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DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

September 10, 2009
Approval: 9/17/09

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 09/25-2

2:30 p.m., March 11, 2009

2. Spain—2008 Article IV Consultation

Documents: SM/09/34 and Correction 1, and Supplement 1, and Supplement 2, and Supplement 2, Correction 1; SM/09/40 and Correction 1

Staff: Traa, EUR; Mühleisen, SPR

Length: 2 hours, 18 minutes

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Executive Board Attendance

M. Portugal, Acting Chair

Executive Directors	Alternate Executive Directors
	L. Lephoto (AE), Temporary
	T. Nguema-Affane (AF), Temporary
	O. Hendrick (AG), Temporary
H-S. Lee (AU)	
	J. Prader (BE)
	M. Agudelo (BR)
	J. He (CC)
R. Guzmán (CE)	
M. Horgan (CO)	S. O'Sullivan (CO)
	J. Poulain (FF), Temporary
K. Stein (GR)	
A. Kishore (IN)	
	M. Xafa (IT)
	H. Yamaoka (JA)
	M. Daïri (MD)
A. S. Shaalan (MI)	S. El-Khouri (MI)
A. Bakker (NE)	
	J. Bergo (NO)
	A. Tolstikov (RU), Temporary
A. Alazzaz (SA)	
P. Warjiyo (ST)	A. Chua (ST)
	S. Antic (SZ), Temporary
	D. Heath (UA)
	J. Talbot (UK)

L. Hubloue, Acting Secretary
F. Gimbel/S. Zucchini, Assistants

Also Present
ECB: G. Pineau, F. Ramon-Ballester. European Department: M. Belka, A. Chopra, J. Daniel, K. Honjo, M. Moreno Badia, B. Traa. External Relations Department: A. Gaviria. Monetary and Capital Markets Department: A. Giustiniani. Office of the Managing Director: J. Rosales. Secretary's Department: M. Miller, M. Yslas. Strategy, Policy, and Review Department: C. Henn, A. Ilyina, M. Mühleisen. Senior Advisors to Executive Directors: W. Abdelati (MI), E. Ahmad (MD), M. Cuenca (CE), C.Dahlhaus (GR), R. Perez (BR), E. Valle (CE). Advisors to Executive Directors: S. Alnefaee (SA), M. Bitans (NO), P. Kanithasen (ST), D. Mevis (BE), C. Mira (CE), S. Na (AU), Y. Shinagawa (JA), M. Tomic (NE).

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2. SPAIN—2008 ARTICLE IV CONSULTATION

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

We would like to thank the staff for a thorough report on the Spanish economy. We are broadly in agreement with the assessment made.

For more than a decade, Spain experienced a period of strong growth during which the economy developed substantial imbalances; namely, the overall level of debt of households and corporate sectors (linked to a large extent to the real estate boom) and persistent large current account deficits. The correction of those imbalances started in 2006[1], albeit in a gradual manner, induced by the combination of rising interest rates and strong international demand, coupled with the country's improving supply capacity. However, the international financial crisis has triggered a credit squeeze and delivered a shock to private sector confidence that has accelerated the correction and caused a severe economic downturn. The policy stance has been revised accordingly.

The latest[2] official projections point to a -1.6 percent growth in 2009. The labor market has deteriorated significantly in 2008, with employment decreasing in the fourth quarter by -3.03 percent (y-o-y) and unemployment reaching 13.9 percent of the total labor force. CPI growth has dropped to 0.8 percent in January, which has brought the differential vis-à-vis the European Union (EU) further below the average (-0.3 percent). Exports have shrunk sharply, but the external sector contribution to growth is increasingly positive, as imports have plummeted.

The Adjustment

The Housing Market

Transactions and prices in the residential construction sector started to decelerate in the context of a tightening cycle of monetary policy in 2006. The credit squeeze, the economic downturn, and the widespread sense of uncertainty have made matters a lot worse. My authorities are aware that a price correction is necessary, even salutary, but it is easy to overestimate the

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[1] See SUR/07/60 Summing Up Spain-2007 Article IV Consultation: "[…] (directors) welcomed the incipient rebalancing of the sources of growth as reflected in a slowing of housing investment and some strengthening of exports.…. these developments were in line with the central scenario of a smooth deceleration of growth over the medium term".

[2] "Spain, Stability program update 2008-2010," approved by the Cabinet on January 16, 2008.

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size of the adjustment. A short-term price overshooting cannot be ruled out, but the extent to which the rapid increase in property prices in Spain was due to a speculative bubble is difficult to determine. Non speculative factors (population dynamics, size reduction of households) were also behind demand dynamics that, while faltering now, may prove more resilient than envisaged by staff[3]. Once stocks are run down and financial conditions stabilize, construction activity should return to sustainable levels. In the short-term, however, the adjustment in the housing sector is having important implications on activity and employment.

The Current Account

The current account deficit was mainly fueled by the buoyancy of internal demand (especially investment) and several demand factors helped explain it: lower interest rates, higher disposable income, intense job creation and well-anchored business and consumer confidence. By 2007 the current account began to adjust, although this trend was concealed by the oil prices raid at the end of 2007 and the first half of 2008. Again, the global financial turmoil has triggered an abrupt balance sheet adjustment, both of households and firms, which is rapidly reducing absorption and improving the current account. The credit squeeze and the shock to private sector confidence are arguably the channels through which the international financial crisis has most violently impacted Spain.

Once the ongoing adjustment is complete, the challenge will be to resume growth on a more balanced manner, with a competitive export sector at the cornerstone. We share the staff's assessment that the Spanish economy needs to improve its flexibility, if often underestimated, and find ways to transfer supply resources invested in housing towards more productive uses. The authorities are committed to accelerating the comprehensive reform process already underway in order to enhance competition, liberalize markets, and encourage supply diversification and greater technological content of our exports.

Financial Sector

The financial sector remains one of the relative strengths of the Spanish economy. The Spanish financial system is centered in a banking industry with a conservative retail business model, with no exposure to toxic

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[3] According to staff) house prices might fall by 30 percent in real terms over four years. In the 2008 April WEO, staff calculated that the house price overvaluation (i.e. not explained by fundamentals) in Spain was around 17 percent in 2007.

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assets, and overseen by a comparatively prudent regulatory and supervisory framework. The staff mentions the dynamic loan loss provisions introduced by the Central Bank as an example of the conservative stance of the supervisor. Rigorous regulations on the perimeter of consolidation have also been vindicated.

The drying up of the interbank markets inevitably put banks under stress, due to the reliance of their funding on European savings. The soundness of their initial balance sheet, and access to the European Central Bank (ECB)'s liquidity window eased the first impact of the liquidity crisis. Authorities also reacted promptly to the situation through measures directed to solve the liquidity problem and to restore confidence.

Looking ahead, the depth and duration of the downturn has now become the main source of concern beyond the adjustment in housing prices. The Banco de España remains vigilant and is closely monitoring developments. Precautionary balances and capital buffers built over years of efficiency gains and profits (including 2008) have so far proven instrumental to cushion the downturn. Yet, nonperforming loans (NPL) ratios continue to deteriorate and there is no room for complacency.

The Policy Response

We share staff's view that, under current circumstances, the economy needs both cyclical support and structural reform, while preserving fiscal sustainability. Authorities have reacted swiftly. The response is built on three pillars: (a) strengthening confidence in the financial system and facilitating the flow of credit to households and firms; (b) cushioning the impact of the downturn; and, (c) accelerating structural reforms that contribute to growth over the long-term. The above policies shall be made compatible with our firm commitment to the long-term sustainability of public finances.

Financial Sector

Confronted with the worldwide seizure in capital markets Spanish banks experienced liquidity pressures, despite their solvency. Among the measures adopted by authorities, described in Box 2 of the staff report, the FAAF is a mechanism established to deal with this transitory funding shortage and is, by no means, a toxic asset rescue program. So far, it has injected 19.3 billion Euros (of a maximum of 50 billion) in medium-term finance, through the acquisition of top quality assets from credit institutions. The FAAF is specifically designed to help activate the flow of credit to

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companies and individuals: up to 25 percent of the funds are awarded in the so-called non-competitive tranche of the auctions, rewarding banks according to their contribution to credit growth.

Some banks have also used government guaranties to issue new debt, for a total of 5.5 billion Euros. The initial amount approved for this line of support (100 billion Euros) will probably not be fully utilized in 2009. Finally, the report duly remarks that the Spanish authorities stand ready to provide capital support to banks in case it were required. However, while some consolidation might help smaller weaker entities weather the storm, no public interventions to address solvency issues are considered necessary so far.

The Banco de España on its part has doubled its efforts in monitoring the situation. The scrutiny of liquidity and solvency positions takes place on a continuous basis and the Bank's supervision is keeping banks under tight control (provisioning and dividend policy).

Fiscal Policy

As a result of previous years of fiscal prudence Spain confronted the crisis from a relatively comfortable position. Year 2007 ended with a general government surplus of 2.2 percent of GDP and a debt-to-GDP ratio of 36.2 percent. This budgetary margin has enabled the Spanish economy to contribute to the European Economic Recovery Plan adopted by the European Council in December 2008.

The set of temporary measures with a direct fiscal impact in 2009 is expected to amount to 1 percent of GDP. These, coupled with other permanent measures—involving lower tax rates and changes in the tax prepayment system to enhance the liquidity of companies and households—will bring the total fiscal stimulus for 2009 to 2.3 percent of GDP. The measures adopted and the operation of the stabilizers will bring the general government deficit to a -5.8 percent of GDP in 2009. The stimulus is consistent with EU criteria and with IMF recommendations:

- The measures are, to the extent possible, both temporary and targeted. They were selected on their short-term effect on growth and employment, but also on account of their longer-term impact. The government remains firmly committed to the long-term sustainability of public finances.

- The Spanish stability program (EU commitment) update envisages an ambitious fiscal adjustment from 2010 onwards, to 3.9 percent of GDP

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in 2011. This includes improvements in the structural balance amounting to over 1 percent of GDP.

The available fiscal space has probably been exhausted and there is no intention to implement further stimulus measures at this point. But circumstances call for caution and for a close monitoring of the situation. Authorities are prepared to react as events unfold over the coming months/years.

Monetary Conditions

It is worth noting that monetary policy is reinforcing the effects of the fiscal stimulus. The sharp decline in the interest rates of the main refinancing operations by the ECB (275 bp since last September to the current 1.5 percent) substantially eases the burden of Spanish borrowers. In particular, most debt held by households is linked to short-term market rates (Euribor). This should help limit the rise in NPLs of banks, and should also help consumption or, alternatively, it will accelerate the needed balance sheet adjustment.

Structural Reforms

Substantial progress has been achieved in this front over the years. The latest update of the OECD product and service indicators places Spain within the group of above-average reformers. Nevertheless, my authorities agree on the importance of accelerating structural reforms to increase growth potential and to facilitate the reallocation of resources from the housing industry. We estimate that the transposition of the Services Directive underway could increase potential GDP by 1.2 percent and we expect qualitatively similar effects from other planned measures, such as the reform of professional services and the increase in competition in transport and energy.

With regard to the reform of the labor market, my authorities are urging social partners to strengthen their dialogue. This dialogue is the framework in which an in-depth and constructive discussion on the functioning of the labor market should address the need for changes in the regulation, that might contribute to smoothing the downturn and facilitating the recovery.

Concluding Remarks

Spain’s demand-driven growth during the past decade was based on easy financing conditions that caused the accumulation of imbalances. Under normal circumstances, the adjustment would have required maintaining a

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restrictive fiscal stance, limiting expenditure and debt, and promoting supply side measures to regain lost competitiveness. The international financial crisis has caused a steep correction of expenditure and debt levels and placed our adjustment process in an extremely adverse scenario, making it more intense and a lot more difficult.

The euro has shielded us from stronger winds but, without the recourse to currency devaluation, overcoming the crisis still requires a rebalancing of our growth model through a reduction of costs, prices and margins vis-à-vis the rest of the world. As recovery takes place, fiscal policy will, to the extent possible, support growth. Meanwhile, we will strive to preserve the stability of the financial sector. Ultimately, a lot depends on the depth of the recession and on the speed of recovery elsewhere. My authorities will cooperate in the relevant fora to contribute to global solutions.

Mr. Majoro submitted the following statement:

The Spanish economy has been severely impacted by the global liquidity squeeze and economic downturn over the last few months, with the drying up of funding for the housing sector, a large external deficit, ballooning fiscal deficit, and a surging unemployment. The spike in food and energy inflation, though subsiding, remains above the European average. With construction activity collapsing, banks under pressure, foreign demand faltering, and competitiveness weak, we note that staff and authorities converge on the economy's pressing needs for both cyclical support and deep structural reforms.

We concur with the staff's assessment on the seriousness of the country's macroeconomic challenges, especially on the possibility that the country could get stuck in a low-growth extended adjustment. We note that banks have weathered well the first impact of tighter funding conditions and weaker asset quality owing to strong prudential cushions. Going forward, we welcome the authorities' commitment to provide a sizable stimulus package to address the critical downside risks. However, we note the several challenges they face in pursuing these objectives, including the ability to provide adequate cyclical support, and capacity to implement deep structural reform that draws support from their' social partners. We concur with the broad thrust of the staff assessment and the reassurances of Mr. Guzmán and Ms. Valle in their buff statement and we focus our observations for emphasis on the risks to the housing and banking sectors, and fiscal policy.

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Risks to the Housing Sector

We note Spain's impressive housing sector development of the recent past. However, we are concerned over the significant divergences between the authorities and staff assessment of recent developments in the sector especially on the new housing starts and price developments. Nonetheless, we concur with staff assessment over the gravity of the adverse effects of the bust in the housing market, especially on the rising unemployment, pressure on banks and their fiscal implications.

The authorities' response with a stimulus package to assist the construction sector to create jobs—especially through public infrastructure—, facilitating mortgage refinancing, limiting foreclosures, promoting the rental market, and expanding subsidized housing are steps in the right direction. We concur with staff recommendations for further improvement of the housing rental market that could improve labor mobility and absorb vacant housing stock. In this regard, and while we see some merit in the authorities' optimism over the country's potential for housing sector rebound on account of the country's attractiveness as a residential destination for many Europeans, we encourage them to persevere with the stimulus effort and, additionally, to implement staff recommendations.

Risks to the Banking Sector

We are encouraged by the banking sector's capacity to weather the initial impact of the global crisis, supported by prudent regulation that reduced incentives for off-balance-sheet vehicles, sound supervision, and the cautious retail-oriented business models that enabled banks avoid investing in opaque structured products. Nevertheless, balance sheet restructuring which includes, inter alia, banks' recourse to the ECB and government funding assistance, disposal of industrial participation, and tightened credit standards, was contributing to the slowdown in the lending growth rate. We note the potential feed back effects of the exposure of Spain's large banks to Latin America that may worsen domestic credit conditions. These risks are paralleled by the increasing bankruptcies among large real-estate developers and a recent surge in impaired loans (NPLs) that are eroding prudential cushions.

We commend the authorities for taking bold steps to address the vulnerability of the banking sector on the funding side, and for adopting legal provisions for potential capital support. We note with encouragement the Bank of Spain's scaled-up surveillance and its readiness to act as needed to forestall systemic disruptions.

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Fiscal Policy

With the sharp downturn in the large tax-yielding housing sector, the fiscal accounts have weakened commensurably. The fiscal stimulus measures of 4 percent of GDP taken by the authorities constitute an appropriate response to the noted sharp downturn in the macroeconomic framework. Despite the divergence between staff and the authorities in the assessment of the impact of the stimulus on the structural deficit, the fiscal balance has moved from a surplus in 2007 to a significant deficit in 2009, exceeding the SGP limits.

We commend the authorities for adopting an exist strategy that entails dropping out of spending once the recession fades. We concur with the authorities' approach to first give the approved measures (current stimulus) a chance to generate their full impact, and, if more measures were required, to consider transfers to the poor and liquidity-constrained families with high spending propensities (extending unemployment support, welfare) and labor-intensive infrastructure spending to protect employment. We concur with staff recommendation that in the latter case further fiscal support should combine with long-run fiscal and product market reforms.

We note that the authorities are mindful that current economic policies do not secure long-run fiscal sustainability due to Spain's high aging costs—which rank highest among advanced countries. Such structural costs may limit the expansion of the country's fiscal space, unless the authorities persevere with structural reforms in the key cost centers. We therefore encourage the authorities to implement, inter alia, pension and health reforms, and limit benefit indexation for the wealthiest, a combination of progressive income tax increases and expenditure cuts in the non-aging related budgets, including phasing out the mortgage interest deductions with the view to fostering the public balance sheet and long-run fiscal sustainability.

With these remarks, we wish the authorities success in meeting their challenges.

Mr. El-Khouri submitted the following statement:

We thank staff for a clear and concise report, and for a very useful and topical selected issues paper. We also thank Mr. Guzmán and Ms. Valle for their most helpful buff statement.

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After many years of vigorous economic growth, the Spanish economy came under substantial pressure in 2008 as a result of a major downward correction in the housing market, and sharply reduced funding for its high external deficit stemming from the global credit squeeze. The authorities have responded to the deteriorating economic situation by taking forceful action, especially in the fiscal and banking areas, for which they are to be commended. Nevertheless, the short-term growth outlook for the Spanish economy, like that for the rest of Europe, remains somber. We agree with the thrust of the staff appraisal and will limit our remarks to few key policy areas.

Housing market conditions have significant implications not only for the pace of economic activity and employment, but also for the quality of bank assets and the level of fiscal revenue. Stabilizing the faltering housing market is therefore a critical element in the overall strategy to set the economy on a path of sustained economic recovery. The authorities have taken a number of measures to assist the housing sector, which are detailed in the staff papers. We note staff's caution about the intention of the authorities to double subsidized housing (VPO) construction as a means of supporting construction activity, given that VPOs represent only a small share of residential construction, and that the resulting inventory increases might have the effect of depressing market prices. We also see merit in staff's suggestion for the authorities to adopt measures to expand the size of the presently small rental market as a means of accelerating inventory absorption, including through a gradual phasing out of fiscal incentives for homeownership.

Fiscal policy has aimed at countering the downturn in economic activity. For the two-year period 2008-09, the authorities have taken stimulative measures equivalent to 4 percent of GDP. As a result, the budget balance is expected to turn from a surplus of over 2 percent of GDP in 2007 to a deficit that could reach as high as 7.5 percent of GDP in 2009, according to the latest staff estimates. The authorities have also taken some "below-the-line" measures in the form of credits and guarantees to support the housing sector, small- and medium-size enterprises, and banks. If all the support is fully used, gross debt and guaranteed debt would increase by 34 percent of GDP during 2007-09, and the debt/GDP ratio could rise to 74 percent by end-2009. Despite the fact that the potential losses on guaranteed debt are deemed small and that this debt will fall quickly once the programs end, debt sustainability considerations dictate that caution be used in determining whether additional fiscal stimulus is to be provided in 2009 if growth were to deteriorate further.

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Spain, like most industrialized countries, faces large challenges associated with population aging that have significant long-term budgetary implications. We note the authorities' agreement with staff that current economic policies do not secure long-term fiscal sustainability. The credibility of fiscal policies to address long-term issues can therefore be enhanced if these policies were to be embedded in a long-run context. As staff notes, this would serve to avoid private agents from turning Ricardian, a point also noted during our recent discussion on Belgium, and to limit the increase in risk spreads. The staff's proposal for the government to publish an intertemporal public sector balance sheet in the annual budget, showing the debt already incurred and the consequences of present policies on the stream of future deficits, is quite interesting in our view, and merits exploration on the part of the authorities.

