INTERNATIONAL MONETARY FUND

SPAIN

Staff Report for the 2006 Article IV Consultation

Supplementary Information

Prepared by the European Department

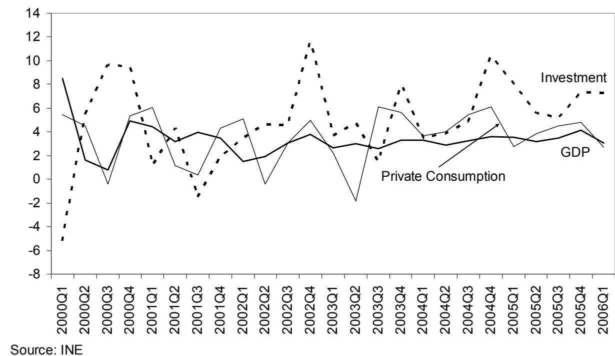
Approved by Susan M. Schadler and G. Russell Kincaid

June 7, 2006

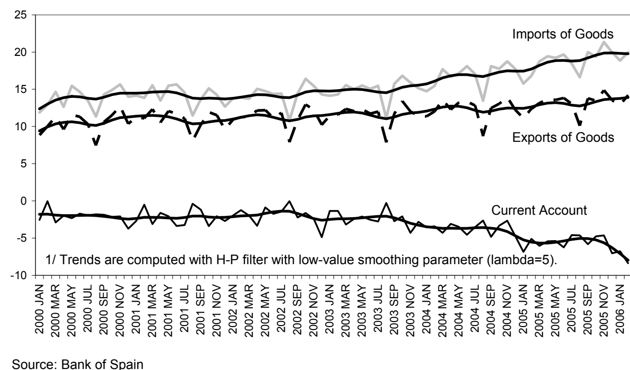
1. This supplement incorporates information that has become available after the circulation of the staff report. These developments do not alter the thrust of the staff appraisal.

2. **GDP growth remained buoyant in the first quarter of 2006: despite some deceleration in private spending and a pickup in exports, the current account deficit widened further, and inflation remained high.**[1] Output grew by 3½ percent in the year to 2006:Q1 (3.1 percent quarter-on-quarter annualized and seasonally adjusted). Data show a quarter-on-quarter deceleration in private consumption and, less markedly, investment. As in other EU countries, both export and import growth rose in Q1. The latest current account data indicate a widening of the deficit by €3.2 billion (0.35 percent of 2005 GDP) in the first two months of 2006 with respect to the same period of 2005. In May, headline inflation

Real GDP, Consumption, and Investment
(Annualized quarterly change in percent)



Current Account 1/
(In billions of euros)



[1] The new information does not materially alter the staff report's projections, but will be incorporated—along with revised global assumptions—in the new WEO round currently underway.

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(4.1 percent) and the inflation differential with the euro area (1.6 percentage points) remained high.

3. **In early June, the government announced medium-term fiscal targets through 2009, as well as the central government's expenditure ceiling for 2007.** While the authorities did not update the official estimate for the 2006 general government outcome (a surplus of 0.9 percent of GDP, set in the December 2005 Stability Program), fiscal data so far this year confirm the likelihood of a better outcome (anticipated in the Staff Report, ¶14). The announced target for 2007, if implemented as announced, would imply a moderately expansionary stance—partly attributed to the entry into effect of the tax reform (see Staff Report, ¶22)—and a continuation of the territorial governments' deficit through 2007. The latter deficit, in the first year of application of the new Budget Stability Law, is officially ascribed to deficits in a number of regions and municipalities that are being addressed under phased adjustment plans. Finally, the government announced its intention to contain central government spending growth in 2007 at 6.7 percent, in line with nominal GDP. These targets are largely consistent with the policy intentions outlined at the time of the discussions and—while commendably envisaging surpluses through 2009—fall short of the expenditure-based fiscal restraint recommended in the Staff Report (¶40) to help curb excess domestic demand in the short term. As in the past, it is however likely—and desirable—that, with the full play of automatic revenue stabilizers (to which the authorities are committed), budget execution will exceed the announced targets.

