing in tourist regions, increasing competition in the distribution sector, and correcting shortcomings in the transportation system. Improvements in these areas should reduce inflationary pressures, increase employment, and improve the competitiveness of tourism and other sectors in the economy.

The Government has made impressive progress in reducing its public sector deficit. The progress, however, has come from the revenue side of the budget, resulting from consistently higher than expected economic growth. Given the peseta's adherence to the ERM, together with the commitment to eliminate credit controls by the end of the year, we agree that the authorities will need to begin using fiscal policy to control demand. In fact, we see the neutral 1990 budget as a lost opportunity to begin using fiscal policy as a means to reduce inflationary pressures. We agree with the staff that plans to eliminate the budget deficit by 1992 should be treated as a minimum objective. We also find the legislated limits on public sector borrowing from the central bank to be interesting; we wonder whether these limits will be implemented by means of an averaging mechanism, so as not to be circumvented by end-year "window dressing."

The main question posed by the Fund staff is whether the current mix of financial policies will adequately cool the overheated economy. Given the data now available--which extend through May 1990--the answer seems to be, "not enough." A second question might be whether the policies taken were appropriate and timely. We regret that the authorities were pushed to counter the years of using indirect monetary policy controls and financial market liberalization by imposing credit controls and deposit requirements on new foreign borrowing. We urge the authorities to rescind these controls as soon as feasible.

The Spanish authorities are to be commended for moving quickly on financial and capital market liberalization. With the deregulation of interest rates, the liberalization of capital flows, and the removal of limits on foreign bank branch expansion, their record is more impressive than that of some larger economic and financial powers. We hear lingering reports of discrimination against foreign financial institutions but hope that, with the full implementation of the current and planned liberalization, these reports will dissipate.

In summary, we agree with the appraisal in the staff report that the authorities will need to build on the progress achieved over the past five years by quickly addressing the roots of inflationary pressures with the careful implementation of financial policies and the correction of structural rigidities.

Mr. Ismael said that he was pleased to note the continued growth in the Spanish economy for the third successive year. In addition, the budget performance had remained satisfactory, resulting in a remarkable reduction in the overall deficit. However, the Spanish economy continued to be overheated, owing to the very rapid growth in credit and monetary aggregates that had intensified inflationary pressures.

Against that background, the various monetary and fiscal measures that the authorities had undertaken to counter the adverse implications of the substantial growth in domestic demand were appreciated, Mr. Ismael continued. Those measures should be further accelerated in the medium term. The authorities had therefore been correct in setting goals to lower the rate of inflation to the EC average and reduce the current account deficit to a sustainable level of about 2 percent of GDP. Nevertheless, it should be recognized that excessive reliance on interest rates to curb credit growth could affect capital flows and, therefore, have unfavorable consequences for investment and growth. The recommendation made by the Board in 1989 should therefore be reiterated, namely, that greater emphasis should be placed on fiscal restraint, which would result in a more judicious mix of monetary and fiscal policies. In addition, in order to attain sustainable external and internal equilibria, real wages should rise by less than the growth in productivity, or fiscal policy should restrain domestic demand even more than currently projected.

Although some progress had been made, another serious problem that the authorities continued to face was that of unemployment, Mr. Ismael remarked. The most promising approach to the unemployment problem was to keep the economy on its path of sustained growth while maintaining wage constraint, increasing high-level vocational education facilities, and removing rigidities in the labor market. In the main, the Board's recommendations from the previous year remained valid in that regard.

The Spanish authorities were to be commended for substantially increasing the level of official development assistance in 1989, Mr. Ismael concluded.

Mr. Landau made the following statement:

In recent years, the Spanish economy has displayed some very specific characteristics. First, it has grown very strongly, with the highest growth rate among OECD countries. Second, Spain has

undergone dramatic structural changes. Mr. Fernández Ordóñez has rightly insisted in his opening statement on the boldness of the moves taken by his authorities in recent years, after their entry into the EC. In particular, the extensive liberalization of the trade regime was especially remarkable because it came at a time of widening and increasing deficits. The staff report also illustrates the extent of the reforms put into place in the financial markets more recently. Finally, the Spanish Government committed itself to exchange rate stability inside the ERM.

As a result, however, the Spanish economy finds itself in an uneasy balance: strong inflation, combined with an important current account deficit, threatens both the overall performance of the economy and the exchange rate objective. The entire process now depends on the pursuit of huge capital inflows, which, up to now, have been spontaneously forthcoming. However, the drying up of such inflows would inevitably lead to a financial and economic crisis and a hard landing of the entire growth process.

I agree with the appraisal contained in the staff report. As I said, the economy suffers both from internal overheating and external deficits. This should make the direction of economic policy easy to define, and priority should clearly be given to reducing internal demand.

This strategy, however, is complicated by two elements. First, unemployment is still very high. Spain needs growth; it is doubtful that the process of structural adjustment could be maintained while continuing to enjoy social acceptability if the economy were to come to a standstill or suffer negative growth in the future. This point has been clearly made by Mr. Fernández Ordóñez in his opening statement.

Second, the external environment is increasingly putting limits on the operation of monetary policy as a means of fighting inflation. Already, spontaneous capital inflows are tending to push up the exchange rate of the peseta. In this context, any rise in interest rates, even if warranted with respect to the internal situation, would yield undesirable results on the external side.

This effect is intensified because, with the increasing liberalization of capital movements, the exchange rate tends to become a less efficient tool of economic management. The supplement to the background paper clearly shows how, in the past, the imperfect substitutability of financial assets made efficient sterilized intervention possible on the exchange market. The authorities could therefore pursue independent monetary and exchange rate

policies. The supplement hints that, with the increasing liberalization of capital movements, this might not be the case anymore. I would appreciate any comments from the staff on the present situation.

Some conclusions may thus be drawn from the overall picture. There is a strong rationale for implementing, in one form or another, an incomes policy. In his opening statement, Mr. Fernández Ordóñez is absolutely right to point to France as an example that exchange rate discipline does not produce fruits overnight. Gaining credibility is a long and painful process. Meanwhile, until expectations have incorporated themselves into the wage formation process, some form of more direct intervention or influence might be necessary. In France, from 1984 to 1986, this took the form of a strong wage policy in the public sector, based on a normative inflation assumption. This led progressively to a reduction of nominal wage claims. This, in turn, gave credibility to the exchange rate objective, which, as a consequence, began to influence wage expectations. I wonder, in this framework, whether the objective of inflation that the authorities are fixing for themselves is ambitious enough. I would appreciate any comment from the staff in this regard.

In the present context of the Spanish economy, fiscal policy is certainly instrumental. It holds the key to monetary stability without high interest rates or exchange rate appreciation. In his opening statement, Mr. Fernández Ordóñez presents the tightening of fiscal policy as an option to be used if income policy fails. I recognize the merits of such a presentation as a prelude to wage negotiations; however, the overall real cost of the adjustment process would be minimized if both a strong fiscal consolidation and a direct influence on income formation were implemented. At the very least, as hinted at by the staff, a quick reduction of expenditure in the public sector would give room for maneuver on the tax side, allowing, for instance, for income tax measures to compensate for the pressure on nominal wages.

