INTERNATIONAL MONETARY FUND

Spain—2011 Article IV Consultation
Concluding Statement of the Mission

Madrid, June 21, 2011

In the face of serious economic and financial challenges, the authorities implemented a strong and wide-ranging policy response over the last year. This has helped the economy to gradually recover and get the necessary rebalancing underway. But the repair of the economy is incomplete and risks are considerable. Hence, there can be no let up in the reform momentum, including further enhancing the credibility of fiscal consolidation, completing financial sector restructuring, boldly strengthening labor market reforms, and following through on the structural reform agenda.

The policy response

1. **The policy response to Spain's economic challenges over the last year has been strong and wide-ranging, helping strengthen market confidence.** The economy was shown to be resilient and policymakers responsive. The resulting improvement in market confidence was critical not just for Spain, but, given Spain's systemic size, for the euro area as a whole. From mid-2010, the Spanish authorities undertook a series of measures targeting the main economic problems facing the country, most importantly:

- *Fiscal.* Consolidation was front-loaded in the May 2010 package, the 2010 deficit target was hit, a strong draft pension reform was agreed with social partners, and transparency was enhanced.

- *Banks.* The saving bank sector was substantially reshaped (while minimizing cost to the taxpayer), capital standards were strengthened, and transparency was improved.

- *Labor.* The 2010 reform increased hiring incentives by easing dismissal costs and criteria, and by granting firms greater flexibility to opt out of collective agreements. Collective bargaining was further reformed in June 2011.

Recent economic developments and outlook

2. The economy is gradually recovering and the rebalancing is underway. Growth has gradually picked up from Q3 2010, led by strong exports as the rebalancing to external demand proceeds faster than expected. Private sector savings-investment balances have improved, helping stabilize debt ratios and reduce the current account deficit. The housing market continues to adjust. Real wages are falling, as necessary given the labor market situation, and unit labor costs are improving. However, unemployment is unacceptably high.

Inflation has also picked up, led by energy prices and indirect taxes, and is again above the euro area average. And sovereign and bank funding costs, under pressure since the start of the euro area debt crisis, remain elevated and volatile.

3. We expect a modest export-led recovery, with growth gradually rising to 1½-2 percent in the medium term. The moderate pace reflects the need to unwind accumulated imbalances, high unemployment, fiscal consolidation, and the still-tight financial conditions facing the Spanish economy. Export growth is projected to remain strong, in line with partner country demand, while domestic demand is expected to improve gradually. Unemployment is projected to fall only moderately in the medium term and to remain well above the euro area average. Inflation is forecast to decline to around two percent as transitory factors fade. And while house prices likely have further to adjust, the drag on output from the residential property sector should cease.

4. **Downside risks dominate.** On the upside, exports could continue their recent strength, despite likely softer European growth, and the impact of recent reforms could prove stronger than expected. On the downside, the key risks are:

- *In the near term*, financial conditions could deteriorate further, reflecting rising concerns about sovereign risks in the euro area. This could put additional pressure on sovereign and bank funding costs for Spain, which in turn could feedback to the real economy.

- *In the medium term*, a protracted slow recovery and, especially, stubbornly high unemployment. In this scenario, domestic headwinds could intensify, creating a downward cycle of falling house prices, slower bank balance sheet repair, and faster household and corporate deleveraging. Combined with potentially unresponsive labor costs, this could undermine employment growth.

The policy agenda

5. **The policy agenda remains challenging and urgent – there can be no let up in the reform momentum.** Unwinding accumulated imbalances and reallocating resources across sectors will take years and many difficult policy choices. And some of the underlying problems of the Spanish economy, especially weak productivity growth and the dysfunctional labor market, remain to be fully addressed. Combined with the risks to the outlook, this means that the reforms to date need to be strengthened. Maintaining the reform momentum means: further enhancing the credibility of fiscal consolidation, completing financial sector reform, boldly strengthening the reforms of the labor market to sharply reduce unemployment, and following through on the structural reform agenda to spur productivity and employment. Such a comprehensive strategy would be helped by broad political and social support.

Public finances

6. **Ambitious fiscal consolidation is underway**. The deficit fell from 11.1 percent of GDP in 2009 to 9.2 percent of GDP in 2010, somewhat better than targeted. This reflected decisive measures adopted in mid-2010. But it also masks that half of the regional governments missed their targets and the central government had to over-perform. The target for 2011 of 6 percent of GDP should be within reach given the full year effects of the 2010 measures and the spending reductions in the 2011 budget. If near-term risks to the outlook materialize, some additional measures may be necessary. But the larger risk to the 2011 target is that some regional governments may again miss their targets. This needs to be avoided: the general government fiscal target is critical and remains the overarching objective, hence, all levels of government should deliver on their commitments.

7. **Achieving the medium-term deficit targets will likely require additional measures.** The government's medium-term fiscal deficit targets are appropriate, but require strong implementation. First, the targets are based on strong spending restraint. Second, under the mission's less optimistic macroeconomic projections, additional fiscal measures of about two percent of GDP will be required through 2014, which also argues for building strong buffers in the 2012 and future budgets. Third, to ensure the debt ratio is on a firmly declining path by 2014 – anchoring longer-term sustainability and market expectations – the government should commit to an early date to achieve the medium-term objective of a balanced budget and should pro-actively manage below-the-line operations (such as privatization). The draft pension reform should also be quickly passed and implemented, and ideally strengthened in some areas (such as making the sustainability clause more automatic).