The Spanish banking system has weathered well the initial impact of the global financial crisis due in part to prudent regulation and sound supervision, for which the authorities are to be commended. The government's support for the banking system has been in line with the common framework agreed by euro-area countries, as described in Box 2 of the staff report. We note that the authorities prefer not to intervene directly by purchasing bank assets, because they consider that banks are best placed to manage these assets. Furthermore, they have refrained from capital injections in order to promote private sector market-based solutions, and to avoid distorting competition. Looking ahead, the situation continues to be challenging. Persistent difficult external conditions may force banks to deleverage further their balance sheets. Moreover, staff stress test results suggest that banks may face capital needs. The authorities have thus acted prudently in establishing legal provisions to support banks with capital assistance, if that proves to be necessary.

We note that Spain's trade deficit has been on an upward trend. An inflation differential with euro partners has persisted, reflecting high margins and high unit labor costs. Strong reforms in the product and labor markets are therefore needed to deflate margins and lower costs, thereby aiding competitiveness. The authorities are proceeding with product market reforms in line with EU Directives and have made good progress on that front, as noted in the supplement to the staff report. Regarding labor market reform, we note that the authorities seek to reduce unit labor costs through microeconomic measures to boost productivity rather than wage moderation, since there is no consensus on the latter among social partners. However, we are doubtful whether the competitiveness gap can be dealt with effectively

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without addressing issues relating to wage indexation and structural macroeconomic labor reform.

With these remarks, we wish the authorities continued success in dealing with the challenges lying ahead.

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

We thank staff for its excellent analysis which strikes a very good balance between short-run and long-run policy challenges. We broadly concur with the assessments and recommendations. We also thank Mr. Guzmán and Ms. Valle for their informative buff statement. After a long period of enviable growth Spain faces serious challenges. Slumping construction activity, deteriorating external demand, and weak competitiveness relative to its trading partners have created a difficult environment for future economic growth. Against the backdrop of lower immigration and shrinking activity in the real estate sector, Spain faces the challenge of significant structural adjustments. The Spanish authorities so far did not need to support the banking sector to the same extent as other countries, yet, pressure on banks may increase. Overall, we strongly encourage the authorities to view the current situation of the economy as an opportunity for necessary reforms which have been put off in the past.

Fiscal Policy

In light of the sharp drop in demand, we regard the discretionary measures as broadly appropriate but also support the decision to first give the approved measures a chance to take effect before any further steps are considered. The sizable stimulus package recently implemented by Spain is in line with the European Economic Recovery Plan (EERP) and represents an adequate response to the economic downturn. Nevertheless, we emphasize staff's assessment that fiscal multipliers have so far been low, with resources (tax cuts) being used by the private sector for deleveraging, instead of spending. We moreover agree with staff that, while allowing automatic stabilizers to operate fully, fiscal policy needs to remain cautious given that the public debt ratio, although still at a moderate level, is expected to increase by 10 percentage points in 2009, and additional assistance to banks may still become necessary.

Nevertheless, from next year on a tighter than envisaged fiscal policy would be necessary to achieve medium-term sustainability, as the authorities' growth projection in the updated stability program is optimistic compared to

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staff's revised growth projections. In a departure from staff's projections, the authorities have already been pricing in the dividend from future structural reforms (fn. 7 and para. 38). However, as has been deplored by staff, to date the fiscal stimulus measures have not been used as a lever to reform labor and product markets. We therefore recommend scaling down fiscal revenue projections in accordance with the lower but currently more realistic growth scenario until the envisaged structural reforms have been addressed. The Fund's projections, pointing to a considerably higher deficit (7 ½ percent of GDP in 2011) than those of the authorities, underscore the challenge of fiscal consolidation over the medium term.

In addition, the recent development of sovereign spreads as well as the downgrading of Spain's sovereign debt rating have shown that financial markets have become more sensitive to debt sustainability issues. This should be an incentive for the authorities to show more fiscal prudence in the medium term and to design their fiscal policy with a long-term financial sustainability framework in mind. Especially they should be encouraged to address the long-term challenges caused by the very high costs associated with an aging population. We note from Mr. Guzmán and Ms. Valle's buff statement the firm commitment of the authorities in this regard. In order to provide a comprehensive assessment of long-term sustainability and link this to the current fiscal policy stance, we support staff's recommendation to publish an intertemporal public sector balance sheet as part of the annual budget document.

Financial Sector

We commend the authorities on their prudent approach to bank regulation, which enabled the Spanish banks to weather the current financial crisis relatively well so far. The dynamic loan-loss provisioning built buffers prior to the onset of the current stress situation, while rigorous consolidation rules have reduced incentives for off-balance sheet vehicles. However, as the quality of domestic assets is set to further deteriorate in line with the housing downturn and banks' foreign activities (although to a lesser extent than in other countries), we support the authorities' vigilance given the very high household indebtedness of about 130 percent of disposable income, which might lead to an above-average ratio of non-performing loans. In this regard, we thank the staff for the highly informative Selected issues paper on the financial sector stress tests. In addition, we commend the authorities on their close monitoring of potential spillovers from foreign markets through close cross-border cooperation with the responsible supervisors.

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Housing

Looking ahead, economic developments will be shaped by the necessary housing sector correction, which will take time to unfold. While we see merit in public assistance for certain groups of house owners to limit foreclosures, we tend to share staff's doubts about building more subsidized houses. These measures would add to inventory and are prone to benefit those for whom they were not intended. In addition, in view of the relevance of the housing sector for the overall economy, better statistical data, i.e. with respect to the precise quantity of inventory, could significantly improve the political decision-making process.

Competitiveness and Structural Reforms

Spain's future growth potential substantially hinges on its ability to bolster international competitiveness. We therefore strongly encourage the authorities to continue to address structural reforms, especially in the labor and product markets, for which staff has given valuable recommendations. We welcome the Spanish authorities' agreement on the importance of accelerating structural reforms as expressed in Mr. Guzmán's and Ms. Valle's buff statement. Spain has suffered from a persistent inflation differential vis-à-vis the euro area in recent years, due to wage inertia from indexation clauses, low productivity growth and a lack of effective competition in key sectors (namely competition in services, electricity and retail). Further staff comments on the latter point would be welcome.

Structural reforms should focus in particular on the labor market, where urgent policy actions are needed. The strong real wage rigidities make the adjustment to the current sharp downturn in business activity almost exclusively dependent on the shedding of labor. This has a lasting (downward) impact on the medium-term growth prospects of the economy. We share staff's recommendations to remove wage indexation and allow for more wage differentiation, especially through opt-out clauses in collective sectoral wage agreements. Also, there should be more delineation between temporary and permanent contracts (at a lower level) in order to avoid the problem of equalizing dismissal costs.

Mr. Bakker and Mr. Tomic submitted the following statement:

We associate ourselves with Mr. Stein's and Mr. von Stenglin's gray. The points presented here are for emphasis.

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During the last decade Spain has narrowed the gap in income per capita with the richer EU economies. Good macroeconomic results, however, were not accompanied by growth in productivity. The labor and product markets remain less than optimally regulated, imposing a burden on economic performance, including unemployment. In order to secure continuation of the convergence to EU standards for its citizens, the authorities need to assess the anti-recession measures in this perspective and make a clear blueprint for labor and product market reforms. Bold action is required in order to avoid a prolonged lower growth path.

The Spanish financial system deserves much credit for its specific regulation of dynamic provisioning, and has shown to be resilient to the first wave of financial turbulence. That said, we are of the view that flexible capital requirements, which combine minimum capital requirements applicable in adverse times and a target level for economic upturns, could be even better means to counter pro-cyclicality without distorting profit and loss accounts. While the impact of the crisis has been limited so far, the huge share of mortgages in the banking assets still pose a serious threat given the current projections for the housing market.

Spain has the highest share of employees with flexible contracts in the euro area. Given that most of the companies could consider ending temporary contracts as the primary method of achieving cost reduction during an economic downturn, it would be interesting to learn more details on the risk of mortgage defaults due to rapidly rising unemployment. The staff is invited to comment.

Public finance and long-run sustainability were serious issues even before the crisis as aging costs are estimated to be among the highest in the EU. We welcome the introduction of the anti-cyclical fiscal rule but further reforms of the pension system are required to secure fiscal sustainability, as the government debt will substantially increase under the current policies. Market forces reflected in increased CDS and sovereign debt spreads and the recent downgrading of the debt rating by one rating agency are clear warning signs. The authorities should define a clear exit strategy for correcting the excessive deficit.

Signs of a competitiveness gap revealed through both measurements based on relative consumer prices and on unit labor costs should not be underestimated. Membership in the currency union necessitates adjustment in the real sector, which may be hard to achieve without full consent by all social partners. However, elimination of the wage indexation and introduction of

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different types of collective agreements which allow opting-out clauses seem unavoidable. Without wage moderation the economic downturn is likely to be prolonged.

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

We thank staff for a well-written set of papers and Mr. Guzmán and Ms. Valle for an informative statement. Spain's prolonged period of strong growth and the concomitant housing boom have led to severe imbalances, including high household and corporate debt and large current account deficits. With the current credit squeeze, the housing-led growth has all but disappeared, and Spain now faces one of the highest unemployment levels in the EU zone. While Spain is confronting the crisis from a relatively strong position, following several years of fiscal prudence and a sound financial sector, the immediate outlook is fraught with considerable uncertainty. Much depends on the economic performance of Spain's trading partners, and flexible responses will be needed. Moreover, improving competitiveness will be key to placing the economy in a high growth, low unemployment trajectory.

As pointed out in the excellent selected issues paper (SIP) on the banking sector, the strong forward-looking prudential regulations, including the adoption of dynamic provisioning, have provided Spanish banks with strong capital and provisioning buffers. The conservative retail business model of the banking sector has also played a role, as highlighted by Mr. Guzmán and Ms. Valle. While banks have weathered the initial impact of the crisis well, they face tighter funding and weaker asset quality. The authorities' cautious approach, providing liquidity support while avoiding capital injections, appears appropriate at the present juncture. The stepped up surveillance of financial institutions, including *cajas*, is sensible, as is the monitoring of cross-border spillovers in cooperation with EU, U.S. and Latin American supervisors. We agree with staff that 2009 will be difficult as the full effects of the housing downturn—with the bankruptcy of large real estate developers—and lower growth are faced. The authorities should be prepared to take corrective actions as needed.

A stronger rental market might be a possible solution to the difficulties in the key housing sector. However, we find it difficult to see how expectations of landlords as well as renters might be changed quickly, given the norms and legal framework that have prevailed in recent memory. We tend to agree with the authorities that the construction of public rental accommodation may well be the most appropriate solution in the short-term.

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This should act to provide a supply of dedicated rental housing and short-term employment opportunities to a hard-hit construction sector. It should also help lower rentals in due course, putting indirect pressure on the private housing market and reducing constraints to labor mobility. While the authorities' proposal may ease difficulties in both housing and labor markets in the short-run, we welcome Mr. Guzmán and Ms. Valle's indication that the authorities continue to work with social partners to achieve a more flexible labor market in the medium term.

The economic downturn, including the sharp drop in housing-related tax revenue, and the fiscal measures undertaken by the authorities to support economic activity have weakened fiscal performance. It is encouraging that these measures have been designed to be temporary to avoid any significant impact on medium-term sustainability. The staff rightly underscores the importance of targeting structural improvements in labor and product markets and addressing long-term fiscal pressures. Furthermore, the large below-the-line supportive measures will add significantly to the size of the public debt, calling for caution. With the possible additional resources needed for the banking sector, as well as pressures from ageing, we agree with Mr. Guzmán and Ms. Valle that there is little additional fiscal space available. However, we welcome their indication that the authorities are closely monitoring the situation and stand ready to react as needed.

We are surprised to see little mention of the local governments and autonomous regions, which will be affected severely by the drop in property-related taxes. Could staff comment on whether Spain's structure of multi-level finance poses an additional area of concern or vulnerability? While we see merit in using the public sector balance sheet approach presented in the SIP, it should presumably also include the sub-national entities. The staff's comments are welcome.

We wish the authorities success in their endeavors.

Ms. Xafa submitted the following statement:

We thank staff for a thorough staff report and useful Selected issues papers. We also thank Mr. Guzmán and Ms. Valle for their informative buff statement. We share the points raised by Mr. Stein and Mr. von Stenglin and focus on key issues.

Spain is going through a hard landing after more than a decade of strong growth led by consumption and residential investment. The authorities

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have responded with sizable fiscal stimulus to support the economy during the severe recession. Nevertheless, the outlook remains sobering. The staff now expects real GDP growth to decline sharply to minus 3 percent in 2009 and to remain negative in 2010 as a result of a major bust in the housing market triggered by the global credit crunch. With domestic demand falling precipitously, the current account deficit is expected to decline by about one half to 5.5 percent of GDP in 2009. Despite considerable cushions built during the upswing, the banking system may need additional capital if NPLs rise much further.

In addition to providing fiscal stimulus, the authorities have taken several measures aimed directly at the housing sector, discussed in detail in SIP I. We share staff's skepticism about the authorities' intention to double subsidized housing (VPO) construction to support construction activity, as it would slow the absorption of the inventory of unsold homes and add to the downward pressure on house prices. By contrast, measures taken by the authorities to help convert existing inventory into VPOs, develop the rental market, and forestall foreclosures are welcome as they would limit the correction and avoid the risk of overshooting.

The authorities have introduced sizable fiscal stimulus, estimated at 4 percent of GDP so far. The stimulus will help offset in part the decline in private demand, but it will widen the general government deficit to 7.5 percent of GDP in both 2009 and 2010, when the banking sector may need additional public support. Moreover, "below-the-line" support to the housing and financial sectors is being provided in the form of credits and guarantees. Although these measures will be phased out as the recession fades, in line with both the domestic Budget Stability Law and the EU Stability and Growth Pact (SGP), the public debt will remain elevated. We thus fully share the staff's concern with fiscal sustainability and support their proposal for publication of an intertemporal public sector balance sheet in the annual budget.

Spain risks getting trapped in a low-growth equilibrium as demand-driven growth with above-average inflation is no longer viable. While we support the authorities' efforts to regain competitiveness through productivity improvements rather than wage moderation, we note that the current low-inflation environment provides a window of opportunity to eliminate wage indexation. We welcome the priority the authorities are placing on accelerating structural reforms to increase growth potential and to facilitate the reallocation of resources from housing to other sectors. Further deregulation of sheltered sectors through the removal of barriers to

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competition in the energy, transport, distribution, and other service sectors would contribute to improvements in productivity. As indicated in Figure 17, the services sector accounts for a substantial portion of the inflation differential with the euro area.

We wish the authorities well in their reform efforts.

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

We thank the staff for their excellent set of papers and broadly agree with the staff appraisal. We also thank Mr. Guzmán and Ms. Valle for their insightful buff statement and we agree with the statement of Mr. Stein and Mr. von Stenglin.

Spain has had robust strong growth for more than a decade. However, imbalances had been building up, which began to unwind in 2007. The downturn in Spain started as a soft landing but the woes of the global economy accelerated the pace of events. We take note that the staff has revised its growth outlook for 2009 and 2010, projecting a decline of 3 percent and 0.7 percent respectively. The authorities need to find a balance between supporting the economy in the short term and taming debt dynamics in the medium to long term. Since the size of the multipliers is uncertain and fiscal support measures are costly, the staff has rightly stressed that this support needs to be accompanied by structural measures so as to free up efficiency resources in the economy. For 2008, the new estimate for the fiscal deficit is 3.8 percent of GDP and it is expected to widen to 7.5 percent in 2009 and 2010. This will put a strain on the financial situation of the public sector. A quick recovery and robust growth after the downturn are essential to prevent the public sector debt from becoming unsustainable.

We thank the staff for the useful paper on the Spanish housing sector as it provides valuable insights and information to achieve an orderly unwinding of the imbalances in this sector. Given the potential impact of the downturn in the housing sector on the soundness of the financial sector and the wider economy, it is important that the authorities take a pragmatic approach towards this issue. We agree with the staff that subsidies to housing construction should be phased out and that additional efforts should be made to expand the private rental market. The authorities have made commendable efforts in this field and we encourage them to accelerate the pace of reforms. In this context, we find Box 2 on page 29 of the selected issues paper (SIP) very interesting. We are glad to note the efforts made by the authorities and the financial sector to limit foreclosures.

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We commend the authorities for the prudent regulation and sound supervision of the banking sector which has so far kept the sector relatively resilient. The principles of dynamic loan-loss provisions which bolstered capital cushions and the rigorous consolidation rules for off-balance sheet vehicles might prove exemplary after the crisis. Since the current financial and economic environment will exert stress on the banking sector of many countries, the staff has correctly cautioned that 2009 could be a very difficult year for the Spanish banking sector as well. The authorities have so far refrained from capital injections which avoid distortionary effects in the markets and saves fiscal resources. In view of the upcoming debt amortizations of Euro 170 billion in the next two years and the stress in wholesale funding markets, we commend the authorities for providing the banking sector with assistance to cope with the funding tightness.

Given the impact of the weakening economy on the asset quality in the banking sector, the recent rise in impaired loans to 3.5 percent and the significant decline in loan-loss provision coverage to 70 percent is a matter of concern. While in comparison to peer countries, these numbers are still relatively comfortable, the direction and strength of these developments warrant extreme vigilance and enhanced supervision.

Given the large exposure of the savings banks (*cajas*) sector to the declining real estate market, we agree with the staff on the need to promote stability of the *cajas* and to continue implementing the recommendations of the 2006 FSAP. We particularly agree that the regulations on consolidation of the sector should be simplified. Efforts should be made to boost capital by the issuance of participation shares and regulations on the issuance of these shares should also be simplified. In any case, it is important that the authorities closely monitor the consolidation process.

The revised numbers for the fiscal deficit projections in 2009 and 2010 signal the limited space that the authorities have for providing further discretionary fiscal support to the economy. Like the staff, we think that the measures implemented so far have helped in avoiding a standstill. Nevertheless, the fiscal resources are scarce and fiscal multipliers have been smaller than expected. In addition, given the downward revision of GDP growth, the cost of the automatic stabilizers remains uncertain. Therefore, for the time being, the authorities should exercise prudence and refrain from further discretionary measures. It would be best to wait to see how the situation unfolds. Further fiscal stimuli should be tied to the implementation of structural reforms as suggested by the staff.

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The debt implications of the programs are important in the short run. These costs may be emphasized by the recent downgrading of Spain and the increased spread over bonds. While deficits may decline, once the fiscal support programs end, the ability of Spain to quickly repay its debt will depend on GDP growth in the years ahead. We believe that an intertemporal public sector balance sheet would be a good tool to asses the intertemporal situation of public finances, especially since the challenges and costs of aging are made more obvious through this tool. Also, in the SIP we found the idea of evaluating different reform options by their impact on the intertemporal balance to be very interesting.

Several measures indicate the competitiveness problems of Spain. To assure a quick recovery of the economy after the downturn has subsided, the corporate sector should be competitive and flexible. We commend the authorities for the good progress they have made in their structural reform agenda as shown by the latest findings from the OECD product and service market reform indicators. Nevertheless, the authorities should also vigorously and swiftly tackle the issues that are hampering the flexibility and increasing the costs in the labor markets. The comments made by Mr. Guzmán and Ms. Valle in this regard are well taken.

