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The Search for Efficiency in the Adjustment Process

Spain in the 1980s

By Augusto Lopez-Claros

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Contents

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The following symbols have been used throughout this paper:

- ... to indicate that data are not available;
- — to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;
- – between years or months (e.g., 1984–85 or January–June) to indicate the years or months covered, including the beginning and ending years or months;
- / between years (e.g., 1985/86) to indicate a crop or fiscal (financial) year.

"Billion" means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

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Prefatory Note

This paper was prepared by Augusto Lopez-Claros, Economist in the European Department of the International Monetary Fund. He received useful comments from a number of Fund colleagues and would like to thank in particular Manuel Guitián, Teresa Ter-Minassian, and L. Alan Whittome for their suggestions and encouragement. The author also benefited from extensive information and remarks provided by the Spanish authorities, to whom he wishes to record his gratitude. This paper also draws on the work of staff teams involved in Article IV consultations with Spain over the last few years. The author is also grateful to Mr. David Driscoll from the Fund's Editorial Division for expert editorial assistance and to Mr. G. Theodore Saxerud and Ms. Shahpassand Sheybani for computational help. Remaining deficiencies are the sole responsibility of the author.

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I Introduction

The economic program implemented by the Spanish authorities over the period 1982–86 may well be an example of the effectiveness of stabilization policies combined with gradual structural reforms in helping a country adjust to domestic and external imbalances. Following a 15-year period of high and sustained economic growth during which real gross domestic product (GDP) increased at an average annual rate of nearly 7 ½ percent—the highest rate of economic expansion in Europe—Spain found itself in the mid-1970s in the midst of a severe crisis. The rise in international oil prices dealt a serious blow to Spain's industrial sector, the principal engine of growth throughout the 1960s and early 1970s. Heavy investment in energy-intensive sectors, such as steel, chemicals, and shipbuilding, and a concomitant substitution of energy sources away from domestic coal toward imported oil had left industry particularly vulnerable to such external shocks and ill-prepared to compete effectively with its counterparts abroad. The oil price rise also coincided with the end of the Franco era and Spain's return to democracy. The emergence, inter alia, of a free trade union movement and the desire on the part of the Government to avert serious social confrontations that might endanger Spain's fledgling political institutions led to a rapid acceleration of wages, which exacerbated the already adverse consequences of the terms of trade loss.[1] The combined effect of these two factors precipitated a steady deterioration of the economic climate and a pronounced drop in the rate of economic growth. Between 1975 and 1979 GDP grew by less than 2 percent a year, well below the rates registered in Spain's main trade partners. By the early 1980s it had become clear that the Spanish economy was facing major economic imbalances and that a comprehensive adjustment program was necessary.

The Government that came to power in the fall of 1982 was aware that the resumption of sustained noninflationary growth could not be achieved through expansionary demand policies. Rather, a medium-term economic strategy was necessary aimed at restoring macroeconomic balance on a sustained basis through improved efficiency in resource allocation and use. In the next four years the Spanish authorities embarked upon a program of adjustment, which, through a combination of demand management policies and structural reforms, led to marked improvements in a number of areas. (See Appendix III.)

Economic growth, which had fallen below 1 percent a year in the early 1980s, resumed and proceeded at rates in excess of those prevailing among its industrial partners. The rate of inflation, which at over 14 percent in 1982 was more than twice the average for the member countries of the Organization for Economic Cooperation and Development (OECD), had fallen below 5 percent by mid-1987. The current account of the balance of payments, which had been in deficit throughout the early 1980s, registered sizable surpluses over 1984–86, equivalent to nearly 2 percent of GDP annually. While Spain's fiscal adjustment efforts were initially less successful, with the deficit remaining above 5 percent of GDP, a number of measures were implemented in the latter part of the adjustment period (1985–86) with term implications. The successful substitution of a number of inefficient taxes by a value-added tax (VAT), the reform of the pension system, and the marked improvement in the balance sheets of the public enterprises have laid the groundwork for a sustained improvement of the public finances over the medium term. Although the official rate of unemployment rose rapidly over the adjustment period, it had leveled off by late 1985 and began to fall during 1986, as employment recovered sharply, partly as a result of measures taken to foster greater labor market flexibility and a substantial deceleration in the rate of growth of wages with respect to the late 1970s and early 1980s.

The measures implemented to ease rigidities in the labor market were part of an effort to support the financial stabilization program by much-needed structural reforms. Significant steps were taken to restructure those sectors of Spanish industry affected by worldwide excess capacity—steel, shipbuilding, and textiles, among others—through an Industrial Reconversion Program, which provided budgetary support to a process of retrenchment involving substantial employment reductions, compensation and retraining for those affected,

[1] It is estimated that between 1973 and 1980 labor costs in Spain rose more rapidly than the price of energy products as these, being subject to Government control, were not fully adjusted to reflect higher import costs.

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and an ambitious investment program intended to accelerate the modernization of key industrial sectors. Energy policy continued to emphasize the need to increase the share of domestic sources in total energy consumption and, in conjunction with demand- and supply-oriented policies implemented as part of the National Energy Plan, the self-sufficiency ratio rose from 34 percent in 1982 to over 42 percent in 1986. Further liberalization of the financial markets, the privatization of an important number of nonfinancial public enterprises, and Spain's entry into the European Communities (EC), which has already led to an opening up of the economy and has the potential to bring about enduring transformations, are other recent noteworthy developments in structural reform.

This paper discusses the main features of Spain's recent adjustment effort and assesses its impact on the overall economic situation. Section II provides a brief historical background on Spain's economic development from 1960 to the early 1980s. The following section discusses the authorities' stance on monetary and fiscal policy and examines the role of exchange rate policy in the recovery of the external accounts. Section IV assesses progress made in structural reforms, with particular emphasis on industrial restructuring, energy policy, privatization, financial sector reforms, social security, and the labor market. Section V analyzes the impact of the above policies on the recent evolution of output and employment, prices, and the external accounts. A brief overview and assessment of the adjustment program and of the policy challenges ahead are presented in Section VI. A number of questions are explored further in the Appendices: Appendix I examines the issue of concealed employment in the Spanish economy; Appendix II presents some empirical estimates on the determinants of export performance; and Appendix III summarizes the Government's broad objectives for the evolution of the Spanish economy.

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II Background

Spain's remarkably high rates of economic growth over the decade and a half between the implementation of the Fund-supported Stabilization Plan of 1959[2] and the onset of the oil crisis in the mid-1970s were largely made possible by a change in the orientation of its economic policies, which had theretofore promoted self-sufficiency in an increasingly interdependent world. Prior to 1959, Government policy had sought the rapid development of an industrial base through a high degree of protection and official intervention in the economy. Rigidly enforced quantitative restrictions on imports and strict export licensing, widespread price controls, and a large body of legislation regulating virtually every aspect of productive activity ranging from procurement and distribution to investment[3] were the main characteristics of what is now referred to as Spain's period of autarky. Policies aimed at promoting self-sufficiency in turn introduced a number of rigidities in the Spanish economy that were to hamper severely the development process. Describing some of the strains on the economy brought about by autarky, Wright (1977) states:

> Industry had developed, but often based on small units whose high costs and inefficiency rendered them quite uncompetitive on world markets. As industrial growth had accelerated so, too, had the demand for products which could not be produced in Spain, and which could not be obtained elsewhere due to the very poor level of exports and the consequent strict implementation of import controls. This created shortages. In 1959, exports equaled less than 4 percent of GNP—lower than the percentage of any OECD country except Turkey. The system of multiple exchange rates created further distortions in prices and costs and had a dampening effect on the balance of payments.[4]

The Stabilization Plan, which had been brought into being as a result of a severe balance of payments crisis over 1958–59, sought to restore financial and price stability, and improve Spain's external accounts through, inter alia, a substantial liberalization of foreign trade. The various measures adopted as part of this liberalization effort were to have a profound influence on the composition of Spanish growth and on the relative role of the tradables sector. The adjustment program was launched with a 43 percent devaluation of the peseta and the elimination of the system of multiple exchange rates, supported by a marked tightening of financial policies. Ceilings were imposed on government expenditures and on bank lending to the public sector. Prices for transport and public utilities were raised by nearly 50 percent, and taxes on gasoline and tobacco were likewise increased. Ceilings on bank credit to the private sector were also imposed.

The objectives of the program were met within a short period. The annual rate of inflation fell from 33 percent in 1958 to 1.5 percent in 1960; the trade balance recorded its first surplus since 1951 as a result of a 50 percent increase in the volume of exports, and so did the current account under the influence of a rapidly growing tourist sector. More important, growth, which had come to a standstill over the crisis years, resumed. Between 1961 and 1974, the Spanish economy grew at an average annual rate of 7.3 percent, with the highest rates (10 percent on average) being registered in the three-year period immediately following the program. This overall growth performance was second only to that of Japan among the member countries of the OECD. As part of an aggressive export promotion program begun in 1959, an export subsidy scheme was introduced to offset the effects of indirect taxes, and rebates were granted for import duties on intermediate goods used in the production of export products. At the same time, restrictions on imports were substantially relaxed, and the number of products subject to quotas sharply reduced. A concomitant liberalization of capital flows, particularly foreign direct investment, gave a special impetus to Spain's industrialization drive by allowing domestic firms to absorb more rapidly technological changes.[5] The combined effect of these measures led to a substantial acceleration in the growth

[2]Spain joined the Fund and the World Bank in the autumn of 1958. A comprehensive history of the relations between the Fund and Spain is provided by Muns (1986).

[3]Public enterprises were required to purchase supplies and equipment on the Spanish market. State authorization was required to expand industrial capacity—and hence output—and to undertake any type of industrial investment. Preferential treatment was granted to certain industries whose development was deemed to be in the "national interest."

[4]Wright (1977), p. 28.

[5]The requirement for prior administrative authorization for foreign investments involving less than 50 percent ownership of a given Spanish enterprise was eliminated in 1959.

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of foreign trade. Both exports and imports in volume terms grew over this period at average annual rates in excess of 15 percent, and their corresponding ratios to GDP more than doubled. The transformation of the Spanish economy into an industrial state was hastened by the diversification of imports implied by the opening up to the outside world that permitted the much-needed renovation of capital equipment. Between 1959 and 1974 the contribution of industry to Spain's GDP rose from 30 to 42 percent, while that of agriculture fell from 20 to 11 percent. The share of the labor force employed in agriculture fell, over the same period, from 42 to 24 percent.

Three factors played decisive roles in enabling Spain to finance the rapid import growth that facilitated the expansion of the industrial sector: an enormous increase in receipts from tourism, emigrants' remittances, and foreign investment. Tourist arrivals rose from 4.2 million in 1959 to over 35 million in 1974, an eightfold increase, which by the early 1970s generated sufficient foreign exchange to finance the entire trade deficit, then averaging about 5 percent of GDP. The growth of tourism over this period had a stimulative effect on other sectors of the economy, such as construction and commerce, and encouraged the development of much-needed infrastructure.[6] Although reliable figures on emigrants' remittances over this period are not available, it is estimated that they were equivalent to between 15 to 20 percent of the trade deficit. For its part, foreign investment began to account for an increasing share of gross capital formation; 20 percent by the end of the 1960s in the industrial sector. Foreign investment in the chemical and motor vehicle industries was particularly heavy. Other factors that had an impact upon Spanish economic growth over this period were the continued prosperity of Spain's main trading partners and the availability of inexpensive imported oil, which induced a rapid substitution away from domestically produced coal, but which was to leave the industrial sector in a vulnerable position at the outset of the oil crisis.

Although the Stabilization Plan of 1959 was a crucial turning point in Spain's economic development, signaling the beginning of a more outwardly oriented policy stance, by the mid-1960s the pace of liberalization had slackened as the authorities embarked upon a series of development plans modeled after the French system of indicative planning. In consultation with the appropriate Government agencies—usually the Ministries of Industry or Agriculture—firms would set specified targets for production or some other indicative variable, and the State would provide the necessary support in the form of fiscal incentives or, most often, subsidized credit. The allocation of such resources tended to be arbitrary, less guided by market realities than by the desire to strengthen industries perceived to be of "strategic" importance. Thus steel and shipbuilding were accorded preferential treatment; not surprisingly these sectors were most adversely affected by the oil price rises and the ensuing international recessions. At the same time, and notwithstanding the beneficial impact associated with the initial round of trade liberalization, the process of industrialization, against a background of nearly two decades of autarky, proved unbalanced, with the bulk of industrial output directed to the domestic market. By the mid-1970s, Spain was still the most closed economy in Western Europe as measured by commodity trade flows; the ratios of exports to GDP stood at 7½ percent and that of imports to GDP at 14½ percent.

An underestimation on the part of policymakers and entrepreneurs of the relative importance of cheap oil and credit, buoyant growth abroad, and the persistence of a statist approach to economic policy has been suggested as being partly responsible for Spain's delayed adjustment to the first oil shock. While, as a result of the rise in oil prices, various measures were implemented in a number of energy-dependent European countries to limit the consumption of energy products, in Spain investment in energy-intensive sectors continued unabated. A partial indication of this may be gleaned from an examination of data on net petroleum imports by Spain and other OECD countries after 1973 (Table 1). While countries differ in available domestic energy resources, all the countries listed are net petroleum importers, and all were thus adversely affected by the rapid growth in the price of crude oil. Nevertheless, it is clear that during 1973–80, Spain's net petroleum imports rose in dollar terms by over 1,200 percent, well above the corresponding increases for the other countries in Table 1 (with the exception of Portugal) and substantially in excess of the cumulative percent increase for the totality of the smaller European countries,[7] the EC, and the OECD (less the United States). A new national steel plan unveiled in 1974, for instance, projected a real average annual growth of steel consumption of 5 percent, with a target of 20 million tons by 1982.[8] These weaknesses were compounded by the rapid increase in real wages after 1974, which raised the relative price of labor at a time when the terms of trade loss would have required a moderation of labor costs. Between 1975 and 1979 employment in industry declined by over 20 percent.

[6]Tourist activity in Spain accounts for slightly more than 9 percent of GDP, a figure not substantially lower than the contribution made by the construction sector. Its influence on employment is no less important: more than 1.1 million people are directly or indirectly employed in the tourist sector, a figure that accounts for more than 11 percent of the labor force. Spain ranks first in most international comparisons of tourist-industry indicators. Specifically, it accounts for more than 10 percent of the total volume of world tourism and 8 percent of the total foreign exchange generated.

[7]All European OECD members with the exception of France, the Federal Republic of Germany, the United Kingdom, and Italy.

[8]In the event, actual consumption that year stood at 8 million tons.

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Table 1. Import of Oil by OECD Countries, 1973–86

	1973–80	1981	1982	1983	1984	1985	1986
	(Cumulative percent increase)	(Annual percentage change)					
Germany, Federal Republic of	629	−10.1	−11.4	−11.3	−2.9	−1.0	−36.8
Japan	868	1.3	−12.2	−11.1	−0.5	−11.1	−40.5
France	821	−7.0	−11.3	−18.1	−2.1	−8.8	−42.7
Italy	858	8.2	−15.6	−7.1	−9.7	0.6	−45.2
Austria	854	−4.8	−21.2	−12.6	0.9	−4.0	−35.9
Denmark	499	−11.8	−4.2	−30.1	−5.9	−4.4	−43.4
Greece	801	−6.4	54.7	−6.4	−10.0	18.9	−49.5
Belgium-Luxembourg	686	13.8	−4.2	−39.9	30.0	−11.2	−47.3
Portugal	1,345	6.9	13.3	−18.6	8.1	−7.7	−25.0
Spain	1,229	5.6	−16.8	−6.5	−10.7	−1.7	−38.7
Switzerland	482	−8.8	−10.6	−3.1	−8.8	2.1	−24.2
Smaller European countries[1]	808	−4.2	−11.4	−18.5	−9.9	−3.2	−43.9
European Community	595	−9.8	−14.9	−19.4	−2.7	−4.9	−42.2

Source: Organization for Economic Cooperation and Development, *Economic Outlook,* June 1987.
[1]Excluding Iceland.

Summing up the plight of the Spanish economy over the second half of the 1970s Graham (1984) suggests that the problems experienced by Spanish industry in the early 1980s could in good measure be attributed to the errors (e.g., continued investment in energy-intensive industries) made then.

> Before these investments began to pay for themselves, recession set in, creating overcapacity. Energy costs put up production and wage costs. To cover these extra charges more money was borrowed at a time when cheap interest rates had evaporated. Industries which had been making steady profits for more than a decade were suddenly overmanned, over producing, their margins being squeezed into the red by the high financial charges. The list was a long one covering the whole steel industry, shipbuilding, cars and trucks, textiles, domestic appliances, paper, chemicals and aluminum.[9]

The absence of an adjustment to the substantially different set of environmental parameters imposed by the first oil price rise may also be inferred from the role of exchange rate policy over this period, which sought to offset, to the extent possible, its impact on domestic prices and eventually on disposable income. Between 1975 and 1979, the peseta appreciated by over 35 percent in real effective terms, while the stock of external debt rose from US$8.5 billion to US$19.5 billion. The adjustment that should have begun after the first oil price rise began to take place in Spain in 1980 just at the outset of the second oil crisis. It was only then that the magnitude of the crisis became fully evident and that a national energy plan was brought into being with the aim of reducing dependence on imported oil.

The early 1980s witnessed a rapid deterioration of the Spanish economy. The combination of an adverse external environment, precipitated by the second oil shock and the ensuing international recession, and an inconsistent stance of domestic policies led to the emergence of major imbalances. The current account of the balance of payments moved from a surplus of 0.6 percent of GDP in 1979 to deficits in excess of 2.4 percent of GDP over 1980–81. Although much of this deterioration can be attributed to the terms of trade loss of 21 percent over the period 1980–81, there is no doubt that it was also linked to the delayed impact of the appreciation of the peseta, which in 1979 alone rose by more than 16 percent in real effective terms. Exports remained stagnant in 1980 while tourist arrivals fell for the first time in more than 20 years. As the recession deepened—GDP grew by less than 1 percent on average over the three-year period ending 1982—the financial position of the general Government worsened steadily, with the nonfinancial public-sector deficit rising from 1.6 percent of GDP in 1979 to about 5½ percent in 1982 under the impetus of rapidly rising social security expenditures, increasing transfers to troubled enterprises, and a tax burden that did not and could not keep pace with the growth of expenditures. Nominal wages, although on a decelerating trend with respect to the rates of growth registered during the late 1970s, continued to rise above the rate of inflation. These factors and the concomitant rapid expansion of the monetary aggregates resulted in a worsening of inflation performance and led to a widening of the price differential with respect to Spain's trade partners, particularly in the EC.

[9]Graham (1984), p. 86.

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III Economic Policy Setting

The authorities entered 1983 determined to bring inflationary expectations under control and to redress the external imbalances. In a year largely viewed as one of transition during which the groundwork was to be laid for future stabilization measures and structural reforms, the authorities adopted an economic program that projected some recovery of output growth to about 2 percent, a deceleration in the rate of inflation to 12 percent by the end of the year, and a reduction of the current account deficit from 2.3 percent of GDP in 1982 to 1.5 percent (Table 2). Policy measures intended to support the attainment of these objectives included a reduction in the targeted rate of growth of M3 by 2½ percentage points to 13 percent, a broad stabilization of the fiscal deficit in relation to GDP at 1982 levels, and a substantial moderation of wages. To restore Spain's external competitiveness the peseta was devalued by 8 percent against the U.S. dollar in early December 1982 and was allowed to depreciate further throughout 1983. By the fourth quarter of 1983 the peseta had depreciated by 11½ percent in real effective terms with respect to the same quarter in 1982 (Table 3 and Chart 1).

Two clearly defined sub-periods can be identified over the adjustment process. The first, covering 1983–84, was characterized by a nonaccommodating stance of policies and a concomitant recovery of output, a major turnaround in the current account of the balance of payments, and a significant deceleration in the rate of growth of prices and costs. The second, over 1985–86, witnessed a relaxation of the policy stance as a result of the continued improvement in the external accounts and in order to facilitate a more balanced composition of growth, particularly a recovery of investment.

