Describes the preliminary findings of IMF staff at the conclusion of certain missions (official staff visits, in most cases to member countries). Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, and as part of other staff reviews of economic developments.

Spain—2010 Article IV Consultation Concluding Statement of the Mission

Madrid, May 24, 2010

Spain's economy needs far-reaching and comprehensive reforms. The challenges are severe: a dysfunctional labor market, the deflating property bubble, a large fiscal deficit, heavy private sector and external indebtedness, anemic productivity growth, weak competitiveness, and a banking sector with pockets of weakness. Ambitious fiscal consolidation is underway, recently reinforced and front-loaded. This needs to be complemented with growth-enhancing structural reforms, building on the progress made on product markets and the housing sector, especially overhauling the labor market. A bold pension reform, along the lines proposed by the government, should be quickly adopted. Consolidation and reform of the banking system needs to be accelerated. Such a comprehensive strategy would be helped by broad political and social support, and time is of the essence.

The outlook: a weak and fragile recovery

1. The necessary adjustment is underway and output has stabilized. Imbalances accumulated during the long boom have begun to unwind, with the current account deficit halving as private savings surged and housing investment fell. Competitiveness has begun to improve as productivity rose and the core inflation differential turned negative. The large fiscal deficit is beginning to fall. Output rose slightly in the first quarter, ending the long and deep recession. But unemployment has soared as firms adjusted employment rather than wages or working hours.

2. We project the nascent recovery to be weak and fragile. Our central scenario is one of continued adjustment of the various imbalances with growth rising gradually to 1½-2 percent in the medium term. Domestic demand recovers only slowly, with private demand weighed down by continued uncertainty, high unemployment, and the need to reduce indebtedness, and public demand by large-scale consolidation. Stronger export growth, however, should support the recovery. Despite rebounding energy prices and the VAT increase, inflation would remain subdued, helping regain competitiveness. Slowing population growth, high unemployment, and weak investment all weigh on potential growth, underlining the importance of growth-enhancing structural reforms.

3. The uncertainty around this outlook is large. On the upside, household consumption could grow more rapidly as confidence firms, and the global recovery and the weaker euro may induce faster export growth. On the downside, the economy may stagnate as the weakness in private demand and fiscal consolidation interact, especially if reforms to boost competitiveness and growth are timid. Financial market conditions may also deteriorate further, raising borrowing costs for both the government and the private sector.

The policy agenda: rebalancing the economy and boosting confidence

4. Policy should focus on fostering the smooth rebalancing of the economy. This calls for urgent and decisive action on:

• making the labor market more flexible to promote employment and its reallocation across sectors;

• fiscal consolidation to put public finances on a sustainable footing; and

• banking sector consolidation and reform to cement the soundness and efficiency of the system.

Such broad reforms in many sectors simultaneously would produce synergies. For example, labor market reform coupled with further liberalization of product and service markets would boost investment and employment and reduce prices, making fiscal consolidation easier and strengthening banks. Such reforms would also support Spain's long-term convergence with higher-income peers. These reforms should be implemented pro-actively to boost financial market sentiment and underpin credibility.

Structural reforms to spur growth through increased competitiveness and employment

5. The labor market is not working. Unemployment is structurally high and excessively cyclical, reflecting the high degree of duality in labor markets. The wage bargaining system, which hamstrings wage and firms' flexibility, is ill-suited to membership of a currency union. The government has provided some broad guidelines for reforming the labor market to be negotiated by the social partners. An agreement is expected by the end of May.

6. A radical overhaul of the labor market is urgent. The reform will need to be ambitious and comprehensive if it is to significantly change labor market dynamics and to avoid missing an historic opportunity. In particular:

• reducing duality and encouraging permanent hires requires lowering severance payments to at least EU average levels and preventing excessive use of unfair dismissals;

• boosting wage flexibility and employment requires coupling this reduced protection of permanent contracts with decentralizing wage setting (for example by moving to an "opt-in" rather than "opt-out" system for collective bargaining) and eliminating indexation.

Care should be taken that any reform does not increase the fiscal cost of the system or make temporary employment more difficult in the near term. Ideally the social partners will quickly deliver such an overhaul, but if not, the government will need to follow through on its commitment to take action itself, including on collective bargaining.

7. Commendable progress in recent years on product and service market reform needs to continue. Many important measures have been taken recently, especially in transposing the EU Services Directive (though implementation will be critical), and in the housing sector in which incentives for buying homes have been partially eliminated and the rental sector is being promoted. Given the pressing need to boost growth and competitiveness, however, Spain should aim to be among the top performers in terms of product and service market liberalization. The priority should be to further reduce restrictions on retail trade, professional services, and the rental market.