The introduction of opt-out clauses in collective labor agreements may be particularly relevant now, given the fact that unemployment suddenly rose from 8 percent in 2007 to 13.7 percent in 2008 and is projected to rise further to 17.7 percent in 2009 and 19.3 percent in 2010. It appears that the lack of flexibility in real wages, at least in part, is directly translating into this sharp rise in unemployment.

Mr. Lee and Mr. Na submitted the following statement:

We thank staff for a well-focused and concise report, and Mr. Guzmán and Ms. Valle for their helpful buff statement.

We note that Spain is not exempt from the ongoing global downturn, despite its long-lasting impressive growth. At the same time, it is reassuring that the economy is in a relatively favorable situation in coping with the evolving financial turmoil, mainly due to a properly-regulated banking sector. Against this backdrop, and given the severity and apparent suddenness of the economic downturn, we agree with staff that it is time for the economy to emerge from housing-led growth and press ahead with a new growth model depending on strengthened productivity and competitiveness.

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The growth outlook in the near term does not seem optimistic at this point, given the sluggish construction activity, faltering foreign demand, and the pressures on the financial sector, as is the case in many other countries. As indicated by the authorities, we look forward to seeing the economy take a V-shaped recovery path. Toward this end, we reiterate that cyclical support, coupled with deep and robust structural reform efforts, are urgently needed at this juncture. A more detailed analysis by staff on structural reforms outlined in the selected issues paper would thus be welcomed, and we call for the authorities' particular and persistent attention to the matter of structural reform.

Given the impact of housing market disruption on unemployment, banks' financial situation and fiscal revenues, there is no doubt that the authorities' adjustment should start with the expeditious stabilization of the housing market in an effort to minimize its spillover effects on financial and real markets. Like the staff, we view the authorities' housing-related measures, including facilitating mortgage refinancing and limiting foreclosures, as suitable and timely. We further encourage the authorities to invigorate the market for housing rentals, which could contribute to the absorption of vacant housing stocks and relieve the pressures on home prices.

We are pleased to note that Spanish banks have well weathered the first blows of the financial crisis and that the main factors for such a good performance are dynamic loan-loss provisioning and rigorous consolidation rules. As pointed out in Box 1, the inherent advantages of these forward-looking prudential frameworks need to be fully analyzed and widely transferred to many other countries facing the same situations. This notwithstanding, the currently degenerating financial crisis continues to negatively affect the banks' operating model and call for banks' further efforts to restructure their balance sheets. In this regard, we urge the authorities to vigilantly monitor market developments and prepare to act accordingly. While the recently-introduced legal provisions for augmenting capital assistance could serve as a contingency scheme, the staff's stress test seems to suggest a possible need for additional capital. Thus, we underscore that capital injection would be warranted should systemic pressures intensify.

On the fiscal front, we consider the authorities' discretionary fiscal expansion, amounting to 4 percent of GDP for 2008-09, as a timely measure in the right direction and consistent with the Fund's recommendation for a fiscal stimulus in addressing a significant downturn. In maneuvering fiscal policy in the period ahead, we strongly emphasize several critical points

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which should not be ignored: (i) the forthcoming fiscal measures need to be balanced between demand-side and supply-side, with more emphasis on the latter, thereby facilitating structural reform in labor and product markets and eventually advancing competitiveness; (ii) they need to be timely and well-targeted, with transfers limited to the poor and liquidity-constrained families and spending focused on creating jobs; and (iii) long-term fiscal sustainability issues need to be fully taken into consideration, given that aging will significantly slow the growth of the working age population, causing the authorities to pay the highest level of aging-related costs among advanced countries. In this vein, we welcome the authorities' enactment in 2007 of a fiscal rule as a timely and forward-looking measure and further encourage the authorities to be active in following staff's recommendation on publishing an intertemporal public sector balance sheet from long-run perspectives. Considering the political tendency toward short-term stabilization policy, the authorities need to enhance their efforts towards long-term fiscal sustainability through sustained consensus-building outreaches to the public.

It is worrisome that the unemployment rate in Spain has almost doubled at 15.4 percent during 1993-2007 compared to the Euro area average of 8.4 percent for the same period, and that it is expected to peak at 17 percent in 2010. We appreciate staff's elaboration on the trend of unemployment and the authorities' policy efforts to create jobs included in the recent fiscal stimulus packages.

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

Mr. Bergo and Mr. Bitans submitted the following statement:

We broadly share the views expressed by Mr. Stein and Mr. von Stenglin in their buff statement. Hence, we will limit ourselves to only a couple of additional questions and remarks.

First, we note that inflation in Spain has until recently been constantly higher than in the euro zone. However, given that the country's price level is still below 90 percent of the euro zone average, we see merit in the authorities' view that part of the higher inflation is determined by the convergence process. It is also worth noting that despite a higher than average inflation rate, Spain's exports have so far grown rather well. On the other hand, the slowdown in industrial production started well before the global financial crisis, and the current account remains in deficit. This would suggest issues with competitiveness. Against this background, does staff have an

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estimate of what would constitute a structural inflation premium over the euro zone that would be economically sustainable?

Second, recent housing market developments in Spain were clearly unsustainable. The correction is now necessary, and we agree with staff that the resources need to be transferred from housing and construction to other sectors. However, as a significant part of the housing stock in Spain is foreign-owned, and therefore partly tradable, the country's housing sector should also be part of the structural reforms that are implemented in this regard.

Third, the banking sector in Spain has evidently benefited from the dynamic loan loss provisions that have allowed the banks to generate liquidity buffers during the good times. These buffers now provide the banking system with time to adjust to the new, less favorable market conditions. In this regard, would staff recommend other countries to follow the Spanish practice of implementing the system of dynamic loan-loss provision? How plausible is it to start this provisioning scheme in the current market downturn?

Finally, as regards fiscal policy, the Spanish authorities must strike the right balance between efforts aimed at cushioning the adverse impact of the current crisis and the need to maintain fiscal sustainability over the medium term. As staff notes in their very helpful Selected issues paper, in order to ensure fiscal sustainability, structural deficits will have to be cut back and spending further contained as the economy recovers. At the same time, a slowdown in population growth and aging will contribute to significant additional spending pressures over the medium to long term. Hence, tax increases in the future may be necessary to achieve fiscal sustainability. In this regard, what would be staff's views on the likely reaction of the corporations and households in Spain to the possibility of future tax hikes and the implied effectiveness of the current fiscal stimulus measures?

Ms. Lundsager and Mr. Wood submitted the following statement:

The housing boom that helped drive Spain's impressive growth over the past fifteen years has come to an end, and accumulated imbalances pose challenges for policymakers. Spain's economy has lost external competitiveness and will likely require deeper structural reform than is currently planned. Measures to open product markets will need to be supplemented by ambitious labor reform and painful wage constraints.

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Fiscal Policy

The authorities' aggressive stimulus has been the appropriate response to the sharp economic downturn. Fortunately, Spain had run fiscal surpluses over the past several years, creating fiscal space to respond to the current crisis. However, fiscal revenues were heavily dependent on the real estate boom, and structural fiscal policy was not as tight as perceived at the time.

We appreciate the staff's detailed analysis of Spain's debt dynamics, and we share the view that current fiscal policies are not sustainable. In the medium term, the authorities will need to implement significant fiscal consolidation, along with structural reforms aimed at boosting the growth rate of potential output. We underline the staff's concern that fiscal stimulus efforts, so far, have not focused on advancing reforms in labor and product markets, missing an important opportunity to address the growing competitiveness gap.

Financial Sector

Spain's prudent dynamic loan-loss provisioning and measures to curb off-balance-sheet vehicles helped limit the effects of the current crisis on bank finances. However, given banks' exposure to real estate and to investments in overseas markets, the risk of asset quality deterioration is significant. Thus, we are pleased that the authorities are anticipating contingencies by adopting legal provisions for potential capital support.

We agree with the staff's assessment that further consolidation of regional savings banks (*cajas de ahorros*) could improve the stability of Spain's financial sector, given the sizeable exposure of the *cajas* to frail real estate and construction sectors. The authorities should move ahead with reforms to the regulatory framework in anticipation of needed restructuring and to identify ways to reduce barriers to inter-regional mergers.

As the largest investor in Latin America, Spanish banks face potential weaknesses in the region that could spill back into the Spanish economy, underlining the need for close cooperation with Latin American supervisory authorities.

Housing

The housing sector is undergoing a serious correction in prices and construction activity. The authorities' efforts to soften the impact of inevitable

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adjustment have been reasonable. Going forward, we agree with the staff's focus on expanding the small rental market. We support the staff's recommendations, such as relaxing restrictions on landlords and clarifying eviction rules, that could help develop the rental market and thus lower one barrier to labor mobility.

As Mr. Guzmán and Ms. Valle note, most debt held by Spanish households is linked to short-term Euribor rates, so ECB monetary easing has helped support household finances. Further ECB easing likely would have a beneficial effect through this channel.

Competitiveness and Structural Reform

During the period of strong economic growth, Spanish prices and wages grew at well above the euro area average. Spain now faces a competitiveness problem that can only be corrected by a period of relatively slow growth in unit labor costs, achieved through faster productivity growth and restrained wage increases. Serious reform is required in labor markets, including more aggressive efforts to reduce labor market segmentation; reduction of wage indexation; curbs on the administrative extension of collective wage agreements, to make wages more responsive to local conditions; and pension reform to address the future burden of aging. With fast-rising unemployment reducing labor's expectations, social partners may be more willing to accept these reforms.

On the product market side, continued focus on implementing the EU Services Directive is necessary. Reforms to the retail distribution sector, for example, can help boost jobs and stimulate demand.

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

We thank staff for a set of well-written and analytical papers and Mr. Guzmán and Ms. Valle for their comprehensive and informative buff Statement.

In the wake of the contraction in GDP in the fourth quarter of 2008,increasing evidence seems to be appearing that the Spanish economy is sliding into a deep and prolonged recession. We commend the authorities for the bold and swift shift in public policy into crisis mode and the number of initiatives launched since October 2008 to resuscitate domestic demand; however, we share the gravity of staff in their assessment of the outlook and the need to brace up for an arduous period ahead.

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Outlook

While the global crisis has accentuated the cyclical downturn that started in 2006, it is the rapid deterioration in domestic conditions that seems to have amplified the downside risks. Lead indicators, particularly industrial production and confidence indicators, have declined precipitously in the first quarter of 2009. The current account deficit, among the highest in the world, is narrowing However, the fact that imports are falling faster than exports is indicative of the weakening of domestic demand. By February 2009, Spain had the highest unemployment rate in the Euro area and this is expected to continue to climb well into 2010. In addition, the sharp increase in household indebtedness alongside the negative wealth effects of declining house prices will likely cause consumption to retrench even further. Fixed investment is expected to fall sizably as construction activity, which powered the past decade of steady growth, is halting at the end of the housing bubble and credit is drying up in the wake of the global financial crisis.

Against the backdrop, we are more pessimistic than staff in the assessment of the outlook as we seethe possibility of several of the downside risks identified by staff as materializing rapidly. Accordingly, we see merit in preparing for a contraction of GDP in the range of 2.5-3.0 percent in 2009, as indicated in independent forecasts, with recessionary effects holding on till 2010. The staff's comments on the likelihood of this worse case scenario would be helpful.

Housing Sector

Alongside the UK, Italy and Ireland, Spain appears to be the most exposed to a rapid downward spiral in the housing cycle. We believe that the downturn in housing activity is yet to bottom out as (i) the retraction of excess demand is still underway with rising household debt making housing increasingly unaffordable; (ii) house prices get pushed down further by accumulating inventory; and (iii) fiscal incentives for housing face the possibility of being withdrawn to create space for the authorities to grapple with the more pressing problems of unemployment and financial stress. We compliment staff for dealing with some of these possibilities in the selected issues paper and invite comments on the wider feedback effects of the housing sector on the overall economy.

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Banking Sector

The resilience of Spain's banking system in the face of the global financial crisis has been impressive. The authorities are to be lauded for sound prudential oversight and, in particular, dynamic provisioning that has delivered adequate capital cushions at this critical time. In addition, the absence of toxic assets in balance sheets, the traditional focus of Spanish banks on retail banking and a tendency to use long-term financing have so far avoided the need for interventions. However, the combined impact of the global financial crisis and the deterioration in the domestic operating environment is being increasingly reflected in rising levels of non-performing assets, choked financing conditions and drained liquidity levels. While liquidity measures have been put in place for purchase of high-quality assets (FAAF) and issue of new debt, the Bank of Spain has indicated the possibility of the need for cleansing of bank balance sheets and restructuring the banking sector if conditions worsen and banks are tested by defaults. The staff's assessment of the preparedness of authorities in this regard would be appreciated.

Fiscal Policy

The staff has projected the headline general government deficit at a little over 6 percent of GDP in 2009, inclusive of the fiscal stimulus and the operation of automatic stabilizers. The buff Statement of Mr. Guzmán and Ms. Valle indicates, on the other hand, that the deficit would be 5.8 percent of GDP in 2009. The recently announced stimulus measures follow on from an already expansionary budget for 2009. Independent estimates suggest that the deficit could rise above 7 percent of GDP in 2009 and close to 8 percent by 2010. Additionally, in a dynamic setting, there are attendant risks: (i) revenues may get eroded further in the downturn; (ii) the downturn may itself turn out to be more pronounced; (iii) there is the possibility of further capital injections into the banking system; (iv) rising debt servicing costs. The staff's comments on reconciling these variances are welcome.

Medium-Term Issues

On the medium-term, we agree with staff that authorities would need to combine strategies for exit from expansionary fiscal policy and return to sustainable public finances with measures for increasing flexibility in labour markets and improvements in international competitiveness. We note from the buff statement of Mr. Guzmán and Ms. Valle that the authorities are committed to accelerate reforms in these directions. We wish them all success.

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Mr. Alazzaz submitted the following statement:

I thank the staff for the excellent staff papers and Mr. Guzmán and Ms. Valle for their helpful buff statement. Spain's impressive growth performance over the past decade has been underpinned by large investments in the housing sector, euro adoption, and a favorable external environment. However, the increased level of corporate and household debt and the large current account deficits, coupled with the impact of the global financial crisis and weaker demand for housing, have caused a severe economic downturn. The risks are also on the downside, as noted in the staff report.

Against this background, the priority is to cushion the downturn and help limit the stress on the financial sector, which could, in turn, feed back into the real economy. To this end, the reduction in interest rates by the European Central Bank should help ease the burden on borrowers. This should promote consumption and help contain the rise in non-performing loans of banks.

On the financial sector, the authorities deserve credit for their regulatory and supervisory prudence that helped limit the impact of the global financial crisis on Spain's banking system. Indeed, as noted in Box 1 of the staff report, dynamic loan-loss provisioning has built buffers before the current stress materialized. The authorities' response to the financial turmoil by purchasing high-quality securities, assuring depositors by raising the deposit insurance limit, and protecting financial stability should further enhance confidence. That said, extra vigilance is still needed in view of the large exposure to the housing and construction sectors and the substantial uncertainty regarding housing prices.

On the fiscal front, I welcome the large stimulus package, which has been facilitated by Spain's record of fiscal prudence. However, in view of the expected sharp rise in the deficit in 2009 and the impact of the aging population on the fiscal accounts, the room for further fiscal stimulus has become much more limited and the need for medium-term fiscal consolidation is evident. Accordingly, I am reassured that the fiscal measures that have been taken are largely temporary and targeted. The envisaged fiscal adjustment from 2010 onwards is also welcome.

Boosting productivity and promoting wage moderation are critical to restore Spain's competitiveness and raise its growth potential. In this regard, I welcome the progress made in structural reform as evidenced by the latest

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update of the OECD product and services indicators. I am also reassured by the authorities' cognizance "of the importance to accelerate structural reforms to increase growth potential and facilitate reallocation of resources from the housing sector." To this end, I welcome the ongoing product market reforms. Labor market reforms along the lines suggested by the staff are also needed to help improve the flexibility and competitiveness of the Spanish economy.

With these remarks, I wish the authorities further success.

Mr. Rutayisire submitted the following statement:

We thank staff for an insightful report, and Mr. Guzmán and Ms. Valle for their informative buff statement.

Spain's real GDP growth has slowed down in 2008 and is expected to contract in 2009. The sharp housing downturn and the global economic and financial crisis have adversely affected private consumption, investment—especially in the construction sector—and the country's external accounts. Unemployment is also rising rapidly.

To alleviate the impact of the contraction of private demand on the economy, the authorities have taken bold fiscal measures. Government efforts to support the housing sector will also help preserve employment, and the state of the banking sector. We agree, however, that these cyclical measures need to be integrated within a longer term fiscal sustainability framework, and that more needs to be done to avoid an extended low-growth adjustment. In particular, additional structural reforms will be necessary to shift from a housing-led growth to a more productive and competitive economy, particularly through labor- and product-market reforms.

Fiscal Policy

We welcome the fiscal measures decided to support demand, amounting to 4 percent of GDP in 2008-09. If growth were to weaken further, we agree with the authorities that additional fiscal measures should be considered, including transfers to poor and liquidity-constrained families, along with labor-intensive infrastructure spending to protect employment. The fiscal deficit, however—before any additional measure—, is projected to reach 6.1 percent of GDP in 2009, raising concerns over the medium-term fiscal outlook.

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Therefore, we urge the authorities to combine potential additional fiscal measures with labor- and product-market reforms that would help enhance long term growth.

Structural Reforms

Against the backdrop of declining competitiveness and high unit labor costs, labor and product market reforms will help cut costs and reallocate resources to more productive use.

We welcome the authorities' plans for product market reform and note that these are in line with the unified European market for goods and services. On labor market reform, efforts by the government to improve job intermediation and boost the effectiveness of active labor market policies are welcome. However, we agree that deeper reforms are needed given the country's daunting unemployment challenge.

Banking Sector

The global financial crisis has had a limited impact on Spain's banking sector compared to other countries, thanks to prudent regulation and sound supervision. Banks' profits remain large while capital adequacy is sound. The authorities have also refrained from purchasing bank assets or injecting capital.

While strong provisioning has helped to build cushions, we note that NPLs are increasing rapidly, as a result of the housing downturn and its impact on construction companies.

We agree, however, that banks' operating environment will become even more challenging with slowing lending growth and deteriorating asset quality (several real-estate developers have filed for bankruptcy), and the authorities need to be vigilant.

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

Mr. Talbot submitted the following statement:

We thank the staff for a helpful and concise report, which illuminates the key challenges facing the Spanish economy at the current juncture. This analysis was usefully buttressed by a well-targeted set of selected issues

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papers. However, we were disappointed with the coverage of spillovers in the report, which seemed to merit a solitary—and all-too-brief—mention in paragraph 30 of the staff report. Further assessment of both the economic and financial linkages would have been most welcome.

We thank also Mr. Guzmán and Ms Valle for their buff statement, which nicely contextualizes the discussions between the Spanish authorities and the staff. We broadly associate ourselves with the views expressed by Mr. Stein and Mr. von Stenglin, so the following comments are for emphasis.

