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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 07/42-1

10:00 a.m., May 16, 2007

1. Spain—2007 Article IV Consultation

Documents: BUFF/07/69; SM/07/139 and Correction 1

Staff: Leipold and Escolano, EUR; Kincaid, PDR

Length: 1 hour, 42 minutes

Executive Board Attendance

M. Portugal, Acting Chair

Executive Directors	**Alternate Executive Directors**
	G. Ukpong (AE), Temporary
	K. Assimaidou (AF)
	H. Torres (AG)
R. Murray (AU)	
	J. Prader (BE)
	M. Agudelo (BR)
	J. He (CC)
	R. Guzman (CE)
	P. Charleton (CO)
	B. Dumont (FF)
K. Stein (GR)	
A. Kishore (IN)	
	M. Xafa (IT)
	N. Yamasaki (JA), Temporary
	M. Daïri (MD)
A.S. Shaalan (MI)	S. El-Khouri (MI)
A. Bakker (NE)	
T. Saarenheimo (NO)	
	A. Lushin (RU)
	A. Al Nassar (SA)
	C. Sucharitakul (ST)
	A. Raczko (SZ)
	P. Pollard (UA), Temporary
	J. Larsen (UK)

A. Linde, Acting Secretary
S. Zucchini/D. Vannier, Assistants

Also Present
ECB: F. Ramon-Ballester. European Department: J. Daniel, J. Escolano, E. Gutierrez, A. Leipold, S. Schadler. External Relations Department: A. Gaviria. Legal Department: T. Laryea, M. Milford. Office of the Managing Director: A. Kammer. Policy Development and Review Department: S. Brown, R. Kincaid. Secretary's Department: P. Ramlogan. Senior Advisors to Executive Directors: N. Conrado (CE), L. Croitoru (NE), A. Guerra (CE), D. Mohanty (IN), J. Pineda (CE), A. Rojas (AG), M. Sidi Bouna (AF), Y. Tok (ST), P. Weber (FF), J. Yoon (AU). Advisors to Executive Directors: J. Bergundhaugen (NO), C. Brinkmann (GR), J. Cardoso (IT), C. Crelo (BE), A. Eng (ST), K. Farrant (UK), P. Gasiorowski (SZ), H. Li (CC), C. Mira (CE), A. Mohammed (MD), N. Riad (MI), E. Uanguta (AE), I. Zakharchenkov (RU).

1. SPAIN—2007 ARTICLE IV CONSULTATION

The Deputy Director of the European Department (Mr. Leipold) submitted the following statement:

> This statement provides information that has become available since the issuance of the 2007 Article IV staff report. The thrust of the staff appraisal remains unaltered.
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> The economy continues to grow strongly. Bank of Spain estimates place GDP growth at 4 percent in the first quarter of 2007 (year-on-year), the same pace as that observed in the last quarter of 2006. The pattern of growth is also estimated to have remained stable, without significant changes in the dominant contribution to growth of domestic demand and in the drag exerted by the external sector. Private consumption and equipment investment remained dynamic, while construction activity decelerated in line with the gradual cooling of the housing market. Through April, inflation remained around 2½ percent, with the differential vis-à-vis the euro area hovering in the 0.5–0.7 percentage point range.
>
> Recent stock market turbulence reflects a correction of the overvalued construction sector, while highlighting the risks to a soft landing. At end-April, construction company stocks declined sharply, with some spillover to banks (heavily exposed to the real estate sector). The cumulative decline of the IBEX 35 index from its peak has however been relatively contained, bringing the index, which has experienced considerably larger gains than in the euro area, to end-2006 levels—still viewed as richly valued by several market analysts. Volatility and some downward sentiment remain, with observers pointing to the risk of a spillover to construction activity—a risk officially viewed as contained.
>
> Strong revenues continue to boost the fiscal accounts; a small surplus target has been set for regional governments in 2008. Exceptionally strong revenue collection raised the central government surplus in the first quarter of 2007 to almost 0.7 percent of (projected) annual GDP, compared to 0.5 percent of annual GDP in the same period of 2006. The authorities cautioned however that this outcome does not yet reflect the effects of the 2006 tax reform, which stand to dampen the likely full-year revenue outturn. In April, the government and the regions agreed to a surplus target for regional budgets of ¼ percent of GDP in 2008—a relatively modest objective in the current cyclical circumstances.

Controversy surrounding the takeover process of a large electricity company has renewed attention on the independence of the regulatory authorities. Divergences of view over the handling of the protracted takeover bid led to the resignation of the head of the securities commission. His replacement failed to garner the support of the opposition and the issue remains the subject of parliamentary enquiries and debate.

Mr. Guzmán and Ms. Mira submitted the following statement:

The authorities would like me to convey to the Board their appreciation for the thorough talks held with staff during the mission to Madrid last March. The staff's perceptions and views on the challenges faced by our economy certainly enrich the policy-making process. We are broadly in agreement with the assessment made. We would like to add a few notes to finish the contours of the overall economic situation.

Outlook

The Spanish GDP grew 3.9 percent in 2006, ending the year on remarkable dynamism with the 4th quarter growth reaching 4.2 percent Early estimates for the 1st quarter of 2007 indicate that the level of activity is sustained.

The qualitative composition of growth improved in 2006 with interest rates hikes cooling real estate investment and private consumption on the demand side. Healthy growth in non- housing investment and exports took over and more than compensated the deceleration of households' overall expenditure. These demand patterns have continued early in 2007. On the supply side, industrial production and productivity improved. Growth is still led by labor employment, yet the pickup in productivity and investment calls for optimism. Employment growth has averaged 2.7 percent on an annual rate over the past five years, the labor participation rate increased almost 5 percentage points over the same period and the unemployment rate dropped to 8.3 percent, still relatively high but close to EU levels. These figures are related to the immigration phenomenon but also to the increased participation of women in the labor market[1].

[1] Since 1995 Spain has received over 4 million immigrants (roughly a 10 percent increase in population), 3 million arriving in the period between 2000 and 2005.

CPI growth decelerated by almost one point in 2006 dropping to 2.5 percent (annualized) at the end of April 07. Although inflation is still above EU levels, the differential vis-à-vis the EU has narrowed to 0.6 percentage points. Early indicators point to a moderation of labor costs growth in the first quarter of 2007, continuing past trends.

To put all this into perspective, we need to recall that 2007 will probably become the 14th consecutive year of continued growth above EU and OECD averages, and that for the past 5 years Spain has been creating on average close to 700,000 new jobs.

The current account deficit increased to 8.8 percent of GDP by year end 2006. No matter how debatable refined calculations on the responsibility of different factors (oil prices, cycle, competitiveness) over this imbalance might be, the government shares the staff's opinion that low productivity growth and the inflation differential with our main competitors harm competitiveness and explain, to a certain extent, the current account deficit.

Authorities though assign a lesser probability to worse case scenarios on growth. A number of factors ought to be taken into consideration; looking back, it is only fair to underline that our current account is not the product of a lower savings rate but of a sustained push of investment. Predictions of a sudden slowdown of growth typically start by depicting developments in the real estate market as an "asset bubble," and presenting its share on growth over the years as "unproductive." This analysis fails, on the one hand, to completely grasp the fundamentals behind real estate prices in Spain over recent years. On the other, it dismisses the source of wealth attached to the development of a sophisticated industry of tourism services, health, and other services for pensioners and other EU residents (the Florida model). Finally, the financial implications on households and corporations of this overinvestment are undeniable, but, again, the risk of a sudden balance sheet adjustment is overestimated.

The real challenge of the Spanish economy ahead is to improve its flexibility, often underestimated, and find the ways to smoothly transfer all the supply resources invested in satisfying housing demand over the past decade to the generation of value-added in sectors that contribute to the rebalancing of our growth pattern. From our perspective, strong growth, increased employment and convergence towards EU income levels are factors that feed good expectations and allow optimism to take the upper hand, as is the fiscal performance over the past years.

Be it as it may, government central scenarios are broadly coincident with those of the staff and predict a soft landing supported by tightening monetary conditions and healthier growth in the EU, developments which have already started to reshape our demand and our supply (increases in industrial production and productivity and on exports, cooling of private consumption and the housing market). These positive signs do not leave us, however, any room for complacency. The basic guidelines of our economic policy address the rebalancing of our growth pattern and our competitiveness problems.

Fiscal Policy

Growth is behind the better-than-expected results in government accounts. The surplus in 2006, equivalent to 1.8 percent of GDP (0.8 percent of General Government plus 1.2 percent of Social Security surplus covered the small regional and local administrations deficit 0.2 percent) bears proof of the government's commitment to a prudent fiscal stance, a commitment that is firmly embedded in the conscience of political parties, trade unions and society, as a whole. This consensus on a responsible fiscal policy and the room of maneuver gained through successive surpluses are probably the most valuable asset of the Spanish economy looking ahead. Less pleasant times may arrive, but a fiscal stimulus compliant with EU rules should go a long way in smoothing the ride.

The 2006 results were indeed the outcome of larger-than-expected receipts, due to corporate performance, in particular. End of April reports on receipts already revealed an 11 percent increase in tax income at an annualized rate, due to buoyant activity and results. However the effects of the fiscal reform will only be noticeable later in the year.

Staff rightly points out that primary expenditure is rising. It is perhaps necessary to recall that Spain still lags behind other developed economies in terms of the capital stock of the country and that, for the most part, expenditure increases have been allocated to investment in needed physical infrastructure, R+D+I activities, and education. In fact, the expenditure to GDP ratio in Spain (38.6 percent of GDP) is still well below EU averages. Innovation and education expenditures are rising from very low levels and are among the top priorities of economic policy for the years ahead. The amounts assigned for R+D+I in the 2007 budget are 34 percent higher than in 2006. Significant increases for infrastructures (10 percent) and education (28 percent) are also budgeted for 2007.

On top of favoring productivity-oriented expenditure, the two other major guidelines of fiscal policy are to contribute to financial stability over the economic cycle and to guarantee the long-term sustainability of public finance.

With regard to the first objective, the new Ley General de Estabilidad Presupuestaria (described in the report) is in force in 2007 and we will see the effects of its implementation in the budget for 2008. The central point of the Law is to introduce fiscal discipline and allow for a symmetrical performance of the automatic stabilizers in each phase of the cycle. Concerted, transparent, and legally binding fiscal targets (for central government, regions and city councils) join rules limiting debt in the regions and other local authorities to assemble the prudential framework needed to guarantee fiscal stability in a country where over 75 percent of the total expenditure (excluding Social Security) is decentralized.

The fiscal target for 2007/09 is a surplus (1 percent, 0.9 percent and 0.9 percent of GDP). After consultations, an agreement has been reached in April by which the regional governments will budget for a surplus equivalent to 0.25 percent of GDP for 2008. This self-imposed restriction is coupled with the capacity to exceptionally generate a 0.25 percent deficit, when destined to finance increases in productivity-oriented expenditures. Local councils will budget for balance.

In relation with the overall cyclical stance of fiscal policy, we believe that the combination of events feared by staff (Paragraph 5) to result in an "untimely procyclical stimulus" in 2007-08, is highly improbable. The staff, for instance, mentions the 2006 reform of both the personal income and the company tax, which aim at improving equity, and simplifying the system while promoting private sector activity. These reforms are a step in the gradual approach adopted towards reaching the ideal tax system for our economic structure. Their expected effects are well quantified and limited[2]. On the expenditures side, there is an overall expenditure ceiling that limits expenditure growth to the nominal growth of the GDP.

[2] In the personal income tax, the minimum, non-taxable income has been increased, tax brackets have been reduced, and the maximum tax ratio has also declined (from 45 to 43 percent). As a result, the decrease in personal income tax is expected to amount on average to 6 percent. As for company tax, the tax ratio has also been reduced from the current 35 to 30 percent over two years (32.5 percent in 2007 and 30 percent in 2008), for SMEs the reduction from 30 to 25 percent is effective immediately.

With regard to the longer term sustainability of Spanish public accounts, three comments come to mind: i) The proceeds of 2006 surplus, following the explicit mandate of the Budget Stability Law have been allocated to a further reduction of the debt levels, now below 40 percent of GDP, and to a new endowment to the Reserve Fund of the Social Security which now holds 41.000 billion € or 4 percent of GDP; ii) Continuous progress in the reform of the Pension System will tackle increased ageing related expenditure (which will reach 8.5 percent of GDP on year 2050). An Agreement between Government and Social Partners was signed in July 2006, introducing a package of measures reducing the number of special regimes, as well as incentives to work longer. This new agreement will improve future sustainability and adequacy. Further efforts, always based on a consensual approach, will follow; iii) The control of health expenditure is guaranteed through the Plan for the Quality of the National Health System, approved in March 2006 with the regional governments, which includes up to 189 measures aiming at different fields of action, and by the new regulations governing the efficiency in the prescription and consumption of medicines.

Financial System

The financial system in Spain remains strong and competitive, dynamic, profitable and well-capitalized. Non-performing loans remain at historical low levels, and precautionary balances are high by all standards, while solvency ratios bear proof of the conservative stance of the supervisor. The 2006 FSAP found a very resilient and healthy financial system. The Bank of Spain has remained vigilant and pursued a prudent and conservative approach in times of boundless expectations. It has closely monitored developments in the context of strong credit growth, and ensured that financial supervision keeps up with innovation on financial products and entities. In our opinion, the financial system is probably the second pillar in the strength of the Spanish economy.

The authorities and the financial entities are currently speeding up the preparations for the implementation of Basel II and the EU Directive on Markets in Financial Instruments (MiFID). This process, together with the recent adoption of the new accounting and reporting rules consistent with International Financial Reporting Standards (IFRS), has placed the financial system in front of onerous tasks. The response to these stressful regulatory times has been satisfactory.

On a different note, the draft Takeover Law and Regulations, which will implement the European Directive on Takeovers, will also contribute to transparency and reinforce the protection of minority stakeholders. The new set of regulations will cover the legal loophole that has recently given grounds to significant controversies on the takeover of Endesa (large electrical utility company) by an Italo-Spanish consortium after months of competing bids.

Finally, we would like to underline that the staff report correctly states that the Spanish financial system does not have a subprime segment in its mortgage market. Tsunamis from the Atlantic coast are not expected soon.

External Sector and Competitiveness

The current account deficit has continued widening in Spain, though at a slower pace, reaching 8.8 percent of GDP. This deficit is mainly explained by the trade balance deficit, although other lines also contributed to the result (a smaller surplus in the service balance-tourism and larger income and transfers balance deficit—remittances and reduced transfers from EU). The net external demand imposed a drag of 1 percentage point to GDP growth, which represented an improvement from the 2005 figure (-1.7 percent). The last quarter of 2006 showed a slowdown in the negative contribution of external demand to -0.9 percent to GDP growth.

From a financial perspective, lower interest rates after EMU have encouraged investments (up to 29 percent of GDP in 2006) in a context of growth. The national savings rate has remained stable at around 20–22 percent GDP over the expansion period thanks to the increase in public savings. A highly dynamic domestic demand—feeding of higher income and employment levels and of the expectations bred by the permanent catch-up process—fueled demand for imports, in a context of high oil prices. Simultaneously, the demand of our main trading partners in the EU weakened substantially (over 75 percent of our exports are EU bound).

The resumption of growth in Europe and a slowdown in oil prices has somewhat reversed the trends. Interest rates increases have also helped dampen absorption and cooled the housing market. On the supply side, the competitiveness problem in our export model might partially be caused by the inflation differential and the euro strength, otherwise related to labor costs and productivity growth. The authorities launched a comprehensive reform process to address this weakness through enhanced competitiveness and competition, markets liberalization to favor the efficient allocation of resources, and to encourage diversification of supply and greater technological content.

Plans and Reforms in Progress

The National Reforms Plan is a medium-term multidimensional strategy launched in October 2005. It has been welcome and lauded by both the OECD and EU Commission. In its first year of implementation, 51 percent of the 312 envisaged measures had already been approved. Some of the major recent accomplishments have been the following:

Fostering innovation and R+D, the Ingenio 2010 for civil R&D and innovation. One of the main elements of the Ingenio 2010 plan is the Plan AVANZA, aimed at enhancing the use of Information and Communication Technologies in Spain at all levels: citizens, public administrations, small and medium-sized enterprises. Administrative procedures and bureaucracy are also being reduced to foster R&D and innovation.

Revision and improvement of the competition framework. A new Law reinforces the Competition Board's independence vis-à-vis the government. The staff report highlights some of the features of the reform (although regrettably, the OECD graphs presented in the report use 2003 data). We are convinced it will help enhance transparency, accountability and efficiency in the economy.

There has been progress in enhancing product market competition, mainly in sheltered markets. In the energy sector, the progressive elimination of tariffs for gas and electricity has been approved, and new rules govern the sharing of the electric interconnection capacity in the market using auctions. The implementation of the Iberian Electricity Market—the integration of the Portuguese and the Spanish electrical markets—is in course. The liberalization measures contributed to enhancing consumption in the liberalized market, which accounts for 83 percent of gas sales and 40 percent of electricity sales. Recent improvements have also contributed to enhancing competition in mobile telephony and broadband Internet services.

As stated before, major infrastructure investment plans are in progress, namely in the area of transport and water[3], the latter a key element in the environmental sustainability of our economy, together with the need to reduce energy intensity.

Labor market reform. The government and the social partners reached the "Agreement for Improved Growth and Employment" in May 2006. Its main objective was the reduction of the level of temporary employment in order to overcome the dual character of the Spanish labor market, which hampers productivity. The authorities believe the reform is a step in the right direction because it strikes the delicate balance of introducing greater flexibility while preserving social peace. Concerning its impact, data already confirm a decline to 32 percent of the ratio of temporary to total employment in the first quarter of 2007.

All in all, contrary to what a hurried reader of the staff report might infer, the authorities consider that very good progress has been made over the years to put Spain among the top reformers in Europe. Yet again, there is no risk of a complacent attitude ahead. In fact, the future implementation of the Services Directive of the EU provides the Government with a valuable opportunity to further enhance competition in sheltered markets.

Exports Are Doing Well

It is worth bearing in mind that exports of goods and services did improve significantly in 2006 (6.2 percent increase, from 1.5 percent in 2005), and this is even more the case when taking only goods (10.6 percent of increase, more than double the 2005 growth rate, of 4.8 percent). Exports of goods towards EU countries have increased by 8 percent, as have those to non-EU countries by 17.5 percent, in a welcome sign of diversification.

Whatever the perceived loss of competitiveness, the Spanish world export market share has not declined significantly over the past years. It remains more or less stable, at 1.8 percent of world total exports, having reached its maximum in 2003 (1.93 percent). The relative loss is not different; in fact it is smaller, than that suffered by other developed economies in the same period. In our judgment, it reflects basically the long-term adjustment in the export quotas caused by the irruption of Far East exports. Furthermore, the loss of market share is concentrated in the period when European demand was

[3] The Strategic Infrastructure and Transport Plan, PEIT, will fund 32 bn Euro or 1.7 percent of GDP in 2005–06, in roads, high speed railways, ports and airports. Water is another sector where ambitious projects are being undertaken under the A.G.U.A. Program (desalination for irrigation, improvement of water supply infrastructure).

at its low, and has recovered thereafter. Export growth and industrial production numbers correlate to this evolution.

Corporate Indebtedness

The financing of our current account deficit has resulted in increased levels of debt for families and non-financial corporations. The staff report hints that if financial pressure were to proceed unbridled, it would at some point trigger a balance sheet adjustment in these sectors that could drive the economy into a halt. The authorities consider that both households and non-financial companies present thus far reasonable asset/liabilities balances and that it is early to consider the trend irreversible, the risk imminent.

The corporate sector indebtedness amounted to 105 percent of GDP in 2006. Companies have taken advantage of macroeconomic stability, strong growth and good prospects to grow both internally and internationally, through non-organic operations (M&A). They adapted their funding structure increasing borrowing in response to the relative cost of raising capital. Such indebtedness ratio, while greater than the EU average, is not exceptional, and should not pose problems under normal interest rate scenarios. The favorable trend in company's profitability shows that the differential between the ordinary yield on net assets and financial costs remains wide, at around 5 percentage points. As the staff report shows, the interest coverage ratio of Spanish non-financial companies remains also at reasonable levels. All in all, corporations seem well placed to respond to higher interest rates and in general maintain a prudent level of financial leverage.