Monetary Policy

Overview

Monetary policy has played a crucial role in the adjustment program implemented by the authorities over the period 1982–86. In late 1982, against a background of accelerating inflation, growing fiscal imbalances, and a rapid deterioration of the external accounts, the authorities significantly tightened the stance of monetary policy. The rate of growth of liquid assets in the hands of the public (ALP) decelerated markedly, short-term interest rates rose sharply, and credit extended to the private sector slowed down. This nonaccommodating stance was instrumental in bringing about a significant deceleration in prices and costs. The rate of inflation fell from 14.4 percent on average in 1982 to 9 percent by the end of 1984, while the rate of growth of nominal wages fell from 14 percent to 10 percent over the same period. In conjunction with an improvement in the external environment, particularly during 1984, when the rate of growth of the volume of non-oil imports in Spain's partner countries rose by over 8 percent, it contributed to a rapid turnaround in the external accounts. By late 1984, however, as the domestic recession deepened (domestic demand fell in real terms that year), the authorities moved toward an easier stance of monetary policy. The need to promote a recovery of investment, which had fallen by over 11 percent in real terms over the 1981–83 period, from 21½ to 20 percent of GDP, and some concern about the increasing burden on the budget of servicing the public debt[10] prompted the authorities to permit a somewhat faster rate of growth of total liquidity and a concomitant fall in interest rates.

The stance of monetary policy over 1985–86 can also be characterized as broadly accommodating. Liquidity growth decelerated less rapidly than in the previous two-year period, interest rates both in real and nominal terms were, on average, lower than during 1983–84, and domestic credit to the private sector recovered significantly. This easier stance contributed to the recovery of domestic demand, which grew by 2½ percent in 1985 and by over 6 percent in 1986, and in particular that of fixed investment, which expanded by a cumulative 15.1 percent in real terms over the same period. Efforts to reduce further the inflation differential vis-à-vis Spain's main trade partners were less successful, however, as the rate of inflation in 1986 remained unchanged with respect to 1985 at 8.8 percent. An important contributing factor behind this development was the introduction of the value-added tax in early 1986 as part

[10]At the end of 1984 the stock of domestic public debt in Spain stood at 19 percent of GDP. The issue of the growing claims on public sector resources made by debt servicing is examined more fully in the section on fiscal policy.

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Table 2. Spain: Selected Economic and Financial Indicators, 1982–87

	1982	1983	1984	1985	1986[1]	1987[2]
			(Percentage changes)			
Demand and output (In real terms)						
Private consumption	0.2	0.3	−0.5	1.8	4.0	4.8
Public consumption	4.9	3.9	2.9	3.1	6.0	9.0
Fixed investment	0.5	−2.5	−5.1	3.9	10.8	14.3
Stockbuilding[3]	−0.2	0.1	—	0.1	0.7	—
Total domestic demand	1.1	−0.1	−0.5	2.5	6.3	7.3
Exports of goods and services	4.8	10.2	11.1	2.9	1.1	5.5
Imports of goods and services	4.0	−0.6	−1.0	5.4	14.9	19.8
Foreign balance[3]	0.1	2.0	2.6	−0.5	−2.9	−2.5
GDP	1.2	1.9	2.1	1.9	3.3	4.7
Summary balance of payments						
Current account (*In billions of U.S. dollars*)	−4.1	−2.7	2.0	2.7	4.2	1.2
Trade balance	−9.2	−7.7	−4.3	−4.3	−6.3	−12.3
Exports	21.3	19.9	22.7	23.5	26.7	33.2
Imports	30.5	27.6	27.0	27.8	33.0	45.5
Services, net	3.5	3.8	5.2	5.9	9.4	11.2
of which: Tourism	6.1	5.9	6.9	7.1	10.5	13.6
Transfers	1.6	1.2	1.1	1.1	1.1	2.3
Current account (*In percent of GDP*)	−2.3	−1.7	1.3	1.7	1.8	0.4
Long-term capital	1.8	3.1	3.3	−1.5	−1.5	10.5
of which: Direct investment	1.2	1.4	1.6	2.0	3.7	4.0
Portfolio investment	—	—	—	0.2	1.2	4.7
Short-term capital and errors and omissions	−1.1	−1.4	−2.0	−1.2	0.3	...
Change in net foreign position of banks	—	0.6	1.2	−1.9	−0.4	...
Overall balance	−3.4	−0.4	4.5	−1.9	2.6	...
Net official reserves (*In millions of U.S. dollars*)[4]	11,046.3	10,726.2	15,213.0	13,300.9	16,001.4	28,070.7[5]
External debt (*In millions of U.S. dollars*)[4]	28,767	29,462	29,577	28,561	24,499	...
Service payments net of anticipated amortizations to GDP	3.7	4.0	4.3	4.4	3.5	...
Service payments net of anticipated amortizations to exports of goods and services	22.4	19.6	19.6	20.7	16.7	...
Real effective exchange rate (1980 = 100)	94.1	82.5	84.9	86.4	92.0	95.2[6]
Percentage change	−0.2	−12.3	2.9	1.8	6.5	3.8[7]
Wages, costs, and prices						
Unit labor costs	10.6	10.4	5.8	5.7	8.3	5.1
Average wage per employee	13.5	13.5	10.0	8.8	9.3	6.6
Productivity	2.6	2.8	4.0	2.9	0.9	1.7
Consumer prices	14.4	12.2	11.3	8.8	8.8	5.3
GDP deflator	13.7	11.6	10.9	8.8	11.5	5.5
Labor market						
Labor force	1.2	1.1	0.6	0.8	1.8	2.0
Employed	−1.0	−0.7	−2.9	−0.9	2.4	3.0
Unemployment rate	16.2	17.7	20.6	21.9	21.5	20.5
Monetary variables						
Liquid Assets (ALP)	16.6	16.0	13.3	12.9	12.0	9.5[8]
Total domestic credit expansion[9]	18.1	15.6	12.0	15.7	13.8	13.0[10]
Share of credit to the general Government in domestic credit expansion	33.3	47.7	85.5	60.1	52.7	35.2
Bank of Spain intervention rate (Overnight)[4]	20.6	21.0	12.5	10.5	11.7	13.9
Three-month interbank deposit rate[4]	17.0	19.0	12.2	10.5	11.8	13.6
			(As a percent of GDP)			
Fiscal indicators						
General Government						
Revenues	31.1	33.2	33.2	34.8	35.8	37.7
Expenditures	32.0	33.1	34.1	35.9	36.2	35.9
Current balance	−0.9	0.1	−0.9	−1.1	−0.4	1.8
Nonfinancial deficit	−5.6	−4.8	−5.5	−6.7	−5.7	−3.6
Overall borrowing requirement	−7.7	−7.3	−8.8	−8.8	−6.8	−4.3

Sources: Bank of Spain, Ministry of Economics and Finance; and Fund staff estimates.
[1]Provisional.
[2]Staff estimates.
[3]Contribution of GDP growth.
[4]End of period.
[5]End of October 1987.
[6]Average for January–November.
[7]Average change over January–November.
[8]Upper limit of a target band centered at 8 percent; 12-month rate of growth for September was 13.9 percent.
[9]By the credit system and the money markets.
[10]Twelve-month rate of growth for September.

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Table 3. Spain: Exchange Rate Developments, 1978–87
(1980 = 100)

	U.S. dollar/ Peseta[1]	Nominal Effective Exchange Rate[2]	Real Effective Exchange Rate[3]	Real Effective Exchange Rate[4]
1978	93.5	96.7	89.0	93.5
1979	106.8	106.2	103.4	105.4
1980	100.0	100.0	100.0	100.0
1981	77.7	91.8	94.3	100.6
1982				
I	70.8	89.5	94.2	101.6
II	67.6	88.7	94.8	101.6
III	63.9	88.7	95.5	103.3
IV	59.7	84.8	91.9	99.4
Year	65.5	87.9	94.1	101.5
1983				
I	55.2	77.4	84.8	91.9
II	51.6	75.2	83.1	91.0
III	47.7	73.1	80.7	89.5
IV	46.4	72.4	81.3	90.8
Year	50.2	74.5	82.5	90.8
1984				
I	46.4	73.6	83.2	94.1
II	46.9	75.1	85.2	95.9
III	43.4	74.0	85.1	97.2
IV	42.1	74.7	85.9	99.0
Year	44.7	74.4	84.9	96.6
1985				
I	39.8	75.0	86.5	102.0
II	41.2	74.9	86.9	99.5
III	42.9	74.3	86.3	96.7
IV	45.1	73.4	85.8	94.2
Year	42.2	74.4	86.4	98.1
1986				
I	48.6	75.1	89.4	97.2
II	50.2	75.5	90.7	97.6
III	52.9	76.6	94.0	100.0
IV	53.2	76.8	94.4	98.9
Year	51.2	76.0	92.0	98.4
1987				
I	55.5	76.2	92.8	96.1
II	56.7	77.1	93.3	95.9
III	57.4	79.9	96.4	99.7

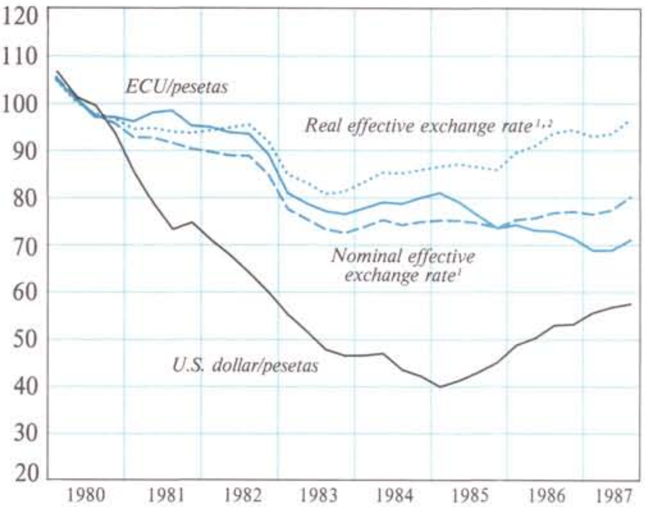
Sources: International Monetary Fund, *International Financial Statistics*, various issues; Fund staff estimates; and Bank of Spain.
[1]Period average.
[2]Trade weighted average of exchange rates expressed as units of foreign currency per peseta. A decline in the index indicates a depreciation. The weights are based on the distribution of export and import trade with 19 partner countries during 1980–82.
[3]Index of the trade weighted average ratio of Spain's consumer price index to the consumer price indices of partner countries multiplied by the nominal effective exchange rate. The weights are the same as in footnote 2, and a decline in the index also indicates a depreciation.
[4]Vis-à-vis the currencies of the member countries of the EC, as calculated by the Bank of Spain.

of Spain's accession to the EC, which added about 2 percentage points to the consumer price index and thus prevented a further deceleration of the rate of inflation.

Implementation

The monetary authorities' efforts to restore a stable financial environment after the crisis years 1980–82 have

Chart 1. Spain: Indices of Exchange Rates, 1980–86
(1980 = 100)



Source: International Monetary Fund, *International Financial Statistics*, various issues; and Research Department. Fund staff calculations.
[1]Vis-à-vis 19 partner countries.
[2]Relative consumer prices corrected for exhcange rate changes.

been centered around one basic strategy: a gradual deceleration of the monetary aggregates according to preannounced quantitative targets. The announcement of such quantitative targets for the money supply was thought to be a key element in the authorities' efforts to shape expectations. The setting of such targets in a medium-term context, involving a progressive deceleration of monetary growth, was seen as the basis for engineering an effective break in inflationary expectations (Chart 2). The monetary growth targets have been given as a band with a width of ± 1.5–2 percentage points, with the implicit understanding that the aim was the mid-point of the range.[11] Although for 1983 the targeted growth rate for M3 was set at 13 percent (± 2 percent; against a projected growth of nominal GDP of about 14 percent) the Bank of Spain also set a target of 16 percent for the growth of the broader aggregate ALP.[12] The rapid development of a market for treasury bills held by the nonfinancial public and other nonmonetary liabilities that were close substitutes for money had begun to reduce the reliability of M3 as an indicator of total liquidity. In subsequent years this shift in emphasis from M3 to ALP was made formal, and the

[11]The monetary program has been based on real growth and inflation objectives from which a target for total liquidity has been derived. Conflicts with other policy objectives, such as the desired evolution of the exchange rate or of interest rates, have often led to temporary deviations from the projected targets. The anticipated behavior of the balance of payments and the borrowing requirements of the public sector have determined the permissible expansion of credit to the private sector.

[12]ALP consists of currency in circulation, sight, savings, and time deposits, banks' nonmonetary liabilities, and money market liabilities.

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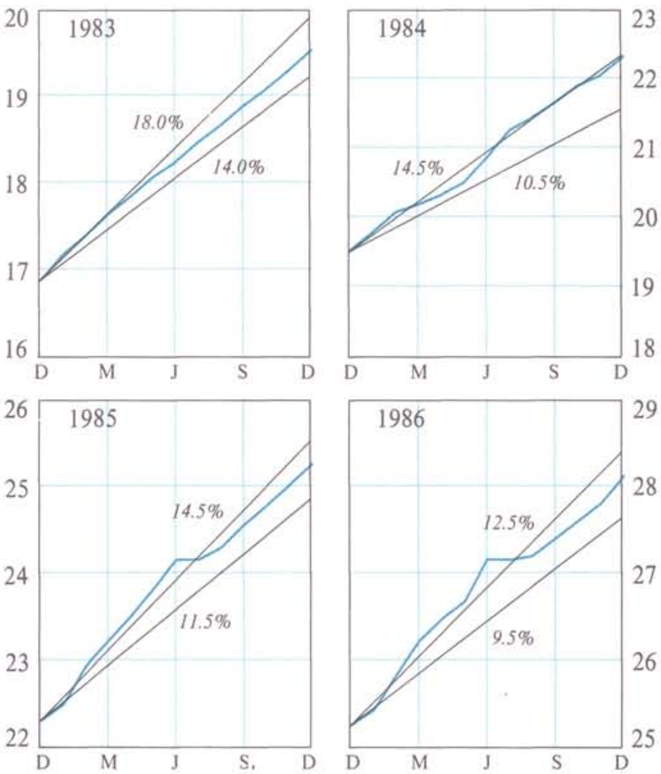
Chart 2. Spain: Total Liquidity (ALP), Target Band and Outturn, 1983–86[1]
(In billions of pesetas)



Source: Bank of Spain.
[1]Monthly averages of daily data, seasonally adjusted.

monetary targets were set with reference to the latter aggregate.

The growing borrowing needs of the public sector and the creation of liquid assets not included in broad money made monetary control in 1983 especially difficult. Because the monetary aggregates were growing in the early part of the year at rates well above the upper limits of their targeted ranges, the monetary authorities began a gradual tightening of monetary policy. Reserve requirements were raised in April and August, while increasing amounts of Certificates of Monetary Regulation (CMR)—a central bank liability used in open market operations—were sold to the banking system. Moreover, moral suasion was used to discourage the banks from stepping up the creation of alternative liquid assets not included in the definition of money, such as bankers' acceptances and various types of bonds (Bonos de Caja y Tesoreria). As a result of these measures, interest rates rose to historically high levels (Chart 3); by the third quarter of 1983 the three-month interbank rate had risen by 6 percentage points to 23 percent, while the rate paid on treasury bills stood at 16 percent, well above the 11 percent rate of inflation. Against a background of rapidly rising interest rates and in order to lower the interest costs associated with the need to finance the budget deficit, which had been largely supported by Bank of Spain financing out of its capital accounts, the cash and mandatory deposit coefficients were replaced by a new, broader cash coefficient. The CMRs were phased out and replaced by a special issue of treasury bills for which a special coefficient was created. These new coefficients added up to 30 percent of the banking system's liabilities, an effective increase of 7 percentage points over the previous system. Notwithstanding the difficulties experienced by the authorities in the instrumentation of monetary policy during 1983, its overall objectives were attained. ALP rose by 15.7 percent, slightly below the mid-point of the target range (Table 4).[13] The rate of growth of consumer prices fell to 12.2 percent while output grew by 2 percent. More significantly, the deficit on the current account of the balance of payments was reduced by nearly US$1.5 billion—from 2.3 to 1.7 percent of GDP. Although the rate of growth of domestic credit was on target, its composition was not, with credit to the public sector rising by over 40 percent against an expansion of credit to the private sector of less than 10 percent.

The evolution of the monetary aggregates during 1984 can be seen as the continuation of the process of deceleration begun in early 1983. Although ALP did not decelerate as rapidly as anticipated in the initial monetary program—a target of 12.5 percent with a lower limit of 10.5 percent and an upper limit of 14.5 percent—this can largely be interpreted in terms of the higher-than-projected public sector borrowing requirement and the unexpectedly large inflows of liquidity through the balance of payments. Foreign exchange reserves increased by over US$4.5 billion, in sharp contrast to the initial program's projection of no change. ALP grew by 14.2 percent or near the upper limit of its target range. Although overall domestic credit expansion was within target, its composition, as in 1983, differed from initial projections. Low private sector demand for bank credit, associated with the domestic recession, appears to have been the overriding factor behind the 6 percentage point shortfall in private sector credit expansion with respect to the original target.

For 1985, the authorities sought a mix of monetary and exchange rate policies that would contribute to a more balanced growth than in 1984, a year in which domestic demand had made a negative contribution to GDP growth. The revival of domestic demand was to come about through an increase in real incomes stemming from lower price increases and reduced inflationary expectations. With this overall objective in mind the rate

[13]Because the ALP figures used by the authorities for the purpose of monetary control/targeting are seasonally adjusted monthly averages of daily data, the rates of growth quoted in the text for the end-of-year outturn differ slightly from those given in the monetary survey (Table 4), which are based on end-of-period stocks.

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Table 4. Spain: Monetary Survey, 1982–86
(In billions of pesetas; end of period stocks)

	1982	1983	1984	1985	1986
Net foreign	211	464	1,251	1,417	1,687
(In millions of U.S. dollars)	1,680	2,962	7,213	9,190	12,739
Domestic credit	18,828	21,758	24,364	28,196	32,080
(Percentage change)	19.8	15.6	12.0	15.7	13.8
Claims on general Government	2,741	4,138	6,367	8,669	10,717
(Percentage change)	61.0	50.9	53.9	36.1	23.6
State	2,097	3,403	5,553	7,574	9,453
Other public sector	644	735	814	1,095	1,264
Claims on the public[1]	16,087	17,620	17,997	19,527	21,363
(Percentage change)	14.8	9.5	2.1	8.5	9.4
Total liquid assets (ALP)	17,557	20,369	23,077	26,072	29,263
(Percentage change)	16.6	16.0	13.3	13.0	12.2
Broad money (M3)	16,604	18,738	20,979	22,135	23,001
(Percentage change)	14.0	12.9	12.0	5.5	3.9
Narrow money	4,918	5,248	5,643	6,327	7,152
(Percentage change)	6.9	6.7	7.5	12.1	13.0
Currency in circulation	1,523	1,686	1,862	2,081	2,402
Sight deposits	3,395	3,562	3,781	4,246	4,750
Quasi-money	11,686	13,490	15,336	15,808	15,849
(Percentage change)	17.3	15.4	13.7	3.1	0.3
Savings deposits	4,032	4,483	4,777	5,300	5,975
Time deposits	7,654	9,007	10,559	10,508	9,874
Banks' nonmonetary liabilities	608	1,058	1,551	3,110	5,236
Money market liabilities	345	573	547	827	1,026
Of which: Treasury bills	63	406	390	686	959
Other items (Net)	1,482	1,853	2,538	3,541	4,504
Memorandum items:					
Deseasonalized ALP[2]	16,871	19,515	22,295	25,274	28,294
(Percentage change)	. . .	15.7	14.2	13.4	11.9
Interest rates (period average)					
Overnight loans to banks	18.0	20.6	13.5	12.4	11.6
Three-month interbank deposits	16.3	20.0	14.9	12.2	11.7
Commercial credits (1–3 years)	17.5	17.6	18.1	16.7	15.4

Source: Bank of Spain, *Statistical Bulletin*.
[1]Includes the public enterprises and the private sector.
[2]Monthly average of daily data; this is the aggregate actually used by the authorities for the purpose of monetary control.

of growth of ALP was targeted at 13 percent with a ± 1.5 percent band of fluctuation. Although this implied a reduction of only 1.2 percentage points with respect to the 1984 outturn, it was consistent, in light of the declining trend in velocity registered in recent years, with real GDP growth of around 3 percent and a further deceleration in the rate of inflation to 7–8 percent. This rate of monetary expansion was also judged to permit a recovery of credit to the private sector, which, however, would still remain negative in real terms; such recovery assumed a marked deceleration in the rate of growth of credit to the general Government from the over 40 percent registered in 1984 to a target of 25 percent in 1985. On the external front, the monetary authorities decided to counteract the heavy inflow of reserves through the balance of payments with some liberalization in the rules governing Spanish investments abroad and the anticipated amortization of external debt, policies that were expected to halt the peseta's appreciating trend seen throughout the previous year.

In the event, ALP grew in 1985 by 13.2 percent. Given GDP growth of 2 percent—wholly led by domestic demand—this implied a drop in velocity of the order of 2 percent. Credit to the private sector rose by close to 7½ percent, while the claims on the general Government by the financial system rose by 34 percent, well above target. Nominal interest rates continued their downward trend, and at the end of 1985 real rates were an average of 3 percentage points below the high levels reached in the middle of the year.