The Macroeconomic Outlook

We broadly agree with the staff's latest GDP projections for Spain (as circulated in SM/09/34, Supplement 2). Nevertheless, we note the large, positive contribution to growth from net trade in 2009. While it seems very plausible to us that imports will fall sharply in response to the severe contraction in domestic demand, the broadly-flat 2009 export projection seemed overly optimistic in the light of the sharp contraction in world trade; Spain's weak competitiveness; and the precipitous decline in exports seen in 2008 Q4. In addition, the forecast for consumption in 2009 remains fairly robust, particularly given the likely negative collateral effect from further house price declines. Further, the staff's comments would be welcome in both these areas.

The balance of risks to growth is clearly skewed to the downside and there is indeed a risk that the recovery will at the very least be a 'protracted U shaped' one (even if not the 'L-shape' that the staff describes). The rapidly deteriorating global outlook, the potential for migratory inflows to ease over the next few years, and the potential operation of a financial accelerator mechanism all support this view. We would be grateful if the staff could comment on how macro-financial linkages have been dealt with in the forecast—are they a downside risk, or are they embedded in the central projection?

Potential Growth and Structural Reforms

We agree with the staff that Spanish potential growth is likely to be somewhat slower in the near-term than in the past, since:

- Previous migratory inflows are likely to have been associated with the Spanish construction boom; robust wage growth (relative to both home countries and other euro-area economies); and the convergence of

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Spanish unemployment to the euro-area average. However, all these supporting factors are now likely to reverse, which could at the very least act as a severe brake on net inward migration.

- Labor market rigidities are likely to exacerbate the hysteretic effects of rising unemployment.

- Weak demand and slower credit growth are likely to reduce productivity growth as support for innovation is held back; access to working capital and trade finance are further restricted; and capital accumulation is impaired by higher company failures and reduced investment opportunities.

We therefore fully support the staff's call for deep structural reforms and welcome the assurances provided in Mr. Guzmán and Ms Valle's statement that the Spanish authorities agree that policies to increase potential growth are of paramount importance. While we applaud the efforts that the Spanish authorities have made in the area of product market reforms, we would urge them to attach a higher priority to the labor market reform agenda along the lines suggested by the staff in the report (¶53). While labor productivity has risen recently as a result of the sharp pickup in unemployment, there remains a substantial, and worrying, differential between unit labor costs in Spain and its trading partners.

Fiscal Policy

Fiscal policy needs to strike an appropriate balance between nursing the economy through the worst of the downturn and ensuring long-term fiscal sustainability.

In the near-term, we welcome the fiscal measures announced by the authorities so far. We note, however, that a sizeable proportion of the stimulus is directed at local authority investment spending. To the extent that these measures are perceived to be temporary, is there a risk that local authorities will avoid undertaking schemes that generate future spending liabilities and to what extent might this constrain the effectiveness of these measures? The staff's comments would be welcome.

In the long term, the staff analysis suggests that Spanish debt dynamics (under unchanged policies) are alarming (figure 14). Given this, any future fiscal stimulus needs to be carefully chosen to maximize the structural reform agenda as the staff suggest. In addition, given that Spain has one of the highest ageing burdens in the OECD, we felt that the staff perhaps underestimates the

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scale of the problem by calling for a 'firmer push by the authorities' [on pension reform]. Further staff comment on the discussions with the Spanish authorities on this issue would be welcome—have the IMF suggested a specific policy response in this area?

Banking Sector and the Housing Market

The Bank of Spain has shown impressive foresight in its policy of dynamic loan-loss provisioning for Spanish banks. This framework has served Spanish banks well and they enter the crisis well-capitalized. In addition, the preponderance of mortgages on variable interest rates has cushioned the impact of the economic slowdown on households' disposable income.

Nevertheless, we agree with the staff that the authorities need to stay vigilant to the risks, particularly from the negative feedback loops associated with the likely decline in house prices. We welcome the assurances made in Mr. Guzmán's and Ms Valle's buff statement in this regard. It is, of course, impossible to tell with any certainty how overvalued the housing market is; how much of an adjustment will take place (including any undershooting) and how far residential investment will need to shrink as a proportion of GDP. Nevertheless, the staff projections for the scale of the likely correction seem plausible to us in light of the historical experience of other countries in similar circumstances and forecasts from independent commentators.

Mrs. Zajdel-Kurowska and Mr. Antic submitted the following statement:

With domestic demand sharply declining, Spain is likely to face a protracted contraction of its economy. The contraction is mainly triggered by a collapse in construction, which had been the driving force behind a unique boom over the last years. The steep increase in unemployment rate, which has become the highest among the EU, as well as rising problems in the banking sector that suffers from a deterioration of asset quality, will add to the adversity. Relief in the form of increased revenues from exports, and even from tourism, will likely fail to materialize because of the faltering foreign demand and the cumulative loss of competitiveness. In the absence of reforms in the labor and product markets, which would increase flexibility and productivity, the current contraction of Spain's economy could well translate in a low-growth extended-adjustment (L-shaped) equilibrium rather than a V-shaped recovery, as staff point out.

Prudent regulation and sound supervision have insulated Spain's banking sector from global financial turmoil and limited the damage from the

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end of the domestic housing boom. In particular, dynamic loan-loss provisioning, contributing to build up considerable reserves for adverse times, and rigorous consolidation rules, reducing incentives for off-balance sheet vehicles, proved to be very successful instruments in preventing banks from over-leveraging. However, the bank's dynamic provisions may not be sufficient to cover all asset losses stemming from the collapse of Spain's housing sector, requiring the banks to improve their capital basis. The authorities are well advised not to intervene directly by purchasing assets, but to promote private sector, market-based solutions first. Following other countries, raising the limit on deposit insurance, establishing a fund to purchase high-quality securities issued by credit institutions and providing government guarantees for credit institutions' new debt issues are adequate measures to deal with the crisis.

These points raise the question of the causes of the crisis in the specific case of Spain. In apportioning the blame, the balance seems more tilted towards too much and too cheap liquidity than towards poor regulation and weak supervision. Could staff comment on that? Would their advice to the authorities differ from the advice given to most countries? Does this mean that the Spanish growth model can be revived, or does it need a profound change?

The fiscal measures taken by the authorities to cope with the downturn were appropriate. However, further measures should be carefully balanced against long-term fiscal sustainability. The cost of additional measures taken on later in 2008 within the "Plan E" as well as quickly evaporating revenues in the context of the housing bust have pushed the fiscal surplus in 2007 into a large projected public deficit for 2009. In that context, could staff comment on the latest seven measures adopted on March 6 by the authorities, which represent an additional fiscal stimulus of 1.5 bn euros? Finally, due to the size of the fiscal stimulus, it is legitimate to ask about the cost of a fiscal over-expansion in the case of Spain. Could staff comment?

Taking into consideration the potential costs of the government's measures to support the housing sector, SMEs and banks, the fiscal outlook is even more worrisome. Indeed, if all credit lines and debt guarantees granted by the authorities are fully claimed, the government's debt ratio would increase by an impressive 34 percent of GDP over a two-year period. In addition, the high cost of population aging puts the long-run fiscal sustainability under pressure. The social security accounts are also at risk with the number of contributors dropping by over 1 million in the past year.

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The composition of the stimulus package seems also typically geared towards measures that have a high multiplier effect instead of measures that address micro-economic inefficiencies. We appreciate the table summarizing the main fiscal measures, but we wonder why it covers only the years 2008 and 2009. Does it mean that all the measures are temporary, even on the taxation side?

The deterioration of the fiscal outlook has prompted Standard & Poor's to remove the triple-A credit rating of Spain. It is also mirrored in a substantial increase in the sovereign spread on Spanish debt. Consequently, government's effective funding costs are expected to increase. Could staff comment?

Against this background, there is an urgent need to address fiscal sustainability. The authorities should follow staff's recommendation to publish an intertemporal public sector balance sheet to guide fiscal policies towards long-term sustainability. The publication, reflecting current assets and liabilities and the net present value of future primary balances, may help to increase public support for adjustments such as the extension of retirement age, parametric pension and health reforms, limiting benefit indexation for the wealthiest and an increase in the progressive income tax. At this occasion we would like to comment that the other advanced countries should also prepare and make publicly available their intertemporal public sector balance sheets.

Structural policies are as important as fiscal policies. Labor and product market reforms aimed at improving competitiveness and increasing productivity are needed. In particular, wage indexation is not helpful within a currency union. Consequently, labor reforms should focus on cutting wage indexation to reduce the inflation differential with the euro area and on increasing job mobility by reducing labor market segmentation. We are worried about the statement by Spain's labor minister that "only 2 out of 10 workers have a good probability of finding a job in the coming months". Does that reflect also the mismatch of labor supply and demand? Further, we suggest that Spain raises its profile in research, development and innovation, as its lags behind most European countries. What is staff's opinion on this? We suppose that the same could be said about education reform, although it would need even more time to have an impact on competitiveness.

Finally, in view of the systemic importance of Spain, could staff inform why this Article IV consultation is concluded more than 21 months after the 2007 Article IV consultation? Is this due to differing views, including among the authorities, as alluded to by staff?

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Mr. Pereira and Mr. Hendrick submitted the following statement:

Spain is facing difficult economic conditions and we are afraid that this global crisis could lead to its worst economic recession in recent history. The staff update has confirmed that the speed of recovery and the long-term prospects for the Spanish economy are not looking great. In the last quarter of 2008 economic growth was negative by 1.0 percent of GDP, and the unemployment rate increased to 13.9 percent. The staff expects a contraction of real GDP of 3.0 percent in 2009—up from the negative 1.7 percent in the staff report, while unemployment is expected to continue rising until reaching a peak at over 19 percent in 2010. The fiscal position continues to deteriorate, and the fiscal deficit for 2009 is now estimated at 7 ½ percent of GDP. The loss of Spain's AAA credit rating and the increase in the sovereign spread are also warning signals.

However, we were encouraged by the authorities' prompt and effective response to the negative consequences of the financial crisis, including in the banking system. The authorities' strategy to deal with the crisis, as explained by Mr. Guzmán and Ms. Valle in their helpful buff statement, seems comprehensive and appropriate. As bank assets are mainly loans and not impaired or toxic assets, we agree with the authorities that, to the extent possible, private sector market solutions should be the first option to deal with banking challenges; and capital injections to banks should only be used if the quality of assets deteriorates more than currently envisaged. So far, the FAAF is working well in reactivating the flow of credit to companies and individuals, with the lending funds backed by quality assets from financial institutions. The Bank of Spain's countercyclical provisioning is also proving its worth, as long as funding tightness is so far the key problem. Likewise, we commend the Bank of Spain for pioneering the use of dynamic loan loss provisions that have proven to effectively mitigate credit procyclicality while helping to build cushions during expansions. In addition, we note with satisfaction that the fiscal stimulus package implemented by the authorities to smooth out the dramatic change in economic activity is commensurate with the size of the downturn and is properly focused on generating growth and employment.

The end of the "housing-led growth model" and the need to look for a new model to enhance growth potential while restructuring private balance sheets is the main challenge ahead. The staff provides a clear picture of the seed of the current crisis. In particular, the selected issues chapter on the housing sector explains the critical contribution of the construction sector to

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output, employment, fiscal revenues, and bank lending. The world crisis has brought the housing boom to a halt, with negative consequences for all parties that benefit from the long-period of strong housing activity. The staff forecasts prices falling by 30 percent in real terms over four years; however, the authorities are more optimistic pointing out Spain's attractiveness as a residential destination for many Europeans, housing market segmentation, and downward price stickiness. Maybe both statements could be of a complementary nature. We would appreciate some clarification from the staff, given the critical role of housing prices in modulating the appropriate policy response and the breadth of the crisis. Also we would like to ask how fast the staff foresees the absorption of inventories.

Spain was a growth leader for nearly 15 years until 2008 and we are confident that the authorities will avoid an L-shaped equilibrium. The economy needs to enhance competitive advantages in sectors non-related to the construction sector, but labor flexibility is not the answer. Like the authorities, we attach greater importance to output market reforms to assist productivity, as well as boosting the effectiveness of active labor market policies and education. We congratulate the Spanish authorities for their above average performance in the latest OECD product and services indicators, and we welcomed Mr. Guzmán's and Ms. Valle's statement that the Spanish authorities agree on the importance of accelerating structural reforms to facilitate the reallocation of resources from the housing industry. We took note of the staff assessment on the competitiveness gap, but tend to agree with the authorities' view that labor reforms without stronger support from social partners will not work.

We endorse the authorities' view that lower unit labor costs could be better achieved through increases in productivity, rather than by imposed wage moderation. Despite the fact that wage increases have outpaced the Euro average, we underscore that Spain has lower average wages that its EU partners. We do not share the staff statement that: "Spain needs extended strong wage moderation and structural macroeconomic labor reforms, including the elimination of wage indexation, earlier adoption of opt-out clauses from bargaining contracts.". It is critical to keep in mind that wage moderation and labor market liberalization may reduce costs, but not without huge social consequences. In a nutshell, the crisis cannot be dealt with by shifting its burden onto the working class. In our view, the suggestion that only more labor flexibility will suffice to avoid an L-shaped equilibrium could be misleading. Shifting the burden to labor will only deepen the crisis.

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Finally, as most advanced countries, Spain will need to strike the right balance between maintaining long-term fiscal sustainability and providing an adequate and timely fiscal stimulus to the economy. We agree that if the recession worsens, more assistance may be needed. At the same time, given the rapid deterioration of the tax base, a debt to GDP ratio close to 50 percent by end 2009, and the fiscal burden of the aging population, a cautious approach is warranted. In any event, the authorities need to be careful to focus additional spending on the most needed segment of the population. In that regard, we welcome the authorities' intentions to consider further transfers to the poor, and additional spending in labor-intensive infrastructure to protect employment.

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

Mr. Mozhin and Mr. Tolstikov submitted the following statement:

We thank staff for interesting and informative papers and Mr. Guzmán and Ms. Valle for their informative buff statement.

Spain has not managed to avoid the negative impact of the global recession. After a long period of strong growth driven by consumption and residential construction, the economy is facing severe slowdown. Fortunately for Spain, its banking system has had little exposure to toxic assets and public debt burden has been substantially reduced in recent years. However, as the crisis continues, the banks' balances are deteriorating, while fiscal position is becoming more and more strained. Against this backdrop, the Spanish authorities should focus on structural reforms aimed at improving competitiveness.

The housing boom was one of the main pillars of Spain's strong economic performance and its sharp reversal inevitably had strong negative impact on growth, employment, banks' balances and public finances. The main challenge for the authorities is to mitigate the speed and depth of contraction and to avoid overshooting. In this regard, measures aimed at limiting foreclosures and activating the underdeveloped rental market to absorb vacant housing stock are welcome.

The impact of the financial crisis on the Spanish banking sector, so far, has been mitigated by its retail-oriented business model, substantial loan-loss provisions and limited investments into structured debt products. The authorities should be commended for implementing the advanced prudential

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and regulatory framework, including dynamic loan-loss provisioning and rigorous consolidation rules. Their efforts to support banking system since the outset of the current crisis have been well targeted and consistent with the common framework agreed by the euro-area countries. However, the authorities should be prepared for further deterioration of bank asset quality and develop contingency plans to assist banks with capital injections in order to forestall systemic disruption.

A substantial countercyclical easing of fiscal policy was warranted by sharp slowdown in economic activity. Spain faces a budget deficit above 6 percent of GDP this year due to housing-related fiscal revenues drop and stimulus measures, including tax reduction and additional public expenditures. This package is also in line with the joint EU approach intended to boost the faltering economy. At the same time, the feasibility of an additional fiscal stimulus in case of further economic slowdown is questionable as it may jeopardize medium-term fiscal position. Before the crisis, Spain's debt was low by the EU standards and declining, but this trend is already turning around. Should all announced fiscal measures be fully implemented, gross debt including guarantees could rise to more than 80 percent of GDP in 2010. In this regard, we agree with staff that further fiscal expansion should not be advisable unless complemented by substantial structural reforms aimed at increasing competitiveness and improving the effectiveness of social expenditures.

The competitiveness indicators point at a widening gap with the main trading partners. As the exchange rate depreciation is not an option in the currency union, improving competitiveness will require ambitious labor and product market reforms. The comprehensive implementation of the European Service Directive could stimulate competition and effectiveness in the services sector. The authorities should also reduce administrative burdens. As for the labor market reform, we see merit in the authorities' efforts to reduce unit labor costs by boosting productivity and improving education. However, they may be insufficient and require time to take effect. Therefore, discussion with social partners on the need for increased wage flexibility and labor market liberalization should be intensified.

With these remarks, we wish the authorities success.

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Mr. Warjiyo and Mr. Kanithasen submitted the following statement:

We thank staff for the report and informative selected issues papers, as well as Mr. Guzmán and Ms. Valle for highlighting the authorities' views in their buff statement.

Spain is going through a difficult adjustment from an economic boom to a substantial slowdown. The global turmoil exacerbated the rapid unwinding of the imbalances that have beset the Spanish economy in the past decade. In the short term, Spain's dilemma is how to navigate itself out of the crisis by addressing the fallout in the housing and manufacturing sectors, without jeopardizing the current unsustainable public debt. In the medium-term, more bold reforms, in particular those in the product and labor markets, are needed to help the economic recovery and to further address the imbalances on the horizon.

We are encouraged to see that the Spanish banking sector is in good health. The authorities deserve praise in their oversight of Spanish financial institutions, especially through their counter-cyclical dynamic loan-loss provisioning. As Mr. Guzmán and Ms. Valle point out, the current strength of banks is also attributed to their lack of exposure to toxic assets. Hence, one of the main lessons from this crisis is that maintaining a conservative strategy in an overly sophisticated and seemingly attractive environment has been the best bet. We are also encouraged by the authorities' swift actions to aid banks in October last year. Yet, as we have witnessed in so many countries, macro-financial linkages operate in both directions, and positions can change dramatically, as demonstrated by staff's stress tests, which warrant caution on both the banking soundness and their implications to the overall macroeconomic conditions going forward.

That said, we would like to offer the following comments:

On the recovery process, we note that the views of authorities and staff diverge on whether the upturn would be rapid or not. Given the high uncertainty and risks for a more protracted global economic downturn, we believe that it is better to err on the side of caution and urge the authorities to better prepared policies for a possible L-shaped equilibrium. We also share with staff the downbeat outlook on immigration—the backbone of Spanish growth in the past decade—not because of inflation differentials, but mainly due to the rising unemployment which may very well deter future entrants to the labor market. Furthermore, despite the recent measures on the housing market, we are not convinced that the market would continue to be supported

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by the demand of vacation homes by other Europeans, as they are affected by the crisis as well. The staff's comments are welcome.

On inflation, the sharp drop in oil prices has helped the headline inflation converge to the euro average in 2008. Slowdown demand would also be expected to ease the inflationary pressures in 2009. Nonetheless, labor market rigidities and wage indexation have prevented a full output-price adjustment. We note that, despite the economic slowdown, wage increases in Spain have outpaced the euro average. How has this translated into wage-price dynamics and unemployment in the short-run? In the medium-term, we agree with staff on reforming rigidities in the labor market as key for increasing the flexibility in the output market and price adjustment.

On the housing market, with US housing prices expected to fall by 10-15 percent by end-2010 as anticipated by WHD staff, we think the projected decline in staff estimates for Spain does not seem excessive, considering Spain is one of the few countries with a bigger boom than the US. One factor being cited is foreign interest, especially from the rest of Europe. What are the prospects for this demand to actually manifest itself? We note that the authorities' house building program is targeted at low-income buyers. Is there a risk of people trading down or are potential buyers being means-tested? Will this worsen the excess inventory at other price points?