We would like to comment on staff's assessment in p. 2 on the medium-term implications of the projected external deficits for private sector (household and corporate) indebtedness. Although we understand that the intention of staff is to call the authorities' attention to the risks involved in the perpetuation of recent debt dynamics, we must argue that there are several methodological concerns that make their calculations of little use when trying to draw policy conclusions.

Household Indebtedness: a Word or Two on the Real Estate Market

It is a well known fact that growth over the past years (1999 onwards) in Spain has relied intensively on the real estate and construction markets. Still, it comes as a surprise the mechanical way in which analysts grossly overestimate the macroeconomic relevance of certain developments.

Authorities have asked me to reiterate some facts that might shed a light on this issue.

The extent to which the rapid increase in property prices in Spain amounts to a speculative bubble is arguably limited. In relation to countries where similar developments have taken place, there are enough reasons to believe that property prices in Spain largely respond to fundamentals

- supported by developments in the demand in real terms: i) increased demand due to immigration; ii) increased demand from European citizens attracted by the relatively low priced and low risk (introduction of the Euro 1999) assets, and facilitated by the development of the low cost airlines; iii) the de-construction of the traditional family unit, together with higher employment, income and living standards have multiplied Spaniards' demand.

- supported by financial factors: i) the already mentioned introduction of the Euro wiped off the currency risk associated to purchasing properties in Spain for European pensioners and residents; and, ii) it also brought negative real interest rates to Spain, and the possibility of accessing finance at previously unheard-of rates; a vibrant financial sector was only keen to react with product flexibility and abundant money. Derivatives helped fund the increase in mortgage finance; iii) and finally with prices on the rise and low interest rates, household wealth, the single most important factor behind decisions on long-term investments, increased well above other countries[4].

- supported by supply side elements: over the past five years an average of 500.000 new properties have been built and put in the market but supply struggles to keep up with demand, construction lags because of its own long cycle and because of the rigidity in the supply of land, a longstanding problem in the Spanish real estate market[5].

Summing up, a number of factors combined to put the real estate market under tremendous pressure in or around 1999. Increases in prices have left us aghast, but we consider them largely motivated by demand and supply forces. Low yields in alternative savings/investment instruments and, some say, an inherent "risk aversion" of Spaniards towards stock markets, also fuel

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[4] Spain has a relatively high ratio of net wealth to GDI (982), above those of Germany, France, Italy or even the UK.

[5] Although measures have been adopted overtime to facilitate the supply of land apt for development, the complex and decentralized planning system regulating the supply of land is certainly contributing to the retard in the response of the construction sector to the booming demand.

property demand: the speculative motivation might be behind a certain percentage of the transactions/investments, but it cannot be considered the driving force.

Prices have decelerated constantly over the past three years. The average rate of increase for 2006 was of 7 percent, the first single digit figure since the 90s. The central scenario for analysts is a progressive reversal of the housing rush of the past years. Increased financial pressure will determine a gradual cooling of demand and prices, while debt levels will stabilize and construction will necessarily adjust. Taking into consideration that housing represents around 50 percent of the construction sector operation and, taking into account also strong activity in infrastructure and other fields, this scenario is compatible with our central macro forecasts. The financial system, on the other hand, holds provisions that cover almost three times doubtful loans, among the highest levels in the world, healthy profits are growing if anything, and non-performing loans amount only to 0.4 percent of the total.

With regard to the financial consequences on families, the staff suggests that the one weak link of the Spanish economy could be the unsustainable level of debt into which the households have gotten themselves. With interest rates going up, total debt represented 114 percent of the households' gross disposable income at year end 2006.

However, the situation remains comfortable when taking into account the families' wealth. Debt amounts to 47 percent of household wealth taking into consideration only its financial component. Were we to consider including real estate wealth in the calculation, would the ratio of debt to total wealth be limited to 13 percent? Admittedly, a dramatic and generalized fall in prices would swiftly change the value of this ratio, but the same would still not necessarily be true for financial assets. In any case, indebtedness to wealth has remained relatively stable over the past 10 years.

A probably more relevant ratio to evaluate financial pressure on households is that of debt service to disposable income. Current data reveal that longer mortgage maturities have allowed this ratio to remain relatively low, at 16.3 percent in 2006, and expected to reach 17.9 percent in 2007. If low or middle-income households were to find difficulties in serving their debt, their first line of defense would probably still be to refinance the conditions of their mortgages: innovation flourished in recent years and the government approved measures to facilitate mortgage switching. Highly indebted lower income households are in any case only 7 percent of the total.

Mr. Torres and Mr. Rojas submitted the following statement:

At the outset, we thank the staff for a well-written and focused report under the streamlined format used for this Article IV discussion, and Mr. Guzmán and Ms. Mira for their very informative buff. Streamlining has provided a means to conduct these discussions by narrowing the issues to the ones considered as key, as determined by the collaborative dialogue between the staff and the Spanish authorities. Such joint effort to focus on the relevant issues should continue to be exerted by the staff as a guideline for Article IV documents in general, not only for countries that have chosen to adopt the streamlined version.

Spain's economy has continued to deliver remarkable economic performance, characterized by GDP above potential output for a number of years, persistent job creation well above that of other EU countries, and ongoing fiscal consolidation initiatives, which has allowed for further reductions of the government debt to GDP ratio, thus improving the government's balance sheet. Going forward, the key policy issues are related to the fiscal policy role in the cycle, the impact of the current account level, and policy measures to enhance productivity which we will review in further detail.

Fiscal Policy

We commend the authorities for maintaining their continuous commitment in terms of fiscal consolidation, as evidenced by the 1.8 percent of GDP structural surplus for 2006. Though such surplus has been mostly the result of higher-than-budgeted tax revenues coming from the corporate capital gains, we commend the authorities for using this surplus to reduce the government debt-to-GDP ratio below 40 percent and to supplement the building-up of the social security reserve fund. Such policy decision will improve the overall balance sheet of the government, an effort which should be maintained and deepened in the medium term, so that fiscal policy can play a key countercyclical role whenever deemed necessary, given the current monetary policy stance of the European Central Bank (ECB).

We welcome the new Budget Stability Law and the rule it embeds. We note, however, that despite the official forecast of a 1 percent GDP surplus for 2007 seems to be well established, the staff remains concerned about the pro-cyclical stimulus of an increase in primary spending. We acknowledge the importance of having a tighter control of primary expenditure over the medium term as a way to enhance the rule's credibility but we note that in their buff, Mr. Guzmán and Ms. Mira, stress that expenditure increases have been allocated to investment in physical infrastructure, research and development (areas where the government could rather easily pace the actual disbursement of expenditures if needed), and also to education (key to increase productivity and raising from very low levels for European standards). In this regard, we would like to ask the staff to further elaborate on the likelihood of this scenario as it clearly differs from the authorities' views. We would also like to ask the staff to clarify the main features of the rule, which were presented in footnote 3 of the report.

Given the existing consensus on the importance of fiscal consolidation, the Budget Stability Law is a major breakthrough as it consolidates fiscal discipline and at the same time allows for a symmetrical response of the automatic stabilizers in each phase in the cycle. According to Mr. Guzmán and Ms. Mira, the targets for the overall government, as well as for the regional governments, have been set recently for the 2007-09 period at a 1 percent and 0.25 percent of GDP surplus respectively, providing a clear and transparent anchor for expectations in terms of fiscal policy over the medium term. The setup of the target will strengthen monitoring and follow-up of the degree of achievement of the set targets at the central government level as well as at the regional level.

Current Account Level

The staff correctly points out that the main risk to the Spain's expansion of last years is the large current account deficit due to the high indebtedness of the private sector. The main driver behind the worsening of the current account since 1998 has been the corporate sector, and lately the household sector has also contributed. It should be noted that the public sector was historically the main driver behind the current account deficit, however given the commitment and efforts of the authorities in terms of fiscal discipline, they now hold a surplus position, counterbalancing the deficit positions of the private sector. Given that Spain is a member of the EMU and has a strong financial sector, there are no foreseeable problems in terms of adequately financing such high current account deficits. However, the implications for the debt accumulation and its associated debt burden should be followed carefully.

It should be noted that such high current account deficits arise from the high borrowing needs of the corporate sector and recently household sectors. Such process of debt accumulation has taken place in the overall context of Spain's membership of the euro zone, and the associated positive externality in terms of lower borrowing costs as well as an easier ECB monetary policy stance overall which has gradually reverted only since last year. In this scenario, foreign savings have financed a dynamic investment process in housing and infrastructure, way above domestic savings. In explaining the reasons behind such dynamic investment process, we concur with Mr. Guzmán and Ms. Mira on the need to discern what the fundamental real factors behind the demand for housing market, such as demographic factors, higher family income, and interest of having a second house for vacation purposes by Spaniards as well as other European citizens are. Also investment in other services industries has taken place, such as the blooming of tourism and the European emulation of the "Florida model" (health and other services for pensioners), all of which required tapping foreign savings.

Going forward, and considering that devaluation is by definition ruled out from the euro area, the key question is then how would a scenario of tighter ECB monetary policy impact on debt-burdened families and corporations. It would be useful if the staff could provide a better description of debt in terms of its maturity structure as well as the terms (amortization schedule; fixed versus floating rates), for corporate as well as household debt, as a way to foresee the potential impact of interest rate increases on the overall debt burden of the household and corporate sector.

Policy Measures to Increase Productivity

The current account deficit also reflects the real exchange rate appreciation and deteriorating competitiveness as evidenced by the graphs of Figure 2 of the report, so further initiatives should be undertaken to regain competitiveness and enhance competition. In this regard, we welcome the authorities' plans to address improve productivity through enhanced competitiveness and competition, market liberalization to improve resource allocation and to encourage diversification of supply and greater technological content. We welcome the National Reforms Plan, which includes the Avanza Plan aimed at enhancing the information and communication technologies at all levels, the new Law that reinforces the Competition Board's independence, and the enhancement of competition in the energy sector through the removal of tariffs for gas and electricity, and measures to enhance competition in other sheltered markets.

We would like to highlight the initiatives undertaken to address labor market reform, such as the "Agreement for Improved Growth and Employment" of last year between the government and its social partners, as it represents a mutually agreed initiative to reduce the existing level of temporary employment in Spain, thus helping to reduce the existing duality of labor markets. We commend the authorities for taking the trouble to reform the labor market so as to provide greater flexibility without compromising social consensus and ultimately social cohesion.

The benefits of the previously mentioned initiatives to increase productivity will definitely be favored by the timing of those initiatives which could not be more appropriate given the likely increase in demand from the rest of the EU, the decline in inflation, export pick-up and recent evidence of incipient productivity gains in manufacturing.

With these comments, we wish the authorities success in their future challenges.

Mr. El-Khouri and Ms. Choueiri submitted the following statement:

We thank staff for a well-written report, and Mr. Guzmán and Ms. Mira for a comprehensive and insightful buff statement. Spain's macroeconomic performance, reflected in robust growth, strong job creation and a solid fiscal position, remained remarkable in 2006. While the strong performance continued to be underpinned by buoyant domestic demand, welcome signs of rebalancing of growth started to emerge. These are manifested in growing non-housing investment and exports, and a moderating expansion in private consumption and construction.

Notwithstanding these favorable developments, the continued high levels of private sector indebtedness and the current account deficit could pose risks for medium-term growth and employment prospects, possibly resulting from a pronounced private sector balance sheet consolidation. Accordingly, policy discussions rightly focused on policies directed at providing a soft landing scenario through "safeguarding budgetary stability while tempering demand; raising supply capacity and improving competitiveness; and keeping the financial sector strong." We note the divergence of views between the authorities and staff on the probability of the risk scenario materializing, despite agreement on the nature of the underlying risks. Given the streamlined consultation process, we wish to raise, in what follows, a few issues that we believe are of macroeconomic relevance and which might have merited a deeper elaboration, possibly through short selected issues papers.

Sustained economic growth, coupled with buoyant fiscal revenues, resulted in a strong fiscal performance in 2006. However, expenditure continued to increase—underpinned by investment and rising regional government spending—adding to demand pressures and contributing to a likely procyclical stimulus in 2007–08. In this context, we see merit in the staff's call for fiscal policy to be supportive of the economy's cyclical requirements, and more particularly, for greater expenditure restraint to contain demand pressures going forward. This is especially important given the expected time required to implement structural reforms aimed at reducing the inflation differential with euro area countries. In this regard, we encourage the authorities to define the central government expenditure ceiling in a way that maintains primary spending constant as a share of GDP. We welcome the authorities' intention that in 2008, the first year of the new Budget Stability Law (BSL), all levels of government, including the regions, contribute to the overall fiscal surplus.

We agree that preserving budgetary stability will require substantial strengthening of fiscal accountability at the regional and local government levels, in line with 2005 fiscal ROSC recommendations. In this regard, we would be grateful for staff's comments on progress in the revision of fiscal federalism┐ , which is aimed at better aligning regions' revenue-raising powers with their spending responsibilities. The staff report briefly indicates that further pension reform is required to ensure the sustainability of public finances over the longer term. While we take note of the recommendations provided in last year's staff report to render the pension system actuarially fair, it would have been helpful for staff to elaborate on the nature of the further pension reforms that would be needed to face the challenges of an aging population.

The comprehensive reform agenda embedded in the National Reform Program (NPR) elaborated by the authorities in 2005, clearly identifies the challenges related to Spain's loss of competitiveness and low productivity growth. Effective implementation of the NPR calls for particular focus on competition-based incentives to enhance the role of the private sector in research and development, and further deregulating sheltered sectors, with the removal of administrative and regulatory barriers to competition in distribution, energy, transport, and other services. This could contribute to the sustainability of the nascent pick-up in productivity witnessed in 2006. Continued employment gains in 2006, further marked by increased female and immigration participation, are particularly encouraging. The staff report alludes briefly to the need for reforms to enhance labor market flexibility, despite the unprecedented large immigration flows, which have "imparted a de facto flexibility to the labor market." In this connection, we would have welcomed further elaboration on the additional reforms needed to enhance flexibility, as well as on the impact of the large immigration flows on labor market segmentation, the evolution of temporary employment compared to the euro area average, and labor costs.

Alongside measures introducing flexibility in the product and labor markets, further information on developments in the housing market would have been helpful. The staff statement notes the recent stock market turbulence, reflecting a correction of the overvalued construction sector. In this context, while noting the assertion by Mr. Guzmán and Ms. Mira that the macroeconomic relevance of real estate overvaluation and related household indebtedness is grossly overestimated, we would welcome staff's views on potential risks of further correction in the property company stocks or in the property market as a whole. Staff's views on measures that might be needed to stabilize the market in case of a sharp correction would also be helpful.

With these remarks, we congratulate the authorities on Spain's strong economic performance and wish them success in facing the challenges ahead.

Mr. Rutayisire submitted the following statement:

We thank staff for a concise report and Mr. Guzmán and Ms. Mira for their informative buff statement.

The Spanish economy has maintained strong growth levels, well above those in the euro area, over the 2001-06 period. We commend the Spanish authorities for promoting a favorable macroeconomic environment that has enabled such performance. In 2006, growth—further rebalanced and broadened—was driven mainly by corporate investment and exports, and was less dependent on its traditional engines, consumption and construction. Employment continued to increase with high labor participation, including among women and immigrants. Amid this buoyant economy, inflation has been kept low thanks to the continued vigilance of the monetary authorities.

We note that, despite this positive outlook, the current account deficit is widening, private sector indebtedness increasing, and the economy approaching its potential. We urge the authorities to address these imbalances to avoid a hard landing of the economy. In this regard, we agree that the authorities will need to continue to temper budgetary demand, increase the country's supply capacity, and pursue the strengthening of the financial sector. Among issues of concern, we would like to underscore the sheltered sectors and protectionism that characterize the Spanish economy. We would like to emphasize the need to avoid any form of protectionism. Is not sector sheltering a violation of Fund's Articles IV which objectives include ensuring that members do not pursue policies that hamper trade? We would appreciate staff's comments on this issue.

On the fiscal front, we commend the Spanish authorities for strong implementation of prudent policies and for the resulting performance. On the revenue side, in 2006, high tax collection on corporate and capital gains has strengthened public finances and enabled the government to enjoy a surplus of 1.8 percent of GDP. This favorable fiscal outlook also helped Spain to reduce sharply its debt to below 40 percent of GDP.

On the expenditure side, the emphasis put by the authorities on "productive expenditure" is encouraging, as it sets the basis for future sustainable growth. Furthermore, awareness of—and wide support within the government for—budgetary stability will help keep expenditures in check. In this regard, we agree that meeting the central government expenditure ceiling and reviving reforms to place the pension system on a long-term sustainable path should maintain primary spending constant as a share of GDP. Furthermore, we share the view that greater fiscal transparency of territorial governments within a highly decentralized system is crucial to further improving fiscal governance and outlook. In this vein, regional governments should also target more ambitious surpluses.

Regarding the external position, we encourage the authorities to take appropriate actions to ease the debt burden and the subsequent current account deficit. We agree that private sector indebtedness has to be addressed within the broader perspective of the Spanish economy's competitiveness. Appropriate solutions to the pointed weaknesses of poor productivity performance, and resilient price and labor cost differentials with trading partners could strengthen corporate gains and help reduce indebtedness.

Turning to structural reforms, we note the authorities' program under the Lisbon agenda. Noticeable efforts have been made in providing public goods and activities with growth-enhancing externalities. However, we call on the authorities to speed up the implementation of the needed measures regarding labor market, competition in sheltered markets, and deregulation of energy tariffs. As outlined above, we pay particular attention to the issue of sheltered sectors on grounds of distorted and unfair trade. Furthermore, making progress in these areas overall will be key to improving the competitiveness of the Spanish economy.

We welcome the continued strengthening of the financial sector in 2006. Nevertheless, we urge the authorities to closely monitor the rapidly growing credit and the high degree of loan concentration in the real estate sector.

Finally, we commend the Spanish authorities for their support to low-income countries and their involvement in the development of Africa. Nevertheless, we urge them to further increase their ODA efforts which, at 0.29 percent of GNI in 2005, remain relatively low compared to those of other OECD countries.

With these remarks, we wish the Spanish authorities success in their challenging endeavors.

Mr. von Stenglin and Mr. Brinkmann submitted the following statement:

We thank the staff for a concise paper and Mr. Guzmán and Ms. Mira for their comprehensive and insightful buff statement. We broadly share the staff's analysis and recommendations.

Economic Performance and Outlook

Spain's economic growth remains impressive. On the back of dynamic domestic demand, the already strong economic growth accelerated in 2006. Buoyant job creation led to decreasing unemployment, and the robust fiscal position strengthened further. Moreover, the recent decline in the inflation rate and the productivity gains in manufacturing are welcome developments.

Overall, the economic outlook remains favorable, especially as growth appears to become more balanced. Yet, external imbalances and high private sector indebtedness in combination with the overpriced housing market pose risks to the expansion. While a soft landing of the economy is still the most probable outcome, there is certainly a risk that price developments in the real estate market could have adverse effects on the economically important construction sector and subsequently on other sectors of the economy. Over the medium term, a decline in net migration could also weigh on the potential demand for housing and, as a consequence, on residential construction. Staff's comments on recent developments in the real estate market and the outlook for this sector would be welcome.

Fiscal Policy

The authorities deserve credit for a prudent fiscal policy stance and a sound medium-term budgetary strategy which is in full compliance with the Stability and Growth Pact (SGP). Owing to stronger-than-expected revenues, the fiscal surplus was well above the target for 2006 and public debt was reduced to less than 40 percent of GDP. At the same time, it is currently difficult to assess whether the significant rise in tax revenues is mainly driven by cyclical or structural developments. Hence, the structural balance has to be interpreted with some caution.

Looking ahead, a procyclical fiscal policy stance should be avoided as real GDP growth is projected to stay above potential in 2007. Increases in primary expenditure should be limited, especially if the fiscal stimulus of the 2006 tax reform and of regional tax-cutting incentives turns out to be higher than expected. Expenditure discipline on all levels of the government will be important and should be underpinned by enhanced disclosure practices in regional and local governments. From 2008 onwards, the new Budget Stability Law should help to avoid a procyclical fiscal policy by ensuring that the automatic stabilizers operate symmetrically.