This having been said, I must confirm that my authorities are impressed by the recent Spanish economic performance, as well as by the place and commanding role that the country has assumed since its entry into the EC.

Mr. Kabbaj said that the opportunity to review the Article IV consultation with Spain, with which the members of his constituency maintained close economic and political ties and to which they looked as an example for the structural modernization of their economies, was welcome. Not long ago, the economic situation in Spain had not been much different from that of many

countries in the Mediterranean area, as it had similarly suffered from those problems associated with inward-looking economies: high rates of unemployment, and heavily protected agriculture and industries.

The Spanish authorities were to be commended for having decisively changed course, first by joining the EC--despite the inequalities that had existed vis-à-vis the other members of that group--and more recently by joining the ERM, Mr. Kabbaj continued. Those courageous moves, together with the implementation of steady and more appropriate financial and structural policies, had produced a stronger economic expansion since the second half of 1985 than in the other principal industrial countries. It was worth noting that, through 1987, Spain had enjoyed rapid economic growth, which had allowed for the creation of almost 1 million new jobs. Interestingly, that development had been associated with a sharp deceleration in inflation, a budgetary deficit, and growth in the monetary aggregates.

Developments in 1988 and 1989 had been somewhat less favorable, Mr. Kabbaj observed, since the continuation of the vigorous economic expansion, fueled by excess demand, had led to a widening of the external current account deficit. The authorities were to be commended for having taken the necessary corrective actions in the fiscal and monetary fields. However, the staff had correctly noted that 1990 was a crucial year for "shaping the conditions under which Spain will face the single European market in 1992."

In that respect, Mr. Kabbaj noted, the information on recent developments contained in the supplement to the background paper was encouraging in that it confirmed that the overheating of the economy had decelerated somewhat. Nevertheless, the main questions facing the authorities were still the two that the staff had posed: whether the tightening had been sufficient to reduce inflation to the EC level by 1992; and whether Spain could continue to grow at a relatively fast rate, in order to attain the EC standard of living and to reduce unemployment.

To say the least, the answers to those two questions were not easy, Mr. Kabbaj remarked. Although, as Mr. Fernández Ordóñez had made clear in his opening statement, the authorities were still determined to arrive at a well-balanced outcome, it remained to be seen whether those two aims were not somewhat contradictory. The past five years had presented almost ideal conditions for Spain in terms of growth, private investment, including high levels of foreign investment, and favorable terms of trade, yet, as Mr. Cassell had noted, the unemployment rate still hovered at about 16 percent--the highest among OECD countries. That situation, which was not peculiar to Spain, could perhaps be addressed at some point by the Research Department.

A similar dilemma faced the Mediterranean countries of his constituency, although those countries had to deal with somewhat more complicated problems, Mr. Kabbaj observed. In order to strike the appropriate balance between the two objectives of reducing inflation and unemployment, and

succeeding in fully integrating Spain into the EC, the authorities would have to implement the fiscal and monetary policies advocated by the staff. On the basis of the staff appraisal, he broadly agreed with the staff on what policies were necessary; however, special emphasis should be put on the implementation of structural policies, especially in labor markets and trade liberalization.

Although they had started from a very low base, the authorities should be commended for doubling the amount of official development assistance in 1989, Mr. Kabbaj concluded. They should further increase the amount of assistance, in order to make it commensurate with the role that Spain was likely to play in the world economy.

Mr. Othman said that 1989 had been another year of impressive growth for Spain, adding to the already impressive record that had placed it among the strongest economic performers in OECD countries during 1986-89.

The Spanish authorities should be commended for pursuing appropriate structural and macroeconomic policies, which had made the achievement of those impressive results possible, Mr. Othman continued. Furthermore, the favorable external environment had undoubtedly contributed positively to the outcome. However, as indicated in the staff report, the economy had started to show signs of overheating by the end of 1988. Those signs had become more evident in 1989; inflationary pressure had continued, accompanied by a further deterioration of the current account deficit and a persistently high unemployment rate.

Confronted with such imbalances, the authorities had rightly implemented a series of macroeconomic measures aimed at reining in aggregate demand, Mr. Othman stated. The success achieved thus far, as outlined in Mr. Fernández Ordóñez's opening statement, was, although commendable, still insufficient. More progress was needed, particularly in addressing the constraints associated with the demand for higher wages and the change in the policy mix necessitated by Spain's participation in the ERM.

The sustainability of the current account in the medium term was another cause for concern, Mr. Othman remarked. In Appendix IV of the supplement to the background paper, the first medium-term scenario--which was more in line with the authorities' orientation on economic policies--demonstrated that the current account deficit would be, on average, 3.7 percent of GDP from 1991 to 1995. In light of the strong rate of foreign investment, Spain should have no problem in financing such an external deficit, provided that it remained attractive to investors and that its producers maintained their competitiveness. However, the persistency of the deficit over the period, together with the uncertainties associated with labor market developments, and the constraints on monetary policy caused by Spain's entry into the ERM, gave cause for concern. It was not clear how long the market would continue to finance such a deficit; for example, a turnaround in market sentiment could take place.

Inflation was another cause for concern, Mr. Othman commented. The authorities' intention to use incomes and structural policies, combined with an appropriate macroeconomic policy stance, should help to contain inflation during the remainder of 1990 and thus achieve the inflation target for the year as a whole. That emphasis was likely to offer lasting prospects for narrowing Spain's inflation differential with its trading partners without causing major losses in employment and output. Success in the fight against inflation remained crucial, as it could help to ease the tension in the labor market and provide confidence to investors.

Unemployment continued to be one of the most serious problems facing the authorities and would remain so in the future, Mr. Othman said. The most promising approach to the unemployment problem was to provide for sustained growth in the economy while maintaining wage moderation, increasing technical education, and removing rigidities in the labor market. The progress achieved thus far in that area was commendable. However, the authorities' task remained difficult, because labor unions, youth, and the long-term unemployed had been pressing for solutions to their respective problems. Undoubtedly, the situation needed time to change; meanwhile, the most important contribution the authorities could make was to continue to promote a high rate of growth and to raise the standard of living.

In the area of trade policy, Mr. Othman noted, the resolve of the authorities to continue to support the efforts for a successful conclusion of the Uruguay Round, and in particular, the dismantling of the Multifiber Agreement, were encouraging. However, important barriers to trade still existed in Spain, especially in areas of vital importance to developing countries. In that regard, he joined the staff in urging the authorities to make further progress in those areas.