As regards fiscal policy, there seems to be a divergence of views on policy options going forward. Nonetheless, given that fiscal space has been exhausted and questions about debt sustainability have come to the fore, we are encouraged with Mr. Guzmán and Ms. Valle's statement that "there is no intention to implement further stimulus measures at this point". We wonder, however, whether a contingency plan is in placed in case the crisis worsens and, say, affecting the financial sector, which may call for further fiscal actions?

Even though the financial sector has entered the crisis in a good shape, results of staff's stress tests are worrisome. NPLs, albeit currently at low levels, are rising fast. Moreover, given fallout from the housing and corporate sector may very well exacerbate the situation, there is a high probability for Scenarios 2 and 3 in the stress tests to materialize. As banks are more likely to need fresh capital in these scenarios, what are the prospects and feasibilities of (1) a consolidation of the smaller banks, particularly the *cajas*, and (2) a capital injection by the authorities, considering the aforementioned constraints in Spain's fiscal position? On spillovers through Santander and BBVA, staff have identified a potential risk from their overseas operations. What are the

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risks that their operations in Spain and other major economies could lead to a contraction in balance sheets in Latin America?

On the longer-term structural issues, we take note that in addition to the current short-term challenges which are already tying up policy responses, the authorities face further, long-standing reforms. The staff has highlighted reforms to correct labor market rigidities and to address competitiveness. We welcome the recent reforms in product market, particularly those on liberalizing the service sector and improving competition. How is the progress of implementation by the local authorities on the reform of the European Services Directive? Specifically on the labor market, we also note some measures to reduce unit labor costs through productivity gains. While we understand the socio-political constraints for a more ambitious labor reform, we tend to agree with staff that wage moderation is urgently needed to lower costs and increase competition, which Spain would very much benefit from in the long-run.

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

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

We thank staff for a set of well-written and focused papers, and Mr. Guzmán and Ms. Valle for their helpful buff statement. The Spanish authorities are to be commended for the country's continued impressive economic performance for nearly 15 years—above the EU average. However, Spain has also been hit by the global financial crisis, particularly its strongly concentrated banking sector. The authorities face a challenge of shifting from housing-led growth to a new model, while maintaining long-term fiscal sustainability.

As we agree with the thrust of the staff appraisal, we would like to make a few comments for emphasis.

On growth outlook, the revised staff projection seems to reflect further downside risks, while the authorities' projection remains unchanged, and the staff's elaboration on the difference is appreciated.

Housing Market

Spain's housing boom was brought to a halt by the funding crunch. It is a challenge for the authorities to make the adjustment and absorb large

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housing inventories, while avoiding sharp housing price declines. In this context, we welcome the authorities' timely measures, and also note there is disagreement on some measures between staff and the authorities, especially on promoting the rental market and expanding subsidized housing. We welcome more debate on this issue. The authorities' early consideration of the long-term housing market development strategy is encouraging.

Banking Sector

The Spanish banking sector made substantial profits in 2008, yet since the development of its housing market was hit by the global financial crisis, and driven by the high share of mortgage loans, construction, and real estates companies—accounting for 60 percent of total loans in the banking sector, we believe the potential risk is increasing, and the deteriorating loan quality will definitely affect the banks' profitability and funding. We note the authorities have taken market-based measures to assist bank funding, rather than purchasing bank assets or injecting capital. Meanwhile, we encourage the authorities to monitor the banking market developments closely, and be ready to inject capital into the banking sector if needed. We welcome staff's helpful recommendations on savings banks' mergers, which we believe merit the authorities' careful consideration.

Fiscal Policy

During the past several years, Spain enjoyed strong fiscal performance in the context of the housing market boom. Under the current situation, the fiscal stimulus package and the authorities' banking support measures put considerable pressure on its fiscal position, and it will bring on a significant deficit in 2009. We note the significant difference in general government deficit projection for 2009 between staff and the authorities. Could staff elaborate? We welcome the authorities' strategy of keeping the measures temporary and targeted. We agree with the authorities and staff that Spain needs more structural reform measures to contributing to its long-term fiscal sustainability, due to the high cost of its aging population, and large debt implications of the current fiscal stimulus measures and the authorities' guarantees.

Structural Reforms

Spain needs to redouble its efforts in structural reforms so as to sustain its growth momentum, and enhance its competitiveness. In the long run, more labor and product market reforms are vital to enhance Spanish

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competitiveness and productivity growth. Although we concur with the authorities that the labor reform needs a consensus before its introduction, we encourage them to further increase the flexibility of the labor market. In this regard, we thank Mr. Guzmán and Ms. Valle for the updated information that the authorities are urging social partners to strengthen their dialogue, and hope they reach an early consensus. The improved product market—as indicated in the latest update of the OECD product and service indicators—is encouraging, and more seems necessary. We encourage an early implementation of the product market reform measures (noted on page 35).

Mr. Fayolle submitted the following statement:

We thank staff for their insightful and comprehensive set of reports, as well as Mr. Guzmán and Ms. Valle for their informative and candid buff statement. In the previous Article IV consultations, we had stressed that the growing risks and imbalances were a source of concerns. We therefore welcome staff's thorough analysis of Spain's challenges. We concur with the remarks made by Mr. Stein and Mr. von Stenglin in their statement, and would like to make the following comments.

The growth regime of past years exposed the economy to substantial risks. One of the main engines of the country's growth has been the build up of a sizable housing boom, which led to important imbalances. The authorities are now a facing tremendous challenge to allow the economy to adjust in the midst of the severe global financial and economic crisis. The collapse of the construction activity and the bust of the housing bubble will have a sharp impact on growth, on banks' balance sheets, and on households' employment and wealth, and therefore consumption. We agree with staff's revised growth forecasts for 2009 and 2010. More generally, the authorities will have to smooth the impact of the ongoing recession while rebalancing growth towards a more sustainable model. This will imply implementing further structural reforms to allow an adequate reallocation of resources and bolster the competitiveness of the economy.

Fiscal policy has responded adequately to the sharp drop in economic growth. Allowing the full operation of automatic stabilizers along with sizable discretionary measures will indeed help cushion the impact of the economic downturn. Most of the measures taken by the authorities appear to be targeted and temporary, and are in line with the principles agreed upon during the European Council in last December. However, we miss in the report a forward-looking assessment of their implied fiscal multiplier. The staff's comments would be welcome. Having said that, we note that the authorities may need to finance capital injections in the banking sector. This could further

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deteriorate the expected sizeable fiscal deficit for 2009. Furthermore, the elasticity of fiscal revenues to revenues from the construction and housing sector has proven to be very important, leading to a significant revision of the structural fiscal balance. In addition, Spain is facing important challenges due to population ageing. Consequently, we agree with staff that public finances will need to be put on a sustainable track as early as developments permit it. Indeed, the recent tightening of sovereign spreads and the downgrading of Spain's rating further stress the need for a cautious approach. We welcome the authorities' awareness of the necessity to ensure debt sustainability over the medium-term.

We share staff's recommendations regarding the ways to respond to the housing bust. In particular, further building of subsidized houses should be avoided and initiatives to develop the rental markets should be implemented. This would help absorbing the excessive inventories. This will be a key to foster an adjustment of the housing bubble through quantities rather than prices. In this regard, we would appreciate if staff could elaborate on the methodology used to assess the extent of the price adjustment they foresee (30 percent in real terms). Has a model of equilibrium prices been used? What is the estimated role of quantities versus prices in the unfolding of the bubble?

Spain's competitiveness gap will have to be addressed through structural reforms. This gap can be explained by several factors: concentration of growth in non-tradable sector where productivity gains are low—construction sector and tourism in particular, limited competition in sheltered sectors, and higher inflation than in most other euro area countries. We therefore strongly agree with the relevance of staff's proposed structural reforms in labor and product markets, in order to help diminish costs and allow a more efficient reallocation of resources. In particular, we stress the need to increase competition in key sectors and to reform the wages indexation mechanisms.

The banking sector has been resilient so far, but the drying-up of external funding and the sector's exposure to real estate poses significant challenges. Spanish banks rely heavily on retail banking, had prudent securitization practices, and were little exposed to toxic assets. Beyond, the authorities are to be commended for having implemented an "ahead of the curve" regulatory framework: the dynamic loan loss provisioning has indeed allowed the banks to build up sizable buffers to protect themselves against a rise in non-performing loans. Banks have therefore weathered well the first round of the crisis. Nevertheless, we note that the stress-tests performed by staff indicate that, given the share of mortgage loans and construction loans in

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the banks' and *cajas*' total assets, a sharper and more protracted downturn could lead to a surge in the ratio of non-performing loans, making the case for recapitalization needs. In addition, the banking sector is also under pressure due to its reliance on wholesale funding. The authorities have responded adequately to the risks stemming from this vulnerability by implementing the FAAF and providing guarantees on banks' new issuances. But the situation will need to be closely monitored. Moreover, we would like to hear more from staff on the linkages between the banking and the real estate sector. Indeed, the participation of banks in the capital of several real estate companies has increased recently, via the execution of guarantee clauses. Given the regulatory capital requirements on such exposures, this could eventually affect the resources of the banking sector. How does staff assess the consequences of these developments? Last, we would appreciate if staff could elaborate on potential vulnerabilities for the banking sector stemming from its exposure to Latin American countries.

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

We thank staff for the well written set of papers and Mr. Guzmán and Ms. Valle for their informative buff statement.

After years of impressive growth, Spain is experiencing the impact of the global financial and economic crisis. While the dynamism of the private sector gave support to this performance, at the same time it fueled a persistent current account deficit which in turn translated into increased levels of debt, both of the corporate sector, and of households. Spain faces the prospect of a sizeable economic downturn, with an increased fiscal deficit, as well as the drying up of funding for the housing sector and the collapse of the construction activity.

Sound supervision and prudent regulation give the support banks need to weather the international financial crisis. The pioneer dynamic provisions set by the Bank of Spain to mitigate credit procycality are giving the system a good cushion to face the downturn of availability of funding. To face an uncertain future, the authorities have put in place a reasonable set of measures that should reduce the probability of using tax-payer's money to capitalize banks. However, it is not clear to us if the same can be said of *Cajas*. Their funding is increasingly more difficult. We understand that the role of *Cajas* in the Spanish society is an important one and in that sense the expected consolidation should be treated carefully given the spillovers that it might have on the public perception and on markets.

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While Spanish Banks' recapitalization and funding seem to be under control, credit growth keeps its downward trend, and has fallen below 10 percent from the peak of more than 25 percent a couple of years ago. Could staff elaborate on the possibility of mobilizing resources to the private sector in the near future? We take note of the important exposure of Spanish banks to emerging markets in Latin America and their low risks in the region.

The authorities' anti-cyclical fiscal support is well placed. The significant size of the fiscal stimulus should help reactivate domestic demand and cushion economic growth. Nevertheless, we suggest caution in giving subsidies to new housing, because it could further increase the excess of supply.

We concur with staff that the Spanish economy could benefit of shifting the engine of growth away from the housing sector. In the meantime, measures to alleviate the sector could be pursued. For example, staff's suggestions to reduce red tape, as leasing restrictions related to the duration of housing contracts, should help absorb the vacant housing stock and reactivate the sector. However, there is a high degree of uncertainty on the future of the housing sector, as evidenced by the substantial differences between the authorities and staff with respect to price projections and the number of new house starts.

We commend the authorities' commitment to keep the pace with the structural agenda to increase potential growth. One of the authorities' main challenges is to obtain the political support to address labor and product market reforms. Progress in those areas should help the country increase productivity to address competitiveness concerns under a currency union.

Mr. Horgan, Mr. O'Sullivan, and Mr. McGoldrick submitted the following statement:

We join others in expressing our appreciation of the staff report. We are especially grateful for the additional detail and background analysis contained in the selected issues paper. The staff report accurately identifies the key policy issues and we welcome the focus on long-term sustainability. We support the thrust of the staff appraisal and we therefore concentrate our remarks on a few points for emphasis.

Economic Background

Thanks to above-average rates of economic expansion, real per capita incomes in Spain have been converging for some time on the EU-15 average.

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This catching-up process has been observed also in price developments. Buoyant growth since 1993 has been accompanied by healthy general government fiscal balances and while much of the fiscal improvement may indeed reflect tax returns from the housing boom which was always unlikely to be sustained indefinitely, the result has been a marked reduction in the level of general government debt. This has left the authorities better positioned than many others as they confront the current crisis, a fact reinforced by Spain's lack of exposure to the fall-out from the US sub-prime crisis. However, as noted in Mr Guzmán and Ms Valle's highly informative buff statement, the period of strong growth also witnessed significant domestic imbalances although signs of correction of these imbalances were already apparent in 2006. In our view, a particularly worrying imbalance is the rate of unemployment which, though declining, remained disappointingly high during the period of sustained growth. This continues to be among the most serious challenges for the authorities though, as with other concerns, Spain is by no means unique in that respect.

Fiscal Policy

With Messrs Stein and von Stenglin, we consider that the discretionary measures taken thus far have been appropriate. We welcome the authorities' statement that an exit strategy is in place in that the measures will drop out once the recession fades. We compliment the authorities on the introduction of the fiscal rule in 2007, a measure of particular value in the context of a heavily-regionalised government spending framework. The staff report usefully focuses on longer-term sustainability issues and we would appreciate some further insights from staff on those issues. In the analysis of the potential fiscal impact of aging, has the staff factored in the widely-observed phenomenon for cost inflation in the health sector to exceed significantly cost increases elsewhere in the economy? In addition, has the staff allowed for the likelihood that a diminishing share of younger persons in the population tends not to be reflected in "savings" in education expenditure?

The staff recommends publishing intertemporal balance sheets to help focus attention on longer term fiscal issues. While the suggestion has obvious attractions, there are also obvious concerns that would have to be addressed. The results of such long term exercises are extremely sensitive to small variations in assumptions about the real rate of interest, migration trends and other factors. This would argue for the use of ranges rather than point estimates. The results are also very sensitive to timely policy interventions, notably around the age of retirement. Any published material should illustrate the impact of possible policy measures and of variations in the working

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assumptions. Above all, the impression should not be conveyed that Spain is unique. Any country where the population is aging is likely to show similar results, on unchanged policies.

Housing Market

The staff report accurately identifies the three primary concerns resulting from Spain's housing market contraction: higher unemployment, pressure on banks, and weaker public finances. We support the view that the "rapid absorption of inventories is paramount" (selected issues, paragraph 38) and that a focus on increasing the flexibility of the private rental market and reallocating fiscal spending from construction toward infrastructure would be helpful. The eventual stabilization of the housing market could provide scope for reassessing the role of fiscal incentives to home ownership. However, we wonder whether the proposals made in paragraph 22 to relax restrictions on those obligations on landlords might not run counter to the broader view that greater labour market flexibility is a priority. Are such restrictions not likely to provide a measure of security to people moving in search of work? The staff's comment would be appreciated.

Financial Sector

Spain's banking sector has thus far weathered the impact of the global crisis well, reflecting "prudential regulation, sound supervision, and cautious retail-oriented business models". We agree with the preference of staff and the authorities that capital injections should be avoided. Thus far, Spain has witnessed less financial sector consolidation than in the EU15 as a whole. Spain has the highest number of local branches in the EU, financial sector concentration is low, banking competition is intense, and the Spanish banking system remains essentially domestic. Can the staff further explain what the implications of the structure of Spain's financial sector could be for its success?

The rationale to secure credit on international markets was in the main sound in a country with the type of sustained performance Spain has put in over the past decade and a half. In this global environment of massive liquidity and low real interest rates, Spanish banks committed a large portion of their funds to the housing sector. This could, until recently, be justified by pointing to the seismic demographic shifts this country has experienced. The authorities deserve particular credit for their vigilant supervision practices and foresight when implementing their program for dynamic loan loss provisions. Indeed, this is one reason why Spanish banks have weathered the initial storm

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remarkably well. Looking forward, however, Spanish banks reliance hitherto on securitization and wholesale markets for funding purposes is a concern, given the significant upcoming refinancing needs. Fortunately, authorities, by establishing the FAAF, have taken decisive action. This, together with ECB refinancing, should continue to ameliorate the effects of these upcoming needs.

Over the course of 2008 the percentage of NPLs increased, as high levels of inflation and increasing interest rates eroded consumer confidence and the freezing of global financial markets developed its full effect. One should not forget, however, that inflation and interest rates have declined substantially since the Article IV mission has concluded. These two forces should combine to significantly dampen the rise of NPLs and further help arrest the rate at which the quality of bank assets are projected to decline. Regarding *cajas*, the attempt to allow the initiative for restructuring to emanate from the private sector should be encouraged and regional deregulation may promote potentially beneficial consolidation of savings banks. It would appear, however, that further expenditure on social housing would be of dubious benefit, given it is likely further to erode the value of housing. An issue that might be worth further investigation is the degree of involvement of banks with developers and how this might affect banks' financial position.

Structural Measures

We note that the staff and the authorities see increased labour market flexibility as being of central importance. An international survey (Global Competitiveness Report 2008-2009) according to which Spain maintained its competitive position in 2008 nonetheless identified "restrictive labour regulations" as by far the most problematic factor for transacting business in Spain. We agree with the staff that "Instead of repressing demand, it is preferable to implement labor and product market reforms to cut costs and reallocate resources to more productive use for a vigorous recovery" in order to improve competitiveness and we note the commitment of the authorities to focus on boosting productivity and improving education. We applaud the authorities for proceeding with product market reforms.

With these remarks, we wish the authorities well.

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Mr. Yamaoka submitted the following statement:

We thank the staff for their well-focused report and Mr. Guzmán and Ms. Valle for their helpful statement. We agree with the thrust of the staff appraisal.

Economic Outlook

Most indicators illustrate that Spain has entered a sharp downturn. Since Spain has neither independent monetary policy nor exchange rate policy under currency union, a key issue is what mechanism could work to achieve the nation's economic recovery, especially when external demand is unlikely to recover soon. If a country under a currency union tries to bolster competitiveness, it will have to reduce unit labor costs through the adjustment in nominal wages, which might cause additional deflationary impacts and raise real interest rates during the adjustment process. In addition, if labor market is not sufficiently flexible, the adjustment of unit labor costs per se will be difficult and the inflexibility in labor market would inevitably lead to higher unemployment. Thus, we would like to encourage the authorities to remain vigilant against persistent downward pressures on the economy.

Fiscal Policy

We support the necessity of counter-cyclical fiscal policy. Having said that, under the current economic environment, fiscal stimulus will have to overcome several impediments in order to be effective. As shown by Figure 4 on page 9 of the staff report, consumer confidence and corporate sentiments have substantially deteriorated. Thus, the decline in marginal propensity to spend may hinder the effectiveness of fiscal stimulus.

Moreover, it may not be easy to "avoid private agent from turning Ricardian" through enhancing communication, since economic entities may become Ricardian due to their rational expectation. People may become Ricardian-type consumers because they "correctly" anticipate the future tax increase that will be necessary "to achieve fiscal sustainability" over the medium term. Needless to say, fiscal sustainability and transparency are extremely important, and it would be critical whether the people believe that fiscal spending could enhance the productivity and the efficiency of the economy.