We welcome the authorities' commitment to maintain fiscal sustainability in the long term. While the current fiscal position is very comfortable, the budgetary impacts of an aging population are probably more pronounced than in other EU countries. As a consequence, further adjustments to the pension system appear to be unavoidable.

International Competitiveness

The development of Spain's international competitiveness remains a cause for concern. In past years, the current account deficit has continuously widened, the real effective exchange rate has appreciated, and unit labor cost growth has been stronger than in the euro area. Until recently, buoyant domestic demand has easily compensated for the weak export performance. Yet, with a high and still increasing debt level in the private sector, rising interest rates, and housing price increases projected to decline, the growth impetus from domestic consumption and investment is expected to weaken over the coming years. While the pick-up in export growth in 2006 is welcome, the contribution from net exports to GDP growth is projected to remain negative. Hence, implementing further structural reforms is necessary in order to foster international competitiveness and to achieve more balanced and sustainable growth in the medium term.

A further deceleration of the inflation rate will be necessary in order to halt the steady increase in the real effective exchange rate. Alongside a prudent fiscal policy stance, moderate wage increases that are in line with the development of labor productivity and not indexed to past price developments are key to contain the growth of unit labor costs and to dampen inflationary pressures. Moreover, structural factors behind inflation should be tackled forcefully. In this context, the deregulation of protected sectors remains an important issue.

A key factor behind the deterioration in competitiveness is Spain's poor productivity growth. While the recent increase in manufacturing productivity is encouraging, it will be crucial to achieve a sustainable and more broad-based improvement in labor productivity. The main reason behind the low-productivity growth in the past appears to be the large growth of low-skilled jobs in the service and construction sectors. In addition, there seems to be room for enhancing the sophistication of manufacturing production processes. Against this backdrop, the measures incorporated in the National Reform Program, including the substantial increase in public R&D and infrastructure spending, are timely. At the same time, we agree with the staff that the efficiency of this spending has to be monitored closely. Moreover, the authorities need to create the right setting for more private investment, including in R&D, in the economy as a whole. Increasing the flexibility of labor and product markets will be as important as the promotion of competition in sheltered markets, such as utilities and network industries. We share the authorities' opinion that the implementation of the EU services directive provides an important opportunity in this regard. Furthermore, we echo the staff's call for a clearer political commitment to contestable and open markets, and we encourage the authorities to fully apply EU regulations in the context of takeovers. Finally, since the information on structural issues in figure 4 date back to 2003, we wonder whether progress has already been made in this area in the meantime. Staff's comments would be welcome.

Financial Sector

The apparent strength and resilience of the financial sector is reassuring given the risks stemming from potential disruptions in the overvalued housing market. At the same time, the rapid credit growth and the growing exposure of banks to the real estate sector warrant close supervisory attention. In this context, it is noteworthy that the growth of credit to finance real-estate activities has implications not only for households, but also for private firms involved in construction and property development. Historically, cyclical downturns have created even more problems for the corporate sector than for the household sector. Hence, given the high level of non-financial private sector indebtedness, mainly at variable interest rates, prudent risk management and strict lending standards remain key in order to contain credit risks in case interest rates increase or housing prices decline significantly.

We appreciate the authorities' commitment to ensure that both the MiFID and BASEL II regulations become effective within their set deadlines.

Mr. Kishore and Mr. Mohanty submitted the following statement:

We thank staff their assessment and Mr. Guzmán and Ms. Mira for their comprehensive buff statement. The economy has shown considerable dynamism with GDP growth consistently remaining above the EU average. The fiscal surplus has increased and the inflation rate has moderated. However, persistence of a large current account deficit and increasing indebtedness of the private sector, particularly the household sector, pose major risks to the otherwise favorable outlook. We note that the authorities are in broad agreement with the staff assessment. We would focus our comments on some of the key issues.

The housing sector has been a major driver of growth in recent years. While the housing sector has started to slowdown, its adverse impact is yet to be felt in the overall GDP growth as non-housing investment and exports are looking up. However, the real effective exchange rate continues to remain overvalued reflecting the inflation differential with the euro area. Moreover, in order to maintain export growth, there is a need to further improve productivity. Hence, much would depend on the pick up in non-housing investment to offset the fall in household consumption. In this context, we would welcome staff comments on the prospects for non-housing investment in the medium term.

The slowing of the housing sector would have a significant impact on the household balance sheet. The household debt as a ratio of gross disposable income remains high. Mr. Guzmán and Ms. Mira indicate that households' indebtedness with respect to their wealth has remained stable over the recent years. However, if house prices were to decline, this ratio would increase. But ultimately it is the capacity to service the debt which is important, and the debt-service ratio is projected to rise. Further, the stocks of construction companies have also started to decline reflecting the slow down. The authorities, therefore, need to remain vigilant to address vulnerabilities arising out of the housing market.

Another area of concern is the continued deterioration of the current account deficit. While GDP growth is expected to slow reflecting the spillover effects from the housing market, the current account is not expected to improve. Ideally, within a currency union, deficits and surpluses among member countries should not matter. But there could be practical limits up to which markets may be willing to finance large deficits. In this context, we would welcome the staff's views on the implications of high levels of current account deficits.

We commend the authorities for their prudent fiscal management, which is reflected in increase in surplus. In terms of expenditure, the emphasis has rightly been on investment in physical infrastructure and education. However, the likely moderation of GDP growth could adversely affect revenue buoyancy. Hence, we tend to agree with the staff that, in the medium term, a expenditure-based countercyclical fiscal stance could be more appropriate. There is also a need to improve fiscal transparency of territorial governments, and in the reporting of off-budget operations.

The financial system remains profitable and well capitalized. With a slowing housing market, the banks could be adversely affected given the concentration of loans in the real estate sector. We are encouraged that the process is underway for implementation of Basel II and the EU Directive on Markets in Financial Instruments (MiFID). This would strengthen risk management practices in the banking sector and facilitate further integration of the financial sector.

With these comments, we wish the authorities success in their policy endeavors.

Mr. Gakunu and Mr. Uanguta submitted the following statement:

We thank the staff for the well written and concise paper and Mr. Guzmán and Ms. Mira for their insightful buff statement. We commend the Spanish authorities for the impressive economic performance anchored on sound macroeconomic and structural policies which they have put in place over the past decade. Some indicators of strong performance have included robust GDP growth, rapid employment expansion, a significant deceleration in inflation, a pick up in manufacturing productivity, and a strong fiscal outturn. We encourage the authorities to sustain the implementation of measures, which have contributed to these achievements for further improvement of the living standard of the populace.

Notwithstanding the progress made, some significant challenges/risks remain. Among the main risks to the economy are high private sector indebtedness, high and growing current account deficit and weak competitiveness stemming largely from low productivity. We welcome the efforts to rebalance the sources of growth, away from consumption to corporate investment and exports, as a positive development that would help address external imbalances. The authorities' commitment to achieve this objective through boosting productivity growth and enhancing competitiveness, while maintaining high rates of employment is a step in the right direction. It is encouraging to note that authorities and staff are in agreement on policies needed to address the root causes of the external imbalance and ensure a continuation of sustainable growth over the medium term. The authorities' National Reform Program under the Lisbon agenda seems to be appropriate in addressing some of the structural bottlenecks that face the economy.

Fiscal Policy

It is encouraging to observe that the authorities place high priority on sustaining fiscal stability in the medium and long term. In this regard, we welcome the convergence of views between the authorities and staff on fiscal consolidation and the application of the new Budget Stability Law. We agree with staff that strengthened transparency and improved monitoring of the budget process remain the most effective means to secure fiscal discipline at all levels of government, particularly at the regional and local government levels. There is also merit in staff's recommendation that given the long-term rise in age- related public spending, further pension reform beyond that agreed in 2006, is necessary to preserve budget stability now and beyond.

Monetary and Financial Sector Policy

Notwithstanding the financial sector resilience, characterized by low intermediation margins, well-capitalized and professionally managed institutions, the authorities' commitment to further strengthen the prudential framework is a commendable effort. We encourage the authorities to continue implementing FSAP recommendations, as keeping the financial sector strong remains key to sustaining continued investment and growth. We note that the recent stock market turbulence in the construction sector, with some spillover to banks, needs some measured attention. The staff's comment on the extent of banks' exposure to the construction sector and the risk thereof would be appreciated.

Structural Reforms

We encourage the authorities to step up competition-enhancing efforts, and to ensure the required full political backing for finalizing pending economic legislation aimed at facilitating the role of private sector in the economy. Such reforms, in our view, are crucial in addressing the current supply constraints as well as improving the country's competitiveness.

With these remarks, we wish the authorities success in their reform endeavors.

Ms. Lundsager and Ms. Pollard submitted the following statement:

Spain's economy continued its strong performance in 2006—output growth accelerated, employment growth was robust, the fiscal surplus increased, and inflation moderated. Moreover, there are preliminary signs that growth rebalancing may be occurring with private consumption and residential investment slowing. Staff's view that economic growth will moderate toward potential appears reasonable.

In light of these developments, the staff highlights the risks to the outlook and emphasizes three policy priorities to minimize the risks: safeguarding budgetary stability; raising supply capacity and improving competitiveness; and, maintaining the strength of the financial system. These are sound recommendations regardless of whether one shares the staff's or the authorities' views on the likelihood of a less than benign growth outcome.

The Budget Stability Law (BSL) appears to be well designed to ensure that fiscal policy is counter-cyclical going forward. We would, however, appreciate more details on the final version of the BSL, particularly whether capital expenditures are excluded. We also agree with the staff that stronger mechanisms to monitor fiscal discipline, particularly in the regional governments, are needed.

The staff report notes that the improved budget performance of recent years has been driven by rising revenues (reflecting the strong economy), as government expenditures have increased. We support the authorities' emphasis on increasing expenditures for investment in infrastructure, R&D activities and education, as noted by Mr. Guzmán and Ms. Mira. At the same time, we see merit in the staff's recommendation to keep primary spending as a share of GDP constant. Meeting both goals may require a concerted effort at expenditure switching. We note the staff's call for a thorough review of the efficiency of priority investment expenditures and would like the staff's views on whether it sees areas of concern.

The staff's view that the real effective exchange rate is overvalued appears reasonable. The exchange rate analysis underscores the need for further productivity enhancements. Even if one disagrees with the assessment that the exchange rate is overvalued, as do the authorities, the policy recommendation is sound and will improve external competitiveness, as well as the growth prospects for the economy.

We concur with the staff that more needs to be done to increase the flexibility of labor markets. Spain has recorded high employment growth in recent years but mostly through the creation of fixed-term employment contracts. The Agreement for Improved Growth and Employment, highlighted in the statement of Mr. Guzmán and Ms. Mira, aims to reduce fixed-term employment through subsidies for permanent contracts and a measure that temporarily allows firms to convert fixed-term contracts to permanent employment with lower severance costs. We believe that reform measures should focus directly on the factors that drive fixed-term employment contracts—including the high cost of employment protection regulations. Loosening labor market restrictions would end the substantial cost advantage of fixed-term employment contracts, providing a greater incentive for firms and workers to invest in job training.

Staff sees the high household indebtedness as a risk to the economic outlook rather than only a financial stability concern. We agree that it appears that the financial sector could withstand a wide range of financial shocks. However, we would like to have seen an analysis of the effects on the financial sector of a significant housing price correction or a large increase in interest rates (as most mortgages are financed at adjustable rates).

Mr. Prader and Mr. Crelo submitted the following statement:

We thank Mr. Guzmán and Ms. Mira for their comprehensive buff statement, which was a useful complement to the staff report. We have some comments on the latter and the streamlined consultation at the end of our statement.

We broadly concur with the statement by Messrs. von Stenglin and Brinkmann and confine our remarks to a few points for emphasis.

Economic Developments

In 2006, Spain's real GDP grew by about 4 percent, an impressive performance enabled to a large extent by the open stance adopted by Spain on immigration. Employment continues to grow at a strong pace, exports are rebounding and an important rebalancing of economic growth, away from the construction sector, is taking place. Nonetheless, a lack of competitiveness and bullish consumer confidence has further widened the current account deficit. Mr. Guzmán and Ms. Mira believe that this trend has been somewhat reversed due to an increase in exports and abating oil prices. However, the staff projections point to a further widening of the current account deficit over the coming two years. While inflation has recently come down, the inflation differential with the euro area still hovers around 0.6 percent, contributing, as agreed by Mr. Guzmán and Ms. Mira, to competitiveness problems. Hence, liberalizing sheltered markets, boosting productivity growth and keeping labor costs in check will be pivotal in regaining competitiveness. In their buff statement, Mr. Guzmán and Ms. Mira state that the competitiveness problem in the Spanish export model is also partially due to the strength of the euro. We would be interested on how important this factor really is as Mr. Guzmán and Ms. Mira explain that exports have increased considerably, especially in non-EU countries.

As noted by the staff, the main factor clouding Spain's promising economic trajectory is the high level of household indebtedness. While the high level of provisions would shield the financial sector from an increase in non-performing loans, the question is whether a tightening stance in monetary policy combined with a concomitant fall in housing prices would render the high level of household indebtedness unsustainable. The fact that the ratio of indebtedness to wealth has been relatively stable over the last ten years is not a guarantee that it will remain so in the future. Whether non-housing financial assets would continue to constitute a buffer if housing prices dwindled is unclear. Mr. Guzmán and Ms. Mira offer us a more nuanced analysis on which we would appreciate the staff's comments. Given the importance of the housing market in Spain and the potential impact on growth, a thorough balance sheet analysis would have been warranted. This topic could have been covered in a second appendix similar to the one dedicated to immigration. Potential spillover effects for neighboring countries in case of a sharper-than-expected downturn in the housing market could also have been dealt with.

Mr. Guzmán and Ms. Mira explain that rising housing prices were driven mainly by supply side constraints, notably the rigidity in the supply of land. We would be interested in knowing whether some additional measures can reasonably be expected to alleviate that pressure.

Fiscal Policy

We commend the Spanish authorities for their good performance in managing their public finances. The fact that the 2006 surplus has been used for a further reduction of the public debt and for a new endowment to the Reserve Fund of the Social Security is particularly welcome. Thus, it comes as no surprise that the Council of the European Union, in its recent assessment of Spain's Stability Program, considered that the medium-term budgetary position was sound and that the fiscal strategy provided a good example of fiscal policies conducted in compliance with the Stability and Growth Pact (SGP). Nonetheless, the Council has also stressed that an expansionary fiscal stance should be avoided against the backdrop of growing external imbalances, partly driven by the inflation differential with the euro area. Like the staff, we encourage the authorities to continue their efforts in strengthening the mechanisms allowing for fiscal discipline and transparency in a highly decentralized system.

The solid fiscal performance is due to the higher-than-expected tax revenues driven by strong job creation and buoyant corporate profits. At the same time, current expenditures have continued to rise. We agree with the staff that fiscal policy should remain cautious and that the first application of the new Budget Stability Law should send the right signal. Nonetheless, one of the pillars of the Stability Program, in line with the National Reforms Plan (NRP), is to foster lagging productivity by increasing infrastructure as well as human and technological capital. As we understand that the staff is broadly supportive of the NRP and that the rise in primary expenditures is partly offset by a reduction in the public debt service, we would welcome staff's comments on the arguments laid out by Mr. Guzmán and Ms. Mira.

As noted by the staff, the long-term sustainability of public finances will hinge to a large extent on preparing for population aging. Age-related expenditure is expected to rise by nearly 9 percentage points of GDP over the long-term. According to the European Commission, the long-term budgetary impact of aging in Spain is well above the EU average. Despite the current fiscal surplus and the decreasing public debt, further pension reform is needed to achieve long-term fiscal sustainability. We would welcome the staff's views on the related measures taken by the Spanish authorities.

Other Issues

We would welcome the staff's comments on whether they consider progress made in the financial system and on the structural reform agenda, as described by Mr. Guzmán and Ms. Mira, as satisfactory. More particularly, on the financial system, could the staff please elaborate on the reasons why the transfer of insurance supervision from the Ministry of Economy to the central bank and the Securities Commission has stalled?

We hope it was not word count that has prevented the staff from informing the Board about the contribution of Spain to Official Development Assistance (ODA).

In the WEO, Spain is one of the countries of the euro area, together with Germany, France and Italy, to take a more prominent place in the statistical appendix. We believe that this was because Spain is considered to be a systemically important country in the region. Therefore, it is surprising that Spain has been chosen to undergo a streamlined Article IV consultation. We would like to know the rationale behind this asymmetric approach. The report is very terse and leaves aside deeper analysis on key issues like the housing market or the pension reform. Also, the insightful buff statement by Mr. Guzmán and Ms. Mira brings some important and nuanced information to the table, which is not included in the staff report. Under such circumstances, we consider it difficult to make an informed assessment. In the same vein, we wonder what the value added is of such a clipped report for outside readers. We would appreciate it if the staff could give us a candid view whether they too share our frustrations in this regard.

With these remarks, we wish the authorities all the best in their endeavors.

Mr. Bakker submitted the following statement:

Key Points

- Imbalances in the economy are becoming an increasing risk to the medium-term growth outlook.
- Like staff, we believe that further fiscal reforms are needed to prepare for the costs of population ageing.

- Mortgage lending to the riskier segments of the market has increased recently and a rising interest rate poses risks, especially to the mortgage payments of lower-income families as a large proportion is financed at floating rates.
- Fostering competition in sheltered sectors and increasing flexibility in labor markets are necessary steps to deal with the lagging productivity growth.

Rebalancing of Growth

The performance of the Spanish economy has been remarkable with 13 consecutive years of strong growth. The cool down of the housing market, the slowdown in consumption growth and the strengthening of exports might be indications of an awaited rebalancing of growth. On the other hand, the external position deteriorated further last year, with the current account deficit reaching a record value of 8.8 percent of GDP in 2006. We share staff's concerns about the low productivity growth that—together with relatively high inflation—has led to a steady decline in competitiveness. These imbalances in the economy are posing an increasing risk to the medium-term growth outlook.

Fiscal Policy

Favorable economic conditions and a strengthening of the fiscal framework led to a commendable fiscal surplus in 2006 for the third year in a row. With primary spending still rising as a percentage of GDP, this achievement mainly came from higher tax revenue. Taming domestic demand is needed to put Spain on a more balanced growth path, but, as underlined by staff, the 2006 tax reform and planned additional spending can effectively serve as an unwanted pro-cyclical stimulus in the coming two years. Further reforms to ensure long-term sustainability of public finances are needed, given the projected costs of population ageing. The large budgetary implications of ageing stem from a relatively generous pension system and a large demographic burden.

Housing Market

There are welcome signs of a soft landing in the housing market. However, with house prices still overvalued by up to 30 percent (according to OECD estimates), we see significant risks associated with an abrupt adjustment in house prices. Indeed, the recent crash in Spanish real estate stocks might signal the end of the construction boom.

We agree with staff that the situation in Spain differs from the housing market problems in the United States, but we do see some important parallels. Although mortgages in Spain are predominantly issued by banks under tight supervision and the sub-prime market plays no important role, mortgage lending to the riskier segments of the market has increased rapidly over the last couple of years. With interest rates on the rise, the growing debt burden could become a serious problem, especially for lower-income families. With most mortgages in Spain having floating interest rates, homeowners are relatively vulnerable to interest rate rises.

The staff is right that the main risks stemming from a slowdown in the housing market are associated with the growth outlook rather than with financial stability. Although private indebtedness has increased rapidly (and is projected to increase further in the coming years), the financial system is considered resilient enough to deal with large adverse shocks. Economic growth, however, could be seriously hampered by a correction in the housing market. Since the construction sector makes up as much as 15 percent of GDP, a slowdown in the housing market that brings about a correction in construction activity could significantly alter the current positive growth outlook.

Financial Sector

The staff mentions competition-promoting activities. In light of their increasing importance, we believe that the special status of the savings banks, Cajas, should be reformed in order to increase competition. The 2006 FSAP gives increased attention to regulation, supervision and governance of the savings banks. Also, a number of recommendations were made on possible reforms: implementation and strengthening regulation on corporate governance; promoting new means to raise high-quality capital; allowing savings banks to merge freely; and reducing the public sector representation ceiling. Could staff comment on the stage of implementation of these recommendations?