Mr. Filosa made the following statement:

The positive performance achieved by the Spanish economy during most of the 1980s continued in 1989. Pushed by brisk investment activity, the rate of growth once again outpaced the rates of the other industrial countries. Furthermore, 1989 witnessed the most substantial improvement in the unemployment situation in the past five years, while the peseta, favored by sizable capital inflows, has remained in the upper part of the fluctuation band since Spain's entry into the ERM. The list of economic achievements should also include important structural reforms, such as the reform of the stock market, which will certainly contribute toward greater efficiency and modernization of the economy, and the wide-ranging trade liberalization reforms. The authorities deserve full credit for these important results and for their commitment to the liberalization and restructuring of the economy that was undertaken in view of the country's forthcoming complete integration into the EC.

Unfortunately, growing inflationary pressures have been building up during the course of the year, despite the resolute fiscal and monetary policies pursued by the authorities. The persistence of these inflationary pressures against the background of deteriorating external competitiveness and widespread supply bottlenecks has led the staff to fully re-examine the present set of economic policies being pursued by the authorities.

On the question of the policy mix, the staff concludes that participation in the ERM necessitates the de-emphasis of monetary policy as an instrument of domestic demand control, whereas reliance on fiscal policy should be correspondingly increased; in this regard, the staff also recommends the adoption of a surplus budget by 1992 and the implementation of a fiscal reform that allows for an increase in indirect taxation. The staff believes that the authorities should refrain from using instruments, such as direct credit controls and incomes policy, that imply a direct intervention by the authorities in crucial markets, such as the credit and labor markets.

However, the analysis of the staff partially overlooks some important needs and constraints--as well as some of the structural changes--that characterize the Spanish economy after the prolonged period of fast growth and capital accumulation. In my view, these needs and constraints require that, in order to contain the present inflationary pressures, the role of incomes policy should be at least as important as the role of budget policy.

An examination of the three areas that are crucial to today's discussion will help to support this view. Regarding monetary policy, I agree with the staff on the distorting effects of direct credit control, which have been well documented in other countries. In the supplement to the background paper, the appendix on the interest pass-through mechanism concludes, rather paradoxically, that "changes in institutional factors favoring a better financial market integration, together with cyclical factors, impeded a quick response of banks' lending and deposit rates to changes in the intervention rate." In some way, therefore, the Spanish authorities have become victims of their own brilliant success in reforming the financial markets. Looking at the problem from this point of view, the adoption of credit ceilings was the only alternative--albeit a second-best alternative--available to the authorities in attempting to engineer an increase in interest rates. In this connection, I would be interested to learn from either Mr. Fernández Ordóñez or the staff whether the workings of the interest rate pass-through mechanism are expected to improve any time soon, so that the usual indirect monetary policy instruments might be efficiently used.

Regarding fiscal policy, I share the staff's view that the role of fiscal policy should be enhanced in those cases in which the authorities decide to fix the exchange rate. This has been the position expressed by this chair on previous occasions. However, in the case of Spain, I wonder whether it is advisable to implement a tighter fiscal policy in order to control domestic demand, as that could cause an unnecessary loss of production and work opportunities. Furthermore, on grounds of feasibility, I have some doubts about the staff's proposals to, respectively, bring the budget into surplus within two years, implement a fiscal reform that enhances the role of indirect taxation, and retain a very restrictive expenditure policy.

Apart from the negative consequences that an enhanced role for indirect taxes would have on inflation and external competitiveness, such policies would certainly catalyze strong social resistance. There are three basic reasons for this. First, the proposed fiscal reform would reduce the degree of progressiveness of the tax system and could therefore be easily opposed on grounds of equity. As a matter of fact, some reduction in the progressiveness of the tax system is already expected to take place, because of the changes in the treatment of capital income and capital gains that are needed as a consequence of the liberalization of capital movements.

Second, and more important, the share of wage income in total disposable income has declined from 67.5 percent in 1981 to 64.3 percent in 1989--an effect that would be even greater if per capita disposable income was considered. Therefore, a tax reform based on higher indirect taxes would exacerbate the natural tendency toward a less equitable income distribution.

Third, Spain is emerging from a period of growth that has transformed the country profoundly. Experience in other countries, including my own, suggests that the supply of public goods in such periods usually falls short of demand. In such circumstances, it would be difficult to further restrain expenditure, especially if the purpose is to bring the budget into surplus.

From these three basic considerations, I would deduce that implementing the staff proposals might cause strong social opposition--an opposition that would certainly have adverse consequences for the wage negotiation process. In particular, an increase in indirect taxes might not only fuel inflation directly, but also indirectly, through higher wage demands.

In the present circumstances, a strong incomes policy appears to be an indispensable complement to the fiscal policy

course that has already been planned. In his opening statement, Mr. Fernández Ordóñez makes reference to the skepticism that has been expressed about the possibility of implementing an incomes policy in a situation of large and easy profits. I do not share such skepticism. A skeptical view of the possibility of implementing an incomes policy does not fully take into account the positive effects that the authorities' commitment to exchange rate stability has on the wage bargaining and price formation processes. If the authorities are fully committed to exchange rate stability--and this certainly is the case for Spain--both trade unions and enterprises will become aware that an excessive growth in wages will not be accommodated by a corresponding change in the exchange rate, but will only trigger the enactment of restrictive economic policies. This simple argument, which is too often overlooked, also explains why it is advisable to join a system of fixed exchange rates despite the existence of inflation differentials. The deceleration of the inflation rate that occurred in Italy in the early 1980s was determined by, inter alia, the change in the behavior of both trade unions and employer confederations brought about by Italy's participation in the ERM.

The staff also seems skeptical about the value of an incomes policy in its argument that a centralized wage bargaining process would increase the strength of trade unions and produce microeconomic distortions and rigidities. According to the staff, strong trade unions would be in a position to resist government guidelines more effectively. In retrospect, however, it should be noted that, in a number of countries--including Germany, Belgium, and France--the successful disinflation process that took place during the 1980s was significantly influenced by some form of coordination between macroeconomic policy and incomes policy. A broad agreement between the Government and the trade unions--which is what incomes policy is all about--has proven to be not only an essential complement to sound financial policy, but also an important policy tool to reduce the costs of disinflation. As far as incomes policy is concerned, therefore, my view is closer to that of the Spanish authorities than to that of the staff.

Mr. Yoshikuni made the following statement:

In 1989, the Spanish economy sustained strong growth, led by domestic demand, which has pushed the average growth rate since 1986 to the highest among OECD countries. Also, unemployment declined sharply, although the level is still high by international standards. The rapid expansion, however, was accompanied by strong inflationary pressures and a widening current account deficit. In fact, the inflation rate is quite high and the external imbalance is quite large, compared with those in other EC countries. It

follows that, given the timetable for the integration of the EC economies, much remains to be done in order to eliminate excess demand and remove the rigidities affecting many areas, including the labor market.