Monetary policy for 1986 was framed in an environment fraught with uncertainty. New legislation on the taxation of financial assets, which exempted treasury bills from an 18 percent withholding tax applied to all other short-term assets, made it difficult to forecast the evolution of the demand for money. In the first half of the year a substantial amount of paper issued by various financial institutions was scheduled to come due, and, given the exclusive tax treatment granted to treasury

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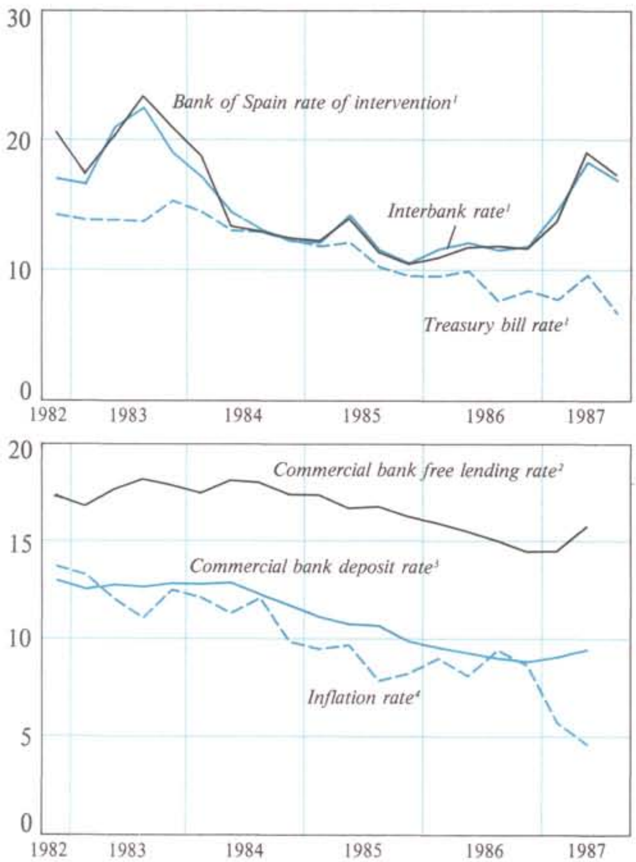
Chart 3. Spain: Selected Interest Rates, 1982 (IV)–1987 (III)
(In percent)



Source: Bank of Spain.
[1]Three month.
[2]One to three years.
[3]One to two years.
[4]Measured by the year-on-year percent change in the consumer price index.

bills, further asset substitution was likely.[14] The extent of this substitution (and thus the changes in the composition of ALP) would depend on the stance taken by the Treasury as regards interest rates. The demand for ALP would partly depend on the resulting mix between fiscal advantage and profitability accorded to treasury bills. Furthermore, the scheduled introduction of the VAT in early 1986 was also expected to have an adverse impact on consumer prices. With these imponderables in sight, the monetary authorities established a tentative band for ALP growth in 1986 centered on 11 percent with a margin of ± 1.5 percent. This rate of expansion was seen to be consistent with real GDP growth in the neighborhood of 2–2½ percent and an 8 percent rate of inflation and to permit growth of credit in the order of 21 percent to the public sector and of 7½ percent to the private sector.

The drastic changes in the international economic environment that characterized 1986—large drops in the price of oil, the continued depreciation of the U.S. dollar, and declining interest rates—did not dissipate these uncertainties. Some deceleration in the rate of growth of ALP did take place; the 12-month rate for December stood at 11.3 percent, or nearly 2 percentage points below the corresponding figure for the end of 1985. M3, which had decelerated rapidly throughout 1985, continued to do so during 1986 with December levels only 3.9 percent above the corresponding levels for December 1985. Most of this deceleration could be attributed to a reduction of time deposits in favor of treasury bills and bank's nonmonetary liabilities, both included in ALP. The authorities accommodated the stimulus to demand engendered by the gain in the terms of trade induced by the lower price for oil. GDP grew by 3.3 percent in 1986, exclusively under the impetus of domestic demand, which rose by 6.3 percentage points.

There can be little doubt that monetary policy made an effective contribution over the initial two-year period to the authorities' anti-inflation objectives. Against the background of rapid monetary expansion in the early 1980s, the associated failure to secure greater price stability and the rapid deterioration of the fiscal accounts, all factors that had eroded the public's confidence in the Government's commitment to reduce inflation and that had been largely responsible for the emergence of large deficits in the current account of the balance of payments, the devaluation of December 1982 and the substantial tightening of money throughout 1983–84 must be seen as key ingredients of the stabilization effort. The conduct of monetary policy over this period may have alleviated the uncertainties generated by the arrival of a Government with a different political orientation and social agenda and no doubt contributed to the deceleration of inflation and nominal wages.

Fiscal Policy

Overview

The financial position of the general Government deteriorated steadily after 1975 as the deficit on a national accounts basis (excluding net lending) rose from an average of 1.1 percent over the period 1976–79 to 5.6 percent of GDP in 1982. This deterioration was the result of expenditure growth associated with a rapidly expanding public sector (public consumption grew at an

[14]The demand for treasury bills was expected to increase substantially as a result of a reallocation of assets within ALP (at the expense of bank deposits) and as treasury bills were substituted for other short-term assets not included in ALP, such as the "pagarés de empresa." At the same time, however, a general movement away from short-term instruments toward medium- and long-term financial assets and real assets could be expected as a result of the new tax legislation and its impact on the relative rates of return of alternative assets.

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average annual rate of about 4½ percent in real terms between 1975 and 1982), improvements in the level and coverage of social security benefits without commensurate increases in contributions, increasing transfers of financial resources to ailing enterprises, and a domestic recession.

It is useful, in making an assessment of recent government policy vis-à-vis the public sector, to distinguish three broad and interrelated areas of fiscal endeavor. Fiscal policy may be examined in terms of its impact on the financial position of the government, the role of the public sector in the provision of goods and services, and the government's regulatory role within the various sectors of the economy. In each of these areas there have been attempts—some quite successful—to introduce structural reforms aimed at enhancing efficiency.[15] Against a historical background of substantial government involvement in economic activity, which had often led to undue regulation and overprotection, and in light of the rising fiscal imbalances that characterized the early 1980s, the process of reform has not been an easy one. Several decades of an interventionist approach to economic policy had given rise to important rigidities whose elimination, in the authorities' view, was to be accomplished gradually.

Over the four-year period of adjustment under review, a number of measures were implemented with important allocational implications for the medium term. The introduction of the value-added tax in early 1986 in the framework of EC accession widened the tax base and substituted for a number of inefficient indirect taxes. A much needed and politically difficult reform of the pension system took place in 1985, whose aims—a deceleration in the rate of growth of beneficiaries and an increase in the level of contributions—began to become evident in 1986. With respect to the public sector's provision of goods and services the trend has been toward a gradual retrenchment in those areas where government presence was not seen as necessary for the accomplishment of specific social objectives (e.g., the alleviation of unemployment in certain regions of the country). Privatization and industrial restructuring have therefore been at the center of the government's retrenchment strategy, which has already improved the financial position of public enterprises. Nevertheless, measured in terms of the magnitude of the public sector deficit, progress in improving public finances has been relatively modest, with the deficit remaining at over 5 percent of GDP throughout most of the adjustment period.

Implementation

From the outset of the reforms the authorities recognized the importance of improving public sector finances. The objective for 1983 of halting their deterioration was overshot, and the deficit on a national accounts basis (excluding net lending) was reduced to 4.8 percent of GDP (Table 5). This outcome was achieved mainly through an increase in the tax burden resulting from increases in the rates of indirect taxation and a modification of the schedule of withholdings for the personal income tax, together with some reduction in exemptions. The combined effect of these tax changes resulted in a substantial increase in tax revenues from 14.6 percent of GDP in 1982 to 16.4 percent in 1983. This improved revenue effort was, however, partly offset by a continued rise in public expenditure, particularly an accelerated increase in pension payments, unemployment compensation expenditures associated with the deterioration of labor market conditions, and a rise both in transfers to enterprises and in the general government wage bill. Current expenditures continued to rise rapidly in 1984, reaching the equivalent of 34 percent of GDP, a 1 percentage point increase with respect to the 1983 outturn. Moreover, there were marked changes with respect to the previous year in the behavior of its individual components. Interest payments on the public debt rose by more than 75 percent owing to the rapidly rising stock of debt and the more explicit accounting of interest charges in the budget stemming from the growth of financing through treasury bills. Social security benefits, which had grown by 15.1 percent in 1983, grew by 11.6 percent in 1984, but actually fell in relation to GDP from 15.1 percent to 14.4 percent on account of a deceleration in the rates of growth of the number of pensioners and of the average monthly pension. A significant deceleration in the rate of growth of current revenue (particularly social security contributions, which also fell in relation to GDP) in association with the domestic recession contributed to the emergence of a budget deficit in 1984 of the order of 5½ percent of GDP.

In 1985 the public finances deteriorated as the nonfinancial deficit rose to the equivalent of 6.7 percent of GDP. Although the 1985 budget had not contemplated any changes in tax legislation, the authorities introduced in May a number of modifications in the withholdings schedule of the personal income tax in an attempt to stimulate private consumption, which had fallen in real terms in 1984 and had shown no obvious sign of recovery in the first months of 1985. These changes contributed to a deceleration in the rate of growth of taxes on income and property, from 19.3 percent in 1984 to 13.8 percent in 1985.

Indirect taxes continued to grow at rates well above those of nominal GDP, expanding in 1985 by 20 percent. This relatively high rate of growth of indirect taxes stemmed from both buoyant revenues on account of the turnover tax, whose coverage was extended throughout the year as a preparatory step in anticipation of the intro-

[15]A fuller discussion of some of these reforms is contained in Section IV.

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Table 5. Spain: General Government Operations, 1982–87
(National accounts basis; in percent of GDP)

	1982	1983	1984	1985	1986[1]	1987[2]
Current revenue	31.1	33.2	33.2	34.8	35.8	37.7
Indirect taxes	7.8	8.5	9.0	9.8	11.1	11.1
Taxes on income and property	6.8	7.9	8.3	8.5	8.4	10.3
Social security contributions	13.1	13.3	13.1	13.1	12.9	12.9
Other current revenue	3.4	3.5	2.8	3.4	3.4	3.4
Current expenditure	32.0	33.1	34.1	35.9	36.2	35.9
Wages and salaries	9.4	9.6	10.5	10.5	10.4	10.4
Goods and services	2.2	2.3	2.7	2.6	2.9	3.4
Social security benefits	15.0	15.1	14.4	15.0	14.6	14.6
Transfers to enterprises	2.3	2.7	3.0	2.4	2.0	1.7
Interest payments	1.0	1.2	2.0	3.6	4.1	3.7
Other	2.1	2.2	1.5	1.8	2.2	2.1
Current balance (Deficit −)	−0.9	0.1	−0.9	−1.1	−0.4	1.8
Capital expenditure	4.7	4.9	4.6	5.7	5.3	5.4
Fixed investments	2.6	2.7	3.0	3.6	3.4	3.5
Capital transfers	2.1	2.2	1.6	2.1	1.9	1.9
Nonfinancial deficit	−5.6	−4.8	−5.5	−6.7	−5.7	−3.6
Overall borrowing requirements (Cash basis)	−7.7	−7.3	−8.8	−8.8	−6.8	−4.3
Memorandum						
Primary deficit	−4.6	−3.6	−3.5	−3.2	−1.6	0.1

Sources: Data provided by the Spanish authorities; and Fund staff estimates.
[1]Provisional.
[2]Preliminary official estimates.

duction of the value-added tax, and a recovery of import taxes associated with a 7 percent expansion in the volume of merchandise imports. The rise in the tax burden in 1985 was to a great extent accounted for by the more rapid growth of indirect taxes. Social security contributions on the other hand grew, as in previous years, at rates well below those corresponding to tax revenues. This performance is largely the result of fiscal policies that have attempted to reduce the costs to the employer of social security contributions with a view to stimulating employment, particularly for new entrants into the labor force.

Perhaps the most salient feature of the public sector's operations in 1985 concerns the rapid increase in the share of current expenditure allocated to interest payments on the public debt. This share rose from 1.2 percent of GDP in 1983 to 3.5 percent of GDP in 1985 as the stock of net public debt rose, over the same period, from 18.1 to 27.5 percent of GDP. This marked increase was partly linked to the changes introduced by the authorities in 1983–84 in financing the deficit, which attempted to shift some of its burden from central bank profits to the budget and thus make its costs more explicit. Central bank financing had led to the rapid growth of the monetary base; to prevent over-shooting the targets for the monetary aggregates, the Bank of Spain had resorted to sterilization through the sale to the banking system of securities (Certificates of Monetary Regulation) and to a concomitant tightening of reserve requirements. The high reserve and investment ratios associated with this process had contributed to the substantial spread between lending and deposit rates, as financial institutions attempted to preserve profitability through relatively high lending rates on that portion of their assets not subject to reserve requirement and through relatively low rates on deposits.[16]

This interest rate wedge has well-known adverse allocational repercussions. It introduces distortionary effects on savings and investment and thus represents a form of taxation of the economy's productive sectors.[17] In the case of financing through issues of government paper, such as the treasury bills introduced in 1983, the costs of the deficit are absorbed by the budget, leading to an increase in the share of current expenditure allocated to interest payments. Financing of this type need not in itself be a particularly severe constraint in the conduct of fiscal policy if the deficits are "small" or declining with respect to GDP. Furthermore, it has none of the negative impact that central bank financing has on the allocation of financial resources. The persistence of growing public sector deficits over time may, however, give rise to a situation in which, even within a relatively short span of time (three years in Spain), there is a rapid growth in the interest component of public expenditure leading, in the

[16]Relatively high (low) in relation to what the rates would be if the above reserve and investment ratios were lower.

[17]In the extreme case of central bank financing without recourse to sterilization the result will be inflation, which is also a form of taxation.

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absence of concomitant cuts in other items of expenditure, to higher deficits and the need for further financing in what can correctly be characterized as a potentially destabilizing situation.[18] The steep rise in the interest burden of the public debt over so short a time underscores the constraints that inevitably begin to emerge for the conduct of financial policies as a result of repeated large public sector deficits. The extent to which the need to finance such deficits strongly influences the fiscal outcome in later periods is made clear by the fact that, net of interest payments, the general Government deficit excluding financial operations actually fell in 1985 with respect to 1984. This would suggest that to the extent that servicing the public debt reflects past fiscal performance, the eventual reduction of the general Government deficit will largely depend on the authorities' determination to reduce noninterest expenditure.[19]

The year 1986 witnessed a return to the trend initiated in 1983 of lower public sector deficits and reduced borrowing requirements. The nonfinancial deficit was reduced to 5.7 percent of GDP. Possibly the most noteworthy fiscal development in 1986 was the successful introduction of the value-added tax. Although it added about 2 percentage points to the consumer price index, it permitted a substantial expansion of the taxable base. In conjunction with the increased taxation of petroleum products—domestic oil prices were only partly adjusted to reflect the sharply lower import prices—the introduction of the VAT led to a 30½ percent rise in indirect tax revenues, which more than compensated for the revenue losses associated with the stimulative measures approved in mid-1985, whose full year impact in 1986 is estimated at about 0.6 percent of GDP. There is ample evidence that the buoyancy of tax receipts during 1986, and also in 1987, is at least partially attributable to genuine improvements in tax collection and administration.[20] In 1986 alone there was a rise of 8 percent in the number of individuals filing tax returns (equivalent to half a million contributors) and a marked increase in the average income declared by individual entrepreneurs. The resumption of the trend toward greater fiscal restraint seen during 1986 appears to have strenghthened in the course of 1987. The strong expansion of economic activity throughout 1987, with real GDP growth close to 4.5 percent, resulted in tax receipts much higher than anticipated in the budget. The general Government nonfinancial deficit (on a national accounts basis and excluding net lending operations) is estimated to have fallen to 3.6 percent of GDP, a reduction of 2 percentage points of GDP with respect to the 1986 outurn.

External Policies

The peseta has been managed flexibly for a number of years, with the Bank of Spain intervening in the foreign exchange markets to prevent undesirable fluctuations and to ensure the maintenance of competitiveness for Spanish exports. Other factors, such as the impact of exchange rate changes on domestic prices, on servicing external debt, and on the rate of accumulation of international reserves, have also influenced the timing and extent of the Bank's interventions. Two major trends can be identified in the evolution of the exchange rate in recent years (Chart 1). Following the 8 percent devaluation of the peseta in December 1982, the various indicators used to measure external competitiveness improved remarkably. The peseta depreciated in 1983 by 23 percent on average against the U.S. dollar and 19½ percent against the deutsche mark; on a trade-weighted basis the nominal effective depreciation exceeded 15 percent, while the real effective rate, expressed in terms of relative consumer prices, recorded a gain in competitiveness in excess of 12 percent with respect to 1982 (Table 3). While the peseta continued to lose ground against the dollar throughout 1984 and the first quarter of 1985, reflecting the marked appreciation of the dollar in the international exchange markets, it began to appreciate against the currencies of its main European trade partners. This resulted in a real effective appreciation during 1984 of the order of 3 percent, thus partly eroding some of the competitive gains that had occurred in 1983 and had led, in conjunction with a substantial expansion of foreign demand, to a 17 percent rise in the volume of exports, the highest rate of growth over the previous decade (Table 6).

The weakening of the dollar in the second half of 1985 did not lead to a deterioration in overall competitiveness because the peseta depreciated against the currencies of the major European countries, which account for over 50 percent of Spanish trade. The Bank's intervention policy during 1986 attempted to maintain the real value of the peseta vis-à-vis the European Currency Unit (ECU) at the average level of 1985. The broad achievement of this target did not prevent a renewed appreciation of the real effective rate. Largely in an effort to mitigate the effects of the rapid accumulation of international reserves, which could have endangered the achievement of monetary policy objectives, the authori-

[18]This process may be aggravated if the economy is characterized by relatively high rates of inflation. A recent study on the impact of inflation on the fiscal deficit concludes that while the outcome depends on the type of debt instrument issued by the government, when the bulk of the debt is held in the form of floating interest securities denominated in domestic currency, the impact of inflation on interest rates will increase the fiscal deficit in real terms. The fiscal deficit thus becomes a function of both, the initial stock of public debt and the level of inflation.

[19]Noninterest expenditure rose from over 36 percent of GDP in 1984 to 38 percent of GDP in 1985. The rate of growth of this type of expenditure—15 percent—exceeded by 3½ percentage points the rate of growth of nominal GDP, a marked reversal with respect to 1984 when noninterest expenditure expanded by 9 percent, or about 5 percentage points below the rate of GDP growth.

[20]The introduction of the VAT in 1986 permitted the fiscal authorities to discover a large number of potential contributors.

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Table 6. Spain: Terms of Trade, Volume and Price Indices, 1978–87[1]
(1980 = 100; prices in pesetas)

	Exports				Imports						
	Total		Manufactures		Total		Non-Oil		Oil Products		Terms
	Volume	Prices	Volume	Prices	Volume	Prices	Volume	Prices	Volume	Prices	of Trade[2]
1978	89.8	74.7	88.4	76.2	85.4	68.4	...	...	88.3	49.3	109.2
1979	100.1	81.7	100.3	83.8	96.8	71.8	...	...	97.6	56.5	113.8
1980	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1981	110.0	115.0	107.4	116.9	95.4	127.0	96.0	117.9	95.2	142.0	90.6
1982	115.3	129.8	110.8	135.4	98.5	144.0	102.8	135.0	92.5	159.6	90.2
1983	123.7	153.5	118.4	157.7	98.0	173.8	99.5	166.3	96.3	186.1	88.3
1984	144.7	172.6	138.6	177.6	98.6	191.4	102.5	186.3	93.5	199.7	90.3
1985	148.3	185.3	141.5	192.0	105.6	196.0	112.8	191.5	95.4	203.3	94.6
1986	142.0	179.1	128.2	200.6	123.1	162.1	139.3	188.0	99.4	100.4	110.6
1987[3]	151.8	184.8	134.1	206.2	150.4	163.6	176.6	118.9	108.3	94.6	113.1
	(Annual percentage change)										
1979	11.5	9.3	13.5	10.0	13.4	4.9	...	...	10.5	14.7	4.2
1980	−0.1	22.4	−0.3	19.3	3.3	39.2	...	...	2.5	76.9	−12.1
1981	10.0	15.0	7.4	16.9	−4.6	27.0	−4.0	17.9	−4.8	42.0	−9.4
1982	4.8	12.9	3.2	15.8	3.2	13.4	7.1	14.5	−2.8	12.5	−0.4
1983	7.3	18.2	6.8	16.5	−0.5	20.7	−3.2	23.2	4.1	16.6	−2.1
1984	17.0	12.5	17.1	12.6	0.7	10.1	3.0	12.0	−2.9	7.3	2.2
1985	2.5	7.3	2.1	8.1	7.0	2.4	10.0	2.8	2.0	1.8	4.8
1986	−4.3	−3.3	−9.4	4.5	16.6	−17.3	23.5	−1.8	4.2	−50.6	16.9
1987	6.9	3.2	4.6	2.8	22.2	0.9	26.8	0.5	9.0	−5.8	2.3

Source: Ministry of Economy and Finance, *Síntesis Mensual de Indicadores Económicos*, December 1987.
[1]Based on customs data.
[2]For total exports and imports.
[3]Preliminary.

ties let the peseta appreciate by 8.8 percent in real effective terms in the 12-month period ending December 1986. This put the index at a level not substantially different from that prevailing prior to the 1982 devaluation.