Labor Market Reforms and Productivity Growth

We agree with the staff that the lack of competition in sheltered sectors and rigidities in labor markets are important contributors to the productivity problem. The 2006 Labor Market Reform was a step in the right direction, but we agree with staff that further reforms in the labor market are necessary to restore competitiveness. Besides the pension reforms mentioned by staff, we believe further reforms concerning the use of different types of labor contracts should be implemented, since these are directly related to labor productivity.

The increasing number of collective agreements that include inflation catch-up clauses is of concern. These collective agreements contain very broad extension clauses, restricting wage differentiation between firms with different productivity levels and further increasing nominal wage inertia. Given the need to readjust the economy to a more stable growth path and improve competitiveness, wage bargaining reforms are necessary. In particular, we believe a move towards decentralization and more flexibility would contribute towards restoring competitiveness, with wages growing in line with productivity.

Mr. Al-Nassar submitted the following statement:

I thank the staff for a well-written report and Mr. Guzmán and Ms. Mira for their comprehensive buff statement. The Spanish economy continues to perform well. Last year, output growth strengthened further, the inflation differential with the euro-area average narrowed, job creation continued at a robust pace, the general government balance turned into a record surplus, and the public debt-to-GDP ratio declined further. It is also encouraging that demand composition has shown some signs of rebalancing with the pickup in non-housing investment and exports.

Credit for the continued impressive economic performance in Spain goes to sustained macroeconomic prudence as well as the wide-ranging reforms to enhance the flexibility of the economy. Looking ahead, while the near-term prospects are highly favorable, downside risks to a soft landing underscore the need for continued vigilance. In this regard, the staff notes that high private sector indebtedness and the related large current account deficit remain the main risk to the positive outlook. Against this background, I agree that the key priorities are to safeguard budgetary stability, raise supply capacity and improve competitiveness, and keep the financial sector strong.

On the fiscal front, I compliment the authorities for achieving a record surplus last year, reducing debt further to below 40 percent of GDP, and continuing to build up the social security reserve fund. I am also encouraged that the strong fiscal performance continued in the first quarter of this year. While buoyant revenues continue to boost the fiscal accounts, it is important to contain primary spending that has been rising steadily over the last few years. It is also essential to ensure fiscal discipline at the regional and local government levels, which account for a large share of government spending.

The new Budget Stability Law contains a number of positive features, especially its emphasis on greater countercyclical flexibility, and I look forward to its first year of application in the 2008 budget. I also welcome the authorities' cognizance of the need to build on the reform of the Pension System agreed between the government and the social partners in July 2006 to help mitigate the long-term fiscal implications of population aging. In addition, timely implementation of the agreed measures with the regional governments on healthcare should help contain the rapid growth in public spending.

Turning to the financial sector, I welcome the assessment that the financial system remains dynamic, well capitalized, and profitable. I am also encouraged that preparations are underway for the implementation of Basel II and the EU Directive on Markets in Financial Instruments. Moreover, it is reassuring that mortgages are predominantly issued by banks subject to tight prudential supervision and strict lending standards. That said, continued vigilance is essential in view of rapid credit growth and large exposures to the real estate sector.

In the structural area, efforts should continue to improve productivity, competitiveness, and dynamism of the economy. In this regard, while progress has been made in enhancing product market competition, further measures to foster competition in sheltered markets remain a priority. It is also important to further improve flexibility in labor markets by building on the 2006 labor market reform, which focused primarily on reducing the incidence of temporary contracts.

With these remarks, I wish the authorities continued success.

Mr. Kashiwagi and Mr. Yamasaki submitted the following statement:

We welcome the continued and more balanced expansion of the Spanish economy, while cautioning that development in the real estate market still warrants the authorities' vigilance. The economy has grown thanks to buoyant private consumption, business investment, and increasing exports. While interest rate hikes in 2006 seem to have contributed to cooling down both real estate investment as well as private consumption, we nevertheless encourage the authorities to continue monitoring closely developments in the real estate market. Given our own experience, it would be prudent to bear in mind that the existence of an asset bubble may not be easily identified, until it bursts, at which point it would have a substantial adverse impact on the entire economy.

We commend the authorities for their prudent fiscal policy management that resulted in achieving a fiscal surplus in 2006, and support the planned increase in expenditures, including Research and Development, presented in the 2007 budget, aimed toward raising the country's productivity and competitiveness over the medium term. Given the fact that parliamentary elections are scheduled to take place in 2008, a key factor in policy management will be the authorities' continued success in maintaining strong fiscal discipline under the Budget Stability Law and stave off pressure to further increase expenditures.

We agree that the country's strong and competitive financial system has underpinned economic expansion, yet we concur with staff in calling for close monitoring of the observed rapid growth in credit and the concentration of loans within the real estate sector.

While the authorities should be commended for having reached the "Agreement for Improved Growth and Employment," we agree with the staff that competition-promoting efforts should be stepped up and underpinned by strengthened political commitment. In this regard, we are pleased to note the continuous progress made in the reform of the Pension System and control of health-related expenditures.

With these remarks, we wish the authorities success in their future endeavors.

Ms. Xafa and Mr. Cardoso submitted the following statement:

We thank staff for the focused report which rigorously documents Spain's strong macroeconomic performance, and Mr. Guzmán and Ms. Mira for their insightful and comprehensive buff statement.

The Spanish economy gathered pace in 2006 from the already prolonged economic expansion that has turned Spain into one of the driving motors of the euro area. GDP growth accelerated for the fourth year running, reaching an impressive 3.9 percent. Rapid growth and prudent fiscal policy have produced budget surpluses that helped reduce the public debt ratio to below 40 percent of GDP from more than 60 percent when the euro was adopted. We commend the Spanish authorities for their accomplishments, which can be a case study for European reform efforts.

However, some, yet distant, clouds are appearing on the horizon, which make it vital for the Spanish authorities to seize the opportunity of the current economic expansion to deepen the structural reform agenda. With the housing market projected to slow, rising interest rates and the pick-up in euro area growth are helping to rebalance demand toward the export sector. This rebalancing could be supported by product market deregulation and further labor market reform to help improve productivity and address the structural factors underlying Spain's relatively high inflation.

The Real Economy and Competitiveness

Strong job creation and rising real incomes prevented private consumption from cooling significantly in 2006, despite rising euro area interest rates. Construction investment remained robust, even though overall investment growth slowed somewhat. Exports benefited from the recovery of the EU economy, but strong growth fueled an even stronger increase in imports, leading to a widening of the current account deficit. The deficit is set to widen further in 2007-08, and the negative contribution of net exports to growth is projected to remain large. As we can ascertain from the staff report (Figure 2), oil prices and Spain's cyclical position justify only partially the deterioration in the current account, as about one third of the deficit was attributed to unexplained factors. Does a deterioration in competitiveness account for the residual? Staff comments would be welcome.

The staff makes a convincing case on the need to raise the economy's supply capacity and to improve competitiveness while tightening the fiscal stance in order to contain demand pressures. Inflation has systematically exceeded 3 percent, well above the euro area average, gradually eroding Spanish competitiveness. The draft Competition Law is a step in the right direction insofar as it would promote competition if fully implemented. Transposing the EU Services Directive also would help open up sheltered sectors to competition.

Fiscal Policy

For the third consecutive year, Spain recorded a general government surplus in 2006 (1.8 percent of GDP, up from 1.1 percent in 2005)—the third largest surplus of the euro area. According to the staff report, in 2006 the structural balance was identical to the overall balance. By contrast, in its

Spring 2007 economic forecast, the Commission estimates the structural balance at 2.3 percent of GDP in 2006. We would welcome staff comments on the reasons for the difference between the staff and Commission's calculations of the structural balance of the general government. To what extent is it due to uncertainty in distinguishing between cyclical and structural components in tax revenues?

A higher-than-expected GDP growth gave rise to buoyant corporate tax revenues which, along with substantial capital gains taxes, were the two most important factors behind the strong revenue performance. Not so good, according to the staff, has been the behavior of primary expenditures, which has been on a rising trend. We share, to some extent, Mr. Guzmán and Ms. Mira's remarks in their buff statement and note that current expenditures have been constant relative to GDP in the past three years. However, we agree with staff that a thorough review of the efficiency of the "productive expenditure" (mainly R&D and infrastructure) is needed to assess its effectiveness. Such a review is all the more important since some capital spending is exempt from the discipline imposed by the new Budget Stability Law.

We note the staff concerns and the Spanish authorities' divergent position regarding the risk of "untimely procyclical stimulus in 2007-2008" (Paragraph 5). We welcome the new Budget Stability Law that will enter into force in 2008. Like staff, we believe that the authorities should use the favorable cyclical position to withdraw fiscal stimulus. The staff proposal to keep primary spending constant as a share of GDP starting in 2008 would help anchor budgetary spending, and would involve a modest tightening (compared to the rising primary spending trend of recent years) that would help cool demand, dampening inflation pressures and safeguarding competitiveness.

We agree with staff that in such a decentralized fiscal system (where regional and local governments account for over 75 percent of government spending excluding social security), strengthened transparency and monitoring is required to secure discipline. We also see a useful role for independent assessments of fiscal policy plans and outturns at the various levels of government. Looking forward, we welcome the involvement of regional and local governments in the fiscal consolidation effort, but question the ad hoc nature of such involvement. After 2008, what is the authorities' intention regarding the consolidation of the fiscal accounts at this decentralized level?

Though we recognize that it is a streamlined consultation, we regret the scarcity of data on the social security system and would have preferred a more thorough explanation of the staff's affirmation in paragraph 7 that "preserving budgetary stability will require further pension reform, beyond that agreed in 2006—a point recognized by the authorities." We also wonder to what extent the large inflow of immigrants has helped ease the long-term fiscal pressures from an aging population.

External Accounts and Financial Sector

Public saving is very far from being sufficient to offset the huge private sector indebtedness that has resulted in rising current account deficits, which have further deteriorated the net international investment position to -57.9 percent of GDP. While this does not seem to raise financial stability concerns, it could adversely affect the economic outlook through wealth effects if the housing market slows down more than is currently expected.

Spain's financial system is dynamic, well capitalized and profitable. Nevertheless, we urge close attention to the risks related to the booming credit to the housing market and the sophisticated new credit vehicles. We regret the standstill on the transfer of insurance supervision from the Ministry of Economy to the central bank on solvency issues and to the Securities Commission on consumer protection. We welcome Mr. Guzmán and Ms. Mira's statement that the preparations for MiFID and Basel II have gained a new momentum.

Structural Reforms

The capacity to implement the necessary structural reforms will be the biggest challenge for the Spanish authorities in the current juncture of less than one year to the March 2008 Parliamentary elections. There is the risk that unpopular measures, such as pension and labor market reforms, will be postponed during this interim period. It would be regrettable if the reforms are not undertaken during the cyclical upturn.

As discussed above, structural reforms are also necessary to foster competition and to deregulate sheltered sectors, with the removal of administrative and regulatory barriers for competition. We regret that the lack of openness of the Spanish market has led the EU Commission to initiate two infringement proceedings against Spain and we urge more independence and resources to the competition authority and sectoral regulatory agencies.

Ms. Agudelo and Mr. Santana submitted the following statement:

We thank the staff for an informative report and Mr. Guzmán and Ms. Mira for their inclusive and detailed buff statement.

Spain's economy kept its remarkable expansion in 2006, extending it to 13 years of uninterrupted positive growth. Productivity in manufacturing sectors continued to grow, inflation declined, job creation remained strong, non-housing investment picked up, export growth reduced the external drag on the expansion, and revenue buoyancy favored the general government balance which posted a record surplus.

High private sector indebtedness and large current account deficit seem to be the most threatening imbalances accumulated through the current expansion. However, we see merits in the argument raised by the authorities about the counterbalancing effect of the factors pointed out by them. On one hand, particularly important are the recent manufacturing productivity gains which, together with the reduction of inflation and the positive export shock, point out towards a sound medium-term outlook. On the other hand, the profound structural changes that took place in the labor market have impacted in a very positive way the supply capacity. The impact of immigration on labor market's flexibility has constituted an astounding positive shock on growth. Thirty percent of the GDP's growth in the last decade and 50 percent in the last five years can be traced back to immigration, a result that should encourage other developed countries to revise their current immigration policies. We welcome the details offered by Mr. Guzmán and Ms. Mira on the characteristics of private sector indebtedness. These evidences lead us to share the view of the authorities that the riskier scenario is less likely to materialize.

On fiscal policy, the new Budget Stability Law will be applied in 2008 and we commend the intention of the authorities to implement it along with a countercyclical spending stance. The three major guidelines of fiscal policy, favoring productivity-oriented expenditure, contributing to financial stability over the economic cycle, and guaranteeing long-term sustainability of public finance, seem the right choices for the historical moment of the Spanish economy. Even though several issues remain to be tackled with respect to transparency and monitoring of fiscal expenditure, the continuing efforts taken by the authorities in those areas are praiseworthy, as, for example, the creation of a government agency that has as one of its duties the review of the efficiency of productive expenditure and the ongoing census of all regional public entities.

The potential effect of the desacceleration of the real state market on the financial sector health has attracted some attention. Therefore, it is reassuring to observe that the issuance of mortgages is predominantly handled by well supervised banks subjected to strict lending standards. We take note of the authorities' intention to apply the strictest Basel II requirements to banks' large industrial participation, as recommended in the FSAP.

Finally, we expect that the authorities' well formulated National Reform Program under the Lisbon Strategy keeps gaining momentum beyond those areas on which it has focused until now—government provision of public goods and activities with growth-enhancing externalities towards fostering competition.

With these comments, we wish the best to the authorities in their future undertakings.

Ms. Sucharitakul and Mr. Eng submitted the following statement:

We thank the staff for an informative report and Mr. Guzmán and Ms. Mira for their inclusive and detailed buff statement.

Spain's economy kept its remarkable expansion in 2006, extending it to 13 years of uninterrupted positive growth. Productivity in manufacturing sectors continued to grow, inflation declined, job creation remained strong, non-housing investment picked up, export growth reduced the external drag on the expansion, and revenue buoyancy favored the general government balance which posted a record surplus.

High private sector indebtedness and large current account deficit seem to be the most threatening imbalances accumulated through the current expansion. However, we see merits in the argument raised by the authorities about the counterbalancing effect of the factors pointed out by them. On one hand, particularly important are the recent manufacturing productivity gains which, together with the reduction of inflation and the positive export shock, point out towards a sound medium-term outlook. On the other hand, the profound structural changes that took place in the labor market have impacted in a very positive way the supply capacity. The impact of immigration on labor market's flexibility has constituted an astounding positive shock on growth. Thirty percent of the GDP's growth in the last decade and 50 percent in the last five years can be traced back to immigration, a result that should encourage other developed countries to revise their current immigration policies. We welcome the details offered by Mr. Guzmán and Ms. Mira on the characteristics of private sector indebtedness. These evidences lead us to share the view of the authorities that the riskier scenario is less likely to materialize.

On fiscal policy, the new Budget Stability Law will be applied in 2008 and we commend the intention of the authorities to implement it along with a countercyclical spending stance. The three major guidelines of fiscal policy, favoring productivity-oriented expenditure, contributing to financial stability over the economic cycle, and guaranteeing long-term sustainability of public finance, seem the right choices for the historical moment of the Spanish economy. Even though several issues remain to be tackled with respect to transparency and monitoring of fiscal expenditure, the continuing efforts taken by the authorities in those areas are praiseworthy, as, for example, the creation of a government agency that has as one of its duties the review of the efficiency of productive expenditure and the ongoing census of all regional public entities.

The potential effect of the deceleration of the real state market on the financial sector health has attracted some attention. Therefore, it is reassuring to observe that the issuance of mortgages is predominantly handled by well supervised banks subjected to strict lending standards. We take note of the authorities' intention to apply the strictest Basel II requirements to banks' large industrial participation, as recommended in the FSAP.

Finally, we expect that the authorities' well formulated National Reform Program under the Lisbon Strategy keeps gaining momentum beyond those areas on which it has focused until now—government provision of public goods and activities with growth-enhancing externalities toward fostering competition.

With these comments, we wish the best to the authorities in their future undertakings.

Mr. Larsen and Ms. Farrant submitted the following statement:

We thank staff for a helpful, concise report that is well focused on the key issues facing the Spanish economy. As staff note, Spain has enjoyed a prolonged economic expansion, with growth consistently outperforming the euro-area average. That has conferred real economic benefits, with standards of living catching up to, though still lagging, the euro-area average; and unemployment reaching its lowest rate in over thirty years, all the more remarkable given the substantial increase in labour supply due to immigration. That said, the rapid expansion has created some underlying imbalances, as revealed by the large current account deficit and the high levels of household and corporate indebtedness. These imbalances create a number of potentially significant downside risks. The staff paper does a good job of outlining how these imbalances may be addressed. We also thank Mr. Guzmán and Ms. Mira for their informative buff statement. We support many of the points raised by Mr. von Stenglin and Mr. Brinkmann and have only a few comments to add.

While we recognise that this report was streamlined, some discussion of spillover effects would have been helpful. In particular, in staff's analysis of risks to the outlook, the implications of a sharper-than-expected slowdown in the United States, a faster tightening in euro-area interest rates and a stronger-than-forecast growth rebound in Germany could all have been usefully considered. In addition, the expected impact of a sharper-than-expected slowdown in Spain on the rest of the euro area could also have been discussed.

Underlying Imbalances and Risks

Spain has experienced rapid growth in house prices, which has created vulnerabilities. So far, the slowing in house price inflation has been well contained, in part because the supply side has responded. It would be helpful to hear staff's views on the implications for the construction sector of slowing house prices, not least because it now represents over 15 percent of GDP. There will also be fiscal implications from a slowing housing market and we would be interested to hear staff's views on this.

Despite this supply response, downside risks remain and the staff report illustrates that low and middle-income households appear particularly indebted, which could exacerbate such risks. Mr. Guzmán and Ms. Mira's buff statement highlights that the authorities consider the bulk of the past rises in house prices to be explained by fundamentals. While recognising the inherent difficulties in drawing such conclusions, we would be interested to hear from staff whether they share that view.

Spain's product mix and specialization in more traditional sectors have made it particularly vulnerable to competition from more dynamic, emerging markets. The relatively fast pace of unit labor cost growth has also undermined competitiveness. Nevertheless, the staff expects export market growth to continue at the same rapid rate in 2007 and 2008 as it did in 2006, despite some slowing in the world economy, including the euro area. Could staff expand on why that is the case and, in particular, to what extent it reflects an expected rise in Spanish competitiveness?

This lack of competitiveness, which is partly responsible for the widening current account deficit, places great emphasis on the need for flexible product and labor markets and other structural measures to improve competitiveness. Such measures are essential if Spain is to ensure a soft landing. We welcome the reassurances in Mr. Guzmán and Ms. Mira's buff statement on the authorities' commitment to address these competitiveness issues and to liberalize markets. We support the authorities' efforts to increase research and development. Nevertheless, we share staff's views on the importance of a clearer political commitment by the government to contestable and open markets. That includes an urgent need to reinforce the independence of Spain's regulators.

Migration

The staff report usefully summarizes a recent report by the authorities on the characteristics of migrants. We would be interested to hear staff's comments on whether migrants have filled skill gaps in Spain and what has been the effect on productivity. Have migrants helped to restrain wage pressures in Spain?

Fiscal Policy

The new Budget Stability Law is a welcome development in building fiscal credibility and transparency for territorial governments. Given the federal nature of Spain, effective fiscal policy requires targets at the territorial level and these targets must be enforced. We would be interested to hear more about how compliance at the regional level will be monitored. Enhanced cooperation between the central government and regional governments should also be a priority, particularly in areas such as education, where expenditures are mostly under the control of regional governments. We share staff's concerns over the need for pension and healthcare reform in order to ensure long-term fiscal sustainability and agree with Mr. von Stenglin and Mr. Brinkmann that further adjustments to the pension system appear to be unavoidable.

Mr. Saarenheimo and Mr. Bergundhaugen submitted the following statement:

We thank staff for a well-written report, and Mr. Guzmán and Ms. Mira for their comprehensive buff. The Spanish economy continues to grow at a remarkable pace, while at the same time showing signs of a somewhat more balanced growth and moderating inflation. Moreover, the financial system remains robust and conducive to further growth. Productivity has recently shown welcome signs of improvement, and house price growth seems to be tapering off from extraordinary levels. However, significant imbalances are still weighing on the outlook for a soft landing, and the authorities should increase their efforts to restrain primary spending, foster product and labor market liberalization and reforming the house market. We associate ourselves with the views expressed by Mr. von Stenglin and Mr. Brinkmann and offer a few comments for emphasis.