I generally agree with the thrust of the staff report and with Mr. Fernández Ordóñez's opening statement. However, in the context of facilitating Spain's smooth entry into the process of EC integration, my first concern is about the degree of financial restraint needed to bring down the rate of inflation, consistent with the stability of the peseta within the EMs. This was the first question that Mr. Fernández Ordóñez posed in his statement. In this connection, I broadly agree with the staff that more stringent policies, particularly on the fiscal front, are required to avoid placing an excessive burden on monetary policy. While I recognize Mr. Fernández Ordóñez's argument for the efficacy of an incomes policy, which was further emphasized by Mr. Filosa, I could not agree more with the comment on page 15 of the staff report that "no incomes policy can succeed if demand pressures are too strong." I also fully agree with Mr. Grosche that a restrictive financial policy should be considered as a complement to incomes policy, rather than as an alternative or a second-best option.

With respect to the issue of how to accelerate the pace of fiscal consolidation, the staff rightly notes that, to a large extent, substantial progress in the fiscal area would require further structural reforms. On the other hand, given the need to alleviate the tax burden on capital income in the context of capital market integration, a shift toward more reliance on indirect taxation is inevitable. At the same time, the authorities will encounter difficulty in maintaining the most equitable tax treatment possible for the various sources of income while avoiding the adverse consequences of the capital market integration. At any rate, there does not seem to be much scope for raising revenue in the immediate future.

On the expenditure side, I welcome the staff's proposal to adjust the pace of public investment. The effectiveness of such flexible implementation depends to a large extent on the size of public investment. According to the background paper, the share of public capital expenditure in GDP is about 5 percent. Therefore, it is not likely that much savings can be realized by delaying the timing of public investment, and, at any rate, such savings are temporary. In view of the high level of resource utilization, however, a slower pace of public investment would have a fairly large effect on the alleviation of bottlenecks--as was often the case in the Japanese economy.

Turning to the external side, I am somewhat puzzled that very little attention was paid to Spain's large current account deficit in this year's staff appraisal. As Mr. Fernández Ordóñez made clear in his opening statement, Spain is running the third largest trade deficit in the world, and its external imbalance in relation to GDP is much higher than that of Japan or the United States. On the other hand, as Mr. Al-Jasser has already noted, the deficit is easily financed by private capital flows, with no adverse consequences for financial policy management.

This poses some fundamental questions. First, like Mr. Othman, I wonder how long Spain can continue to finance the deficit easily. Second, in the context of the need for greater global savings, which has been unanimously agreed at previous Board discussions, how should we evaluate the continuation of Spain's large current account deficit? One argument is that Spain should actively reduce the deficit in order to provide net savings to other parts of the world and meet the growing investment opportunities. On the other hand, one could argue that Spain's high growth rate is evidence of the efficient investment opportunities prevailing in the country; the fact that the deficit is financed smoothly could be seen as proof of the confidence of external creditors in the Spanish economy. If that is the case, the efficient allocation of resources in a global context would not make it appropriate to reduce the current account deficit by discouraging investment; rather, it should be reduced by promoting domestic savings. That, in turn, underscores the staff's argument for accelerating the pace of fiscal consolidation. But, one might still ask, if the deficits of some countries are justified on the basis of large investment opportunities, how can we press for the reduction of the Spanish deficit? An elaboration of this point by the staff would be appreciated.

At any rate, the reduction of the external imbalance should not lead to a reversal of the liberalization process that Spain has pursued for many years. In this connection, I very much welcome Mr. Fernández Ordóñez's strong assertion that this has not been the case.

Mr. Kwon made the following statement:

Spain has made impressive progress over the past few years in adjusting internal and external imbalances, but this adjustment process will need to continue for some time to come. As the staff report has pointed out eloquently, Spain is now facing the task of cooling down domestic demand while not discouraging the growth momentum that is essential for bringing down the still high level of unemployment. Another task facing the country is the

integration of the economy into the EMs. In this context, I welcome the staff's emphasis on the need for Spain to craft macroeconomic and structural policies from the perspective of EC harmonization. To my mind, this perspective has brought into clearer focus the importance of fiscal policy in Spain's efforts to achieve a low inflation rate and sustainable growth.

I agree with the staff that the flexibility of monetary policy is constrained by the need to sustain the current central rate of the peseta in the ERM. In addition, overreliance on monetary policy in the past may have impinged on its ability to address the problem of inflation now without generating other problems relating to investment and growth objectives. Mr. Fernández Ordóñez also correctly pointed out that the dismantling of direct controls on *financial aggregates will add an additional burden to monetary policy*. On the topic of exchange rates, I fully agree that, in the present situation, a devaluation of the peseta might not be the most efficient way to improve Spain's competitiveness; it might serve to undermine the authorities' efforts to reduce the inflation rate to that of other EC countries.

It is appropriate, therefore, that fiscal policy should play a major role in the adjustment process. In this regard, while I very much welcome the authorities' commitment to attain a balanced budget by 1992, I agree with the staff that efforts to this end should be seen as a minimum requirement.

I also endorse the staff's view that a more vigorous effort on structural adjustment, especially in the areas of labor market and tax reforms, can help to ease the macroeconomic policy load. In fact, there appears to be a convergence of views between the authorities and the staff on the need to accord high priority at this stage to structural reforms, which I can fully support. More specifically, the authorities should continue their efforts to improve the overall quality of labor and to remedy the uneven distribution of skills, which has led to wage pressures in some areas and high unemployment rates in others. In this regard, the staff may have a point in relating the high price of housing in some areas to the low degree of labor mobility. In addition, wage indexation, whether ex ante or ex post, could reintroduce serious rigidities in the labor market that could wipe out the gains obtained so far in labor market reform.

As to the tax system, I fully endorse the staff's views on the proper approach to tax reform and the urgency of harmonizing Spain's tax system with the other EC countries, in order to avoid eroding Spain's competitiveness.

Finally, in the area of trade liberalization, I can endorse Mr. Fernández Ordóñez's remarks regarding the trade-off between sovereignty and regional concerns and the benefits to the world economy of multilateral agreements.

Mr. Obame made the following statement:

We are pleased to note from the staff report that the Spanish economy continued to perform generally well in 1989 and in the first part of 1990. Real GDP growth, fueled mainly by domestic demand, remained robust, substantial gains were registered on the employment front, and fiscal consolidation was pursued. However, it appears that the expansion in domestic demand also led to intensified inflationary pressures in 1989 and to a widening of imbalances in the external sector. Nevertheless, as a result of the measures implemented by the authorities on the fiscal and the monetary fronts, there are indications that inflation, although still high relative to Spain's trading partners, subsided somewhat in the early part of 1990.

In this connection, I generally share the staff's view that further adjustment needs to be pursued, in order to reduce the internal and external imbalances, preserve Spain's competitiveness, and meet the forthcoming challenge of the EC single market.

I broadly concur with the staff appraisal and with what previous Directors have said. Two policy issues that are particularly important are the need to control inflation and the need to pursue structural reforms in the labor market. With respect to the first issue, it is worrying to note that the authorities' initial inflation target of 3 percent could not be achieved in 1989. In fact, as a result of the strong domestic demand that further overheated the economy, the inflation rate more than doubled. In the face of this situation, we are encouraged to learn from the staff and from Mr. Fernández Ordóñez that the authorities are keenly aware of the need to reduce inflation and narrow the gap between Spain and the other EC countries, as demonstrated by the fiscal and monetary policies implemented in 1989. Their intention to rely mostly on fiscal and incomes policies to achieve this objective seems appropriate.