The picture of competitiveness that emerges from the recent evolution of unit labor costs in the manufacturing sector is not radically different. The ratios of Spain's index of unit labor costs in the manufacturing sector to a weighted average of the corresponding indices for 16 industrial countries and for the EC, adjusted for changes in the nominal effective exchange rate, are presented in Table 7. The table also presents the results of such comparison vis-à-vis a number of partners or competitors. In all cases, there was a marked improvement in the relative competitive position of Spain in 1983, followed by some erosion of these gains in 1984, and little further change during 1985 and 1986. While the ratios for 1986 as a whole still compare favorably with 1982, the comparison vis-à-vis the set of 16 industrial countries during 1986 is somewhat less favorable on account of the appreciation of the peseta mentioned above.

The relatively active exchange rate policy over the initial phase of the adjustment process (1983–84), followed by the broad stabilization of the real exchange rate vis-à-vis the ECU, has played a crucial role in the restoration of Spain's external accounts. Much of this improvement can be attributed to the strong growth of the export sector which, over 1981–84, grew at an annual average rate of 9¾ percent in real terms (Chart 4). Table 8 shows the rates of growth of merchandise exports over the previous six-year period and the evolution over time of a number of variables that are thought to have had an important influence on export performance. The information presented in Table 8 permits a qualitative assessment of the impact of such variables as the real effective exchange rate and the evolution of domestic and foreign demand and thus sheds some light on the reasons for the marked turnaround in the external accounts referred to above. (See Appendix II for further discussion of this issue.)

Changes in the competitiveness of the peseta have been a key factor in the turnaround. Allowing for a one-year lag in the impact of exchange rate changes on trade flows, Table 8 shows a close correspondence between real effective depreciations and export growth. The relatively poor performance of exports in 1980, despite a large rise in the volume of non-oil imports among Spain's partner countries, followed a real appreciation in the previous period in excess of 16 percent. The substantial improvement in the following years—exports expanded in real terms by a cumulative 45 percent between 1981 and 1984—coincided with a real depreciation of the peseta in excess of 20 percent. This relationship appears to be particularly strong in 1984 when exports grew by 17 percent, following a 12¼ percent real depreciation of the peseta in the previous year.

Export performance also appears to be linked to domestic demand developments. The Spanish authorities claim that the relative weakness of domestic demand has frequently spurred export growth. The inverse association between these two variables is clearly borne out by

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Table 7. Spain: Competitiveness in Manufacturing, 1980–87
(1980 = 100)

	1980	1981	1982	1983	1984	1985	1986	1987[1]
Spain/Federal Republic of Germany[2]	100.0	102.7	96.9	85.1	89.8	90.7	83.8	80.8
Spain/France[2]	100.0	99.1	98.6	88.2	90.5	87.4	84.8	86.2
Spain/Italy[2]	100.0	97.9	91.8	75.1	77.5	76.2	74.2	73.8
Spain/United Kingdom[2]	100.0	90.2	93.3	89.8	93.5	91.0	100.6	107.0
Spain/Cyprus[2]	100.0	87.0	79.0	67.6	67.1	63.6	70.1	...
Spain/Portugal[2]	100.0	89.4	91.7	91.5	96.3	96.5	100.1	...
Spain/EC[3]	100.0	99.4	97.8	87.2	90.5	89.4	87.5	87.8
Spain/industrial countries[4]	100.0	94.0	89.7	78.9	80.2	79.2	82.0	85.7

Sources: Bank of Spain; and Fund staff calculations.
[1] Staff forecasts.
[2] Ratio of Spain's unit labor cost index in the manufacturing sector over the index of comparator country, adjusted for changes in the exchange rate between the currencies of the two countries.
[3] Ratio of Spain's unit labor cost index in the manufacturing sector over a weighted average of unit labor cost indices of eight member countries of the European Community adjusted for changes in the nominal effective exchange rate.
[4] Ratio of Spain's unit labor cost index in the manufacturing sector over a weighted average of unit labor cost indices of 16 industrial countries adjusted for changes in the nominal effective exchange rate. The weights are based on the distribution of Spain's exports and imports during 1980–82.

Table 8. Spain: Determinants of Export Performance, 1980–86
(Annual percentage change)

	1980	1981	1982	1983	1984	1985	1986
Merchandise exports (Volume)	−0.1	10.0	4.8	7.3	17.0	2.5	−4.3
Non-oil imports in partner countries (Volume)	6.9	4.6	1.5	3.2	8.1	3.7	2.2
Lagged real effective exchange rate[1]	16.2	−3.3	−5.7	−0.2	−12.3	2.9	1.8
Terms of trade	−12.1	−9.4	−0.4	−2.1	2.2	4.8	16.9
Total domestic demand (Volume)	2.1	−2.3	1.1	−0.1	−0.5	2.5	6.3
Memorandum:							
Current account balance							
(In percent of GDP)	−2.4	−2.7	−2.3	−1.7	1.3	1.7	1.8

Source: Fund staff calculations.
[1] Vis-à-vis 19 partner countries and lagged one period; a negative sign indicates a depreciation of the peseta.

the data over the 1980–86 period. After three years of virtually no growth, domestic demand recovered in 1980 and grew by slightly over 2 percent even as the rate of growth of exports fell from an annual average of 10.6 percent over 1977–79 to −0.1 percent. Over the next four years Spain experienced its deepest recession in recent history, with domestic demand falling in real terms in 1981 for the first time in more than 20 years. Although there was a recovery in 1982, further contraction over 1983–84 brought the cumulative drop in domestic demand over the period to nearly 2 percentage points. This same period witnessed a sustained expansion of exports and some of the largest gains in market shares over the previous decade. The recovery of domestic demand in the second half of 1985 and throughout 1986 appears to have contributed, in conjunction with other factors, to a substantial contraction of exports. Although there was a marked improvement in tourist activity, merchandise exports actually fell by over 4 percent in real terms in 1986.[21]

The turnaround in Spain's external accounts would not have been as rapid had it not been for the sluggishness of imports. During 1981–84, imports of goods and services fell by a cumulative 2 percent in real terms, reflecting the slackness of domestic demand. Imports recovered in 1985–86, growing by well over 20 percent in volume, but, as mentioned above, the role of domestic demand had changed radically with respect to the prior four-year period and other factors, such as a decline in interest rates and gains in the terms of trade, came to play a relatively more important role in the determination of the current account surplus (Chart 5).

[21] Empirical studies carried out at the Secretariat of State for Commerce suggest that the relationship between the rate of growth of domestic demand and export performance may have been weakened in recent years as a result of the increasing relative importance of other factors, particularly the competitiveness of the peseta. This is borne out by the data for 1985–86, although in light of the radical changes which took place in the course of 1986 in Spain's external sector, such as the changes in the commodity composition of imports stemming from the decline in the price of oil products or the implementation of a number of trade liberalization measures stemming from Spain's entry into the EC, there may have been substantial variations in the relative importance of the variables affecting export performance, and comparisons with previous years may be somewhat misleading.

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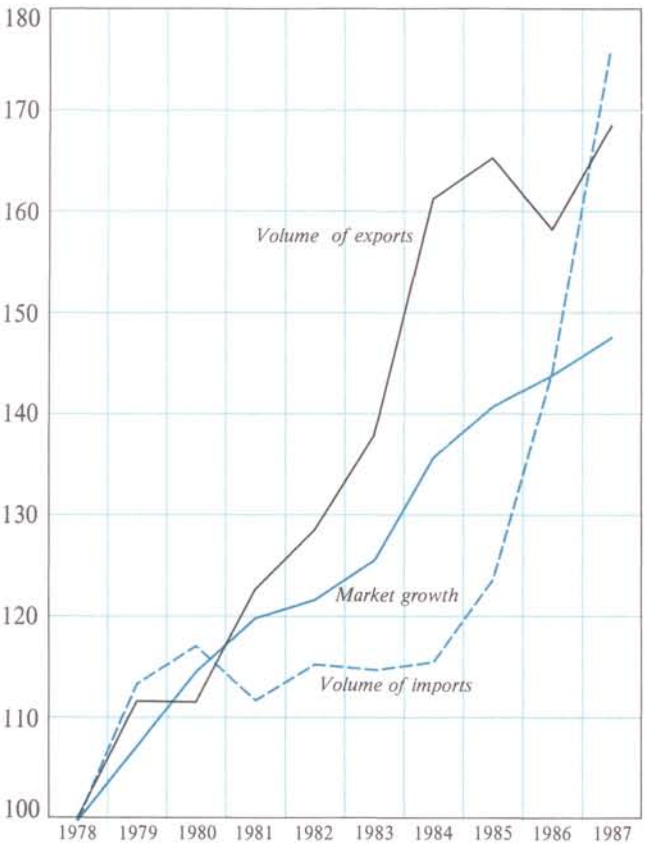
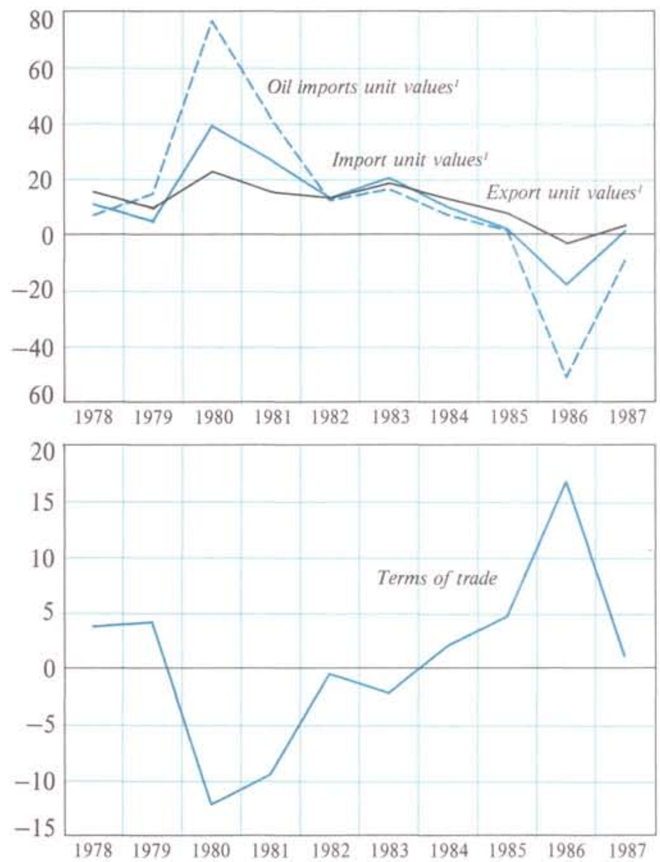
Chart 4. Spain: Trade Developments, 1978–86
(1978 = 100)



Source: National Institute of Statistics; and International Monetary Fund, staff calculations, Research Department.

Chart 5. Spain: Trade Prices and Terms of Trade, 1978–86
(Percentage change over previous period)



Source: National Institute of Statistics and Ministry of Economy and Finance.
[1]Based on customs data, in pesetas.

A number of policy measures were implemented during 1985–86 in the area of external liberalization. The substantial relaxation of the rules governing foreign direct investments introduced in mid-1985 was followed in late 1986 by a corresponding liberalization of investments abroad undertaken by Spanish residents. As part of Spain's accession to the EC, tariffs on industrial imports from EC countries were sharply reduced (and are to be phased out by 1992) while those on imports from non-EC countries also began a process of reduction intended to bring them down to the EC's Common External Tariff (CET) within the same time frame. Nontariff trade barriers and quantitative restrictions were likewise largely eliminated. At the same time, the additional protection traditionally given to Spanish industry through an export subsidy scheme was eliminated as part of the overhaul of the system of indirect taxation implied by the introduction of the VAT. A detailed discussion of these liberalization measures is provided in Section IV.

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IV Structural Reforms

The Spanish authorities' stabilization effort was supported by a number of important structural reforms. This section focuses on the progress made thus far in industrial restructuring, energy policy, privatization, financial market liberalization, social security and pension reform, and the labor market. Liberalization measures in the context of EC accession adopted in the latter part of the adjustment period (1985–86) are also discussed.

Industrial Reconversion Program

The deceleration of industrial activity in Spain in the second half of the 1970s, particularly in the traditionally important steel, shipbuilding, textiles, and home appliances sectors, reflected a sharp deterioration in the financial position of a large number of public and private enterprises. Although several of these sectors were adversely affected by worldwide excess capacity, the excessive growth of labor costs, inefficient pricing policies, overmanning, and delays in the modernization of capital stock all contributed to this deterioration. The first comprehensive attempt to integrate financial support through the budget with a restructuring of Spanish industry began in 1981 with the signing of the Industrial Reconversion Act. This law envisaged a significant retrenchment of a number of sectors, accounting for about 30 percent of total industrial activity. Employment reductions were to be accompanied by the restoration of enterprises' balance sheets and the subsequent implementation of an investment program designed to speed up the technological modernization of those sectors with good profit prospects.

From the start there were serious difficulties and delays in the implementation of the program, stemming largely from anticipated employment cutbacks and their differential impact on industries and geographic areas. The restructuring effort was given a special boost in 1983 with the publication of a White Paper on reindustrialization and the subsequent approval, in mid-1984, of a new Law on Reconversion and Reindustrialization and the setting of specific employment targets for individual sectors. The program called for a reduction in employment of approximately 67,000 over 1984–86, equivalent to about 26 percent of total employment in those firms affected, or about 2½ percent of industrial employment (Table 9). By the end of 1986 about 77 percent of the anticipated employment reductions had actually taken place, with particularly pronounced cutbacks in the shipbuilding, steel, and textile sectors.

The program has sought to lessen the social costs associated with this process of retrenchment through a number of complementary measures aimed at facilitating the return to the labor force of those workers who lost their jobs. Fiscal and financial incentives have been set up for firms willing to settle in those geographic areas most affected by the reconversion (the so-called Zones of Urgent Reindustrialization).[22] Workers over 55 have been given the option of taking early retirement while others have received severance payments and unemployment compensation for up to 18 months. Workers have also been given the option of surrendering their severance payment to the Employment Promotion Fund, whose revenues would be used to supplement unemployment benefits and, through retraining, to assist the workers in seeking new employment opportunities, offering subsidies to firms willing to hire them on a permanent basis. Developments to date indicate that, of the total number of workers affected by the Program, 25 percent had taken early retirement, 35 percent had decided to participate in the Employment Promotion Fund, and the rest had been made redundant.

The financial costs of the Program have been considerable. By end-December 1986 about Ptas 820 billion (equivalent to 2½ percent of GDP) had been spent in an effort to restore enterprises' balance sheets through subsidies, other transfers, and various loan guarantee schemes through the Instituto Nacional de Industrias (INI) and the Official Credit Institute. Well over four fifths of these resources had been absorbed by the steel, shipbuilding, and textile sectors. The total cost of the program is presently estimated at over Ptas 1.1 trillion, most of which would have been spent by the end of 1987. As the employment reductions and financial restructuring foreseen in the reconversion program approach their expected targets, the associated investment program is scheduled to come on stream. Investments in

[22]These zones are Asturias, Barcelona, the Basque country, Cadiz, Galicia, and Madrid.

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Table 9. Spain: Employment Impact of the Industrial Reconversion Program
(In thousands)

	Number of Participating Enterprises	Employment		
		Initial	Actual[1]	Targeted
Large shipbuilding	2	21.3	13.1	13.4
Small and medium shipbuilding	27	15.4	10.5	10.2
Carbon-based steel	3	42.8	28.7	22.8
Specialty steel	11	13.7	8.8	5.0
Home appliances	18	23.9	11.9	10.9
Textiles	683	108.8	98.9	98.9
Fertilizers	10	8.5	8.1	7.0
Electronic components	17	3.7	2.3	2.2
Other	20	42.2	34.5	26.2
Total	791	280.3	216.8	196.6

Source: Ministry of Industry and Energy.
[1]As of December 31, 1986.

the second half of 1986 in the sectors affected by the reconversion effort amounted to Ptas 208 billion, a figure only slightly above the total for the previous three-and-a-half-year period.

Provisional estimates through the end of 1986 on profitability and productivity in the sectors affected point to significant improvements in the cashflow positions of all sectors,[23] particularly steel, and an acceleration of productivity growth. Despite the programs' high financial costs, the authorities are of the view that industrial restructuring could not have been postponed and that important net savings are likely to be generated in coming years.

Energy Policy

Despite Spain's heavy dependence on imported oil, energy consumption after the first oil crisis continued to rise as domestic prices were not adjusted to reflect the sharply higher import costs. Although domestic energy production, mainly through the use of coal, rose by over 60 percent between 1973 and 1980, the growth of demand was sufficiently strong to maintain the self-sufficiency ratio largely unchanged—at around 29 percent—and to lead to widening deficits on the external energy balance. By the early 1980s, net imports of energy products were well in excess of US$12 billion, equivalent to 40 percent of merchandise imports. While the consumption of primary energy per unit of output in the OECD as a whole exhibited a decelerating trend after 1973, in Spain it actually rose. Time series data for the period 1973–85 show that while Spain's consumption per unit of output rose by some 6 percent, the average for the OECD over the same period actually fell by over 21 percent.

A concerted approach to Spain's energy problem was first introduced in mid-1979 with the implementation of the National Energy Plan (NEP), later updated in 1983 and approved by Parliament in 1984. The Plan's underlying strategy was based on both demand- and supply-oriented policies. It sought to reduce oil consumption through a more realistic pricing policy that reflected more rapidly changes in international prices.[24] As part of the NEP, domestic energy prices were raised several times between 1980 and 1986, and the gap with respect to the European average was substantially reduced. Legislation was passed in mid-1982 offering tax benefits, grants, and concessionary loans to the industrial sector for oil-substitution projects. At the same time, energy conservation measures were adopted, including compulsory energy-audit procedures for the industrial sector. The NEP targeted, for the period 1984–92, a cumulative reduction in energy consumption per unit of output of 10.5 percent. These policies have been largely successful. Between 1982 and 1986 total energy consumption rose by 2.3 percent against a real GDP growth of 9.5 percent. Over the previous decade the cumulative rates of growth for these two aggregates had been 20.2 and 18.6 percent, respectively. The diversification away from oil products was particularly pronounced as their share in the consumption of primary energy fell from 62.2 percent in 1982 to 52.5 percent in 1986.

On the supply side, the NEP sought to reduce Spain's external energy dependence through the expansion of domestic sources, particularly hydropower, coal, and nuclear energy. The share of energy requirements covered by domestic sources rose from 34 percent in 1982 to 42 percent in 1986 and is projected to rise further to 46 percent by 1992 (Table 10). The share of oil in total primary energy consumption is targeted to decline

[23]Except shipbuilding, where the improvement was marginal on account of weak sales.

[24]Prices of petroleum products in Spain are administered. Over time they have tended to adjust more slowly to changes in market conditions.

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further to 47 percent by 1992. Nuclear energy has played an increasingly important role as a domestic energy source. The NEP's nuclear program has seen a rapid expansion in the share of nuclear energy in total primary energy consumption, from 1.6 percent in 1980 to nearly 9 percent in 1986. This share is expected to rise to 12 percent by 1992 as two more nuclear power plants come on stream in addition to the eight currently in operation.

Privatization

In recent years, INI, Spain's largest state holding company, which controls a large number of basic and strategic industries, including several in the communications and transport sectors, has conducted a far-reaching and long-overdue program of financial restructuring. INI was established in the 1940s with the aims of creating an industrial base to meet the rapidly expanding needs of the domestic market and of fostering the development of industries necessary for national defense. Throughout the 1950s and 1960s, INI invested heavily in large-scale energy-intensive industries. As this was a period of buoyant worldwide economic growth in which Spain performed remarkably well, INI grew in size and influence, eventually including in its portfolio dozens of enterprises, employing over 200,000 people and responsible for over 15 percent of total industrial production. By the early 1970s INI had become the largest industrial concern in Spain and was among the 20 largest in Europe. Most of INI's output was absorbed by the domestic market.