Given the still low real interest rates, fiscal policy bears a heavy burden in macroeconomic stabilization. We note staff's assessment that the surplus does not seem to have a tangible impact on domestic demand, partly due to tax reductions, and we join Mr. von Stenglin and Mr. Brinkmann in calling for vigilance on the fiscal stance as the outcome of the tax reform materializes. The regional budgetary autonomy, which encompasses 75 percent of public spending excluding social security, represents a challenge for fiscal prudence. We look forward to the Budget Stability Law taking effect in 2008, although it could have benefited from a more progressive surplus requirement.

While the current fiscal surplus is a commendable achievement in itself, there are several reasons to caution against reading too much into it. First, as Mr. von Stenglin and Mr. Brinkmann note, it is unclear to what extent the surplus can be considered structural. Public sector balance benefits from exceptionally buoyant revenues boosted by the boom in the tax-rich construction sector. Currently, residential investment accounts for more than 9 percent of GDP. In particular, the 800.000 dwellings built last year are substantially above any estimate of the long-term equilibrium. Residential investment returning to a more sustainable level of 500.000 dwellings per year or less would alone result in a significant reduction in tax revenues.

Second, public balances in Spain are currently benefiting from a temporary demographic boost. The country enjoys a double benefit of a low dependency ratio, due to both prolonged low birth rates and the large cohorts of older workers not yet having entered retirement. Linking increased public savings to a more ambitious pension reform could prove useful to alleviate spending pressures in the upcoming general election process while also addressing the long-term challenge of ageing.

Overall, in light of both cyclical and demographic considerations, we consider the current surplus level in Spain as quite moderate.

Current signals from the real estate market point to a slowdown. Many dwellings are unoccupied, and the recent deceleration in house price growth is a welcome sign of a necessary correction—and we note that the authorities recognize that current house prices are not fully explained by fundamental factors. The associated vulnerability of the broader economy remains unclear. Experience from other countries shows that a contraction in the construction sector can have substantial repercussions in the rest of the economy.

Against this background, and given the important role played by the real estate sector over the economic upturn, a more detailed analysis of the links between the real estate sector and other sectors, as well as the potential macroeconomic implications of a correction in the real estate market, would be highly useful. Moreover, we believe the Spanish economy provides an excellent opportunity to discuss the likelihood of spillover effects that an unwinding of imbalances in the real estate market in Spain might have on other European countries.

While we acknowledge that the financing of the world's second largest current account deficit is not a problem per se due to EMU participation, the associated buildup of financial liabilities in the private sector represents a risk of sharp balance-sheet adjustments and increases the interest-rate sensitivity of domestic demand. We encourage the authorities to reinforce their current efforts to address the fundamental issues underlying the persistent inflation differential and loss of competitiveness vis-à-vis the euro area. The authorities should also work to increase the flexibility of wages and the mobility of workers with permanent contracts. All these reforms would also help bringing real interest rates towards more neutral levels and thus contain credit growth and excessive investment.

We strongly agree with staff on the appropriateness of a thorough quality assessment of public spending on R&D, infrastructure and education. We would in particular like to emphasize that the use and design of incentives and projects should always be guided by the needs of the private sector. Further, several product markets remain under relatively strict regulation and weak competition, and the government's interventionist line in a few cases has clearly demonstrated the issue. While we welcome the new competition law, we are, therefore, still looking forward to see how the law performs faced with other political concerns.

The continued resilience of the financial sector is encouraging, and we encourage the Bank of Spain to remain vigilant to the high credit growth and the exposure to the real estate market. In line with the point made by Mr. von Stenglin and Mr. Brinkmann, we emphasize that while the households' real estate debt represents mostly a risk to domestic demand, the corporate borrowers are historically much more prone to default. Adding the very high share of household incomes dependent on the construction sector, the authorities would be well advised to monitor the developments in this sector very carefully as the credit cycle turns.

Mr. Charleton submitted the following statement:

We thank the staff for a concise streamlined report, which clearly articulates the key issues. Mr. Guzmán and Ms. Mira have also provided a very comprehensive buff statement. While the staff and the authorities share the same analysis of the economic situation in Spain and differ mostly in respect to the degree of risk and urgency of policy action, these differences are important. On balance, we find ourselves somewhat closer to the staff's position. The imbalances built up over recent years during the period of buoyant growth were, to some extent, inevitable but more could have been done to address structural weaknesses during this period, especially respecting labour market reform and the contestability of markets.

Economic Growth and Competitiveness

In common with several other EU members, the advent of monetary union in 1999 provided Spain with a long period of historically low interest rates—perhaps too low—and a major boost to confidence. The consequent borrowing and building boom added greatly to growth and attracted strong inward migration. But growth was, at least until recently, strongly biased towards construction and certain services.

Given migration and population growth, Spain needs to enhance productivity and sustain high economic growth rates. The sheer size of the current external deficit underscores the relatively weak competitiveness record. While the data given in footnote 1 may not be definitive, there is a significant real exchange rate gap (REER). The persistent margin of Spanish inflation over the euro area in general represents an erosion of competitiveness not compensated for the better productivity. The rise of the euro itself has a further impact. The authorities need to remain fully conscious that it may be relatively easy to lose competitiveness within a monetary union but much harder to regain it.

Fiscal Policy

The staff looks to the authorities to at least partially offset the private sector-driven boom through a somewhat tighter fiscal policy. In reality, it is probably very difficult to expect a country with a surplus of nearly 2 percent of GDP to push for even bigger surpluses, especially where the public debt ratio is quite low. The staff is also right to caution about the rising trend of primary spending. Revenue buoyancy at times of strong economic growth almost inevitably leads to extra spending. The real test will come when growth inevitably eases and buoyancy dissipates, which could happen quite quickly if the housing market was to adjust rapidly. We should also be conscious that a growing population puts extreme pressure on infrastructure, schools, health care and other social services. Moreover, as Spain catches up with its European neighbors, it will experience strong public demand for European levels of social provision.

Further, a real fiscal challenge will come from managing the fiscal balance in a less favorable environment in a very decentralized country. While decentralization brings many benefits, it runs a risk of weakened fiscal control. The Spanish system is, as yet, untested. We share the staff's concern about the need to establish clear and binding mechanisms to guarantee fiscal discipline.

Housing Market/Financial Stability

On the housing market, we observe many of the same features as have been evident in Ireland. We are also conscious of the very recent degree of nervousness in the housing market but would be inclined to agree with the authorities that the market is fundamentally sound and well underpinned by demographics and real economic factors. We would be reasonably sanguine about a soft landing, but both the volume of activity and real prices need to decline over time. While the Bank of Spain has been vigilant, their ability to control credit markets in an EMU context is very limited. Prudential standards have been well maintained. No doubt some portion of households will suffer as the market adjusts, but we would not foresee systemic issues.

Reform Program

We find progress on the reform of labor and product markets less reassuring, notwithstanding the positive points set out in the buff statement. Greater progress could have been made over the past five buoyant years. It is not clear that factors behind the high prevalence of temporary employment contracts have been fully resolved and the level of such contracts is still very high. Has any significant progress been made on regional and youth unemployment?

The contestability of markets in general also remains at issue. We fully support the staff's emphasis on the importance of clearer political commitment to contestable and open markets and greater independence of the sectoral regulators from relevant ministries. One gets the impression that the authorities are somewhat reluctantly opening up under pressure from European peers, rather than looking at market contestability and competition as positive elements in raising productivity and efficiency.

Overall, Spain has been one of the stronger growing among the large European economies and we wish the authorities success in continuing this trend.

Mr. Lushin and Mr. Zakharchenkov submitted the following statement:

We commend the staff for the concise and well-focused report and Mr. Guzmán and Ms. Mira for their very informative buff statement.

In 2006 Spain experienced yet another year of robust GDP growth reaching 3.9 percent and strong job creation. Buoyant fiscal revenues have allowed for achieving a surplus at the general government balance of 1.8 percent of GDP and contributed to a reduction of public debt to 40 percent of GDP. We commend the Spanish authorities for these accomplishments. Also, there were some welcome signs of a slowing in domestic demand and cooling of the housing market. On the negative side, the external position, notably the current account, has deteriorated further to 8.8 percent of GDP suggesting the existence of competitiveness problems and raising concerns about the future sustainability of current expansion. While some progress has been achieved in implementing the structural reforms agenda set out in the National Reform Program, it appears that more needs to be done to fully seize the opportunity provided by the current benign conditions.

As pointed out by the staff, the main risks to the on-going expansion stem from high private sector indebtedness and the related large current account deficit. Against this background, the staff focuses on three economic policy priorities needed to ensure the continuity of growth, namely: safeguarding budgetary stability; raising supply capacity and improving competitiveness; and maintaining soundness of the financial sector. We note that the Spanish authorities agreed on the nature of risks but assigned lesser probability to the hard landing scenario. Nevertheless, policy priorities set out by the staff certainly have their merit regardless of how economic events will unfold and we encourage the authorities to broadly follow the staff's advice.

In light of the need to contain demand pressures, the staff's recommendations to maintain the expenditure-based countercyclical fiscal stance are well placed. The recently adopted Budget Stability Law provides an excellent framework to do so. We agree with the staff that the first year of its implementation (2008) should set a standard, which would ideally include keeping the primary spending constant as a share of GDP and targeting a surplus at the regional government level. Since the Spanish fiscal system is highly decentralized with 75 percent of spending being executed outside the federal government, we see considerable merit in the staff's advice to strengthen fiscal accountability and improve reporting procedures at the regional and local levels.

Figures 2 and 4 of the staff report suggest that there is considerable scope to allow for greater flexibility and competition in the labor and product markets. The arguments in favor of deeper structural reforms in these areas are not new and have been on the table for quite some time now. It is, therefore, disappointing that the authorities see lesser urgency than the staff in advancing structural reforms during the "good times." The staff concluded that although the authorities' home-grown National Reform Program is sufficiently comprehensive and well-designed, its implementation in some key areas (notably, overcoming special interests, fostering competition in the sheltered markets, and improving flexibility in labor markets) has clearly lagged behind. We were pleased to learn from the buff that a number of initiatives in these areas are on-going and there is no risk of a complacent attitude on behalf of the authorities going forward.

Turning to the financial sector, it is comforting to learn that the overall system is judged to be resilient and well prepared to absorb potential shocks. We note that the staff seems to see the rapid increase in household debt and the growing exposure of the banking sector to the mortgage market as a risk to economic outlook rather than a financial stability concern. We also noted interesting observations by Mr. Guzmán and Ms. Mira who argued that the issue of household indebtedness may be somewhat exaggerated by the observers. We are of the view that these risks are difficult to quantify at this stage and that there is not much that the authorities can do about them. Nevertheless, we support the Bank of Spain's continued vigilance in this regard. The expected implementation of the Basel II and the EU Directive on

Markets in Financial Instruments (MiFID) is welcome and should proceed forthwith.

With these remarks, we wish the Spanish authorities continued success in their endeavors.

Mr. Daïri and Mr. Mohammed submitted the following statement:

We appreciate the succinct staff report and thank Mr. Guzmán and Ms. Mira for their comprehensive statement. Both documents offer a favorable account on the evolution of the Spanish economy over the past decade, with a prolonged period of high growth and employment—significantly higher than the euro area average—and a strong fiscal performance. These remarkable successes were, however, achieved in a context of persistent, though declining price and labor cost differentials with the euro area average and a steadily rising current account deficit reaching 8.8 percent of GDP in 2006. Recent developments reflect the start of the much-needed rebalancing of demand—from a moderating trend in household consumption and a cooling housing market towards growth in non-housing investment and firming net exports—and point to a gradual deceleration of growth toward the economy's estimated potential in 2007-08.

While the availability of external financing is not in question, staff considers the magnitude of the current account deficit, projected to reach 9.5-10 percent of GDP through the forecast horizon, to be "symptomatic of risks to medium-term growth." These risks arise in two major areas: weak competitiveness stemming from inflation differential and low productivity performance vis-à-vis the euro area, and the "intrinsic limit" on the accumulation of private sector liabilities, which is the counterpart of the current account deficit; this creates the potential for a significant balance-sheet adjustment on the part of low- and middle-income households, unable or unwilling to continue to accumulate debt (mainly at variable rates), especially if accompanied by a simultaneous correction of real estate valuations.

While agreeing on the nature of the underlying risks, the authorities offer several convincing arguments for the low probability of these risks materializing and for the likelihood of a smooth re-absorption of the accumulating imbalances and a "soft landing" (Paragraph 3 of the staff report). Mr. Guzmán and Ms. Mira elaborate further on the issue. First, in their view, the current account deficit does not reflect a lower saving rate, but a sustained increase in investment; however, the stability of the saving ratio may conceal a drop in private savings, and staff clarification on recent trends in total and private savings will be appreciated. Second, the rapid increase in property prices is not viewed as reflecting an asset bubble, but as a result of fundamental factors operating in the real estate and construction markets. Among these fundamental factors perhaps the most remarkable is the massive arrival and absorption into the labor market of 2.1 million immigrants during 2001–06, which accounts for one-half of the employment growth in the period, and increased domestic labor supply, especially through a rise in female participation. As indicated in Appendix I, these supply factors have also helped labor market flexibility, through higher geographical and sectoral mobility, and have contributed to improved fiscal accounts. The study also finds that one-fourth of the 1.6 percent annual per capita growth in 2001–05 is directly accounted for by immigration, although the same phenomenon may have "possibly slowed real wage growth." How the cost-benefit calculus of this demographic works out in Spain may have broader implications for other countries of net immigration and may hold lessons for one area where globalization has lagged most, namely the liberalization of labor movements across countries. Staff may wish to comment.

As indicated by Mr. Guzmán and Ms. Mira, the consensus on fiscal responsibility and the track record of prudent fiscal policy, the strength of the financial sector and its supervision, and a consensual and successful approach in tackling the key issues of labor market, pension, and health reforms bode well for the continuation of high and sustainable growth performance, particularly if supported by continued commitment to enhancing competition and fostering innovation. The authorities are well-advised to implement the key primary spending limit under the Budget Stability Law and enhance transparency of territorial government finances and their consistency with the fiscal consolidation path.

During the last Board discussion, this chair commended the Spanish authorities for their commitment to increase ODA to 0.5 percent of GDP by 2008 and to reach the 0.7 percent UN target in the near future. We are pleased to note from DAC 2006 statistics that progress is being made toward meeting these thresholds and we encourage the authorities to move more expeditiously in this direction.

Mr. Murray and Mrs. Mañalac and Mr. Yoon submitted the following statement:

We thank staff for the concise and well-written paper and Mr. Guzmán and Ms. Mira for their comprehensive buff statement.

We are pleased to note the continued strong performance of the Spanish economy. Besides adding another year to its continued robust expansion, the sources of economic growth are being rebalanced toward corporate investment and exports. Moreover, inflation has also moderated considerably. The fiscal position continues to be prudent despite the rising expenditure. The National Reforms Plan, a comprehensive medium-term strategy, is proceeding smoothly as planned, which will help strengthen overall competitiveness of the economy. Despite the impressive performance and a favorable outlook, however, we note with concern that persistent imbalances could cloud the outlook. While we pleasingly note the recent moderation in private consumption and construction investment, we encourage the authorities to further strengthen policy efforts to limit the leverage of the private sector and to enhance productivity. As we broadly agree with the thrust of the report, we limit our comments to a few points.

We note the sizable difference in views between staff and the authorities on the assessment of downside risks and the pace of adjustment, despite broad agreement on the future direction of the economy. As staff pointed out, the rapidly growing financial indebtedness of the private (household and non-financial corporate) sector, translated directly from a persistent large savings-investment deficit, does not seem sustainable if continued. In addition, the widening of the household sector's financial deficit as it spends more than it earns poses reasons for concern. The weak financial balance of the private sector, both household and corporate, could entail a protracted period of weak economic activities once the current favorable external environment ebbs away and/or a balance sheet adjustment begins to exert a negative spillover to the economy. Considering the high level and the rapid pace of the private sector leverage, there is need to be more cautious in interpreting the current situation and medium-term outlook, which will help safeguard the economy against possible adverse shocks.

Given the absence of monetary policy and signs of overheating, we see merit in the use of fiscal measures to rein in domestic demand. In this regard, we welcome the improved fiscal surplus in 2006 at 1.8 percent of GDP and also the authorities' strong commitment to keeping fiscal prudence, as evidenced in the new Budget Stability Law indicated in Mr. Guzmán and Ms. Mira's buff statement. Regarding the source of fiscal consolidation, we concur with staff that fiscal restraint needs to be focused on the expenditure side, which is more effective in curtailing domestic absorption and lowering inflationary pressure. While we sympathize with the authorities on the need to boost productivity, the public sector could play a lesser role especially when private sector investment is already strong. Investments in such area as R&Ds have often been proved to be more productive when these are undertaken by the private sector with the role of the state being complementary and minimal.

We welcome the authorities' efforts to address longer-term fiscal sustainability, setting aside the proceeds of the 2006 fiscal surplus, achieving further progress on pension reforms and controlling health expenditure. We also welcome the self-imposed agreement between the central and regional governments that the latter will budget for a surplus equivalent to a quarter percent of GDP for 2008. Given a highly decentralized fiscal system, there should be strengthened efforts to improve fiscal transparency and monitoring for regional governments, and we encourage further improvement in this area, as already highlighted by the authorities. As staff did not cover pension reform that will cast a significant fiscal burden in the future, we would welcome staff's explanation on the progress and the prospects of further reform.

The most appropriate way to correct the current account imbalance is through enhancing competitiveness and reducing inflation gaps with trading countries. In this regard, we welcome the authorities' determination to implement the structural reform agenda articulated in the National Reforms Plan. In particular, we are pleased to hear progress in enhancing product market competition in sheltered markets, including the approval of the progressive elimination of tariffs for gas and electricity and enhancing competition in mobile telephony and broadband Internet services. Moreover, we believe that the draft Competition Law, which strengthens the independence of the competition authority and stipulates desirable procedural features, will help enhance transparency and accountability so as to establish a level playing field in the product and service markets. We commend the authorities' initiative to overcome the dual character of the labor market through social consensus, but encourage the authorities to address underlying causes by making further progress in lowering strict employment protection.

Spain's financial system remains sound and well-supervised as evidenced in the 2006 FSAP findings. However, given rapid credit growth and loan concentration in the real estate market, and also considering the recent episode of stock market turbulence, we encourage the authorities to remain vigilant on downside risks.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. He and Ms. Li submitted the following statement:

We thank staff for the well-written and focused paper, and Mr. Guzmán and Ms. Mira for their informative buff.

The Spanish authorities are commended on their impressive economic performance in 2006. The unemployment rate has retained its declining trend over the past several years. Due to buoyant fiscal revenue, the government balance was in surplus. However, the macroeconomic imbalance between strong GDP growth and the widening current account deficit should be a cause of concern. Looking forward, we share staff's view that Spain's near-term prospects are good; however, lack of competitiveness and private sector indebtedness remain the principal challenges for medium-term growth. While we are in broad agreement with the thrust of staff's appraisal, we wish to confine our comments to the following points for emphasis.

Despite pickup in exports, Spain's current account is projected by the staff to remain significantly negative over the medium term. In the context of the currency union, the burden of addressing the challenge of competitiveness in Spain falls heavily on wage policy and labor productivity. The task would be more particularly challenging for Spain if the large labor inflow, which has favorably contributed to the average skills, fiscal account and market flexibility, should peter off. We encourage the authorities to continue their efforts to improve labor productivity by removing rigidities, and facilitate the upgrading of domestic labor skills. We found the authorities' attached study on immigration very useful.

Spain needs to redouble its efforts with other structural reforms to maintain its growth momentum in the face of long-term challenges. We welcome the draft Competition Law strengthening the powers and independence of the competition authority and limiting the government's capacity to overrule its merger decisions. Lack of competition in the sheltered sectors has been one of the reasons for lower productivity growth in the past and we welcome the authorities' efforts to strengthen competition in these sectors. Data provided by staff indicate that the Spanish domestic market is one of the most restricted, particularly in retail activity. As data relate to 2003, staff's explanation on whether there has been some improvement in this sector would be appreciated. We encourage the authorities to implement the National Reform Program under the Lisbon agenda.