As far as incomes policy is concerned, given the impact of wages on price increases, we support the authorities' approach, which is aimed at achieving a negotiated global pact with employers and trade unions that should result in moderate wage settlements over the next three years. We share the view that this pact, together with a reduction of distortions in the labor market,

should also contribute to an abatement of inflationary pressures, an enhancement of competitiveness in the economy, and an improvement of the external sector position.

Second, with respect to the issue of labor market reform, the high rate of unemployment, which was over 17 percent in 1989, deserves continued attention from the authorities. The staff has mentioned that, despite the extensive reforms undertaken in recent years, bottlenecks still exist in several areas. In particular, it appears that the educational system is not quite adapted to the current requirements of the economy and, furthermore, that the low degree of geographic mobility of labor is a factor undermining competitiveness in some sectors, such as the tourism industry. In this context, we are encouraged by the fact that vocational training is being emphasized by the authorities, and that a new system of education is being formulated.

Finally, with respect to the two scenarios developed by the staff on the medium-term prospects, it appears that Scenario II, which entails a more restrictive fiscal and monetary stance, would produce a faster convergence of the Spanish inflation rate with the average inflation rate of other ERM countries. Moreover, such a restrictive stance would lead to an improvement of the external sector position in the medium term. Given the challenges ahead, particularly the constraints of the forthcoming single market in Europe, we would urge the authorities to take this scenario into consideration in the design of their medium-term policies. Meanwhile, we encourage the Spanish authorities to pursue the program of trade liberalization, to which, as noted by Mr. Fernández Ordóñez in his opening statement, their commitment remains firm and irreversible. We would also urge them, in connection with the UN target, to review to the extent feasible the low level of their official development assistance.

Mr. Dai said that, after four years of commendable rapid development, Spain had been confronted since 1989 with a dilemma of growth and inflation--a problem that seemed to be of particular significance, as Spain would face the single European market in the not too distant future. It was indeed important for the authorities to strive to bring down the inflation rate to the EC average by 1992 while maintaining a relatively fast growth rate, in order to reach the EC standard of living.

Despite the series of measures designed to tighten fiscal and monetary policies that had been implemented in the past year, cooling down the overheated economy remained an essential high-priority policy objective, Mr. Dai continued. For the year as a whole, domestic demand had increased by 7.7 percent and the consumer price index had continued

to rise--by 6.8 percent, well above the rate for partner countries. As Mr. Fernández Ordóñez had pointed out in his opening statement, the need for further adjustment and additional measures appeared to be appropriate.

He supported the authorities' efforts in pursuing further adjustment on both the demand and supply fronts, Mr. Dai stated. In view of the constraints imposed by the ERM discipline and the intended abolition of the policy of direct credit control, it was quite reasonable to place more emphasis on fiscal policy in the adjustment process, coupled with the implementation of an incomes policy.

However, there were several noteworthy problems to consider, Mr. Dai remarked. There was a potential risk of spiraling inflation in the economy, in view of the fact that rising wages were the main factor pushing up prices and, in turn, wages were further affected by the price hikes. A special cause for concern was the tendency of wage increases to move ahead of increases in productivity: the statistics on page 18 of the staff report showed that the increase in average wages in 1990 would again be greater than that in prices, and that unit labor costs would continue to rise.

Moreover, the long-term downward trend in the private savings ratio was certainly a cause for concern, Mr. Dai said. If that trend were due to the changes in consumer behavior resulting from the rapidly growing economy of the past few years, it constituted a new problem of a structural nature. Structural policy measures, in addition to monetary policy instruments, might be needed to reverse that undesirable trend. In the circumstances of an overheated economy, such a change in the propensity to save might also be related to inflationary expectations.

The most serious bottlenecks in the Spanish economy--directly associated with the overall efficiency and competitiveness of the economy--were in the areas of human resources and technological developments, Mr. Dai observed. As a result, the coexistence of a high growth rate with a high unemployment rate was a striking feature of the Spanish economy. However, a fundamental resolution of those structural impediments could not be realized in a once and for all adjustment; one should not wait until potential bottlenecks became acute obstacles, and an overheated economy forced one to apply shock therapy rather than make a soft landing. In that sense, structural adjustment implied a dynamic and long-term process. With an active and well-thought-out adjustment, undue disruption could be avoided, or at least kept to a minimum cost.

The authorities' firm commitment to a liberal trade policy should be commended, Mr. Dai commented, as well as the progress that had been made in official development assistance contributions.

The Deputy Director from the European Department said that, with respect to monetary policy, a number of Directors had noted that the transmission mechanism had long been imperfect. Those Directors had wondered whether

the working of that mechanism had improved or was likely to show further improvement. In fact, the level of competition among the Spanish banks had increased, and the gap between the Bank of Spain's intervention rate and the banks' lending and deposit rates had decreased and was likely to decrease further.

The question had been raised whether the gap between the authorities' targeted credit growth rate and the actual credit growth rate could be taken as evidence that the credit ceilings had not been binding, the Deputy Director continued. Before coming to that conclusion, however, one should bear in mind the sharp increase in disintermediation and, in particular, the increase in recourse to commercial paper. The evidence indicated, therefore, that the credit ceilings had been binding, and that the difference between the actual rate of growth of credit and the indicative rate set by the authorities had arisen simply because certain banks had somewhat prudently remained below their credit ceilings.

In the context of the fixed exchange rate and Spain's entry into the ERM, and with the liberalization of financial markets, monetary policy was now more difficult to implement, the Deputy Director observed. The mobility of capital had increased, and, as a result, monetary tightening had been offset by capital inflows. As a number of Directors had mentioned, that lack of room for maneuver was one of the main problems confronting the authorities.

In the area of fiscal policy, the staff's suggestion that a reduction in social security contributions might have a favorable effect on employment had been questioned, the Deputy Director noted. However, the social security contributions were very large in Spain--almost 3 percentage points of GDP higher than the average for EC countries. Associated with that phenomenon were the usual problems connected with the wedge between take-home pay and labor costs to employers. The staff's view was that the social security contribution paid by employers was a tax on employment, and a reduction in that tax would be favorable to employment. However, the issue was admittedly complicated by uncertainties surrounding the incidence of taxation and by the possibility that a reduction in taxes would be accompanied by higher wages.

Owing to changes in exchange controls and, in particular, to the introduction of a more liberal system for nonresidents' deposits, a shift from long-term to short-term capital inflows had occurred, the Deputy Director said. As a result, in the first five months of 1990, long-term capital inflows had declined over the same period in 1989.