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Banking Sector

According to the staff report, the "banking sector has weathered well the initial impact of the global crisis". Nonetheless, the credit spreads on bank debts, as well as sovereign risk indicators, have increased and remain high. In this regard, we would welcome the staff's further elaboration on the backgrounds behind the rise in these risk premiums, as well as on its impacts on the financing costs of economic entities, if any.

We would like to encourage the authorities to monitor carefully the negative impacts stemming from the housing downturn, since the risks and losses are shared not only by the banking sector but also by the holders of mortgage-backed securities. In addition, downward price stickiness in housing market, if any, could delay the recovery in housing demand and squeeze the source of bank profits over the medium term.

Besides, we are especially interested in Spain's dynamic loan-loss provisioning. Since dynamic provisions during the period of favorable business conditions may reduce bank profit, we would like to know how the banks and the authorities manage the possible "conflict of interests" in terms of the relationship with tax authorities and shareholders, and how they maintain the transparency of banks' income statement. In addition, how to calculate the amount of provisioning on securitized loans could be another interesting issue, since the costs of provisioning might influence banks' incentives to remove loans from its portfolio through securitization. We would welcome the staff's further elaboration on these issues, if any.

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

The staff representative from the European Central Bank (Mr. Pineau) made the following statement:.

The extended period of robust growth in Spain came to an end in mid-2007, and economic activity has been decelerating rather sharply since then. We concur with the staff on the prospects for a prolonged adjustment, as the imbalances that have been building up over recent years continue to unwind and risks remain tilted to the downside during this process, in light of significant interaction between housing and banking sector developments.

Looking ahead, it is questionable whether construction and housing could serve, once again, as a main growth engine in an environment where

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labor and product market rigidities are likely to hamper the economic rebound in the short to medium term. These weaknesses—that is, rigidities—underscore the need for the authorities to look beyond short-term stabilization efforts and to address long-term growth challenges. These challenges mainly relate to raising labor productivity rather than focusing on potential output, leading to a more intensive growth pattern.

I agree with the main points made by Mr. Stein in his gray, and I will focus on fiscal policy, competitiveness, and the financial sector.

On fiscal policy, we would like to emphasize that there is very limited space for further fiscal expansion. Spain has implemented a sizable fiscal stimulus package since last year, and the combined effect of discretionary measures and automatic stabilizers on economic activity during 2009-10 is well above the euro area average. Moreover, the authorities' fiscal position is facing a number of challenges in both the short term and medium term, including increased funding costs in light of rising indebtedness, the risk of further contingent liabilities associated with banking sector restructuring, and demographic pressures related to population aging.

The need to adhere to a long-run sustainability framework is recognized by the authorities, who are committed to initiating fiscal consolidation as from next year. Such a commitment is also consistent with the need for the authorities to focus their policy efforts on addressing structural issues.

On external competitiveness, we note that Spain has suffered from a persistent inflation differential vis-à-vis the euro area partner countries. This is due to wage inertia, reflecting indexation clauses, very low labor productivity growth, and a lack of effective competition in key product markets.

Labor costs rose by an average of about 3 percent per year—or twice the euro area average—during the 1999-2008 period. The harmonized competitiveness indicators of the euro system show that cumulative competitiveness losses during the same period amounted to 16 percentage points. We, therefore, agree that there is a need to implement fundamental reforms in the product markets where the level of competition remains too low.

On the labor market, longstanding shortcomings can no longer remain unaddressed. As recently stressed by the Bank of Spain, the substantial increase in the unemployment rate by about 5 percentage points to

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13.7 percent last year (the highest among EU countries), combined with a 5 percent increase in wages during the same period, confirms the persistence of rigidities in the labor market. We agree with the staff that there is a need to address the indexation scheme and to look at the differentiation between temporary contracts and permanent contracts.

Turning to the financial system, we agree that the banking system has coped well with the global crisis so far. The authorities deserve credit for the adoption of a sound prudential and regulatory framework, including dynamic provisioning and rigorous consolidation rules. It is also the case that, as a result of these efforts, the authorities have not been forced to support the banking sector to the same extent as other countries in the euro area, as evidenced by the limited participation in the asset purchase fund and banking guarantee schemes.

However, in the period ahead, further pressures might appear in the system: a property downturn, rising unemployment, increased funding pressure, and deteriorating asset quality. Given that 60 percent of outstanding bank loans have been extended to the troubled property sector, the financial system's dependence on wholesale funding is a source of concern.

While large Spanish banks have already seen a drop in their share price and increased credit default swap premiums, developments in this context have not been out of line with other euro area peers. More importantly, uncertainty appears to surround the savings banks, the *cajas*, as their exposure to the property market is considerable. In this context, a potential need for the public sector to assist in the restructuring of this segment of the banking sector cannot be ruled out.

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

I would suggest that the questions fall into several categories: the real economy, the housing market, the banking sector, the fiscal position, and structural reforms, as well as some miscellaneous questions.

On the real economy, there is a significant downward revision of the 2009 growth forecast. One Director asked whether it could be between -2.5 percent and -3 percent. In fact, we are now expecting a 3 percent drop in GDP, reflecting a trend in the high frequency indicators. It is important to note that the last quarter of 2008 and the first quarter of 2009 have a relatively high weight in the expected average annual growth rate. As for macro-financial

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linkages, households and private-sector companies continue to repair their balance sheets through deleveraging, which has a negative impact on domestic demand.

On export performance, the staff report includes figures that now appear overly optimistic. In our WEO submission, which led us to the -3 percent growth forecast, we expect export growth—this is, the national accounts concept of export growth in real terms—to decrease by 19 percent in 2009, while import growth is expected to drop by 27 percent this year. If somebody had told me in the third quarter of 2008 that trade could drop by such large amounts, I would not have believed it. While there is a significant, positive contribution from the foreign balance, it is clear that both exports and imports are significantly shrinking at the moment.

Given the rigidities in the current system, the Spanish labor market is facing a perverse wage-price dynamic in the short term. Companies are trying to adjust to the current situation by laying off workers. Given that layoffs are very expensive, total labor costs have increased, while companies are facing a deflationary business environment. In other words, output prices for Spanish products are easing significantly, while total input costs are rising. The authorities have to address this issue. It does not help that companies have only a limited range of adjustment tools, with many firms opting for bankruptcy procedures. Most small- and medium-sized enterprises do not emerge from these bankruptcy procedures.

Currently, the country is facing a rapid increase in the unemployment rate, with many analysts expecting a jump from 3 million unemployed workers to more than 4 million. Our WEO projection for 2010 includes an unemployment rate of more than 19 percent. The authorities have launched a sizable assistance program, administered by local governments. These are public works aimed at keeping people employed and providing alternatives, including for people who lost their jobs in the construction industries. I should say—and the State Secretary was very honest with us about this—that this is not long-term infrastructure investment. These are local, municipal, and regional government public works, which are not expected to lift long-run potential output nor give rise to long-run fiscal costs. The current programs, worth about 8 million euros, can be gradually phased out as the economy recovers.

Earlier this week, the authorities unveiled seven new measures for the labor market, designed to facilitate part-time jobs and to help reduce or postpone payroll taxes, thus lowering costs. The measures were discussed

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with the social partners, but negotiations have been held up by disagreements between union officials and employers. The government sought to break the deadlock by announcing the seven measures, based on state subsidies. We believe that this is an inefficient policy in the absence of structural labor market reforms. Nor do we believe that such reforms should be led by social partners who simply agree to disagree and then the government winds up providing subsidies to contain the damage. We have encouraged the authorities to look at this issue more closely.

On the structural inflation premium, we do not have a formal model of this. We estimate that Spain's consumer price index has been about 1 percentage point higher than that of its peers in the euro area, reflecting the country's stronger economic growth path in recent years. We have no reason to believe that this premium may soon shrink. We are concerned that, after an extended period of higher-than-average unit labor costs and inflation, Spain may need to go through a period of below-average unit costs and inflation to meet the euro area average. It is unclear whether a member of a monetary union can afford to have average inflation or labor costs that are structurally higher than that of its peers.

In the staff report, we mentioned a number of feedback effects from the housing dynamics, which are closely connected to the labor markets through the labor-intensive construction sector. Employment in that sector is declining particularly fast. This trend is critical for the fiscal accounts, including for local and regional fiscal accounts, because the housing market and everything attached to it represent a considerable tax base. We estimate on a preliminary basis that the shrinkage of the tax base is equivalent to 2 percent of GDP, undermining the revenue base for the public sector. The banks are also closely linked to this trend, given their exposure to the housing markets through mortgages and loans to developers and real estate companies.

The housing-related multiplier in the real economy is very large. Sectors connected to the housing markets and construction also include land management, the manufacturing industry, and real estate services. Water and sanitation, and utilities in general, tend to be attached to housing and construction. The retail industry is also a closely linked sector. So, the connection between housing and the rest of the economy, both in financial and in real terms, is quite strong.

We have been asked to clarify our view that house prices could see a potential 30 percent drop. Could this inventory be worked off somewhat faster? What is the potential role of foreign—i.e. European—demand for

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Spanish housing? We have done some independent modeling, some of which is reflected in the selected issues papers. We also looked at case studies of other countries that had gone through a significant housing downturn. Apparently, there are two magic numbers in big housing turnarounds—30 and 5. The former refers to the percentage decline in house prices from the peak to the new bottom before the market starts stabilizing, while the latter refers to the length of this cycle measured in years. To be sure, data for specific cases may vary. But it is remarkable that, in countries such as Finland, Sweden, Spain (in the early 1990s), and the United States, this 30-5 pattern kept showing up. Spain currently happens to be right on track, according to our estimates. We are not suggesting that Spain will necessarily follow this pattern. Rather, it is a benchmark that we can use to develop recommendations on contingency measures.

We held talks with our colleagues at the Caja Madrid, the second-largest *caja,* or savings bank, in Spain. They gave us an excellent presentation on the Spanish economy. Surprisingly—and we had not coordinated our numbers—they had a 32 percent fall in house prices in Spain in their own models. This is a real estate savings bank. So, we got some comfort that we were looking at similar dynamics. We also received a detailed paper from the research department of BBVA, the second-biggest bank in Spain. This team has a very high prestige in Spain. I believe there were two versions of their estimate: a 24 percent drop and a 28 percent decline. So, our 30 percent estimate is not impossible, I am afraid.

On the issue of European demand for vacation or second housing in Spain, this is well taken. The Ministry of Housing believes that demand for this housing could be somewhat lower in this recession, resulting in a decline in house prices in this segment as well, but not as much as the staff might be expecting. The Ministry pointed to the fact that Spain boasts some of the attributes that can be found in Florida or California. Many people in northern Europe—Germany, the United Kingdom, the Netherlands, and the Nordic countries—like to go to the Iberian Peninsula, which includes Portugal, Spain, and stretches out to the French Mediterranean, and buy houses there either for vacation or for retirement. This is a captive, and potentially large, market for Spain. Spain already has developed considerably on this basis.

If Spain were the only country in a difficult position, one could redeploy expenditures and reignite growth through exports and tourism. Given that the country's European peers are also affected by the crisis, there is little net additional support from abroad for a recovery in Spain. While the potential

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for increased foreign demand is there, policy makers should probably not count on this engine of new growth in the short run.

Turning to banks and financial sector policies, we were asked about the link between unemployment and loan impairment. Whatever aspect of the economy we looked at—from fiscal policy and banking to structural reform—everything seemed to be pointing to the labor market. A regression analysis of two long-term data series, respectively, on nonperforming loans and unemployment numbers produces a remarkable correlation. It shows that difficulties in the economy are transmitted via unemployment through to bank balance sheets. We are worried about this. Those who lose their jobs cannot service their mortgage loans.

Many real estate developers have used banks to finance their business expansion. These developers are working with the banks to achieve workouts of their liabilities. Sometimes the banks are taking over properties in lieu of payment. The Bank of Spain is looking at this very closely; it requires banks to set aside more capital, and to classify these borrowers as substandard. The approach is fairly conservative. But, given the scale of the problem, we are worried about the magnitudes that may be involved. The important question is how these properties are valued. Some banks have joined forces by creating professionally run real estate entities to manage these properties. It all depends on the valuation of the assets in these entities, on which the banks have a claim. It will take some time before we know how this will play out.

As for the authorities' preparedness to address banking issues, the Bank of Spain is both technically and legally very well-equipped. Mr. Guzmán was kind enough to send us the appropriate laws. We believe that the Bank of Spain is firmly in control. The Bank mostly plays a technical role. If fiscal funds were required to support the banks, then that would be difficult, as it would be for any other country facing such a challenge.

As for the Spanish deposit insurance institutions, they have about 7 billion euros in reserves. They can be drawn upon—and have been in the past—to help banking sector restructuring and consolidation. This is comforting to know. The policies of the ECB have also been very helpful in providing liquidity to banks. In common with their European peers, the Spanish banks have participated in these liquidity programs. In the staff report, we recommend that the fiscal authorities keep "some powder dry" to cope with possible requests for further capital assistance for banks. At this moment, we do not see that this is necessary.

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There are two very large Spanish banks with big operations in Latin America. We had good meetings both with Santander and BBVA. They told us that the Bank of Spain extended its supervisory and regulatory regime to the banks as a group, as a consolidated entity. As a result, banks maintain countercyclical provisions not just for their activities in Spain, but are forced to also maintain them for their global activities. This is one of the reasons why the credit rating agencies regard these two large banks as being well regulated and relatively sound.

The banks gave us some additional information. Mexico is a difficult market for them at the moment. They are present in Brazil, which is mildly affected by the downturn, as is Argentina. Chile is doing quite well. Venezuela is difficult, because Santander is seeking to resolve a dispute with the government of Venezuela over one of its local banks. In short, the management of the two banks is very carefully managing these operations, but they do import, to some extent, risks from these overseas markets. The supervisors are in close contact with their overseas colleagues.

Could the structure of the banking system help or hinder the recovery in Spain? The country has one of Europe's biggest branch networks, and some consolidation is likely to take place in the system. This is one of the avenues through which banks can increase their economies of scale. So, we see some positive aspects in these opportunities.

According to the rating agencies, the *cajas*, or savings banks, benefit from a mutual support system. None of the *cajas* has ever formally gone bankrupt. Instead, struggling banks are usually absorbed through mergers, and they also have means of managing difficult situations. Without the mutual support system, the rating of the *cajas* would be one notch below the current level. The cooperative banking system has a similar arrangement.

Against this background, we believe that financial sector adjustment is possible. The banks are looking at opportunities to consolidate and to reduce their costs. This process, however, will take some time, and the Bank of Spain clearly needs to monitor this very closely.

What is the impact of credit spreads and sovereign risk on financing costs? Spanish sovereign debt has maintained a high rating: Standard & Poor's recently nudged it down by one grade, while Moody's and Fitch have maintained their AAA rating. However, spreads over German bonds have widened: bond yields have decreased slightly—now just below 3 percent—while Spanish sovereign bond yields have remained constant. So, despite the

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wider credit spread, financing costs have not increased, all other things being equal. What happens if markets normalize? If the bond yield were to drift up to its long-term average, would the credit spread shrink? Or would it increase in parallel, affecting financing costs for the sovereign? We will have to see how this is going to work out.

What is the effect on banks and non-financial corporations in Spain? Fortunately, the Spanish sovereign rating is still quite strong, which helps to keep financing costs down for the private sector. If Spanish banks use government guarantees to place debt—and many European countries have introduced these systems—then the sovereign bond yield represents a price floor.

On countercyclical provisioning, this is quite a technical subject. The Japanese chair has sought more information on this issue, and we will provide further details on a bilateral basis. It is important to note that the Bank of Spain's decision to introduce countercyclical provisioning was heavily criticized. Many analysts, including the Fund, pointed out that profit-and-loss statements would no longer reflect what was actually happening within the banks. The global accounting bodies were among the most vociferous critics. The provisioning system was revised in 2004, and there has been further fine-tuning to accommodate some of the original concerns. There were questions as to whether one should use capital requirements or provisioning. The Bank of Spain is open to discussing all these issues. It is important to note that the banks originally opposed the new system. Faced with a global financial crisis, they now appreciate the value of this protective system. The Bank of Spain deserves credit for its foresight and perseverance.

Turning to fiscal issues, the authorities seem to have a fiscal deficit estimate that differs from our projection. This is simply a matter of timing. We formally changed our macroeconomic outlook for the WEO last week, and that is why we have to adjust our fiscal picture. Our focus is on the automatic stabilizers; this is not a different estimate of the impact of fiscal measures. When we were in Madrid, we compared our estimates with the Ministry's. There is no difference of opinion on the basic dynamics of the fiscal picture. The Minister cannot revise his macroeconomic picture every month, as we do, because he has a budgetary system to run. When the next revision comes, the authorities are likely to change their estimates. Whether they will exactly match our numbers remains to be seen.

Will local authorities be able to scale back the extra spending? We believe that they will be able to do so when the public works drop out of the

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base. Is there a vulnerability to our estimates from local governments? Yes, there are such vulnerabilities; for example, the recent revision in the headline deficit for 2008 reflects an update of local government figures. There is concern about the current pressures facing local governments.

The idea behind the public sector balance sheet is to capture the entire public sector, including central government assets and liabilities, as well as local and regional government assets and liabilities. Public enterprises should also be in the public sector balance sheet.

How will households and companies react to future tax increases and current deficits? We do not have an answer to this question, but one thing that keeps coming up is the issue of confidence. If the government explains to the public why certain things are necessary and presents clear and transparent data, including projections, fiscal policy tends to be accepted and tends to have a bigger effect.

Are we taking into account the fiscal impulse and the multipliers? Some of the measures that the government has introduced are permanent, particularly the tax cuts. We have included them in our long-term baselines, even though the numbers we presented in the report cover only two years. Moreover, the effects of the fiscal impulse are not immediately felt through economic growth, because the private sector currently focuses on repairing its balance sheets. We tend to look at the fiscal impulse as being directly connected to growth because that is the lens through which we assess a fiscal impulse, but this is not necessarily how it comes out. Still, fiscal policy may well be doing something very valuable, because in the absence of this impulse, the counterfactual would be that growth would have been much lower, because the only way the private sector can then adjust is by cutting expenditures even more brutally. It also depends on what the private sector is concerned with: the balance sheet or the stock accounts; the flow accounts or the revenues and expenditures. We do need to understand these issues well to see what the private sector is doing with this fiscal impulse.

On pension reform, we have not taken a detailed look at this issue at this time. We agree that this is important, and the authorities are working on it. Federalism is another important topic. Because of the other pressing issues, we chose not to cover it in great detail at this time.

Have we included health cost inflation in the projections of aging costs and education savings? We used aging cost data from the Aging Working Group in Europe, which counts Spain as a member. We agree that in most of

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these projections, which are harmonized across countries, the health cost inflator, the vector that increases health costs, is tied to wages. This means that aging costs are probably understated, because history suggests that health cost inflation increases faster than wages. So, there is a risk to aging cost estimates from that angle.

I also tend to agree with the observation that many countries making long-term projections assume that education budgets will shrink as the number of young people declines. I am not sure that it works out this way, because governments want to encourage lifelong education. Faced with an older human capital stock, so to speak, a government is likely to change education spending. I am not sure that I would necessarily dial it down because there are fewer young people.