With regard to the fiscal policy, we welcome Spain's tightened fiscal stance last year, with the fiscal surplus rising from 1.1 percent of GDP in 2005 to 1.8 percent in 2006, despite being based on higher-than-budgeted revenues. Given the robust economic performance in 2006, we agree with staff that Spain should take this opportunity to strengthen its fiscal consolidation efforts, especially on expenditure constraints. We welcome the authorities' recognition of the need for all levels of government—including the regions—to contribute to this outcome and encourage them to implement further measures. We commend the authorities on the progress in strengthening transparency and monitoring, but more needs to be done to ensure the sound implementation of fiscal discipline in a highly decentralized system. Further improvement in expenditure composition in favor of R&D, and infrastructure and education is also warranted. In this context, we agree with staff that a review of the efficiency of productive spending on R&D and infrastructure is necessary and should be done as soon as possible.

Spain's broadly healthy financial system in 2006 is encouraging. Although loan losses remained low and provisions were high, we reiterate the need for banking supervisors' close monitoring of the rapid credit growth, large exposure to the real estate sector, and the high private indebtedness. We encourage them to prepare the necessary preventive measures to minimize potential credit risks and address possible solvency problems. We also welcome staff's recommendations on issues related to supervisory institutions, savings banks, and implementation of Basel II.

With these remarks, we wish the authorities success in their future reform endeavors.

Mr. Raczko and Mr. Gąsiorowski submitted the following statement:

We would like to thank staff for the report and Mr. Guzmán and Ms. Mira for the buff statement that—taking into account a very concise staff's paper—was very useful for the evaluation of the Spanish economy.

We would like to congratulate the authorities for the continuing growth accompanied by reduction of unemployment and contained inflation. We are pleased to read in the buff statement that this pattern has been confirmed also in 2007. We also welcome the authorities' decision to liberalize the labor market by opening it to the new EU members. We believe that this decision will not only serve to spur competitiveness in the labor market but will also positively influence long term financial stability of the pension system.

We would also like to congratulate the authorities on the continued strong fiscal performance both at the central and sub-national levels, as well as envisaged surpluses until 2009, accompanied by a reduction of the government debt. We note that the positive balance was mainly due to the increase of revenues. Despite the fact that the size of fiscal tightening was reduced by the increase of expenditures, we sympathetically see that the increase was related in half to the investment while salaries in the public sector were kept constant. We hope that these investments will be used effectively to increase competitiveness of the Spanish economy and therefore we deem the current fiscal stance as appropriate. Therefore, together with continuation of counter-cyclical fiscal stance, we would also suggest that the authorities continue reforms aimed at the product and goods market. These reforms should lead to a reduction in inflationary pressures and also improvements in productivity and competitiveness.

Although the robust growth and the solid fiscal stance create a positive economic outlook, downside risks related to the growing current account deficit and rising private sector indebtedness still exist. The impact of higher interest rates on private consumption and on the housing market is indeed already felt. Also staff's projections clearly indicate the possible negative macroeconomic impact in case of a more pronounced adjustment. We realize that the authorities and Spanish banks assign low probability to an adverse rebalancing scenario thanks to various counterbalancing factors. Nevertheless, vigilance is warranted.

Given the importance of the property market to the macroeconomic development, we would welcome a more detailed analysis of this sector. The authorities mention various factors that enhance prospects for a soft landing, such as demographic dynamism. However, high private indebtedness with majority of housing loans bearing a floating rate as well as significant banks' lending to the real estate companies require thorough vigilance. Another factor to be carefully monitored is a possibility that the house prices are overvalued due to the fact that a substantial share of demand for residential units comes from possibly fickle overseas demand for holiday homes. The construction sector also generates significant employment opportunities.

To prevent an adverse economic scenario and ensure growth, staff set—among other things - priority in keeping the financial sector strong. In this regard, we concur with staff that major risks relate to rapid credit growth and to loan concentration in the real estate sector. This might be mitigated since, in staff's assessment, a contraction of the real estate market may only to a lesser extent affect the banking sector. In this regard, we would like to have staff's assessment on whether the equity exposure (to real estate companies) also of the second tier Spanish banks could indirectly affect financial stability?

Although we admit that the size of current account deficit poses a threat under unfavorable conditions, we are also pleased to learn from the buff statement that the authorities are taking actions to enhance competitiveness in order to reduce vulnerabilities. We note that the financial sector is strong thus ensuring that capital inflows are properly invested.

Finally, we regret that the potential international spillovers from Spain's large macro-economic imbalances are not discussed in this paper. We presume that events that could materialize and the corrective measures proposed by the authorities and by staff could have an impact on the economic outlook in Europe, in the euro zone and in Latin America. Although staff has perfectly portrayed the main Spanish economic issues, the size of the report which was prepared during the streamlined consultations was not sufficient to use the Spanish example to enrich current debate on the outcomes of the global imbalances.

Mr. Duquesne submitted the following statement:

We thank the staff for a very concise report. We also thank Mr. Guzmán and Ms. Mira for their very extensive and informative buff statement. It usefully complements the staff's report.

The report's conciseness leaves us a bit uneasy. As stated on previous occasions, we have no objections of principle against short and streamlined reports. Yet, we note that Mr. Guzmán's and Ms. Mira's buff is as long as the staff's own text analysis. In light of noticeable imbalances in the economy, of the regional importance of Spain, and of potential vulnerabilities, a more thorough analysis by the staff of reasons for either comfort or discomfort would have been judicious. We would appreciate it if PDR could clarify the reasons why Spain was identified as a relevant candidate for such a "light" report.

Since we concur with the statement by Mr. von Stenglin and Mr. Brinkmann, the following is for emphasis and clarification by the staff:

It is welcome that Spain is expected to enjoy another year of strong, albeit slightly moderating, economic growth. Signs that some rebalancing in the sources of growth is taking place are encouraging, as the growth regime of past years exposed the economy to substantial risks.

An important question at the present juncture is to determine what, in recent and short run developments, is structural and what is cyclical.

This holds for the incipient rebalancing in the external accounts, with imports likely to slow in tandem with domestic demand while exports should be driven by strong foreign demand. The rise in exports may partly mitigate the decline in market shares evidenced since 2004. This points to the need to tackle competitiveness problems and adjust export product specialization. Like Mr. von Stenglin and Mr. Brinkmann, we consider that the current account deficit, which is expected to continue to grow over the short run, is a source of risks to the outlook. We note that the unexplained part of the deficit is also growing. We encourage the staff to look into this further.

Higher inflation than in euro area partner countries is part of the explanation for the countries' disappointing competitiveness. The staff, like last year, suggests that oil prices are driving the differential in inflation. We remain unconvinced, like last year, by this analysis. The contribution of oil to inflation in Spain is not significantly different from that in the euro area. More convincing drivers are food and service prices. This suggests that limited competition in sheltered sectors is playing a role in the recent trend.

Competitiveness is improving, thanks to productivity gains in the manufacturing sector. Given the external position of the economy, further analysis by the staff on productivity, building on last year's selected issue paper, would have been warranted. We note that, while declining, unit labor costs still grow faster than the euro area average. We would appreciate the staff's views on the scope for further productivity gains in the economy over the medium term, given the large share of the construction and tourism sectors. Their view on the impact of relatively skilled immigration on productivity would also be appreciated.

High non financial private sector indebtedness, mainly at variable rates, is another source of risks to strong growth. We note the authorities' view that households' solvency risk is mitigated by the wealth accumulated through housing assets. This analysis rests on the assumption that the strong construction and housing sectors are driven by resilient factors. We also note the authorities' emphasis on the fact that the housing market has been gradually slowing down for three years, which provides some comfort on the likelihood of a smooth rebalancing of growth. Graphs provided by the staff suggest that corporate profits remain healthy despite a sharp rise in debt level. Yet, we would be interested in having the staff's assessment on a sector-by-sector basis, in particular the performance of non-construction industries against that of construction. We encourage the authorities to continue monitoring closely both credit growth and housing market developments.

A procyclical fiscal policy stance should be avoided in 2007. In light of the projected significant impact of aging on public finances over the medium term, it is critical that the authorities strive for fiscal performances that go beyond the Stability and Growth Pact. A more thorough analysis of the recent pension reform would have been warranted.

The representative of the European Central Bank submitted the following statement:

The staff has produced an authoritative assessment on the state of the Spanish economy. The Spanish authorities are to be commended for the maintenance of the robust pace of economic activity in recent years which has placed real output growth consistently above the average for the euro area as a whole. The continued overall health of public accounts and the strong fiscal discipline which has helped to underpin the dynamic pace of economic activity should also be highlighted.

The ECB would like to support the statement by Mr. von Stenglin and Mr. Brinkmann, which is also broadly in agreement with the staff assessment. As rightly noted by staff, the near term outlook for the Spanish economy is bright, but a number of challenges remain further ahead:

As regards the overall macroeconomic scenario, the on-going correction in the housing market might imply a stronger reduction in housing activity than currently anticipated. In turn, this might lead to a sharper balance sheet adjustment than currently envisaged—correctly identified by staff as the main downside risk to the Spanish economy—due to the possible spillovers on employment and private consumption. Overall, this could suggest a more moderate growth performance relative to the staff baseline scenario.

Concerning fiscal policy, the extent to which the increase in the revenue-to-GDP ratio in recent years should be viewed as structural or temporary in nature remains uncertain. The recent buoyancy of tax revenues might have been heavily influenced by the surge in the property market, as the volume and value of property transactions has boosted revenues from value-added and transactions taxes in recent years in addition to contributing to corporate and capital gains tax revenues. As a result, the sensitivity of tax revenues to developments in the property market might be significant.

The uncertainty in distinguishing between cyclical and structural components in tax revenues calls for particular caution in interpreting estimates of the structural balance, which might currently overestimate the true strength of the underlying budgetary position. As argued by staff, this also calls for maintaining primary expenditure growth at a level that is sustainable over the longer term. More broadly, a pro-cyclical loosening of fiscal policy should be avoided, with automatic stabilisers being allowed to operate even if this leads to persistent or growing budget surpluses in the near term. Notwithstanding the political sensitivities associated with the maintenance of a sizeable budget surplus, there is a strong rationale for doing so in order to contribute to improving fiscal sustainability by further reducing debt and building up the social security reserve fund.

As regards structural issues, the staff report rightly identifies the importance of a clear commitment to promote competition in key sheltered sectors as well as to safeguard the independence of supervisory bodies. Strengthening product market competition (particularly in the energy and retail sectors) seems crucial. A number of studies have found that lack of competition in the product market may partly be responsible for the maintenance of positive inflation differentials with Spain's main trading partners, entailing a loss in competitiveness. These challenges are rightly identified in the National Reform Program under the Lisbon Agenda, but a more firm implementation would be desirable.

Concerning the labor market, the staff is right to identify the need to consolidate recent gains in labor market flexibility with further reform. The new labor market reform is a step in the right direction. However, as noted by staff, the outcome of the reform is limited, especially in light of the fact that it took more than two years of discussions to be agreed upon and that the reform momentum has largely stalled in light of the political cycle. Fighting fixed-term employment would require a more decisive reduction in currently high dismissals costs. In addition, the wage bargaining framework should be revised away from largely centralized collective bargaining to better reflect differences in productivity developments across sectors and regions, as well as to phase-out the ex-post wage indexation provisions in collective agreements. This is also contributing towards eroding the competitiveness of the Spanish economy by inducing nominal wage and inflation persistence.

A continued robust fiscal policy stance relative to the underlying cyclical position coupled with appropriate policy measures in product and labor markets should also help in the fight against inflation. The persistent positive differentials of inflation in Spain relative to the euro area average are the negative aspect of its relatively higher growth performance. The ECB welcomes the recent downtrend in Spanish inflation and looks forward to further progress in this context.

As regards the financial system, the ECB agrees with the staff that continued vigilance is warranted to monitor credit growth and undue loan exposure to particular sectors of the economy, in order to ensure the continued strength of the system as a whole.

Mr. Guzmán made the following additional statement:

I would like to make a few comments at the beginning of the meeting, in particular to convey the sincere appreciation of my authorities for the whole exercise of the Article IV consultation. This gratitude is addressed first and foremost to the staff team, headed by Mr. Leipold, with the extremely competent and rigorous help of Mr. Escolano, Mr. Guiterrez, and Mr. Bennett. The thoroughness of the staff's analysis and policy recommendations are, as usual, extremely useful. The value we attach to the dialogue with the mission team goes beyond the mere output of the staff report. In any case, I would also like to thank Directors for their statements, which also provide the authorities with valuable advice and guidance. A full report of the Board's discussions and staff's recommendations will be sent my authorities as soon as possible.

I would like to comment on one issue that featured in the preliminary statements, and that struck as the result of a misinterpretation. Several preliminary statements pointed to the substantial disagreement between the authorities and the staff on the risk assessment of the economic situation in Spain. In our opinion, the differences in the probabilities assigned to certain downside risk scenarios and the differences in the definition of the nature and size of the effects this scenario would entail are relatively small. This is so because my authorities broadly share the diagnosis and policy conclusions contained in the staff report. Needless to say, we also appreciate most of the recommendations contained in the preliminary statements. Therefore, when we referred in our statement to my authorities' assigning a lesser probability to a worst case scenario on growth and considered that the financial consequences, for example, of a slowdown in the housing market were frequently overestimated, we wanted to reflect the extensive coverage that property market developments receive in the domestic and international economic press.

In these almost boring times of generalized growth, the press is particularly eager to look for catastrophic events in the perennial quest for the newest "sick man" of Europe. Having read the Directors' preliminary statements, I realize that we probably over stressed our disdain for this press coverage, which one could call the "momentum catastrophicum literature." Our statement probably drew some Directors into thinking that the dialogue between authorities and staff was characterized by significant differences of perceptions. The opposite is quite true.

Please excuse me for this long intervention at the beginning of the meeting, but I believe that a clarification was warranted.

Extending his remarks, Mr. Murray thanked Mr. Guzmán for his further clarifications and expressed his puzzlement as to whether Spain could be considered one of the "sick men" of Europe.

With reference to the issue of streamlining, the original review of the Medium-Term Strategy (MTS) had foreseen that with some caveats countries that would be chosen for the streamlined Article IV consultation process had to be nonsystemic and stable, Mr. Murray continued. Spain could perhaps fit this definition. It was puzzling however to try to understand how management and staff selected countries for streamlined Article IV consultations. Spain was indeed a systemically-important country and, while it had a solid performance and was relatively stable, certain vulnerabilities could not be overlooked. It seemed that the decision to have a streamlined consultation with Spain in this exercise had not been appropriate. The upcoming Board review of experience with streamlined Article IV consultations would offer a good opportunity to assess specific country cases.

The Acting Chair (Mr. Portugal) confirmed that the Board review of experience with streamlined Article IV consultations would take place at the end of the summer or early in the fall and would offer an opportunity for further discussion. It was hoped that by then, enough experience would be accumulated to be able to consider the matter thoroughly.

Mr. Daïri broadly agreed with Mr. Murray, and noted that he had raised the question of streamlining in several other cases. However, it was worth noting that these comments were not meant as a criticism of the staff's work, which was—as usual—of outstanding quality in informing the Board. The issue of concern was more about the process of streamlining per se than the specific exercise on Spain.

Mr. Murray clarified that he did not see any correlation between the length of the report and the quality of the analysis. On the contrary, the Board ought to be presented with short but comprehensive reports. However, it was worrying that in the case of Spain, because of the streamlining process, there were important policy issues that had not been covered to the extent that some Directors had expected.

A similar issue had been discussed a few weeks before at the Board meeting on New Zealand, Mr. Murray continued. That economy had a large current account deficit and a sound fiscal position, which raised numerous questions in terms of the various policy objectives to be pursued. Spain fit into a similar category, as many others economies would, particularly as countries moved into a fiscal surplus. Those surplus positions were crowding in the private sector and leading in some instances to quite large current account deficits, which nonetheless for the time being financial markets seemed to be comfortable with. The concern in the cases of New Zealand and Spain was that a streamlined consultation would not be sufficiently thorough to assess those issues appropriately.

Mr. Saarenheimo noted the good quality of the staff report and thanked the staff for the illuminating analysis of competitiveness that had been carried out vis-à-vis a peer group of countries. Yet, there was some evidence that the analysis might have benefited from a slight loosening of the word count limit.

There was however another point to be made that had been mentioned in some of the Directors' preliminary statements, Mr. Saarenheimo continued. The fiscal surplus in Spain was nearly 2 percent of GDP, and some Directors rightly observed that going forward it would be difficult politically to increase it more. From a more general perspective, it was often difficult to convince Parliaments to allow surpluses to grow. However, some good lessons could be drawn from the Nordic countries that, in similar situations, had established pension funds to channel the explicit fiscal surpluses to good use. In the case of Spain, where the fiscal impact of population aging would be substantial, such a policy measure would make economic and political sense.

Mr. Prader agreed with Mr. Daïri that the staff had done a good job. However, it was evident that it had been seriously constrained by the word count and not able to discuss in detail issues such as spillover effects. It would be important that at the review meeting on streamlining such an artificial and arbitrary limit on word count, which unduly constrained the staff, would be removed. In addition, if the staff and management felt that Spain was an ideal candidate for streamlining, then the country should have been downgraded in the WEO, in contrast to its upgrading to the status of G-7 countries only a few years before.

Mr. Kishore asked the staff to clarify what were the implications of the deteriorating current account deficit in Spain, given that the country was part of currency union and, in principle, surpluses and deficits should not matter. Were there any implications for the financial markets?

Mr. Bakker remarked that on streamlining he preferred to postpone his judgment. Nevertheless, a relevant question in that respect was whether the discussions with the Spanish authorities had been as effective as they would have been under the standard Article IV consultation procedures. A second question was whether the Board had been sufficiently informed by the streamlined report for a good discussion. The circulation of 23 grays was proof to the fact there was no lack of information and all the relevant issues were on the table.

A final issue concerning streamlining was whether the questions at stake could be more thoroughly explored in the context of an Article IV consultation or whether other reports like the GFSR or the WEO should be relied on for the analysis of spillover effects, Mr. Bakker continued. While a review of streamlining would take place later in the year, the staff's comments on whether streamlining had hindered in any way the effectiveness of the current Article IV consultation would be useful.

Mr. Murray observed that the interventions by Mr. Saarenheimo and Mr. Bakker had raised some more general important issues. While it was difficult to know whether these issues fit into the Spain's Article IV consultation, it was evident that the political economy around the surplus countries was becoming a major issue. It was becoming an even larger issue where some countries had set up future funds or pension funds. Policy objectives could be conflicting and it was difficult to know exactly what the financial sector's reaction to all of that would be. It was also more difficult to assess what the vulnerabilities were, and whether they had been covered in detail under the streamlined Article IV consultation. In addition, in the case of Spain, the country did not have the ability to control monetary policy, which complicated things further in terms of short-term objectives.

The Deputy Director of the European Department (Mr. Leipold), in response to questions and comments from Executive Directors, made the following statement:

> Many questions were addressed to the staff in the 23 preliminary statements issued. I will try to address some now without taking undue advantage of the fact that Spain is the only item on the Board's agenda today.
>
> I will address some general questions regarding the risks in the housing market and the construction sector, some aspects of the policy response the staff advocates, and the effectiveness of this year's consultation.

Mr. Escolano will, with your permission, address some questions on the outlook and on immigration and some other more specific ones.

On a more a general comment, I found it quite comforting that we seem to have moved on from a debate that the Board has had several times in past years as to whether current account deficits matter in a monetary union. I recall the first heated debate on this on Portugal some years ago. I believe that, perhaps because of the experience of Portugal, at present there is more of a unanimity of views that, while the nature of the external constraint is no doubt different in a monetary union, it is not a financing issue, to answer Mr. Kishore's question. In that regard, a monetary union makes a substantial difference because of the common currency and the absence of exchange rate risk. Nonetheless, a large and persistent current account deficit should be a warning signal since there is a limit to the continued accumulation of debt.