In the mid-1970s, however, as a result of the adjustment imposed on the Spanish economy by the oil crisis, INI began to be increasingly used by the Government as an escape valve, absorbing the substantial employment losses being registered in virtually every sector of the Spanish economy but which were particularly pronounced in the industrial sector. This role frequently included the take-over of failed or bankrupt enterprises. As a result, losses mounted rapidly, reaching Ptas 107 billion by 1981 and Ptas 204 billion by 1983, with the burden of financing largely falling on the budget.

A process of rationalizing INI's enterprises was set in motion by the new government, aimed at the containment of the losses of its enterprises and the restoration of sound balance-sheet positions. At the same time there was a shift in its overall industrial strategy, with greater emphasis being placed on adapting capacity and type of productive enterprise to the present and prospective nature of domestic and external demand, with particular accent on the requirements and needs of the European market. A key element in the consolidation and improvement of the financial position of INI was the realization that a number of firms under its control, deemed neither to be of strategic national interest nor to fulfil some other essential public role, such as providing employment opportunities in particularly disadvantaged regions of the country, might, for technological or economic considerations, fare better in private hands or benefit from some type of mixed ownership. Thus in 1985 and 1986, a number of key enterprises in both the industrial and the services sectors were sold to private concerns. The Swedish firm SKF, for instance, acquired total ownership of a ball-bearings enterprise in which it had had a minority interest. On a larger scale, Volkswagen acquired a controlling interest in SEAT, Spain's largest auto manufacturer, with a commitment for total ownership by 1990. INI's decision to part with SEAT had been precipitated by mounting losses (over US$3 billion between 1980 and 1985) and the recognition that it lacked the technical expertise and the marketing skills needed to make the firm viable. In 1987 the government announced its intention to sell minority holdings, through the stock exchange, in several large state-owned companies, including Iberia Airlines and the oil concern REPSOL, S.A. Such sales, while still permitting the Government to retain control over the companies' long-term strategies, were expected to make the firms more responsive to market signals and thus to enhance efficiency.

INI's operational losses fell for the fourth consecutive year in 1987, reaching an estimated Ptas 50 billion, over Ptas 150 billion below 1983 levels (Table 11). Employment, which had peaked in 1982 at 219,000, had fallen by 1986 to 169,000 and is estimated to have fallen by an additional 6,000 in 1987. Furthermore, losses have been increasingly concentrated in a few sectors, such as steel, shipbuilding, and heavy transportation equipment. Losses in the steel sector in 1986 were partly attributable to the elimination of export subsidies stemming from Spain's entry into the EC. This process of retrenchment has had a beneficial impact on the budget. Whereas in 1982 state transfers covered over 71 percent of INI's participation in the financing of the operational losses and capital expenditures of its enterprises, by 1986 this share had fallen to 30 percent.

Financial Sector Reforms

The liberalization in early 1987 of interest rates on demand deposits and on savings deposits of less than six months and the accompanying substantial reduction in the banks' mandatory investment coefficients were two significant steps in a process of deregulation, which, for at least a decade now, has attempted to reduce some of the distortions associated with a highly regulated financial market. Prior to the introduction of the above measures, more than half of total bank deposits were subject to administrative controls that kept rates below market ones. At the same time, approximately 48 percent of the liabilities of financial intermediaries were subject

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Table 10. Spain: Sources of Energy Supply and Self-Sufficiency Ratios, 1973–92

	1973	1980	1982	1983	1984	1985	1986[1]	1992[2]
				(In millions of tons of coal equivalent)				
Domestic production								
Oil	1.09	2.28	2.19	4.25	3.47	3.27	2.70	3.60
Solid fuels	10.06	16.30	20.41	20.86	19.60	20.20	21.40	24.80
Natural gas	0.03	0.05	0.07	0.10	0.30	0.45	0.25	1.83
Nuclear energy	2.36	1.90	3.23	3.92	7.73	9.39	11.85	16.26
Hydroenergy	10.45	10.85	9.71	9.98	11.19	11.11	12.96	15.31
Total	23.99	31.38	35.61	39.11	42.30	44.40	49.16	61.80
Net imports								
Oil	54.90	69.14	60.24	56.93	53.72	56.18	55.28	60.29
Solid fuels	4.48	3.69	6.64	6.46	6.17	8.49	8.14	9.36
Natural gas	1.49	2.75	3.32	3.40	3.10	3.01	3.85	4.50
Nuclear energy	−0.28	−0.31	−0.29	−0.28	0.23	—	−0.30	−0.30
Hydroenergy	−0.45	−0.19	−0.82	0.26	1.07	—	—	—
Total	60.14	75.08	69.08	66.77	63.88	67.68	66.97	73.85
				(In percent of total consumption)				
Self-sufficiency ratios								
Solid fuels	1.9	3.2	3.5	6.9	5.7	5.5	4.6	5.6
Oil	69.2	81.5	75.5	76.4	72.1	70.4	72.4	72.6
Natural gas	2.0	1.8	2.1	2.9	10.6	13.0	6.1	28.9
Nuclear energy	113.5	119.5	109.9	107.7	100.0	100.0	102.6	101.9
Hydroenergy	104.5	101.8	109.2	97.5	101.6	100.0	100.0	100.0
Total	28.5	29.5	34.0	36.9	38.1	39.6	42.3	45.6

Source: Ministry of Industry and Energy.
[1]Provisional.
[2]Targets of the 1983 National Energy Plan.

Table 11. Spain: Operational Losses of Public Sector Enterprises, 1981–87[1]
(In billions of pesetas)

	1981	1982	1983	1984	1985	1986	1987[2]
National Institute of Industries	106.7	137.0	204.2	185.2	162.8	117.4	50
Of which:							
Automotive	31.6	32.6	35.8	23.8	53.4	24.0	12.5
Air transport	4.0	12.5	29.6	17.1	16.3	−1.7	−18.0
Steel	31.0	35.2	36.8	39.0	25.4	20.8	16.2
Shipbuilding	28.1	26.4	35.9	56.8	44.3	36.4	40.0
Capital equipment	5.1	9.3	39.0	23.5	29.6	22.3	21.5

Source: Secretariat of Economics and Planning.
[1]Profits and losses of public sector enterprises before government transfers.
[2]Fund staff estimates.

to reserve and investment coefficients. Thus a large share of the financial system's assets was deposited with the Bank of Spain or invested in assets with below-market yields. Not surprisingly, over time the spreads between borrowing and lending rates tended to be large as the tax on the financial system implied by the reserve and investment coefficients was reflected in the rates of return on unregulated assets (Chart 3).

The deregulation of interest rates mentioned above (rates on deposits of one year or more had been free since 1977, while rates on time deposits of six months or more were set free in 1981) is expected to enhance competition among Spanish banks, a process likely to be gradually reinforced by the implementation of the agreements negotiated with the EC in the Treaty of Accession, which contemplate the unrestricted access of EC financial institutions to the Spanish market by the end of 1992.

The reduction of the mandatory investment coefficient from 23 percent to 11 percent was a particularly welcome development. This coefficient has two components: one for monetary control and one for investment in specific productive sectors. The first, stipulating the share of bank deposits that must be kept in the form of treasury bills, is to remain at 10 percent; the second, which took the form of preferential credit facilities at lower than market rates for state-directed investments, particularly for housing, agriculture, capital goods, and exports, was reduced from 13 percent to 1 percent. This reduction was expected to increase the supply of loanable funds and was viewed as an important step in the authorities'

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efforts to ease rigidities and eliminate distortions in the financial markets. These liberalization measures coincided with the marked improvement in the profit position of the Spanish banks—pre-tax profits in 1986 rose by over 20 percent with respect to 1985 to Ptas 230 billion (US$1.64 billion)—associated with the recovery of the Spanish economy.

Labor Market Policies

Unemployment Trends

Labor market conditions in Spain have deteriorated significantly over the past decade. The labor survey puts the official rate of unemployment for 1986 at 21½ percent, the highest of all OECD countries. While there is evidence that the development of a sizable underground economy has lessened the adverse social consequences of this historically high rate, unemployment remains too high. Over the ten-year period ending in 1985, more than 1.9 million jobs were lost, as total recorded employment fell by about 16 percent and the number of unemployed persons rose from ½ million in 1975 to nearly 3 million by the end of 1985. Furthermore, the duration of unemployment in Spain has been longer than in most other countries in Western Europe, with the share of persons unemployed for one year or more reaching 57 percent of total unemployed in 1985, compared with 17 percent in 1975. The rising level of unemployment has reflected particularly large employment reductions in the industrial and agricultural sectors where, over 1975–85, more than 1.8 million positions were lost—by far the largest sectoral employment decline in Western Europe. The official statistics also show that the burden of unemployment in Spain has been unevenly distributed, falling disproportionately on women and youth.

A question frequently raised about Spain's unemployment problem concerns the apparent contradiction between the large number of unemployed, as estimated by the Official Labor Survey (EPA), and the widespread perception that the country has enjoyed a relatively large measure of social peace. This question was at the forefront of economic policy discussions in mid-1986 when, notwithstanding the continued deterioration of labor market conditions over the preceding four-year period, the Government of Mr. Felipe Gonzalez was reelected for a second term with a sizable majority.

A number of hypotheses have been advanced to explain this phenomenon. The OECD, for instance, claims that on account of strong family ties the extent of moral and financial support to the young unemployed, who account for nearly half of the total unemployed, is more widespread than elsewhere in Europe, as demonstrated by the fact that 94 percent of the young live with their parents or other family members. The EPA has itself shown that the unemployment rate among "heads of households" has been closer to 7–10 percent and that 42 percent of these receive unemployment compensation, while an estimated 53 percent derive some income from the underground economy. These statistics suggest that the "typical" Spanish family is one in which the father is likely to be employed, earning considerably more in real terms than in the early 1980s, and enjoying a substantially expanded level of social services, such as education and public health. His wife, and particularly his working-age children, on the other hand, would have experienced difficulties in securing employment. An important proportion of the latter would have found employment prospects sufficiently discouraging to decide to postpone entry into the labor force and pursue higher education, as evidenced by the 50 percent increase in educational enrollment between 1977 and 1985 for those in the 20–29 age group. Appendix I further examines the incidence of concealed or irregular employment in Spain and the extent to which the official rate of unemployment overstates the associated social costs.

A number of demographic and economic factors help explain these unfavorable labor market developments. Spanish growth throughout the 1960s and early 1970s was led by the industrial sector. The rapid expansion of capacity and the development of such industries as steel, chemicals, and transport equipment induced substantial changes in the sectoral composition of employment. Employment in industry rose from 2.7 million in 1965 to 3.3 million in 1974, even as employment in agriculture under a process of modernization partly induced by the expansion of the industrial sector fell from 4.1 million to 3.1 million over the same period.[25] This drastic reduction in agricultural employment in itself had no adverse impact on the unemployment rate as a rapidly expanding economy and important migratory flows to other European countries absorbed the excess supply of labor.[26] Furthermore, the rate of female participation in the labor force remained very low.[27]

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[25]Nearly 90 percent of total domestic migration during this period was to Spain's four most industrialized centers: Madrid, Barcelona, the Basque country, and Valencia.

[26]The net migratory outflow throughout the 1960s and early 1970s is estimated at about ½ million people.

[27]The rate of female participation in the labor force in Spain is so low by European standards as to be puzzling. That it cannot solely be explained by the possibly discouraging effect that the deterioration of labor market conditions after 1974 might have had on women wishing to enter the labor force is made clear by the fact that the rate was already the lowest then and has not fallen since. That it is not an Iberian phenomenon—to be explained in terms of certain social differences vis-à-vis the rest of Europe—is made clear by the fact that the Portuguese female participation rate is actually higher than the European average. Some authors have suggested that it may partly reflect some degree of Spanish self-imposed economic isolation over the 1950s and 1960s, which slowed the dissemination of rapidly changing attitudes as regards the role of women in society seen elsewhere in Europe.

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The onset of the oil crisis had a particularly devastating impact on the Spanish economy. Industrial production, which over 1970–74 had grown at an average annual rate of over 10 percent, fell by 6½ percent in 1975. Spain's dependence on imported energy sources (its self-sufficiency ratio in 1974 was below 30 percent) and the increasingly energy-intensive character of its exports resulted in a substantial deterioration of export performance. The sizable changes in relative prices brought about by the oil crisis had an impact on Spanish industry that went well beyond that felt in other oil-importing European countries. Spanish growth over the previous decades had been based on an inward-looking set of policies that, in an increasingly interdependent world, had sought to promote self-reliance and independence through a high level of protectionism and official intervention in the economy. These policies had in time given rise to an economy that was not only the most closed in Western Europe (Table 12),[28] but that also proved to be ill-equipped to withstand the competitive pressures brought about by the oil crisis and to adjust to a significantly different external environment. The concomitant deceleration of output growth in Spain's most important partner countries brought about a reversal of the migratory flows seen over the 1960s and early 1970s, which had absorbed much of the excess labor generated by the transformation of the agricultural sector.

Table 12. Spain: Selected Foreign Trade Figures, 1986
(In percent of GDP)

	Exports, f.o.b.[1]	Imports, c.i.f.[1]	Total trade[1]	Rank Order
Germany, Federal Republic of	38.8	30.3	69.1	6
France	23.4	25.2	48.6	10
United Kingdom	23.8	28.1	51.9	8
Italy	27.2	27.9	55.1	7
Canada	25.0	23.5	48.5	11
Spain	16.5	21.3	37.8	12
Netherlands	64.5	60.3	124.8	2
Sweden	37.1	32.4	69.5	5
Switzerland	40.2	44.1	84.3	3
Belgium	86.8	86.7	173.5	1
Greece	17.2	34.6	51.8	9
Portugal	34.7	45.6	80.3	4

Source: Organization for Economic Cooperation and Development, *Economic Surveys*.
[1]At current prices and exchange rates.

[28]In 1974, the share of Spanish exports plus imports to GDP stood at 29.2 percent, or drastically below that of the Federal Republic of Germany (48.2 percent), Italy (43.6 percent), Portugal (73.0 percent), Belgium (118.7 percent), or even Greece (42.3 percent).

Other factors that brought pressure to bear on the labor market were those associated with the changing age structure of the Spanish population. For reasons thought to be partly related to the sustained period of growth enjoyed by Spain throughout the early 1960s, the birth rate accelerated. This gave rise to a demographic "bubble," which was to burst with full force in the early 1980s.[29] The acceleration in the rates of growth of the labor force over the period 1981–85 (over 1 percent a year with respect to the no-growth period 1976–80) certainly reflects the impact of such higher birth rates and coincides with the most marked increase in Spanish youth unemployment.

The drastic reduction in employment levels in the second half of the 1970s and the concomitant increase in the rate of unemployment coincided with a substantial acceleration of labor costs. A number of measures of the price of labor are shown in Chart 6 which is reproduced from the 1986 study by Dolado and others on Spanish industrial unemployment. Regardless of the measure used, it is evident that real labor costs in Spain have shown a sharp upward trend, particularly after 1975. Between 1975 and 1979 the real cost of labor faced by employers in the industrial sector (defined to include social security contributions) rose at an average annual rate of 9 percent, an increase without any parallel in the OECD. This period also witnessed the fastest rise in employers' social security contribution rates, from 19½ percent of gross pay in 1975 to over 24 percent in 1979, one of the highest in Western Europe.[30] Even if allowance is made for the effect of taxes on wages, an acceleration can be noted of wages net of employees' social security contributions and direct and indirect taxes after 1975, the terms of trade loss notwithstanding. That much of the rise in real labor costs cannot be interpreted in terms of secular improvements in productivity is made clear by a brief examination of the evolution of real unit labor costs (Table 13). Although output per employee rose substantially over this period, the rise in real labor costs per person was sufficiently high to more than offset this gain in productivity, and real unit labor costs rose between 1975 and 1979 by over 25 percent. In sharp contrast, real unit labor costs rose only slightly or actually fell in most of Spain's European partners.[31]

Although real wages in the industrial sector continued to rise after 1979, they did so at a substantially reduced

[29]With the exception of females aged over 70, the two age strata with the proportionally highest number of males and females in 1984 corresponded to those aged 16-to-19 and 20-to-24 years.

[30]According to the OECD, the ratio of employers' to employees' social security contributions in Spain is probably the highest among OECD members.

[31]Save for Spain, where there was no adjustment of real labor costs to the first oil price rise, in all other countries the adjustment took place in 1976. But even then the adjustment path was not through a reduction of real wages but rather through improvements in productivity, sometimes associated with lower levels of employment.

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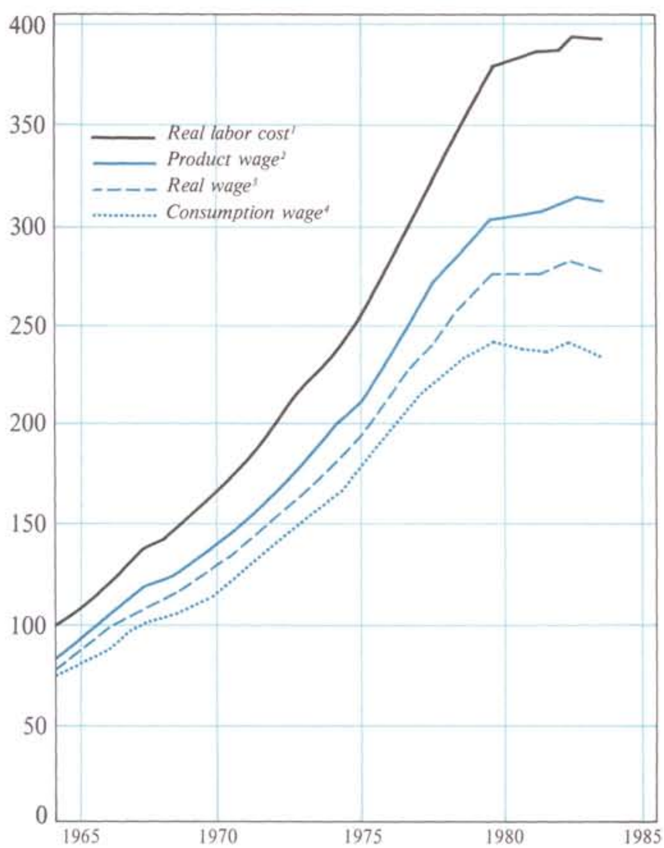
Table 13. Real Unit Labor Costs in Industry in Selected OECD Countries, 1975–85
(1975 = 100)

	1975	1979	1980	1982	1983	1984	1985
United Kingdom	100.0	98.6	100.4	96.1	92.4	91.0	91.4
Belgium	100.0	96.0	99.5	97.5	93.1	92.6	92.6
Denmark	100.0	103.0	99.6	97.0	91.2	84.5	85.9
France	100.0	97.9	97.8	96.4	103.7	92.0	87.2
Germany, Federal Republic of	100.0	100.4	105.0	104.3	100.3	98.6	97.4
Italy	100.0	89.3	86.0	90.5	91.4	86.8	84.7
Netherlands	100.0	99.8	101.1	98.8	97.3	88.6	86.3
Spain	100.0	125.2	122.4	114.9	110.5	104.9	102.2

Sources: Bank of Spain; and Fund staff calculations.

Chart 6. Spain: Real Wage Developments, 1964–84
(1964 = 100)



Source: Dolado, Malo de Molina, and Zabalza, 1986.
[1]Gross pay inclusive of employer's social security contributions.
[2]Real gross pay.
[3]Real gross pay minus employee's social security contributions, adjusted for changes in indirect taxes.
[4]Real wage minus income taxes.

pace. The decline in real unit labor costs registered thereafter was induced by persistent labor shedding; between 1979 and 1985 employment in industry declined by 20 percent. The evolution of the real wage gap in the industrial sector over the period 1970–85 is shown in Chart 7. Prior to 1975 actual productivity and real labor costs per employee rose at approximately the same rates of growth, so that the real wage gap remained constant and small with respect to the base period chosen (1970). Thereafter until 1979, the real wage gap widened by nearly 46 percent. Although employment did not fall immediately, by 1978 the labor market had begun to adjust, and employment in industry fell by nearly 2 percent and continued to do so every year thereafter. Although real wages decelerated after 1979, the narrowing of the wage gap reflected primarily the fall in employment.[32] By 1985 the real wage gap had nearly returned to its 1975 size but the rate of unemployment stood at 21.9 percent of the labor force. That unemployment after 1979 rose rapidly despite the substantial deceleration of real labor costs may be interpreted in terms of the overmanning of Spain's industrial sector (throughout the 1970s employment in the industrial sector of the great majority of Spain's European partners, such as the United Kingdom, the Federal Republic of Germany, Denmark, Belgium, and Holland, had fallen steadily and sometimes substantially), the continued structural transformation of Spanish agriculture (in the

[32]The adverse impact of persistent real wage growth on Spanish employment has been amply confirmed by empirical studies, the relative scarcity of reliable data notwithstanding. A recent attempt by the OECD to explain the evolution of employment in the Spanish industrial sector over the period 1965–85 found the long-run elasticity with respect to real average labor costs, productivity and energy prices to be −0.7, 1.0, and −0.3, respectively, suggesting that the dominant factor behind the decline in industrial employment was the "failure of real labor costs to adjust in a period of very slow growth of output and of underlying productivity and rising energy prices since 1975." (OECD, *Economic Survey*, April 1986.) The rapid adjustment of nominal wages to prices and their increasing insensitivity to the rate of unemployment suggests that the Spanish labor market—or its industrial sector in any event—functions so as to maintain real wages, even at the expense of rising unemployment. The OECD goes on to suggest that this "points to the existence of a wage-price spiral, the unwinding of which has been extremely slow," despite the sharper deterioration of labor market conditions with respect to other European countries.