In the area of structural policies, the prospects for trade union reform were not very good, the Deputy Director commented, as the current Government was trying hard to improve its relations with the trade unions. The prospects for privatizing public enterprises were better. Although, from an

ideological standpoint, the Government did not favor privatization, it had nevertheless resorted to privatization when it had been financially or economically advantageous to do so.

It was quite possible that inflationary expectations could account for the decline in the savings rate of households, the Deputy Director remarked. However, inflation could affect savings in two different ways: inflationary expectations could tend to reduce the propensity to save; or, those expectations might induce households to increase their savings in order to maintain their real value. It was therefore difficult to distinguish between the two effects. Generally, however, cross-country studies had shown a positive correlation between inflation and saving, meaning that the tendency for households to maintain the real value of their savings had been stronger.

It was clear that the main adjustment tasks would be concentrated in the areas of the current account and the inflation rate, the Deputy Director observed. Directors had expressed different views about the magnitude of the current account deficit. Some speakers had wondered whether too much was not being made of that problem, given that the counterpart to the current account was primarily investment, and that the current account was more than financed by the long-term capital inflows. Those points were valid; however, there could be too much of a good thing. The capacity of the economy to absorb investment was limited, and too much investment would contribute to overheating and to labor market pressures. In that sense, the current account balance was perhaps not actually the problem, but rather the mirror image of the problem. One could even say that, without the large current account deficit, the overheating problem would be even worse and the inflation rate even higher.

From a medium-term viewpoint, however, one had to wonder whether a current account deficit of the magnitude of Spain's was sustainable, the Deputy Director continued. The authorities and the staff agreed that the deficit would be sustainable only if conditions in Spain were favorable, namely, if competitiveness were maintained and overheating were eliminated. However, those events were unlikely to occur with a current account deficit of 4-5 percent of GDP. The authorities had estimated that the deficit was sustainable at about 2 1/2 percent or, at most, 3 percent of GDP.

The other principal target of the adjustment policy was inflation, the Deputy Director remarked. As one Director had observed, rather than the average inflation rate of the EC countries, the target should be the inflation rate of the low-inflation EMS countries. With respect to the question of the inflation target's ambitiousness, a distinction must be made between what was desirable and what was realistic. In 1989, the authorities had set an inflation target that had been overshoot by a substantial margin, and they did not wish to be put in the same position again; the targeted rate of inflation was therefore not what they actually hoped to achieve, but rather what they realistically expected would follow from both the implementation of their policies and the outcome of the wage negotiations.

The second major issue was the method of the adjustment, the Deputy Director commented. Spain's case was interesting as an example of a country not only undergoing adjustment under fixed exchange rates, but also joining the ERM in a situation of overheating. The authorities had undoubtedly realized at the time of entry that bringing down the rate of inflation would be a major challenge; with the usual instruments of monetary policy no longer at their disposal--for the reasons already mentioned--any tightening of monetary policy would be offset by capital inflows. The foregoing considerations, incidentally, should not be taken as a seconding of the suggestion that Spain's entrance into the ERM had been untimely.

It could be argued that the adjustment could take place through the continued implementation of the current policies, the Deputy Director said. Spain had more than \$45 billion in official reserves, which it could use to defend its exchange rate. However, if the exchange rate were defended solely by means of monetary policy, the traded goods sector would be squeezed, unemployment would spread throughout the rest of the economy, and wages would be depressed--a situation that could be characterized as one of lower inflation rates, but also of slower growth.

Some Directors had discussed the possible use of other adjustment methods that put more emphasis on fiscal and incomes policies, the Deputy Director continued. Reference had been made to both the French and Italian adjustment experiences; the Belgian experience had also been mentioned as an example of a country that had successfully utilized incomes policy in the EMS context to reduce the cost of adjustment, lower inflationary expectations, and speed up the disinflationary process.

Only one Director had expressed doubts about the appropriateness of a further tightening of fiscal policy, the Deputy Director noted. The staff felt that, given the limited use of monetary policy, further fiscal tightening was indispensable for achieving the adjustment sought by the authorities on the external side and for reducing the inflation rate. There was still room for slowing down expenditures, particularly in the area of public employment; even public investment could be spread more evenly than before, thereby ameliorating the overheating in the construction sector.

In general, there was no connection between the rate of growth and the rate of inflation, the Deputy Director stated. High growth and low inflation could coexist, and vice versa. The results depended to a large extent on how the adjustment took place. As Mr. Grosche had suggested, reliance on an incomes policy, supported by a somewhat tighter fiscal policy, would seem to be the best way to both reduce inflation without unduly slowing down the rate of growth and lower the unemployment rate, which, as a number of Directors had noted, remained very high.

The current account balance could be improved through the implementation of fiscal policy measures without recourse to exchange rate adjustments, the

Deputy Director from the European Department observed. *Ceteris paribus*, a reduction in the budget deficit would result in an increase in public savings, which could then be expected to reduce the current account deficit.

Mr. Filosa said that, with respect to fiscal policy, the staff was correct to stress the need for fiscal consolidation and the possibility of reducing the fiscal deficit; however, given Spain's relatively small fiscal deficit and external debt, the staff papers seemed to place too much emphasis on the need for action in the fiscal sphere and not enough on the need for a viable incomes policy. In order to reduce the inflation rate quickly and contain demand--particularly consumption demand--more emphasis should be put on incomes policy. A number of Directors, particularly Mr. Landau, had referred to the importance of using both fiscal and incomes policies, and the staff had touched on the role that incomes policy could play in Spain; nevertheless, it seemed that the status of incomes policy as an effective policy instrument in the present circumstances was still unsettled.

More broadly, advocacy of incomes policy as an instrument for fiscal consolidation was still considered to be a somewhat radical position, Mr. Filosa continued. The prevalence of that view--with respect to not only industrial countries, but also developing countries--was in itself worthy of discussion. According to classical economics, it was better to reduce inflation and contain demand through orthodox monetary and fiscal policies than to resort to incomes policy. However, experience gained in the disinflation process in other countries showed that that was clearly not the case. Among the countries that had been successful in reducing inflation, Germany deserved special mention. Obviously, its system was very different from Spain's, but a substantial factor in Germany's economic success was the agreement that existed between trade unions and the Government on broad national policy objectives.

Because of the volume of long-term contracts that had to be negotiated, Mr. Filosa suggested, it seemed logical to initiate a process of coordination in Spain that could enable the centralized trade unions and the authorities to work together in setting beneficial economic targets. The United Kingdom's unpleasant experience with incomes policy in the early 1970s should therefore be forgotten, as Spain could provide an excellent opportunity to observe again the effects of a policy mix that put more emphasis on incomes policy.

The Deputy Director from the European Department said that incomes policy could play a useful role, but at a cost. The Directors would soon have a chance to discuss the staff reports for Sweden and Australia, two countries that had made heavy use of incomes policy and centralized wage bargaining. The staff had concluded that, in terms of wage restraint, those two countries had accrued definite macroeconomic benefits over time, but at the cost of a diminished flexibility in the wage formation process, a lack of dispersion of wage settlements, and an absence of enterprise bargaining that reflected the individual circumstances of an enterprise. Therefore,

the staff could not wholeheartedly endorse the use of incomes policy in all countries. Undoubtedly, incomes policy could usefully play a limited role--as it had in France, Belgium, and Italy--as long as it was supported by appropriate financial policies.

