Table 4. Spain: Indicators of External and Financial Vulnerability 1/

(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	
					Latest observation	Date of observation
External indicators 1/						
Exports (annual percent change, in U.S. dollars)	6.0	7.4	2.9	1.6	3.6	September
Imports (annual percent change, in U.S. dollars)	4.4	11.3	8.4	3.3	0.5	September
Terms of trade (annual percent change)	-1.6	3.8	1.7	-1.5	...	...
Current account balance (settlements basis)	0.5	-3.1	-2.1	-1.9	-2.5	September
Capital and financial account balance	0.6	1.1	3.1	4.4	3.8	September
Of which : Inward portfolio investment (debt securities etc.)	1.7	2.4	6.6	12.0	1.6	September
Inward foreign direct investment	0.9	1.6	2.3	7.6	0.4	September
Other investment liabilities (net)	2.6	3.1	2.5	7.2	1.6	September
Official reserves (in U.S. dollars, billions, end-of-period) 2/	69.1	31.8	33.5	35.3	31.2	October
Broad money to reserves	7.7	9.5	10.1	...	...	...
Central Bank foreign liabilities (in U.S. dollars, billions) 2/	62.0	69.8	77.4	74.5	66.8	October
Foreign assets of the financial sector (in U.S. dollars, billions)	181.1	206.4	254.9	313.3	318.1	October
Foreign liabilities of the financial sector (in U.S. dollars, billions)	270.3	347.2	423.1	506.7	521.7	October
Official reserves in months of imports 2/	4.7	2.5	2.2	2.2	2.1	September
Total external debt	23.1	24.5	30.6	31.7	30.6	June
Of which : General government debt	15.7	16.2	18.2	...	...	...
Total external debt to exports (ratio)	1.2	1.3	1.7	0.8	0.8	June
Exchange rate (per U.S. dollars, period average)	146.4	180.1	186.4	184.9	188.8	December
Financial market indicators						
Public sector debt (Maastricht definition)	68.1	60.7	58.9	56.6	...	...
3-month T-bill yield	5.0	3.8	3.0	4.6	3.1	November
3-month T-bill yield (real)	3.1	2.0	0.8	1.2	0.4	November
Stock market index	195.0	286.1	309.1	330.0	278.4	November
Share prices of financial institutions	207.2	336.3	355.1	413.8	381.9	November
Spread of 3-month T-bills with Germany (percentage points, end-of-period)	1.7	0.4	0.1	0.3	0.1	November
Financial sector risk indicators						
Share of foreign exchange loans in total lending (percent)	10.4	7.2	6.7	7.1	...	...
Share of foreign deposits in total deposits (percent)	6.1	7.7	22.9	25.1	...	...
Share of real estate sector in private credit	27.4	27.8	28.7	...	...	...
Share of nonperforming loans in total loans	2.9	2.0	1.5	1.2	1.2	September
Share of nonperforming loans in total assets	1.2	0.9	0.7	0.6	0.6	September
Risk-based capital asset ratio (national definition) 3/	12.2	11.5	11.1	10.5	...	...

Sources: Bank of Spain, *Economic Bulletin* and *Statistical Bulletin* ; data provided by the authorities; and IMF, *International Financial Statistics* .

1/ The interpretation of some indicators is affected by the launch of monetary union in 1999.

2/ Reserves and foreign liabilities refer to the Bank of Spain, both before and after EMU.

3/ Comparable data for June 2001 is not available, but not accounting for accrued profits the ratio is 10.0.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2001 Article IV Consultation with Spain

On February 1, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Spain.[1]

Background

The strong expansion of the late 1990s has tapered off—and unease about risks of overheating has given way to concern about the current slowdown. The economy grew by over 4 percent annually during 1997–2000—reflecting strong consumption, competitive exports, wage moderation, and supply conditions enhanced by structural reforms. Policy credibility contributed, as interest rates declined steeply in the run-up to monetary union. Recent months, however, have seen growth projections cut—and the inflation differential with the euro average subsiding, in contrast with the first half of 2001 when the differential increased.

Recent indicators confirm that growth continues to slow:

Annualized real GDP growth was about 2 percent in the third quarter of 2001, compared to 2.5 and 3 percent respectively in the second and first quarters. Industrial production has been decreasing during most of 2001, and in November stood about 1 percent lower than a year before. And since the second quarter of 2001, consumer and industrial confidence indicators have shown a pessimistic balance for the first time in recent years.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the February 1, 2002 Executive Board discussion based on the staff report.

The annual growth of employment has slowed to under 2 percent in the third quarter of 2001 from about 5 percent in 2000. With participation slipping, unemployment has continued to decline: at just over 13 percent in the third quarter it was at the lowest level since 1980, though still the highest among the advanced economies.

In December, the 12-month headline rate of CPI inflation was 2.7 percent less than 1 percentage point above euro-area average, compared with inflation of about 4.3 percent in June nearly 1.5 percentage points over euro-area average. Still, service sector inflation continues to run at about 4 percent, and core inflation—excluding food and energy—is fluctuating around 3.5 percent.

Household debt has increased from 35 percent of GDP in 1997 to 50 percent in 2001. While this is about the EU average, the rise has been rapid. Firms, too, have increased their leverage. On the supply side, banks are profitable and well capitalized, though facing increased risks, especially in Latin America. Bank lending has slowed of late, while savings banks have expanded their market share in the mortgage and consumer finance areas.

The main goal of the 2001 budget was to achieve general government balance, while increasing investment—and this appears to be broadly on track, despite slower growth. When the budget was presented, real GDP growth was assumed to be over 3.5 percent, against a likely outcome closer to 2.7 percent. Sticking to a balance target would imply a contractionary impulse (at the structural primary level) of close to 0.5 percent of GDP. With the easing of monetary conditions, however, the overall stance of macroeconomic policies in 2001 appears to have been broadly neutral.