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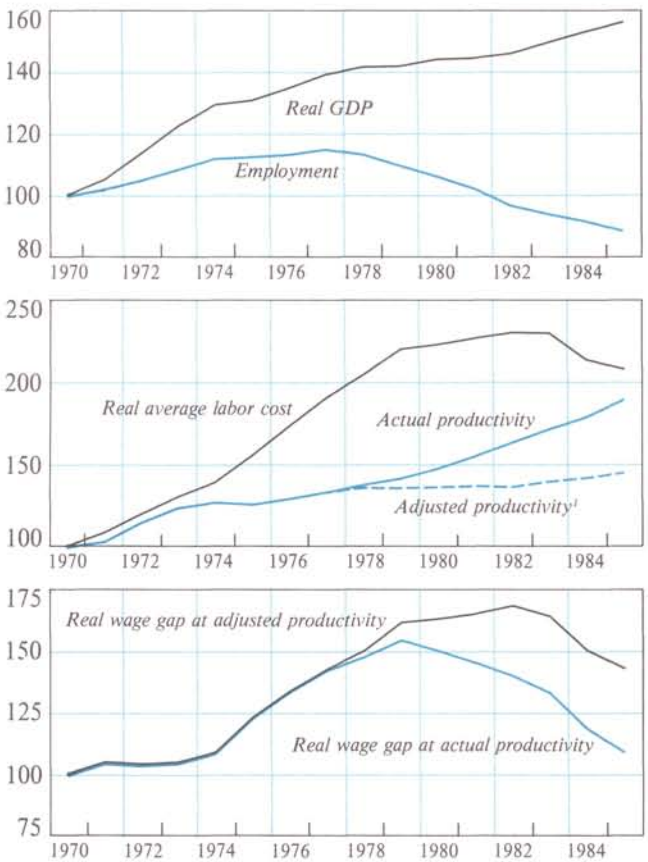
Chart 7. Spain: Real Wage Gap, 1970–85
(1970 = 100)



Source: Bank of Spain, and Fund staff estimates.
[1]Adjusted for effect of reduction in employment.

six-year period ending 1985 agricultural employment had fallen by a further 15 percent), and "increasing business uncertainties and the impact of rising interest rates and raw material prices on cash flow and profits."[33]

Wage Policy

Throughout the 1980s sectoral wage negotiations in Spain have been largely conducted within the framework of national agreements between the employers' federation and the trade unions. The Government's role has varied over time; in certain years (1983, for instance) the authorities did not intervene directly in the negotiations, limiting their participation to the implementation of a wage policy at the public sector level, which was judged consistent with the overall inflation objectives and which, it was hoped, would serve as the point of reference for the private sector. In other periods, notably in connection with the negotiations leading to the Economic and Social Agreement (AES) covering 1985–86, the Government was an active partner, setting the agenda and entering into a number of legislative commitments involving, inter alia, labor market flexibility, social security reform, and better working conditions. Occasionally, as in 1984 and 1987, no agreement was arrived at and wage negotiations were conducted at the level of the firm.

The above wage bargaining process has had benefits and costs. Among the costs may be noted the limited scope for wage differentiation to reflect differences in productivity and in the financial condition of enterprises that the setting of a narrow band for wage settlements at the sectoral level necessarily imposes. It could also be argued that the inclusion of a wage revision clause in the agreements, triggered in the event that consumer prices exceeded the official target, strengthened the linkage between prices and wages and may have retarded the needed adjustment of real wages and undermined competitiveness. Wage drift, the high cost of layoffs, and other nonwage costs at times resulted in nominal labor costs rising at rates above the upper margin contemplated in the wage agreements. There is a broad consensus in Spain, however, that viewed against the background of the disorderly conditions prevailing in the labor market prior to 1978, the year in which the first such agreement became operational and which had witnessed the rapid acceleration of real wages and a concomitant deterioration of employment, the agreements contributed to the emergence of greater social consensus on labor issues. The periodic process of consultation among the social partners coming, as it did, after several decades of interventionism in which wage policy consisted mainly of government decrees implemented through the Ministry of Labor is thought to have been an important factor in the consolidation of democracy in Spain. At a more practical level, the agreements led to a dramatic reduction in the number of days lost to strike activity, from a high of 16.1 million man-days in 1977 to about 2 million man-days in 1986.

Labor Market Flexibility

The substantial reduction in employment levels over 1975–85 would suggest that the relatively high degree of wage rigidity that has characterized the Spanish labor market would have as its counterpart some flexibility as regards quantity adjustments. A number of indicators, however, point to precisely the opposite. A frequently quoted survey of a large number of major Spanish enterprises carried out in 1983 showed that the average duration of employment in Spain is nearly 15 years,

[33]OECD, *Economic Survey*, April 1986.

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among the longest in the OECD.[34] This observation is consistent with the predominance of open-ended labor contracts in most Spanish enterprises and the high level of severance payments for firings.

The above statistics on the duration of employment also corroborate the well-known fact that the Spanish labor market is greatly segmented, with a core of some eight million workers enjoying a relatively high degree of job security and a peripheral group of about two million people—among whom women and youth are overwhelmingly represented—for which the rate of job turnover is extremely high and for which the average duration of employment is below one year. Not only is the annual flow of new contracts as a proportion of total employment in Spain one of the highest in the OECD, but it has risen substantially in recent years reaching over 17 percent in 1984.[35] The very high female and youth rates of unemployment have reflected the increasing polarization of labor market conditions in Spain. Perhaps nothing underscores better the segmented nature of the Spanish labor market than the fact that it is characterized by both the highest average duration of employment and one of the highest proportions of long-term unemployed in total unemployment in the OECD.

Nearly 50 percent of the overall increase in employment in Europe over the mid-1970s and early-1980s can be explained in terms of the growth of part-time employment. The OECD interprets this trend as a labor market response to the increased rigidity of wages. The reduction in the average number of hours worked per employee registered throughout most OECD countries is thought to be directly related to the greater incidence of part-time in total employment. While the number of hours worked per employee has also fallen in Spain over the same period, it is well known that until 1984 the flow of part-time employment was insignificant. Dolado and Malo de Molina (1985) indicate that the ratio of part-time to total employment in Spain was ten times smaller than the average for the EC. The reduction in the number of hours worked in Spain has instead been the result of legal measures that have, over time, shortened the normal length of the working week and of various provisions stemming from the collective wage agreements, which, inter alia, significantly increased labor costs for overtime work. Thus, while in most other European countries wage rigidity had as a counterpart some increased flexibility through recourse to more part-time employment, in Spain wage rigidity was actually accompanied by a drop in the number of hours worked per full-time employee and a concomitant increase in labor costs per hour.

As part of a comprehensive effort to encourage the creation of new employment opportunities, the Spanish authorities have introduced over 1984–85 a variety of legal measures intended to foster greater labor market flexibility. Among these stand out the introduction of fixed-term contracts and part-time employment, the granting of fiscal incentives to reduce firms' labor costs, such as reductions in the social security contributions paid by employers or the granting of direct subsidies, the reduction in the retirement age at full pension, and a general tendency toward a relaxation of the rules governing layoffs.

The deterioration of labor market conditions in Spain came to a halt in the second half of 1985. Employment, which had fallen uninterruptedly for a number of years, began to recover in the third quarter of the year despite a further drop in employment in agriculture. The recovery in the industrial sector was regarded by the authorities as a particularly significant development given the sector's steady decline over the previous decade. The process of recovery continued over 1986–87 with employment rising between the first quarter of 1986 and the second quarter of 1987 by 6.3 percent. With the exception of agriculture, for which there was a drop of 5 percent over the same period, employment continued to expand in all sectors and, as in the case of services, which account for over half of total employment, at the particularly high rate of 8.4 percent. That the reduction in the rate of unemployment was small—from 21.9 percent in 1985 to 20.5 percent in 1987—is attributable to a substantial acceleration in the rate of growth of the labor force from 0.8 percent in 1985 to 1.8 percent in 1986 and an estimated 2 percent in 1987, stemming from a strong recovery in the labor force participation rates for females and the young.

The significant improvement in the employment outlook for the young (aged 16 to 24 years) appears to be directly related to the measures taken in recent years to eliminate long standing rigidities in the Spanish labor market. During 1986 alone more than 300,000 positions

[34]Although cross-country comparisons demand caution on account of differences in the types of samples used, this number is much higher than the corresponding estimates for Japan (11 years), the United Kingdom (8½ years), Canada (7 years), Australia and the United States (6½ years). For these same countries, the share of employees with less than 5 years' seniority exceeds 57 percent in Canada, Australia, and the United States, is around 47 percent in the United Kingdom, 33 percent in Japan but nearer 11 percent in Spain. At the other end of the distribution, the share of employees with 15 or more years is well below 20 percent in all countries save Japan, where it is 28 percent; the corresponding share in Spain exceeds 40 percent. Even making allowances for the fact that by concentrating on large enterprises the Spanish figures probably have an upward bias, it is clear that the duration of employment in Spain is high indeed.

[35]The corresponding ratio for 1985 is 24 percent, but the increase is largely the result of the new employment schemes implemented by the Government as part of its efforts to foster greater labor market flexibility.

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were created as limited duration contracts rose by 24 percent, part-time contracts by 44 percent, and apprenticeship and training contracts by 51 percent with respect to 1985. All of these types of flexible employment were initially conceived as measures to improve the employment outlook for the young; the statistics suggest a significant measure of success.

Social Security and Pension Reform

Substantial improvements in the level and coverage of social security benefits without commensurate increases in contributions led to a steady deterioration in the financial situation of the social security agencies since the mid-1970s. Pensions, which account for over 60 percent of total social security expenditures, had risen between 1977 and 1985 by nearly 40 percent in real terms. The growth of expenditures along with a marked fall from 95 percent in 1977 to 77 percent in 1985 in the share of total revenue accounted for by contributions led to increased reliance by the system on financing through the budget. Furthermore, demographic changes in the structure of the Spanish labor force and some abuse of the pension schemes had induced, in recent years, a drop in the relationship between the active and the passive populations within the system. From a ratio of 3 to 1 in 1977 it had fallen to about 2 to 1 in 1985 and was, on then prevailing trends, projected to fall further to 1.5 to 1 by 1993.

The unsustainable nature of the imbalances affecting the social security system and the risks they posed for the budget led the Spanish authorities to undertake a comprehensive reform of the pension system in mid-1985. Attempting both to increase the number of contributors and to reduce the number of beneficiaries, the new pension law tightened significantly eligibility requirements by increasing the length of the period required to qualify for a pension from 10 to 15 years of contributions and by raising the coverage of the income on which contributions are paid. The law also made the size of the pension dependent on the average of the wages earned over the last eight years of work instead of the previous two as had been the norm, a practice which had frequently led to the artificial inflation of salaries over this period. These measures are thought to have been instrumental in the increase in the number of contributors and the volume of contributions during 1986, as well as for the stabilization of the ratios of pensioners to contributors and of total expenditures on pensions to contributions. They also contributed to a marked deceleration in the rate of growth of disability pensions from an annual average of 8.5 percent over 1981–84 to 2.5 percent over 1985–86.

Liberalization in the Context of EC Accession

The increasing relative importance of the EC as both Spain's principal market and supplier underscores the presence of a process of integration that has been in operation in some form or other for well over a decade. As far back as 1970 Spain had signed a Preferential Agreement with the EC as part of which the latter eliminated quantitative restrictions on Spanish industrial exports and substantially reduced tariffs on industrial and agricultural products, while Spain undertook to reduce, over a seven-year period, trade barriers against imports from the Community. This gradual opening up to the EC was given impetus in the late 1970s when formal negotiations got underway with the aim of attaining full membership. Spain's (and Portugal's) accession to the Community on January 1, 1986 thus brought to an end several years of detailed and often difficult negotiations dealing with a vast array of issues affecting virtually every sector of the economy. Trade liberalization, capital and labor mobility, industrial and agricultural policy, regional development, financial relations, transport, education, and the law are but a few of the areas in which some direct or indirect impact is anticipated as a result of accession.

Perhaps the most important short-term implication of accession concerns the further opening up of the Spanish economy stemming from the gradual reduction in the level of protection vis-à-vis both the EC and the rest of the world. Tariffs on industrial imports from EC countries had already been reduced by 22 percent by early 1987 and are scheduled to be phased out by 1992, while those against imports from non-EC countries will have been reduced, also by 1992, to the EC's Common External Tariff. Non-tariff trade barriers between Spain and the EC were eliminated on accession with some quantitative restrictions on certain imports from the Community remaining for a period of four years. Spanish quantitative import restrictions vis-à-vis third countries for products for which the Community does not maintain restrictions were likewise eliminated upon accession. Furthermore, under the terms of the Treaty of Accession, Spain became a party to the various bilateral and multilateral preferential trade agreements which were signed by the Community with third countries and for which the CET was not binding. Thus, for instance, as part of the terms negotiated by the Community under the Lomé Convention, Spain abolished, without reciprocal benefits, customs duties on virtually all exports of 65 countries of Africa, the Caribbean, and the Pacific (ACP). It also extended to all other developing countries, under the EC's system of generalized preferences, zero tariffs on their exports of industrial and semi-finished

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goods and reduced tariffs on well over 300 processed agricultural products.[36]

In mid-1985, as part of a policy intended to facilitate Spain's transition into full membership in the EC, the Spanish authorities undertook a substantial liberalization of the regulations governing foreign direct investments. Before the introduction of these measures, prior administrative authorization was required for foreign investments involving more than 50 percent ownership of those enterprises with capital in excess of Ptas 25 million. Foreign investment in smaller enterprises and where the share of foreign ownership did not exceed 50 percent needed to be declared to the Directorate General of Foreign Transactions, and, in the absence of a reply within a 30-day period, could be taken as approved. The liberalization measures taken in mid-1985 consisted mainly in the extension of the procedures governing investment in small enterprises to all foreign investments, regardless of the size of the enterprise or the extent of foreign participation.[37] Largely as a result of this liberalization, inflows of foreign direct investment in 1986 amounted to Ptas 401 billion, a 43 percent increase with respect to the previous year. The share of foreign direct investment originating in EC countries during 1986 rose to 65 percent, a significant increase with respect to the 47 percent registered in 1985. It is thought that traditionally important investors, such as the United States, the Federal Republic of Germany, and other EC partners, will find Spain's investment climate more attractive as a result of the greater political stability necessarily implied by the forging of closer ties with the rest of Europe.

Direct investments abroad by residents were also liberalized in late 1986, more than two years ahead of the schedule agreed upon in the EC Accession Agreement. Within generous limits, financial institutions and resident individuals are now free to purchase foreign securities in foreign stock markets.[38]

The introduction of the value-added tax on January 1, 1986 resulted in the elimination of the system of fiscal adjustments at the border, which had sought to offset the effects of indirect taxation on domestically produced goods. Recent studies carried out by the Secretariat of State for Commerce suggested that a number of subsectors of Spanish industry appeared to have received some level of protection through both the tariff structure and higher rates for the special compensatory tax on imports than would have been warranted by the indirect tax burden on domestically produced goods. Frequently, these same subsectors—steel being the most important example—also appeared to have benefited from export subsidies through tax rebates at rates in excess of the levels needed to offset the effect of the turnover and other indirect taxes. Although the elimination of these subsidies has had an adverse short-term impact on key sectors of Spanish industry,[39] there is a widespread consensus that in the medium term it could not but enhance competition and lead to a more efficient allocation of resources.

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[36]Spain's compliance with the terms of the EC's preferential agreements with these countries induced a certain amount of trade diversion, as in the case of imports of coffee and cocoa, which had traditionally been supplied by a number of countries in Latin America but which would henceforth be supplied by the ACP. The Common Agricultural Policy's (CAP) requirement that cereals be purchased from EC member countries at higher than "world" prices, or from nonmembers at the so-called "threshold" price, which is also higher than the world price, also resulted in some trade diversion (see *IMF Survey*, March 9, 1987). Nevertheless the overall impact of the process of trade liberalization resulting from accession will be to further open up the Spanish economy to its trade partners both within and outside the EC.

[37]Certain strategic sectors, such as defense, public services, mass media, and air transport, were excepted, and prior authorization will still be required.

[38]The Bank of Spain announced in October 1987 that the buying of foreign notes and travellers checks against pesetas was completely liberalized. Henceforth, any Spanish resident, individual or corporation, would be allowed to undertake such purchases without further limitation other than the obligation of being property registered.

[39]The steel sector, in particular, found itself in the midst of a crisis in 1986—it is estimated that the reduction in effective protection was of the order of 15 percent—aggravated by the appreciation of the peseta against the U.S. dollar and the continued slackness in demand in a number of traditional importers of Spanish steel in the Third World.

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V Economic Performance

Output and Employment

After a fall in real terms over 1983–84, domestic demand strengthened in the course of 1985 increasing for the year as a whole by 2½ percent, the first significant expansion since 1980. Private consumption grew on average by 1.8 percent, supported by the recovery of employment (after several years of persistent deterioration), the growth of labor and other incomes, and by a marked increase in social transfers, all of which resulted in an expansion of real disposable income of around 1½ percent. The reduction in early 1985 in the withholding rates for the personal income tax is also thought to have provided a special boost to consumption expenditure.

Nearly equally important, in terms of its relative contribution to GDP growth, and more important on account of its poor performance over the previous four-year period, was the recovery of fixed investment. After falling by a cumulative 10 percent in real terms between 1981 and 1984, investment expenditure rose by 4 percent during 1985. This expansion was supported by the marked improvement in the profit position of enterprises, the introduction of new fiscal incentives,[40] and a fall in interest rates, which increased the attractiveness of real assets relative to financial ones, as well as the improved outlook for demand. A 7 percent rise in investment in equipment goods and, after several years of decline, some recovery of construction-related investment provided a special boost to this component of domestic demand. Real GDP is estimated to have grown by about 4 percent in the second half of 1985, underscoring the fact that the Spanish economy appeared then to have entered a period of sustained expansion.

The growth of domestic activity accelerated significantly in 1986. Supported by the favorable impact of a large (over 16 percent) gain in the terms of trade and the relative easing of financial policies since 1985, domestic demand rose by 6.3 percent in real terms. The rate of growth of fixed capital formation accelerated to 10.8 percent, reflecting the continued improvement in the profit position of enterprises and in the demand outlook, as well as a substantial increase in the inflows of foreign direct investment[41] and the desire on the part of Spanish entrepreneurs to modernize the industrial structure so as better to face increased competition within the EC. Underlying this remarkable expansion of investment were a 17 percent real rate of growth for investment in equipment goods and a 7 percent rise in investment in construction. Private consumption grew by 4 percent, reflecting the continued recovery of employment—nonagricultural employment rose by 5 percent with respect to 1985—and the full year impact of the stimulative fiscal measures introduced in 1985. Real GDP grew by 3.3 percent in 1986, reflecting the negative contribution to GDP growth made by the foreign balance. Shifts in Spain's relative cyclical position, some import penetration as a result of EC accession, and some loss in the competitiveness of the peseta resulted in a negative contribution by the external sector of nearly 3 percentage points.

Although real GDP is estimated to have grown by about 4½ percent in 1987, the composition of growth was not significantly different from that registered in 1986. The further deterioration in the real trade balance was offset by the continued buoyancy of domestic demand, particularly private consumption, but also fixed capital formation, which expanded by 14 percent in real terms— the highest growth rate over the past decade and a half—and contributed 2½ percentage points to overall GDP growth. This acceleration in the pace of economic activity was supported, inter alia, by the continued recovery of employment, the improved profit position of enterprises, and a sharp increase in the inflows of foreign direct investment, reflecting both the strengthening of commercial ties with EC partners and renewed confidence abroad in the underlying strength of the Spanish economy.