Official Fiscal Projections 1/
(In percent of GDP)

	2005	2006	2007	2008	2009
General government balance	1.1	0.9	0.7	0.8	0.8
Central government	0.4	0.1	0.2	0.2	0.2
Social security	1.1	0.9	0.7	0.6	0.6
Territorial governments	-0.4	-0.1	-0.2	0.0	0.0

Sources: Ministry of Finance and Economy, and authorities' projections.
1/ Actual for 2005; Stability Program (December, 2005) for 2006; and Council of Ministers (June 2, 2006) for 2007-09.

4. **The social partners and the government have reached agreement on a limited pension reform.** The reform includes incentives to prolong the effective working life, marginally extends the effective minimum contribution period (from 12.8 to 15 years), and consolidates the agricultural and self-employed regimes into the general system. It also extends the coverage of widowers' pensions and increases pensions of those retired early as a consequence of dismissal. It leaves the base period to compute pensions untouched. Overall, while the agreement represents a helpful move in the direction advocated by staff, the long-term sustainability of the social security accounts will require further action.

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IMF Executive Board Concludes 2006 Article IV Consultation with Spain

On June 12, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Spain.[1]

Background

With growth of 3.4 percent in 2005, Spain continued its prolonged economic expansion. Over the last year, the economy created more than 60 percent of all new jobs in the euro area, accommodating large immigrant inflows and rising female labor force participation while unemployment declined further. Domestic demand—notably consumption and investment in construction, and more recently equipment—remained the main pull on activity, supported by employment and housing wealth gains. In contrast, net exports increased their negative growth contribution to some 2 percentage points. Growth was concentrated in nontradables, with sectors exposed to foreign competition experiencing little gain. Advance indicators point to some gradual softening of consumption and housing market inflation, amidst overall still buoyant activity in the short term.

Despite recent interest rate hikes, liquidity and credit conditions remain expansionary, with real interest rates negative or close to zero. Private sector credit grew at over 20 percent, spearheaded by real estate lending, and household indebtedness rose to over 110 percent of disposable income by end-2005. Headline and core inflation differentials with the euro area widened to 1.8 and 1.6 percent respectively in the first quarter of 2006 and unit labor cost growth, while slowing down, remained above the euro area average.

The external position deteriorated further in 2005, with the current account deficit reaching 7½ percent of GDP. Financial institutions intermediated external savings to meet the increasing

[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.

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financing need of the nonfinancial private sector, mainly through the issuance of mortgage-backed securities in euro-area markets. Net external liabilities reached 46 percent of GDP.

Buoyant revenue drove the 2005 general government budget into a surplus of 1.1 percent of GDP, the first since the 1970s. However, non-interest spending (adjusted for one-time operations recorded in 2004) rising by 0.3 percentage points of GDP. As a result, fiscal demand withdrawal was insufficient to offset loose monetary conditions. Budget and spending plans for 2006–07 also imply a moderately expansionary stance. The Budget Stability Law and financing arrangements with the regions are undergoing reform. These reforms aim at increasing the cyclical flexibility of the fiscal rules and regions' ownership and co-responsibility, while also expanding the leeway afforded to territorial governments, with greater reliance on peer pressure to achieve budgetary discipline. Age-related fiscal costs are set to rise considerably over the longer term, with the onset of pension system deficits staring during the next decade.

The authorities' National Reform Program under the Lisbon agenda aims to raise per capita incomes and employment rates, by improving Spain's productivity performance, which has lagged behind internationally, and enhancing other determinants of competitiveness. Reforms implemented in recent years in labor and product markets have improved their flexibility. Nevertheless, distribution and retail, and other services, and domestically-oriented industries account for most of the inflation differential and remain sheltered by significant regulatory and administrative barriers to competition. The authorities are introducing a labor market reform package that will temporarily ease conversion of temporary labor contracts into special open-ended contracts with comparatively low dismissal costs and fiscal incentives, while strengthening restrictions for temporary contracts. No change is envisaged for regular open-ended labor contracts.