That said, I would like to leave no room for any remaining misinterpretations. The risks to growth that the staff sees in Spain are not premised on there being a real estate bubble, which may burst. This is a possibility that cannot be ruled out, and I appreciated Mr. Kashiwagi who from the height of his experience in Japan cautioned us that an asset bubble is difficult to perceive until it bursts. Thus, it is always good to be careful. Yet, the main risk the staff sees is another one. It is that everyone, the staff, the authorities, and the stability program, the Bank of Spain—that incidentally is going to begin publishing its own projections as part of its input into the BSL considerations—forecasts large current account deficits in the medium term. These will have to be financed by additional debt accumulation by the private sector, and everybody agrees that this cannot go on indefinitely. At some point, and admittedly it is hard to predict when, this phenomenon will come to an end.

The correction of the large current account deficit could happen gradually and smoothly, which is the staff's scenario. However, it could also happen in a more abruptly and pronounced manner, in line with the risk scenario. As Mr. Guzmán clarified in his opening statement, the differences between the staff and the authorities in evaluating this risk are not as large as some may have been led to believe. I would rather define them as relatively small. Yet, partly different perspectives are almost inevitable, given that the authorities—as just recalled by Mr. Guzmán—are responsible for calming some nervous observers while the staff are responsible to shake possible complacency that there may be in policy circles. We believe that it is the task of policies to avert the adverse outcome scenario even if uncertain in its timing, extent, and intensity; especially when the prescribed policies have virtues in their own right. As Ms. Lundsager and Ms. Pollard and Mr. Lushin noted in their grays, the staff's policy recommendations for Spain are sound regardless of whether one shares the staff's or the authorities' view on the likelihood of a less-than-benign growth outcome.

I would like to discuss now the issue of the housing market and construction sector that seems to interest several Directors. There were questions about recent developments in the real estate market, bank exposure to the construction sector, and the staff's assessment of housing price overvaluation and of potential risks of further corrections in housing prices. As regards recent developments over the last two years, housing prices have continued to rise, even if the rate of increase of prices has decelerated smoothly, as the authorities have been projecting for some time. House price inflation fell from slightly over 17 percent in the fourth quarter of 2004 to slightly over 7 percent in the first quarter of 2007. This has happened in response to increases in supply, rising interest rates, and higher household debt, which are the factors that underlie the staff's and the authorities' baseline scenario. Therefore, from that perspective, things are evolving in the direction we had anticipated. At present, supply indicators indicate only a small, mild deceleration in housing construction. Housing construction thus remains strong, with a risk of being too strong and perhaps not matched by adequate demand. Part of the current strength of the sector reflects a spurt in construction that was triggered by trying to avoid falling under a new and stricter building code that has now come into force. That was a temporary factor.

Mortgage credit growth has also declined but remains still strong at around 19 percent. However, as Mr. Caruana used to explain to the mission team when he was Governor of the Bank of Spain, it is apparently a fairly common phenomenon that the deceleration of mortgage credit growth always lags that of house prices.

As regards the overvaluation of the real estate market, the staff did some calculations in earlier staff reports, and results do no differ much this year. Undoubtedly there are several fundamental factors—which are listed in Mr. Guzmán's statement and in earlier staff reports—that account for the bulk of the increase in house prices in the previous period. Spain has rather unique elements at play in that direction. Nevertheless, the staff, the OECD, and the Bank of Spain converge in estimating an overvaluation on the order of 20 to 30 percent. While this is a large number, it is still a number that most analysts generally view as one that can be reabsorbed with a smooth adjustment path toward equilibrium in the medium term.

That is what the staff envisages in the baseline scenario. However, if a sharper contraction were to occur, as many Executive Directors observed, growth would suffer given the size of the construction sector in Spain, which is about 10.5 percent of the total gross value added. It is estimated, and the staff did this in last year's stress tests—the details are explained in a technical note to the FSAP—that a 30 percent decline in real estate prices over two years would decrease GDP growth by 0.4 and 0.7 percentage points in years one and two, respectively. That would also increase unemployment by 0.2 and 0.6 percentage points respectively vis-à-vis the baseline.

As regards the impact on the financial system, banks are heavily exposed to the construction sector. Not only does credit to construction on real estate companies account for 25 percent of bank loan portfolios, but if mortgage loans are considered as well, banks' exposure to the real estate sector broadly defined amounts to over 60 percent of the loan portfolio. While that is large, the FSAP stress tests found the financial sector to be resilient to the housing price decline that I just described. A variety of other shocks were also added, including interest rate increases and their related macroeconomic impact. I think the evolution of macro-prudential indicators since these tests were run do not suggest that the results would be different if they were run again today. This is largely due to the Bank of Spain's strict attitude toward provisioning and, in general, credit quality, which is reflected in the absence of a sub-prime mortgage market in Spain.

If I may turn to fiscal policy, I would like to offer my reaction to Mr. Saarenheimo's point about the political difficulties of raising further an already high surplus. I think that in terms of the public consensus on budgetary stability, Spain, even though because of its geographic location it is considered part of the Mediterranean countries, is more similar to the Nordic countries. It was surprising for me to hear that, with a surplus of 1.8 percent of GDP, at a meeting with the trade unions, for example, one of the trade unions said the fiscal surplus should be higher. That does not happen in many countries. There are no calls to spend the revenue windfalls in contrast with the experience of France earlier this decade, with the "Cagnotte episode", or of that of Italy, with what the Italians like to call the "tesoretto," namely higher revenues than they had expected. In that sense Spain is closer to the Nordic countries than to the Mediterranean ones.

There were a number of questions on why the staff was concerned with the rise in primary expenditures, given that they are—to a large extent—"productive expenditures" directed to improving infrastructure, R&D, and education. This additional spending has resulted from strong budget increases in these sectors. As Mr. Charleton also noted, a growing population contributes to put pressure on infrastructure, on schools, on health care, and other social services. Still, such a rapid increase in what is called priority expenditure requires that it be truly productive. This is why the staff recommends that the use of public money and the government's sponsorship of activities be subject to a scrupulous cost-benefit and efficiency analysis to ensure value for money.

In this connection, the staff agrees with Mr. Murray and Mr. Saarenheimo that investments in such areas as R&D have often proved to be more productive when they are undertaken by the private sector, with the role of the state being complementary and minimal. Similarly, because of the high degree of decentralization that has taken place in Spain, there is a need for a rigorous evaluation of territorial government spending, which currently accounts for over 75 percent of total public spending, excluding social security.

In this environment of high decentralization it is not surprising that several Directors had questions about fiscal federalism. In particular, there was a question on what the progress has been on revising the arrangements for the financing of the regions and aligning the regions' revenue raising powers with their spending responsibilities. In fact, this revision has actually been postponed to the next legislature. The staff has advocated for a long time now, that a successful decentralization of competences be accompanied by mechanisms that grant territorial governments significant powers to set their own taxes. Having said that, we are not completely displeased that such a revision has been postponed, given the political economy of the present government, whose majority is thin and depends on the support of small regional parties. This is not the best setting to reform the financing of the regions in a way that would secure fiscal discipline.

The 2008 surplus target for the regions was well received. However, there is some concern that it may have been set ad hoc and Ms. Xafa asked what the authorities' intentions are beyond 2008. I would like to reassure that the BSL foresees a rather institutionalized process for each year, with negotiations between the government and the regions and targets set for the region as a whole as well as individually. Yearly targets are set for the subsequent three years, with following year's target being the binding one and the others being revised in the subsequent years in light of cyclical developments.

Mr. Larsen inquired about how compliance with the regional targets can be monitored. This is a relevant question because it touches on enforcement issues. The timeliness of statistical information continues to be an issue. The authorities are trying to address it, albeit not as rapidly as the staff would have liked. However, the core of the problem remains enforcement, which is exacerbated by Spain's decentralized system where the central government has limited power. Thus, enforcement has to be based on cooperation and shared responsibility. That is why we have repeatedly encouraged the authorities to reflect on how best to strengthen fiscal governance mechanisms. In this connection, while I would rather avoid any reference to the much-debated issue of fiscal councils, I believe that Spain would be a good case to establish mechanisms that identify fiscal misbehavior, elicit public censure, and stimulate corrective action. Transparency and peer pressure are key and some form of independent review of the regions' fiscal policies could help. Nonetheless, the staff has left it to the authorities to ponder about it.

On labor markets, there were questions on what labor market reforms the staff sees as necessary to institutionalize the de facto flexibility that is being imparted by immigration. Two grays describe exactly what the staff sees as needed reforms in the Spanish labor market. Mr. Bakker's gray has arguments in favor of wage bargaining reforms and Ms. Lundsager's gray stresses the need to change the rigidity of employment protection in permanent contracts. We fully support both arguments. In both areas, immigration has played an interesting role. For example, the incorporation of migrant workers and the increase in female participation—which in itself is increased by the arrival of migrant workers because they provide labor for the care taking of children and of the elderly, freeing the women to participate in the labor force—has resulted in an increased proportion of workers not covered by collective agreements. They were 24 percent in 2000, they are now 37 percent. At the same time, as regards the duality of the labor market, the incidence of temporary contracts in Spain edged upward as a result of immigration. It is now 32 percent vis-à-vis around 18 percent in the EU. There is a chart in the staff report that shows the relative incidence of temporary employment across countries.

On product markets, several Directors noted that charts on page 12 and 13 of the staff report end in 2003, and considered that it would have been interesting to know what has happened since. However, the staff is using OECD indicators and those are unfortunately the latest ones available. We are not in a position to replicate them. However, the staff feels that all countries are making progress and that the relative rankings are unlikely to have changed much. I cannot provide more extensive comment than this. Nonetheless, I would like to react quickly to some observations in Mr. Rutayisire's gray. It is worth clarifying that the reference to sheltered sectors in the staff report is not a reference to trade barriers, but to licensing requirements, or bureaucratic procedures that restrict competition in the domestic market. Indeed, restrictions in the Spanish markets apply to nationals and foreigners alike, perhaps even more to the former. Such restrictive provisions, are pervasive, for example in retail distribution, professions, certain services, taxis, etc. Many of these regulations are regional or municipal responsibilities, an area where the implementation of the EU services directive could play a useful role.

There were questions on the progress in implementing the FSAP recommendations, which are summed up in Table 6 on page 22 of the staff report. On the whole, the authorities are making progress, given that the exercise was carried out only last year. This reflects the fact that the authorities fundamentally agreed with the staff's recommendations.

As regards the governance of the savings banks, which was mentioned in one of the questions, nothing has really changed yet on the ground. But what has changed is a much more active debate about it. The fact that the savings banks want to expand abroad—and for that they need the Bank of Spain authorization—gives the authorities a little bit more leverage in asking for the changes that they would like to see.

There was also a question as to why insurance supervision has not been separated from the ministry of economy as foreseen. I think the short, honest answer to that question is politics. In a pre-electoral period, it turned out to be difficult to find the needed broad consensus that such a change in supervisory arrangements would require. However, I think that progress will take place in the next legislature.

Let me end by discussing a subject dear to everyone's heart, namely streamlining. As far as the staff is concerned, the depth and the richness of the discussions with the authorities were not any different from those of past years. To use Mr. Guzmán's characterization in his buff statement, the talks were thorough. Indeed, a smaller and shorter mission helped generate greater selectivity and focus, and not at the expense of depth.

Whether the staff report is adequate is for the Board to assess. On streamlined Article IV consultations, more generally, there are different views, and Directors will have the opportunity to discuss this issue in the next few months. As to the question of why Spain was selected as a candidate for a streamlined consultation, the MTS provides limited guidance on which countries ought to be selected. It says that the selection of countries can be flexible. Non-systemic and stable countries are an obvious choice. However, other countries could become candidates too if not much has change since the previous year's Article IV consultation. Mr. Murray referred to Canada, certainly a G-7 and a systemic country and in some ways New Zealand, whereas Spain is not a G-7 country.

The staff's rationale for choosing Spain as a candidate for streamlining is that Spain's performance and challenges remain similar to those discussed in 2006. However, this choice can be a subject for debate and perhaps will be when the Board will discuss the review of streamlining.

The staff representative from the European Department (Mr. Escolano), in response to questions and comments from Executive Directors, made the following statement:

I will address the questions posed by several Directors on different aspects of the staff's macroeconomic framework and projections. I will also stand ready to answer any additional questions either here or bilaterally, if need be.

Ms. Xafa observed that in the current account decomposition presented in Figure 2 of the staff report, over one third of the current account deficit remains unexplained by oil prices or the cyclical position, and asked whether the residual is due to competitiveness losses. The short answer is that that inference is indeed warranted. Given the practical and theoretical difficulties entailed by an assessment of competitiveness, the staff uses a variety of methodologies. In this particular case, the staff has tried to eliminate the part of the current account deterioration that is explained by oil price or cyclical variations, and what remains can be presumed to be of a structural nature. This unexplained residual has increased substantially in the last three or four years, as can be seen in the graph. Other analyses also point to competitiveness losses, as an explaining factor. Incidentally, let me point out that the euro appreciation appears to have contributed to a loss of competitiveness, with a real effective exchange rate appreciation by one or two percentage points since early 2006.

Regarding the prospects going forward, the staff envisages a continuation of large current account deficits, as mentioned by Mr. Leipold, peaking at close to 10 percent of GDP by 2009-2010. This is about 0.8 percent of GDP higher than the authorities' projections contained in the updated stability program. However, the updated stability program was premised on the current account deficit projected for 2006, which was about that .8 percentage point of GDP lower than what has actually been. The new data have become available since the authorities issued the updated stability program. I would say that our projection on the current account deficit is—at least in terms of the profile—similar to that of the authorities over the medium term, with its level adjusted to reflect the recent developments.

Some Directors asked for clarification as to what underlies our current account projections. I am afraid that on that, our methodology is fairly unexciting. The staff projected exports based on demand for imports of partner countries, weighted by the weight they have on Spanish exports. That results in the increasing export activity that we envisage. In that sense, it is not that we are keeping constant the growth of exports going forward just because it happened in 2006, rather it is a result of what we obtain looking at partner countries. Similarly, the imports are also projected based on historical elasticities and forecast evolution of domestic demand and exports. That basically underlies the current account deficit. Again, with regards to exports, imports, and other areas we have a profile that, despite some minor differences, is similar to that of both the authorities and other observers. Underpinning these projections there is a slight back-loaded recovery in domestic private savings. We do not expect the government to contribute additional savings during the medium term.

Investment, on the other hand, will remain high although it is expected to decelerate mainly on account of construction investment. However, non-construction investment is also expected to decelerate over the medium term, with the total investment contribution-to-growth ratio going from 2 percent at the peak in 2005 to 1.3 by the end on the period in 2010. Regarding future productivity developments, our projections are consistent with a smooth, also back-loaded, increase in productivity, which has been .8 in 2006 and we expect it to be in that order in 2007, increasing up to 1.4 growth by 2011, as reforms take hold. This is not really a high level of increase in productivity by historical or international standards. Thus, we feel that out projections are fairly conservative. A better outcome could indeed be envisaged if reforms were fruitful.

Some Directors asked about the relation between immigration and wages and productivity. This is an interesting topic, and based on the authorities' study summarized in the Appendix 1 of the staff report, immigration has had a downward effect on both wages and productivity. The downward impact on wages resulted in a reduction in the growth of the capital-labor ratio, one of the two elements that determine productivity. So, immigration has resulted in higher labor intensity than otherwise. This effect is estimated to have dampened annual productivity growth by 0.2 percentage points during the period 2001-2005. The effect of immigration the total factor productivity, the second factor behind productivity, is estimated to have been more or less neutral in the short term. However, over the medium term, the authorities expect it to be positive. This would be consistent with the experience in other countries that have a longer history of immigration like the United States.

With regard to the question on the difference vis-à-vis the European Commission's structural balance, which they estimate to be 2.3 percent of GDP, the staff has not had an opportunity to discuss with the European Commission's officials the latest spring forecast, which was issued one week ago. My understanding is that we are both using historical elasticities. However, the commission officials consider a negative output gap of over one percent of GDP, meaning that the actual output is below potential by that amount. We do not believe that that is consistent with the overall picture suggested by other indicators. It may be the result of the use of the statistical filters that the Commission applies to all countries, for consistency, without too much country-specific adjustments. We will ask that to the Commission officials at the first opportunity. We are, however, fairly convinced that the output gap is not substantially negative. That was also the assessment of the Bank of Spain when we discussed it with them.

Several Directors formulated questions regarding pension reforms. The latest agreement on social security reform, which mostly tightened the requirements to qualify for partial retirement, modestly increased the working period to compute pensions, and increased payments to certain collectives and activities, is welcome. Although this is only a first package of measures, as recognized by the authorities in their stability program, a wider range of reforms needs to be implemented in the next legislature in line with the staff's recommendations. The recommendations that the staff made in the 2006 Article IV consultation have not changed. In particular, in our view, reforms should encompass actuarially fair incentives to prolong the working life, extend further the working period to compute pensions, and expand further the level of private provision. With regard to the financial situation of the Social

> Security, strong immigration inflows have only postponed the appearance of deficits in the social security system. It is currently estimated that on a cash-flow basis these deficits would appear about the middle of the next decade. That would be further postponed by the use of a reserve fund that, as indicated by Mr. Saarenheimo, the authorities have established. Such a reserve fund for the social security amounts to about 4 percentage points of GDP at this point, but it keeps increasing. It will help postpone the deficit by over five years. Nevertheless, the root problems will eventually drive the system into deficits. Thus, the reform of the system is necessary.
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> Finally, on ODA, let me clarify the facts, which in the staff's view are very positive. For 2007, the authorities have increased the budget allocation for ODA by 39 percent relative to 2006. Including debt relief, it would be about .42 percent of GNI in 2007. In addition, the authorities have announced the intention to raise it to .5 percent of GNI in 2008, toward an explicit medium-term objective of .7 percent of GNI. Thus, summarizing ODA has almost doubled, increasing from about .27 percent of GNI in 2005 to an expected .5 in 2008.

Ms. Xafa thanked the staff for the clarifications, especially with regard to the BSL. While the negotiations between the central and the territorial governments were an institutionalized process, it still seemed that the law lacked a clear and binding operational framework. For instance, it was not clear on what the discussions or the negotiations were based and what the target of the authorities would be. The staff had proposed a rule that had the benefit of clarity and transparency, namely keeping primary spending constant relative to GDP. The authorities were not ready to commit to such a rule. Did they have an alternative rule in mind?

Mr. Saarenheimo made the following additional statement:

> The staff described the calculated effects of a 30 percent decline in housing prices as resulting in 0.4 percentage point and 0.7 percentage point departures from the baseline in the first and second year, respectively. Those seem to be low numbers. I suspect the difficulty is in defining what we are really looking at. If a 30 percent decline in housing prices is postulated as a purely exogenous event, that outcome may be plausible. However, in the real world experiences, an instance where housing prices have been reduced by 30 percent is always associated with an economic environment that is seriously depressed and in a downward departure from trend growth far greater than that. So, in that sense, it might be more illuminating to look at such an event in a broader perspective, considering what kind of

circumstances might lead to such a correction and what that would entail for GDP growth.

As for the differences between the commission and the staff in the output gap estimate, someone once defined the real time definition or measurement of output gap as chasing a black cat in a dark room. It is a difficult measurement issue and it is a difficult concept to conceptualize. As a point of reference, whenever this discussion arises, I think of what happened in Finland from 1980s to 1990s. If you just use the data from Finland up to 1990 and try to calculate the output gap, you obtain an outcome of around 4 to 5 percent structural surplus of fiscal balance in that year. If you then factor in what happened over the next ten years, the assessment changes by about 6 or 7 percentage points of GDP, to a structural deficit. So, the current Spanish fiscal balance may look very different a few years down the road. It seems that debating whether it is 1.8 versus 2.4 percent of GDP is a little bit irrelevant in the scale of events.

Finally, on the pension fund, I was aware of the Spanish pension fund. I do define it as rather small. In Finland, the fund amounts to more than 60 percent of GDP, accumulating an annual surplus of several percentage points of GDP. There would be a good case for Spain to think of something more of that magnitude.

Mr. Dumont recalled that the review of streamlining was not the subject of the current meeting. While the issue would be discussed in a few months, in the meanwhile it was important to be able to assess at a country level what was the concrete impact of the procedure. What were the concrete differences in staff’s work between a regular and a streamlined Article IV consultation? In spite of the lack of a selected issues paper, had the staff prepared some specific studies that nonetheless should be brought to the attention of the Board? In other words, was a streamlined consultation a summarized outcome on the basis of a regular process or a summarized process leading also to a summarized outcome?