Mr. Grosche remarked that one should try to be as precise as possible in discussing the relative centralization of incomes policies in different countries. For example, Germany did not have an incomes policy in the proper sense of the word; it was left to the unions and the entrepreneurial associations to negotiate wages in a centralized fashion for the individual industries. The Government made it very clear that it did not take responsibility for the results of those negotiations, which might include, *inter alia*, high operating costs, job losses, and excessive public demand.

In discussing centralized incomes policies, therefore, he was not advocating government involvement in those negotiations, Mr. Grosche stated. However, the idea of an industry-wide negotiation process had merit. An averaging out of the interests in one industry--the metal industry, for example--could be quite useful in restraining the wage demands in those sectors that were experiencing particularly high profits while cushioning those sectors that were less competitive.

Mr. Fogelholm said that incomes policies had been very widely used in the Nordic countries, with varying degrees of success. Governments had usually taken active roles in implementing those policies, including through the generation of tax concessions.

The staff was correct to point out the weaknesses of an incomes policy approach, Mr. Fogelholm continued. Furthermore, a growing consensus of opinion held that an incomes policy's usefulness was very much dependent on the particular circumstances of each case. During times of crisis management, centralized incomes policies and agreements could be very useful; trade unions could frequently be rallied *en masse* during those kinds of emergency situations. However, as some of the Nordic countries had discovered, incomes policy agreements tended to worsen the situation for countries whose economies were overheated. In those circumstances, minimum wage levels--which were usually not extremely low--would be negotiated, but wage drift, excessive demand for labor, and labor market rigidities would usually result in large salary increases across the board. As the Spanish economy seemed to fall into that category, it was unlikely, therefore, that an incomes policy approach would be of help. Mr. Fernández Ordóñez's personal views on that subject would be appreciated.

Mr. Filosa said that, although he agreed with Mr. Grosche's intervention and the first part of Mr. Fogelholm's, the latter's concluding comments had made him a little uneasy. Mr. Grosche had described the workings of an ideal incomes policy in his reference to the German experience: the Government set broad guidelines, after which incomes policy became the responsibility of the trade unions. That arrangement--strictly speaking, as

Mr. Grosche had pointed out, it was not an incomes policy--had not created distortions in the German economy. Moreover, as Mr. Fogelholm had noted, incomes policies had produced positive results in times of crisis; and, although the Spanish economy could not be characterized as being in crisis, the inflation that was threatening it needed to be corrected promptly, in order to maximize the country's advantages.

Furthermore, the kind of income guidelines used by the German authorities might be applicable in Spain, Mr. Filosa suggested. It was critical, however, that methods should be devised to overcome the macroeconomic rigidities to which that process was susceptible. In that connection, Spain had an advantage over other non-EMS countries, including the Nordic countries, in that its commitment to the defense of the exchange rate gave it a means by which the Government could set guidelines for the wage negotiation process. Given the 1992 deadline for the single European market, therefore, an increased emphasis on incomes policy--rather than fiscal policy--during the transitional period might prove to be very helpful in accelerating the disinflationary process.

Italy's experience with incomes policy illustrated Mr. Fogelholm's point about the importance of each country's unique circumstances, Mr. Filosa continued. The attempt to implement an incomes policy during a period of political unrest had only worsened the situation. Because of the trade unions' opposition to the government policy, the Phillips curve had been even steeper than envisaged. He hoped that Spain would not suffer the same results.

Although at present any incomes policy recommendation would be too vague and generalized for use in the surveillance procedures, the Board's discussion of the topic was nonetheless important, Mr. Filosa remarked. However, in future discussions on incomes policy, Directors should perhaps focus on those specific institutional arrangements in each country that might favor the Board's policy recommendations, in order to strengthen the relevance of the recommendations.

Mr. Noonan said that he agreed with Mr. Fogelholm's views on incomes policy. A consensus was needed for the satisfactory negotiation of a collective settlement. Furthermore, that settlement had to be continually enforced, even in the face of subsequent wide profit margins; any deviation would provide a precedent for other groups to follow. If a consensus did not exist, and if conditions--such as those in Spain--were not favorable, any negotiated settlement would merely provide a floor from which wages would begin to drift upward.

Mr. Fernández Ordóñez commented that a clarification of the Government's incomes policy might alleviate some of the Directors' concerns, as it would point to a convergence of views among the authorities, the staff, and the Board. First, it should be emphasized that the impact of a competitiveness

agreement with the trade unions was meant to be felt more in terms of nominal than real wages. The authorities still felt that the projected growth of the economy would enable real wages to continue to increase; however, if stabilization policies alone were employed by the Government to reach the average inflation rate of the EMS countries, and if nominal wages continued to increase at the rate of 8 percent, the cost would be enormous.

It was also important to understand that, under the proposed competitiveness agreement, the Government intended to apply different guidelines to different enterprises, Mr. Fernández Ordóñez said. The negative correlation that currently existed between wages and productivity in Spain was to be corrected under the new agreement, which would link wages to results, profits, and productivity. In that respect, the competitiveness agreement differed from other centralized agreements that applied the same wage rates across the board.

With respect to the proper mix of fiscal and incomes policies, Mr. Fernández Ordóñez said, the authorities wanted to implement both the "first best"--incomes policy--and the "second best"--fiscal policy. However, referring to the options in that way was somewhat misleading, in that the first-best approach, which focused on reaching an agreement with the trade unions, also included a tightening of fiscal policy and a reduction in the fiscal deficit. As Mr. Cassell had pointed out, the Government's deficit reduction during the past year had resulted more from increases in revenues than from decreases in expenditures. However, owing to the decline in the domestic demand growth rate, and the subsequent slowdown in VAT revenues over the past six months, the current year's deficit target was more meaningful, in that it would not be attained without a reduction in expenditures.

Employment had been increasing at the extremely robust rate of 6 percent in the nonindustrial sector, Mr. Fernández Ordóñez stated. Therefore--and contrary to the assertions of the trade unions--the incomes policy and the measures aimed at suppressing rigidities in the labor market had been successful. However, despite the strong economic growth rate, the unemployment rate had not improved: the long-standing labor market rigidities, combined with the increases in income following the return of democracy, had created an employment crisis in Spain that was reflected in the extremely low activity rate. The unemployment rate was therefore a poor indicator of the success of the Government's policies, because the official unemployment rate of close to 20 percent did not include all of the people who were actually unemployed. In fact, if Spain's activity rate were the same as the United Kingdom's, its unemployment rate would be close to 40 percent. Given those labor market bottlenecks, therefore--including the delays in training workers--employment could not grow at a faster rate; patience was needed while the large numbers of unemployed were being absorbed into the economy.