The recovery of domestic activity and particularly the beneficial effects of a number of legal measures taken to

[40] Namely, the possibility of writing off new investments in fixed capital for projects initiated in 1985 if at least 10 percent of planned expenditures were carried out during the year and the widening and increasing of the tax deduction for investment in residential construction.

[41] Foreign direct investment in 1986 accounted for about 16 percent of total gross domestic investment; the corresponding figure in 1985 had been 9 percent and the average for the previous four-year period had been closer to 4 percent.

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reduce rigidities in the labor market contributed to the continued recovery of employment throughout 1986 and 1987. Total employment between the last quarter of 1985 and the second quarter of 1987 increased by 6.6 percent, with a particularly pronounced recovery in the services sector, where employment grew by 10.1 percent. An increase in participation rates, however, permitted only a small reduction in the rate of unemployment to 20½ percent.

Inflation

Spain's inflation performance throughout the 1970s and early 1980s compares unfavorably with that of most of its industrial trading partners. The average annual rates of growth for the Spanish consumer price index and those for the Federal Republic of Germany, France, the United Kingdom, and Italy, Spain's four most important European trade partners,[42] are presented in Table 14. Not only have Spain's consumer prices risen relatively more rapidly, but their evolution over time has not always reflected prevailing international patterns. Such departures with respect to the observed price behavior of other industrial countries may be interpreted in terms of a number of interrelated factors.

The relatively large weight of labor costs in the determination of overall costs for the economy[43] and the wage explosion which took place over the period 1975–79 go a long way toward explaining the differences in inflation performance vis-à-vis other trade partners referred to above. The unusually large share of labor costs in total costs is in turn related to the relative closeness of the Spanish economy. The ratio of Spanish imports (and exports) to GDP is the lowest in the EC and one of the lowest in the OECD, Spain's great dependence on imported energy notwithstanding (Table 12). Furthermore, although the share of goods in the consumer price index (CPI) basket subject to some form of control or administration has fallen in recent years,[44] refined petroleum products are still included in this group. In time this has resulted in an overall price level that has not always reflected immediately or fully changes in energy prices abroad and that may have been partly responsible, over the 1973–81 period, for one of the highest cumulative rates of growth in the OECD for net petroleum imports (Table 1).

Over 1981–84, prices in Spain exhibited a slowly decelerating trend, which was most pronounced over the 1983–84 period. The tighter stance of financial policies adopted in 1983 resulted in a significant fall in the rate of growth of total liquidity and promoted a degree of moderation in wage settlements that contributed to a deceleration of inflation. The concomitant deceleration in the prices of imported goods, particularly oil products, also played an important role in slowing down inflation. The rate of inflation continued to fall in 1985; the average for the year was 8.8 percent, or 2½ percentage points below the corresponding rate for 1984. Energy prices made an important contribution to moderating the rise in consumer prices, rising by 4½ percent, compared with 10½ percent in 1984 and an annual average of 20 percent over the three-year period ending in 1983. Inflation differentials vis-à-vis the OECD and the EC had narrowed, by end-1985, to 3.6 and 3.2 percentage points, respectively, the lowest since 1980 (Table 15).

Price developments in 1986 were affected by a number of factors. The introduction of the value-added tax on January 1 as part of Spain's accession to the EC is estimated to have added about 2 percentage points to the overall price level. Although the impact of the VAT appears to have been largely limited to a one-time jump in the consumer price index, the decline in the price of imported petroleum and other primary products, the effective appreciation of the peseta[45]—particularly vis-à-vis the U.S. dollar—and the onset of the process of tariff reductions implied by EC accession, are all thought to have affected significantly the evolution of prices over the year. In the event, prices decelerated only marginally through May and actually rose rapidly through September while the inflation differential vis-à-vis the OECD and the EC widened to about 6 percentage points by the end of the year.

A number of factors help explain these price developments. The authorities' decision not to pass on fully to consumers the reduction in oil prices and thus provide a windfall to the budget with a view to reducing the deficit was certainly important. To the extent that reductions in energy prices are not passed through to users, the deceleration in the rate of inflation is less pronounced, at least in the short run. The marked increase in the CPI in the third quarter, totaling nearly 3½ percentage points, can largely be attributed to its food component (mainly fresh fruits and vegetables), traditionally the most volatile in the CPI basket. More important, wages showed an upward trend throughout 1986. Data show

[42]These countries account for about 45 percent of Spain's total trade (Table 16).

[43]Although the relative importance of the various cost components has undoubtedly changed in recent years, in 1975, the most recent year for which such cost distribution is available, labor costs accounted for 61 percent of total costs, followed by agricultural products' prices (20 percent) and imported inputs' prices (16 percent).

[44]At the end of 1986, the share of the basket subject to some form of control stood at 13 percent.

[45]The monetary authorities felt that some appreciation of the peseta was perhaps inevitable in light of the rapid accumulation of international reserves (stemming from a better than expected current account performance), which could have put in jeopardy the overall objectives of monetary policy as regards the rates of growth of the monetary aggregates.

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Table 14. Selected CPI Growth Rates, 1971–87
(In percent)

	1971–79	1975–79	1979	1980	1981	1982	1983	1984	1985	1986	1987[1]
Spain	15.0	18.4	15.7	15.5	14.6	14.4	12.2	11.3	8.8	8.8	4.7
Germany, Federal Republic of	5.0	4.2	4.2	5.4	6.3	5.3	3.3	2.4	2.2	−0.2	0.9
France	9.2	10.1	10.7	13.4	13.4	11.9	9.5	7.7	5.8	2.5	3.1
United Kingdom	13.4	15.7	13.5	17.9	11.9	8.6	4.6	5.0	6.1	3.4	4.5
Italy	13.1	15.5	15.5	21.2	17.8	16.5	14.6	10.8	9.2	5.8	5.7
EC-10	9.6	9.9	9.1	12.4	11.3	9.8	7.3	6.1	5.4	2.9	3.3

Sources: International Monetrary Fund, *International Financial Statistics*; and European Community, *Eurostatistics*.
[1]Twelve-month rates of growth for October.

Table 15. Spain: Price and Cost Developments, 1982–87
(Annual percentage change)

	1982	1983	1984	1985	1986[1]	1987[2]
CPI (Year)	14.4	12.2	11.3	8.8	8.8	5.3
Food	15.1	10.7	12.5	9.5	10.7	3.5[3]
CPI (December)	14.0	12.2	9.0	8.2	8.3	4.7[3]
Inflation differentials						
Spain-OECD	6.6	6.9	6.0	4.2	6.0	0.8[4]
Spain-EC	4.6	4.9	5.2	3.4	5.9	1.4[4]
Unit labor costs	10.6	10.4	5.8	5.7	8.3	5.1
Average wage per person[5]	13.5	13.5	10.0	8.8	9.3	6.6
Productivity	2.6	2.8	4.0	2.9	0.9	1.7
Output	1.2	1.9	2.1	1.9	3.3	4.7
Employment	−1.4	−0.9	−1.8	−1.0	2.4	3.0

Source: Ministry of Economics and Finance.
[1]Provisional.
[2]Staff estimates.
[3]Twelve-month rate for October.
[4]October.
[5]Including social security contributions.

both an accelaration in the rate of growth of nominal wages per person and contractual wage increases stemming from collective agreements with respect to 1985. The acceleration in the rate of growth of nominal wages together with a significant reduction in productivity (directly related to the improvement in the employment situation) led to an increase in the rate of growth of unit labor costs from 5.7 percent in 1985 to 8.3 percent in 1986.

Largely as a result of the renewed acceleration of consumer prices and the associated implications for then impending wage negotiations for 1987, the Spanish authorities implemented a series of measures in the latter part of 1986 with the aim of preventing too large a departure from the official inflation target. Fuel prices for industrial use were reduced by close to 20 percent, and a number of restrictions against food imports, particularly from the EC, were lifted. Prices, especially the food component, actually fell in November, and the outturn for the annual rate of inflation was 8.8 percent. Because the CPI had captured throughout 1986 the impact of the VAT introduced in January of that year, the 12-month rate of inflation decelerated markedly in early 1987; by October it had fallen to 4.6 percent.[46] The rate of inflation in 1987 is estimated to have fallen to 5¼ percent on average, partly reflecting the once-and-for-all impact associated with the introduction of the VAT and the moderation of import and food prices. The inflation differential vis-à-vis the EC was projected to be reduced from 6.1 percent at the end of December 1986 to about 1½ percent by the end of 1987, underscoring the substantial progress made in the course of the year (see Chart 8).

External Accounts

The remarkable improvement in the external accounts over the 1982–86 period is one of the highlights of the adjustment program undertaken by the Spanish authorities (see Chart 9). The current account of the balance of payments moved from a deficit of 2½ percent of GDP in

[46]These wage and cost developments notwithstanding, the gain in the terms of trade during 1986 was sufficiently large to lead to a GDP deflator of about 11½ percent and a further improvement in firms' profit shares.

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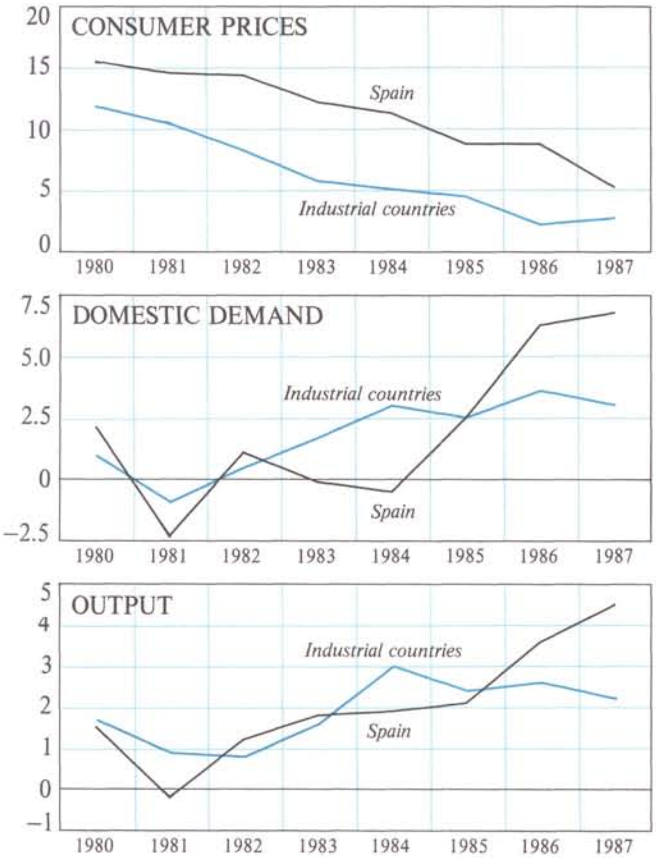
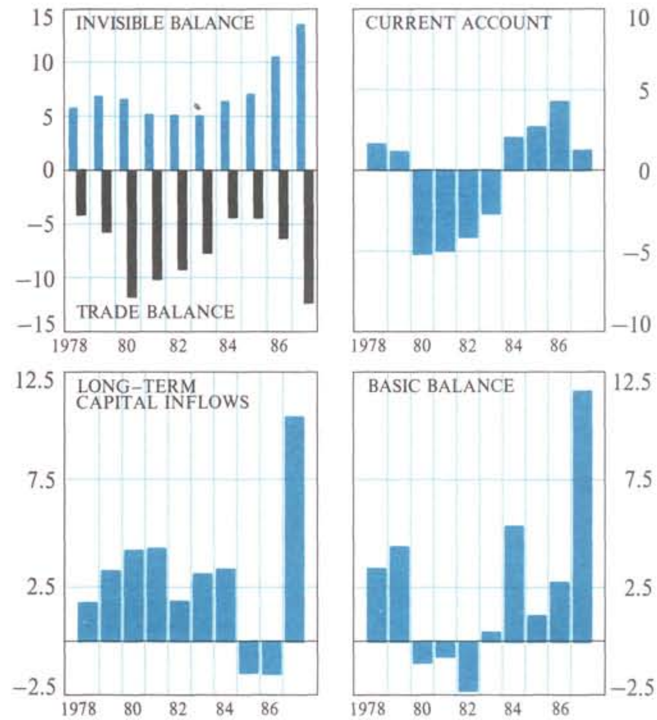
Chart 8. Inflation, Domestic Demand, and Output in Spain and Other Industrial Countries, 1980–86
(Annual percentage change; unless otherwise noted)



Sources: Bank of Spain; and International Monetary Fund, Research Department.

Chart 9. Spain: Balance of Payments, 1978–86[1]
(In billion of U.S. dollars)



Sources: Bank of Spain, Secretariat of State for Commerce; and Fund staff estimates.
[1]Transactions basis

1982 to a surplus of 2 percent of GDP in 1986. International reserves, which had reached a five-year low at the end of 1982, recovered sharply and stood at US$17.3 billion at the end of 1986, the highest end-of-year level (see Chart 10 and Table 16). The stock of external debt, which had risen rapidly from US$19.5 billion in 1979 (10 percent of GDP) to US$28.8 billion in 1982 (16.2 percent of GDP) had fallen below US$24.5 billion (10.7 percent of GDP) by 1986, as the authorities embarked upon a program of anticipated repayment of external debt. The 1986 ratios of debt-service payments to GDP and to exports of goods and services net of anticipated amortizations stood at 2.1 and 11.9 percent, respectively, low by international standards.

Much of the improvement in the current account that took place over the adjustment period can be imputed to developments in the trade account. On a transactions basis the trade deficit fell from 5.1 percent of GDP in 1982 to 2 percent in 1986 with the bulk of the adjustment taking place in 1984, when exports grew in volume terms by 17 percent under the impetus of the 12 percent real effective depreciation of the peseta registered over the previous year and a sharp recovery of foreign demand. At the same time there was a substantial deceleration in the rate of growth of the import bill, much of which could be attributed to a reduction in the dollar value of energy imports stemming from both lower prices and cutbacks in the volumes imported as part of the Government's policy of reducing dependence on foreign sources of energy.

Invisible receipts have also played a role in the recovery of the current account. With an average of 43 million tourists a year over the period 1982–86—in excess of the total Spanish population of some 38 million—tourist receipts have continued to be an important source of foreign exchange (US$12 billion in 1986) and the dominant factor in the invisibles account. At the same time, the reduction in the stock of external debt and an easing of international interest rates contributed to a reduction of investment income outflows, which fell from about 1½ percent of GDP in 1983 to 0.9 percent of GDP in 1986.

The rapid growth of domestic demand, both in the latter part of 1986 and throughout the first half of 1987, and the further reduction in tariff protection stemming

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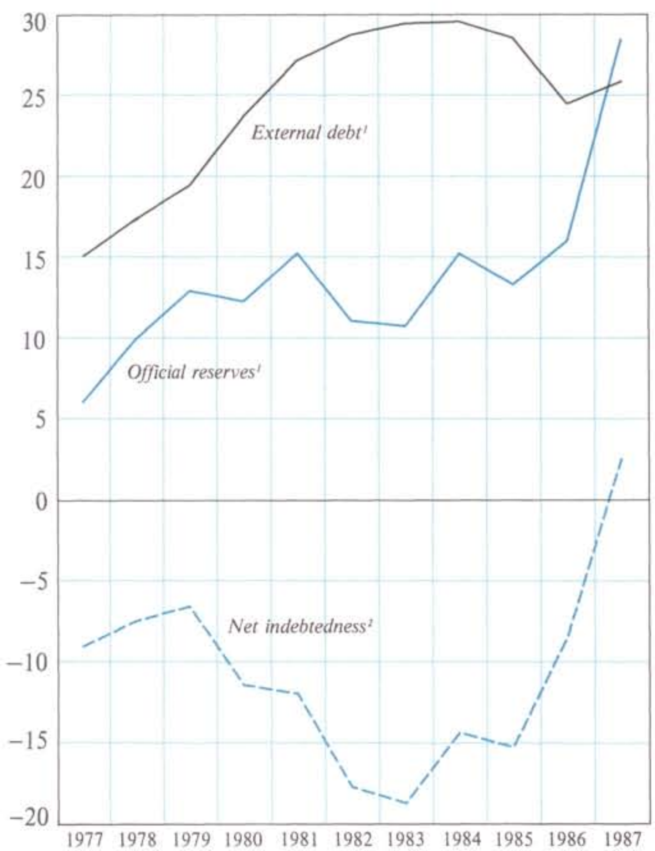
Chart 10. Spain: Indebtedness, 1977–87



Source: Bank of Spain, *Statistical Bulletin*, various issues.
[1]End-of-period figures.
[2]Defined as the difference between official reserves and the outstanding stock of external debt.

from Spain's accession to the EC (tariffs on industrial imports from EC countries were reduced by a further 12½ percent on January 1, 1987) fueled a sharp expansion of imports; in the first ten months of 1987 non-energy imports grew by 27 percent in volume terms as the trade deficit rose to nearly US$8.7 billion, more than twice the level registered in the corresponding period of 1986. The better-than-expected performance of tourism—over 50 million tourist arrivals and gross receipts of nearly US$16 billion—and a 7 percent rise in the volume of merchandise exports prevented, however, a more pronounced deterioration of the current account. The authorities' present estimates for the current account of the balance of payments for 1987 project a surplus of about US$1½ billion (0.4 percent of GDP), less than half the level registered in 1986, but still at a comfortable level. Underlying this forecast is a negative contribution to GDP growth from the external sector of about 2 percentage points.

As regards developments in the capital account, in both 1985 and 1986 there was a significant transfer of resources to the rest of the world. The authorities' stance on the prepayment of foreign credits resulted in net long-term capital outflows of about US$1.5 billion in both years. Public sector capital outflows exceeded US$2 billion in 1986, the largest such outflow ever. Long-term capital outflows would have been much larger but for a sizable increase in foreign direct investment, which rose by 83 percent in dollar terms with respect to 1985. Private foreign long-term investment inflows in the first ten months of 1987 exceeded US$8.7 billion, reflecting dramatic rises in direct and portfolio investment. Taken together these grew by nearly 100 percent in dollar terms

Table 16. Spain: Official International Reserves, 1982–87

						1987		
	1982	1983	1984	1985	1986	I	II	October
			(In millions of U.S. dollars)					
Net official reserves	11,046.3	10,726.2	15,213.0	13,300.9	16,001.4	17,620.5	22,275.4	28,070.7
Assets	11,064.5	10,726.8	15,213.0	13,300.9	16,001.4	17,620.5	22,275.4	28,070.7
Gold[1]	3,666.1	3,826.8	3,832.1	3,722.0	3,785.0	3,791.5	3,804.8	3,056.2
IMF position	248.4	336.6	356.9	384.1	453.9	474.7	583.0	587.0
SDRs	224.6	68.5	151.9	264.9	378.8	398.4	444.3	460.5
Foreign exchange	6,925.4	6,494.9	10,872.1	8,929.9	11,383.4	12,955.9	17,443.3	23,967.0
Liabilities	18.2	0.6	—	—	—	—	—	—
Liabilities to IMF	5.5	—	—	—	—	—	—	—
Compensatory Financing Facility	—	—	—	—	—	—	—	—
Oil Facility	5.5	—	—	—	—	—	—	—
Other	12.7	0.6	—	—	—	—	—	—
			(In months of imports)[2]					
Net official reserves	4.4	4.7	6.7	5.7	5.8	—	—	7.6

Sources: Bank of Spain, *Statistical Bulletin*; and International Monetary Fund, *International Financial Statistics*.
[1]In December 1981, gold was revalued in Spanish statistics to US$251 per ounce. Subsequent adjustments have been based on the following rule: (1) if the accounting price is greater than 80 percent of the market price it is to be revised downward until it is equal to the latter, these adjustments are to be made on a monthly basis; (2) if the market price is over 50 percent higher than the accounting price, the latter is to be adjusted upward, with the change being equal to the percentage increase in excess of 50, these adjustments are to be made on an annual basis.
[2]Imports of goods during the corresponding calendar year.

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with respect to the corresponding period of 1986. There remarkable increases reflect the substantial liberalization of the regulations governing foreign direct investments introduced in mid-1985 as well as Spain's entry into the EC, which has led a number of firms from other EC countries to increase their participation in Spanish enterprises with a view to a more active role in the domestic market.[47] By the end of October 1987 official international reserves exceeded US$28 billion (Table 16).