On reform policies, there was a question on competition in services, electricity, and retail. The authorities at a very high level are promoting product and services market reforms. This effort, called the National Reform Program, is led by the Prime Minister's Office. Under the program, the central authorities use European Union initiatives to overcome reform resistance within the regional and local governments. There is some progress, given the support from the highest levels. The current administration, being a Labor government, is very keen on improving competitiveness through productivity increases rather than wage moderation.

There are some 20 reform initiatives that were launched in the middle of last year. The Spanish news media has actually monitored these projects, providing regular assessments of the 20 working groups. A case in point is the draft law on professional services, to be prepared by this summer. The reform efforts will also cover, among others, regulatory entities connected to network industries. In Spain, such entities have been less than effective because of their limited independence. There is also an element of retail reform in the National Reform Package. For example, some licensing requirements have already been eliminated or reduced for smaller stores—up to 2,500 square meters. There have been negotiations over large stores, the Wal-Marts of the world, but these tend to run into local opposition, and we do not know at this stage how this is going to evolve.

As for electricity, there has been some change in the market structure. Italy's Enel has recently acquired a 25 percent stake in Endesa, the largest electricity company in Spain. I believe some banks and *cajas* sold their respective stakes to Enel. Some structural changes have proved to be more difficult: when the electricity tariffs were reset to a market-based system, there

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were existing debts among enterprises, called “tariff deficits”, that had yet to be amortized. This is quite a battle, because the Spanish authorities, in discussions with the electricity industry, has not yet found a way to amortize this pre-existing debt, and we think it needs to be resolved in order to move forward on further reforms in the electricity sector.

There was a broad-based question on the causes of the crisis. We are not in a position to comment on the policies that Spain imports from other countries, but credit conditions definitely were easy, and liquidity was ample for a number of years. However, Spain’s regulation and supervision are among the best we have seen, and we do not believe that regulation and supervision at the banking level were deficient. We would argue that, since the private sector was so buoyant during this time, the fiscal stance should have been stronger. To be sure, there was a fiscal surplus in the past few years, but one has to take into account the overall savings-investment balance.

Finally, we agree that the current Article IV consultation has come somewhat late. The previous Board discussion was held in May 2007. Since then, three things have happened. One was the general election in May 2008. Second, Mr. Leipold, who is the institutional memory on Spain in the staff, has retired from the Fund as part of the restructuring process. Third, none of the new team members had ever been on an Article IV mission to Spain. We felt that we had to do our homework properly before discussing issues with the government.

Mr. Daïri considered that the Fund’s downsizing efforts had had an extremely detrimental effect on the surveillance function. Separately, he wondered whether the staff’s housing market gauge (an estimated 30 percent drop from peak to trough) underestimated the appreciation that preceded the market decline.

Mr. Bakker considered that the dynamic provisioning system might face another test as credit quality deteriorated both in Spain and in Latin America. Would these buffers offer sufficient protection against future losses? Notwithstanding the benefits of dynamic provisioning, a sharp increase in NPL ratios might force the banks to accept capital injections. On the vulnerability of local governments, which had been highlighted in Mr. Daïri’s statement, was the multi-tier structure in the public sector adding to vulnerability?

Mr. He made the following statement:

On trade, we keep being surprised by the large drop in trade flows country-by-country. The question is to what extent this is due to difficulties in

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trade financing or to real demand change. Maybe the staff could shed some light on this from the Spanish perspective.

On a related issue, based on your assessment, there is a large perceived gap in competitiveness. I am surprised to see that, in the charts on page 10 of the staff report, export growth is expected to hold up relatively well, while imports are expected to drop sharply. This does not seem to square with your assessment of the country's competitiveness, and with the fact that the growth outlook for Spain is somewhat similar to other trading partners.

As for the labor market, the staff noted during the previous consultation that the labor flow, or immigration inflow, was relatively large and that absorption was quite strong. However, given the rigidity in the labor market and the high unemployment rate, I wonder whether this flow is still holding up. If that is the case, then where does the flow go? To a different segment of the market that is not regulated?

Mr. Hendrick made the following statement:

First, I would like to strongly associate myself with Mr. Daïri's comments about our downsizing and the impact on the Fund's work. I have first-hand experience with this issue.

Regarding the labor market, I understand that in Spain at least one third of the contracts are fixed-term appointments, while the other two thirds are combined in some kind of class of contracts that is more or less flexible. I do not understand the discussion on labor flexibility, partly because we are overly focused on the segment that has truly standard contracts.

We are also concerned about the small businesses, some of which have chosen to file for bankruptcy protection because it is a relatively cheaper option. I wonder why most of the small businesses offer classic contracts rather than fixed-term appointments, which would be the more natural way. It is important to pay attention to those small businesses, because they are, like their peers in many other countries, an important engine of the economy.

On debt sustainability, the tables in the staff report show that, even under normal circumstances, the figure is very high—almost 160 percent of GDP by 2013. Obviously, in an inter-temporal framework, this is not a viable option. I would appreciate the staff's view on how this is going to be corrected. In some countries, for example, external private debt is driven by trade-related factors such as working capital and pre-financing of exports and

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imports. In other countries, private debt largely consists of corporate long-term debt, which creates a rollover risk. Given that the table in the staff report provides no details, we wonder about the nature of Spain's private external debt problem. On public-sector debt, the table in the staff report shows government debt with and without the use of guarantees and credit lines. How can one make a projection with the use of credit? Is there an indication that significant credit is already being used?

Ms. Xafa made the following statement:

Externally-funded credit booms and loss of competitiveness due to overheating and to insufficient structural reforms is a common theme in Southern and Eastern Europe, as the region tries to adjust to the global financial crisis. In fact, if one were to replace the word "Spain" with "Greece" in the staff report, one would have a ready-made report for Greece. So, it is entirely appropriate that Mr. Traa is also the mission chief for Greece.

Under the staff's revised estimates, growth is expected to decline substantially this year—minus 3 percent—despite a significant fiscal stimulus equivalent to 4 percent of GDP. If I understood the staff's comments on the multiplier correctly, we cannot be certain whether the fiscal multiplier is weak or whether growth would be much weaker without the fiscal stimulus. In other words, we do not really know to what extent there will be a private sector offset to the government spending. That could be an empirical question for a future selected issues paper.

To what extent will the fiscal stimulus affect the Budget Stability Law? Is this a temporary departure from the Budget Stability Law and from the Stability and Growth Pact? Is there a commitment to return to the stability targets at any specific point in time?

Finally—although these questions may be for Mr. Guzmán—what are the regional implications of the erosion of the housing-related tax base? Presumably, some regions within Spain are more affected than others. How would this affect the regional debate under the Budget Stability Law?

Mr. O'Sullivan made the following statement:

I have one comment and three small questions on the housing sector. The comment is in response to the excellent replies given by the staff, for which I am very grateful. It is interesting to hear the staff's view that the fiscal response could have been somewhat stronger. That, of course, would be true

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of most countries, given the sudden and larger-than-expected drop in output. In the case of Spain, it is probably important to look at what has been done, what has been achieved. In fact, we should look at the substantial improvement in the general government debt ratio, which has left Spain well-positioned, which is acknowledged in the staff report. It is also important to note that Spain has at all times moved within the European fiscal rules.

According to the staff's reply, the decline in output in the housing sector could create a hole in the fiscal balance that is equivalent to 2 percent of GDP. Is this a first-round effect? Does this take into account the multiplier effects on the rest of the economy?

There is a lot of interesting material in the staff report about the stock of housing, which will be available, the number of units currently unoccupied or unsold, the overhang of this housing output on the market. I would be interested to relate that to the annual requirement for new housing units in Spain. What is Spain's requirement per annum based on its demographics?

Finally, on the difference between various housing market segments, I would be interested in getting the staff's view on whether the recent—and likely further—price declines are evenly spread through the vacation part of the market and the non-vacation part of the market, and whether the number of unoccupied units is evenly spread between these two segments.

Mr. Talbot noted that the staff had mentioned that substantial downward revisions to exports and imports would update the WEO forecast. Were the projections that staff had circulated that week consistent with those numbers? Would those revised projections lead to the 3.7 percentage points contribution to exports?

The clarifications on the local government spending in the context of the fiscal package were welcome, Mr. Talbot continued. It would be interesting to understand whether such spending would be effective in serving as a temporary measure until the economy bounced back. Were those measures temporary?

Mr. Warjiyo recalled the staff's comment on the high correlation between unemployment and credit conditions, noting how the decline in housing prices would ultimately impact real estate, as well as the credit conditions to those segments of the population. Comparing large and smaller banks, was it fair to conclude that smaller banks would be impacted earlier than the larger banks by the crisis? What was the likelihood that smaller banks would consolidate, particularly the *cajas?*

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It was also interesting to consider how the credit conditions would have some impact on banks' capital, which had already been analyzed by staff in Scenarios 1, 2, 3, Mr. Warjiyo continued. What would be the impact on the capital conditions? What policies were the authorities considering to deal with those concerns? Fiscal implications also had to be considered, given that the fiscal space in Spain after the latest fiscal stimulus would be much more limited.

Mr. Heath thanked the staff for the lucid analysis of the staff report, and underscored that the explanation of Spain's deteriorating competitiveness relied on lagging productivity and increasing labor costs. However, in the selected issues paper on productivity growth and structural reforms, most of the analysis pointed to issues related to labor productivity and product market rigidities, without much reference to the role of capital. Product market rigidities were barriers to entry that certainly suppressed rates of return. As a consequence, capitalization would tend to be lower. In that respect, it had to be wondered if the staff had a measure of the gap in capitalization in Spain compared to other OECD countries.

The staff representative from the Strategy, Policy, and Review Department (Mr. Mühleisen), in response to questions and comments from Executive Directors, made the following statement:

> Let me just comment on some issues from the more general SPR perspective.
>
> Let me start with the housing sector. We have recently taken the housing model that was in the October 2007 WEO, and ran that with updated data. The outcome is that Spain, as many other advanced countries, still seems to be having an overvalued real estate market, at least as far as the residential market is concerned. Some of the models show that prices may be, as of the end of the third quarter of 2008, more than 10 percent overvalued relative to the fundamentals of the model as well as relative to other countries. In the fall of last year, Spain was in the top third of the distribution of overvalued housing markets.
>
> We also had another look at a model that Executive Directors saw in the context of the staff report for the Article IV consultation with Italy, which considered the increase in sovereign debt spreads across Europe. The increase in spreads for Spain is explained by the model's common factor, namely general risk aversion in the market and concerns about liquidity and solvency across all countries in Europe. In contrast to other countries, Spain has a small, unexplained component of that spread increase. Some of the other factors, for example the size of the deficit, do not seem to affect the increase in the spread at all. So, from that perspective, the increase in spreads has not

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been substantial and has been mostly explained by general factors and less idiosyncratic ones.

On trade finance, I do not have any specific information on Spain, but let me mention that Directors should have received or may receive in the next few days the results of the first trade finance survey that, among others, our department has contributed to. The general gist of the results is that while trade finance is important, the impact on trade is currently partly being overshadowed by the general deterioration in financial conditions across the globe.

A second survey is in preparation, even if at this point I cannot give you a specific date of when the results will be ready. The preparatory work, which is being done outside the Fund, will be underway soon.

Let me also touch upon the linkages that the Spanish economy has with countries in Latin America. We are all familiar with BIS data and the exposures and the cross links between Spain and countries in the region. What we found relatively helpful during the crisis so far has been looking at the conditional probabilities of distress. I do not want to go into details, as the working papers are available on the Fund's website. But the main idea is using credit-default swap spreads (CDS) and other high-frequency financial data to assess the probability that an issuer of securities can fall into distress, given that another issuer of securities goes into distress, and those issuers can be sovereigns, corporates, or banks. That model shows a strong increase over the fall of last year of the probability that a Spanish bank could fall into distress if one of the sovereign issuers in Latin America went into distress.

That probability has fallen quite rapidly after the European countries have implemented a strong support package for their banking sectors, but it has since increased again. So, there are concerns in the market about banks' exposures to Latin America. However, the risks in terms of the distress probabilities for Spanish banks look significantly smaller than that of other banks from countries that are also active in Latin America. At the same time, it should not be surprising that, given the strong role that the Spanish banks play in the region, the causation in the other direction is also high. So, if there were to be a problem with one of the Spanish banks, the impact on sovereign distress probabilities in Latin America would also be quite high—significantly above 50 percent.

Finally, let me quickly comment on the question on loan-loss provisioning in Spain. Directors will have seen the IMF Lessons Paper that

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was circulated a week or two ago. There is a chapter on policies to mitigate procyclicality in the banking sector. That chapter broadly states that it is important to pursue those policies, in part because they balance the need to take proper account of current risks against the need to do so without exacerbating the current situation.

One area for reform that is identified in that paper is the fact that provisions should be based on expected losses through the cycle, and dynamic provisioning is a very good starting point for that discussion. So, that debate is ongoing in international fora and with regulators, and I am sure MCM is pursuing those options very rigorously.

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

I may not remember all the details of the follow-up questions asked by Director. Thus, I am happy to touch base with you bilaterally after the meeting.

On the 30 percent rule of thumb concerning the overvaluation of housing prices, the distribution is also not exactly the same in all countries. When considering different countries that have gone through a housing prices correction, it can be noted that there is a period in which house prices increase above the long-term average and then, beyond a certain point, start decreasing. These paths can be different however. In some cases, it takes very long to reach a peak and in other cased it can be a rather quick progress. The staff does not pretend to know what will happen going forward in the specific case of Spain, by indicating that the overvaluation in the housing market is around 30 percent. However, we see what is happening in Spain and we compare with an average set of other countries, this is the patter we are observing.

I would be hesitant in being more specific as every country has specific issues in the banking sector and the housing market. The external environment also plays an important role when a country goes through this type of adjustment. Currently, there is little Spain can rely on in terms of generating new growth or getting out of the recession through the foreign balance, given that foreign markets are also weak. All of these factors are impacting on the dynamics of the housing market. However, this is not a surprise to us, as we found that these patterns were fairly well established.

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On the dynamic provisioning, it would be incorrect to think that such a phenomenon is not of concern to us. In our view—and I state this in general terms—Spain has benefited from the cushion of dynamic provisioning for at least two years. You may see the numbers in the staff report, and these are also included in the bulletin of the Central Bank of Spain. The numbers of coverage were over 200 percent at some point and have decreased to 70 lately, which, however, is still higher than in most countries.

The difficulty and the concern is, if this crisis protracts and dynamic provisions no longer apply, the system could still experience significant stress. This is the spirit in which we presented the argument that fiscal policy should keep "some powder dry" to the authorities. In my view, they are fully on board in this regard, because they have created the legal instruments to assist banks to do that, if necessary. The big benefit for the Spanish banks is that they made quite high profits in 2008, unlike banks in other countries. This is a dividend from the excellent supervisory and regulatory provisions that were in place.

On the issues related to federalism—which tend to be highly complex and need to be studied more closely—we have not, by choice, gone into much detail at this point in time. The authorities are revising the country's federalist structure, generating a highly complicated ongoing debate. This is one of the reasons that made us prefer to wait before delving into this issue. We do not feel that we have the expertise in-house to make a strong statement in that realm.

On trade and competitiveness, what we see in Spain and in the region more generally—we have worked on a cross-country paper for some of the Mediterranean countries—is they tend to all exhibit some firmness in exports in the niches in which they have a competitive edge. So, it is not that competitiveness problems manifest necessarily through a collapse in exports. What happens is that, with the domestic economy being very buoyant in past years, the suction of imports in these countries has been enormous. Import competition—whether you take Portugal, Spain and, to some extent, but much less so, Italy and Greece—is where these countries exhibit a very strong import current account dynamic. This is therefore where the biggest adjustment is taking place at the moment. The past strong domestic absorption is currently decreasing.

In our view, if we project this phenomenon, for the external position to be sustained, some relative price changes need to take place in addition to shrinking domestic absorption. All of the countries in the Southern Euro Area

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exhibit very similar difficulties, in that regard. What they have in common is a very poor international investment position as well as a poor external balance. There is, however, a big difference between Greece and Spain. These two countries have a similar international investment position, but in Spain much of the debt is private. The public sector has less debt. In Greece, the reverse is true. So, the distribution between the sectors in Greece and Spain is exactly the opposite.

Labor immigration is declining. The impressive growth of the past years has attracted many immigrants to Spain to work in the construction sector, which is labor-intensive. The education level of some of those immigrants was quite high. The economy is adjusting dynamically to the weakening of the cycle, and there are fewer immigrants coming into Spain at present. In addition, some of them are returning to their home countries. Immigration is much less pronounced today than it was at the peak of the economic cycle.

On the labor market in Spain, the concern we have is that a dual labor market is emerging. There is one labor market for tenured jobs, representing the insiders, and then there is a labor market for fixed-term jobs, representing more precarious workers. These are not part-time positions. They may be full-time, but they are fixed-term contract, so they come with different benefits than tenured jobs. What the OECD has pointed out in their research is that the return on education that is obtained from entering the Spanish labor market has a dual nature, because there is a blockage in moving from the fixed-term contracts toward the permanent jobs. Permanent jobs tend to ensure better careers. So, if this blockage exists and you have duality in the labor market, the return on education tends to be lower except for that part of the labor force that move abroad.

With regard to small- and medium-sized enterprises, a large enterprise can benefit from economies of scale and reduce employment costs as a percentage of total costs. Differently, in small- and medium-sized enterprises, labor is basically the biggest share of costs. If adjustment, in a flexible way, is not possible except by breaking contracts in a court, this becomes a major problem.

The staff would encourage more flexibility before the vast bulk of companies reach the stage where the only escape they have is to go through a Chapter 11 type of process. That represents a point of almost no return. So, severance costs are still a problem, but a fixed-term contract is not the same as a part-time contract. These are different things.

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On private external debt, the bulk of it is related to housing, because the banks provided the mortgages and the banks then placed real-estate-mortgage-backed paper abroad in the international capital markets. So, a substantial part of that debt is from the housing sector and facilitated the housing boom. A substantial chunk of it is held through banks in the United Kingdom and Germany.

Corporations also hold a significant chunk of debt. Some of this is related to the Spain economy having integrated into the world economy. In the 1960s and 1970s, Spain was a relatively closed economy, and then it started opening. Spanish corporations have now ventured abroad, to Latin America, in particular, but have also extended their linkages to other European and Euro Area countries. This process was financed in part by placing debt.

What we are witnessing at the moment is some of the large Spanish companies divesting these external holdings to reduce their debt. So, this indebtedness is the result of Spain growing dynamically after being isolated in the past. This took decades, but Spanish companies are now much more represented in other parts of the world than they used to be only 25 or 30 years ago.

Turning to long-term public debt, our calculations have already embedded in them the provisions that the government has put in place to assist the banking system during the financial crisis. So, the liquidity fund that is being set up is included in our calculations. Once this process reverses, these debts will drop out automatically. There will be a hump in debt over the next few years, but it will decrease when the system stabilizes. If banks use fully the guarantees provided by the authorities, there are at least two definitions of debt that can be considered. One is the actual debt issues and the other one is debt plus government-guaranteed debt. This would cause a temporary increase in the government-guaranteed debt. The relevant issue, for policy reasons, is what the expected fiscal costs for the government can be for providing this guarantee support.

On the Domestic Budget Stability Law in Spain, it is somewhat more restrictive than the SGP. What we expect will happen is that the authorities, as they improve the fiscal balance, will first comply with the SGP, and then gradually they will seek to comply with internal laws.