The FSAP found that the financial system is dynamic, profitable, professionally managed, and under strong supervision. The system is characterized by a high degree of financial intermediation, wide access to financial services, and low intermediation margins. The payments and securities' settlement systems were deemed robust and well integrated internationally. The financial system has been able to withstand substantial shocks, such as the financial disruption in Latin America of a few years ago. The FSAP recommended exercising vigilance with respect to developments in the mortgage market; bolstering the independence of financial sector supervisors; improving governance and market discipline of savings banks; and adopting a conservative treatment of financial institutions' industrial participations under Basel II.

Executive Board Assessment

They welcomed the continued strong growth performance of the Spanish economy, marked by robust job creation that has accommodated large immigrant flows into the labor market, a concomitant rapid income catch-up to euro area levels, and a solid fiscal position. They commended the authorities for the implementation of reforms since the early 1990s that have underpinned this performance, by opening the economy, enhancing its flexibility, and establishing stability-oriented policy frameworks.

Directors considered that short-term growth prospects remain buoyant and well above the euro area average, with some moderation in domestic spending as a result of rising interest rates likely to be compensated by stronger demand for Spanish exports. At the same time, however, the

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already large current account deficit is projected to widen further. In this regard, Directors cautioned about the possible adverse implications for the medium-term outlook of the continued erosion of Spain's competitive position, which has been driven by a persistent price and cost differential and—more fundamentally—weak productivity growth. A number of Directors also noted the risk of a more pronounced domestic demand slowdown prompted by private sector balance sheet consolidation, as households reduce their high indebtedness and/or real estate valuations correct.

Against this background, Directors supported the authorities' National Reform Program (NRP), which focuses on improving productivity, market flexibility, and competitiveness. They stressed that regaining competitiveness within EMU will require building on the NRP through the implementation of bold supply-oriented structural reforms.

As the NRP is implemented, Directors called for greater emphasis on competition-based incentives to enhance the role of the private sector in research and development, and on further deregulating sheltered sectors, with the removal of administrative and regulatory barriers to competition in distribution, energy, transport, and other services. In distribution in particular, productivity gains have been low by international standards and the inflation differential large due to a range of barriers to entry. Directors welcomed steps to strengthen the competition authority, and advised that these be complemented by procedures that ensure the full independence of sectoral regulatory agencies. Directors noted that an open approach to competition has served Spain well for many years, and called for it to be continued—in close collaboration with the European Commission—as the EU internal market extends to more sensitive areas.

Directors welcomed the continued improvement in labor market performance, on the heels of labor market reforms implemented over the past decade, but noted that there is scope for greater labor market flexibility. They considered that the recently announced reform of labor contracting provides some practical incentives for reducing Spain's relatively high incidence of temporary contracts. At the same time, a lasting reduction in the high share of temporary employment will require reducing the rigidity and high dismissal costs of regular contracts—which are left unchanged in the recent reform. Directors encouraged the social partners to review the collective wage bargaining system in order to better link wage and productivity increases across industries, firms, and regions, and to promote greater labor mobility.

Directors commended the authorities for achieving an appreciable fiscal surplus, continuing to accumulate resources in the Pension Reserve Fund, and reducing public debt—a good example of policies conducted in compliance with the revised Stability and Growth Pact. They noted, however, that the 2005 fiscal surplus stemmed largely from the buoyancy of revenues, while expenditure growth remained high, especially at the regional level, adding to demand pressures. Against this background, Directors supported the authorities' intention to allow the full play of revenue stabilizers, and generally recommended that this be accompanied by greater spending restraint at all levels of government. Some others were more cautious about the need for further fiscal tightening at this time.

Directors welcomed the greater flexibility and cyclical sensitivity of the new Budget Stability Law (BSL). They stressed that continued budget discipline within Spain's highly decentralized fiscal system requires a robust budgetary framework. In this regard, some of the BSL's features entailed a risk of insufficiently ambitious targets in good times. Directors stressed the importance

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