Mr. Bakker observed that the trend of mortgage lending lagging real estate developments was common in many countries. In the Netherlands, such a trend was caused by consumers taking up additional market shares to maintain consumption. In the case of Spain, was the continued market growth fueling consumption, or was it taking up finance for real estate? The assessment on the impact on medium-term growth would be different depending on the source.

Mr. Murray made the following additional statement:

I would just like to thank staff, first of all, for some very clear analysis this morning. As well, I wanted to thank Mr. Leipold in particular, for his analysis on political economy issues. I want to react briefly, in reaction to some of his answers on political economy issues. The four major economies in my constituency, Korea, Australia, New Zealand, and the Philippines, have a very strong political commitment to prudent fiscal outcomes. In some of those countries, there is a very strong commitment to surpluses. In the context of the short-term issues facing Spain, is it significant that they might be moving from a 1.8 percent of GDP surplus to a 1 percent? In light of the political economy, just how large can your surpluses be stained politically? This leads me to my second issue, and this is the real dilemma for the increasing number of surplus countries of the short-term versus the medium term. This issue is very much amplified for Spain, because there is so much emphasis on using fiscal policies rather than monetary policies as a short-term leave. However, in many instances, we really are looking at fiscal these days in a medium-term framework. Again, my question is just how much is that a dilemma for Spain, between the short-term and the medium-term uses of fiscal policy.

As Mr. He pointed out in his gray, in the longer-term, because of the currency union, everything is linked to issues of nominal wages and flexibility of the labor market and flexibility of the economy more generally, in terms of competitiveness. Adjustments of real wages, which in the flexible exchange rate environment can be done at least in the short term through the movement in prices, are therefore different. Thus, just how much of a dilemma is this for Spain?

The very interesting analysis in the appendix on immigration brings me to labor markets. Some of the countries in my constituency have long traditions of immigration, and I make the observation that the richest nation on earth was built on a wave after wave of immigration. I have no doubt of the benefits of immigration, particularly over the medium- to longer- term. Immigration could entail that Spain may go through a period of reduced total factor productivity. But as these people get attached to the labor force and as they induce changes in behavior of the existing labor force, I have no doubt that the longer term prognosis is nothing but significantly positive. In our gray, just as in the U.S. gray, we do think the issue of labor protection is a very serious one. The movement to temporary employment is all about getting around labor protection. Unwinding that in some ways is very counterproductive. To be looking at labor protection is really looking at the root cause of all of this.

Australia's experience with a housing construction boom lasted, thanks to a quite strong demand for new housing, stimulated in part by immigration. However, huge capital gains were being made in the existing housing market, as is the case, I presume, in the United Kingdom. This, in turn, fuelled the construction boom. The market did not collapse in Australia, and we were very lucky. A resources boom replaced the housing boom, so many issues were masked in aggregate figures. However, around big cities such as Sydney and Melbourne, the bursting of the consumption expenditure growth was a more serious issue than the actual issue of housing and housing construction.

When a country navigates through a period of significant labor market changes, in immigration, labor markets and the reduction of unemployment, the output gap is crucial. In Australia and New Zealand, we have witnessed a huge reduction in the unemployment rate, which we never thought was possible. As with Spain, employment growth is huge. It makes one wonder exactly where the output gap issue, finally, leads one.

The Deputy Director of the European Department (Mr. Leipold), in response to questions and comments from Executive Directors, made the following statement:

Ms. Xafa said that the budget stability law lacks a clear and binding operational framework. To some extent, this is true. However, since Mr. Guzmán may have a different view, I will let him also respond to that. As I said at the beginning, given the constitutional setup in Spain, it has to be a question of cooperation and co-responsibility. And there is nothing binding that can be imposed on the regions or the municipalities by the central government. That said, it is not lacking in rules as such, as there are intergovernmental agreements on this respect, as envisaged in the BSL.

The central government may not agree to our suggestion to keep primary spending constant in relation to GDP, even though they said they would think about it. However, they do have a very well established approach in setting their budget, which is to have a binding expenditure ceiling set on overall expenditure, and let the automatic revenue stabilizers play around that. They also have a rule whereby all social security surpluses are devoted to the social security fund. Moreover, they have rules regarding the permissible deficit even in a low growth scenario (which is growth under 2 percent), when the combined deficit of the central government and the lower levels of government cannot exceed 1 percent of GDP. Of course, if you throw in social security, which is in surplus, it is a much more binding requirement than the Stability and Growth Pact stipulations. There was a critique in last year's report regarding various aspects of the BSL, and there are areas where we would have liked it to be more precise and less ambiguous. However, it is not quite as loose as perhaps it may appear.

On Mr. Saarenheimo's point that we may be underestimating the impact of house price declines of the size of 30 percent, I would not disagree. We used the Bank of Spain models to assess the impact of the house price declines. However, it is true that analysts using the reduction in the share of construction on GDP to make it return to historical values from its current high values, and based also on experiences in other countries, estimate the GDP loss at something between .4 and .9 percent per year, for almost a decade. This is much longer than we have, as we have only done it for two years. Therefore, I agree that this is something one will want to look into further.

I think that on the output gap, certainly it is a black box, for the reasons noted also by Mr. Murray, particularly in countries undergoing Spain's structural changes.

On pension funds, the numbers you quoted for the Nordic countries, of course, do serve to show that Spain still has a way to go before it is truly “Nordic” in that sense.

On Mr. Dumont's question on the substantive differences in the work of the staff for the streamlined consultation, perhaps the most substantive difference in that sense is that there are no selected issues papers. Mr. Dumont asked whether that means we do not do the analysis. Of course, we do carry it out, but perhaps in a less polished way. We prepared many internal technical notes, and other elements which we used for ourselves in presenting our case to the authorities, some of which we also shared with them. However, they were not polished in the same way that a final Selected Issues Paper would be. And, in some ways, the fact that these notes do not need to be prepared in a fairly polished way, allows us to examine a wider range of issues prior to the mission. In essence, that is the main difference.

Mr. Bakker clarified that, like Mr. Murray, he was interested in knowing whether in Spain, mortgages were used to fuel consumption on the basis of the rising value of the underlying collateral.

Mr. Murray added that such equity withdrawals were used for purposes other than what the banks were contracting for, and the banks perhaps willingly ignored that. Moreover, when conditions deteriorate and interest rates rose, mortgages—including more mainstream housing mortgages such as direct housing mortgages—were quickly paid back. Such a development would negatively impact consumption.

The Deputy Director of the European Department (Mr. Leipold) remarked that it was not clear whether the Spanish experience could be entirely reassuring in that respect. The Bank of Spain had assured the staff that overall, mortgages in Spain did not fund consumption. If at all, it seemed that consumption loans funded housing purchases. The implications of that were not entirely clear Therefore, there did not appear to be mortgage equity withdrawal as such, and the phenomenon of using mortgage loans to fund consumption seemed to be very limited, if at all.

As Mr. Murray mentioned, the authorities were reluctant to surpass officially the 1.8 percent of GDP budget surplus target, given the political economy complexities, the Deputy Director continued. At the same time, they subsequently de facto overachieve it. It is unclear how long that could continue, as the outturn was based on underestimating revenue. Thus, the officially posted target for the following year, which might change when the budget was actually finalized, did foresee a decline in the surplus. However, the staff doubted that the decline would be as marked as posted, but there might be some decline, because of the tax reform, tax reductions, and a number of other factors that might lead to lower revenues. Mr. Murray considered that there were significant long-term gains from implementation of labor market reforms. Also, labor protection was a fundamental underlying issue that needed to be addressed. Thus, he wondered about the tensions between short-term and medium-term objectives for fiscal policy.

Mr. He wondered about how the large inflow of labor impacted labor costs in general, as well as the structural changes in the economy. With large labor inflows, labor costs could be expected to remain muted. However, the staff's analysis seemed to indicate otherwise. Moreover, as the average of the inflow of labor was more qualified than the domestic average, the labor inflow could be expected to upgrade the nature of the economy. However, that did not seem to be happening. Perhaps there were some institutional rigidities that prevented the economy from fully capitalizing on the quality and magnitude of labor inflows.

The staff representative from the European Department (Mr. Escolano) confirmed that large rigidities existed in the labor market that prevented a larger benefit from the immigration. The increase in wages and the increase in productivity worked in opposite directions. Productivity growth had been very low in Spain, and that had contributed to a larger increase in unit labor costs than in the rest of the European Union. Moreover, as the staff had mentioned in the past, there were rigidities in the labor markets that had facilitated wage increases above productivity.

On immigration, on average, the educational level of immigrants was higher than that of the overall working population, the staff representative continued. When controlling for age, however, the opposite was true. Therefore, in the end, it seemed that the human capital of new entrants in the labor market entailed that the contribution of immigrants was less than would appear in the whole. Also, the jobs that immigrants had occupied, at least initially, had mostly been in sectors that had experienced very little increase in total factor productivity or productivity in general. These sectors were mostly construction and tourism. Such jobs tended to contribute less to productivity than other jobs in the economy, although in time immigrants could move to other sectors. The contribution had been mostly neutral in the short term. On the downside, there was the need to adapt to a new culture and to new ways of working, which could have made the net impact on total factor productivity lower.

Mr. Murray observed that immigration was usually linked to a desire to succeed. For instance, Hispanic migrants to the United States had been driven by a desire to escape from poverty. Their hard work led to large productivity gains. The longer-term effect was that the immigrant population eventually mirrored local population, and over time, new workers were needed—perhaps on an exponential scale. Therefore, immigration did not significantly assist fiscal policy in that respect.

The Acting Chair (Mr. Portugal) considered that the current Article IV Board meeting was one of the most interesting that he had attended so far. The staff did a thorough and convincing job in responding to the questions, and there was a rich debate among Directors, who had drawn on their own considerable domestic policy experience. It would appear that the streamlined Article IV process had not constrained the quality of the discussion. Indeed, the Secretary had indicated that the current meeting was longer than the previous year's meeting, which had been conducted according to the standard format.

Mr. Guzmán made the following concluding statement:

> First, I will try to be very brief, and try to round a little bit some of the staff's responses in order to put my authorities' position on two or three little things. On streamlining, we fully agree. To us, as I said in the buff, the discussions were exactly the same as previous years. The level of depth and the analysis was as thorough as in other occasions. So, that is all I have to say on that point and the fact that this debate, the whole set of suggestions in the grays, the number of grays and so forth, leads us think that streamlining for the Spanish authorities is not a problem, and has not been a problem this year in our case.

On Ms. Xafa's questions, I understood probably that there were also doubts on the institutional model around the fiscal performance by regions. Now, the political organization of Spain is relatively young. And, in particular, in the field of developing the fiscal authority constitutionally envisaged for the regions, it is an ongoing process. The budget stability law has very specific, and we believe, very precise rules. To a certain extent, they are tighter and more stringent than European Union standards. However, translated into the regional debate, the regional model is now based on a control of income, and debt. The central government still has control over the basic amount of tax income, as well as, the level of indebtedness of the regions. Expenditure is a matter that needs to be dealt with, because of the regional and political peculiarities of the country, needs to be debated on a periodic basis, on an institutional framework that is based on the constitution, with periodic biannual negotiations with the regional authorities on their budget. The model needs to progress, and negotiation on the evolution of this model is ongoing. It reaches highs and lows, depending on the political composition of parliament.

As Mr. Leipold hinted, the final aim is to have fiscal core responsibility, developed to the same level as expenditure transfers. So, the regions collect the tax income, necessary or proportional to the way they spend it. That would be the ideal outcome. The system is now 30 years old. The first regions with full fiscal powers started in 1983, so it is an ongoing process. It is a delicate balance, but so far, it has worked reasonably. This perhaps complements that side of the regional aspect, which is always extremely useful. Any recommendations from outside institutions help the Spanish government put things in order, as well as the perspectives for regional discussions.

Mr. He's question on immigration is very useful. The immigration has arrived in surprising numbers. As pointed out, the level of skills and education is higher on average than that of native workers. However, those skills are deployed in sectors where not always needed, such as construction services. This leads to a situation very much along the lines of what Mr. Murray's analysis of the consequences of such immigration. In other words, we are talking about the productivity reservoir. There is an enormous workforce there, in comparison to the size and quality of the Spanish standards and labor market. This produces a situation where individuals strive to emerge from the lowest income levels of Spanish society. We trust this will also help the rest of the mission that the government is envisaging in its efforts to increase productivity.

Again, our thanks go to the staff and the Board for their input and comments. From the whole debate, we extract valuable conclusions. In our mind set, we are aware that Spain is growing at, or close to, its potential. Of course, this is good news. It has brought historical consequences in terms of employment and the rate of participation, as well as, in terms of income levels. Our income levels are converging towards European averages. However, we are of course aware that we have accumulated a large current account imbalance, reflected partially in growing levels of private sector indebtedness. This needs to be addressed. We could argue for hours on the factors behind the current account imbalance, and in fact, we have argued with the staff for hours. Inflation differentials and other indicators point indeed toward a loss of competitiveness. My authorities and I would like to stress, and we often need to re-remind, that the inflation differential is also largely a by-product of the long upward phase of the cycle, a 14 year old sustained push in domestic demand. If you consider this, and consider that excess demand has coincided over time with a low growth period in our main export markets, you probably will have a fairer or rounder picture. Nevertheless, as I said in the introduction, and as Ms. Lundsager points out in her statement, the fact of the matter is that we agree with staff and with all the grays, in that to a certain extent there exists a competitiveness problem, driven by low productivity growth. This needs to be addressed.

The authorities are reasonably satisfied with the developments in 2006, and trust that the tightening of the monetary conditions and healthier growth in the EU will help reshape our growth pattern, cooling demand for imports, private consumption in the housing market and increasing industrial production and exports. The government's central scenarios are coincident in this with those of the staff and other institutions, and predict a soft landing. Whatever the degree of deceleration of the economy might be over the short and medium term, and Mr. Leipold has read out a few predictions, two extremely valuable assets remain in the hands of the authorities: a strong commitment to fiscal stability and the solvency and prudent oversight of our financial system.

With regard to fiscal policy, I would like to reassure the Board that we take good note of the calls to avoid a procyclical stimulus in the short and medium term. However, in regard to my authorities' track record in this field, I was going to give one further piece of evidence, but Mr. Leipold beat me to it! The trade union that required the Spanish authorities to budget a higher surplus than the one budgeted for next year is in fact the Communist trade union. The thing in Spain is that budget surpluses are strongly and deeply associated with good economic times. And that is the end of the story. Over the past 14 years, we have been growing, and the fiscal stance has been increasingly tighter. So, people, agents, and most importantly, parliaments tend to think that budget stability is associated not with good policy, but with good performance. This is a very useful notion.

The continuity of this policy might very well stem from the fact that Spain has only had three ministers of finance over the past 22 years, one of them you know very well. I think that guarantees a degree of consistency to the approach. Where a slowdown to finally arrive, the fiscal stimulus would help soothe the pain.

On the other front, we are confident, as well, on the continuously vigilant attitude of the central bank with regard to the financial situation of the private sector and the exposure of the banking system to low income households and corporations, in the context of growing interest rates. We share the concerns expressed in several grays and we closely monitor developments.

More generally, however, we still believe that the real challenge of the Spanish economy, in the medium term, is to find ways to smoothly direct all supply resources invested in satisfying housing demand over the past decade to the generation of value added in export oriented sectors.

The other useful set of consequences we extract from the discussions relate to structural and long-term issues of the Spanish economy. Some are of a fiscal nature, and highlight the need to deal with aging related expenditure. I wish we were able to contribute to pension funds in such amounts. We have been consistently reducing debt levels, and we have been funding as Mr. Leipold pointed out, a fairly representative social security reserve fund, which doesn't allow us any room for complacency, but gives us more time. As does the immigration phenomenon. It does not solve the issue. But, it buys us more time.

However, these issues are going to be addressed, and the approach of successive governments in this field is always a progressive and consensual approach because of the productivity sensitivity, of course. The other fiscal issue is the need to improve the checks and the evolution of the regional expenditure. I thank very much everybody for pointing out that weakness, that concern. It is an ongoing process. There were also questions as to whether the surplus for the regions that had been adopted for only 2008 was a one-off wonder. The surplus for the regions has been agreed, and informed positively by the regions for the next three years at the same level, 0.25 percent of GDP.

Other structural reforms relate to framework regulations in goods and services markets, whose behavior we will encourage, to improve further in order to increase competition and allow the most efficient allocation of resources. The reform of the labor market will be addressed again in the near future. We know that steps recently adopted are not the final point of the reform.

Finally, we must guarantee the cost efficiency of every euro invested in research and development innovation and education and infrastructure, as suggested by many grays, in order to effectively deliver the needed productivity boost.

Progress has been made in many of these areas over the years and we consider, indeed, that Spain is not an under performer in most of them. But booming growth does not blind the authorities, and the commitment to reform is as present as ever.

The Acting Chair (Mr. Portugal) made the following summing up:

Directors agreed with the thrust of the staff appraisal. They commended the stability-oriented macroeconomic policies and structural reforms that have underpinned Spain's prolonged economic expansion. They welcomed the continued strong output and employment growth observed in 2006 and so far in 2007, as well as the incipient rebalancing of the sources of growth as reflected in a slowing of housing investment and some strengthening of exports. Directors noted these developments were in line with the central scenario of a smooth deceleration of growth over the medium term. Directors also welcomed the positive contribution of large immigration flows to Spain's growth performance.

Directors, nevertheless, cautioned that the sustained increase in private sector indebtedness, reflected in the widening current account deficit, poses risks going forward. In particular, they noted that a sharper-than-expected balance-sheet consolidation, a possible correction in high real estate valuations, and the need to regain competitiveness within EMU may—given persistent economic rigidities—entail a possibly protracted period of slow growth. To forestall such a scenario, Directors stressed the need to safeguard budgetary stability while tempering demand; to expand supply and improve competitiveness by increasing productivity and reducing inflation relative to the euro area; and to preserve financial sector stability.

Directors welcomed the unprecedented fiscal surplus of 1.8 percent of GDP in 2006 and the reduction of government debt to less than 40 percent of GDP. They noted however that this result was due to revenue buoyancy and that primary spending has been rising steadily. Directors thus called for a more resolute expenditure-based countercyclical fiscal stance in the current favorable environment, in keeping with the new Budget Stability Law. To this end, many Directors advised that the 2008 budget aim to keep central government primary expenditure constant as a share of GDP. While Directors saw merit in the authorities' strategy to increase spending on infrastructure, research and development, and education, some suggested that a thorough review of the efficiency of such spending be undertaken.

Directors stressed that regional governments, which account for a large share of expenditure, should contribute to fiscal restraint by aiming for an appropriately ambitious surplus. Successful implementation of the Budget Stability Law also requires strengthening fiscal accountability by improving transparency of the public accounts, in particular through more timely reporting of fiscal data at the territorial level.

Directors underscored the need for further steps to secure longer-term fiscal sustainability, particularly in light of the potential budgetary impact of the ageing population. While welcoming the continued accumulation of social security surpluses in the Reserve Fund and the contribution of the recent pension reform, Directors encouraged early action in the next legislature to place the pension and health care systems on a sustainable long-term path.

Directors encouraged determined implementation of the authorities' National Reform Program, which addresses some of the key factors constraining productivity. They called, in particular, for stepped-up implementation of competition-enhancing efforts, underpinned by a strong political commitment to promoting contestable markets. Specifically, Directors supported early passage of the new Competition Law, proactive exercise of the competition authority's new powers, and a strengthening of the independence of sectoral regulators. Directors also saw implementation of the EU Services Directive as an opportunity to foster deregulation and competition in sheltered sectors. Several Directors also noted the need for more ambitious labor market reforms.

Directors welcomed the vibrancy, soundness, and stability of the financial sector, and encouraged continued Bank of Spain vigilance in the face of strong credit growth and exposure to the real estate sector. Directors looked forward to passage of pending legislation to implement the Markets in Financial Instruments Directive and Basel II.

It is expected that the next Article IV consultation with Spain will be held on the standard 12-month cycle.

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SHAILENDRA J. ANJARIA
Secretary