Forecasts for 2002 have been marked down progressively in recent months. The economy should continue to expand at a rate significantly above the euro-area average, but the staff's projection is now for growth of only some 2.1 percent—based on a gradual and broad-based recovery of activity in the second half of 2002. Investment and consumer spending are likely to pick up from the third quarter, as confidence recovers; and the contribution of the external sector is projected to turn positive during the course of the year. With wage growth moderate, unemployment is likely to be broadly unchanged at just under 13 percent, while inflation is expected to fall to under 2 percent by year-end.

Executive Board Assessment

The Executive Directors commended Spain's sustained implementation of sound macroeconomic policies and structural reforms. Oriented firmly toward medium-term goals, these policies have fostered rapid economic growth, while reducing inflation to relatively low levels. Directors considered that, in view of this exemplary performance, Spain is well-placed to ride out the current weakness in the world economy, and to achieve sustained growth and convergence with its most advanced EU partners over the medium term. This will require using the scope that is available to respond flexibly to the fiscal impact of slower growth, while keeping up the pace in labor and product market reforms that are crucial for continued job creation, productivity growth, and reducing regional disparities.

Directors noted that growth in 2002 will likely be well below the 4 percent average of recent years, although still at a margin above the euro-area average. Earlier inflation worries have abated due to receding demand pressures. Vigilance will nevertheless continue to be required, since a renewed rise in the inflation differential vis-à-vis other euro-area economies, or an appreciation of the euro, could weaken Spain's competitive position. In this regard, Directors welcomed indications of continued wage moderation, which is testimony to the prudence of labor unions in fostering conditions to sustain the rapid job creation of recent years. They considered, however, that the widespread use of wage indexation should be monitored closely, and a number of them favored its scaling back. Directors also highlighted the importance of perseverance with structural reforms, which should help ensure that competition dampens any potential tendencies toward unwarranted price increases, particularly in the services sector.

Directors welcomed the authorities' decision no longer to aim for a fiscal surplus for 2002 in the face of the deterioration in the outlook for economic growth. It will remain important to avoid pro-cyclical policies at the present juncture. Directors considered that the commendable gains by Spain in achieving fiscal discipline and credibility have positioned the authorities well to allow a full play of automatic stabilizers while maintaining strict expenditure control at all levels of government. Combined with monetary conditions in the euro area, which are relatively easy in terms of Spain's cyclical position, this should help ensure an overall moderately expansionary policy stance, which Directors considered to be appropriate for the current economic outlook.

Directors commended the decisive steps taken in 2001 to strengthen Spain's medium-term fiscal framework, in particular the approval of the Budgetary Stability Law and the signing of regional financing arrangements between the central government and the autonomous communities. They agreed that the medium-term central government spending ceilings set under the Budgetary Stability Law, together with the balanced budget rule, should help protect spending on investment and education while safeguarding medium-term fiscal discipline. Directors urged the authorities to use the flexibility available under the BSL to take appropriate account of cyclical developments. They welcomed the importance attached to fiscal responsibility and transparency at all levels of government in the new fiscal framework, while noting that more timely regional fiscal data will be key for monitoring developments under the framework. Directors also welcomed the authorities' plan to move ahead with the reform of the corporate income tax.

Directors underscored the importance for long-term fiscal sustainability of comprehensive action to address the challenge of an aging population. The surplus in the social security fund is part of the solution, but should be complemented by entitlement reforms that discourage early retirement and align contributions and benefits more closely. While current immigration trends might well delay the demographic shock, its impact on the public finances will remain considerable. Accordingly, Directors encouraged the authorities to step up efforts to mobilize political and social support for early agreement on reforms that would allow adjustments to pension entitlements to be phased in gradually, and improve the incentives to remain in the labor market, building on some promising reforms that have recently been adopted to promote later retirement.

Directors welcomed the recent labor market reforms aimed at fostering more rapid job creation, especially the extension of open-ended contracts with low firing costs to a wider range of workers, and the relaxation of restrictions on part-time contracts. While Spain's unemployment rate has substantially declined in the past years, it remains nevertheless the highest among the advanced economies and subject to wide regional dispersion, and Directors therefore urged the authorities to continue their efforts to streamline reintegration policies, rationalize unemployment benefits, and lower labor income taxation. They also considered that improvements in wage differentiation, and steps to promote training and worker mobility, in particular by addressing rigidities in the housing market, will be helpful in addressing the mis-match in the labor market.

Directors commended the authorities' efforts to strengthen competition in product markets, including actions to increase the competition agency's resources and ensure its independence. They encouraged further action to foster competition and liberalization, including in the network industries, as progress in these areas will be key to enhancing productivity growth and EU convergence. Some Directors cautioned against the trend toward creating new regional public sector enterprises, and suggested that regional regulations should not impede the nation-wide trend toward greater competition in product markets.

Directors noted that the financial sector has undergone a profitable expansion, and that banks enjoy strong capital ratios. They welcomed the supervisors' increased vigilance over banks' overseas investments in light of the crystallization of international risks due to developments in Argentina, and emphasized the need to continue a conservative accounting treatment of such assets. However, while recommending continued close monitoring, Directors saw no grounds to expect any significant impact from these developments on economic growth or credit availability in Spain. They noted that, as the financial system continues to evolve, supervisory coordination will remain key, including in the growth area of private pensions. Directors welcomed Spain's efforts to combat money laundering and the financing of terrorism. They encouraged the authorities to consider participation in the Financial Sector Assessment Program in a timely manner.

Directors encouraged Spain to increase its funding for official development assistance towards the UN target of 0.7 percent of GNP.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.