8. **Improving fiscal frameworks would help underpin the consolidation targets**.

In the short term, the focus should be on sub-national finances. In particular:

- While central government transparency standards are strong and the Bank of Spain's reporting of outstanding liabilities of all levels of government is comprehensive, the transparency of sub-national accounts has substantial scope to improve. Specifically, sub-national accounts should be available at the same frequency and coverage as those of the central government (moving to quarterly reporting on a cash and national account basis should be an immediate goal) and rebalancing plans should be more quickly finalized and should be published.

- Existing policy levers for ensuring sub-national compliance with deficit targets should be strictly applied, including the debt authorization system and withholding discretionary matching transfers.

In the medium term: a nationwide comprehensive review of major spending programs could help identify high-quality expenditure savings; an independent fiscal council could bolster fiscal credibility (for example, by providing the macroeconomic framework for the budget);

and spending control mechanisms, including expenditure rules, could be usefully implemented at all levels of government.

Financial sector

9. **Despite far-reaching policy action and substantial efforts by banks to improve balance sheets, market pressure persists**. Market participants continue to see the outlook for profitability in the banking system as difficult and remain uncertain whether real-estate related losses have been fully recognized. Although potential capital needs are limited and affect only a few institutions, funding and capital-raising remains more difficult for Spanish banks than for their peers. It also potentially creates a negative feedback loop with sovereign funding conditions.

10. **A decisive implementation of the envisaged strategy would help allay market concerns.** A rapid restructuring of the financial sector, combined with robust capital and liquidity buffers, would also foster a faster reallocation of credit across sectors. Key measures to this end include:

- *Weak banks.* Those banks that have no prospect of covering their capital shortfalls from the market should be rapidly restructured or, if not clearly viable, quickly resolved. As envisaged, FROB support should be seen as a last resort, provided on no better than market terms, and strictly temporary.
- *Buffers.* Given the uncertainty about their operating environment, banks should be encouraged to continue building up capital, liquidity, and provisions. Spain's systemic banks should go further in building these buffers, in line with emerging international best practice.
- *Stress tests.* The forthcoming Europe-wide stress tests ought to underpin confidence about the extent of any potential capital needs. It is encouraging that the coverage of Spanish banks is, again, to be much wider than in the rest of Europe. To strengthen market confidence, it would be useful to fully disclose the underlying data and specific methodology behind the results.
- *Transparency.* Enhanced disclosure should become a permanent feature of the Spanish system. The scope, granularity, and comparability of disclosed information by individual institutions could be further improved under the aegis of the Bank of Spain.
- *Savings bank reform*. It is important that the next stage of the process – raising capital from the markets – be promptly implemented. Going forward, we see merit in further reducing savings banks' ownership of commercial banks. Savings bank governance could also be further improved in the near term by increasing the number of independent members on executive boards and reducing political representation further.

The labor market

11. **A bold strengthening of reforms is needed to substantially reduce unemployment.** The labor market is being reformed in the right direction. But the results to date do not provide sufficient confidence that the reforms will quickly deliver an improvement in labor market dynamics that is as strong as the severity of the problem requires. Spain's unemployed need a decisive improvement in employment prospects, without which Spain could face persistently high unemployment and duality, with the young especially affected by joblessness and revolving temporary contracts. A bolder reform would also help counter the headwinds from the deleveraging of the economy and prompt the reallocation of labor across sectors. Policy should thus err on the side of boldness rather than gradualism.

12. **This calls for deepening and broadening the reforms so far.** In particular:

- *Collective bargaining* needs to be effectively decentralized to the firm level to allow wages to adjust to firm-specific conditions. This would foster employment and the reallocation of labor. The decree-law of June 10 has some promising clauses and social partners should pro-actively pursue the opportunities for firm-level flexibility that the reform offers. The scope for firm-level flexibility should also be strengthened during the Parliamentary approval process. But if there are not clear and immediate signs the reform is delivering the necessary firm level flexibility, a more radical reform should be introduced.
- Social partners should move away from *inflation indexation*, which is endemic compared to other countries. It is inconsistent with the functioning of a currency union and especially damaging during times of high unemployment, structural shocks, and cost-push inflation. Instead, reference could be made to guidelines based on productivity and regaining competitiveness with main trading partner countries. The removal of indexation should be accompanied by stronger competition in the nontradable sector to reduce pressure to increase prices.
- *Severance payments* should be further lowered to at least EU average levels and should be better designed to make permanent hires more attractive. The 2010 reform was a step in the right direction and its effects may strengthen over time. But severance payments remain high and still likely constitute a significant deterrent to the use of permanent contracts once employment growth strengthens.
- These measures should be supported by *broader reforms*, including further improving the retraining of workers with mismatched skills, supporting youth employment, and ensuring that the incentives to return to work are sufficient. Recent improvements in active labor market policies, such as allowing private placement firms, should be especially useful in this regard.

Other structural reform

13. **Further progress needs to be made on enhancing competition in nontradable sectors.** Positive steps have been taken over the past year, such as the ongoing implementation of the Services Directive and the removal of the mortgage deduction for income tax. But significant entry barriers remain in a number of sectors, and further liberalization is critical for regaining competitiveness, boosting employment, and reducing mark-ups. Key reforms, many of which are on the government's agenda, should include: fully implementing the Services Directive and Sustainable Economy law, opening up regulated professions, continuing to foster the growth of the under-developed housing rental market, reducing restrictions on retail opening hours, reforming the bankruptcy law, and ensuring the reduction of payment delays (as per recent legislation).

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