The question of the social security contribution was perhaps one of the few areas of difference between the authorities and the staff,

Mr. Fernández Ordóñez commented. The staff disapproved of the contribution, looking on it as a tax on employment, but the authorities, mindful of the need to maintain revenues in general, did not think that the time was right for its elimination.

Regardless of any positive benefits that might accrue, it was difficult to envisage any trade union reforms taking place in the near future, Mr. Fernández Ordóñez observed. Given the present mood in Spain, which was conducive to demands for total freedom and unconditional collective bargaining rights, it would not be easy to discuss the imposition of restrictions on trade unions. Accordingly, the authorities were hoping mainly to avoid the occurrence of protracted strikes.

In the context of parliamentary discussions on joining the European Monetary Union, Mr. Fernández Ordóñez noted, a measure had been introduced to limit the central bank's financing of public expenditures. If unification proceeded as planned, that measure would be put forward to the legislature for ratification.

Some Directors had wondered whether the peseta had not joined the ERM prematurely, Mr. Fernández Ordóñez remarked. Indeed, had the peseta not been a part of the ERM during the year, it would probably have appreciated significantly without any deterioration in the current account balance. The flow of financing would have continued, but prices would have conveyed the erroneous signal that the country was gaining in the fight against inflation, when, in fact, the gap between tradable and nontradable goods was growing. In those circumstances, the authorities felt that they had made the right decision, even if the results had not quite lived up to expectations.

Although Mr. Fogelholm and Mr. Cassell had suggested that greater emphasis should be placed on indirect taxation, Mr. Filosa had correctly pointed out that, at a time of overheating, that type of policy could ignite the inflationary process, Mr. Fernández Ordóñez observed. For that reason, the authorities were very cautious in implementing the changes in the tax structure required to achieve harmonization with the EC.

The authorities agreed with the staff that the current account deficit was benign if it did not exceed 2.5 percent of GNP, Mr. Fernández Ordóñez said. Any deficit smaller than that percentage could be financed by foreign indirect investment; any larger deficit, however, was not sustainable, regardless of investors' confidence in the Spanish economy. Therefore, rather than ignoring the situation until it became much more serious, the authorities should address any deterioration in the current account immediately.

As Mr. Posthumus had suggested, the inflation target for the next year should be the average rate for EMS--as opposed to EC--countries, Mr. Fernández Ordóñez considered. Mr. Posthumus had also observed that the

staff's medium-term scenarios seemed to imply that higher inflation rates were preferable, as lower inflation rates appeared to go hand-in-hand with reductions in wealth. It was therefore regrettable that that presentation of the scenario did not help to reinforce the message that should be conveyed, namely, that reduced inflation would lead to faster growth.

The timing of the Board's discussion of the Spanish economy was crucial, Mr. Fernández Ordóñez concluded, because the coming months would be spent in preparing and negotiating the budget for the next fiscal year. In 1989, unfortunately, the Article IV consultation discussions had occurred only after the Government had already implemented its budgetary measures.

The Acting Chairman made the following summing up:

Executive Directors commended the Spanish authorities for the recent performance of the economy, which included an expansion of demand, output, and employment in 1989 that continued to exceed that in partner countries. Directors observed, however, that inflation had accelerated in 1989; progress on inflation convergence had come to a halt; and the current account deficit in the balance of payments, while remaining financeable, had increased markedly. Against this background, Directors welcomed the tightening of financial policies in the course of 1989. However, the prevailing view of Executive Directors was that progress toward the stabilization of the Spanish economy was too slow. Moreover, they were not convinced that the additional measures envisaged by the Spanish authorities in the field of incomes policies--a pact among the social partners geared to the consistency of wage increases and productivity gains--and of structural reforms would be sufficient by themselves. Directors generally urged the authorities to see incomes policy and structural measures not as an alternative, but as complementary to tight macroeconomic policies, in which fiscal restraint should now play a major role. The views expressed on the extent to which incomes policy would contribute significantly to the economy varied among Directors, although a number of Directors were generally sympathetic to the view that incomes policy could play a role.

Most Directors regarded the reduction of the fiscal deficit in 1989 as not having been sufficient to cope with excess demand, thus obliging the authorities to rely excessively on monetary policy and high interest rates. The entry of the peseta into the exchange rate mechanism of the European Monetary System (EMS) now made greater reliance on fiscal policy a necessity. Accordingly, while acknowledging the need for public investment in infrastructure, Directors urged greater expenditure restraint, including restraint on wages, together with sustained widening of the tax base and improvements in tax administration. These actions should help bring demand under greater control, while promoting inflation

convergence and better balance in the external current account. Directors encouraged the authorities in their intention to advance the complete removal of the fiscal deficit, which had been targeted for 1992. They also supported plans to streamline and harmonize the tax system within the broader EC context, to tighten expenditure control, and to promote private savings.

Noting their concern about the distorting effects of credit ceilings and foreign exchange regulations on resource allocation, Directors welcomed the authorities' intention to do away with those measures by the end of 1990.

Directors agreed that the catch-up process in which Spain was involved and its still high unemployment called for continued faster output growth than on average in other EC countries. They argued, however, that the pace at which the current account deficit was widening and the worsening inflation performance indicated that relatively fast growth was not sustainable without further progress on fiscal policy and structural reforms aimed at strengthening the supply side of the economy and increasing labor market flexibility. Spain's participation in the exchange rate mechanism of the EMS would also place a heavier burden on fiscal policy and underlying structural reforms.

While Directors were of the view that efforts to restrain demand would help bring an adjustment in the current account, they saw that the sustainability of a relatively high current account deficit depended on its continued association with rising domestic investment, long-term capital inflows, and a low level of external indebtedness.

Directors welcomed measures implemented in the process of European financial and economic integration to liberalize financial markets and to remove ahead of schedule most controls on capital outflows. The resulting increase in efficiency and competition should enhance the sensitivity of bank rates to monetary policy instruments and facilitate the removal of quantitative restrictions. Directors noted with approval that, in addition to progress in strengthening the structure of financial markets, the Spanish authorities had also targeted corresponding improvements in the goods market, with a view to ensuring the competitiveness of Spanish enterprises in the single European market. In that context, most Directors reiterated the overriding need, as they saw it, to increase flexibility in the labor market.

Directors commended the Spanish authorities for the significant increase in official assistance flows in 1989 and the continuing trade liberalization.

It is expected that the next Article IV consultation will take place on the standard 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/111 (7/11/90) and EBM/90/112 (7/13/90).

2. EXECUTIVE BOARD COMMITTEES - NOMINATION

The Executive Board approves the nomination by the Managing Director for the vacant positions on the Committee on Administrative Policies and the Committee on Liaison with the Contracting Parties to the GATT, as set forth in EBD/90/202 (7/9/90).

Adopted July 12, 1990

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/90/181 (7/10/90) is approved.

APPROVED: June 25, 1991

LEO VAN HOUTVEN
Secretary