Fiscal policy: restoring sustainability

8. Ambitious fiscal consolidation is underway to reach the three percent of GDP deficit target by 2013. To achieve the implied 10 percent of GDP improvement in the primary balance from 2009 to 2013, the government has taken a wide range of measures, including the fiscal package approved by the Cabinet last week. We fully support this package. It significantly strengthens and front loads the envisaged adjustment and enhances credibility by taking concrete and bold measures, such as cutting public sector wages. The new path for the deficit is also appropriate. This path implies cutting the deficit by more than five percentage points of GDP in 2010 and 2011 and would put the government debt ratio (which would still be lower than the euro area average) onto a downward path in a reasonable timeframe.

9. Achieving these targets will be critical and any slippage should be aggressively pre-empted. Risks to achieving the targets come from both the implementation of the measures and the underlying projections of a fairly rapid recovery. Any slippage in attaining fiscal targets will make it difficult to put government debt on a firm downward path in a reasonable timeframe and undermine credibility. It is thus critical that the supporting structural reforms are quickly implemented and additional high-quality adjustment measures are prepared in advance to allow pre-emptive correction of any prospective slippages and avoid surprises. Such measures should protect the most vulnerable segments of society and could include further reducing spending (which has increased sharply over the last decade), and raising revenue by reducing tax benefits and further increasing relatively low VAT and excise rates.

10. Bold pension reform should also be implemented soon. Spain faces strong spending pressures over the longer term due to aging and slower population growth. The government has outlined possible reforms, including raising the retirement age to 67. These measures, together with others (in particular, an automatic link to life expectancy) would strengthen the sustainability of the system and bring Spain closer in line with European peers that have already reformed their pension systems. As such reforms would boost fiscal sustainability without undermining growth, they should be quickly adopted.

11. Stronger fiscal frameworks could help. As the bulk of spending occurs in Autonomous Communities, their role is critical, underscoring the need for strong mechanisms to ensure they deliver the needed adjustment. Institutionalizing spending review processes could also help improve the quality and durability of spending reductions. It might also be useful to consider options to bolster the credibility of fiscal policy, for example, by establishing an independent fiscal council (like Sweden's or Belgium's) to provide objective analysis of fiscal developments and long-term sustainability issues.

Banks: accelerating consolidation and reform

12. The banking sector is sound but remains under pressure. Although impaired assets have increased with the downturn, Spanish banks overall report robust capital and provision buffers, supported by a strong supervisory framework. But the risks remain elevated and unevenly distributed across institutions, focused mainly on the savings banks. The situation is also complicated in that much of banks' repossessed real assets is land, which is particularly difficult to value. On the liquidity side, although funding is generally of good duration, market conditions remains difficult and access limited. Further strains may arise from the unwinding of the exceptional liquidity measures by the ECB, the ending of the funding guarantee scheme, and from the intense competition for deposits. These funding difficulties, coupled with lower earnings due to weak credit growth, provisioning for troubled assets and the system's overcapacity, will likely lead to pressure on profitability.

13. Consolidation needs to accelerate to reduce overcapacity and produce more robust institutions. Progress, under the aegis of the Fund for Orderly Bank Restructuring (FROB), has been too slow, though the recent agreement between the two main political parties in this regard is encouraging. Much more progress needs to happen before the FROB deadline of end-June 2010. The Bank of Spain should be prepared to intervene promptly if pockets of weakness remain. To this end and to enhance investor confidence, a comprehensive and transparent bank-by-bank "diagnostic" based on conservative assumptions on asset valuation and prospects could usefully be carried out.

14. The legal framework of savings banks should be updated for the new economic context. Performance among savings banks is highly diverse and the sector has an important role to play, but the current legal structure is not well suited to Spain’s needs going forward. Under the current framework, cross-region mergers still need to be approved by regional governments, the sector remains closed to external investors, and savings banks’ capacity to raise external capital remains limited, putting public funds are at risk. The legislative and policy priority should be to: (1) reduce political influence in savings banks; (2) enhance their ability to raise external capital, and (3) offer an opportunity to transform into stock-holding companies, and, indeed, requiring this for systemically important savings banks. This reform should be implemented promptly so savings banks can have the full range of options to raise capital as soon as possible.

IMF EXTERNAL RELATIONS DEPARTMENT

Public Affairs		Media Relations	
Phone:	202-623-7300	Phone:	202-623-7100
Fax:	202-623-6278	Fax:	202-623-6772