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On the housing sector, the country went through a strong housing boom, which generated lots of fiscal revenues. The question is how much of this is structural as the housing boom continued 15 years. The staff has calculated that about 2 percent of GDP of what was considered to be permanent fiscal revenues was actually related to the housing boom. So, looking forward, we have adjusted the structural estimate of our revenues by 2 percent.

The demographically sustainable steady state of housing construction in Spain is about 400,000 units per year. At the present time, there are different estimates of the number of inventories. The number referred to by the market, at around 1 million units, is higher than the one indicated by the Ministry of Housing in Spain. This implies that 2 ½ years will be needed to absorb this inventory. There are other dynamics underway. Because the permits for housing construction peaked fairly recently, and given that it takes almost 2 years to deliver a finished house, it will take about another two years before all these units will have come onto the markets. Together with the application time it takes to get housing permits approved, nearly five years is the number that we used as a benchmark to consider how long it takes to go from originating a project to actually delivering the dwelling.

We were asked what the prospects are for demand of vacation homes from other Europeans to materialize. We have not looked at this issue in great detail, but our impression is that the volatility of vacation residences in terms of their price is bigger than that of owner-occupied residences. So, vacation homes will tend to depreciate somewhat faster than owner-occupied houses when the economy experiences a downturn.

On the WEO projections, the numbers that we have mentioned are those that have submitted to our colleagues in Research. It is an iterative process, and we may still need to update the numbers.

As for the question on whether public works are effective for growth, and if the resources allocated to these areas can be considered an investment or are just an attempt to support employment, the latter is probably true. I am not sure that public works represent a major contributor to the dynamic potential of Spain. This is another example where, if fiscal funds are used to stimulate the economy, we would strongly recommend that countries use them to explicitly build up potential capital. However, this is not always the case.

Turning to the question on the relationship between the housing downturn and the banking sector, the crisis is taking so long to unfold that

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banks are still at risk and are being monitored. The staff considers that the dynamic process of the housing market adjusting is by no means over. This could take until some time into 2010, before bouncing back in 2011. The process often turns out to be nonlinear. It tends to go fast and it is likely to have an S-shaped curve. A sharp reduction in prices takes place in a fairly short period of time, and then it slows down and it takes awhile before it increases again. However, it is not a linear process.

As for whether small banks are more likely to be impacted by the crisis than large ones, it all depends on their exposure. Sometimes small banks are much healthier than larger banks. However, sometimes large banks have abilities to cope with pressures than small banks do not have. In the case of Spain, some regional or local banks are very heavily exposed to real estate or to developers, thus being more under stress than bigger diversified banks.

On capital, it is true that the staff analysis mostly focuses on labor productivity, which had been decreasing in part because the composition of GDP had changed, namely sectors with lower labor productivity were growing very fast, such as construction. Manufacturing was growing less fast, and that is where productivity gains tend to be higher. So, you have a composition effect which is now partially recovering. However, we observed that, in the decomposition of potential growth in labor, capital, and total factor productivity, total factor productivity is not growing very rapidly. This requires a whole new set of investigations. The only area—and this comes from the KLEMS Databases managed by the EU—where there are small gaps in Spain vis-à-vis other European countries is on Information and Communications Technologies capital. On other capital stocks, we did not find many major differences. The difference tended to come through total factor productivity, not through capital stock per se.

Ms. Agudelo asked if the risks generated by the *cajas* could be systemic. What were the fiscal vulnerabilities or the potential fiscal costs originating from these savings institutions?

Ms. Xafa had referred to growth and the building up of important imbalances, Ms. Agudelo continued. When talking about global imbalances, Europe's balance of payments was always in relative equilibrium. However, the case of Spain was testament to the fact that differences between countries could be important and could create sizable vulnerabilities and risks. It had to be wondered if, because of the existence of the monetary union, the debate on the size of single members' current account balances or the sustainability of their external debt positions were less compelling.

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The staff representative from the European Department (Mr. Traa) underscored that *cajas* were foundations; they were neither public nor private. They were unusual entities organized by an umbrella organization. In the past, if some *cajas* had experienced difficulties, they had merged into a neighboring *caja*, typically within the same region. The issue that created vulnerabilities for the *cajas* was that they were regionally based. So, if there was a regionally weak market or a large exposure to real estate development, the savings banks—like in the United States in the 1980s when the Savings & Loan Crisis had taken place—could be exposed to pressures that were exacerbated regionally, whereas that would not happen for very large banks in Spain that had global diversification. That was the type of concern related to the *cajas*. There was some private participation in *cajas*, but they also had public participation.

On the EU, the observation that, as a whole, it had a fairly well-balanced external account was correct, Mr. Traa continued. But, within the EU, there were substantial differences, where the Southern countries tended to have current account deficits and the Northern countries tended to have current account surpluses. As for the balance of payments for Spain, most financing came from Germany, the Netherlands, and the United Kingdom. That pattern was causing some stress to the euro zone in terms of competitiveness and how the economies interacted. Those factors of stress within the euro area were more difficult to deal with, given the picture that the euro area, as a whole, presented to the rest of the world.

Mr. Guzmán made the following concluding statement:

> At the outset, I want to thank staff for providing very good comments and observations. I also want to thank my colleagues for their written and oral statements, which I will convey as faithfully as I can to my authorities.
>
> Before proceeding with my concluding statement, I want to touch very briefly on a few issues that were addressed by the staff and that might deserve further attention.
>
> As for the risk that exposure to Latin America can imply for the Spanish banking sector, the staff's answer provided a valuable contribution in trying to explain a very complex model based on CDS. It is only fair to acknowledge candidly that it is not the same to be exposed to specific countries, with certain imbalances and financial sector situations, than to have claims or to be engaged or have invested in countries in Latin America.
>
> Overall, the staff alluded to the information provided by our main banks. The levels of debt, public and private, in Latin America over the past decade have been reduced substantially; the currency mismatch in the levels of debt, both in the private and the public sectors, are much lower at present;

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and the fact that citizens are not allowed in most places to borrow in foreign currencies talks by itself.

Our main banks are well aware that an economic downturn in Latin America will affect their performance. The latest analysis by rating agencies tends to agree that the business model of these institutions, the fact that they are internationally and sectorally diversified gives them a more solid footing than that of other institutions that have invested heavily in countries where such circumstances are not exactly the same.

On the adjustment process that is taking place in the housing sector, discussions could trail for a long time. On prices, The October 2008 WEO indicated an overvaluation of house prices of around 17 percent. The staff today suggested 30 percent. Others claim 10 percent. The authorities do not know what will happen. What we do know, and this has been empirically tested, including through valuable Fund's contributions, is that when an asset bubble is a housing bubble, the length of the recovery is longer, causing adjustment to be more protracted. We are not so concerned by the extent of the adjustment, but rather that it is a smooth adjustment.

Turning to demographics, we have a strong, significant difference of view with the staff in terms of the evolution of demographic in Spain over the next years. There is certainly a rigidity in prices, which the staff touched upon in some past staff reports. There is another structural problem in Spain, which is the Land Law. Development of land is extremely regulated and it is one of the main factors behind the potential loss of income for local authorities, which control the progressive development of land. We have agreed with the staff that they will try to investigate this issue further in the future. I agree that they already had a full array of issues for consideration this time around.

The most important thing is that adjustment be as short as possible. In that sense, I need to recall that I have stated in my buff statement that the deceleration in the housing market in Spain started in 2006. It did not start in October last year. Price and transaction agreements were already decelerating back then at a sensible pace.

In connection with a question asked by Mr. Fayolle, I want to stress that the large investment or participation of banks in housing promotion companies is a sensitive issue and a major important problem for the banking sector. De facto, it is almost a settled issue, as it took place in 2007 and 2008 in Spain, with several different situations. Three companies failed so the debt

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has already been absorbed by the balance sheets of our banking system. Several companies diversified and have been able to internalize the problems.

What we find at present is that the banking sector is dealing with the crisis. The authorities are by far more concerned with the economic downturn and the increase in the unemployment rate, more generally, and with the adjustment in house prices, more specifically.

With regard to the *cajas*; they are local saving banks. The German example is similar. In the Middle Ages and in the start of the Modern Ages, the pawn companies were transformed into savings institutions. When the first financial crisis took place, probably around the 17th century, they were transformed into local authority-governed entities, because the local authorities had to take charge of their debt.

Ever since, the *cajas* have typically become mixed foundations, with both regional- and local-authority interests—extremely political. The governance of those corporations is a problem that has been diagnosed for a long time. They have social objectives, which complicate the issue of regional boundaries and interregional movement.

There is no instance in which private capital can be directed into the *cajas*, because of their quasi-public nature. That explains the model of intervention. The authorities let them reach the point of no return, letting them fail and thus forcing their absorption by another *caja*.

Turning to federalism, the authorities were in the process of discussing, as the staff noted, a new model. The deepening of the crisis, however, has caused the debate to come to a halt; as no resources were available any longer. This is why we see this crisis as a huge opportunity, not only in terms of structural reforms, but also because the revenue losses are going to be rather uniform across regions.

I do not agree with the staff on being able to calculate what the effect of the housing downturn on tax revenues is. It is a very complex calculation, because there are several taxes and surcharges both at the local and regional levels, which affect the end result. However, I do not think it is a significant part of our overall public income. What certainly will happen is that local and regional authorities are going to suffer, as I said, in differentiated proportions. The good thing is that the central government has control on the final outcome. This is a fiscal problem; it cannot be denied. It is not the only one we have, as the staff report points out well. However, it is a problem that at

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least has a national solution. It needs to be agreed at the national level and it is going to be affected by political considerations. The process is going to be complicated. If the economy stabilizes at some point when the fiscal perspectives are clearer after this stimulus, we will have to deal with that.

Let me thank again colleagues for their contributions. In general terms, we have stated that we broadly concur with the staff report's diagnosis and policy advice. My authorities were aware of the problems afflicting the Spanish economy before the international crisis started.

In our buff statement, we tried to better contextualize what was a home-grown problem and what instead was caused or exacerbated by the international crisis. You have heard about the policy responses. We have been bold on fiscal policy. We believe that those fiscal measures have been—to the extent possible—timely, targeted, and seeking to achieve the maximum effectiveness in terms of growth. The financial sector entered the crisis better positioned than other sectors. Nonetheless, we have had to produce support in terms of liquidity and funding for our banks.

All in all, we agree and are committed to ensure medium- and long-term fiscal sustainability. We are aware, and we have been for some time, of the need to implement significant structural reforms in the product market and, especially, in the labor market.

Having said all this, I would just like to leave you with several considerations that may better explain our perspective on a future scenario, based on the figures we today have. We consider that the effects of the fiscal stimulus imparted in Spain can contribute to softening the crisis and to spurring an earlier recovery. We have been bold; you have seen the figures. We believe that the discretionary measures, plus the full operation of the automatic stabilizers, are going to produce a sizable impact on the Spanish economy.

The role of the automatic stabilizers should not be dismissed as less important. The discussion of the multipliers—these discussions are legitimate but tend to be rather speculative—may fail to identify a common conclusion. Nonetheless, that type of debate should not mask the fact that the larger the stimulus with the same multipliers, the larger the effect will be. This is one of the rationales for our fiscal stimulus being so bold.

We all understand that, in exercising surveillance, the IMF needs to focus on the problems afflicting an economy and to deliver its policy advice.

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The truth, however, is that, in doing so, we often underestimate or overlook certain factors that have been inherently positive in the immediate past. In the case of Spain, we have had 14 years of continued growth in the process of convergence spurred by the European Union and the monetary union accession. The boom decade was not only about housing. The economy capitalized and invested in infrastructures and capital to an extent that right now, talking about the factor endowment, it is realistic to say there is not such a substantial difference in terms of our capital base vis-à-vis our EU partners.

We are confident, particularly in the context of the integration into the European Union, that our industrial sector has become more competitive, better equipped, and can probably better deal with the consequences of this crisis today than it was the case in most previous instances.

A third factor, mentioned in our buff statement, is that the developments in oil prices and interest rates are currently helping a lot. We have calculated that about a quarter or a third of a point of GDP is going back to the borrowers' pockets who are paying carrying lower mortgage payments because of the fall in the EURIBOR rate. That is a significant advantage. At the same time, when talking about consumption, other factors ought to be considered as well. The confidence factor is still weighing on demand.

However, we are less pessimistic than the staff on demographics and productivity. Labor market flexibility is far bigger today than in the previous recession in Spain in 1992-93. Today, the shedding of labor is far easier and less costly than on previous occasions. The problem with unemployment is undeniable—a tragedy that has been afflicted Spain for a long time. While such an observation does not question the staff's recommendation of further flexibility and reforms in labor market regulations, it has to be brought to bear to understand that the adjustment for companies might be easier this time around.

Let me elaborate on the financial sector. We share the staff's overall assessment of the situation. However, cross-country analysis tends to simplify matters and look for common factors and denominators, thus sometimes overlooking or playing down important differences.

I will enumerate a number of factors that illustrate the characteristics of the Spanish mortgage industry and the effects of the crisis on banks' balance sheets vis-à-vis o other countries. The first difference relates to profits; as the staff mentioned. By this, I mean that those profits have taken place with increased provisions and with reduced dividends, and—despite

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that—banks have been able to declare important levels of profits. A lot has to do with the Spanish banks' originate-to-distribute-retail model, with no exposure to sub-prime markets. It has to be taken into account that profits took place a year and a half after the squeeze in credit had started—around August of 2007.

The second factor to consider is that 98 percent of the mortgages in Spain are subscribed at variable rates. The fall in the Euribor has thus helped a lot. Nonperforming loans, impaired assets, are at 3.5 percent. This is a much less concerning situation relative to that of banks in other countries. Loan-loss provision, the consumption of the generic provisions has been fast, but it has been taking place for some time. The level today is at 70 percent, above the average of European countries before the crisis started. So, that needs to be taken into account.

A third factor to be considered is that mortgages in Spain are collateralized not only with property but also with the current and future wealth of the borrower. This happens in several other European countries. It is not the same for mortgages in the United States or the United Kingdom. The loss-given-default ratio is far lower in Spain.

Looking forward, we place a lot of trust in the effectiveness of our supervisory activities. When dealing with the deterioration of the economic environment, which we agree is already taking place, the Bank of Spain's strong supervision provides us with a degree of comfort that potential problems will be taken care of in a timely manner and dealt with prudently.

Still, in relation to the financial sector, we would like to inform the Board what we have expressed our concern to staff on several occasions about the extreme stress tests conducted and reported in the selected issues paper. We consider them as highly unrealistic and based on technically debatable assumptions. Let me reiterate that we understand that the whole purpose of such tests is to highlight the potential need for capital injections and for creating some fiscal space. In that regard, the point is well taken and shared. However, we have two concerns as to the communication policy related to these stress tests.

First, I am awaiting instructions from my authorities on the publication of those results, because of their sensitive nature and their implications for the extreme volatility in markets at this stage. I hope the Board understands that this is common-sense prudence. More importantly—and staff was balanced in presenting their conclusions and Directors have been balanced in their written

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statements—less-informed people and the press may characterize the IMF's advice to my authorities as centered only on the need to save "dry powder" for capital injections in banks. This would certainly be a pity. From my authorities' point of view, that piece of advice is less valuable than the other two main policy advices that stand out in the staff report. The pressure that the IMF can bring to bear—and the staff is perfectly aware of this—into the policy debate taking place today in Spain on the fiscal front and on accelerating structural reforms is much more valuable to us than to call for caution on the banking front.

To conclude, let me reiterate that my authorities are fully aware of the downside risks to the central scenario presented in the staff report and the measures needed to avoid a protracted low-growth period. They remain committed to closely monitoring the situation and acting, as needed. Let me, however, also express a personal conviction shared by my authorities. Just as Spain's problems were exacerbated, as a result of the international crisis, we are convinced that the length and the intensity of the recession in the rest the world, and in particular in Europe, will determine—to a great extent—the speed and the recovery prospects for our country.

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

Executive Directors agreed with the thrust of the staff appraisal. They noted that, following a long period of strong growth, the Spanish economy has entered a severe downturn. While a gradual correction of the imbalances built up during the boom years had already been under way, the global financial crisis has triggered their abrupt unwinding. Directors expected the downturn in 2009 to be substantial, driven by de-leveraging in the private sector and weak external conditions.

Directors commended the authorities for their timely and substantial fiscal and financial sector responses to help cushion the downturn. They emphasized that these efforts need to be complemented by reforms to bolster competitiveness and to avoid a prolonged period of slow growth and high unemployment which would make returning to fiscal sustainability more difficult. They underscored the need for sustained efforts to reduce domestic costs and increase flexibility and productivity, aimed at slowing the growth of unit labor costs.

Directors concurred that adjustment in the housing sector would likely take time. They welcomed the authorities' efforts to activate the rental market to lower vacancies, and to provide mortgage assistance to newly unemployed

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workers in order to limit foreclosures. Most Directors questioned the desirability of building more subsidized homes given that they could add to inventory at this time.

Directors commended Spain's early application of bold countercyclical fiscal policies, and encouraged the authorities to build on these policies to achieve growth-enhancing reforms. They felt that automatic stabilizers should continue to function freely. Given the projected increase in the public debt ratio and the possible need for assistance to banks, further fiscal stimulus measures should be considered only if warranted by a further worsening of the downturn. These measures should be well-targeted and aim at facilitating structural reforms. More generally, Directors underscored the need for fiscal policies to be anchored in a prudent, long-term sustainability framework. They encouraged the authorities to publish an inter-temporal public sector balance sheet as part of the annual budget documents, showing the debt already incurred and the consequences of present policies on future deficits. Given the high costs associated with an aging population, Directors stressed the need for pension and other long-term reforms to ensure fiscal sustainability.

Directors stressed the need for a vigorous implementation of product and labor market reforms to improve competitiveness, reduce the inflation differential with the euro area, and increase productivity. They welcomed the plans for product and service market reforms that are in line with a unified EU market for goods and services, and looked forward to the timely implementation of the relevant Directives. Directors generally called for comprehensive labor market reforms. In this regard, most Directors underscored the importance of wage moderation and differentiation by reducing wage indexation, combined with reforms to bolster labor flexibility, employment, and competitiveness.

Directors praised the timely banking assistance and strong supervisory and regulatory policies, including dynamic loan-loss provisions, which have helped banks weather the crisis well. Nevertheless, the challenge remains to assist banks through the very difficult operating environment, and to curtail the excessive reliance on wholesale funding. Directors welcomed the design of the liquidity and funding assistance to banks, with appropriate sunset clauses and pricing, and enhanced deposit insurance, as agreed with EU partners.

Directors expected that deteriorating asset quality and higher capitalization demanded by markets would continue to weigh on the outlook,

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and increase the likelihood of consolidation in the banking system. They welcomed the authorities' readiness to act as necessary, focusing on market-based solutions to the extent possible, complemented with the provision of capital if needed to forestall eventual systemic pressures.

Directors noted that the vulnerability of the savings banks, stemming from their dependence on local real estate activity, calls for close monitoring. They welcomed the increased acceptance of interregional mergers, and considered that greater use of participating capital shares, as conditions permit, would bolster balance sheets. Directors welcomed the continued strong resilience of Spain's two largest banks, while stressing that tight cross-border cooperation with EU, U.S., and Latin American supervisors will remain crucial in these testing times.

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

APPROVAL: September 17, 2009

G. RUSSELL KINCAID
Acting Secretary