[47]The evolution of the capital account in 1987 was also affected by monetary developments. Liquidity was boosted in the first few months of 1987 by a pronounced shift in the sources of financing of the budget deficit. Recourse to monetary-base financing was precipitated by a fall forced by the Treasury in the rate of return on treasury bills and the resulting lack of interest by the banks and the nonbank public. At the same time credit to the private sector rose sharply in response to strong demand. The overshooting of the targets for monetary expansion forced the Bank of Spain to raise its intervention rates in the interbank market as well as the reserve requirement; bank rates quickly followed suit. The emergence of a substantial interest rate differential in favor of Spain and the authorities' determination to prevent too pronounced a real appreciation of the peseta with respect to the currencies of Spain's EC partners led to central bank intervention in the foreign exchange markets and the imposition of certain temporary measures to stem short-term speculative capital inflows while continuing the liberalization of outward medium- and long-term capital movements. The widening of the interest rate differential brought to a halt the process of prepayment of external debt seen over the previous two-year period. By mid-year the Treasury began to issue a new type of treasury bill (letras del Tesoro) which is exempt from any fiscal advantage and which should facilitate the control of bank liquidity.

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VI Assessment and Tasks Ahead

This paper has examined the impact of the adjustment program undertaken by the Spanish Government during 1982–86. Implemented in response to the serious deterioration of the economic situation that took place in the late 1970s and early 1980s, the program sought to redress the imbalances affecting the Spanish economy through a combination of demand management policies and structural reforms. Whether viewed in terms of a simple before-and-after comparison of various economic and financial indicators or in terms of its impact upon resource allocation, the adjustment effort was successful in a number of important areas.

In the decade and a half ending in 1974, Spain had grown faster than any other country in Europe. This growth had been led by the industrial sector, notably through the development of energy-intensive industries. The effects of the terms of trade loss brought about by the first oil price rise were compounded by the rapid increase in real wages after 1974 at rates far in excess of those warranted by productivity gains. At the same time, a rapid expansion of credit contributed to inflationary pressures and, in conjunction with an exchange rate policy that sought to offset the impact of the higher oil prices, led to a substantial erosion of external competitiveness. Increasing transfers of financial resources to ailing enterprises and rising social security expenditures resulted in a steady deterioration of public finances. The lack of an effective adjustment to the first oil crisis left the Spanish economy vulnerable to the new round of oil-price increases registered over 1979–80. In conjunction with the widening fiscal imbalances, this further terms-of-trade loss led to current-account deficits over 1980–82 in excess of 2 percent of GDP and a substantial increase in external indebtedness. Over the same period the average rate of growth of GDP fell below 1 percent a year.

The main elements of the adjustment program were an initial depreciation of the peseta in conjunction with a nonaccommodating stance of financial policies. This policy stance was supported by a number of structural reforms aimed at improving resource allocation.

Monetary policy played a key role in the adjustment effort. In late 1982, against a backdrop of accelerating inflation and growing fiscal and external imbalances, the authorities significantly tightened the stance of monetary policy. The rate of growth of total liquidity fell, interest rates rose sharply, and credit to the private sector slowed down. This tighter stance contributed to a deceleration in the rate of inflation and nominal wages. Together with the 12 percent real depreciation of the peseta over 1983 and a marked expansion in the rate of growth of non-oil imports in Spain's partner countries, it led to a turnaround in the external position as the current account of the balance of payments registered a surplus of US$2 billion (1.3 percent of GDP) during 1984. In the next two years, as the external situation continued to improve and with the aim of promoting a recovery of domestic demand, particularly investment, the monetary policy stance was relaxed. Liquidity growth decelerated less rapidly, interest rates fell, and credit to the private sector recovered. Although nominal wages began to exhibit an upward trend, rising by about 2 percent in real terms in 1986, by mid-1987 inflation had fallen below 5 percent, the lowest rate over the previous 17-year period.

The progress in the fiscal area would appear to have been less satisfactory when viewed in terms of the size of the nonfinancial deficit, which over the period 1982–86 hovered around 5½ percent of GDP. A closer look at the various components of the general government's operations, however, and an assessment of the likely impact of a number of policies implemented in the latter part of the adjustment period, with potentially important fiscal implications, suggest that the groundwork may have been laid for further progress in the fiscal area in the medium term. The introduction of the value-added tax in early 1986 is a measure with important implications over the medium term. The elimination of a plethora of inefficient indirect taxes, applied and collected at all levels of government, and the substantial widening of the tax base implied by the VAT already had a beneficial impact on 1986 revenues. Although a number of issues need to be addressed in the medium term concerning the financing of the social security system,[48] the reform of the pension system in 1985 did lead to a deceleration in the rate of growth of beneficiaries and an increase in the level of contributions. Privatization and industrial

[48]Issues that will also have to be confronted by most governments in the OECD.

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restructuring, two areas in which significant structural reforms were implemented, together with the emergence of more efficient management, contributed to a marked improvement in the financial position of public enterprises.

Despite these positive developments, a number of fiscal weaknesses remain. Foremost among these is the underlying structure of public expenditure, which may have prevented a more rapid reduction of the deficit. Numerous expenditure commitments entered into by the Government over the previous two decades, frequently in response to conjunctural sectoral needs, have in time limited severely the authorities' room for maneuver and may have had an adverse impact on such specific areas as public investment in infrastructure. There is evidence that, in an effort to keep the deficit within manageable levels, the authorities have frequently opted for reductions in public investment expenditure. Quite aside from the implications which such a policy may have on the provision of important services, such as roads, a distortion is introduced in the pattern of public expenditure as investment projects are no longer judged on the strength of their merits but rather on the extent to which they might contribute, in the short run, to a widening of the growing deficit.[49] An additional policy option open to the authorities, at least in principle, might be to raise taxes. If, however, the growing public sector requirements stem from rising expenditures rather than faltering revenues, it could be argued that a viable solution to the fiscal imbalances in the medium term must come largely through the expenditure side. It must also be pointed out that the sensitivity of the interest component of public expenditure to fluctuations in interest rates may also impose additional constraints on the exercise of monetary policy and may lead to attempts by the authorities to put a ceiling on interest rates on government paper merely on the grounds that not to do so would prove a threat to the budget. This higher degree of intervention in the financial markets may come at a time, as was the case in early 1987, when the authorities' own stated policy as regards financial regulation is a move toward freer, less-regulated markets. Thus the need to evaluate the cost of all expenditure commitments and to examine periodically their economic justification, particularly within the context of a rapidly changing economic environment brought about by EC accession, emerges as one of the most important tasks ahead if Spain is to respond effectively to the competitive pressures implicit in EC membership. In this regard, a recent study undertaken by the Bank of Spain, which examines the costs to the budget of Government intervention in the private sector, underscores the existing wide scope for efficiency gains in the allocation of public financial resources and suggests that this may well be an area for the implementation of further reforms in the medium term.

Progress, albeit on a more limited scale, was also made in the labor market. In 1984–85 the Spanish authorities enacted a number of measures to foster greater labor market flexibility, such as the liberalization of fixed-term contracts and part-time employment, the reduction of employers' social security contributions, and the granting of fiscal incentives for the hiring of the young through apprenticeship and training contracts. The remarkable recovery of employment in the second half of 1985, throughout 1986, and the first half of 1987 suggests that the institutional framework for a sustained expansion of employment has begun to be put in place. The estimated real rate of growth for the Spanish economy in 1987 (4½ percent) made an important contribution to this expansion. Nevertheless, employment prospects would be enhanced by increased labor market flexibility as the nation's productive apparatus undergoes further restructuring in order to meet effectively the challenges and opportunities afforded by EC membership. Efforts should continue therefore to remove remaining legal and administrative impediments to geographic and functional mobility of the labor force and to giving increased weight to productivity considerations in the wage-bargaining process.

The Government's medium-term economic strategy is to consolidate the recent gains by maintaining the economy on a path of noninflationary growth. Monetary policy is likely to continue to play an active role in this process, as was made clear in early 1987 when the Bank of Spain tightened its stance significantly in response to the buoyancy of domestic demand and the concomitant expansion—well above target—of private sector credit. The recent signing by the Bank of Spain of the Basel Agreement of March 13, 1979, by which the Central Banks of the Nine established the operating procedures for the European Monetary System (EMS), may be taken as an indication of the authorities' commitment to eventual membership in the system.[50] Entry into the EMS is not likely to take place before 1989, but, in the view of the authorities, on account of the various processes of liberalization currently being implemented in Spain, affecting both the current and the capital accounts of the balance of payments, the goal of membership will impose a continued commitment to the maintenance of a stable financial environment.

The implementation of economic policy in Spain in coming years will take place within the context of the prior agreements arrived at with the EC as part of accession. These agreements, dealing with virtually every aspect of economic activity and intended to

[49]The 1986 budget, for instance, envisioned a 15 percent cutback in public investment expenditure.

[50]At present the signing of the Agreement has only one important operational implication: Spain has made available to the European Fund for Monetary Cooperation 20 percent of its gold and foreign exchange reserves in return for the equivalent amount in ECUs.

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strengthen the bonds of interdependence between the EC's member states, will serve as a frame of reference for the conduct of national economic policies and will continue to imply some curtailment of sovereignty in specific areas. The Spanish authorities are of the view that such curtailment is inherent to any process of economic integration and that its costs will be more than offset by the benefits derived from the associated greater degree of consultation and cooperation with Spain's EC partners. Spain's phased transition into full membership is scheduled to come to an end in 1992 and coincides with the EC's projected completion of the so-called internal market.[51] The 1987 unanimous ratification by the EC's member states of the Single European Act, an amendment of the Treaties of Rome, which provides for a significant streamlining of the Community decision-making process, has given a new impetus to the accomplishment of the internal market goal.[52] It is therefore expected that within a period of seven years (1986–92) Spain will have become a full partner in a more economically integrated Europe. The continuation of the adjustment effort through the maintenance of financial policies geared toward moderate, noninflationary growth of demand, and through further structural reforms to improve the supply response of the economy, would, if carried out with determination, ensure that Spain's integration into the EC is fully successful.

[51]The completion of the internal market is an attempt by the EC to eliminate, by 1992, all remaining barriers to the free flow of goods, services, labor, and capital across member states.

[52]For a fuller discussion of this issue see Lopez-Claros (1987).

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Appendix I
Concealed Employment in the Spanish Economy

The OECD's most recent *Employment Outlook* (September 1986) refers to the increasing incidence and importance of "concealed activities, linked to the emergence of new forms of working arrangements."[53] It highlights a number of policy concerns that stem from the existence of varying degrees of concealed employment, such as the adverse effects on the public finances through misallocation of social benefits and, in general, the unintended distortions that the implementation of a given set of policies on such issues as contribution rates, labor market flexibility, and part-time employment may introduce in the presence of sizable concealed or irregular activity. It also refers to "the effect of concealed employment on public perceptions and on public acceptance of government policies and the legal framework." The Spanish authorities have long been aware that substantial concealed employment may have introduced an upward bias on the official rate of unemployment.[54] With the aim of gauging the extent of this bias and of obtaining important qualitative and quantitative information on overall working conditions in Spain, the authorities conducted in late 1985 a comprehensive survey of Spain's employment situation.[55]

Perhaps one of the most interesting and novel features of the survey, which was based on a sample of some 63,000 people taken from every region of the country, is that it attempted to make inferences about working conditions in general, and the employment status of those interviewed in particular, through a study of the various ways in which those interviewed had used their time over a given period. This procedure largely preempted some of the biases that may have affected the official survey, in which employment status is self-determined. The rigorous sampling techniques used, the large sample size, and the meticulous way in which the survey was actually carried out in the field go a long way toward validating many of the study's main conclusions.

At the outset the study underscores the difficulties that are sometimes encountered in attempting to capture in a single figure or set of figures such broad concepts as unemployment, employment, or the size of the labor force. It appears that a more accurate characterization of labor-market conditions in Spain is to say that within each of these broad categories—employed, unemployed—there is a clearly identifiable core or nucleus surrounded by a number of peripheral groups whose members, depending on the definition used, can be variously classified. Thus, for instance, a core of unemployed did not work at all during the period of reference (the quarter preceding the survey) and whose members actively sought employment; these would account for approximately 10 percent of the labor force over 14 years of age. If to this group are added all those individuals who, regardless of their contact with the labor market, classify themselves as unemployed,[56] the rate of unemployment then rises to 18 percent. The estimated rate of unemployment is closer to 16 percent on exclusion of those who had some remunerated activity over the period of reference.

The notion of concealed or irregular employment is arrived at through an examination of the subject's relation vis-à-vis the social security system. Three groups are identified: those who are employed and thus have a theoretical obligation to contribute to the system and do not (1,826,000); those who are employed and receive unemployment compensation (118,000); and those who contributed to the inappropriate regime within the social security system (314,000). These 2.3 million persons account for about 17 percent of the labor force. The index of irregularity—defined as the ratio of those employed under irregular conditions to total employment—was estimated to be 21.9 percent for the labor market as a whole and was particularly high for those 25 years and under (46.6 percent), those who work at home

[53]The OECD defines concealed employment as "employment which, while not illegal in itself, has not been declared to one or more administrative authorities to whom it should be made known, thereby leading to the evasion of legal regulations, the evasion of taxes, or the evasion of a reduction of social security entitlements."

[54]The official labor survey (EPA), for instance, has repeatedly shown very high rates of unemployment in key labor-intensive export sectors—shoes, leather goods, certain textiles—while other indicators showed an unprecedented degree of productive activity.

[55]Centro de Investigaciones Sociológicas (1986).

[56]The EPA's first question asks the subject if he/she is unemployed. In contrast, following a series of questions on the use of their time the present survey *ends* with the same question. This change in methodology leads to an estimated reduction of 490,000 in the number of unemployed with respect to the EPA.

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(43.8 percent), the part-time employed (47.6 percent), females (36 percent), and those with low incomes (36 percent).

The above figures highlight and substantiate claims made in a number of more limited studies that the Spanish labor market is greatly segmented, and that the burden of unemployment, while not as heavy as that suggested by the official rate of unemployment, is very unevenly distributed among the various social strata. They also suggest the need for further measures to foster labor market flexibility, such as those adopted in 1985, which, through a reduction of employers' social security contributions for the young and the part-time employed, must have contributed to a reduction of concealed employment.

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Appendix II
Some Determinants of Spanish Export Performance

It was argued in the text that a qualitative assessment of export performance over the 1980s underscored both the key role played by various indices of competitiveness and the differential impact of foreign and domestic demand, with increases in the latter usually associated with decelerations or actual drops in the volume of exports. The behavior of Spanish exports over the period 1970–85 is well described by the following equation.[57]

$$EX_t = \underset{(1.69)}{11.36} - \underset{(0.19)}{1.40}\ DDEM_t + \underset{(0.05)}{1.65}\ FDEM_t - \underset{(0.06)}{0.17}\ COMP_{t-k} \quad (1)$$

$S.E.=0.023$, $R^2=0.99$, Durbin-Watson $=1.40$, $K=6$ quarters

This regression, based on annual observations, explains export performance (*EX*), as measured by an index for the volume of merchandise exports, in terms of three variables: domestic demand (*DDEM*), an indicator of foreign demand (*FDEM*), and a lagged index of competitiveness (*COMP*). All variables are natural logarithms. The indicator of foreign demand used is a trade-weighted index for the volume of non-oil imports in Spain's 27 most important trade partners. The index of competitiveness is given by the ratio of indices of nontradable to tradable goods' prices as compiled by the Secretariat of State for Commerce. As can be observed in Chart 8, the time profile of this index after 1975 is not substantively different from the real effective exchange rate index shown in Table 4, which is a trade-weighted average ratio for Spain's consumer price index to the consumer price indices of partner countries, multiplied by the nominal effective exchange rate. Both indices exhibit the same dynamic behavior, and there is a close correspondence between local maxima and minima. This is not the case before 1975, however. The index used for the real effective rate is based on 1980–82 average trade weights. To the extent that, over the sample period, there have been substantial changes in the commodity composition of Spanish trade and hence in the relative importance of individual trade partners, particularly as a result of the first oil crisis, the index will, over extended periods of time, tend to lose some of its reliability as an indicator of competitiveness. The Secretariat's index was thus preferred because it incorporates an adjustment for the impact of the first oil price rise.

[57]Standard errors of the coefficients are in parentheses.

Various lag specifications were used for the index of competitiveness. Although the estimated equation uses annual data, the above index was available on a quarterly basis; this permitted the estimation of equations where the definition of the index is not constrained to be the average of the four quarters corresponding to a given calendar year but could, in principle, incorporate quarters from two different years. Thus, equation (1) may be interpreted as follows: export performance in 1984, for instance, depends on the contemporaneous values of the domestic and foreign demand variables and on the index of competitiveness corresponding to the average of the last two quarters of 1982 and the first two quarters of 1983, for a lagged response of six quarters. The results reported in equation (1) are not significantly altered if the length of the lag on the index of competitiveness is reduced to five quarters:

$$EX_t = \underset{(1.91)}{10.97} - \underset{(0.22)}{1.38}\ DDEM_t + \underset{(0.06)}{1.64}\ FDEM_t - \underset{(0.06)}{0.13}\ COMP_{t-k} \quad (2)$$

$S.E.=0.026$, $R^2=0.99$, Durbin-Watson $=1.326$, $K=5$ quarters

A further shortening of the lag to four quarters leads to unsatisfactory results; the estimated coefficient on the index of competitiveness is no longer significant. These results would suggest that the delayed response of exports to changes in competitiveness is no shorter than about 15 months.

All the coefficients in equation (1) have the expected signs. The elasticity of export performance with respect to foreign demand is estimated to be 1.65. The corresponding elasticity with respect to domestic demand is −1.40. A 1 percent rise in the index of competitiveness (equivalent to a depreciation of the peseta) leads to a 0.17 percent rise in exports. All estimated coefficients are significant at the 1 percent level, while the Durbin-Watson test statistic for serial correlation does not reject the hypothesis of no serial correlation.

Although data for 1986 was available for the variables used in equations (1) and (2), the estimation period was truncated in 1985 on account of the many changes which took place during 1986 in Spain's trading practices. The elimination of the export subsidies implied by the introduction of the value-added tax, the reduction of tariff protection vis-à-vis its EC partners, and the marked shifts in the composition of Spanish trade associated with

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EC membership are likely to have affected the nature of the relationship between export performance and the explanatory variables used. For this reason the above equations are unlikely to be useful for forecasting purposes. They do, however, provide useful insights into the relative impact of individual variables on export performance over 1970–85.

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Appendix III
Highlights of the Government's "Programa Económico a Medio Plazo 1984/87"

A summary of the Government's broad objectives for the evolution of the Spanish economy may be found in a series of White Papers issued at the outset of the adjustment program. The *Programa Económico a Medio Plazo*[58], in particular, is a useful document which sets out clearly the Government's economic aims in a medium-term perspective. It begins by recognizing that, to safeguard its sustainability, economic growth must be based on the establishment of internal and external macroeconomic balance. It acknowledges that expansionary demand policies can spur growth in the short-run but that the eventual emergence of imbalances, sometimes requiring the imposition of restrictive measures, is likely to entail net welfare losses and lead to distortions in the allocation of resources.

Given the internal and external imbalances which have beset the Spanish economy during the early 1980s, the program establishes a series of intermediate objectives as necessary conditions for the attainment of sustained growth. These intermediate objectives include:

a. a gradual reduction in the rate of inflation (to 5 percent by 1987) through, inter alia, a nonaccommodating stance of monetary policy, and an incomes policy based on wage moderation;

b. a reduction of the deficit in the current account of the balance of payments through a realistic exchange rate policy and a firm commitment to export promotion;

c. a reduction of the public sector deficit through expenditure restraint and a rise in the fiscal burden largely stemming from improved collection procedures.

[58] Secretariat for Economy and Planning, *Programa Económico a Medio Plazo 1984/87: Evolución General y Proyecciones de la Economía Española* (Madrid: Ministry of Economics and Finance, 1984).

Important as the attainment of these objectives is to achieve sustained growth and to foster a recovery of employment, the program recognizes that a number of structural reforms are necessary to improve the supply response of the economy and to facilitate the modernization of key productive sectors. It identifies the need for such reforms in:

a. the industrial sector, through a retrenchment of those subsectors affected by excess capacity and a reorientation of industrial activity toward areas with better medium- and long-term prospects;

b. the social security system, with the aim of redressing the underlying financial imbalances;

c. the labor market, with the aim of alleviating the unemployment problem through a series of flexibilization measures (e.g., part-time employment and fixed-term contracts);

d. the management of public enterprises, with particular emphasis on the need to lighten their burden on the budget;

e. the energy sector, through a new National Energy Plan based on a series of demand and supply measures intended to bring the sector's productive capacity in line with potential demand and to foster the development of domestic energy sources;

f. the financial system, with the aim of removing a number of rigidities hampering the efficient allocation of financial resources.

Such stabilization measures and structural reforms were judged to be essential for the attainment of the program's ultimate objective: an annual average rate of real GDP growth of 3 percent over the program period.

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